Change For The Sake of Change:
A Critical look into Corporate Governance

I. Introduction

Throughout legal scholarship, there has been an on-going debate about the proper role of workers, management and stockholders in corporate governance. At one end of the debate is the conservative contractarian camp, which seeks to defend the status quo in corporate governance. The contractarian believes that "the business corporation is organized and carried on primarily for the profit of the stockholder."[1] Alternatively, there is the progressive corporate scholarship, which believes that many of the justifications for stockholder dominance, such as agency cost, residual nature of their claims, and inability to contract, also apply to other stakeholders, namely workers.[2] The progressive corporate scholar believes that corporations are not merely private organizations, but public institutions; therefore, they should be governed more like other areas of public law such as constitutional law and environmental law. [3]

Regardless of which camp one may identify with, there is little doubt that the stockholder-oriented model of the corporation is without equal in its ability to create wealth and develop resources. Barack Obama, the current President of the United States, Warren Buffet, one of the richest individuals in the world, and several prominent academic scholars have acknowledged as much.[4] In fact, Henry Hansmann and Reinier

[1] Kent Greenfield, *The Place of Workers in Corporate Law*, in 39 B.C. L. Rev. 283, 284 (1998).
[2] *Id.* at 287.
[3] Kent Greenfield, The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities 2 (The University of Chicago Press 2006).
[4] Barack Obama, President of U.S, Inaugural Address (Jan. 20, 2009) ("Nor is the question before us whether the market is a force for good or ill. It's power to generate wealth and expand freedom is unmatched."). *See generally* Stephen M. Bainbridge, *Community and Statism: a Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, in 82 Cornell L. Rev. 856 (1997). *See also* Warren E. Buffet, Our Country Has Faced Far Worse Travails, Newsweek, Mar. 9, 2009, at 1 ("Though the path has not been smooth, our economic system has worked extraordinarily well over time. It

Kraakman, two renowned legal scholars, further developed this argument. Hansmann and Kraakman declared that the current stockholder model of the corporation represents the end of history of corporate law because of its ability to generate wealth and because of a lack of superior alternatives.[5]

Until about a year ago one might have believed Hansmann and Kraakman's assertion. However, with the recent credit, housing, and financial crises taking place throughout the developed world, it seems that the end of history account of corporate law may have been declared far too soon. Kent Greenfield, a progressive corporate scholar, anticipates that changes in the structure of corporate governance could help make corporations more accountable to the general public and help minimize the frequency of such catastrophic events. These circumstances have renewed the debate between contractarian and progressive corporate theorists. In this paper I will attempt to address this dispute by taking a critical view of the progressive scholarship's critique of the dominant ideology and a few of the fundamental justifications for stockholder primacy. In particular, this paper will focus on the progressive scholarship's assertion that the arguments used to explain shareholder dominance, also apply to employees. The paper will address a few of these claims, including the argument that employees experience agency costs and that employees are in a better position to ensure firm survival.

This paper will explain how contractarian and progressive law theorists have addressed the tension in the law between stockholders, management and employees. I

---

has unleashed human potential as no other system has, and it will continue to do so. America's best days ahead.").

[5] *See generally* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439 (2001).

will also include data from a recent study at the Wharton School of Business, which compares the efficiencies in modern co-determination regimes to that of the dominant ideology.

Finally, I will conclude by making a recommendation for the future of corporate governance. While I ultimately believe that the corporation best serves society by focusing on the maximization of profit for its stockholders, I also agree that there is a means to ease the tension between the contractarian and progressive law scholarship with the advancement of worker representation through a thoughtful, yet realistic solution.

II. Corporations are Organized to Benefit Society

In the United States and other developed nations, the modern corporation has achieved superior economic results in comparison to any other form of business. This is in part because of the powers bestowed onto this form of business organization such as limited liability, indefinite lifespan, distinct status as an entity separate from its owners and managers, the ability to raise capital, and several other beneficial concessions.[6] As Hansmann and Kraakman have stated in their article "The end of History of Corporate Law", in return for these legal concessions, "all thoughtful people believe that corporate enterprise should be organized and operated to serve the interests of society as a whole, and that the interests of stockholders deserve no greater weight in this social calculus than do the interests of any other members of society."[7] While the conservative contractarian may not agree with legal concession theory, a contractarian would agree that society does

[6] Greenfield, *supra* note 3, at 42.
[7] Hansmann & Kraakman, *supra* note 5, at 10.

benefit the most when corporations are operated under the shareholder primacy norm. Regardless of one's view on concession theory, if the presumption that corporations are organized for the benefit of society is believed as true, then the real focus of the debate between conservative contractarians and progressive corporate law scholars is centered around how best to ensure that the corporation is pursuing goals that provide a net benefit to society.

