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Corporate Constituency Statutes and Employee Governance

Brett McDonnell

University of Minnesota Law School, bhm@umn.edu

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CORPORATE CONSTITUENCY STATUTES AND EMPLOYEE GOVERNANCE

Brett H. McDonnell[†]

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[†] Associate Professor, University of Minnesota School of Law. I thank Stephen Bainbridge, Daniel Farber, David McGowan, Lawrence Mitchell, and Paul Rubin for helpful comments on an earlier version of this article.

I. INTRODUCTION

In whose interests are corporations governed? In whose interests should they be governed? These foundational questions in corporate law have been debated since at least the Berle-Dodd exchange in the 1930s.¹ Most American commentators have asserted a simple answer: the interests of shareholders.

The debate flared up in the 1980s as states began to pass corporate constituency statutes. These statutes allow corporate officers and directors to take into account the interests of a variety of corporate stakeholders in carrying out their fiduciary duties to the corporation. The statutes suggest that a corporation should, or at least may, be run in the interests of more groups than just shareholders. The corporate constituency statutes therefore threaten decades of American thinking about the governance of corporations. As a result, many scholarly papers have appeared attacking or defending the constituency statutes.

On their face, constituency statutes seem attractive to someone with an interest in employee involvement in corporate governance. However, the statutes were passed in response to the takeover wave of the '80s, and many commentators have charged that their main intent and effect is to help entrench incumbent managers. This aspect of the statutes is far from attractive (unless you are an incumbent manager). This article tries to sort out these conflicting perspectives. I ultimately conclude that while there are some decent arguments for constituency statutes, and they are not as harmful as many of their opponents feared, they are, all in all, not a good idea. They are a poor substitute for direct employee involvement in corporate governance.

This article provides a simple, formal model of the interaction among managers, shareholders, and employees in governing a business organization. Most formal work in corporate governance focuses only on the relationship between managers and shareholders. There has been relatively little formal modeling that includes employees as an important constituency in governance. To ask questions about constituency statutes and employee governance, one must extend that traditional framework.

Section II examines the constituency statutes and the scholarly

1. See A.A. Berle, Jr., *Corporate Powers as Power in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

literature on them. It also examines related literature on the effects of takeovers on employees and on employee involvement in corporate governance.

Section III presents the basic formal model. A manager chooses how much effort to undertake, which affects both the total output of the firm and benefits personal to the manager. The manager also chooses how much of the total output to allocate to employees rather than shareholders. A variety of mechanisms induce the manager to take into account the effects of output received on both shareholders and employees, but not fully. As a result, the manager tends to set effort too low.

Section IV extends the model to add in the effects of a takeover threat. If the amount of firm output allocated to shareholders is lowered, the possibility of a takeover increases, and if a takeover occurs, the manager is punished. As a result, the manager both increases her effort level and allocates a greater fraction of output to shareholders. Shareholders are better off, while the effect on employees is ambiguous.

Section V then considers the effect of existing constituency statutes. These statutes allow managers to take defensive actions that reduce the threat of a takeover, claiming such actions benefit other constituencies. The effect of this use of the statutes as a shield for managers is to reduce both managerial effort and the amount of output allocated to shareholders. Shareholders are worse off, while the effect on employees is ambiguous.

Section VI models employee involvement in corporate governance. It does so by assuming that employees have some ability to punish or eliminate managers with whom they are unhappy. The possibility of such punishment occurring increases as the amount of output that employees receive decreases. As with a takeover threat, this mechanism increases managerial effort. Unlike takeovers, this mechanism induces managers to allocate more output to employees as opposed to shareholders. Thus, employees are better off, while the effect on shareholders is ambiguous.

Section VII sets out the final variant of the formal model. This involves using constituency statutes as a sword against management, rather than a shield. Employees, shareholders, or perhaps others can sue managers. The chance of such suit increases as total output decreases. This mechanism is intermediate between takeovers and employee governance in terms of its distributive

effects, although probably empirically weaker than either in terms of its effect on managerial effort.

Section VIII concludes with a discussion of the formal model, relating it to the issues from the literature discussed in section II. It suggests several conclusions:

- Economic models of corporate governance, which have focused mainly on managers and shareholders, should take into account a variety of other stakeholder groups—sections III through VII add employees to the model.
- While many commentators have concluded that shareholder gains in hostile takeovers do not come in part at the expense of employees, that issue is far from conclusively decided. While the literature has focused on employee losses through lowered employment or wage levels, changes in working conditions and other intangibles should be examined as well.
- There is a redistributive argument in favor of a fiduciary duty to employees. Serving as agents for shareholders may help employees, which we want to encourage if we think employees deserve a greater slice of the pie.
- While a revised fiduciary duty and employee governance may both help tilt the playing field toward employees, the revised fiduciary duty does so at the cost of lessened discipline of managers, whereas employee involvement in governance may help control managerial opportunism. In other words, while a broadened fiduciary duty may help distribute income from shareholders to employees, it does so at the cost of reduced efficiency; employee governance may redistribute income and power while improving efficiency. Thus, employee involvement in corporate governance is more desirable than constituency statutes.

II. THE LITERATURE

A. *The Statutes*

The first corporate constituency statute was passed in 1983 in

Pennsylvania. A total of thirty states now have some variant of a corporate constituency statute.² Under these statutes, a corporation's officers and directors are allowed to give weight to the interests of enumerated groups other than shareholders in the performance of their fiduciary duties. The statutes differ along a variety of dimensions. For example, they differ as to which constituent groups are included. All statutes mention employees and customers; other groups mentioned include suppliers, creditors, local communities, and the state and national economies. Most, though not all, statutes specify that directors may consider the long-term as well as the short-term interest of the corporation.³

The statutes are generally vague as to how directors should weigh the interests of varying groups. A few specify that no single interest may dominate; most do not even say that much.⁴ In a few states the statutes apply only in the context of a potential change in control.⁵ In almost all of the states the statutes are permissive, not mandatory. That is, directors may take the interests of the enumerated groups into account, but they are not required to.⁶ In several states the enumerated groups (other than shareholders) are explicitly denied standing to sue under the statute; in other states the lack of standing appears implicit.⁷ In several states, a corporation either must opt in for the statute to apply, or may opt out.⁸

Of note in the provisions just listed is the permissive nature of the statutes in almost all states and the lack of standing of constituent group members to sue under the statutes. These features lend credence to the charge that the statutes reduce the disciplinary pressure of shareholder suits on directors without a concomitant increase in pressure from other groups. The statutes are a shield for managers, not a sword for employees or other non-shareholder groups.

To date, it appears that constituency statutes have had very little use in the courtroom. Few court cases have even mentioned constituency statutes, and the statutes do not seem to have been

2. Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85, 95 (1999).

3. *Id.* at 97.

4. *Id.* at 98.

5. *Id.* at 100.

6. *Id.* at 101.

7. *See id.* at 108.

8. *See id.* at 101-02.

decisive for the outcome in cases that do mention such statutes.⁹ Of course, whether the statutes have affected actual behavior is a more difficult question.

One possible reason that constituency statutes appear to have had little visible impact is that they were adopted at the same time that states also adopted other anti-takeover statutes. Perhaps even more importantly, corporations adopted a variety of anti-takeover devices, such as poison pills, staggered boards, elimination of written consents, supermajority provisions, interested shareholder provisions, and the like.¹⁰ Common law in the leading corporate law state, Delaware, has largely allowed boards to adopt these measures with little interference. Thus, directors and officers have found a variety of means to defend their interests. When pressed in court, they generally have been able to defend those means without resort to constituency statutes. If managers can so defend their actions without using constituency statutes, they prefer to do so, as admitting in court that an action is defensible only by reference to groups other than shareholders is not likely to help the corporation's share price.

