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BOOK REVIEW

THE CURIOUS INCIDENT OF THE WORKERS IN THE BOARDROOM

EMPLOYEES AND CORPORATE GOVERNANCE
(Margaret M. Blair & Mark J. Roe eds.)

Brett H. McDonnell*

In Silver Blaze, Sherlock Holmes investigated the disappearance of a prize horse and the killing of its trainer.¹ At one point in the investigation the officer in charge, Inspector Gregory, asks Holmes, "'Is there any other point to which you would wish to draw my attention?'"² Holmes replies, "'To the curious incident of the dog in the night-time.'"³ Gregory says "'The dog did nothing in the night-time.'"⁴ "'That was the curious incident,' remarked Sherlock Holmes."⁵

On the night that the horse was taken, the dog had not barked enough to awake two guard boys in a nearby loft.⁶ From this Holmes deduced that someone familiar to the dog must have taken the horse, which absolved the leading suspect and helped lead to finding the true culprit.⁷ This story is a nice illustration of the proposition that one must pay attention to silence, where that silence is surprising or informative.

Students of corporate governance study how decisions are made within corporations. Employees are a crucial part of any corporation.

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2. Id. at 27.
3. Id.
4. Id.
5. Id.
6. See id. at 32.
7. See id.
Much of a business’ success depends on how well its employees do their jobs. Employees must be motivated, and myriad decisions must be made as to who does what within the organization. Employees know much about what is going on within a business, and have ideas about how things could be done differently. Corporations differ greatly in how they use such information. One would expect that students of corporate governance would have focused much attention on the relationship between corporations and their employees. One might further expect that corporate law does much to help structure the relationship between corporations and their employees.

One would be wrong. In economics, the theory of the firm largely analyzes the relationship between shareholders and managers. The relationship between the firm and its employees is usually studied in another field, labor economics. Similarly, in legal scholarship, students of corporate law are generally quite distinct from students of labor law. The distinction among legal scholars mirrors the distinction between two quite separate bodies of law.

In corporate law, employees’ voices are the barks not heard. Their absence can teach us much. But what does it teach? Reasonable minds differ. In one view, as Holmes concludes, this dog did not bark. Employees are relatively silent in corporate governance because there is no reason for them to speak. Perhaps there really is something different and special about the shareholder-manager relationship because shareholders are the owners, the residual claimants, or the contractual parties most vulnerable to managerial opportunism. How shareholders can and do constrain managers to act in the best interests of shareholders is indeed a subject deserving of separate study and laws.

An opposing view notes a possible problem in Holmes’ reasoning. Perhaps the dog barked, but the nearby boys did not hear it. After all, they were both sound sleepers. One needs adequate confidence in his or her ability to be aroused by a barking dog under the circumstances. Perhaps corporate governance scholars have just slept through “the barks” without realizing the significance of employees to their field. Perhaps the tools of legal analysis and economic and financial theory, which corporate law scholars have deployed over the last several decades to study shareholders and managers, should be expanded to study employees as well. Perhaps corporate law, too, should be reformed to consider the interests of employees.

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8. See id. at 8.
The contributors to *Employees and Corporate Governance* choose the latter alternative, to varying degrees. They examine the role of employees in corporate governance from a number of interesting and valuable perspectives. Employee involvement in corporate governance can take a variety of forms. Most obvious is the appointment of employee representatives to the board of directors. However, employees may be involved at other levels as well, or instead, including helping make decisions at their particular unit—for example, through quality circles, or through informal participatory management techniques. Unions may also be seen as injecting a degree of employee governance into a corporation. The papers in *Employees and Corporate Governance* consider a variety of alternatives. Nine of the ten papers were originally presented at a 1996 conference at Columbia Law School sponsored by the Sloan Project on Corporate Governance.

This Review draws four lessons and questions for future research and debate from this book. First, a variety of factors point in opposing directions as to the costs and benefits of various forms of employee involvement in corporate governance. A greater voice in decision-making may improve employee motivation and hence effort, and may also allow corporations to use many good ideas which their employees can suggest. Employee involvement may also improve the incentive of employees to invest in firm-specific human capital. On the other hand, considerations of diversification, comparative competence, capital market problems, and decision-making costs counsel against at least some forms of employee involvement in governance. Unfortunately, this is not the rare case of a one-handed economist for which Harry Truman wished. Economic theory points every which way, and neither refining that theory nor empirically testing it will give us anything close to a clear, coherent, generally agreed upon economic theory of employee governance.