III. Ideological Overview

1. The Contractarian Ideology

In corporate governance theory and practice, the contractarian model is now considered the dominant legal vantage point.[8] Contractarianism embraces the corporate form of business organization as nothing more than a nexus of contracts establishing the various rights and obligations among all the inputs acting together for the purpose of producing goods or services.[9] As Professor Stephen M. Bainbridge has explained, "employees provide labor…. stockholders provide equity capital, bear the risk of losses and monitor the performance of management."[10] Because contractarianism is derived from the discipline of law and economics, its focus is to use economic models to explain why corporate governance exists in its current form.[11] Furthermore, it proposes to use these explanations to properly align future behavior to optimal performance.[12] In this regard, the nexus of contract theory of the firm is simply a metaphor or elaborate

[8] Bainbridge, *supra* note 4, at 859.
[9] *Id.*
[10] *Id.*
[11] *Id.* at 862.
[12] *Id.*

illustration that helps explain the current state of the corporation before determining what appropriate future regulation(s) might entail.[13]

Contractarian ideology views corporate law as nothing more than a statutory gap-filler for the explicit and implicit bargains that comprise the firm.[14] Corporate law is not a set of mandatroy rules, but is "instead a series of default rules that can be either accepted or bargained around as suits the participants in the firm."[15] In this regard, corporate law "serves as an off-the-rack standard form contract, it allows participants efficiency gains as they need only vary those provisions that do not suit them."[16] Because of this belief, it is contented that shareholders receive fiduciary duties, and thus, primacy, because they are the party that is willing to "pay" the most for that set of contractual rights.[17]

2. The Progressive Ideology

Progressive corporate scholarship believes that corporations are much more than private organizations designed to serve the interests of stockholders. Instead, progressive theorists view the corporation as a public entity.[18] In this view, the law can be used to restrict and compel the corporation to serve a broader constituency, including society as a whole.[19] Additionally, progressive corporate theory believes that changes within corporate governance are necessary to effectuate the transformation required to address issues of fairness, balance of power, and other disparities within society.[20] Other areas of

---

[13] *Id.*
[14] Kellye Y. Testy, *Capitalism and Freedom- for Whom?: Feminist Legal Theory and Progressive Corporate Law*, 67 Law & Contemp. Probs. 89 (2004).
[15] *Id.*
[16] *Id.*
[17] *Id.* at 91.
[18] *Id.* at 90.
[19] *Id.*
[20] *Id.* at 91.

public law, such as tax law, environmental regulation, and constitutional law, are much too protracted and reactive to create the change necessary to truly make a difference. Progressive corporate law scholars recognize how influential corporations are within society, and believe that the public interest can best be protected from within the firm rather than by outside regulation.[21]

IV. Agency Problems

1. Agency Problems for Stockholders

One of the major underlying assumptions about corporate law involves the need to encourage capital investments.[22] Whether one deems the corporation as a nexus of contracts or as a model based on team production, all thoughtful people understand the importance of ensuring capital investment in new businesses and products. However, in order to encourage stockholders to invest in corporations and not place their money in other financial vehicles such as bank accounts, bonds, or various commodities, society has enacted several laws that make corporate ownership (through the purchase of stocks) a superior risk to reward investment.[23]

One set of laws society has imposed on corporations to spur investment are fiduciary duties. These duties ensure management serves stockholder interests and allows sufficient protection for stockholders to separate themselves from the ownership of their capital for control of the corporation.[24] Due to this separation of ownership and control,

---

[21] Greenfield, *supra* note 3, at 30.
[22] *Id.* at 49.
[23] *Id.*
[24] *Id.* at 47.

several agency issues become apparent.[25] These agency issues along with inefficient and ineffective market protections are the key rationales for enacting fiduciary duties to reduce the difference between stockholder and managerial incentives.[26] Effort, time horizon and risk aversion are all examples of agency issues between stockholders and management.[27] Management has a reverse incentive regarding effort because they do not bear the risk of loss, nor do they reap all the rewards associated with the corporation.[28] Management also has reverse incentives regarding time horizon because management tends to pursue short-term gains at the expense of long-term growth, while a diversified stockholder would prefer all decisions be made for the pursuit of long term growth.[29] Management and stockholders interests are also unaligned in terms of risk profile because management tends to make decisions that are insufficiently risky for their stockholders.[30] Because stockholders are diversified in their respective investment portfolios, they prefer the individual firms that make up their portfolios to take much higher levels of risk than management would like.[31] Management is more risk averse with business decisions because they stand to lose their job and suffer injuries to their reputation if a decision is too risky and fails.[32]

Given the number of divergent incentives, market mechanisms such as institutional investment monitoring, the product market and capital markets are not