B. Arguments Against and For the Statutes

The traditional view in American corporate law has been that the fiduciary duties of corporate directors run to the shareholders of the corporation.¹¹ There have been times when that was debated, most notably the Berle-Dodd debate of the 1930s.¹² There are doctrines that to a degree soften shareholder dominance. For instance, corporate charitable giving is allowed; it is defended as being in the long-term interest of the corporation.¹³ In *Unocal*, the Delaware Supreme Court left some room for the consideration of " 'constituencies' other than shareholders,"¹⁴ although it does not appear that a decision can be defended if it hurts shareholders. The dominant view, though, clearly has been that directors and officers are to run the corporation in the interests of shareholders,

9. See *id.* at 108.

10. See *id.* at 109; Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 38 (1992).

11. *Dodge v. Ford Motor Co.*, 204 Mich. 499, 507, 170 N.W. 668, 684 (1919).

12. See Berle, *supra* note 1; Dodd, *supra* note 1.

13. See JESSE H. CHOPER *et al.*, CASES AND MATERIAL ON CORPORATIONS 40-41 (5th ed. 2000).

14. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

and shareholders alone.

Corporate constituency statutes challenge that dominant view. It is therefore no surprise that many have opposed them.¹⁵ The traditional argument for the dominant view is that shareholders are the owners of the corporation. Hence they have the right to expect that their property is managed in their interest.¹⁶ This traditional argument is in considerable tension with the contractarian point of view, which has come into vogue with the infusion of economic thought into corporate law scholarship. This view portrays the corporation as a nexus of contracts between a variety of parties that interact through the corporation, potentially including all of the groups mentioned in corporate constituency statutes. The corporation is merely a convenient legal fiction, which may help structure these interactions. The question for corporate law, on this approach, is what set of legal rules provides the most efficient set of incentives for the parties. Particular attention is paid to the ways in which laws may help constrain the potential opportunism of managers in a large public corporation. Under this approach, there is nothing necessarily special about the status of shareholders as owners of the corporation. That label simply begs all of the interesting questions about the incentives different potential legal rules provide.¹⁷

Although contractarianism calls into question the traditional argument for a shareholder-only fiduciary duty, it leads to several arguments of its own for that position. Shareholders are the residual claimants for a corporation. They receive what is left of a corporation's earnings after all other contractually required

15. See 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 (1991); James J. Hanks, Jr., *Playing With Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991); Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27 (1996); Committee on Corporate Laws, *Other Constituencies Statutes: Potential For Confusion*, 45 BUS. LAW. 2253 (1990). There is a fairly large literature on constituency statutes, which I only sample here. My point in this section is simply to give a quick sense of some of the major arguments made for and against constituency statutes and corporate governance, in order to set the stage for the argument I make in the following sections.

16. See Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C.L. REV. 283, 288-89 (1998).

17. See Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1204 (1991).

payments are made. Only residual claimants have the proper incentive to maximize the total net value that a corporation creates; holders of fixed claims only care about ensuring that the obligations to them are fulfilled. Because shareholders bear the risk that a corporation faces, they need to be able to control its decisions.¹⁸

One problem with this argument is that shareholders are frequently not the only residual claimants. Employees may well be residual claimants too. Employees may possess skills and knowledge that are specific to their particular corporation and of little or no value if they were to become employed elsewhere. To the extent that this is so, employees, like shareholders, have an interest whose value varies with the long-term value of the corporation.¹⁹ Another problem with this approach is that the law does not really treat shareholders as residual claimants.

A related argument is that, as residual claimants, shareholders care about a uniquely wide range of managerial decisions concerning the corporation. It is not possible to completely contract over all these decisions. Although a variety of other mechanisms protect the interests of shareholders thus exposed, a court-imposed fiduciary duty helps protect shareholders further.²⁰ The response is that employees also care about a wide range of decisions within the corporation, and are similarly unable to completely contract over them.²¹ Some contractarians argue that employees care about a more limited range of decisions than shareholders, particularly employment decisions, wages and benefits, and some aspects of working conditions. They also argue that employees can protect themselves better contractually.²² However, it would appear that quite a wide range of decisions within a corporation affect the well-being of employees. "Working conditions" covers most of what goes on within a corporation. Most adult Americans spend a large number of hours working in a corporation; what goes on during that time is of intense interest to

18. See Macey, *supra* note 15, at 26-31.

19. See Greenfield, *supra* note 16, at 305-08; Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1194 (2002).

20. See Macey, *supra* note 15, at 36-39; STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 424-26 (2002).

21. See generally Committee on Corporate Laws, *supra* note 15; see also Stout, *supra* note 19, at 1196; Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 318-22 (1999) [hereinafter Blair & Stout].

22. See BAINBRIDGE, *supra* note 20, at 428-29.

them. Indeed, on its face it would appear that employees, who unlike shareholders are not diversified, are more seriously exposed to the consequences of managerial decisions than are shareholders and have fewer disciplinary mechanisms available to them. (One consequence is that, like managers and creditors, employees are likely to prefer lower-risk decisions than shareholders would prefer). The ability of many, indeed most, American workers today to protect their interests contractually is quite questionable.²³

Another major argument for a shareholder-only duty is that a more diffuse duty owed to many groups would make the fiduciary duty of little value to anyone. The more groups who receive the benefit of such a duty, the more likely it is that the interests of those groups will conflict.²⁴ Where interests conflict, managers may play one group off against another in defending their actions. Courts will have a hard time aggregating conflicting interests, and hence will go along with the managers' defense. Why, then, focus on shareholders only, as opposed to some other group? It may be easier to measure returns to shareholders than returns to other groups.²⁵ Fiduciary duties have their most legitimate bite in situations where the interests of corporate managers go against the interests of all other stakeholder groups, and hence the conflicting interest problem does not arise. The application of a fiduciary duty to shareholders in circumstances where the interests of various stakeholders (other than managers) collide is a less legitimate use of fiduciary duty.²⁶

I find the last-mentioned "too-many-masters" argument the most compelling of all those made against constituency statutes. It may well explain why the statutes came into being in the first place. The statutes were passed in the context of the hostile takeover wave of the 1980s. In many states, the management of embattled corporations was the impetus for the statutes. This history helps explain why the statutes are permissive rather than mandatory. On the other hand, at least some observers believe that other corporate constituencies, especially employees (and particularly unions) did

23. See O'Connor, *supra* note 17, at 1214-17; Blair & Stout, *supra* note 21, at 318-22.

24. See O'Connor, *supra* note 17, at 1214-17; Blair & Stout, *supra* note 21, at 318-22.; BAINBRIDGE, *supra* note 20, at 421.

25. See Stout, *supra* note 19, at 1200.

26. See Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 592-94 (1992).

support the statutes once they were raised as an issue.²⁷ The takeovers of the '80s seem to have caused much anxiety for many employees and their political supporters, which may have made the statutes popular. An important question is thus the extent and frequency to which hostile takeovers go against the interests of employees.

C. *The Effects of Takeovers*

A related literature has considered the effects of hostile takeovers on various corporate stakeholder groups.²⁸ Takeovers tend to generate a great deal of wealth for the shareholders of target companies. A major question has been whether this increased wealth is due to enhanced productivity and efficiency, or whether it comes in part at the expense of other stakeholders.