Second, we must look to surrounding legal, economic, and social institutions to help understand why certain kinds and degrees of employee involvement in corporate governance exist in a given society. Such institutions, combined with the prevailing forms of corporate

9. *Employees and Corporate Governance* (Margaret M. Blair & Mark J. Roe eds., 1999) [hereinafter ECG].
10. See id. at 3.
11. See id.
12. See id.
13. See id.
14. See infra Part III.A.
15. See infra Part III.B.
governance, constitute a complementary system which, once in place, becomes self-reinforcing, even though in many cases the path by which that system is established is haphazard and accidental. Comparisons across such systems become quite difficult, and attempts to lift an idea which works well in one system and use it in a different system should be viewed with caution.

Third, efficiency is not all we should care about.\textsuperscript{16} The contributors to \textit{Employees and Corporate Governance} all draw on economics, and hence, all focus on efficiency. However, the stories they tell often show that the agents who helped create corporate governance structures often had many ends besides just economic efficiency in mind. A just distribution of income and wealth and economic democracy are two other values that are of particular relevance to this book's topic. Economists have a comparative advantage over political philosophers and other social scientists in analyzing efficiency, and it is truly an important social value. However, we should not ignore other values. Moreover, as the above two points help make clear, drawing definite conclusions as to the Pareto superiority or inferiority of opposing alternatives will often be next to impossible. Economists may then need to restrict themselves to giving a rough sense as to problems likely to arise with different arrangements and which actors are likely to gain or lose under them. The audience can then ponder these results in the light of their preferred normative concerns.

Finally, the book provides a good example of what is a pervasive problem in law and economic analysis.\textsuperscript{17} Neither economic theory nor empirical testing provides anything close to clear answers to most policy questions arising in this area. We should not expect this situation to change soon, or even for quite awhile. What, then, can researchers in this area say to policy makers? How do we as a society make policy in light of the pervasive and probably lasting uncertainty relating to the social effects of various alternative policies? A few suggestions are offered below, but full disclosure must be made up front: this small Book Review will not answer that big question.

Part I of this Review describes and examines the theoretical papers which make up the first four chapters of \textit{Employees and Corporate Governance}. Part II looks at the more applied papers, which fill out the rest of the book, divided into three sections: German codetermination, Japanese corporate governance, and employee share ownership in the

\textsuperscript{16} See infra Part III.C.

\textsuperscript{17} See infra Part III.D.
United States airline industry. Part III suggests directions for further research and possible legal reform.

I. THEORETICAL FRAMEWORK

A. Why Capital (Usually) Hires Labor

Economists studying corporate governance have not totally ignored employees. There is a relatively small, but significant, body of theoretical literature on "labor-managed firms." This literature tries to analyze how firms owned and controlled by their own employees would differ from firms owned by shareholders who are not employees of the firm. The literature also tries to explain why labor-managed firms are relatively rare, and under what circumstances they are most likely to exist.

Gregory Dow and Louis Putterman survey this literature in the first chapter, Why Capital (Usually) Hires Labor: An Assessment of Proposed Explanations. This paper largely recapitulates earlier work by Dow and by Putterman. However, for those not familiar with their work, the paper is a very good introduction to this literature.

Dow and Putterman distinguish five sets of reasons why capital usually hires labor. The first stems from a major article by Armen Alchian and Harold Demsetz. "Teamwork is often more productive than work by isolated individuals," but it is hard to observe effort and contributions by individual members of a team. An entrepreneur solves the problem by specializing in monitoring the employees. This

19. See id.
20. See id.
21. Gregory Dow & Louis Putterman, Why Capital (Usually) Hires Labor: An Assessment of Proposed Explanations, in ECG, supra note 9, at 17, 17-57. Capital usually hires labor in the sense that shareholders (providers of capital) are seen as owning the firm and hiring labor, rather than employees owning the firm and paying providers of capital a fee for their service, as in a labor-managed firm. See id. at 19.
23. See Dow & Putterman, supra note 21, at 23-27.
25. Dow & Putterman, supra note 21, at 23.
26. See id.
monitoring has the correct incentive, which is to maximize the value the firm creates if she is the residual claimant of revenues from the firm's activities. Dow and Putterman point out that, in theory, a variety of alternative mechanisms are available to motivate workers in a team other than this one. They argue that the limited empirical evidence available goes mostly against the Alchian and Demsetz story. Alchian and Demsetz's story does not explain well the authority inherent in the employment relation.

The second set of reasons looks to credit markets. Employees generally have limited wealth and hence may have trouble financing labor-managed firms themselves, while adverse selection and moral hazard problems limit the ability of such firms to raise funds in credit markets. However, in addition to other problems with this explanation which Dow and Putterman discuss, it is not clear why labor-managed firms would face difficulties greater than standard entrepreneurial start-ups, on the arguments presented here. It is possible to make a credit market-based argument focusing on the unfamiliarity of financial markets with labor management as an organizational form, but Dow and Putterman do not make that argument.