[25] Testy, *supra* note 14, at 90.
[26] Greenfield, *supra* note 1, at 298 (1998).
[27] Greenfield, *supra* note 3, at 48 (2006).
[28] *Id.* at 49.
[29] *Id.* at 49.
[30] *Id.*
[31] *Id.*
[32] *Id.*

sufficient to protect the stockholder from these agency costs at an optimal level.[33] Thus, corporate law's role is to facilitate this relationship through the creation of fiduciary duties that flow from management to the stockholders.[34] Additionally, "according to [contractarian] theory, investors and managers would agree to them [fiduciary duties] anyway if they could bargain cost-free, and the legal duty is an efficient alternative to complicated and messy contracts defining such duties expressly."[35]

2. Agency Problems for Employees

While it is generally accepted that stockholders face agency problems, the progressive corporate scholarship points out that employees also face similar agency problems.[36] Employees contribute their labor to the corporation and are subject to the control of management, whom they must depend on to "maximize the return on that input and share that return with them."[37] This is not an agency problem as defined by law, but an economic agency cost, because employees "in any on-going contractual relationship ... face costs associated with monitoring to ensure that the other contracting party is satisfying her obligations under the contract."[38]

In this economic context, workers, like stockholders, must determine whether contributing their resources of time, skill and labor will generate a greater return than by working elsewhere or engaging in other activities.[39] Employees believe that by showing up to work, management can optimize her input so that the individual employee's skills

---

[33] *Id.* at 49.
[34] Testy, *supra* note 14, at 91.
[35] Greenfield, *supra* note 3, at 49.
[36] Greenfield, *supra* note 1, at 299.
[37] Greenfield, *supra* note 3, at 50.
[38] *Id.*
[39] *Id.* at 51.

are worth more than they would be otherwise. Furthermore, like a stockholder, employees must rely on management's good faith effort, care and skill to ensure that the employees will share in the gain created by their collective efficiencies.[40] If management's interests diverge too far from that of the employee's, the workers will have received a lower return than expected. However, instead of reduced stock price, the worker will have a job that is less desirable due to decreased wages, poorer working conditions and fewer benefits.[41]

Several means are available to employees to help reduce these agency costs. For instance, because employees are physically present inside the corporation, they can observe the corporation in a way that other constituents cannot.[42] This gives workers access to information that is not visible to outside investors.[43] Unlike stockholders, workers are not allowed into the boardroom for the most important strategic decisions, decisions that have direct and severe effects on the workers themselves.[44] This form of informational asymmetry between management and employees has kept employees uninformed, and has allowed management to mislead employees about many important and far-reaching decisions such as layoffs, plant closings and outsourcing.[45]

Employees also have the option to quit their job if they feel that management is not maximizing their return on labor. This option is much more drastic and costly than the comparable option for stockholders.[46] Because the stock market is liquid, a

[40] Greenfield, *supra* note 1, at 300.
[41] Greenfield, *supra* note 3, at 51.
[42] *Id.*
[43] *Id.*
[44] *Id.* at 52.
[45] *Id.*
[46] *Id.*

stockholder suffers very low costs when selling her shares. A diversified stockholder can easily find a replacement stock that has almost identical risk to reward return ratios.[47] Unfortunately, when an employee quits her job, she may not be able to find a job that matches her skill set with the same ease as a stockholder.[48] A worker can only hold one or two jobs, while a stockholder owns hundreds of shares, meaning the harm of quitting is much greater than the selling of one's shares.[49]

The progressive scholarship states that the harm from quitting is even more pronounced when an employee develops firm specific skill-sets.[50] The longer an employee works for the same company, the greater the probability of the specialization of her labor. However, this also subjects employees to a firm's opportunistic behavior.[51] Developing firm specific skill-sets makes the option of quitting more costly for the individual employee because management knows that no employee will exit as long as her current wage is greater than what is available on the market.[52] The present employer is able to hold an employee "captive," by reneging on any implicit agreements, knowing the total compensation packages available on the open market is substantially lower and less attractive.[53]

The progressive argument concludes by stating that workers face many agency problems and they, too, deserve additional protections beyond what the market offers.

---

[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] Greenfield, *supra* note 1, at 303.
[53] *Id.*

Moreover, because employees' market protections are less reliable and more vulnerable, workers may have a stronger argument for fiduciary duties than stockholders.[54]

3. The Appraisal of Employee Agency Problems

From an economic perspective, it seems obvious that workers face several agency problems that bolster the argument for fiduciary duties to flow from management to the workforce. However, just as a mirage in the desert leads a wandering soul to exert all of her energy chasing after it with the hopes of quenching her thirst, the progressive scholar also appears to be arguing for something that is not there to begin with. The progressive scholar's assumptions about the weak market mechanisms that protect employees are not completely accurate. Because workers are not privy to board level decision making, employees are subject to informational asymmetries that can lead to management misleading its employees about important strategic decisions. However, this is not an entirely correct statement. Due to powerful and extremely efficient capital markets, employees do not need to be present at strategic meetings to know if management is making sound business decisions. Employees can simply measure the market reaction to senior management discussions. For example, if post-board meeting, the stock price increases, employees can rely on that increase to inform themselves that management is making business decisions that benefit the corporation. Alternatively, if the market reaction is a decrease in the stock price, employees will know that management is taking steps that might be harmful to the corporation. Employees can rely on these sources of secondary information to inform themselves whether it would be more desirable to continue to working for their current employer or to seek opportunity elsewhere. A

[54] *Id.* at 303.

progressive scholar may respond that this use of secondary information does not indicate that the corporation is acting in the employee's best interest. While that may be a correct statement, secondary market information, along with a daily physical presence within the corporation, does provide employees with at least, if not more information, than any other firm constituent, including stockholders.