Of most interest here is the claim that perhaps some of the gains to target shareholders come at the expense of the employees of the target corporation. One widely cited article by Andrei Shleifer and Lawrence Summers posited that hostile takeovers may serve as ways to break implicit contracts between corporations and their employees.²⁹ Such contracts may exist to help overcome incentive problems created by employee investment in firm-specific human capital. Such investment leaves employees vulnerable to opportunism by management, which may not increase wages as promised in response to the investment. Although there may be other mechanisms, such as corporate reputation, to deal with this problem, Shleifer and Summers suggested that corporations may instill a culture and set of values in managers so that they care about how their decisions affect employees and do not want to break implicit contracts with them, even when it may be in the shareholder's interest to do so. Managers loyal to employees, in other words, may act as a corporate commitment device. Hostile takeovers, which replace such loyal managers with ones who have no ties to existing employees, may breach that commitment. An example may be the classic case of *Cheff v. Mathes*,³⁰ where management bought back shares from a potential hostile acquirer

27. See Springer, *supra* note 2, at 95-96.

28. Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (Alan J. Auerbach ed., 1988).

29. See *id.* at 41-42.

30. 199 A.2d 548 (Del. 1964).

allegedly to alleviate the fears of its sales force. That “allegedly” points to the core problem in this area—it could be that the real point of the share buyback was to protect the current managers.

The Shleifer and Summers article led to much comment and debate, but not all that much systematic empirical investigation. Many anecdotal tales support the story of takeovers leading to drastic cuts in employment and/or wages. However, there is little statistical evidence supporting the claim that such anecdotes are typical.³¹ Indeed, the few empirical studies on point suggest no tendency for hostile takeovers to result in lower wages or employment within the target corporations.³² However, one study by Brian Becker does suggest that takeovers may lead to worsened work conditions for employees.³³ However, Becker reaches this result by examining the differential size of takeover premiums in unionized and non-unionized target firms and finding the premiums are greater in unionized firms. He reasons that unions help employees achieve better work conditions, and that the premiums are higher in unionized firms because the takeovers help shareholders take back those employee gains.³⁴ The point is very interesting, but the empirical evidence he presents is too indirect to be confident in his conclusion. Perhaps the difference between union and non-union firms is due to differences in work conditions, but perhaps there are other reasons for the union/non-union differences. More direct measures of working conditions would be preferable, though difficult to obtain.

Oliver Williamson raised another issue in a comment on the Shleifer and Summers article.³⁵ Shleifer and Summers posit that there are managers who loyally stick by employees even where immediate corporate incentives suggest they should not. Such behavior may be an optimal form of assuring implicit contracts with the employees, but it may instead be an instance of managerial

31. See O'Connor, *supra* note 17, at 1200-02.

32. See Charles Brown & James L. Medoff, *The Impact of Firm Acquisition on Labor*, in TAKEOVERS: CAUSES AND CONSEQUENCES 33 (Alan J. Auerbach ed., 1988); David Neumark & Steven Sharpe, *Rents and Quasi-Rents in the Wage Structure: Evidence for Hostile Takeovers*; Joshua Rosett, *Do Union Wealth Concessions Explain Takeover Premium?: The Evidence on Contract Wages*, 27 J. FIN. ECON. 263 (1990).

33. Brian I. Becker, *Union Rents As a Source of Takeover Gains Among Target Shareholders*, 49 INDUS. & LAB. REV. 3 (1995).

34. See *id.*

35. See Oliver E. Williamson, *Comment*, in TAKEOVERS: CAUSES AND CONSEQUENCES (Alan J. Auerbach ed., 1988).

opportunism. Managers who value a quiet life may make overly generous concessions to employees. The discipline imposed by takeovers may induce management to roll back those concessions. If the firm survives as a result of some employee losses, the remaining employees may be better off.

Thus, it is unclear whether or not hostile takeovers, or the threat thereof, have significantly hurt employee well-being. If they have, it is not clear whether this is due to a socially suboptimal reneging on implicit contracts or rather to an all-in-all beneficial tightening of organizational slack. One possibility is that takeovers lead to worsened working conditions for employees, for which they are not adequately compensated by increased wages. The change in working conditions may indeed lead to a net increase in efficiency (measured in the Kaldor-Hicks sense),³⁶ but may be a loss to employees. I model this possibility in section IV.

D. Employee Governance

Recognizing a fiduciary duty in favor of employees is an indirect way of trying to ensure that corporations are governed in part in the interest of employees. A direct route is to have employees themselves involved in corporate governance. This could take the form of employee share ownership, electing employee representatives to the board of directors, employee involvement in quality circles, work councils, or the like. There is scattered but somewhat substantial literature on employee governance, with much debate over its likely effects.³⁷

Through their jobs employees gain much information about how things are going within a corporation, and how they might go better. Employees often have a good sense of which managers are doing a good job, and which are not. On many matters employees are likely to be better informed than the scattered small shareholders of a public corporation. This may make employees more effective monitors of managers than shareholders.³⁸

36. That is, those who gain are able to compensate those who lose and still be better off after the compensation, although this potential compensation need not actually take place.

37. For a recent selection of related work, see MARGARET M. BLAIR & MARK J. ROE, *EMPLOYEES AND CORPORATE GOVERNANCE* (1999). For a good earlier paper, see Alan Hyde, *In Defense of Employee Ownership*, 67 *CHI.-KENT L. REV.* 159 (1991).

38. See Joseph E. Stiglitz, *Credit Markets and the Control of Capital*, 17 *J. OF MONEY, CREDIT, & BANKING* 133 (1985). Eugene Fama has argued that lower level

Employees, who after all work together daily, may also be better able to overcome collective action problems, which notoriously plague scattered shareholders of a public corporation.

Employee governance may also be an effective commitment device to induce employees to invest in firm-specific human capital. I described above the incentive problems that may stop employees from making such investments. If the employees are assured that decisions will be made with their interests in mind, they are likely to be less worried about any possible holdup problem that may arise after they invest in firm-specific human capital.³⁹

Employee governance may also be an effective motivational device. If such governance increases employee loyalty to the corporation, they may be induced to work harder and better with less monitoring of their effort or with lower wages. They may also be more likely to engage in mutual monitoring of their fellow employees.⁴⁰

Some also advocate employee governance for non-efficiency reasons. Such governance may shift the distribution of income and wealth more in favor of employees, which would please those of an egalitarian bent. Employee governance may be valued for its own sake—both for psychological reasons such as reducing alienation and increasing work satisfaction, and for philosophical reasons tied to the value of democracy.⁴¹

Despite these potential advantages, employee governance is not widely observed. There are debates as to why, but skeptics have pointed to a number of potential disadvantages. External investors in both the bond and equity markets may be reluctant to invest in employee-governed corporations. If employee governance is linked to employee ownership, this may leave employees badly

managers are often good monitors of higher level managers. See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293 (1980).

39. See Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993); Blair & Stout, *supra* note 21. Employees may invest in firm-specific human capital by, e.g., the expenditure of valuable time learning information and procedures that are specific to the firm.

40. See Gregory Dow & Louis Putterman, *Why Capital (Usually) Hires Labor: An Assessment of Proposed Explanations*, in BLAIR & ROE, *supra* note 37, at 25-26; Eugene Kandel & Edward P. Lazear, *Peer Pressure and Partnerships*, 100 J. POL. ECON. 801 (1992).

