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Employee Primacy, or Economics Meets Civic Republicanism at Work

Brett H. McDonnell*

This paper argues for employee primacy in corporate governance. "Employee primacy" has two elements: ultimate employee control over the corporation, and an objective of maximizing employee welfare. In methodology, the argument draws both upon economics, understood more broadly than in most corporate law scholarship, and upon civic republican ideas. The paper presents four different arguments favoring employee primacy. (1) Employee primacy is likely to create the most surplus within the corporation due to incentive effects and the wealth of information that employees possess. (2) Corporations characterized by employee primacy are more likely to be socially responsible, and hence generate fewer negative externalities, than corporations characterized by shareholder primacy. (3) Employee primacy will lead to a more egalitarian distribution of wealth and political power. (4) Employee primacy will produce citizens better fit to participate within a political democracy.

Introduction

The rise of law and economics scholarship in corporate law has been connected to a strengthened focus on a shareholder primacy¹ model of corporate governance. Law and economics-based scholarship began to dominate corporate

* Associate Dean for Academic Affairs and Professor, University of Minnesota Law School. I thank Bernard Adell, Brian Bix, Bernie Black, Kent Greenfield, Frank Gevurtz, Mark Gould, Claire Hill, Peter Huang, Kate Litvak, Martin Malin, David McGowan, Beth Mintz, Larry Mitchell, Eric Rasmussen, Paul Rubin, Chantal Thomas, Tom Tyler, Dirk Zetsche, and participants in the 2005 Sloan Program for the Study of Business in Society Retreat and the 2005 meetings of the Canadian Law and Economics Association and the Midwestern Law and Economics Association for very helpful comments on an earlier draft.

¹ By "shareholder primacy" I mean both shareholder control of ultimate decision-making power within a corporation (i.e., through election of the board of directors) and the goal of maximizing shareholder wealth. See *infra* notes 13 through 16 and accompanying text.

law scholarship in the seventies and eighties. The work of Frank Easterbrook and Daniel Fischel is emblematic of the growing influence of law and economics in corporate law. They wrote a series of influential law review articles in the eighties, culminating in their now-classic book, *The Economic Structure of Corporate Law*.² At around the same time, corporate governance scholarship, activism, and legal rules and decision-making increasingly came to focus on maximizing the value of corporate shares as the main objective of corporate law and life. The work of Easterbrook and Fischel reflects this focus on shareholders, and helped to create it.³ Nowadays, law and economics, in softer and harder versions, has come to be the dominant mode of analysis in corporate law scholarship, and shareholder primacy is widely though not universally accepted as the goal of corporate law.⁴

These trends are not inevitable. Law and economics is not the only way to think about corporate law. Even if one does accept a law and economics methodology, doing so does not entail that shareholder primacy is the proper goal of corporate law. I challenge shareholder primacy as the appropriate model for corporate law, arguing instead for employee primacy in corporate decision-making. "Employee primacy" has two elements: ultimate employee control over the corporation, and the maximization of employee welfare.

I defend employee primacy using two different sets of ideas. The first is law and economics, but applied more broadly than usual within corporate law scholarship. I recognize that corporate law has effects well beyond those usually considered, and applying economic reasoning to that wider range of effects can lead to very different conclusions about the optimal shape of corporate law.⁵ The second set of ideas is civic republicanism. Writing on civic republicanism and on corporate law rarely overlaps, but republican ideas can offer a very useful perspective on corporate law. In my hands, at least, we will see much convergence between civic

² FRANK EASTERBROOK & DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

³ See *id.* at 36-39.

⁴ For a particularly strong recent statement on the dominance of shareholder primacy, see Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439 (2001). The many papers of Lucian Arye Bebchuk exemplify the contemporary approach.

⁵ In doing so this article shares much in common with a recent essay by William Klein, which briefly but perceptively lays out the many different possible criteria one can use in evaluating corporate law. See William Klein, *Criteria for Good Laws of Business Association*, 2 BERKELEY BUS. L.J. 13 (2005).

republicanism and a broadened approach to law and economics. I will focus on several themes from civic republicanism. Active involvement in affairs affecting one's life is important and valuable. Overly-great income and wealth inequality threaten political democracy. Politics can and should strive to understand and realize public good through political deliberation. Such deliberation in turn can help citizens become virtuous and flourish as human beings.⁶

In this essay, I will apply both civic republican ideals and a broader than usual understanding of economics to thinking about the choice between shareholder primacy and employee primacy. Various forms of employee participation in corporate governance present a deep challenge to the shareholder primacy vision of the corporation. Should employees have a significant role in making decisions within the corporation, and if so, what decisions? Should employees elect some or all members of the board of directors? Should the interests of employees count in deciding what a corporation should do, even when employee interests clash with shareholder interests?

I present four different arguments favoring employee primacy:

(1) Employee primacy is likely to create the most surplus within a corporation due to incentive effects and the wealth of information that employees possess;⁷

(2) Corporations characterized by employee primacy are more likely to be socially responsible, and hence generate fewer negative externalities, than corporations characterized by shareholder primacy;⁸

(3) Employee primacy will lead to a more egalitarian distribution of wealth and political power;⁹ and

(4) Employee primacy will produce citizens better fit to participate within a political democracy.¹⁰

The foregoing arguments suggest that employee primacy is attractive for many reasons. A major question, then, is why we observe so little employee participation in corporate governance, if its benefits are as great as suggested here. Shouldn't firms that create such large benefits for their participants tend to do well within a free market that allows them to grow and compete with other sorts of

⁶ See *infra* section III.

⁷ See *infra* section IV.

⁸ See *infra* section V.

⁹ See *infra* section VI.

¹⁰ See *infra* section VII.

businesses? I suggest two responses to this challenge.¹¹

First, businesses that adopt employee primacy may lack supporting institutions, such as laws, that shareholder-run businesses enjoy in an economy where the latter predominate. Success may breed success, and failure may breed failure. Second, many of my arguments for employee primacy suggest external effects on groups outside the core constituencies within corporations, and there is no good reason to expect that markets on their own will cause corporations to internalize those externalities. These two arguments suggest gains to be had from interventions favoring employee primacy. However, we must approach with care – possible gains from intervening will not always translate into actual gains. Therefore, rather than requiring employee primacy of all corporations, I advocate more restrained efforts such as subsidies, tax breaks, default rules of employee board representation, and well-developed schemes of employee representation which would provide corporations with an expanded menu of options.¹²

This paper tackles a wide range of arguments against shareholder primacy, each of which is quite involved. I plan to explore many of the specific arguments more fully in future work. However, the arguments are inter-related, and addressing them as a whole enables us to develop a broader context by which we can understand each individual argument more fully. What follows, then, is both a sketch of and a preliminary defense for a research agenda on the role of employees in corporate governance. Though only a preliminary sketch, the story it is trying to tell is of central importance to modern economic and political life. Since at least the mid-nineteenth century we have struggled with how to reconcile the efficiency of large corporations with a vision of ordinary, hard-working people working together as equals to create a better, more democratic community. Employee primacy can help bring together competing themes that have dominated the American story for much of its history.

I. Employee v. Shareholder Primacy

Observers of American corporate law have perceived a shareholder primacy norm,¹³ although one can dispute that perception.¹⁴ Stephen Bainbridge has broken

¹¹ See *infra* section VIII.

¹² See *infra* section IX.

¹³ The number of possible references for this point is huge. Just to take some of the leading lights, see Adolf Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE*

down this norm into two parts: (1) the objective function of the corporation should be to maximize shareholder wealth, and (2) shareholders should have ultimate control over the corporation (via ultimate control over the board of directors).¹⁵ The assumed objective function appears mainly in fiduciary duty cases. As noted, it is debatable how often courts really characterize that duty as running to shareholders, rather than to the corporation generally, but, at least on occasion, courts do explicitly focus on shareholders.¹⁶ Shareholder election of directors, shareholder approval of fundamental changes, and the ability of only shareholders to sue for violations of fiduciary duty are the main sources of ultimate shareholder control over the corporation.

This paper presents employee primacy as an alternative to shareholder primacy.¹⁷ Employee primacy challenges both parts of the shareholder primacy

LAW 36-38 (1991); Henry Hansmann & Reinier Kraakman, *supra* note 4; 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).

¹⁴ See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002).

¹⁵ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 573 (2003). Bainbridge accepts the first principle while rejecting the second. Jill Fisch points out a third part to the norm: scholars use measures of shareholder value, e.g. stock price event studies, to evaluate the effectiveness of corporate law rules. See Jill Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006). This is an important point, but not particularly relevant for the argument in this paper, so I will focus on the two elements of shareholder primacy stated in the text.

¹⁶ The classic case is *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919). Even *Dodge* has serious limits—the court did mandate the payment of a dividend to shareholders, but it refused to require Ford to limit the expansion of its operations as the plaintiffs had requested. A major more-recent case is *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), which explicitly recognizes the principle of shareholder wealth maximization, although *Revlon* duties arise in quite limited circumstances. *Blasius Industries v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) explicitly recognizes the principle of ultimate shareholder control as central to the legitimation of board authority, but again it applies in limited circumstances. Much of the time the business judgment rule blunts any strong duty to shareholders. See Smith, *supra* note 14, at 309-10. Indeed, *Dodge* is hard to square with the business judgment rule.

¹⁷ One could consider other groups as well—for instance, creditors, suppliers, customers, and local communities. I will largely ignore these others (with a limited exception in section V). In part that is because I am taking on quite enough in my consideration of employees here, but in part it is because I believe that employees have a deeper claim to consideration and involvement in the corporation. The corporation is central to the life and livelihood of its employees in ways that are generally not true for other constituent groups.

norm. A strong version of employee primacy would recognize two principles: the maximization of employee well-being as the corporation's objective function, and ultimate employee control over decisions within the corporation. Employee control over decision-making can take many different forms. It helps to think about the different forms of employee participation as varying along several different axes:

Employees may participate in decisions at different levels of a business. If employees elect the board of directors, they are participating at a high level in the broadest decisions affecting the business. If employees elect representatives to a workplace safety committee within one particular plant, they are participating in decisions that are narrower both as to the type of decision and as to how much of the business is affected.¹⁸

Employees may directly participate in a decision or elect representatives who will act for them.

Which employees participate may vary, ranging from a small subset of employees to all employees of the corporation.

Employees may help participate in a broad range of decisions, or only limited types of decisions. For instance, employee involvement could be limited to decision affecting workplace safety.

Employees may have sole discretion over a particular decision, or may share decision-making authority with other groups. If they share authority, employees' share in that authority may vary from a majority voice, to an equal voice, to a minority voice.

Employees could be given the sole standing to sue in derivative actions, or could share that standing with shareholders or other groups.

The various arguments for and against employee primacy will be more or less salient depending on what form of employee participation one considers. To focus discussion, most of the time I will focus on a version of employee primacy that is vigorously opposed to shareholder primacy: election of the board of directors by all employees of the corporation and only by employees of the corporation, with employee welfare maximization as the corporation's objective. I will note, however,

Employees also typically know more about what is going on within the corporation than other groups. See *supra* section IV.

¹⁸ As an example, mandatory employee participation in Germany takes both forms. Under codetermination, employees elect a certain percentage of the supervisory board. Employees also choose representatives to works councils which help make specified decisions at lower levels of the business. See *infra* note 188.

places in the argument where points raised apply more strongly to less pure variants of employee primacy. My main focus is on decision-making rather than the objective function; sometimes I will speak of employee participation, rather than employee primacy, to emphasize this focus.

As I have noted, the general objective of this paper is to compare employee primacy with shareholder primacy. However, just as employee primacy comes in various forms, shareholder primacy looks different in different types of corporations as well. Indeed, we can classify versions of shareholder control along the same dimensions as for employee participation:

Shareholders may participate in decisions at different levels of a business. The basic rule is that shareholders elect the board, must approve specified board-initiated fundamental changes such as mergers and amendments to the certificate of incorporation, and may amend the bylaws, whose permitted scope is disputed.¹⁹ However, under some circumstances shareholders may be able to take control over lower-level decisions usually left to the board or officers.

Shareholders may directly participate in a decision or elect representatives who will act for them—electing representatives is far and away more common.

Which shareholders participate may vary—some shares may be non-voting, other shares may vote only under specified circumstances, and some shares may have super-voting rights.

Shareholders may have sole discretion over a particular decision, or may share decision-making authority with other groups.

Shareholders may have sole standing to share in derivative actions, or could share standing with employees or other groups.

A key distinction among shareholder-run businesses is between close corporations and public corporations. In the latter, shares are publicly traded and there are many shareholders; in the former, there are a small number of shareholders who are often more actively involved in corporate decision-making, indeed are themselves often directors and officers. Shareholders thus typically participate much more actively in close corporations than in public corporations. Moreover, close corporations are typically much smaller and thus represent much less concentrated wealth and power. This suggests that civic republicans might look more favorably upon close corporations than public corporations. As I will show,

¹⁹ See Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L. J. 205 (2005).

they would be right to do so.²⁰ It is also true that some perceived problems with close corporations might suggest problems with employee primacy.

II. Economics and Civic Republicanism

The methodology of this paper uses arguments from both economics and from civic republicanism and related philosophical and political movements. This section lays out some relevant basic background ideas from economics and civic republicanism. The following sections will then apply those ideas in comparing employee and shareholder primacy.

The standard law and economics approach to corporate law advocates shareholder primacy.²¹ This is actually somewhat puzzling. After all, a leading concept in the early application of law and economics to corporate law was the idea of the corporation as a nexus of contracts. The corporate form is a useful legal fiction that covers the essentially contractual, market-based interactions between a variety of different parties: shareholders, employees, creditors, customers, suppliers, and so on.²² If so, then why do shareholders, among all of these groups, deserve special

²⁰ My focus in this paper is purely on corporations. Considering other forms of business associations would bring in yet more variety of forms. Thus, some partnerships may resemble shareholder-run corporations, while others may look more like employee-run corporations. Even in thinking about corporations, the opposition between shareholder primacy and employee primacy does not exhaust the possibilities. For instance, Stephen Bainbridge accepts the shareholder wealth maximization norm but sees ultimate control as vesting in the board, not shareholders. See Bainbridge, *supra* note 15. Alternatively, one could agree with Bainbridge on ultimate board control, but reject shareholder wealth maximization in favor of either employee wealth maximization or maximizing the combined wealth of a variety of corporate constituencies—the work of Blair and Stout is at least close to that view. See Blair & Stout, *supra* note 14. To keep the tale from becoming too tangled, I will mostly limit myself to shareholder primacy versus employee primacy in corporations, with occasional asides on alternatives, mostly in footnotes such as this one.