Oliver Wendell Holmes Jr. once said that "The life of the law has not been logic; it has been experience."[55] This is appropriate to the progressive argument that employees cannot change jobs as easily as a stockholder can sell her stocks, and that the cost of switching jobs is much greater compared to selling shares. While it may be true that changing jobs is more costly than selling stocks, this argument does not take into account the experience of how employees actually behave in the work place. Because employees are logical and rational, they too understand that management can take advantage of firm specific skill-sets. Employees also know that switching jobs can be a costly experience. This is why employees tend not to leave one job until they have already secured a position with another employer. Employees are also fearful of management "capture" of firm specific skill-set and one can imagine, an employee may attempt to avoid the development of firm specific skills and instead, develop skills sets that are broad based and have application in multiple industries. This behavior can be observed by the troves of experienced workers that leave high paying and secure positions to pursue broad based skill-sets in degree programs such as Masters of Business of Administration, Certified

[55] Oliver Wendell Holmes Jr., The Common Law 1 (1881).

Financial Planning and Accounting Practices.[56] These skill-sets ensure that most thoughtful employees are not subject to extreme wage decreases, such as a switch from car manufacturing to bicycle construction.[57]

For employees that are unable to develop broad skill-sets, there is another powerful tool to ensure that a change in positions is not as costly as the example above. Employees can use networking as a tool to ensure that they develop industry wide contacts with management from organizations that operate in the same or similar business channels.[58] This allows an individual employee to develop firm specific skill-sets that are applicable to other employers without the fear of such a drastic cut in her total compensation package.

Professor Greenfield states that the market protects workers from agency costs less well than it protects shareholders.[59] Upon further analysis, it becomes clear that Greenfield's claim is in fact true, employees are not fully protected by market mechanisms and do suffer from a few attenuated agency costs. However, it is equally true that Greenfield's claim is overstated, through the use of secondary information, networking and the development of broad based skill-sets, there is not enough evidence of substantial agency costs to support the suggestion that fiduciary duties should flow to

[56] Francesca Di Meglio & Cathy Dove, BusinessWeek.com, *MBA: A Mere Option*, http://www.businessweek.com/debateroom/archives/2007/05/mba_a_mere_opti.html (last visited May 7, 2009) (Graduate business schools provide a lifetime worth of knowledge, leadership, and networks that allow students to change industries and secure positions in management.).
[57] Greenfield, *supra* note 3, at 53 (Stating that firm specific skills could be costly for employee and used the example above as a specific instance.).
[58] Diana Darling, EffectiveNetworking.com, *The Networking Survival Guide*, (April 29, 2002), http://www.effectivenetworking.com/content/press007.html ("According to statistics gathered by the Sandler Sales Institute, If someone introduces you and attends and introductory meeting or call, the chance of closing the business or getting the job is 80%. Similar chances through a cold call are 1%.").
[59] Greenfield, *supra* note 3, at 53.

employees. Thus, there must be some other argument that can justify the inclusion of these duties to flow from management to the workforce.

V. The Residual Claim Argument

1. Stockholders and The Nature of Their Status as Residual Claimant

Agency costs only explain one reason why stockholders receive fiduciary duties. In addition to the minimization of agency costs, contractarians also believe that stockholders receive fiduciary duties because of their status as the firm's sole residual claimant. Stockholders' claim against the corporation is residual in nature.[60] As the owners of common stock, a stockholder does not receive anything until all other constituents' claims against the corporation are satisfied. If the corporation is unable to meet these other obligations, the stockholder receives nothing, but if the corporation is able to return an amount greater than the value of all other constituents' claims, the stockholder is entitled to the entire outstanding amount. As holders of the last claim on the corporation, stockholders have the greatest interest in maximizing the long term value of the firm because that is the only means to assure their claims increase in value.[61] This position as the residual claimant is inherently risky, and because stockholders are able to bear greater risk than other constituents of the corporation, stockholders are uniquely qualified to tend to the firm's overall profitability.[62] Workers, creditors and other constituents are fixed claimants who tend to "resist risky activities."[63] Conversely,

[60] *Id.*
[61] *Id.*
[62] Greenfield, *supra* note 3, at 27.
[63] *Id.*

"stockholders' interests and the interests of the enterprise as a whole are more closely aligned than the interests of any other claimant and the firm."[64]