41. See Brett McDonnell, *ESOPs' Failures: Fiduciary Duties When Managers of Employee-Owned Companies Vote to Entrench Themselves*, 2000 COLUM. BUS. L. REV. 199, 238-41 (2000).

underdiversified. Investment in firm-specific physical capital may be more significant than in firm-specific human capital. Employee ownership or control may discourage external takeovers, thus weakening that source of managerial discipline. Employees as a group may have more divergent interests than shareholders as a group, and so employee involvement in governance may lead to high decision-making costs.⁴² Vesting authority in the board of directors may allow better coordination and monitoring of decisions, and effective vesting of authority may be inconsistent with mechanisms that subject the board to voting on its decisions.⁴³

In this article I do not try to weigh these various benefits and costs of employee governance.⁴⁴ My concern here is with the comparison between corporate constituency statutes and employee governance. Much support of the former seems to stem from a support for the latter. I am sympathetic to the position that their effects are similar. Indeed, I will note some arguments in its favor. It would appear that both the constituency statutes and employee governance are likely to have distributive effects that favor employees, although probably the effects are much stronger in the case of employee governance. I also agree that employees often have a long-term stake in the success of their corporation that at least equals, and often much exceeds, the stake of shareholders. Moreover, employees may well be less able to protect those interests than are shareholders. For instance, exit is generally much easier for shareholders than for employees, at least in public corporations.

However, constituency statutes strike me as inferior to employee governance. For one, where the statutes and employee governance do have similar effects, the latter is likely to have much stronger effects. Thus, if increasing employees' share of the surplus is desirable, then employee governance is likely to achieve this more than constituency statutes. Of course, if one opposes increasing the share employees receive, this will make employee governance appear less attractive.

Furthermore, in at least one important way constituency statutes and employee governance have different effects.

42. See Dow & Putterman, *supra* note 40, for an overview.

43. See BAINBRIDGE, *supra* note 20, at 201-03.

44. Indeed, I am skeptical about our ability to do so in any systematic, persuasive way. See Brett H. McDonnell, *The Curious Incident of the Workers in the Boardroom*, 29 HOFSTRA L. REV. 503 (2000).

Constituency statutes make corporate managers less subject to disciplinary pressures. They weaken the effect of hostile takeovers by helping managers defend against such takeovers. Employee governance, in contrast, is a potentially powerful way of disciplining managers, as employees have much information about the effectiveness of managers as well as incentive to use that information.⁴⁵ I should point out, though, that some argue that employee governance can have very high costs.⁴⁶ I leave to another day discussion of the costs of employee governance.⁴⁷

III. THE BASIC MODEL

One thing at least is clear about the matters discussed in the previous section. More than just shareholders, managers, and the board of directors interact within a corporation. We need to understand how these groups interact with others, and how interactions among these groups affect others. The particular group on which I focus is employees. Standard economic models of firms focus only on shareholders and managers, using a principal-agent model. This clearly needs to be expanded.⁴⁸ In this section I describe and analyze a simple formal model of the interaction among shareholders, employees, and managers. Later sections expand the basic model to include the effects of takeover threats, employee involvement in governance, and constituency

45. The model in this article assumes employee involvement in corporate governance either through a significant ownership stake or else through board representation. It does so by focusing on the ability of employees to replace managers. Employee knowledge and interest, however, may actually be best used at a lower level of the firm. I do not model such lower-level employee governance here. Note that when I speak of an employee ownership share, I mean ownership of the firm in which they work. Involvement in other firms, e.g., through union pension funds, does not fit this model.

46. See, e.g., HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 89-92 (1996); Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469 (1979); Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997) (book review).

47. *But see infra* notes 80-81 and accompanying text.

48. See John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-player Game*, 78 GEO. L.J. 1495 (1990). A notable exception is Jean Tirole, *Hierarchies and Bureaucracies: On the Role of Collusion in Organization*, 2 J.L. ECON. & ORG. 181 (1986). Masahiko Aoki has presented a cooperative bargaining theory of the firm in which employees are featured. See MASAHIKO AOKI, *THE CO-OPERATIVE GAME THEORY OF THE FIRM* (1984).

statutes.

A firm in the basic model has three constituencies: a manager, shareholders, and employees. Only the manager's decisions are explicitly modeled; the reactions of shareholders and employees appear implicitly as effects of those decisions. The manager makes two decisions, one of which is the manager's effort level, x .⁴⁹ A higher effort level leads to higher total output created by the firm, represented by Y .⁵⁰ However, greater effort lowers the private benefits the manager receives, where B represents those benefits.⁵¹

The other variable that the manager controls is the distribution of the output created by the firm. The output is divided among the manager, shareholders, and employees. The manager receives αY , the shareholders receive $S = \beta Y$, where α and β are proportions, and the employees receive $W = (1 - \alpha - \beta)Y$. I assume that α is fixed and that the manager chooses β . Both B and W may be unverifiable, as private benefits to managers and some of the surplus received by employees may take the form of job-related perks and conditions that are hard to measure.

Although this article focuses on takeover threats, employee control, and constituency statutes as ways of controlling managers, there are of course other ways of providing incentives to managers to make decisions in the firm's best interests. These include managerial labor markets,⁵² reputation, and norms.⁵³ I shall not model these and other mechanisms in detail. Rather, I shall use a reduced form approach⁵⁴ by assuming that the returns received by shareholders (S) and employees (W) affect the private benefits that the manager expects to receive (B). For example, if shareholders

49. $x \geq 0$.

50. With $dY/dx > 0$ and $d^2Y/dx^2 < 0$ — the former condition merely says that Y increases as x increases, and the latter is a technical condition needed to ensure that the values given in the first order conditions below actually lead to maximum outputs, not minimum outputs.

51. With $\partial B/\partial x < 0$ and $\partial^2 B/\partial x^2 < 0$ — these conditions are analogous to those in the previous footnote.

52. See Fama, *supra* note 38, at 292-95.

53. See Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001), available at http://papers.ssrn.com/paper.taf?abstract_id=241403 (last visited May 16, 2004); Donald C. Langevoort, *The Human Nature of Corporate Boards: Laws, Norms and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001).

54. That is, rather than explicitly modeling these other mechanisms, I shall just throw their assumed effects into the effects of S and W on B .

receive higher returns, then the manager will have a better reputation and be able to do better in the labor market.⁵⁵ Similarly, if employees receive higher returns, then the manager will have better relations with her fellow employees, will be able to induce the employees to work harder, and will believe that she has better conformed with a norm of fair dealing. Formally, I assume that B is a function of S and W as well as x (the manager's effort level), with increases in either S or W leading to an increase in B .⁵⁶ Given these returns, the manager will choose x and β to maximize $B + \alpha Y$, which is called the manager's objective function.

We want to consider how the manager will choose x and B given this objective function, and in later sections compare those choices with how she would set x and B in the presence of a takeover threat, constituency statute, or employee governance. The tool by which economists determine how such choices are made is called the first order condition—this defines the choices of x and B that maximize the manager's objective function. In Table 1, I have collected the first order conditions for both this version of the model and for the variants on that model, which we shall explore in later sections. For this basic version, the first order condition with respect to x is:

$$\frac{\partial B}{\partial x} = - \left(\alpha + \beta \left(\frac{\partial B}{\partial S} \right) + (1 - \alpha - \beta) \left(\frac{\partial B}{\partial W} \right) \right) \frac{dY}{dx} \quad (1)$$

We can get some perspective on this choice of x by comparing it with the social optimum. Let us for now define the social optimum simply.⁵⁷ Suppose that the social welfare function simply adds the private benefits received by the manager and the net output generated by the firm, $B + Y$. Suppose further that the effects of S and W on B are simply distributional, and do not affect net welfare. Then the social welfare problem is to choose x to maximize $B(x) + Y(x)$. The first order condition is:

$$\frac{\partial B}{\partial x} = - \frac{dY}{dx} \quad (3)$$

Comparing (1) with (3), several points emerge. First, if $\alpha = 1$,

55. See Fama, *supra* note 38, at 292-95.

56. That is, $\partial B / \partial S > 0$ and $\partial B / \partial W > 0$.

57. Later on we shall consider some complications based on distributional concerns. Note that the optimum social welfare is the social optimum.