²¹ In addition to the sources cited in note 13, see, e.g., ROBERTA ROMANO, *THE GENIUS OF AMERICAN LAW* (1993); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1921 (1996). The ubiquity of the shareholder wealth maximization goal in law and economics scholarship also appears in empirical work that uses changes in shareholder value as the only measure of interest. See Jill E. Fisch, *supra* note 15. It is worth noting, though, that while most law and economics scholars endorse a shareholder primacy norm, many of those same scholars also endorse a strong version of the business judgment rule, out of a belief that market mechanisms adequately protect shareholders and a skepticism about the value of judicial intervention. A strong business judgment rule, however, seriously limits the legal enforceability of a shareholder wealth maximization norm. See Blair & Stout, *supra* note 14, at 299-300.

²² The nexus of contracts approach was taken from Michael C. Jensen & William H.

legal protection? Even if we are focused on maximizing the net social wealth generated within the typical corporation, it is not obvious that shareholder primacy achieves that. Most of the debate over shareholder primacy to date focuses on this question of what legal rules best maximize the net wealth generated for constituencies clearly within the corporation, and we will consider that debate and ask what civic republican ideas might add to it.²³

But the focus of law and economics on shareholder primacy is puzzling for broader reasons. Economics need not inevitably confine itself to the net social wealth generated for one group within a corporation. It takes a complex chain of reasoning to reach the point of shareholder primacy. Economics is concerned with maximizing some measure of net social welfare generated for society as a whole, taking into account the full range of direct and indirect effects of a given set of policies. In measuring social welfare we may well care about distributive effects—who gains and losses from a rule. Economists and legal scholars offer some reasons why we should ignore distributive effects in setting legal rules, but those reasons are debatable. Even if one ignores distributive effects, corporate law rules could affect society through many different causal paths. Scholars generally ignore most of these paths, and focus instead on the direct effect on productive efficiency within the firm. Even focusing narrowly on production within the firm, shareholder primacy does not follow—other groups, including employees, are involved within the firm. A further set of arguments must narrow the focus to the interests of shareholders alone.²⁴

Each step of the argument for shareholder primacy is eminently contestable, leading to a variety of reasons to question it. First, one should not concentrate on “wealth” understood narrowly. Welfare economics focuses on preferences and welfare, not on narrow financial wealth. Thus, the direct effects of working conditions and corporate decision-making on employee welfare matter to economic

Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN ECON. 305 (1976). For a summary of the application of this approach in legal scholarship, see Easterbrook & Fischel, *supra* note 13, at 1-39.

²³ See *infra* part IV.

²⁴ For a similar questioning of shareholder primacy starting with a high level of generality then narrowing, see KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES* (2006). Dan Farber and I make a similar point concerning the usual goals of law and economics scholars in the fields of intellectual property and antitrust in Daniel A. Farber & Brett H. McDonnell, *Why (and How) Fairness Matters at the IP/Antitrust Interface*, 87 MINN. L. REV. 1817, 1820-21 (2003).

analysis of corporations, even if such effects are not easy to measure.²⁵

Second, distributive effects matter within economics. What counts is not simply maximizing net social welfare, but achieving an acceptable distribution of well-being.²⁶ Admittedly, most current law and economics scholarship focuses on efficiency and maximizing total welfare, without reaching the question of distribution. The leading justification for doing so is that distributive concerns are best addressed through tax-and-transfer policies, leaving other legal rules (such as corporate law) to focus only on efficiency.²⁷ Chris Sanchirico has presented strong arguments from the theory of the second best and informational economics as to why achieving redistribution through taxes alone may not in fact be efficient.²⁸ Here, I will present a different set of reasons, tied to institutional and political feasibility, as to why we should care about distribution as well as efficiency in setting the rules of corporate law.²⁹

Third, actions within the corporation may have systemic, general equilibrium effects outside those groups that are clearly within the corporation, and corporate law may systematically affect such action. Thus, current scholarship focuses on partial equilibrium effects, and we need to consider general equilibrium effects as well. I will consider two kinds of general equilibrium effects. The first is how corporations affect local public goods and externalities. For instance, a corporation can affect the community in which it is located through pollution, a negative externality, or through generating jobs, which has a positive external effect on economic development. The standard law and economics response to such effects is that other areas of the law should internalize such externalities.³⁰ However, the law may not perform this function adequately, and shareholder-run versus

²⁵ See *id.*

²⁶ One good contribution of LOUIS KAPLOW AND STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002), is to emphasize this point.

²⁷ See Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821 (2000); Kaplow & Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994).

²⁸ See Chris William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003 (2001); Chris William Sanchirico, *Exchange: Should Legal Rules be Used to Redistribute Wealth? Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797 (2000).

²⁹ See *infra* part VI.

³⁰ The best known statement of that position is Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (magazine at 33).

employee-run may differ systematically in the types of externalities they generate in the absence of adequate external legal controls.³¹ The internal balance of power within corporations may also generate powerful external effects via the political system. Large corporations powerfully influence political lobbying, and hence the laws that we can expect to see. Economics-influenced scholars have of course focused much on lobbying in the public choice literature,³² but have done rather less to consider the connection between public choice and corporate structure.³³

Finally, the nature of corporate decision-making may also affect the human capital and underlying preferences of participants. Employees who actively engage in corporate decisions may be better equipped for political action, and may like political activism more. This effect is a further possible externality effect of corporate structure. The effect on preferences, however, is a much more non-standard economic argument than those I have already listed. Standard economic analysis takes individual preferences as given.³⁴ However, some economists have challenged the standard analysis,³⁵ and I will consider what their work has to say about corporate decision-making as well.³⁶

I will be comparing and contrasting these ideas drawn from economics with ideas that emerge from democratic theory, particularly the civic republican tradition in political history, philosophy, and other disciplines. Civic republicanism covers a

³¹ See *infra* part V.

³² Good overviews include DANIEL A. FARBER & PHILIP F. FRICKEY, *LAW AND PUBLIC CHOICE* (1991); DENNIS C. MUELLER, *PUBLIC CHOICE III* (2003); and Robert P. Inman, *Markets, Governments, and the "New" Political Economy*, in 2 *HANDBOOK OF PUBLIC ECONOMICS* 647 (Alan J. Auerbach & Martin Feldstein eds. 1987).

³³ See *infra* part VI.

³⁴ The best statement of that approach is Gary S. Becker & George J. Stigler, *De Gustibus Non Est Disputandum*, 67 *AM. ECON. REV.* 76 (1977).

³⁵ See *ECONOMICS, VALUES, AND ORGANIZATION* (Avner Ben-Ner & Louis Putterman eds., 1998); Brett H. McDonnell, *Endogenous Preferences and Welfare Evaluations*, in *NORMS AND VALUES IN LAW AND ECONOMICS* (Aristides Hatzis, ed., forthcoming Sept. 2008); George A. Akerlof & Rachel E. Kramton, *Economics and Identity*, 115 *Q. J. ECON.* 715 (2000); Samuel Bowles, *Endogenous Preferences: The Cultural Consequences of Markets and Other Economic Institutions*, 36 *J. ECON. LIT.* 75 (1998); Herbert Gintis, *Welfare Criteria with Endogenous Preferences: The Economics of Education*, 15 *INT'L ECON. REV.* 415 (1974); George A. Akerlof & Rachel E. Kramton, *Economics and Identity*, 115 *Q. J. ECON.* 715 (2000); AVNER BEN-NER & LOUIS PUTTERMAN EDS., *ECONOMICS, VALUES, AND ORGANIZATION* (1998); Claire A. Hill, *The Law and Economics of Identity*, 32 *QUEEN'S L.J.* 389 (2007); Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 9 *PHIL. & PUB. AFF.* 317 (1977), <http://ssrn.com/abstract=844345>.

³⁶ See *infra* part VII.

wide swathe of ideas and political movements; it means different things to different people.³⁷ Here, I will give a very brief history of republicanism, intended to spotlight the ideas within republicanism that interest me and to draw attention to the political and economic context in which those ideas developed. Republicanism underwent a brief revival in the law reviews in the eighties;³⁸ I share many values with that revival, but will focus less on judges and more on institutions that most articles in that genre ignore.³⁹

The great philosophical expression of the classical republican ideal began with Aristotle.⁴⁰ Aristotle saw the main point of politics as allowing citizens to develop and express their civic virtue. Humans are fundamentally social, and they can only truly flourish through exercising civic virtue in their political interactions.⁴¹ The classical notion of republicanism reappeared in renaissance Florence, most prominently in the work of Machiavelli.⁴² Republicanism then made its way to Great Britain at the time of Cromwell and thereafter. A variety of political writers used republican rhetoric during the English Civil War, most importantly James Harrington.⁴³ Of particular note for us is Harrington's stress on the importance of maintaining rough equality in wealth for achieving republican political equality.

Republican ideas made their way across the Atlantic to the American colonies, and played an important role during the founding period.⁴⁴ Much of our

³⁷ The most influential modern historical account of republicanism is J.G.A. Pocock, *THE MACHIAVELLIAN MOMENT: FLORENTINE POLITICAL THOUGHT AND THE ATLANTIC REPUBLICAN TRADITION* (2nd ed. 2003).

³⁸ Leading articles in the republican revival included a 1988 Yale Law Review symposium, including Frank Michelman, *Law's Republic*, 97 YALE L.J. 1493 (1988) and Cass R. Sunstein, *Beyond the Republican Revival*, 97 YALE L.J. 1539 (1988); Frank Michelman, *Foreword: Traces of Self-Government*, 100 HARV. L. REV. 4 (1986); and William H. Simon, *Social-Republican Property*, 38 UCLA L. REV. 1335 (1991); Cass R. Sunstein, *Interest Groups in American Public Law*, 38 STAN. L. REV. 29 (1985).

³⁹ See Paul Brest, *Further Beyond the Republican Revival: Toward Radical Republicanism*, 97 YALE L.J. 1623 (1988).

⁴⁰ See ARISTOTLE, *THE NICOMACHEAN ETHICS* (Martin Ostwald, trans., Prentice Hall, 1962); ARISTOTLE, *POLITICS* (Ernest Baker, trans., Oxford, 1946).

⁴¹ For an interesting critique of law and economics as not appreciating the importance of virtue to human happiness and flourishing, see Mark A. Sargent, *Utility, the Good and Civic Happiness: A Catholic Critique of Law and Economics*, 44 J. CATHOLIC LEG. STUD. 35 (2005).

⁴² See NICOLÒ MACHIAVELLI, *DISCOURSES; THE PRINCE*. For a lengthy analysis of how republican ideas functioned within the politics of Florence, see Pocock, *supra* note 37.

⁴³ See JAMES HARRINGTON, *THE COMMONWELTH OF OCEANA*.

⁴⁴ The most influential accounts of the role of republican ideas in the Revolutionary period are GORDON WOOD, *THE CREATION OF THE AMERICAN REPUBLIC* (new ed. 1998) and

subsequent history was caught in the tension between Hamilton and Jefferson. Hamilton set out the path for the tremendous growth in American economic and political power. Yet, that power has come at the cost of inequality, corruption, and distorted democracy that Jefferson feared. At various points in our history, as Hamiltonians have struck out for more power, Jeffersonians have pushed back. As Stephen Presser has argued, extending limited liability to corporations, and the move to general incorporation, was meant in good part to encourage the growth of smaller businesses to act as a counter-weight.⁴⁵ Unions tried to protect the interests of employees within the new big businesses. There were sporadic efforts in the nineteenth and twentieth century to experiment with employee primacy.⁴⁶ The antitrust laws also sought to limit the political power of large businesses.⁴⁷ A variety of laws aimed at limiting the power of financial capitalists such as bankers and insurers, including Andrew Jackson's attack on the Bank of the United States, limits on share ownership by insurers, and the Glass-Steagall Act.⁴⁸ Both philosophers as

BERNARD BAILYN, *THE IDEOLOGICAL ORIGINS OF THE AMERICAN REVOLUTION* (enlarged ed. 1992). A very influential transmitter of republican ideas to the colonists was MONTESQUIEU, *THE SPIRIT OF LAWS* (1748).

⁴⁵ See Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148 (1992); Presser, *The Bogalusa Explosion*, "Single Business Enterprise," "Alter Ego," and Other Errors: *Academics, Economics, Democracy and Shareholder Limited Liability: Back Towards a Unitary "Abuse" Theory of Piercing the Corporate Veil*, (Discussion Draft No. 6, 2005), available at <http://www.law.ucla.edu/docs/presser.pdf>.

⁴⁶ The most successful group of cooperatives in the U.S. appeared in the Pacific Northwest in the mid-twentieth century in a group of plywood companies. See KATRINA V. BERMAN, *WORKER-OWNED PLYWOOD COMPANIES: AN ECONOMIC ANALYSIS* (1967); EDWARD S. GREENBERG, *WORKPLACE DEMOCRACY: THE POLITICAL EFFECTS OF PARTICIPATION* (1986); JOHN PENCANEL, *WORKER PARTICIPATION: LESSONS FROM THE WORKER CO-OPS OF THE PACIFIC NORTHWEST* (2001). The most successful experiments have been in Europe, particularly the Mondragon system of cooperatives in Spain and the Italian cooperative leagues. On Mondragon, see GEORGE CHENEY, *VALUES AT WORK: EMPLOYEE PARTICIPATION MEETS MARKET PRESSURE AT MONDRAGON* (1999); WILLIAM WHYTE & KATHLEEN WHYTE, *MAKING MONDRAGON* (2nd ed., rev. 1988); HANS WIENER WITH ROBERT OAKESHOTT, *WORKER-OWNERS: MONDRAGON REVISITED*; HENK THOMAS & CHRIS LOGAN, *MONDRAGON: AN ECONOMIC ANALYSIS* (1982). On the Italian leagues, see PIERO AMMIRATO, *LA LEGA: THE MAKING OF A SUCCESSFUL COOPERATIVE NETWORK* (1996); MARK HOLMSTROM, *INDUSTRIAL DEMOCRACY IN ITALY: WORKERS' CO-OPS AND THE SELF-MANAGEMENT DEBATE* (1989). The best economic overview of workers' control may well be GREGORY K. DOW, *GOVERNING THE FIRM: WORKERS' CONTROL IN THEORY AND PRACTICE* (2003).