The third reason involves risk aversion and insurance. Employees already have much at stake in the success of their firm. Were they to invest financially in that firm as well, they would become even further exposed to firm-specific risk. Outside investors, in contrast, can reduce risk through diversification. Dow and Putterman note, though, that employee governance allows employees a greater role in managing the risk that they face, and probably reduces risk caused by the threat of layoffs. Also, imposing some firm-specific risk on employees is generally optimal under standard principal-agent theory, and empirical

27. See id.
29. See id.
34. See Dow & Putterman, supra note 21, at 31-35.
35. See id. at 33-34.
evidence on profit sharing and agricultural contracting arrangements does not clearly support the risk aversion explanation.\textsuperscript{15}

The fourth set of reasons relates to asset-specificity and investment incentives.\textsuperscript{37} Much interesting work focuses on incentives created by different ownership structures to invest in firm-specific capital, given an inability to completely contract as to the future use of that capital.\textsuperscript{15} Discussion of this factor will be deferred until the discussion of Margaret Blair's contribution, which focuses on it, except to note that here too the theory becomes indeterminate once one notes that human capital as well as physical capital may be firm-specific.

The final major set of reasons explored relating to why capital usually hires labor is that labor-managed firms have higher costs in decision-making.\textsuperscript{39} Shareholders allegedly agree on one basic goal, maximizing the expected stream of profit, whereas the large variety of employees in a firm may have a range of differing and conflicting goals.\textsuperscript{29} Henry Hansmann has argued this point most forcefully.\textsuperscript{41} Dow and Putterman point out, though, that there are various ways to limit this problem, and decision-making costs appear to account for some, but far from all, of the observed variance in employee governance.\textsuperscript{42}

After discussing a variety of factors which they consider less important, Dow and Putterman conclude that in order to be able to weigh in on policy matters, economists must refine their theory and test it more.\textsuperscript{43} They recognize the barriers to such work, and summarize those barriers well: "At a theoretical level, the available hypotheses are often fuzzy on causal details and potential interactions between factors. Different hypotheses sometimes have parallel empirical implications. It is not always obvious what the relevant proxy variables would be. The required data may not exist in any convenient form."\textsuperscript{44}

\textsuperscript{36.} See id. at 34-35.
\textsuperscript{37.} See id. at 35-42.
\textsuperscript{38.} This work is summarized in OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 56-72 (1995).
\textsuperscript{39.} See Dow & Putterman, supra note 21, at 42-45.
\textsuperscript{40.} See id. at 42.
\textsuperscript{42.} See Dow & Putterman, supra note 21, at 43.
\textsuperscript{43.} See id. at 50.
\textsuperscript{44.} Id.
Quite so. Despite these barriers, Dow and Putterman urge more theoretical and empirical work.\textsuperscript{45} Such work may weed out some theoretical positions, and at any rate, it sharpens our understanding, clarifies the connections between various institutions, and may suggest new questions of which we have not yet thought. However, we should recognize the likelihood that such work is likely to lead to no clear policy implications for the foreseeable future, during the lifetime of any life currently in existence. This Review returns to this point in Part III.

\textbf{B. Firm-Specific Human Capital}

Margaret Blair’s contribution to the volume is entitled \textit{Firm-Specific Human Capital and Theories of the Firm}.\textsuperscript{46} Firms may be more productive if their employees invest in firm-specific human capital.\textsuperscript{47} For instance, knowledge about a firm’s organizational structure and the formal and informal roles of various employees within that structure is a form of human capital that is of use only as long as the employee possessing such knowledge continues to be employed at the firm. An employee possessing such knowledge will be more productive.

However, if it is costly for an employee to invest in such firm-specific human capital, a problem arises. The firm may have an incentive to appropriate the gain from that investment, since the employee cannot credibly threaten to go to another firm, as his or her firm-specific capital is of no value elsewhere. For instance, suppose the knowledge described in the previous paragraph increases the value of an employee’s work to the firm by $10,000 per year. The firm, however, may decide not to raise the employee’s wage to reflect that fact, and the firm’s competitors would not offer a higher wage either, as that firm-specific knowledge is of no use to them. Knowing this possibility, the employee may under-invest in such capital. If the firm and the employee could, at low cost, write a complete contract which prevented the firm from expropriation in all possible eventualities, the problem would disappear. Such contracts, however, would be prohibitively expensive and in many instances not enforceable, as a court may not be able to verify whether a state of affairs specified in the contract in fact occurred.

\textsuperscript{45} See id.

\textsuperscript{46} Margaret M. Blair, \textit{Firm-Specific Human Capital and Theories of the Firm}, in ECG, \textit{supra} note 9, at 58, 58-90.