then the firm achieves the social optimum. This is no surprise: in that case, the manager bears all costs and receives all the benefits.⁵⁸ I assume that wealth constraints and imperfect debt markets require that $\alpha < 1$ —that is, to fund the company the manager must bring in other shareholders. Second, if $\partial B/\partial S = \partial B/\partial W = 1$, then the firm will again achieve the social optimum. That is, if the mechanisms summed up by the effect of S and W on B succeed in making the manager fully internalize the effects her choices of x and β have on shareholders and employees, then we again achieve the social optimum. I shall assume that those other mechanisms have some effect, but they are less than perfect.⁵⁹ Given those two assumptions, the manager's choice of x given by equation (1) will be less than the social optimum given by equation (3). The manager bears the full private costs of effort (B), but gets only a fraction of the gains in output which that effort achieves. Hence, she will work less hard than we would like her to work. Thus, there is room for other mechanisms to help align the incentives of managers with the interests of the other two constituencies.

The manager also must choose the distribution of output between shareholders and employees. The first order condition of the manager's objective function with respect to β is:

$$\frac{\partial B}{\partial S} = \frac{\partial B}{\partial W} \quad (2)$$

The manager equalizes the marginal effects of changes to the shareholders' and employees' shares on the private benefits that the manager receives.⁶⁰

IV. THE THREAT OF A TAKEOVER

In the basic model of section III, the manager has an incentive to expend too little effort—that is, to set x too low. In this section we consider the first of several possible additional mechanisms to

58. This is a standard result.

59. In particular, $0 < \partial B/\partial S, \partial B/\partial W < 1$.

60. I assume that no side bargaining occurs among the manager, shareholders and employees, and I also set aside possible general equilibrium effects. Such effects might limit the ability of those managers to set how much employees and shareholders actually receive. I also assume that the amount received by employees and shareholders, and total output, are not observable by third parties, and thus a legally binding contract cannot be written that sets those levels. This may be, for instance, because a part of the return that employees receive is the quality of their working conditions.

improve the incentives the manager faces. This section introduces the threat that the firm may be taken over and the manager punished, e.g., by being fired. The chances of a takeover are tied to the gains that shareholders receive: the higher the gain to shareholders (S), the lower the probability of a takeover.

Formally, let $p(S)$ be the probability of a takeover, with the probability decreasing as S increases.⁶¹ If there is no takeover, the manager's return is as above. If there is a takeover, then the manager is penalized by an amount P , i.e., her return is $-P$.⁶² The manager's objective function is then $(1 - p)(B + \alpha Y) - pP$.

The first order function giving the manager's choice of effort level x is:

$$\beta \left(\frac{dp}{dS} \right) \left(\frac{dY}{dx} \right) (B + \alpha Y + P) = \quad (5)$$

$$(1 - p) \left(\frac{\partial B}{\partial x} + \left(\alpha + \beta \frac{\partial B}{\partial S} + (1 - \alpha - \beta) \frac{\partial B}{\partial W} \right) \frac{dY}{dx} \right)$$

While slightly complicated, (5) can be fairly easily compared with (1), the first order condition for x in the absence of a takeover threat. For (5) to hold, it must be that x is greater than the x that satisfies (1).⁶³ That is, the threat of a takeover induces the manager to choose a higher effort level x . That is no surprise: because a takeover penalizes the manager, and because increasing x reduces the chances of a takeover, the takeover threat naturally induces the manager to set x higher than if the threat did not exist.

The manager can also determine β . How does the takeover threat affect that choice? The new first order condition for choosing β is:

$$(1 - p) \left(\frac{\partial B}{\partial S} - \frac{\partial B}{\partial W} \right) = \left(\frac{dp}{dS} \right) (B + \alpha Y + P) \quad (6)$$

Because the right-hand side of (6) is negative and $1 - p$ is

61. That is, $dp/dS < 0$. Note that the probability of a takeover with respect to shareholder gain is $p(S)$, but for the sake of clarity, the variable S will be omitted hereinafter.

62. $P \geq 0$.

63. To see this, note that the bracketed expression on the right-hand side of (5) contains (1). Since the left hand side of (5) is negative, and $1 - p > 0$, for (5) to hold we must have: $\partial B/\partial x < \beta \partial B/\partial S + (1 - \alpha - \beta) \partial B/\partial W dY/dx$. Given the second order conditions for $B(x)$ and $Y(x)$, this can happen only if x is greater than the x that satisfies (1).

positive, for (6) to hold we must have $\partial B/\partial S < \partial B/\partial W$.

Comparing this with (2), the condition for choosing β with no takeover threat, and again taking into account the second order conditions, we see that the share that shareholders receive must be set relatively higher with the threat of a takeover than without, meaning that the share that employees receive must be lower. Again, this makes sense. The manager wants to reduce the threat of a takeover, and because the probability of a takeover is tied to how much shareholders receive, the takeover threat induces the manager to increase the relative share of output given to shareholders.

The threat of a takeover thus has divergent effects on the three constituencies. Shareholders are better off: the total output of the firm increases, and their share of that output also increases. Managers are worse off: a takeover, if it occurs, makes them worse off, and in response they devote more effort to increasing firm output than they would if they did not face that threat.

The effect on employees of the takeover threat is ambiguous. On the one hand, the threat increases the total firm output available to be divided up among the constituencies. On the other hand, their share of that output decreases. Either effect could predominate.

What can we say about social welfare as a result of the takeover threat? We saw in the previous section that in the absence of such a threat the manager sets effort too low. The takeover threat increases the manager's effort. Thus, at least for a low probability of takeover, the manager's effort level is closer to the social optimum as a result of the takeover threat. However, there are at least three caveats to that statement.

First, the statement ignores P . If P is merely a redistributive effect rather than a deadweight social loss, that may be acceptable.⁶⁴ If P is a deadweight social loss, then we must revise the social welfare function to equal $B + Y - pP$. The comparison of the social optimum with what the manager chooses is then more complicated.

Second, with a higher probability of a takeover, the incentive can overshoot—that is, the takeover threat can induce the manager to choose x higher than the social optimum.

Third, society may care about distributional effects. As used so

64. Although, see the third caveat in the text below.

far, the social welfare function simply adds the amounts received by the three constituencies. We may, however, care about who receives the net product. For instance, if employees are typically less wealthy than shareholders, and we value income equality, then a mechanism that increases total wealth created but decreases the amount that employees receive may not be attractive.⁶⁵

V. CONSTITUENCY STATUTES AS A SHIELD

The threat of a takeover makes the manager worse off. She is thus willing to take action to reduce or eliminate that threat. This action may itself be costly, e.g., by diverting some of the manager's time and attention that could otherwise be spent on productive activity. Reductions in the probability of a takeover, either achieved by such action or exogenously, will lessen the effects analyzed in the previous subsection. The existence and contours of a court-imposed fiduciary duty on the manager is one factor affecting the probability of a takeover. If courts impose a strict fiduciary duty that discourages antitakeover defenses, then the probability of a takeover will be higher and the manager will be able to lower that probability less with a given expenditure of effort. A weak fiduciary duty has the opposite effect.