⁴⁷ See HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 47-51 (2nd ed. 1999).

⁴⁸ See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

well as political activists have pointed to the tie between economic and political democracy.⁴⁹

Several relevant themes emerge from this historical and philosophical work. First, active involvement in affairs that affect one's life have a bearing on one's personal happiness and sense of well-being. Second, limiting inequality in wealth is important to achieving political equality and real democracy. Third, there may indeed be such a thing as a public good, understood through a process of political deliberation. Fourth, political deliberation helps citizens become virtuous and flourish as social beings. That some famous philosophers made these arguments in the past does not, of course, make them true. Some of these claims involve empirical questions, which I will explore below. Others involve normative disputes, which I will also explore. Note that there is a close relationship between these themes and the considerations from economics set out earlier. The rest of this paper will develop these ideas in more detail, and examine what light they shine on the choice between shareholder primacy and employee primacy.

III. Effects on Intra-corporate Surplus

Most law-and-economics-based corporate law scholarship has focused on internal efficiency, that is, on generating the largest possible surplus within a corporation. By surplus, I mean the net benefits generated for all corporate constituency groups—it is emphatically not equal to profits, which is just one component of the corporate surplus. The standard position has been that shareholder primacy will promote internal efficiency best.⁵⁰

The preference for shareholders is a bit surprising given the widespread picture of the corporation as a “nexus of contracts.” This picture is drawn from a highly influential paper by Michael Jensen and William Meckling, and depicts the

⁴⁹ BELLAH ET AL., *HABITS OF THE HEART: INDIVIDUALISM AND COMMITMENT IN AMERICAN LIFE* (2008 ed.); G.D.H. COLE, *GUILD SOCIALISM RESTATED* (New Brunswick 1980); JOHN DEWEY, *INDIVIDUALISM: OLD AND NEW* (1930); DEWEY, *LIBERALISM AND SOCIAL ACTION* (1935); AMITAI ETZIONI, *THE SPIRIT OF COMMUNITY: RIGHTS, RESPONSIBILITIES, AND THE COMMUNITARIAN AGENDA* (1993); JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY*; CAROLE PATEMAN, *PARTICIPATION AND DEMOCRATIC THEORY* (1970); JEAN-JACQUES ROUSSEAU, *THE SOCIAL CONTRACT*; MICHAEL J. SANDEL, *DEMOCRACY'S DISCONTENT: AMERICA IN SEARCH OF A PUBLIC PHILOSOPHY* (1996); MICHAEL WALZER, *SPHERES OF JUSTICE: A DEFENSE OF PLURALISM AND EQUALITY* (1983); ROBERT B. WESTBROOK, *JOHN DEWEY AND AMERICAN DEMOCRACY* (1991).

⁵⁰ For an interesting reflection on some shared interests of managers and labor, see Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1 (2007).

corporation as the product of voluntary relationships between many different groups, including shareholders, employees, creditors, suppliers, and customers.⁵¹ These relationships are often long-term, so the agreements between the different groups cannot anticipate all contingencies that will arise during the course of the relationships. The groups must thus determine who will decide what to do as various contingencies arise, and on what basis they will make those decisions.⁵² In large corporations, a managerial hierarchy has emerged, with lower level managers making more day-to-day, low level decisions and supervising the work of employees, and higher level managers making more strategic decisions and supervising the lower level managers. The questions then become, who should have ultimate control over the managers and in whose interests should the managers be making their decisions? The conventional answer to both questions under shareholder primacy is shareholders, but why should the corporation be run only in their interests, and subject to their ultimate control?

The leading plausible defenses of shareholder primacy are tied to the status of shareholders as a corporation's residual claimants. Shareholders are entitled to the stream of profits, or the difference between the revenues the business generates and the costs it incurs in generating those revenues. This leads to two different arguments for granting shareholders special status. First, as residual claimants, shareholders are particularly vulnerable and need special legal protection. Second, as residual claimants shareholders have incentives to make decisions that maximize total surplus. Let us consider each argument in a bit more detail.

The first argument asserts that shareholders, as residual claimants, face severe contracting problems. Every decision within a corporation potentially affects the residual claimants, because every decision may affect both revenues and costs, and hence the residual. Trying to specify what managers should do in every decision through an explicit contract would be prohibitively expensive. Imposing a fiduciary duty on managers provides a cheaper way than such an explicit contract to

⁵¹ See Michael C. Jensen & William H. Meckling, *supra* note 22.

⁵² The transactions cost theory of the firm, growing from the work of Oliver Williamson, has emphasized the problem of incomplete contracting. See OLIVER WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* (1985). The property rights theory of the firm, growing from the work of Oliver Hart and collaborators, has also focused on the problem of incomplete contracting. See OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* (1995).

require that managers make decisions that do not hurt shareholders.⁵³ Other constituencies, including employees (so the argument goes), are concerned about a more limited number of decisions, and hence can protect themselves more readily through an explicit contract.

The second argument asserts that residual claimants prefer choices that maximize the total surplus produced. Given the inability to write complete contracts telling managers what to do in all situations, we want corporate decision-makers to use their discretion to make decisions that maximize total surplus. Residual claimants have the appropriate incentive, since by definition the residual is the difference between the revenue the corporation generates and the costs it creates.⁵⁴

Others have called these arguments based on the residual claimant status of employees into question. For one, it is not at all clear that shareholders are the sole residual claimants in a corporation. Many employees are also residual claimants. That is clearly true for employees who receive part of their compensation through profit sharing or stock options. Even for those with set salaries, most employees have claims against the corporation that become more valuable if the corporation does well. When the corporation does well, their pensions are safer and their jobs are more secure, which is particularly important for employees who have invested in firm-specific human capital.⁵⁵

It is also not clear that employees can protect themselves contractually more easily than shareholders. Employees too, as residual claimants, care about a wide range of decisions within the corporation. Indeed, they probably care more than non-employee shareholders, as decisions within the corporation affect not only their expected future financial returns but also their present and future working conditions. Moreover, insofar as employees have made firm-specific human capital investments they are particularly vulnerable to decisions that reduce the value of that investment.⁵⁶ Indeed, employees may well be more vulnerable for at least one

⁵³ See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 426-27 (2002); Easterbrook & Fischel, *supra* note 13, at 92; Macey, *supra* note 13, at 36.

⁵⁴ See Easterbrook & Fischel, *supra* note 13, at 36; ROBERT C. CLARK, *CORPORATE LAW* 389-90 (1986).

⁵⁵ See Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 305-06 (1998); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 907-08 (1993); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 49-53 (1991); Blair & Stout, *supra* note 14, at 278-79.

⁵⁶ See Greenfield, *supra* note 55, at 316; O'Connor, *supra* note 55, at 916-19.

key reason: shareholders can diversify their holdings, while employees cannot diversify their jobs.⁵⁷ Shareholders also have a variety of other ways to protect themselves: the market for corporate control, the market for corporate managers, equity-based compensation of managers, and so on. Indeed, conventional law-and-economics-based scholars frequently point to precisely those factors in justifying the weakening of fiduciary duties through the business judgment rule.⁵⁸

Finally, it is also not clear that shareholders always have good incentives to maximize total surplus. It is well understood, for instance, that since limited liability forces creditors to bear risk in the event of bankruptcy, shareholders have an incentive to undertake overly-risky projects, an incentive which worsens as a corporation nears insolvency.⁵⁹ Given firm-specific investments that have been made in a corporation, shareholders may well favor corporations taking on more risk than is socially optimal.⁶⁰

The argument that employee participation would lead to politicized, costly decision-making procedures is, I think, the strongest argument against such participation. Many have made this point, with Henry Hansmann making it in the most detailed and persuasive treatment.⁶¹ Employees differ among themselves more than shareholders—employees may be new or near retirement, have low or high skills, be poorly or well paid, have no or significant supervisory responsibility, and so on. Shareholders differ too, but not as much—at least in a public corporation, their main focus will typically be maximizing the share price. Thus, shareholders are likely to argue less in making decisions, leading to lower decision-making costs. Hansmann does not argue that employee primacy never makes sense, but rather that it is most attractive in businesses where labor heterogeneity is less, as well as ones where the need for outside financing is less. Some firms will find employee primacy to be the best form of organization; most will not. The market will sort out where

⁵⁷ The importance of diversification is a key insight of modern finance theory. See RICHARD A. BREALEY AND STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 153-60 (5th ed. 1996).

⁵⁸ See, e.g., Easterbrook & Fischel, *supra* note 2, at 94-97.

⁵⁹ Courts have recognized this problem, and at a certain point recognize a fiduciary duty running to creditors along with, or instead of, shareholders. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991).

⁶⁰ See Greenfield, *supra* note 55, at 308-10.

⁶¹ See HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996); Hansmann, *When Does Workers Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749 (1990); Hansmann, *Worker Participation and Corporate Governance*, 43 U. TORONTO L.J. 589 (1993).

employee primacy makes sense and where it does not.

This argument is powerful, but not decisive. There are several counterarguments. First, shareholders may differ more than the argument assumes. Shareholders may intend to hold for a short or long term; they may be individuals, mutual funds, or union or public pension funds. Complex and extensive modern derivative markets complicate the interests of equity holders even more.⁶² Second, employee primacy may have large benefits, discussed below, that justify its higher costs. Third, it might be possible to reduce greatly the costs of employee primacy. Precisely why corporations fail to do just that may be explained in a variety of ways and, in a later section, I will discuss possible reasons exhibiting network effects why we observe little employee primacy even if it is more efficient than shareholder primacy.⁶³

Another potential problem with employee primacy is diversification. If employee primacy is tied to employee share ownership, then employees may wind up putting too many eggs in one basket. If their employer fails, not only do they lose their jobs, but they also lose the value of their shares. This may prevent workers from joining firms featuring extensive employee ownership and may also make such firms overly risk averse and less likely to innovate.⁶⁴ Of course, this problem can be avoided if participation is not tied to ownership. Moreover, if it is found desirable for incentive reasons to tie participation to ownership, then the loss of diversification may just be part of an inevitable tradeoff—to motivate people one needs to give them a stake in both the upside and the downside of the business.⁶⁵

A further problem with employee primacy is that it makes external equity financing more costly and difficult to obtain. External investors will be less willing to invest money in businesses whose boards are elected by its employees than in otherwise similar businesses whose boards are elected by its shareholders, as the investors will be concerned about decisions being made against their interests. In a later section, I will discuss ways that worker-run businesses can ameliorate this financing problem, but it does remain a cost of doing business. Another problem

⁶² See Shaun P. Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775.

⁶³ See *infra* Part VIII.

⁶⁴ See Samuel Bowles & Herbert Gintis, *The Democratic Firm: An Agency-Theoretic Evaluation*, in *MARKETS AND DEMOCRACY: PARTICIPATION, ACCOUNTABILITY AND EFFICIENCY* 13 (Samuel Bowles et al. eds. 1993).

⁶⁵ See Joseph E. Stiglitz, *Incentives and Risk Sharing in Sharecropping*, 41 REV. ECON. STUD. 219 (1974).

worth raising is the dynamic efficiency of employee primacy. Would firms characterized by employee primacy innovate as much as those characterized by shareholder primacy? Concern about job redundancy may suggest no. On the other hand, employees are the source of many new ideas, and might be likely to suggest more innovations in companies where they are given a greater say and also where they may fear getting laid off less. I am not aware of systematic evidence on this question.

A final classic problem worth mentioning is the horizon problem. The claim is that firms controlled by their employees will under-invest. Investments involve costs incurred today in the interest of attaining future benefits. Insofar as many employees may not be with a firm to benefit from increased future revenues, they will then have less incentive to invest.⁶⁶ However, this problem is solved if the employees can sell their membership rights in an employee-run firm. However, for various reasons these markets might not exist or might not work well.⁶⁷ The problem can also be resolved or reduced by individual capital accounts or by greater reliance on debt financing.⁶⁸

It is also worth briefly mentioning here two significant recent approaches that deny shareholder primacy without embracing employee primacy. Stephen Bainbridge's model of director primacy rejects shareholder ultimate control while still accepting shareholder wealth maximization.⁶⁹ Bainbridge's argument is complex and nuanced, but to summarize ruthlessly, he focuses on the need to have some ultimate decision-making authority in a large organization where complete contracts are impossible. The board fills that role. Bainbridge regularly draws upon the work of Kenneth Arrow to argue that attempts to make the board more accountable to shareholders would undermine the board's necessary authority.⁷⁰

⁶⁶ See Eirek G. Furubotn, *The Long-run Analysis of the Labor-Managed Firm: An Alternative Interpretation*, 66 AMER. ECON. REV. 104 (1976); Eirek G. Furubotn, *Toward a Dynamic Model of the Yugoslav Firm*, 4 CANADIAN J. ECON. 182 (1971); Eirek G. Furubotn & Svetozar Pejovich, *Property Rights and the Behavior of the Firm in a Socialist State: The Example of Yugoslavia*, 30 Zeitschrift fur Nationalokonomie 431 (1970); Svetozar Pejovich, *The Firm, Monetary Policy, and Property Rights in a Planned Economy*, 7 WESTERN ECON. J. 193 (1969).

⁶⁷ See Dow, *supra* note 46, at 152-61.

⁶⁸ See *id.* at 153; Jaroslav Vanek, *The Basic Theory of Financing of Participatory Firms*, in THE LABOR-MANAGED ECONOMY: ESSAYS BY JAROSLAV VANEK 171 (1977); David P. Ellerman, *Theory of Legal Structure: Worker Cooperatives*, 18 J. ECON. ISSUES 861 (1984).

⁶⁹ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. UNIV. L. REV. 547 (2003); Bainbridge, *supra* note 53.

⁷⁰ See Bainbridge, *supra* note 53, at 198-99; Bainbridge, *supra* note 69, at 550.