Professor Macey provides an illustration of this point by using both a fixed and residual claimant. Imagine a firm that will owe $1 million to the fixed claimants at the end of year one.[65] This firm also has the choice between two distinct projects, A and B, each of which are mutually exclusive options.[66] Suppose further that the expected present value of project A is $3 million and project B is $3.5 million.[67] A stockholder would prefer choice B due to the possibility of an additional $500,000 return.[68] Fixed claimants, conversely, have no preference with regard to either investment because either way they will receive their $1 million.[69] Thus, the firm and society are better off with project B because it maximizes the value of the firm and the wealth of society.[70]

The example by Professor Macey demonstrates that stockholders always have the proper incentives to maximize the long run profits of the corporation, which also purports to maximize the value of the residual claimant's position.[71] Furthermore, "stockholders are the only group of constituents that have a meaningful stake in every decision made by a solvent firm."[72] As a superior risk bearer compared to management and employees, stockholders are better suited as residual claimants because as a whole, stockholders want

[64] *Id.* at 54.
[65] Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 Stetson L. Rev. 23, 28 (1992).
[66] *Id.*
[67] *Id.* (Project A's expected value is $3 million because there is a 50% chance of a $1 million return and a 50% chance of $5 million return. Project B's expected return is $3.5 million because there is a 50% chance of $1 million return and a 50% chance of $6 million return.).
[68] *Id.*
[69] *Id.*
[70] *Id.* at 29.
[71] Greenfield, *supra* note 3, at 54.
[72] *Id.* at 26

to maximize the value of the firm. This ensures all fixed claimants such as employees, creditors, and others receive compensation for their inputs, and ultimately assures the most efficient use of resources by the firm. Thus, society benefits by making fiduciary duties flow exclusively from management to stockholders.

2. Employees Have a Residual Claim Against The Corporation

Progressive Scholars believe that workers have claims against the firm that are residual in nature. Employees have several unfixed explicit and implicit claims against the corporation.[73] Unfixed, explicit claims include retirement plans, bonuses and other types of benefits that are tied to organizational value.[74] Unfixed, implicit claims include working conditions, firm-specific skill sets and even one's comprehension of promotion and disciplinary polices.[75] Similar to stockholders, employees believe that their individual return on labor, time and skill depends on the strength of corporate profits.[76] "As a class, employees gain when the firm prospers, and lose when it suffers."[77] This position makes the interests of employees similar, if not identical, to stockholders' interests in terms of the economic well being of the firm.

Besides having a keen interest in the total net wealth of the corporation, employees are also in a better position to care for the interests of the firm.[78] When compared to stockholders, employees tend to be risk averse, while stockholders are risk neutral or risk preferring.[79] Stockholders tend to prefer management make decisions that

---

[73] *Id. at* 55.
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.* at 56.
[78] *Id.*
[79] *Id.*

will maximize the expected value of that decision, even if that same decision has a high variance, or large discrepancy in the possibility of the outcome.[80] In other words, a stockholder prefers that management choose the business decision that has the highest possible return, even if the range of possible outcomes is larger than other more conservative choices. Stockholders, because of their status as diversified investors, prefer firms make decisions that risk bankruptcy for the possibility of higher payoffs.[81]

Employees, unlike stockholders, are not diversified in their labor investment because they often work for only one employer.[82] Workers are not indifferent towards decisions with high variance because of the consequences they face if bankruptcy occurs.[83] If bankruptcy occurs, workers can lose more value than a diversified stockholder. A stockholder only loses the value of his shares in one of possibly hundreds of companies in which she invested. A worker can lose her job, retirement benefits and any firm specific skill set that she cannot transfer over to a new position.[84] Intrinsically, workers value decision making that affords stability, rather than decisions with more variance.[85] Thus, the progressive scholar argues that workers, and not stockholders, are in a better position to manage the interests of the firm because workers would tend to prefer decisions that result in fewer high-risk propositions, and ultimately a lower probability of firm failure.[86]

---

[80] *Id. a*t 57.
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*

From the perspective of society, it is reasonable to assume that stability and avoidance of harm are preferred to the maximization of corporate profits.[87] When a firm liquidates due to high-risk decisions that failed to yield results, the resulting harm to the community at large is disproportionate to the gain in corporate profits.[88] Thus, society desires consideration of other values besides just profit maximization. Society might prefer constituents who do not only concentrate on corporate profit, but also value permanence and longevity.[89] Accordingly, workers, not stockholders, have stronger incentives to care about the success and continued existence of the firms that employ them.