Suppose the manager can choose to expend d ⁶⁶ on putting in place takeover defenses that reduce the possibility of a takeover. The probability of a takeover, $p(d, S)$, is now a function of expenditure on d as well as the return to shareholders, with the probability of a takeover decreasing as the manager spends more on d .⁶⁷

The manager now chooses x , β , and d to maximize $(1 - p)(B + \alpha Y) - pP - d$. The first order condition with respect to d is $-\partial p / \partial d (B + \alpha Y + P) = 1$.

65. Law and economics scholars often argue that we should use tax policy to achieve whatever distribution of income we desire. Other legal policies, including corporate law, should be set only to maximize efficiency. The argument is that tax policy redistributes income at less cost to efficiency than do other policies. See Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994). However, recent work calls this argument into question. See Chris W. Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003 (2001); see also Daniel A. Farber & Brett H. McDonnell, *Why (and How) Fairness Matters at the IP/Antitrust Interface*, 87 MINN. L. REV. 1817, 1824-26 (2003).

66. $d \geq 0$.

67. $\partial p / \partial d < 0$ and $\partial^2 p / \partial d^2 < 0$.

Now, imagine that a change in fiduciary duty rules makes it easier for the manager to block a takeover with a given level of expenditure—the (probably weak) effect of current constituency statutes. Formally this means that $|\partial p/\partial d|$ is greater for a given d ; that is, a change in d has a greater effect on decreasing p , the probability of a takeover. From the above first order condition and the fact that $\partial^2 p/\partial d^2 < 0$, this implies that the manager's optimal choice of d will increase. As a result, the probability of a takeover will decrease. This makes sense: if it becomes easier to block a takeover, the manager will spend more on avoiding a takeover.

This change in fiduciary duty has two effects on the social surplus. First, the increase in d is a direct social cost. Second, there is the effect induced by the decreased probability of a takeover. From the previous subsection we saw that a lower probability of a takeover means that the manager chooses a lower level of effort. This lowers the social surplus. It also reduces the manager's incentive to transfer a greater share of the surplus to shareholders. Thus, shareholders are unambiguously hurt by the weakening of the fiduciary duty. The effect on employees is ambiguous: they will get a bigger share of a smaller pie.

VI. EMPLOYEE GOVERNANCE

Now consider the possibility of employee governance as a mechanism for checking managerial opportunism. Suppose that if employees are dissatisfied with their return they might replace the manager. This may be because they have enough votes on the board to remove the manager or possibly through the threat of a leveraged buyout, perhaps financed through an employee stock ownership plan, to take control of the firm.

The model of how this threat works is formally very similar to the model of a takeover threat in section IV. Let $q(W)$ be the probability that employees remove the manager, with that probability decreasing as employees' share of output increases.⁶⁸ If there is no removal, the manager's return is as in section II. If employees remove the manager, then the manager receives a return of $-P$.⁶⁹ The manager's objective function is then $(1 - q)(B +$

68. $dq/dW < 0$. Note that although the probability that employees will remove the manager is $q(W)$, for clarity, the variable W will be omitted hereinafter.

69. $P \geq 0$.

$\alpha Y) - qP$.

The first order condition with respect to x is:

$$(1 - \alpha - \beta) \left(\frac{dq}{dW} \right) \left(\frac{dY}{dx} \right) (B + \alpha Y + P) = \quad (7)$$

$$(1 - q) \left(\frac{\partial B}{\partial x} + \left(\alpha + \beta \frac{\partial B}{\partial S} + (1 - \alpha - \beta) \frac{\partial B}{\partial W} \right) \frac{dY}{dx} \right)$$

We should compare (7) with (1), the first order condition for the choice of effort in the absence of a takeover threat and employee governance, and with (5), the first order condition for choosing effort with a takeover threat. By the same argument as with the comparison of (5) with (1), the threat of employee removal induces the manager to choose a higher effort level x than if there is no such threat and no takeover threat.⁷⁰ The intuition is also the same: the manager will work harder to increase output, and hence how much the employees receive, and thereby reduce the chances of being fired.⁷¹ It is less straightforward to compare the choice of effort under the threat of employee removal as opposed to under the threat of a takeover—it depends on the relative responsiveness of p and q (the probabilities of removal) to changes in S or W (the amount of output received by shareholders or employees).

The manager can also set β . The first order condition for this choice under the threat of employee removal is:

$$(1 - q) \left(\frac{\partial B}{\partial W} - \frac{\partial B}{\partial S} \right) = \frac{dq}{dW} (B + \alpha Y + P) \quad (8)$$

Because the right-hand side of (8) is negative and $1 - q$ is positive, for (8) to hold we must have $\partial B / \partial W < \partial B / \partial S$.

Comparing this with (2), the condition for choosing β with no takeover or employee removal threat, and with (6), which holds under the threat of a takeover, and taking into account the second order conditions, we see that the share that employees receive must be set relatively higher with the threat of employee removal than if neither threat exists, and the employee share is higher with neither threat than with a threat of a takeover. Managers want to reduce

70. See *supra* note 63 and accompanying text.

71. See Section IV.

the threat of being removed. When that threat comes from employees, they see that employees get more of the firm's surplus; when the threat comes from shareholders, managers give them a greater share of the pie.⁷²

The threat of employee removal is thus the mirror image of the takeover threat analyzed in section IV. It has mirror effects on the three constituencies in our model. Employees are now better off than with no threat: the total output of the firm increases, and their share of that output also increases. Managers are worse off: employee removal, if it occurs, negatively affects managers, and in response they put forth more effort than they would in the absence of a threat. The effect on shareholders is ambiguous as compared with the case of no threat: total firm output is higher due to the threat of removal, but the shareholder share of that output decreases.

VII. CONSTITUENCY STATUTES AS A SWORD

Finally, consider a different possible application of the fiduciary duty concept. In section V the manager's fiduciary duty was considered insofar as it affected the manager's ability to defend against a takeover threat. The fiduciary duty concept could instead be applied directly to the manager's decision-making within the firm. If either shareholders *or* employees believe that the manager has behaved in a way that does not maximize returns to the firm, they could sue and seek to have the manager disgorge her gains. Assuming that employees can sue goes beyond current corporate constituency statutes, which do not grant standing to employees.⁷³

The formal model of this possibility is similar to that for the takeover threat and the threat of removal by employees. Suppose that with some probability the manager will be found guilty of a violation of fiduciary duty, $r(Y)$.⁷⁴ An individual shareholder or employee chooses whether or not to sue the manager for breach of fiduciary duty. The probability of liability is a decreasing function of the surplus generated by the firm, Y .⁷⁵ If the manager is found liable she is penalized by an amount, L ; otherwise, she receives the

72. See generally Mitchell, *supra* note 26.

73. See *supra* note 7 and accompanying text.

74. Note that although the function $r(Y)$ is the probability that the manager will be found guilty of a fiduciary duty violation, for clarity, the variable Y will be omitted hereinafter.

75. Thus, $dr/dY < 0$, and $d^2r/dY^2 < 0$.

managerial return as defined in section III.

The manager's objective function is now $(1 - r)(B + \alpha Y) - rL$. The first order function with respect to x is:

$$\left(\frac{dr}{dY}\right)\left(\frac{dY}{dx}\right)(B + \alpha Y + L) = \quad (9)$$

$$(1 - r)\left(\frac{\partial B}{\partial x} + \left(\alpha + \beta \frac{\partial B}{\partial S} + (1 - \alpha - \beta)\frac{\partial B}{\partial W}\right)\frac{dY}{dx}\right)$$

Comparing (9) with (1), the first order condition in the absence of a threat of suit, takeover, or employee removal, we see by the same logic as with (5) and (7) above that (9) results in a higher choice of effort, x , and hence higher firm output, Y .⁷⁶ Again, the choice of x in the presence of the threat of a lawsuit is trickier as compared with the choice of x under the takeover and employee removal threats, depending on the relative responsiveness of p , q , and r to changes in the amount received.