Thus, he argues for ultimate authority lodged with the board, not shareholders. However, he accepts the standard arguments for shareholder wealth maximization.⁷¹ It is interesting that Bainbridge does allow that for some businesses, some forms of employee participation may be valuable. The types he finds likely to be most valuable are participation in lower level decisions, rather than company-wide, strategic decisions at the board level. Employee participation can help deal with informational and motivational problems that hierarchy can create.⁷² Bainbridge does not believe there is any good reason for government to mandate or encourage any form of employee participation.

Margaret Blair and Lynn Stout in their team production model reject both principles of shareholder primacy.⁷³ Like Bainbridge they argue for the ultimate authority of the board, but unlike him they argue that the board's goal should be to promote the interests of a variety of stakeholders, including both shareholders and employees. They argue that in public corporations a variety of groups make firm-specific investments subject to possible exploitation, and each must be induced to cooperate and not shirk. The board is a "mediating hierarch" that looks out for all involved groups while punishing all of them if their shirking leads to poor performance. Note that Blair and Stout limit their theory to public corporations; for close corporations, they think a shareholder primacy model applies.⁷⁴

What sort of arguments can we derive from civic republicanism to advance our thinking about what sort of structure and rules will be efficient (in the sense of maximizing total corporate surplus, not necessarily maximizing profit) within a corporation? For one, the observation that employees too are residual claimants, particularly where they invest in firm-specific human capital,⁷⁵ fits well with republican philosophy. Part of that philosophy is a celebration of persons tied to particular institutions and communities through specific knowledge and relationships built up over time—which economists inelegantly label firm-specific human capital. Beyond this, republicanism points to two other arguments for the internal efficiency of employee primacy: psychic gains to employees, and the

⁷¹ See Bainbridge, *supra* note 53, at 419-29.

⁷² See Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657 (1996); Bainbridge, *Privately Ordered Participatory Management: An Organization Failures Analysis*, 23 DEL. J. CORP. L. 979 (1998).

⁷³ See Blair & Stout, *supra* note 14.

⁷⁴ See *id.* at 319.

⁷⁵ See *supra* notes 55 through 56 and accompanying text.

knowledge that employees can bring to bear in decision-making.

A key assumption of republican, and more broadly participatory, philosophy is that people thrive upon being involved in important decisions that affect their lives.⁷⁶ Modern social science supports this insight. Job satisfaction increases when employees are able to participate in decisions affecting them.⁷⁷ If employees feel that decisions are made in a just way, it increases their feelings of satisfaction and self-esteem.⁷⁸ In turn, participation in decision-making is one important way to increase the sense that decisions are made in a just way.⁷⁹ Even though the satisfaction from such involvement is non-pecuniary, it counts for an economic calculus. The economist's notion of efficiency includes as a social gain anything that individuals feel makes them better off. Psychic gains from participation, and psychic losses from being cut off from participation, may be hard to measure quantitatively, but they matter. Nothing in economics denies that. In calculating the net impact of employee primacy, the increased satisfaction of employees is an important element that we must put on the plus side of the ledger.

It is true that economics has traditionally been skeptical of psychic gains and losses that are hard to measure through observable behavior. Recently, however, a number of economists researching human happiness have become more willing to consider non-traditional measures, including self-reporting.⁸⁰ A robust insight of this literature has been the large effect of nonfinancial variables on happiness.⁸¹ Work time is a large part of the day for most adults; how satisfied they are with that time will play a large role in their overall life satisfaction.⁸² In contrast, research suggests that beyond a certain point overall social increases in wealth (as opposed to

⁷⁶ See Aristotle, *supra* note 49; Mill, *supra* note 49; Pateman, *supra* note 49; ROBERT A. DAHL, A PREFACE TO ECONOMIC DEMOCRACY (1985).

⁷⁷ See TOM R. TYLER & STEVEN L. BLADER, COOPERATION IN GROUPS: PROCEDURAL JUSTICE, SOCIAL IDENTITY, AND BEHAVIORAL ENGAGEMENT 54-55 (2000); Peter Warr, *Well-Being and the Workplace*, in WELL-BEING: THE FOUNDATIONS OF HEDONIC PSYCHOLOGY 392 (Daniel Kahneman et. al. eds. 1999); B.D. Cawley, L.M. Keeping, & P.E. Levy, *Participation in the Performance Appraisal Process and Employee Reactions*, 83 J. APP. PSYCH. 615 (1998); A.P. BRIEF, ATTITUDES IN AND AROUND ORGANIZATIONS (1998); EDWARD LAWLER, HIGH INVOLVEMENT MANAGEMENT (1986).

⁷⁸ See Tyler & Blader, *supra* note 77, at 185-87.

⁷⁹ See *id.* at 100-01.

⁸⁰ See Bruno S. Frey & Alois Stutzer, *What Can Economists Learn from Happiness Research?*, 40 J. ECON. LIT. 402 (2002).

⁸¹ See *id.* at 403.

⁸² See MIHALYI CSIKSZENTMIHALYI, *FLOW: THE PSYCHOLOGY OF OPTIMAL EXPERIENCE* (1990).

individual increases within a society) do not increase overall happiness very much.⁸³ Thus, increasing satisfaction at work may well be valuable even if it has no or negative effect on productivity. Indeed, a major survey of American employees done as part of the investigation of the Commission on the Future of Worker-Management Relations⁸⁴ found that most American employees want more involvement in decision-making at work.⁸⁵

But we may not need to make that tradeoff. Much research suggests that increased satisfaction at work makes employees more productive.⁸⁶ Recent empirical studies on procedural justice suggest that if people feel that decisions affecting them are made in a just way, they are more likely to abide by those decisions and try to promote the goals of the organization. Employees who believe their employer is just will regulate themselves. This allows the organization to reduce costs involved with monitoring employees, thereby increasing the efficiency of the business. Involvement in decision-making is one important way of making people believe that the process is more just and legitimate.⁸⁷

Another advantage of employee primacy is that employees naturally learn much about a business simply by doing their jobs. They know much that absentee shareholders do not know. Moreover, employees are naturally motivated to use that information to improve how things are going for them—once again, more motivated than most absentee shareholders who own a diversified portfolio. Thus, if we are looking for informed and motivated participants to act as a check on managers, employees are a natural choice.⁸⁸ Furthermore, participatory employees may be

⁸³ See *id.* at 416-18; Richard Easterlin, *Will Raising the Incomes of All Increase the Happiness of All?*, 27 J. ECON. BEHAV. ORG. 35 (1995); Peter H. Huang, *Beyond Cost-Benefit Analysis in Financial Regulation: Process Concerns and Emotional Impact Analysis*, (Temple University Beasley School of Law Legal Studies Research Paper Series, Paper N. No. 21, 2006), available at <http://ssrn.com/abstract=870453>.

⁸⁴ U.S. DEP'T OF LABOR & U.S. DEP'T OF COMMERCE, FACT-FINDING REPORT: COMMISSION ON THE FUTURE OF WORKER-MANAGEMENT RELATIONS (1994).

⁸⁵ See RICHARD B. FREEMAN & JOEL ROGERS, WHAT WORKERS WANT 16 (1999).

⁸⁶ See Warr, *supra* note 77; Michell T. Iaffaldano & Paul M. Muchinsky, *Job Satisfaction and Job Performance: A Meta-Analysis*, 97 PSYCHOL. BULL. 251 (1985).

⁸⁷ For overviews of this research, see Tom Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings*, 70 BROOK. L. REV. 1287 (2005); Tyler, *Psychological Perspectives on Legitimacy and Legitimation*, 57 ANN. REV. PSYCHOL. 375, LEGITIMACY AND LEGITIMATION xx (2005); Tyler, *Social Justice: Outcome and Procedure*, 35 INT'L J. PSYCHOL. 117 (2000); Tyler & Blader, *supra* note 77; Matthias Benz & Alois Stutzer, *Do Workers Enjoy Procedural Utility?*, 49 APP. ECON. Q. 149 (2003).

⁸⁸ See Joseph E. Stiglitz, *Credit Markets and the Control of Capital*, 17 J. MONEY, CREDIT &

more motivated to work hard themselves, and to monitor whether or not their fellow employees are working hard.⁸⁹ On the other hand, botched attempts at participation can backfire. If employees feel that they are being manipulated and their employer does not really care about or listen to their input, they can grow resentful.

To be sure, this advantage has its ambiguities. Employees in a large business may know a great deal about some things, but less about the kind of financial and strategic issues that occupy much of a board's time. This may argue for a lower-level and more limited form of employee participation than employee primacy. Furthermore, the strength of employees' motivation is a mixed blessing. Insofar as they are motivated to use their knowledge to suggest actions that help the business generally, everyone benefits. However, insofar as they are motivated to advocate ideas that benefit them personally at the expense of others, participation can lead to problems.⁹⁰ Many of the employees who participate most may turn out to be cranks—we all know the type.

Nonetheless, a variety of empirical studies do suggest that various forms of employee participation often lead to improved firm productivity, although the evidence is ambiguous—it is hard to control for selection effects.⁹¹ This leads to a question that advocates of employee participation must face: if such participation does increase the internal efficiency and productivity of businesses, why do we not see more of it? Shouldn't more productive businesses thrive in a competitive

BANKING 133 (1985); Margit Osterloh & Bruno S. Frey, *Shareholders Should Welcome Knowledge Workers as Directors* (Institute for Empirical Research on Economics, University of Zurich, Working Paper No. 283, 2006).

⁸⁹ See Eugene Kandel & Edward P. Lazear, *Peer Pressure and Partnerships*, 100 J. POL. ECON. 801 (1992); Bowles & Gintis, *supra* note 64, at 28. See also *supra* note 87 and accompanying text.

⁹⁰ See Paul R. Milgrom, *Employment Contracts, Influence Activities, and Efficient Organization Design*, 96 J. POL. ECON. 42 (1988); Paul R. 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).

⁹¹ See John P. Bonin *et. al.*, *Theoretical and Empirical Studies of Producer Cooperatives: Will Ever the Twain Meet?*, 31 J. ECON. LITERATURE 1290 (1993); ALAN S. BLINDER ED., *PAYING FOR PRODUCTIVITY* (1990); Saul Estrin *et. al.*, *The Productivity Effects of Worker Participation: Producer Cooperatives in Western Economies*, 11 J. COMP. ECON. 40 (1987); JOHN PENCANEL, *WORKER PARTICIPATION: LESSONS FROM THE WORKER CO-OPS OF THE PACIFIC NORTHWEST* 46-52 (2001); but see R. Oystein Strome, *Better Firm Performance with Employees on the Board? Not in the Long Run*, (University College of Ostfold, Paper No. 1757, 2007) available at <http://ssrn.com/abstract=967445> (finding that Swedish firms with employee board representation have lower performance in Tobin's Q and return on assets).

market?⁹² I defer consideration of that question to a later section.⁹³ Note that even if employee primacy leads to greater efficiency (in the sense of net benefits generated for all relevant constituency groups), it need not lead to greater profit, and it may be that in a capitalist economy markets tend to select more for profitability than efficiency. One also needs to be careful about what form of employee participation has the strongest effects. Although I focus for the most part on ultimate control over the corporation through electing directors, involvement at lower levels, e.g. through works councils, may make as much, or even more, sense.⁹⁴

Note that at least some of the arguments presented here for the internal efficiency of employee primacy apply more strongly to comparisons with shareholder primacy in public corporations, as opposed to close corporations and small businesses. Shareholders in the latter are typically heavily involved in the business, and thus they realize the psychic gains from participation and have the information needed to make business decisions. Indeed, insofar as one advocates employee primacy in the form of employees voting for directors as a way of reducing the principal-agent problem that boards face, employee primacy is unnecessary for businesses dominated by one or a few shareholders or owners, as that problem is not present for such businesses. We will see that this is a recurring theme—the republican arguments for employee primacy over shareholder primacy often apply more to a comparison with large, public corporations than with small, close corporations. On the other hand, the decision-making costs of employee participation also increase with the number of employees, so the effect of firm size on the desirability of employee participation is uncertain.

IV. Effects on Others: Corporate Social Responsibility

The previous section focused on the net surplus generated for groups within the corporation: shareholders, employees, managers, and perhaps creditors. Decisions made within corporations affect many other persons as well. Corporations

⁹² This is a core argument for many opponents of employee primacy. See Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. Bus. 469 (1979); Hansmann, *supra* note 61, at 22; Bainbridge, *supra* note 72, at 704-05.

⁹³ See *infra* part VIII.

⁹⁴ See WORKS COUNCILS: CONSULTATION, REPRESENTATION, AND COOPERATION IN INDUSTRIAL RELATIONS (JOEL ROGERS & WOLFGANG STREECK, EDS., 1995); Stephen F. Befort, *A New Voice for the Workplace: A Proposal for an American Works Councils Act*, 69 Mo. L. Rev. 607 (2004).

may pollute air and water, give to charities, provide or take crucial jobs from local communities, aid governments in violating human rights, and so on. Roughly, the distinction here is between groups that voluntarily choose to deal with the corporation and those who the corporation affects despite their choices. A vast literature on the social responsibility of corporations debates whether and to what extent corporate decision-makers should take into account the interests of such groups.⁹⁵ What, if anything, can civic republicanism and the employee vs. shareholder primacy question add to this ongoing debate? Republican ideas suggest that employee primacy or shareholder-run close corporations are likely to result in corporate decision-makers who are more inclined to take into account such external effects than are the managers of public corporations run in accordance with the principles of shareholder primacy.

There are several strong arguments against corporate managers taking into account goals other than maximizing profits. First, if prices adequately reflect both the social costs a business generates and the social benefits it creates, then maximizing profit will maximize net social benefit. Indeed, even if market prices are not completely right, private bargaining may internalize remaining externalities.⁹⁶ Second, corporate managers are not necessarily well-placed to determine what is best for society as a whole.⁹⁷ Consider, for instance, the managers of Dow Chemical in a classic shareholder proposal case involving napalm.⁹⁸ Shareholders sought to introduce a shareholder proposal that would recommend that the company stop selling napalm to customers who planned to use it against humans, a response to the controversial use of napalm in the Vietnam War. The shareholders alleged that Dow's managers had stated that in selling napalm to the military they were not seeking to maximize profit, but rather following a course that they found morally and politically desirable. How should managers make such choices, in cases where the morally correct outcome is disputed? Third, in seeking to influence corporate actions, activists are "seeking to attain by undemocratic procedures what they

⁹⁵ For a sampling of this literature, see, e.g., three recent symposia: *Socio-Economics and Corporate Law Symposium: The New Corporate Social Responsibility*, 76 TUL. L. REV. 1580 (2002); *Corporations and the Role of the State*, 35 U.C. DAVIS L. REV. 523 (2002); *Corporate Social Responsibility: Paradigm or Paradox?*, 84 CORNELL L. REV. 1282 (1999).