\textsuperscript{47} See id. at 59.
The economic literature now features a large and growing number of articles and books attacking this issue from a variety of angles. Blair provides a useful survey of some of that literature. She maintains that legal scholarship on corporate governance has not yet adequately come to grips with it. The firm-specific human capital problem provides a possible argument for a larger role for employees in firm governance, or for a fiduciary duty running in favor of employees. Such mechanisms would help prevent firms from exploiting employee investments in firm-specific human capital. However, this is just one possible argument that arises from the literature—it is not at this point a clear, agreed-upon policy implication by any means. There are other potential solutions to the problem. For instance, the firm, rather than the employee, could pay for the investment. Or the firm may reward its employees for their investment to enhance its reputation and encourage further employee investment.

At the beginning and end of her paper, Blair makes an intriguing, if incomplete, argument that firm-specific human capital considerations may point to a return to the entity theory of the firm. The entity theory emphasizes that the corporation is a separate legal entity, not simply the sum of its various parts. She contrasts this with contractarian theory, which treats the firm as a nexus of contracts between the various parties who make up the firm. Some models within the human capital literature suggest a role for a separate third-party as owner of a firm's assets. Blair suggests the separate entity theory may make legal sense of those models. In this paper the idea is barely more than a suggestion, which needs much more detail and argument. It is thus not possible to evaluate it at this point.


49. See Blair, supra note 46, at 58-59.
50. See id. at 77-80.
51. See id.
52. See id. at 59, 85-87.
53. See id. at 59.
55. See Rajan & Zingales, supra note 48, at 422.
56. See Blair, supra note 46, at 59.
57. The suggestion is developed further in Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247 (1999).
C. Political Culture

David Charny contributes a cross-national comparison of various forms of organization in which employees have a partial, but not total, voice in managerial decisions. He focuses on one particular objection to employee participation in decision-making: Employees as a group may have quite heterogeneous interests, both among themselves and in contrast to shareholders, and as a result, conflicts often arise and decision-making becomes costly. Charny acknowledges the problem, but argues that there may be a variety of ways to reduce it.

Charny situates the relationship among employees and between employees and management within a “game-theoretic schema,” though he does no formal modeling. The group of employees as a whole contains a variety of subgroups. Those subgroups may either compete among themselves or work together to increase gains to employees as a whole. Employees as a whole, in turn, may either compete or cooperate with management. Competition among employee subgroups may make cooperation with management more likely, so it is not a priori clear whether subgroup competition is good or bad for the corporation as a whole.

Beliefs and norms concerning corporate governance, which Charny terms “political culture,” may crucially affect the likely outcomes of interaction between employees and management. Political culture may provide focal point outcomes, deliberative procedures, and sanctions for defections from the proposed equilibrium outcome. His discussion of these points is interesting and suggestive, but could use much more fleshing out.

Charny discusses three different national systems of corporate governance. Germany provides a formalized system for employee participation in governance, Japan provides for informal representation

59. See Charny, supra note 58, at 95-96.
60. See id. at 100-04.
61. See id. at 96-100.
62. See id. at 97.
63. See id. at 98.
64. See id.
65. See id.
66. See id. at 100.
67. See id. at 101.
68. See id. at 100-04.
69. See id. at 104-09.
of employee interests in governance, and the United States provides for little employee participation. He considers the relative ability of these three systems to adapt to new technologies and changed economic circumstances. He finds that the United States system provides management greater flexibility, but at the cost of losing potentially valuable employee input. He tentatively suggests that the German system may be more adaptable and less likely to deteriorate to a regime of no participation under current circumstances than the Japanese system. Again, the discussion is suggestive, but could use further articulation.

D. Levels of Participation

Perhaps the most valuable theoretical contribution is Tailored Claims and Governance: The Fit Between Employees and Shareholders, by Edward B. Rock and Michael L. Wachter. They focus our attention on forms of governance other than formal participation in the boardroom and forms of compensation other than stock ownership. Rock and Wachter argue that, properly understood, employee participation in governance is, in fact, widespread, but at a level and in a form where it can do the most good. They single out four features as determining the optimal type of participation for a particular group within the firm: match-specific or relationship-specific investments, asymmetric information, risk aversion, and transaction costs.

Employees in a large public corporation frequently participate in decisions within their work units, but not in corporation-wide policy setting, because employees have much useful information about their own work units, but little to add to firm-wide strategy. Employees rarely receive compensation based on performance, they argue, because of both employee risk aversion and the difficulty of measuring

70. See id.
71. See id. at 110-13.
72. See id. at 108, 111-12.
73. See id. at 110-11.
74. Edward B. Rock & Michael L. Wachter, Tailored Claims and Governance: The Fit Between Employees and Shareholders, in ECG, supra note 9, at 121, 121-59.
75. See id.
76. See id. at 124.
77. See id. at 123.
78. See id. at 124.
79. See id. at 129-30. A point which Rock and Wachter do not substantiate with empirical evidence.
performance. When employees do receive performance-based pay, it is typically tied to the performance of their unit, rather than that of the corporation as a whole. Investors in a public corporation, by contrast, typically have low match-specific investments and hence, high turnover in their relationships with the corporation. Therefore, investors rely mostly on their ability to sell their shares to protect their investment (the Wall Street rule), with some reliance on other protective mechanisms as well.