The other choice variable is the share that employees receive. The first order condition for this is:

$$\frac{\partial B}{\partial W} = \frac{\partial B}{\partial S} \quad (10)$$

Expression (10) is the same expression as (2), which gives the distributive choice in the absence of any of the three threats considered in the elaborations of the basic model.⁷⁷ That is, unlike the takeover and employee removal threats, the lawsuit threat considered here does not induce the manager to shift the distribution of the surplus from employees to shareholders or vice versa. That is because in this model, both shareholders *and* employees can sue for a violation of fiduciary duty. The chances of getting sued only depend on the total income produced, Y , not on how much goes to either of the two constituencies. Note how this varies from current practice. As things stand, only shareholders can sue for a violation of fiduciary duty. One would thus expect this to induce managers to transfer income to shareholders. Expanded constituency statutes that gave employees standing to sue as well would change that effect.

Although formally similar (in this model) to the threats of

76. See *supra* notes 62 and 69 and accompanying text.

77. The first order condition is actually $-dr/d\beta(B + \alpha Y) + (1 - r)(\partial B/\partial W + \partial B/\partial S)Y - dr/d\beta * L = 0$. However, since r depends only on Y and changing β does not affect Y in this model, $dr/d\beta = 0$ and this expression reduces to (10).

takeover and removal by employee, there are a variety of reasons to expect that this use of fiduciary law would add less to the disciplining of managers. First, the penalty imposed on the manager is typically weaker, i.e., $L < P$.⁷⁸ Second, courts are generally reluctant to find liability in managerial operating decisions, a reluctance doctrinally expressed by the business judgment rule.⁷⁹ Formally, this means that r is likely to be near 0. Third, if courts are not very good at determining whether a manager's actions have subtracted value from the firm, then the probability of liability will not be very responsive to performance, i.e., $\partial r / \partial Y$ is likely to be small. Of course, these effects also imply that while the fiduciary duty check is unlikely to act as a strong deterrent, it is also less likely to over-deter and induce a higher-than-optimal effort level, a risk that all three mechanisms share in theory.

One must compare the costs of the mechanisms as well as their benefits. The takeover mechanism involves monitoring by outside takeover specialists of many potential targets, plus the considerable costs involved in the takeover itself. Moreover, managers may engage in costly defensive actions that reduce the chances of a takeover without increasing output. Monitoring costs of employee governance may be relatively low, as employees monitor how managers are performing as a byproduct of doing their jobs, but employees may face significant collective action costs in coordinating their decision-making,⁸⁰ and there may be influence costs as managers lobby employees to preserve their jobs.⁸¹ Litigation costs are the most obvious cost for the fiduciary duty mechanism. There may also be some costs in monitoring and searching for firms where suits have a good chance of success, although allowing employees to sue may reduce these costs considerably. The legal mechanism reduces or eliminates the collective action issues that occur for the removal mechanism. The legal mechanism may create some incentive to take costly action to reduce the chance of a suit, although offhand this would seem a

78. See generally FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.1.3 (2000).

79. See BAINBRIDGE, *supra* note 20, at 269-86.

80. The problem arises because employees typically have more diverse interests in the corporation than do shareholders, and hence more cause for dispute. See HANSMANN, *supra* note 46, at 89-92.

81. See Paul Milgrom & John Roberts, *Bargaining Costs, Influence Costs, and the Organization of Economic Activity*, in PERSPECTIVES ON POSITIVE POLITICAL ECONOMY (J. Alt & K. Shepsle eds., 1990).

less-serious problem than the comparable incentives arising under the other two mechanisms. Thus, it seems the legal mechanism is likely to provide low expected benefits, but also low costs, as compared to the other two.

VIII. DISCUSSION AND CONCLUSION

Theoretical analyses like those in sections III through VII above, without more, prove nothing about the real world. I hope the models presented are suggestive, however. In particular, I hope to have suggested the following points.

- A. *Economic models should take into account a variety of stakeholder groups beyond managers and shareholders.*

Although in theory the nexus of contracts approach to the corporation⁸² recognizes that many different groups interact through the corporate form, most formal models of the corporation use a principal/agent framework that focuses on managers as the agents of shareholders and ignores employees. Separate models treat employees as agents of the firm. Modeling needs to go beyond this framework and consider the simultaneous interaction of managers, shareholders, and employees. The models of sections III through VII have considered how executive compensation, takeover threats, fiduciary duty, and employee governance may affect the behavior of shareholders, managers, and employees, and in turn how the equilibrium outcomes affect the payoffs that those three parties receive. The model used is quite simple, and merely illustrative. Although some work has gone beyond the shareholder/manager model,⁸³ more needs to be done.

- B. *Although most commentators have concluded that transfers from employees are not an important factor in hostile takeovers, that issue is far from conclusively decided.*

After Shleifer and Summers suggested that observed shareholder gains from takeovers may be explained in part by losses to other stakeholders, and in particular employees of target corporations, a relatively modest amount of empirical literature has

82. See *supra* notes 17-18 and accompanying text.

83. See *supra* note 48.

examined this point.⁸⁴ The widely believed verdict on this point is that transfers from employees or other stakeholder groups to shareholders are small to nonexistent. In the case of employees, the literature has mainly focused on data concerning employment and wage levels, finding little evidence of drops in either as a response to hostile takeovers.

The model presented here raises at least two questions about this conclusion. First, it may well be the *threat* of hostile takeovers, rather than the actual occurrence of takeovers, has the main effect. Note that it is this threat of takeovers, rather than the actual aftermath of a finished takeover, on which the above models focus. Testing the effect of threatened takeovers on employees rather than executed takeovers is much harder, and I do not believe it has been done yet. Second, the harm to employees may come not in layoffs or wage cuts, but rather in uncompensated or undercompensated worsening of employment conditions—harder work, longer hours, less generous training, and so on. The only paper I am aware of that has tried to test for such harms has found a significant effect.⁸⁵ The variable used in that paper is crude enough that the result is far from conclusive, but it is at least suggestive.

C. There is a redistributive argument in favor of a fiduciary duty favoring employees.

If one finds the previous point plausible, namely that takeovers and takeover threats can harm employees, then it is not clear that fiduciary duties should run only in favor of shareholders. Sections III through V found that managerial opportunism can reduce the total surplus, that the takeover threat can limit this effect, and hence that a weakened fiduciary duty that allows managers to defend against takeovers more easily will tend to reduce the total social surplus. However, because the takeover threat may hurt employees, the revised fiduciary duty may help them by reducing that takeover threat. If one is firmly convinced in the goal of Kaldor-Hicks efficiency and nothing else, then so what? However, Kaldor-Hicks efficiency, more than Pareto efficiency, can be questioned as a social goal. This is particularly true where efficiency suggests a scheme that benefits shareholders at the

84. See *supra* notes 31-34 and accompanying text.

85. See Becker, *supra* note 343.

expense of employees, given that shareholders are on average wealthier than employees. Although the standard law and economics line is that redistributive goals should be ignored in a policy area such as this, and instead pursued through tax and transfer instruments, this line has come under some attack.⁸⁶

D. While a revised fiduciary duty and increased employee governance may both help tilt the playing field toward employees, the revised fiduciary duty does so at the cost of lessened discipline of managers, while employee governance provides a new tool for strengthening the discipline of managers.