⁹⁶ This is of course a leading message of Ronald Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

⁹⁷ See Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, THE N.Y. TIMES, Sept. 13, 1970 at 33.

⁹⁸ See *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970).

cannot attain by democratic procedures.”⁹⁹

Each of these points has good counterarguments. Prices may not fully reflect the social costs and benefits of corporate actions. Transaction costs are often too high for Coasean bargaining to work. Indeed, given these market imperfections, shareholders, who are also members of the society affected by the social costs of corporations, might not even want corporations to maximize profits single-mindedly.¹⁰⁰ As for managerial decision-making, managers are often better placed than politicians or agency bureaucrats to know the effects their decisions will have on the world. Like other members of society, managers have a conscience, and they can consult it where the moral effects of a decision are debatable.¹⁰¹ Friedman’s prescription that we should seek limits on corporations through politics instead looks suspect once one realizes that corporations themselves often play a central role in creating laws, or blocking their creation, and also influence government agencies in how they enforce laws.¹⁰²

One further important argument for corporate social responsibility relies on norms. Law and economics traditionally regards the legal system as creating a set of implicit prices that internalize externalities.¹⁰³ However, enforcement of legal rules is highly incomplete. Even law and economics scholars have increasingly come to recognize that we rely upon people following the law because they believe it is the right thing to do, even if they do not think they will get caught if they break the law. A highly simplified variant of economics would have managers calculate the expected costs and benefits of following the law, and choose to break the law when the expected benefits to shareholders exceed the costs. Given imperfect legal enforcement, though, we might well prefer that corporate managers follow the same set of norms that individuals acting outside corporate roles generally do.¹⁰⁴

If one accepts the anti-corporate social responsibility arguments, then the

⁹⁹ Friedman, *supra* note 97.

¹⁰⁰ See Ian B. Lee, *Corporate Law, Profit Maximization and the “Responsible” Shareholder*, 10 STAN. J. L. BUS. & FIN. 31 (2005).

¹⁰¹ See Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533 (2006).

¹⁰² The next section will focus on these issues.

¹⁰³ Externalities occur where the actions of one person have un-priced effects on others. One internalizes an externality by getting the actor to bear the full costs and benefits her action has on others.

¹⁰⁴ See Lee, *supra* note 101; Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005).

remainder of this section is uninteresting. But suppose that at least some of the arguments for responsibility are strong enough that corporations should consider the external effects of their actions. In such a case, the question becomes how the structure of corporate decision-making affects the likelihood of corporate decision-makers considering such effects. Are firms subject to employee primacy more likely to consider external effects than firms that follow shareholder primacy?

Some critics of shareholder primacy argue that the pressure to increase share price has induced corporate managers to violate laws and norms and impose costs on society in ways that they would see as unethical acting in their roles as individuals.¹⁰⁵ However, even those who believe that shareholder primacy in public corporations has such consequences disagree on the cure. Some, such as Mitchell, Elhauge, Blair, and Stout, call for giving managers more discretion.¹⁰⁶ They hope that if managers focus less on pleasing shareholders, they will focus more on pleasing other groups, including those suffering from corporate pollution and so on. However, critics fear that if managers focus less on pleasing shareholders they will focus more on pleasing themselves.

An alternative approach makes corporations more directly accountable to other constituencies. Corporate constituency statutes in many states already *allow* managers to take into account the interests of various groups other than shareholders or employees. A more muscular version of these statutes would *require* managers to take other constituencies into account, and allow members of constituent groups to sue for violations of fiduciary duty. More modestly, one could simply require corporations to reveal more information about the social effects of their actions.¹⁰⁷ More ambitiously, one could require boards to include representatives of different constituencies.¹⁰⁸ I will not consider such approaches here.¹⁰⁹ Considering constituencies other than employees and shareholders would

¹⁰⁵ A good sustained argument for the case that shareholder primacy has created many public bads is LAWRENCE E. MITCHELL, *CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT* (2001).

¹⁰⁶ See *id.*; Blair & Stout, *supra* note 14; Elhauge, *supra* note 104.

¹⁰⁷ See Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

¹⁰⁸ See RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* (1976); Alfred F. Conard, *Reflections on Public Interest Directors*, 75 MICH. L. REV. 941 (1977).

¹⁰⁹ For an examination of the choice between employee participation and constituency statutes, see Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227 (2005).

raise a new set of questions and considerations that would further complicate an already complicated discussion. Moreover, few if any other constituencies have as strong a stake in a corporation as its employees.

What I will consider is how employee primacy would affect corporate actions. Is there any reason to think that corporations run in the interests of, and subject to the ultimate control of, their workers will pollute less, give more to charity, give to less elitist charities, help out more in the local community, violate human rights less, and so on? Many, maybe most, such external effects are concentrated in the local community in which a corporation is located. The corporation's workers will mostly live in that community as opposed to the shareholders of a public corporation. The workers are thus more likely to care about the local external effects, either because they themselves are directly affected, or because they know people who are, or because they feel social pressure to reduce bad effects on their neighbors.¹¹⁰

Note that this argument for employee primacy also favors close corporations, whose shareholders also will usually live in the community where the business is located. However, the argument may favor employee primacy more than a close corporation. In a close corporation, fewer people will typically have a larger stake each in the corporation's income than is the case with employee primacy. That higher stake in the corporation's income gives them incentive to focus more on increasing the corporation's private return, at the expense of increasing a public bad.¹¹¹

Another possible difference is in the effect of governance structure on the values and norms of corporate managers. As we have seen, some believe that shareholder primacy in public corporations tends to encourage managers to ignore norms that they would otherwise try to follow if they were acting on their own

¹¹⁰ Of course, not all external effects are local. For externalities that are felt beyond the local community where a firm is located, employee primacy would presumably be less helpful.

¹¹¹ See John E. Roemer, *Would Economic Democracy Decrease the Amount of Public Bads?*, 95 SCANDINAVIAN J. ECON. 227 (1993). A complication is that shareholder diversification in public corporations may actually give public corporation shareholders reason to internalize external effects insofar as those effects reduce profits in other corporations whose shares they own, and their shares in any one company's profits are not large. Would this be enough to counter-balance the benefits discussed in the text from employees considering local external effects? That is a tough empirical question, but my guess is that more often than not firms exhibiting employee primacy would internalize externalities better than public corporations run according to shareholder primacy.

behalf.¹¹² That might not happen under either employee primacy or within a close corporation. In these firms, those with ultimate control are actually present at the point of production. They are less likely to want decisions made on the basis of one abstract financial principle, maximizing profit, and more likely to take into account the full range of matters that concern them as human beings.

I think that arguments such as these at least in part underlie longstanding republican preferences for small-scale local industry. Republicans want decision-makers to be rooted in the local community so that they are more likely to take the community's interests into account. Much traditional distrust of big business and absent owners reflects concerns about what will happen when managers and owners are not so rooted. The first impulse of most economists is probably to dismiss such localism, but in a world of imperfect markets and rampant externalities, economists should recognize that localism has its place.

There is not, to my knowledge, a lot of systematic empirical evidence currently available on the effects about which this section speculates. There are a few interesting pieces of evidence, however, such as relatively high social spending by existing worker cooperatives—the Mondragon cooperatives, for instance, set aside ten percent of net income for social funds.¹¹³ More systematic evidence comes from a series of empirical sociological studies on the nexus between various organizational characteristics and pollution rates conducted by Don Grant, Andrew Jones, and co-authors. These papers do not deal with worker-run firms, but their evidence is still suggestive. Consistent with the hypotheses of this section, the studies find that larger firms tend to pollute at a higher rate¹¹⁴ and that firms located in communities with higher social capital tend to pollute at a lower rate.¹¹⁵ On the other hand, they also find that firms with shareholders located out-of-state do not pollute more than firms with in-state shareholders,¹¹⁶ which goes against the grain of the analysis here. Indeed, even the shareholding of public corporations is

¹¹² See *supra* note 105 and accompanying text.

¹¹³ See Whyte & Whyte, *supra* note 46, at 42.

¹¹⁴ See Don Sherman Grant II, Albert J. Bergesen, & Andrew W. Jones, *Organizational Size and Pollution: The Case of the U.S. Chemical Industry*, 67 AM. SOC. REV. 389 (2002).

¹¹⁵ See Don Grant, Andrew W. Jones, & Mary Nell Trautner, *Do Facilities with Distant Headquarters Pollute More? How Civic Engagement Conditions the Environmental Performance of Absentee Managed Plants*, 83 SOC. FORCES 189 (2004).

¹¹⁶ See Don Grant & Andrew Jones, *Do Foreign-Owned Plants Pollute More?: New Evidence from the U.S. EPA Toxics Release Inventory*, 17 SOC'Y & NAT. RES. 171 (2004).

disproportionately concentrated with local shareholders,¹¹⁷ which could limit the difference between shareholder-owned public corporations and employee primacy.

I should also mention one other important external effect where employee primacy seems unlikely to have a positive effect and could have a negative effect. Firms subject to employee primacy are unlikely to be any less racist or sexist and more inclusive than shareholder-run firms, and may well do worse on this score. Employee participation seems likely to more effectively lower decision costs and thus work better where workforces are relatively homogenous, if one accepts Hansmann's account of when employee participation works best.¹¹⁸ Employee-run firms are likely to recognize this, and recruit members who resemble their current members. This is not by any means certain, and there is an extensive literature on diversity in decision-making and workforces that has identified a variety of conflicting effects.¹¹⁹ However, the likely effect of employee participation is to encourage more homogeneity. Classical versions of civic republicanism have been accused of racism and sexism, with some justice.¹²⁰ There are presumably ways to limit this tendency, but we should nonetheless acknowledge the problem.¹²¹ No form of social organization is uniformly superior on all dimensions of evaluation. Employee primacy would create many benefits, but also some serious costs; this is one of them.

V. Distribution and Politics

Civic republicans want to reduce economic inequality. Economic inequality leads to corruption and undue influence for the rich. Civic republicans thus favor economic systems that do not generate too much inequality. Such suspicion of concentrated wealth seems a far remove from law and economics. Yet, I will argue that the republican concern about corruption has a fair amount in common with public choice theory. Moreover, employee primacy is a powerful response to

¹¹⁷ See Joshua D. Coval & Tobias J. Moskowitz, *The Geography of Investment: Informed Trading and Asset Prices*, 109 J. POL. ECON. 811 (2001); Joshua D. Coval & Tobias J. Moskowitz, *Home Bias at Home: Local Equity Preference in Domestic Portfolios*, 54 J. FIN. 2045 (1999); Gur Huberman, *Familiarity Breeds Investment*, 14 REV. FIN. STUD. 659 (2001).

¹¹⁸ See *supra* note 61 and accompanying text.

¹¹⁹ See generally Devon W. Carbado & Mitu Gulati, *The Law and Economics of Critical Race Theory*, 112 YALE L.J. 1757, 1795-1802 (2003).

¹²⁰ See Kathleen M. Sullivan, *Rainbow Republicanism*, 97 YALE L.J. 1713 (1988).

¹²¹ This is another question that deserves further exploration, and I hope to do so in future work.

concerns about unequal wealth and power. Employee primacy could generate greater equality directly through within-firm salaries, reduce distorting corporate political influence, and limit the ability of managers to use corporate funds to achieve personal and class ends through politics.

The first question to ask is whether there is any systematic difference between employee primacy and shareholder primacy in generating inequality. The answer seems to be yes, although it depends in part on the type of employee primacy one considers. American corporations guided by shareholder primacy generate substantial inequality of both wealth and income. Although many Americans do own shares, directly or indirectly, share ownership is still highly unequal, and an important source of differences in wealth. Moreover, American public corporations generate great wage inequality. Most notorious is the huge growth in compensation of CEOs and other top executives relative to what ordinary workers receive.¹²² More generally, there seems to be a growing division between skilled professionals and less skilled workers.

Firms subject to employee primacy seem to generate less inequality, for several reasons. First, residuals are distributed to workers, not shareholders. Second, wage differentials typically are narrower in worker-owned firms than in their shareholder-owned counterparts.¹²³ Moreover, as the next section will argue, more widespread employee primacy could affect social norms, leading more people to prefer more egalitarian outcomes.

Even granted that employee primacy tends to generate greater equality in wealth and income, the question remains whether this is a good reason for legally favoring employee primacy. One could simply deny that greater equality of wealth or income is an attractive goal. However, accepting economics as a useful tool

¹²² See LUCIAN ARYE BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

¹²³ See Dow, *supra* note 46, at 25; Ben Craig & John Pencavel, *Participation and Productivity: A Comparison of Worker Cooperatives and Conventional Firms in the Plywood Industry*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS (Martin Neil Baily *et al.*, eds. 1995) 121, 133 (Northwestern plywood coops); Cheney, *supra* note 46, at 48-49 (Mondragon); Will Bartlett *et al.*, *Labor-managed Cooperatives and Private Firms in North Central Italy: An Empirical Comparison*, 46 IND. & LABOR RELATIONS REV. 103 (1992) (Italian coops). A selection effect probably explains some of this difference: in an economy where few businesses engage in employee primacy, workers with a preference for egalitarianism are disproportionately drawn to such businesses. If employee primacy became more widespread, the differences between shareholder-run and employee-run firms might narrow. However, it appears unlikely they would disappear completely.

certainly does not entail accepting that position. I will not engage in the fundamental philosophical debate as to the attractiveness of a more egalitarian distribution of resources, but will simply assume that achieving somewhat more equality than the U.S. currently experiences is a worthy goal.¹²⁴

Even some who support employee primacy and favor a more egalitarian distribution of income do not think that achieving great equality is a good argument for employee primacy.¹²⁵ There are other ways to redistribute wealth and income, especially tax-and-transfer policy (i.e., taxing the rich and giving subsidies to the poor). Economists have long argued that tax-and-transfer policies are the best way to redistribute wealth. The second fundamental welfare theorem is the classic statement of that position.¹²⁶ More recently, Kaplow and Shavell have provided a formal argument for using only tax policy to redistribute wealth even in a second-best world where many of the perfect-market assumptions of the second welfare theorem do not hold.¹²⁷ However, Chris Sanchirico has shown that this argument is not necessarily a plausible application of the theory of the second best.¹²⁸

I want to consider a somewhat different sort of response to the Kaplow and Shavell argument. The structure of corporations may have a powerful effect on lobbying, and hence on legislation. Thus, we may want the law to encourage certain corporate structures over others, e.g. employee primacy over shareholder primacy, because otherwise the sorts of redistribution we would like to achieve may not be politically feasible.¹²⁹

We can make this argument using public choice and the theory of the firm. Public choice sees politics as a competition among different interest groups.¹³⁰ Who

¹²⁴ The gold-standard modern argument for a more egalitarian distribution is of course JOHN RAWLS, *A THEORY OF JUSTICE* (1971). Even if one accepts the argument for a more egalitarian distribution, there is a very tricky question as to what we should be distributing. Is it welfare (Harsanyi, Kaplow & Shavell), primary goods (Rawls), capabilities (Sen), some measure of resources (Dworkin) or what? For now, let me note that on most plausible theories, wealth and income are either a part of the measure of what we should be distributing, or at least a somewhat useful proxy for whatever it is we should be distributing.