Rock and Wachter further argue that, in closely held corporations, investors and employees are more similar, as investors are typically less diversified and less able to sell their shares. Moreover, employees typically have a better sense of the corporation’s overall strategy and position, and each individual employee has a more appreciable effect on overall performance. As a result, investors and employees are treated more similarly in closely held corporations, with employees having more input in firm-wide governance and a share in firm ownership, typically through stock options.

The Rock and Wachter paper provides many valuable insights and a useful general framework. It suffers, though, from a familiar tendency to see the task of theory as simply to explain the efficiency of existing patterns, and of only existing United States patterns at that. They implicitly assume that what has survived in the American marketplace must be the most efficient outcome. However, as other papers in the volume help explain, a number of factors may constrain the evolution of work organization patterns. Rock and Wachter come up with persuasive arguments for the efficiency of the patterns which they describe, but if current United States reality was rather different, the same basic building blocks could explain that different reality too. For instance, Rock and Wachter argue that employees generally have few useful ideas to add to thinking about what products to develop and market. Perhaps. But then again, perhaps not. Through their involvement with the firm’s technology and with suppliers and customers, employees may gain some very useful ideas as to product development strategy. Take, for instance, the failure of Xerox to market the personal computer, which it helped

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80. See id.
81. See id. at 131.
82. Rock and Wachter prefer this term to “firm-specific,” but the meanings are similar. See id. at 123.
83. See id. at 138-43.
84. See id. at 142.
85. See id. at 139-40.
86. See id. at 150-51.
develop. Had the senior managers of Xerox listened better to their scientists who came up with some of the core breakthroughs in personal computing technology, the history of Xerox might have been quite different. Even if in very broad strokes the Rock and Wachter picture is correct, how much and what type of employee involvement exactly is optimal may vary widely with circumstances and supporting institutions, and there is no guarantee that contemporary American firms have necessarily found the best mix.

II. NATIONAL APPLICATIONS

The second, third, and fourth sections of *Employees and Corporate Governance* examine German codetermination, Japanese corporate governance, and employee share ownership in the United States airline industry, respectively.

A. German Codetermination

Since 1976 German law has required that large corporations provide for formal employee involvement in corporate governance. German corporations have two governing boards, rather than a single board of directors as in the United States. The supervisory board engages in general oversight, while the management board engages in more detailed decision-making. Under codetermination, large corporations must have employee representatives on their supervisory boards. In the first paper included in this section, Katharina Pistor argues that codetermination was instituted to ensure political peace between capital and labor, with little consideration for its possible effects on corporate governance. She argues that putting employees in the boardroom increases the costs of collective decision-making for supervisory boards, diminishing their ability to effectively monitor management. She further argues that codetermination makes German

88. And in some industries since 1951. See Katharina Pistor, Codetermination: A Sociopolitical Model with Governance Externalities, in ECG, supra note 9, at 163, 167-72.
89. See id. at 172-75.
90. See id. at 171.
91. See id. at 168, 171.
92. See id. at 165. German employees also participate in decision making at the shop-floor level through workers’ councils. See id. Note that this level of employee involvement in corporate governance is more appropriate than the supervisory board level under Rock and Wachter’s theory.
93. See id. at 163-93.
94. See id. at 179.
corporate governance into a "multiplayer game" in which management can play shareholders and employees against each other. Pistor admits that there is limited empirical evidence supporting her position, although there is little evidence against it either. She notes that in the wake of the 1976 law extending codetermination, a number of corporations changed their bylaws to limit codetermination's impact. This is of interest, but it is unclear how much one can learn from this. Perhaps it simply reflects a struggle between shareholders and employees over the surplus corporations generate, without major implications as to the size of that surplus.

Pistor also tries to draw conclusions from interviews with representatives of labor unions, political parties, and legislators. These give a sense that codetermination has led to less control of management by shareholders, or anyone else for that matter, but again the evidence is weak. She also makes the interesting observation that employees are most involved in making decisions on wages and working conditions, and much less involved in decisions concerning business strategy. This fits well with Rock and Wachter's theory.

In this section's second paper, Mark Roe extends his project of developing a political theory of corporate finance to Germany. Roe argues elsewhere that United States corporate finance institutions did not simply evolve as the best response to the financial challenges facing corporations. Rather, they are a path-dependent development, which to a significant degree reflect American political distrust of concentrated financial power. The large banks which dominate German and Japanese corporate finance were more limited in the United States as a result.