Although I am not nearly as opposed to constituency statutes as many writers on the subject, they do strike me as problematic. The problem is that their main effect is loosening court-imposed discipline on corporate managers. Although this may help employees in the takeover context,⁸⁷ the statutes come at a cost. True, a revised fiduciary duty could be used outside the takeover context to affirmatively push managers to take actions that favor groups other than just shareholders (as modeled in section VII). However, for a variety of practical reasons this use of the constituency statutes seems unlikely. Not only does the business judgment rule and the limited capacity of courts work against it, but the limits of the statutes themselves also strongly discourage this use.⁸⁸

In contrast, employee involvement in corporate governance works as a potentially powerful additional mechanism to control managerial opportunism and to direct the corporation toward greater efficiency. Employees have an abundance of information on the functioning of the corporation and managers, and incentives to use that information to improve the corporation's performance, if given a way to do so.⁸⁹ Although a variety of mechanisms exist to limit managerial opportunism, this is a potentially powerful alternative with much to commend it. This is not to deny the many objections to employee involvement in governance, nor to try to resolve the numerous issues that arise in

86. See *supra* note 65.

87. As mentioned above, the effect of these statutes has actually been, in all likelihood, quite limited, either for good or for bad.

88. See *supra* notes 76-77 and accompanying text.

89. See *supra* note 38 and accompanying text.

considering it.⁹⁰ That goes beyond the bounds of this article. My point here is simply that employee governance is potentially a much more powerful and useful reform than corporate constituency statutes. Still, if employee involvement in corporate governance is otherwise undesirable or politically infeasible, and if the distributive effect of takeovers on employees is of great concern, constituency statutes may be defensible. I do not believe there is currently enough systematic evidence of a strong negative effect of takeovers on employees for this argument to persuade me, on balance.

To restate the basic point: the threat of a takeover serves to discipline managerial opportunism. However, it also makes managers shift returns to shareholders from other groups, such as employees, because a high return to shareholders reduces the probability of a takeover. Constituency statutes, to the extent they do anything, reduce the distributive effect of takeovers by reducing the probability of takeovers, and thus also reduce the positive disciplinary effect takeovers provide. Employee governance can function like a takeover threat to impose discipline on managers. Unlike takeovers, employee governance induces managers to shift returns from shareholders to employees, as high returns to employees become more important to managers' well-being. Thus, employee governance may achieve the distributive shift from shareholders to employees that justifies constituency statutes, with lower managerial misbehavior.

I realize that I have not gone into much detail in this article as to exactly what I mean by employee governance. As noted earlier,⁹¹ the formal model focuses mainly on forms of governance that give employees the ability to remove managers. Thus, employee representation on the board of directors, or forms of large-scale employee ownership that allow employees to vote for the board, are what I have in mind here. These forms of employee governance are especially attractive if one believes that employees, through their daily activities, naturally gain pertinent information about the performance of high-level managers. If one instead believes that employees have a particular advantage in information that is most useful at lower levels of decision-making, then other forms of employee governance, such as works councils or quality circles, may

90. See *supra* notes 41-43 and accompanying text.

91. See *supra* note 45.

be more attractive. These different forms of employee governance may also differ in their costs. I will have to tackle those issues in a later article.

I should mention one argument that is sometimes made in defense of constituency statutes. Even after acknowledging their limits, supporters sometimes argue that the statutes may help to move values and beliefs in the direction of greater involvement of employees and other stakeholders in corporate governance.⁹² This argument fits with a recent spate of work on the norm-influencing effects of law.⁹³ This is not the place to evaluate that work. However, at least in the context of constituency statutes, any effect of those statutes on popular beliefs or values is certainly very far from proven. I find it hard to believe that relatively obscure corporate law statutes, which have been very rarely invoked in practice, have had or will have much influence on public norms.

Scholars and activists who yearn for greater employee involvement in corporate governance should advocate measures that successfully accomplish this goal. Whether this should be through private or public initiative, or indeed whether it is ultimately an attractive goal at all, are questions I leave for another day. However, telling corporate managers that they should, or may, take employee interests into account does nothing to make employees themselves actually more involved in decision-making. Nor do other arguments, on balance, make a compelling case in favor of corporate constituency statutes.

92. See Mitchell, *supra* note 26, at 641-43; Katherine Van Wetzel Stone, *Employees As Stakeholders under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 69-72 (1991).

93. For examples in the corporate law area, see *supra* note 53.

Table 1: First Order Conditions for Choice of x and β in Various Versions of the Model

Basic version: Choice of x	(1) $\frac{\partial B}{\partial x} = - \left(\alpha + \beta \left(\frac{\partial B}{\partial S} \right) + (1 - \alpha - \beta) \left(\frac{\partial B}{\partial W} \right) \right) \frac{dY}{dx}$
Basic version: Choice of β	(2) $\frac{\partial B}{\partial S} = \frac{\partial B}{\partial W}$
Social optimum: Choice of x	(3) $\frac{\partial B}{\partial x} = - \frac{dY}{dx}$
Takeover threat: Choice of x	(5) $\beta \left(\frac{dp}{dS} \right) \left(\frac{dY}{dx} \right) (B + \alpha Y + P) =$ $(1 - p) \left(\frac{\partial B}{\partial x} + \left(\alpha + \beta \frac{\partial B}{\partial S} + (1 - \alpha - \beta) \frac{\partial B}{\partial W} \right) \frac{dY}{dx} \right)$
Takeover threat: Choice of β	(6) $(1 - p) \left(\frac{\partial B}{\partial S} - \frac{\partial B}{\partial W} \right) = \left(\frac{dp}{dS} \right) (B + \alpha Y + P)$
Employee governance: Choice of x	(7) $(1 - \alpha - \beta) \left(\frac{dq}{dW} \right) \left(\frac{dY}{dx} \right) (B + \alpha Y + P) =$ $(1 - q) \left(\frac{\partial B}{\partial x} + \left(\alpha + \beta \frac{\partial B}{\partial S} + (1 - \alpha - \beta) \frac{\partial B}{\partial W} \right) \frac{dY}{dx} \right)$
Employee governance: Choice of β	(8) $(1 - q) \left(\frac{\partial B}{\partial W} - \frac{\partial B}{\partial S} \right) = \frac{dq}{dW} (B + \alpha Y + P)$
Constituency statute as sword: Choice of x	(9) $\left(\frac{dr}{dY} \right) \left(\frac{dY}{dx} \right) (B + \alpha Y + L) =$ $(1 - r) \left(\frac{\partial B}{\partial x} + \left(\alpha + \beta \frac{\partial B}{\partial S} + (1 - \alpha - \beta) \frac{\partial B}{\partial W} \right) \frac{dY}{dx} \right)$
Constituency statute as sword: Choice of β	(10) $\frac{\partial B}{\partial W} = \frac{\partial B}{\partial S}$

Table 2: Variables, Functions, and their Values

Variable	Represents
x	Manager's Effort Level
Y	Firm Output
B	Private Benefits Manager Receives
W	Benefits Employees Receive
S	Benefits Shareholders Receive
P	Amount Manager is Penalized if a Take-Over Occurs
L	Amount Manager is Penalized if Found Liable for Breach of Fiduciary Duty
d	Amount Manager Spends on Implementing Takeover Defenses
Function	Represents
q(W)	Probability that Employees Remove Manager
r(Y)	Probability that Manager will be Found Guilty of a Fiduciary Duty Violation
p(S)	Probability of a Takeover
p(d, S)	Probability of a Takeover if a Manager is Able to Implement Takeover Defenses