¹²⁵ See Dow, *supra* note 46, at 26.

¹²⁶ See HAL R. VARIAN, *MICROECONOMIC ANALYSIS* 200-02 (2nd ed. 1984).

¹²⁷ See Kaplow & Shavell, *supra* note 27.

¹²⁸ See Sanchirico, *supra* note 28.

¹²⁹ For a version of this argument, see Thomas F. Cotter, *Legal Pragmatism and the Law and Economics Movement*, 84 GEORGETOWN L.J. 2071 (1996); see also Reza Dibadj, *Weasel Numbers*, 27 CARDOZO L. REV. 1325, 1382-84 (2006).

¹³⁰ See, e.g., Gary Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q. J. ECON. 371 (1983); Sam Peltzman, *Toward a More General Theory of Regulation*,

will do better in this competition depends in part on who finds it easier to organize effectively. One key branch of public choice theory has posited that smaller groups whose members get more concentrated benefits and costs from legislation are more likely to be able to organize than more diffuse groups whose members have less at stake individually.¹³¹

The modern public corporation has led to a smaller number of larger corporations than in the traditional economists' model of atomistic competition. Standard public choice (Mancur Olson version) suggests that fewer, but larger, businesses will find it easier to work together to lobby legislatures.¹³² Moreover, managers of such corporations often have much cash on hand to finance such lobbying. The theory of the firm suggests that to the extent that corporate structure does not fully constrain such managers,¹³³ they might use it to advance agendas that benefit them.¹³⁴ As a result, legislation is likely to go too far in benefiting large corporations and their managers.¹³⁵

What could employee primacy do to limit this problem? For one, to the extent that such organization helps limit undue managerial discretion,¹³⁶ it could limit the misuse of corporate funds to lobby for measures that benefit managers personally and as a class. Also, firms subject to employee primacy will typically tend to be smaller than shareholder-owned firms,¹³⁷ leading to more dispersed industrial structure in which political organizing should be harder. Employee primacy may enable groups representing employees to organize more effectively

19 J. L. & ECON. 211 (1976); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FORMULATIONS OF CONSTITUTIONAL DEMOCRACY* (1962). For good overviews of public choice theory, see the references in note 32.

¹³¹ See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965). I read once, I wish I could remember where, that this book would have been better named *The Illogic of Collective Action* or *The Logic of Collective Inaction*.

¹³² See Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. REV. 1103 (2002).

¹³³ See *supra* section IV.

¹³⁴ See Victor Brudney, *Business Corporations and Stockholders' Rights Under the First Amendment*, 91 YALE L.J. 235 (1981).

¹³⁵ Jurisdictional competition for incorporations arguably exacerbates this tendency. See Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99 (2004).

¹³⁶ See *supra* section IV.

¹³⁷ See Dow, *supra* note 46, at 142-64. The idea intuitively is that employee-run firms will be more reluctant to add new employees in good times because they must share profits with the new employees.

and thereby present a countervailing power to political groups that represent the interests of managers, shareholders, or small businesspeople. Of course, sometimes employees and their representatives will pursue selfish aims contrary to the public interest. Still, by equalizing the political playing field, this could lead to legislation that is more likely to reflect the interests of a range of groups, and more likely to attempt to redistribute income away from the wealthy.¹³⁸

Before moving on, I should address at least one important response. If laws affecting corporate organization do indeed affect political organization, then those in charge of large public corporations, and their political minions, should realize that, and hence oppose legal changes that are likely to undermine their power. Thus, although it may have made sense for small businesses, employees, and the like to enact laws in the late nineteenth and early twentieth century that limited the growth of large public corporations, those opponents of big business lost. Legal reforms today to endorse employee primacy are unlikely to succeed if they pose a threat to the managers of large public corporations.¹³⁹

This is a powerful objection, and, indeed, I am not optimistic about the prospects for significantly expanded employee primacy, or even lesser forms of employee participation, in the U.S. But dim hope does not imply no hope at all. First, some growth can occur within the private sector even given existing law. If that happens, it could provide a political base for more supportive law, which could spur further growth, and so on in a virtuous cycle. Second, some political institutions within the complex system of American governance may be more open to change than others. Some state legislatures may be willing to pursue reforms. Some courts may be more resistant to political pressure, and judges on some issues may be willing to interpret laws in ways that favor employees. Some executive agencies, for instance the National Labor Relations Board under a Democratic president, may be more open to pressure from employee advocates. Voters may be more willing to accept some sorts of reforms than explicit redistribution through the tax and welfare system.¹⁴⁰ These institutional differences can be strong reasons for

¹³⁸ See JOHN KENNETH GALBRAITH, *AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER* (1952) on the concept of countervailing power.

¹³⁹ This resembles one part of Kaplow & Shavell's brief response to the political feasibility objection to their argument for using only tax policy to redistribute. See Kaplow & Shavell, *supra* note 27, at 675.

¹⁴⁰ See Edward J. McCaffery & Jonathan Baron, *The Political Psychology of Redistribution*, 52 UCLA L. REV. 1745 (2005).

pursuing laws that we can achieve through more friendly institutions rather than following possibly more efficient tax laws that must pass through a currently quite unfriendly Congress. Of course, should employees succeed in obtaining more political power, the result will not be unmitigatedly good—like any other group, employees will sometimes use political power to achieve ends that benefit themselves but not society as a whole. But overall the effect of having the less economically well-off better represented than they are now seems likely to be positive.

VI. Values and Endogenous Preferences

Civic republicans see a close tie between virtuous citizens and effective political deliberation. Each helps produce the other. Virtuous citizens do not simply pursue their own self-interest through politics, but rather deliberate together to try to understand and bring about a common good. This process of collective deliberation in turn helps individual citizens realize and perfect their nature as political and reasoning beings.¹⁴¹ Civic republicans fear corruption for its effect on both individuals and the democratic process. The fear of financial capitalism and concentrated wealth derives in large part from a fear of their corrupting effect on individual virtue.¹⁴²

In the modern legal literature on republicanism, this has translated into a focus on ways in which individual preferences are endogenous to the political process.¹⁴³ It is thus no surprise that Cass Sunstein was a leader in the republican revival, as Sunstein has concerned himself with endogenous preferences in much of his work.¹⁴⁴ The law review civic republicans focused mainly on how courts, and to a lesser degree legislatures, influence social norms. They focused less on the role of economic interactions in shaping individual norms, although the occasional writer did argue that the new republicans should think more about such things.¹⁴⁵

¹⁴¹ A wide variety of philosophers and political thinkers have made similar points for millennia. See Aristotle, *supra* note 40; Machiavelli, *supra* note 42; Rousseau, *supra* note 49; Dewey, *supra* note 49; HANNAH ARENDT, ON REVOLUTION (1963).

¹⁴² See Pocock, *supra* note 37; Wood, *supra* note 44.

¹⁴³ See Sunstein, *supra* note 38.

¹⁴⁴ See, e.g., CASS R. SUNSTEIN, BEHAVIORAL LAW AND ECONOMICS (2000); FREE MARKETS AND SOCIAL JUSTICE (1999); *How Law Constructs Preferences*, 86 GEO. L. J. 2637 (1998); *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 (1996).

¹⁴⁵ Brest criticized the republican revival along these grounds. See Brest, *supra* note 39. An excellent effort to apply civic republican ideas to economic institutions is William H.

In thinking about the interaction between corporations, the law, and individual preferences and norms, we are moving further away from mainstream economic thought. Economists typically treat individual preferences as fixed.¹⁴⁶ The growth of behavioral economics and behavioral law and economics has changed that somewhat in recent years. Behavioralists have questioned some of the traditional rationality assumptions economists make by drawing on the work of cognitive psychologists. They see preferences as more unstable and context-dependent than the traditional economic approach.¹⁴⁷

The hope is that employee primacy can create both skills and values that support greater democracy in the political world. A variety of philosophers and economists have rested their case for employee participation in part on this hope.¹⁴⁸ Much empirical work suggests that various forms of employee participation do make workers happier with their jobs, with the effect stronger for forms focused on the immediate work environment.¹⁴⁹ Whether that translates into more, and more effective, involvement in political life is less clear. Some researchers have found little connection.¹⁵⁰ A possible explanation for little connection (or even a negative connection) is that participation in the workplace substitutes for participation in politics, both as a source of satisfaction and also as a drain on time. Still, more

Simon, *Social-Republican Property*, 38 UCLA L. Rev. 1335 (1991).

¹⁴⁶ For a leading and influential statement of this approach, see GARY BECKER, INTRODUCTION TO THE ECONOMIC APPROACH TO HUMAN BEHAVIOR; George J. Stigler & Gary S. Becker, *De Gustibus Non est Disputandum*, 67 AMER. ECON. REV. 76 (1977).

¹⁴⁷ See McDonnell, *supra* note 35. For overviews of behavioral law and economics, see Christine Jolls, Cass R. Sunstein, & Richard Thaler, *A Behavioral Approach to Law and Economics*, 15 STAN. L. REV. 1471 (1998); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051 (2000). For a reflection on the role of norms in the theory of the firm, see Reza Dibadj, *Reconceiving the Firm*, 26 CARDOZO L. REV. 1459 (2005).

¹⁴⁸ See, e.g., Pateman, *supra* note 49; Samuel Bowles & Herbert Gintis, *The Democratic Firm: An Agency-Theoretic Evaluation*, in MARKETS AND DEMOCRACY: PARTICIPATION, ACCOUNTABILITY AND EFFICIENCY (Samuel Bowles et. al. eds., 1993); Bowles & Gintis, *The Revenge of Homo Economicus: Contested Exchange and the Revival of Political Economy*, 7 J. ECON. PERSP. 83 (1993); BOWLES & GINTIS, DEMOCRACY AND CAPITALISM: PROPERTY, COMMUNITY, AND THE CONTRADICTIONS OF MODERN SOCIAL THOUGHT (1986); RONALD M. MASON, PARTICIPATORY AND WORKPLACE DEMOCRACY: A THEORETICAL DEVELOPMENT IN THE CRITIQUE OF LIBERALISM (1982).

¹⁴⁹ For an overview of this research, see JOHN L. COTTON, EMPLOYEE INVOLVEMENT (1993); see also *supra* notes 77 and 85 and accompanying text.

¹⁵⁰ See E. GREENBERG, WORKPLACE DEMOCRACY: THE POLITICAL EFFECTS OF PARTICIPATION (1986).

researchers have found a positive correlation between workplace participation and political participation.¹⁵¹ Of course, a correlation does not prove causation—perhaps certain people like democratic decision-making, and hence are drawn to both politics and worker-controlled businesses. At least one study, though, controlled rather effectively for this by studying the effects of exogenous changes in job structure, and found that such changes changed the leisure and political behavior of workers.¹⁵² It does seem at least plausible, if currently not fully proven, that effective participation within the workplace will make people both better able to engage in group decision-making and also more interested in doing so.

Insofar as democratic participation within the firm increases skills that also help for democratic participation in politics, we can easily understand the possible normative implications. Such skills clearly help both the individual workers and those who interact with them. Thus, within-the-firm participation may generate a positive externality, and we know that such externalities tend to be under-produced. That does not yet necessarily entail that governmental intervention is required—we must look closer before reaching that conclusion.¹⁵³ We can see a possible inefficiency of the private sector here, however, because it will produce too few people with strong skills supporting democratic involvement, since a firm does not have incentive to consider the positive effects workers with democratic skills have on the political system.

Changed preferences present a similar externality—if employees from a participatory business go out and participate more in political life, that benefits other citizens.¹⁵⁴ Of course, sometimes those employees will pursue goals that hurt some others, or even society generally. Still, insofar as one believes that on balance democratic participation in decision-making is a good thing, then social institutions that increase such participation create a net public good. However, changed

¹⁵¹ See Melvin L. Kohn, *Unresolved Issues in the Relationship Between Work and Personality*, in *THE NATURE OF WORK: SOCIOLOGICAL PERSPECTIVES* 154 (Kai Erikson & Steven Peter Vallas eds. 1990); MELVIN L. KOHN & CARMEL SCHOOLER, *WORK AND PERSONALITY: AN INQUIRY INTO THE IMPACT OF SOCIAL STRATIFICATION* (1983); Stephen C. Smith, *Political Behavior as an Economic Externality*, in *ADVANCES IN THE ECONOMIC ANALYSIS OF PARTICIPATORY AND LABOR-MANAGED FIRMS: A RESEARCH MANUAL* (Derek C. Jones Jan Svejnar eds., 1985) 123.

¹⁵² See Robert Karasek, *Job Socialization: A Longitudinal Study of Work, Political and Leisure Activity*, reported in Samuel Bowles, *Endogenous Preferences: The Cultural Consequences of Markets and other Economic Institutions*, 36 J. ECON. LIT. 75, 99 (1998).

¹⁵³ Section VIII will explore this point further.