In this contribution, Roe argues that Germany is not the first-best optimum that all financial systems would necessarily gravitate to if only their governments allowed it. Rather, a different set of political pressures and institutional responses shaped a unique path for Germany. Codetermination was imposed for political reasons generally unrelated

95. The phrase comes from John C. Coffee, Jr., Unstable Coalitions: Corporate Governance As a Multi-Player Game, 78 GEO. L.J. 1495 (1990).
96. See Pistor, supra note 88, at 179-81.
97. See id. at 181.
98. See id. at 183-88.
99. See id. at 188-91.
100. See id. at 189.
101. See Mark J. Roe, Codetermination and German Securities Markets, in ECG, supra note 9, at 194, 194-205.
103. See id. at 170-71.
to corporate governance concerns. Roe argues that weak German securities markets may be a response to codetermination.

Under codetermination, shareholders are skeptical of having a strong supervisory board, as it would strengthen the power of labor. Strong boards are palatable only if there is a large shareholder who can counterbalance employees—diffuse shareholders, as in the standard United States public corporation, would not be able to join together adequately to balance labor. The alternative reaction to codetermination is to have a weak board, so that employees’ role on the board does less to hurt the interests of shareholders. A weak board, though, does not fit well with a United States-style stock market of diffuse shareholders, as the latter requires a strong board to counterbalance managerial opportunism. The point is not that codetermination caused German boards to be weak, but rather that given codetermination, it is now hard to put stronger boards, and hence stronger securities markets, in place.

It is an interesting story. There are questions. Roe mentions other possible mechanisms for defending shareholders from management, including takeovers and product and capital market competition. He does not explain why these have not or could not be expanded in Germany, even if boards remained weak. These factors are much more important as relating to disciplining managers of United States corporations than strong and independent boards have been.

Another question for Roe, and for Pistor as well, is how they view corporate governance in Germany vis-à-vis the United States and other countries. Roe’s tone in this paper suggests that Germany is at a disadvantage. However, his tone in his work on United States institutions suggested that, if anything, the United States was at a disadvantage. Perhaps American economic success in the 1990s made him change his mind. Perhaps, though, he thinks that the two systems are roughly equal in their ability to discipline managers. They simply do so in different ways. Perhaps the best and most knowledgeable

104. See id. at 213-15.
106. See id. at 195.
107. See id. at 195, 203-04.
108. See id. at 202.
109. In the United States, boards have traditionally been largely passive and management-dominated, although this may have changed somewhat over the last decade or two. See Ira M. Millstein & Paul W. MacAvoy, The Active Board of Directors and Performance of the Large Publicly Traded Corporation, 98 COLUM. L. REV. 1283, 1285 (1998). The effectiveness of boards with a majority of independent shareholders in enhancing corporate performance is far from proven. See generally Sanjì Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 BUS. LAW. 921 (1999).
comparative study of corporate governance tentatively suggests that the German system works better than those of the United States, United Kingdom, France, or Japan, a point at some odds with the tone of Roe and Pistor.\textsuperscript{110}

The final paper on codetermination is more empirical. Theodor Baums and Bernd Frick perform an event study examining the effect of court cases concerning codetermination on corporations' prices.\textsuperscript{111} They study the effect on both individual affected firms and on firms within industrial sectors likely to be more affected by a decision. They find no significant effects.\textsuperscript{112} This is more or less in line with previous empirical work, although some earlier work did find that codetermination had a negative, though modest effect.\textsuperscript{113} The Baums and Frick paper thus presents another challenge for Pistor and Roe.

\section*{B. Japanese Corporate Governance}

Unlike Germany, Japan does not legally require employee involvement in corporate governance, and Japanese non-management employees are rarely formally represented at the board level or given large shares of stock.\textsuperscript{114} However, many scholars have argued that large Japanese corporations typically give a strong informal role to the interests of their employees in corporate governance.\textsuperscript{115}

Ronald J. Gilson and Mark J. Roe challenge one aspect of this alleged feature of Japanese corporate governance.\textsuperscript{116} They consider lifetime employment in large corporations, a widely noted feature of