3. An Analysis of Employees' Residual Claim Strengthens the Argument For Fiduciary Duties To Flow From Management to Stockholders

Even the most conservative contractarian would agree that employees have a strong desire to ensure the economic viability of the corporation. A contractarian may concede that workers have a stronger interest than most of the other firm constituents. However, the weakness of the progressive scholarship's argument is that it applies to any of the firm's constituents. Bondholders, creditors, employees, consumers and stockholders all have strong economic incentives to ensure the firm remains a going concern. Therefore, the true rationale for enacting fiduciary duties to flow from management to employees must be that employees are risk averse and prefer decisions that favor lower returns for added stability. The classic fairy tale of the tortoise and the hare is demonstrative of this progressive argument. In this fable, it is the measured and

---

[87] *Id.* at 58.
[88] *Id.* at 58.
[89] *Id.* at 59.

determined pace of the tortoise that help him win the race, whereupon he exclaims, “Slowly does it every time!".[90] However, in an ultra competitive and increasingly global economy, the fast-paced hare usually comes out on top. People still appreciate the value of the tortoise, but when considering where to allocate one’s “investment,” everyone wants a “hare” because of its ability to generate superior returns.

Firms willing to take high payout and high variance risks are less likely to face bankruptcy than firms that are willing to sacrifice profits for less volatility. This counter intuitive proposition is especially accurate in the context of the global marketplace. In the global economy, the firms that take strategic risks are the ones that tend to produce the most innovative products and generate the healthiest returns. The generation of better than average returns attracts all constituents to invest their respective inputs with a firm. As progressive scholars have previously stated, employees want to work for corporations that will maximize the value of their input. This also holds true for all other constituents to the firm. Furthermore, firms that generate higher returns have more capital to attract constituents from other less productive firms by offering greater total compensation packages. Firms that value and judge risk accordingly are the ones that maximize societal wealth through profit generation, growth of employment opportunities and the development of new product markets. This domino effect of firms that produce better than average returns actually causes firms that set goals of stability and slow growth to become less competitive and ultimately bankrupt due to stockholder demand of higher

[90] Childhoodreading.com, The Tortoise and The Hare, http://childhoodreading.com/Arthur_Rackham/Tortoise_and_the_Hare.html (last visited May 1, 2009).

dividends, loss of top talent, higher cost of capital and eventually a loss of consumer demand.

An illustration of the argument above exists in the Web Search Engine product market between Google and Microsoft. In this example, Microsoft has used a managed growth strategy with a preference for decisions that are less volatile.[91] Conversely, Google started as a venture capital backed company because of its high reward and high volatility business model. Due to these differences in business strategy, Google currently dominates the Search Engine Market with 72.11% of the market share, while Microsoft ranks a distant third with only 5.56% of the market share.[92] This market domination has generated higher than average returns, allowing Google to retain and bring in better "investments" from all corporate constituents. Google can acquire the best talent because it can offer higher total compensation packages when compared to its competitors.[93] Thus, the argument that workers are in a better position to manage the interests of the firm because workers would tend to prefer decisions that result in fewer high-risk propositions, and ultimately a lower probability of firm failure, is an unsupported proposition. The argument does not satisfy society's demand to ensure its corporations behave in a manner that reduces risk of failure, and does not provide a basis for granting fiduciary duties to employees.

---

[91] Daisuke Wakabayashi, Reuters.com, *Microsoft Quarter View Disappoints, Bullish on '09* (April 24, 2008), http://www.reuters.com/article/ousivMolt/idUSWNAS970220080424 ("Microsoft is an extremely conservative company with respect to guidance.").

[92] Brafton.com, *Microsoft to Attack Search Engine Market*, http://www.brafton.com/industry-news/microsoft-attack-search-engine-market-$1285288.htm (Last visited May 1, 2009)(Brafton specializes in niche news media source, relying on full time professional journalist to report exclusively on the internet regarding issues affecting particular industries or firms).

[93] Money.CNN.Com, *100 Most Desirable MBA Employers*, http://money.cnn.com/magazines/fortune/mba100/2008/index.html (last visited May 1, 2009) (Google is the most desirable employer for the past 3 years.).

VI. Other Arguments Against Employee Fiduciary Duties

1. Dual Fiduciary Duties is Not a Workable Alternative

Even if one is not convinced that employees should not receive fiduciary duties, requiring directors to have dual fiduciary duties is an untenable task. By creating fiduciary duties that flow to both stockholders and employees, it would allow management too much leeway on every strategic decision, "no matter how arbitrary, to be rationalized on the grounds that it benefits some constituency of the corporation."[94] This type of multiple stakeholder model would not benefit workers, but would serve to benefit incumbent managers, who could justify any decision with less accountability to any one group of constituents.[95]

Professor Macey demonstrates this argument through the example of a firm deciding whether to relocate its headquarters from a metropolitan city to a suburban community.[96] In his example, the small town has better schools, lower labor costs and lower taxes.[97] With only one set of fiduciary duties flowing to stockholders, this decision would be easy to support. If moving increases the value of the firm or cuts costs to a satisfactory level, management would support the move. However, with multiple duties flowing to stockholders and employees, the decision becomes much more complicated. Stockholders may profit, some employees may benefit, but other employees may suffer.[98] Furthermore, the move may create a loss for society due to the loss of jobs and revenue in