¹⁵⁴ See Bowles, *supra* note 152, at 105.

preferences and values present a harder problem than increased skills. How are we supposed to evaluate the states of affairs: using the values workers have without employee participation, or those they would have if they did engage in such participation? One useful effect of the standard assumption of fixed preferences is that it allows us to avoid this awkward question. But those who deny the assumption must face up to the question.¹⁵⁵

Recent work in economics on norms and organizations is of some help.¹⁵⁶ Trust is a norm that is of value in both workplaces and the political sphere.¹⁵⁷ If employees who are engaged in joint production trust their fellow employees and their employer, they will be willing to work harder, and all will then benefit from the resulting increased output.¹⁵⁸ Similarly, trust between citizens and political leaders will allow political systems to give leaders greater discretion to come up with good outcomes.¹⁵⁹ Trust, in turn, is more likely if people believe that others are likely to be trustworthy.¹⁶⁰ Working closely with fellow employees and managers in making

¹⁵⁵ See McDonnell, *supra* note 35.

¹⁵⁶ For a collection of articles that both provides a good overview and helps to advance this area of research, see AVNER BEN-NER & LOUIS PUTTERMAN, EDS., *ECONOMICS, VALUES, AND ORGANIZATION* (1998). See also Matthew Rabin, *Incorporating Fairness into Game Theory and Economics*, 83 AMER. ECON. REV. 1281 (1993); George Akerlof, *Labor Contracts as Partial Gift Exchange*, 90 Q. J. ECON. 749 (1982).

¹⁵⁷ Although in some circumstances trust may not be socially desirable. See Claire A. Hill & Erin A. O'Hara, *A Cognitive Theory of Trust*, available at <http://ssrn.com/abstract=869423>. Indeed, even within the workplace, insofar as building in-group trust may lead to discrimination against socially marginalized groups it can be problematic. See *supra* notes 118 through 121 and accompanying text; Frank B. Cross, *Law and Trust*, 93 GEO. L.J. 1457 (2005).

¹⁵⁸ See Avner Ben-Ner & Louis Putterman, *Values and Institutions in Economic Analysis*, in Ben-Ner & Putterman in *ECONOMICS, VALUES, AND ORGANIZATION* (AVNER BEN-NER & LOUIS PUTTERMAN, EDS., 1998); Ernst Fehr & Simon Gächter, *How Effective Are Trust- and Reciprocity-Based Incentives?*, in *ECONOMICS, VALUES, AND ORGANIZATION* (AVNER BEN-NER & LOUIS PUTTERMAN, EDS., 1998); Andrew Schotter, *Worker Trust, System Vulnerability, and the Performance of Work Groups*, in *ECONOMICS, VALUES, AND ORGANIZATION* (AVNER BEN-NER & LOUIS PUTTERMAN, EDS., 1998); Jonathan Baron, *Trusts: Beliefs and Morality*, in *ECONOMICS, VALUES, AND ORGANIZATION* (AVNER BEN-NER & LOUIS PUTTERMAN, EDS., 1998).

¹⁵⁹ See Jonathan Baron, *Trusts: Beliefs and Morality*, in *ECONOMICS, VALUES, AND ORGANIZATION* (AVNER BEN-NER & LOUIS PUTTERMAN, EDS., 1998).

¹⁶⁰ See Avner Ben-Ner & Louis Putterman, *Values and Institutions in Economic Analysis*, in Ben-Ner & Putterman in *ECONOMICS, VALUES, AND ORGANIZATION* (AVNER BEN-NER & LOUIS PUTTERMAN, EDS., 1998); Andrew Schotter, *Worker Trust, System Vulnerability, and the Performance of Work Groups*, in *ECONOMICS, VALUES, AND ORGANIZATION* (AVNER BEN-NER & LOUIS PUTTERMAN, EDS., 1998).

decisions may allow employees to build more trust.¹⁶¹ Insofar as this trust generalizes from the workplace into the political realm, it could improve political decision-making.¹⁶²

However, evaluating the value of workplace participation must go beyond the goal of building trust. For further guidance on the complications of evaluation given endogenous preferences, economists need to look to other disciplines. Psychology and sociology can tell us more about the dynamics of how social norms are created and changed. History can tell us about how we developed our current values, and reveal other possibilities. Political philosophy can help evaluate our current state.

The work of Jurgen Habermas illustrates the potential utility of political philosophy in this context. Habermas focuses our attention on how people come to develop their beliefs and values through interaction with others in social institutions. In talking and acting within groups, we must make assertions and back them up with reasons. Through the back and forth of argumentation, subjecting our beliefs to criticism from others, we can improve our beliefs and values.¹⁶³

Habermas's approach is clearly related to republicanism, especially the modern law professor's variant with its emphasis on deliberation, although his goals are to some degree different.¹⁶⁴ A big part of Habermas's project is to reconstruct philosophical understandings of truth and rationality, concerns that are rather distantly removed from mine here. However, Habermas also develops his critical theory as a basis for suggesting reforms in modern society that fit pretty well with the practical suggestions of republicanism and this paper.¹⁶⁵ It clearly gives some reason for endorsing employee primacy. Workers actively involved in making work decisions within a group are engaged in the very sort of process through which we

¹⁶¹ See *supra* notes 87 and 158.

¹⁶² See Baron, *supra* note 159.

¹⁶³ The leading formulation of his thought is JURGEN HABERMAS, *THE THEORY OF COMMUNICATIVE ACTION*, VOL. 1: REASON AND THE RATIONALIZATION OF SOCIETY (1981) and JURGEN HABERMAS, *THE THEORY OF COMMUNICATIVE ACTION*, VOL. 2: LIFEWORLD AND SYSTEM: A CRITIQUE OF FUNCTIONALIST REASON (1985).

¹⁶⁴ See the references in note 38. Other philosophers who could be used to similar effect include Dewey, Arendt, and perhaps even Rawls. On Dewey and economic democracy, see Westbrook, *supra* note 49; on Arendt, see *supra* note 141; on Rawls, see JOHN RAWLS, *POLITICAL LIBERALISM* 216-20 (1993); RAWLS, *JUSTICE AS FAIRNESS: A RESTATEMENT* 198-202 (2001).

¹⁶⁵ See Thomas McCarthy, *Translator's Introduction*, in HABERMAS, *THE THEORY OF COMMUNICATIVE ACTION* VOL. 1 (1985).

expect to see truth emerge, following a Habermasian approach.¹⁶⁶

The contemporary law scholars' revival of republicanism has focused heavily on deliberation and the development of moral values. However, it has mostly done so in a rather elitist way. The spotlight is on deliberation in courts and legislatures, and how the legal rules those political elites devise affect the values of ordinary folk. The ordinary folk do not play a very large role in the main action. Employee primacy provides a much more direct, important, and intimate role for everyday people in the crucial process of deliberation that molds moral values.

Note that we must be careful about what kind of employee participation the arguments of this section tend to favor. The arguments most strongly favor more direct forms of participation at lower levels, where employees can actively engage with co-workers and managers on a daily basis. However, election of board representatives may have some value as well in preparing for political participation; indeed, such participation more closely resembles most political participation.

I should also note a problem with employee participation, one that we have already encountered in another guise or two.¹⁶⁷ Employee participation might be more effective within more homogenous groups of employees, and we might expect participatory businesses to be relatively homogenous. If so, though, it is not clear that the trust generated within such a closed in-group will generalize to participation in the more diverse setting of political life. Indeed, it could help generate conflict between conflicting groups within a polity. This is another variant of the frequent objection to republicanism as breeding ethnocentrism, and we cannot easily dismiss it. As I have already said,¹⁶⁸ no form of social organization comes without costs. As we continue to explore the relative costs and benefits of employee primacy, this tendency towards homogenization is an important cost we will have to weigh in the balance.

Still, on the whole we have seen many great benefits available from employee primacy. It tends to generate more well-being within corporations, generate fewer negative externalities outside of them, foster a more egalitarian

¹⁶⁶ Will this lead to too many meetings? Am I just an intellectual over-valuing activities in which I have a comparative advantage? These are good questions. Answering them would take us too far afield in an already rather sprawling article. I point out that at least I am in good company; the approach to political and social life I advocate here has an old and distinguished pedigree.

¹⁶⁷ See *supra* notes 118 through 121 and accompanying text.

¹⁶⁸ See *supra* note 121 and accompanying text.

economic and political system, and nurture democratic values.

VII. Why So Little Employee Primacy?

That's all very fine and well, but if employee primacy is so great, then why do we see so little of it? Opponents would argue that the arguments canvassed here favoring employee primacy are not that strong, and the problems with employee primacy make it impractical for most businesses. The infrequency of firms featuring employee primacy shows that employee primacy does not work well for most businesses. Is that correct?

A full-fledged response goes beyond the scope of this paper, but I owe at least an outline of an answer. We must break down the above arguments for employee primacy into two categories. The first category draws upon the arguments raised in section III, focused on intra-corporate surplus. If employee primacy does indeed generate a higher net surplus than shareholder primacy, then the question becomes why businesses do not adopt it. It should be possible to pay each constituent group in the corporation as much as or more than they receive in conventional corporations, so that each group should be willing to make the switch. Why does that not happen? The second category addresses the arguments raised in sections IV through VI. All of these arguments concern various types of externalities that in part affect groups outside of the corporation. For these, economics suggests much less evolutionary pressure in favor of an efficient outcome. However, we must consider whether these arguments are plausibly strong enough to worry about, and if so, whether any sort of governmental intervention will improve things. We must also worry about the political feasibility of any proposed intervention.

Consider first the question of intra-corporate surplus. Skeptics of employee primacy have long pointed to its relative rarity as evidence that it does not work as well as conventional models of corporate governance.¹⁶⁹ What might stop companies from adopting employee primacy despite its relative efficiency? One possibility is that the law may inhibit some forms of employee participation in employee decision-making. A leading possible suspect is section 8(a)(2) of the National Labor Relations Act, under which it is an unfair labor practice for an employer "to dominate or interfere with the formation or administration of any labor

¹⁶⁹ See, e.g., Jensen & Meckling, *supra* note 92; Hansmann, *supra* note 61; Bainbridge, *supra* note 72.

organization or contribute financial or other support to it.”¹⁷⁰ Section 2(5) of the Act defines a labor organization as “any organization of any kind, or any agency or employee representation committee or plan, in which employees participate and which exists for the purpose, in whole or in part, of dealing with employers concerning grievances, labor disputes, wages, rates of pay, hours of employment, or conditions of work.”¹⁷¹ Although this presumably does not affect employee election of directors, it does, as interpreted by the National Labor Relations Board and courts,¹⁷² seem to call into question many forms of employee participation, such as works councils.¹⁷³

Supporters of employee primacy have noted a variety of other possible factors that impede the growth of employee participation in corporate decision-making.¹⁷⁴ Outside financing may be harder to obtain. This could be due to the sheer unfamiliarity of worker control,¹⁷⁵ or because providers of outside financing fear that worker-controlled firms will be harder to discipline. However, the development of alternative, more sympathetic capital-providing institutions would certainly help the success of worker-controlled firms. A leading example is the Mondragon complex of cooperatives, where a bank, the Caja Laboral Popular, is at the center of the complex.¹⁷⁶ Other financial innovations that could encourage employee primacy include developing something like preferred shares shaped to the needs of employee-owned businesses, developing and improving systems of employee contributions and accounts similar to those in Mondragon, and developing a system of cross-holding among employee-run businesses, similar to what we see among Japanese firms. This latter could also help reduce the

¹⁷⁰ 29 U.S.C. § 158(a)(2) (2007).

¹⁷¹ 29 U.S.C. § 152(5) (2007).

¹⁷² See, e.g., *Elctromation, Inc.*, 309 N.L.R.B. 990 (1992), *enforced*, 35 F.3d 1148 (7th Cir. 1994).

¹⁷³ See Befort, *supra* note 94; Bruce E. Kaufman, *The Employee Participation/Representation Gap: An Assessment and Proposed Solution*, 3 U. PA. J. LAB. & EMP. L. 491 (2001); Samuel Estreicher, *Employee Involvement and the “Company Union” Prohibition: The Case for Partial Repeal of Section 8(a)(2) of the NLRA*, 69 N.Y.U. L. REV. 125 (1994); Charles B. Craver, *The National Labor Relations Act Must Be Revised to Preserve Industrial Democracy*, 34 ARIZ. L. REV. 397 (1992).

¹⁷⁴ See, e.g., *Dow*, *supra* note 46; *Bonin et. al.*, *supra* note 91; Bowles & Gintis, *supra* note 64.

¹⁷⁵ BRETT H. McDONNELL, *LABOR-MANAGED FIRMS AND BANKS* (1985) (unpublished, Ph.D. dissertation, Stanford University) (on file with Stanford University Library).

¹⁷⁶ See *supra* note 46.

diversification problem.¹⁷⁷

Also, as noted above, workers may face higher decision-making costs than shareholders because of the greater heterogeneity in their preferences as to what the business should do.¹⁷⁸ However, skilled managers and skilled workers could lower those costs, e.g., by running meetings more smoothly or communicating with one another in more efficient and less conflictual ways. Additionally, skilled managers and workers will be available in greater numbers in economies that have many worker-controlled firms. Schools at various levels, from elementary to business school, will reflect the prevailing model of social organization and help train future workers and managers with the skills that fit that prevailing model.¹⁷⁹

Considering another factor, several analysts have noted that worker cooperatives would do better if there were a developed market for membership, that is, a market where persons could buy membership in such cooperatives.¹⁸⁰ These markets might develop and work better if there were a large number of cooperatives. As a final factor for now, and one of particular interest to lawyers, employee primacy would be more likely to flourish if there were a well-developed body of law to help define rights and responsibilities within such firms under various circumstances.¹⁸¹ Legislators and courts are unlikely to develop such law, though, in the absence of worker-controlled firms.

Each of these explanations for the dearth of worker-controlled firms has the following structure. Firms featuring employee primacy would generate a greater internal surplus in the presence of some factor—favorable financial institutions, managers and workers skilled at democratic decision-making, membership markets, laws, and so on. That factor, however, is likely to develop only if many firms featuring employee primacy are present. The lack of such firms keeps the factor

¹⁷⁷ See *supra* note 64 and accompanying text. Of course, Japan is not the exemplar that it seemed several decades ago. For some thoughts on the U.S./Japan comparison, see Brett H. McDonnell, *Convergence in Corporate Governance—Possible, But Not Desirable*, 47 VILL. L. REV. 341 (2002).