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  \item \textsuperscript{110} See Jonathan P. Charkham, Keeping Good Company: A Study of Corporate Governance in Five Countries (1994). One might argue that Germany and Japan look less attractive relative to the United States now than they did in the 1980s or early 1990s. Perhaps, but one should beware of letting the pendulum swing too far in that direction based on the current success of the United States economy. There are complex tradeoffs in comparing the United States, Japanese, and German systems, and it is not clear we can convincingly show that one is superior overall. See Franklin Allen & Douglas Gale, Comparing Financial Systems 21-22 (2000).
  \item \textsuperscript{111} See Theodor Baums & Bernd Frick, The Market Value of the Codetermined Firm, in ECG, supra note 9, at 206, 206-35.
  \item \textsuperscript{112} See id. at 225, 230.
  \item \textsuperscript{113} See id. at 210-15.
  \item \textsuperscript{114} See id. at 206, 206-35.
  \item \textsuperscript{115} See id. at 225, 230.
  \item \textsuperscript{116} See id. at 210-15.
  \item \textsuperscript{117} See Chamy, supra note 58, at 104, 106.
  \item \textsuperscript{118} See id. at 206, 206-35.
  \item \textsuperscript{119} See id. at 225, 230.
  \item \textsuperscript{110} See id. at 210-15.
  \item \textsuperscript{111} See id. at 210-15.
  \item \textsuperscript{112} See Chamy, supra note 58, at 104, 106.
  \item \textsuperscript{113} See id. at 104, 106.
  \item \textsuperscript{114} See id. at 104, 106.
  \item \textsuperscript{116} See Ronald J. Gilson & Mark J. Roe, The Political Economy of Japanese Lifetime Employment, in ECG, supra note 9, at 239, 239-74.
\end{itemize}
Japanese companies. It is frequently argued that a promise of lifetime employment encourages employees to invest in firm-specific human capital. Gilson and Roe disagree. They argue that the guarantee of lifetime employment does nothing to encourage greater investment in human capital by firms. Rather, this is accomplished by the fact that Japanese external labor markets are relatively closed. Employees in one firm have much difficulty in finding a comparable job elsewhere. Given that fact, which Gilson and Roe argue would be unacceptable to Americans, corporations then have an incentive to invest in the human capital of their employees. That is correct, but leads to an important empirical question: How much of Japanese investment in human capital is borne by corporations, and how much by their employees? Gilson and Roe have one skimpy footnote claiming that firms pay most for training in general skills, and present no evidence whatsoever as to firm-specific skills. This lack of evidence is odd, given its importance to their argument.

Gilson and Roe also argue that, as to firm-specific human capital investment by employees, the risk employees will face is not that they will be fired, but that the firm will lower their salaries to the competitive level. However, firms may choose to fire employees rather than lower wages as a commitment device. If firms choose to lower wages, claiming economic hardship, employees may not be able to tell whether the hardship claim is accurate, and may therefore conclude that the firm is reneging on its implicit contract. If the firm instead fires employees in response to hardship, the firm bears a cost from losing employees with firm-specific capital, making its decision more credible.

But, the firm and employees might both prefer a guarantee of employment combined with the ability to lower wages in response to hardship. If managers are understood to govern the corporation in the interests of employees, then employees might trust that wage cuts are not reneging on a promise. Analysts have indeed argued that managers govern Japanese firms in part in the interests of employees, and are understood to do so. The lifetime employment guarantee combined

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117. See id. at 240.
118. See Blair, supra note 46, at 58-90.
120. See id.
121. See id.
122. See id.
123. See id. at 242 n.11.
124. See id. at 245-46.
125. See sources cited supra note 115.
with corporate governance in favor of employees might, then, encourage employee investment in firm-specific human capital.

Gilson and Roe argue that lifetime employment originally developed as a political response to labor strife in post-World War II Japan. Complementary institutions, such as the firm-bank relationship, internal promotion, early retirement, and a closed external labor market then evolved in conjunction with lifetime employment, giving rise to a coherent system in which the various parts reinforce each other. The story thus fits with Roe’s approach to corporate finance in the United States and Germany.

In the other paper on Japan, Nobuhiro Hiwatari tells the story of how enterprise unionism developed in post-World War II Japan. Under enterprise unionism, both blue and white-collar employees join the same union, which is sovereign at the firm level. How such unions developed is of interest in its own right. The most general point of interest to the broader themes here is that political pressure at key historical points created different market and union structures in different countries. After that, the countries may "follow different trajectories because of the reinforcing effect of different surrounding structures, even when common problems, such as the global stagflation of the 1970s, would appear likely to compel them to converge." 

C. Employee Share Ownership

The lone paper in the fourth and final part of Employees and Corporate Governance considers the case of the United States airlines industry, and particularly United Air Lines ("United"). Jeffrey N. Gordon focuses on employee ownership in firms undergoing economic transitions. He argues that employee stock ownership can help address four transitional problems: just allocation of transition costs, efficient bargaining over one-time costs, efficient bargaining over ongoing transition costs, and the creation of superior structures for transitional

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126. See Gilson & Roe, supra note 116, at 251-55.
127. See id. at 258-62.
128. See supra notes 101-09 and accompanying text.
129. See Nobuhiro Hiwatari, Employment Practices and Enterprise Unionism in Japan, in ECG, supra note 9, at 275, 275-313.
130. See id. at 276.
131. Id. at 307.
133. See id.
Gordon concludes that whether United will provide a successful precedent for a new organizational form is an "open question." United's recent extreme problems with on-time performance, apparently due in good part to a labor dispute with its employee owners, seem to cast doubt on United's success. Thus far, there has been no good analysis of why United's pilots helped cause such trouble for the corporation of which they owned a major part.