[94] Macey, *supra* note 62, at 32.
[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] *Id.*

the metropolitan area.[99] The effects of this decision would be magnified if this were not just a move from one city to another, but from within the Unites States to a country abroad. "Imagine now that the proposal to relocate comes not from incumbent management, but from an outside bidder who is launching a hostile tender offer for the company at a substantial premium over the current market price of the firm's shares."[100] Dual fiduciary duties could be used to justify resisting such an offer even though it would be in the best interests of the stockholders.[101]

A progressive scholar may retort that management already operates under a multi-fiduciary duty regime. In the modern corporation, stockholders do not only posses common stock, but some own preferred shares, or different classes of common stock. [102] Each of these types of stock can come with drastically different rights including dividend payments, rights with respect to liquidation and greater control in voting. These differences can create conflicts among the various stockholders as some preferred stockholders may prefer the firm not engage in certain risky projects or that the firm liquidate for a price that would not be acceptable to common stockholders.[103] Despite these conflicts, management has been able "to discharge fiduciary duties to all of these claimants simultaneously."[104]

Management has not been successful in its ability to provide fiduciary duties to multiple classes and types of stockholders. Due to their inability, society, with common

---

[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.* at 33.

law and through legislature, has enacted several regulations to ensure some classes of stockholders go unharmed by other more senior or controlling classes. For instance, the law protects minority shareholders and ensures that majority owners do not extract value during mergers and acquisitions. Furthermore, both California and Delaware Corporate Law have regulations in place to protect all classes of stock in connection with firm financings, reorganizations, mergers and sale of asset events.[105] These statutes are evidence of management's inability to provide fiduciary duties to multiple classes and types of stocks because if management was able to provide fiduciary duties to multiple parties, precise statutes addressing these specific situations would not be necessary. One type of stockholder could simply rely on his fiduciary duty to sue management and if management was not acting in the best interests of the stockholders, that plaintiff would have a successful claim. However, in these situations, management would be acting in the best interests of the stockholders, just not all of them. Hence, societies necessary imposition of law that ensures management's interests are aligned with all stockholders. This begs the question, if management is unable to provide fiduciary duties to stockholders whom have the same overarching goal for firm management, how could management also effectively look after the interests of another constituent with drastically different goals for firm governance?

<u>2. Employee Participation Models Create a Net Loss for Society</u>

In several of his law review articles, Professor Bainbridge has argued against employee participation, or inclusion in firm governance, because there seems "to be no

[105] Cal. Corp. §903a-c (2009), Cal. Corp. §1201a (2009), Cal. Corp. §2115c (2009), 8 Del. C. §242b1-2 (2008), 8. Del. C. §251C (2008).

conclusive evidence that employee involvement in corporate decision-making leads to any identifiable long term economic benefits."[106] He further asserts that nations such as Germany and Japan, who have adopted co-determination regimes, offer no evidence that employee involvement produces long-term commitments to the firm or investments of firm specific assets by workers.[107] Finally, he states that the dominant ideology is more efficient and competitive when compared to any modern co-determination regime.[108] Studies have indicated that corporations operating under a stockholder primacy model have lower unemployment rates when compared to German enterprise.[109] Recently, Professor Frank Allen from the Wharton School of Business did a comparative study of stockholder and stakeholder oriented firms and discovered that stakeholder oriented companies have lower output and higher prices, and can have greater firm value than stockholder-oriented firms.[110] While Allen's study confirmed that stakeholder oriented firms generate greater wealth for workers and the corporation as a whole, it also concluded that stakeholder oriented models end up being worse for other constituents in society, namely consumers.[111] Through the use of complex mathematical analysis and a comparative study of society's that operate in stockholder and stakeholder models of firm governance, Allen discovered that when employees have a larger role in firm governance,

---

[106] Bainbridge, *supra* note 4, at 879.
[107] *Id.*
[108] *Id.*
[109] *Id.* at 880.
[110] Frank Allen ET AL., Whose Company is it?: New Insights into the Debate over Shareholders v. Stakeholders, 3-10 , 17-25 (2007) *available at* http://knowledge.wharton.upenn.edu/article.cfm;jsessionid=a8308782f99c636f6ab5?articleid=1826.
[111] *Id.*

the firms innovate less, produce less and ultimately charge more for the same goods, fundamentally producing a net loss for society.[112]