¹⁷⁸ See *supra* notes 61 through 63 and accompanying text.

¹⁷⁹ See SAMUEL BOWLES & HERBERT GINTIS, *SCHOOLING IN CAPITALIST AMERICA: EDUCATIONAL REFORM AND THE CONTRADICTIONS OF ECONOMIC LIFE* (1977).

¹⁸⁰ See Dow, *supra* note 46, at 148-56.

¹⁸¹ See David Ellerman & Peter Pitegoff, *The Democratic Corporation: The New Worker Cooperative Statute in Massachusetts*, 11 N.Y.U. REV. L. & SOC. CHANGE 441 (1982-83). On possible network effects and path dependence in the development of legal rules, see Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995); Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996).

from developing, which in turn keeps firms featuring employee primacy from developing, and so on in a vicious cycle. These arguments all feature types of network externalities—a particular product, or standard, or way of doing things, is more productive the more widely it is used. Markets featuring network externalities typically exhibit multiple possible equilibria. One equilibrium may be Pareto-preferred to another, and yet the inferior equilibrium may prevail. Once one is stuck in an inferior equilibrium, there may be little or no impetus to move to a better outcome. Government intervention potentially can help such a system move to a better equilibrium.¹⁸² Of course, innovation does happen despite such obstacles. However, the fact that some desirable innovations do occur does not imply that all good innovations will occur, and the more radical the change from existing institutions, the more strongly will such effects block innovation.

These network externality stories do not supplant existing explanations for the patterns of employee primacy that we observe, but rather they supplement them. Consider, for instance, the important work of Henry Hansmann and Stephen Bainbridge. Both scholars grant that in certain circumstances, some forms of employee participation can have positive effects of the sort discussed in section III. However, employee participation also has costs, particularly in politicized and thus expensive decision-making due to the greater heterogeneity of workers than shareholders. Thus, the theories of Hansmann and Bainbridge suggest that some but not all businesses will choose to involve employees in decision-making, with the relative heterogeneity of employees compared with shareholders as a key variable affecting the prospects of employee participation.¹⁸³

The network externality story suggests that the relative advantage of employee involvement in decision-making will vary depending on how many other businesses have a similar form of involvement. Although it will always be true that employee involvement will be more attractive in businesses with more homogenous employees, in economies with a high degree of employee involvement, a higher proportion of businesses will find such involvement to be worth doing. Depending

¹⁸² See, e.g. W. Brian Arthur, *Self-Reinforcing Mechanisms in Economics*, in *THE ECONOMY AS AN EVOLVING COMPLEX SYSTEM* 9 (Philip W. Anderson et. al. eds., 1988); Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332 (1985); Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479 (1998); but c.f. S.J. Liebowitz & Stephen E. Margolis, *Path Dependence, Lock-In, and History*, 11 J.L. ECON. & ORG. 205 (1995).

¹⁸³ See Hansmann, *supra* note 61, and Bainbridge, *supra* note 53.

on the exact nature of the relationship between net benefits in individual businesses and the economy-wide level of employee involvement, this may lead to multiple possible equilibrium levels of the proportion of businesses that choose to involve employees in decision-making.

A closely related argument for why firms subject to employee control might generate a greater intra-corporate surplus and yet not flourish in the market place comes from some work by Gregory Dow.¹⁸⁴ Dow shows how firms with employee control may be more efficient, but their current members do not capture the full surplus that they generate because some of them will leave the firm before all future benefits generated by current investments are achieved. This leads to a tendency to invest at a lower rate than shareholder firms, leading the latter to dominate in the market. Of course, if investment is too low, the employee-run firms will be less efficient, but Dow shows that there can be an intermediate realm where employee-run firms grow more slowly than shareholder-run firms and yet are more efficient. Dow argues that perfectly functioning markets for membership in employee-run firms would eliminate this problem, but that in the real world membership markets are likely to be imperfect at best.

Consider now the arguments in sections IV through VI. All of these concern externalities that in part affect groups outside of the corporation. Pollution affects those who live near the polluting plant. Political lobbying leads to laws that affect everyone in a jurisdiction. Changed values and preferences of workers affects others in a community when those workers move to other businesses, interact with others in the community, particularly in local politics, or when they pass their values on to their children. Wherever significant externalities exist, markets may not lead to efficient outcomes. Of course, markets may work despite externalities—that is the point of the Coase theorem.¹⁸⁵ However, where transaction costs are high enough, market outcomes will generally not be efficient.

Inefficiency does not, however, automatically justify government intervention. First, if one believes that the effects described in sections IV through VI exist, they may not be great enough to notice. Is that so here? It is hard to say, in the absence of economies with large number of firms featuring employee primacy.¹⁸⁶

¹⁸⁴ See Dow, *supra* note 46; Gregory K. Dow, *Democracy Versus Appropriability: Can Labor-managed Firms Flourish in a Capitalist World?*, in *MARKETS AND DEMOCRACY: PARTICIPATION, ACCOUNTABILITY AND EFFICIENCY* 176 (Samuel Bowles *et. al.* eds. 1993).

¹⁸⁵ See Ronald Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

¹⁸⁶ One example of a large economy that does feature a significant amount of

Externalities such as pollution are certainly important, but would employee-controlled corporations pollute noticeably less than corporations run according to shareholder primacy? Corporate lobbying certainly has major effects on our laws, which in turn have major effects on our economy and society, but how different would corporate lobbying be under employee primacy? Values favoring democratic participation could certainly boost political democracy, but how much would employee primacy actually affect political action? We have bits and pieces of evidence, discussed in the relevant sections above, but it is hard to reach systematic conclusions on any of these topics. Still, the arguments laid out here are significant enough that employee primacy could have a quite notable positive impact outside of the corporation itself.

Even so, we have not yet justified any and all interventions in favor of employee participation. Even if there are notable benefits, we must trade these off against the costs, and determine how well any particular suggested intervention would do at achieving as much benefit as possible at the lowest feasible cost. These are obviously very hard to estimate. I next turn to the question of suggesting and justifying legal interventions to encourage employee participation.

VIII. Possible Interventions

The previous section laid out a variety of reasons why markets might not produce the best possible number of corporations adopting employee participation in its various guises. We might be better off with more employee participation than the market produces when left to its own devices. This suggests that we might improve society by intervening legally to promote employee primacy. Nevertheless, we must be careful in moving from the theoretical possibility of improvement to actual interventions. The gains from greater participation may turn out to be small, and the costs great. I will thus suggest interventions that are modest, flexible, and reversible.

What, then, might we do to help encourage employee participation? I will focus here on participation at the level of selecting board representatives.¹⁸⁷ One

employee participation through the system of co-determination is Germany. For some of my thoughts on the comparison between German and American corporate governance, see Brett H. McDonnell, *Convergence in Corporate Governance – Possible, But Not Desirable*, 47 VILL. L. REV. 341 (2002).

¹⁸⁷ But reforms encouraging lower-level participation also matter. One place to start is revising section 8(a)(2) of the National Labor Relations Act. See the sources cited in note

question is whether one wants to encourage employee-only boards, or an even mix of employee and shareholder representatives, or simply a minority of employee representatives.¹⁸⁸ On first principles, each alternative has its virtues, but political reality dictates focusing on the last possibility, minority employee representation. I would not suggest mandatory employee representation; rather, governments could provide positive incentives, such as a subsidy or tax break, to businesses that have employee board representatives. Or, one could adopt default rules¹⁸⁹ that prescribe employee representation on the board, but allow firms to opt out of the default should enough of their workers agree. One might want to require that employees reaffirm that opting out periodically. An even milder intervention would retain existing default rules that do not feature employee primacy, but make it easier than now for businesses to opt in to forms of employee participation. For instance, a relatively well worked out legal scheme can be made available to employee-run firms; interesting recent research suggests that the availability of such "menu" options can strongly affect the outcomes observed¹⁹⁰ and it would be helpful to study the Massachusetts experience with a statute for worker cooperatives in this context.¹⁹¹

Some of the arguments for employee participation suggest benefits to participation at a lower level of decision-making than the board of directors. One might then look to a different part of the German experience and consider the possibility of encouraging works councils.¹⁹² These would operate at the plant or

173.

¹⁸⁸ Sharing the election of directors between shareholders and employees is often called co-determination, and is far more common in Europe than in the U.S., particularly in Germany, where forms of co-determination are required for firms above a certain size. There is a vast literature on co-determination, which is obviously relevant to this paper's topic, but exploring that literature would take us too far away from my central argument. For some good discussions of co-determination, see THEODOR BAUMS & PETER ULMER, EDs., *EMPLOYEES' CO-DETERMINATION IN THE MEMBER STATES OF THE EUROPEAN UNION* (2004); Katherine Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in *EMPLOYEES AND CORPORATE GOVERNANCE* 163 (Margaret M. Blair & Mark J. Roe eds., 1999); Stefan Prigge, *A Survey of German Corporate Governance*, in *COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH* 943 (K.J. Hopt et. al. eds. 1998).

¹⁸⁹ See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87 (1989); Brett H. McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 *SMU L. REV.* 383 (2007).

¹⁹⁰ See Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, working paper.

¹⁹¹ See Ellerman & Pitegoff, *supra* note 181.

¹⁹² See Befort, *supra* note 94.

office level rather than corporation-wide, and would involve employees in making a more limited set of decisions over matters that more immediately affect them, such as health and safety or workplace rules. In keeping with the experimental flavor of my suggestions, one could start with works councils that cover only a narrow range of topics, and if the experiment seemed to be working expand their scope over time. Once again, I would not require that businesses adopt works councils, but rather encourage them as with the suggestions for board representation: through tax incentives, subsidies, default rules, or menu options. At the very least, we should reform section 8(a)(2) of the National Labor Relations Act to allow more experimentation.¹⁹³

Another possibility is to promote employee primacy through giving employees standing to bring derivative actions.¹⁹⁴ As noted above, one of the major ways that current corporate law achieves shareholder primacy is through allowing only shareholders to bring derivative actions.¹⁹⁵ A full-fledged change from shareholder primacy to employee primacy thus needs to re-consider who should be allowed to sue on behalf of the corporation. Such a change would raise concerns about strike suits and the abuse of such suits to further goals that help employees at the expense of other constituencies. However, the same sorts of mechanisms that we currently use to tame shareholder derivative actions could also limit employee derivative actions. This question deserves more detailed study.

Should these suggested reforms be pursued at the state or national level? The difficulty of estimating the costs and benefits suggests experimenting with different approaches in different jurisdictions—one of the key benefits of jurisdictional choice within the U.S.¹⁹⁶ and of differences in corporate governance between countries.¹⁹⁷ On the other hand, if one fears that state competition entails

¹⁹³ See *supra* note 173.

¹⁹⁴ A derivative action occurs where an officer, director, or controlling shareholder has engaged in action that has hurt the corporation. Generally, it is the board that has the authority to protect the corporation where it has been hurt. However, where those who caused the harm dominate the board, it may be unrealistic to expect board action. Recognizing this, the law allows for derivative actions to be brought on behalf of the corporation when the board will not do so. In American corporate law, only shareholders have standing to bring a derivative suit.

¹⁹⁵ See *supra* note 16 and accompanying text. For further discussion, see *supra* note 117.

¹⁹⁶ See Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. Corp. L. 99 (2004).

¹⁹⁷ See McDonnell, *supra* note 186.

that states will not adequately consider the interests of employees in setting corporate governance rules,¹⁹⁸ then we might need to implement these suggestions at the national level. Whichever works. It may well be, at the moment anyway, that the most feasible place to start is with a few large, liberal states in which there are enough sympathetic legislators and which are not terribly invested in the competition for corporate charters—California and New York, for instance. On the other hand, international competition and the threat of losing capital and business due to globalization may prevent even the federal government from acting.

Conclusion

I have brought together the traditionally separate conceptual worlds of law and economics and civic republicanism,¹⁹⁹ and used them to explore the choice between shareholder primacy and employee primacy. I hope to have shed light on law and economics, civic republicanism, and corporate governance.

By bringing together law and economics with civic republicanism, I want to encourage a broadened understanding of the former. The impact of different corporate governance systems on the environment, politics, and even social values are all topics that economics can speak to. In doing so, law and economics does lose some of its distinctiveness, and merges into other forms of “law and”—law and society, law and political theory, law and psychology, law and history, and so on. That is not such a bad thing. Each discipline has something to teach the others, and all shed some light on the law.

In comparing shareholder primacy with employee primacy, we have seen many potential benefits from getting employees involved in corporate governance. However, there are costs as well, and the size of both costs and benefits is uncertain and contested. I believe that on the whole the arguments favor action to promote more employee participation. However, the action should be modest, reversible, and experimental. Rather than trying to impose employee primacy on all corporations within the U.S., we should encourage participation through subsidies, tax breaks, menus, and default rules.

Also of interest is the fact that the arguments favoring employee primacy

¹⁹⁸ See Mark J. Roe, *Delaware's Politics*, 118 Harv. L. Rev. 2491 (2005); McDonnell, *supra* note 198.

¹⁹⁹ Not completely separate, mind you—Cass Sunstein is a pivotal figure who spans both worlds.

over shareholder primacy have, in many cases, suggested greater problems with shareholder primacy in public corporations than in close corporations. Small businesses run by a few active shareholders have many of the social benefits of employee primacy. Indeed, had we broadened our scope to include partnerships as well as corporations, we would have seen even closer affinities to employee primacy. The comparison makes employee primacy look less radical than it might otherwise appear, as does the tie with civic republicanism, an ideological strain whose roots go back to the American Revolution and beyond, and which has re-appeared in various strains throughout American history. Active participation in matters that affect one's life, aversion to extreme inequality, shared deliberation to reach a public good, the gains from a virtuous life spent working with others—these are all values that Americans have recognized from the New England town meeting to *It's a Wonderful Life*. How to reconcile these goods with a modern, technological market economy dominated by large corporations has been a central tension of American economic and political life at least since the rise of large industrial corporations after the Civil War. Employee primacy is one attractive response to that central tension.