Professor E. Han Kim's article addresses the same phenomenon that Professor Allen observed through the publicized example of United Airlines.[113] Professor Kim states, companies have considered employee ownership a tool that could engage more cooperation among employees, while helping create value and employee investments in the firm.[114] In 1994, United Airlines used this strategy by issuing its employees equity shares controlling 55% of the firm's cash flow, and provided employees with considerable firm influence by controlling 3 of the 12-member director board.[115] This plan intended to increase employee retention, provide cash incentives to ensure the firm produced above market returns and was a catalyst to make United Airlines a more competitive firm.[116] After completion of the deal, United Airlines hired Gerald Greenwald as CEO.[117] Initially the plan proved successful by lowering employee absenteeism, turnover and increasing stock price.[118] Three years later these effects began to dissipate as a pilot union strike was close to erupting.[119] A new CEO was hired and he immediately resolved the dispute by rewarding the pilot union with the highest paying deal in the industry.[120] This same cycle occurred again when the mechanics union

---

[112] *Id.*
[113] E. Han Kim, *Corporate Governance and Labor Relations* 15-19, (University of Mich.- Stephen M. Ross Sch. of Bus. Working Paper, Paper Mar. 4, 2009) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1353487.
[114] *Id.*
[115] *Id.*
[116] *Id.*
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] *Id.*

threatened a strike.[121] Another new CEO was hired and the mechanics union obtained a favorable deal, "making United the most expensive airline to operate on a per mile basis."[122] In December 2002, the firm declared bankruptcy, hurting stockholders, employees and society.[123] Professor Kim used this example to demonstrate that stockholder value, and not stakeholder value is the proper model for firm governance.[124] She elaborates that when employees have ownership rights in the firm, they tend to use those rights to their own advantage.[125] She finally states, "When employees are given dominant position in [firm] governance and decision-making, as in the extreme case of UAL [United Airlines], companies appear to become vulnerable to a kind of corporate socialism in which total value is destroyed.[126]

The employee ownership plan adopted by United Airlines is an example of a failed experiment. However, demanding large salaries is not the only way employee ownership can work to the detriment of society. "One study argues that managers worried about hostile takeover threats may seek an alliance with workers in which they pay above-market wages in return for workers' votes against hostile bids."[127] "Such excessive employee ownership actions can erode the value of corporate growth opportunities by raising labor costs to unsustainable levels, causing firms to invest less, suffer poor performance and have lower value."[128]

---

[121] *Id.*
[122] *Id.*
[123] *Id.*
[124] *Id.* at 27.
[125] *Id.* at 18.
[126] *Id.*
[127] *Id.* at 17.
[128] *Id.*

While these arguments are compelling in demonstrating that the dominant ideology produces greater returns, lower unemployment and ultimately is more efficient than employee participation regimes, one cannot help but feel that Bainbridge and the contractarian ideology are lacking in their critique of progressive theory.

The progressive scholarship is not merely advocating that employee participation is the most efficient use of resources, but that it can provide a just and fairer approach to governance of the institutions that affect us all. Progressive scholars are concerned with decreasing wealth disparities and the externalities that harm the firm's other constituents, like employees. These concerns are important and deserve significant attention. However, with respect to employees, the internal workings of corporate governance may not be the best place to address these issues. Employees do suffer greater harm when the corporation liquidates, but granting control to employees is not a solution that society can stand behind.

IV. Recommendation For The Future of Corporate Governance

While ultimately it is in society's interest to continue to operate under the model of shareholder primacy, soon corporations will face extreme recruiting issues. Forbes magazine published an article explaining this dilemma:

> By 2010, about 76 million baby boomers, or those born between 1946 and 1964, are set to retire.[129] Boomers make up about one-third of the U.S. workforce, and there aren't enough younger workers to replace them. Labor

[129] Scott Reeves, Forbes.com, *An Aging Workforce's Effect on U.S. Employers*, http://www.forbes.com/2005/09/28/career-babyboomer-work-cx_sr_0929bizbasics.html (last visited May 2, 2009).

> shortages in key industries will force a radical rethinking of recruitment, retention, flexible work schedules and retirement.

This labor crisis can serve as the necessary catalyst to help solve the tension between contractarians and progressive theorists. As stated throughout this paper, employees are not in the best position to manage the corporation. However, soon top-level talent will have leverage for the investment of their labor input. Corporations can continue to recruit top talent and in turn generate superior profits for its stockholders by granting employees more influence in firm governance. In fact, it may be the most cost effective means to retain talent in what will be one of the most competitive workforces in history.[130] This is by no means advocating fiduciary duties that flow to the workforce, but instead, corporations could operate with more transparency by allowing the workforce to attend board meetings or giving advance notice when adverse actions may occur, directly affecting employment. Corporations could develop the use of an employee "board" where the workforce can have some influence or can contribute in decisions that directly affect their positions within the firm. This type of hybrid solution would provide a cost effective way to retain and recruit top talent without entering compensation wars, while providing employees with greater total compensation in the form of firm control rather than salary and benefits. Accordingly, this hybrid solution would be the most efficient, fair and just possibility to ensure that corporations continue to operate under the correct model of governance and yet, still provide the workforce with the added benefit of transparency and decision making capabilities.

[130] *Id.*