III. Future Directions

Employees and Corporate Governance does not definitively resolve whether employees have been left out of corporate governance because employees have all in all had little to add to it—they have not barked—or because those who create and study corporate governance structures have been unable to hear what employees have to say. It is more plausible that employees have indeed barked in the area of corporate governance, but corporate law and scholarship have not heard them. The range of topics the papers in Employees and Corporate Governance cover, and the large number of insights those papers provide, support that position. Corporate governance scholars can learn many lessons if they follow the lead of this volume's contributors and consider the interaction of employees with shareholders and managers. In what remains, this Review considers four lessons or questions extracted from this book.

A. Economic Theory and Evidence Only Get You So Far

The invasion of ideas from economics has been the great trend in corporate law scholarship over the last two decades. This book is a soldier in that triumphal army, although it often launches more or less friendly fire on some of the work in the first wave of the attack. The internal shell fire should come as no surprise. Despite the hopes of some proponents of law and economics, economic theory is generally rich enough to provide good arguments for all sides in any interesting policy debate, and empirical economic methods are impoverished enough that
they rarely give compelling reasons for choosing among those arguments.

Some of the contributors to *Employees and Corporate Governance* provide reasons why various forms of employee participation in corporate decision-making might enhance a corporation's productivity. Such participation might enhance incentives to invest in firm-specific human capital, as Blair emphasizes.\(^\text{138}\) Employees may glean from their work many ways to improve productivity, as Charny and Rock and Wachter recognize.\(^\text{139}\) Employee governance or ownership may motivate employees to work harder or better, as Dow and Putterman point out.\(^\text{140}\) In some circumstances, employee involvement in governance may help induce the variety of subgroups of employees to pull together for the good of the corporation, as Charny and Gordon argue.\(^\text{141}\) Each of these arguments, though, has counter-arguments and limits.

On the other hand,\(^\text{142}\) the contributors point to a variety of factors suggesting that various forms of employee involvement in governance or ownership may detract from productivity. Outside investors may be justifiably reluctant to invest in corporations with employee governance for a variety of reasons, as Dow and Putterman, Pistor, and Roe argue.\(^\text{143}\) Risk aversion and a lack of diversification suggest major problems for employee stock ownership, as Dow and Putterman and Rock and Wachter point out.\(^\text{144}\) Dow and Putterman and Charny cite high decision-making costs caused by employee heterogeneity.\(^\text{145}\) Employees may simply have little of value to add to questions of broad strategy, as Rock and Wachter argue.\(^\text{146}\) Each of these arguments, too, has counter-arguments and limits.

Drawing conclusions given such a range of complex considerations is no easy task. There are at least three navigational strategies. One is to engage in ever more complicated and sophisticated theoretical work to more fully understand the different factors and their inter-relation. Dow and Putterman urge this approach.\(^\text{147}\) It is certainly worth pursuing, but

\(^{138}\) See discussion *supra* Part I.B.

\(^{139}\) See Charny, *supra* note 58, at 95; Rock & Wachter, *supra* note 74, at 122.

\(^{140}\) See Dow & Putterman, *supra* note 21, at 23-27.

\(^{141}\) See Charny, *supra* note 58, at 96-100; Gordon, *supra* note 132, at 318.

\(^{142}\) No one-handed economists on hand here.


\(^{144}\) See Dow & Putterman, *supra* note 21, at 31-35; Rock & Wachter, *supra* note 74, at 155.


\(^{146}\) See Rock & Wachter, *supra* note 74, at 125.

\(^{147}\) See Dow & Putterman, *supra* note 21, at 50.
even relatively simple economic models often yield ambiguous results. Models of the complexity required here are virtually certain to be highly ambiguous in what they suggest for policy.

A second strategy is to aggressively test the various theoretical arguments, and see which ones do the best. Dow and Putterman also suggest this, and Baums and Frick actually, and commendably, try to do it. This approach is of course the classic Friedman positivist model, which has guided the self-understanding of economists for decades. It is unsettled whether this approach ever does much good for empirical problems that are hard and hotly contested, as ours certainly is. The theory to be tested is complex and pliable—inconvenient empirical results can be readily explained away in most instances. The data is fragmentary and highly imperfect. In order to deal with these problems, econometric methodology has had to build in too many assumptions to reach a persuasive answer—any analyst’s results are always readily questioned by the other side. Continued empirical research is certainly of value and should be commended, but it is doubtful that it will provide us with clear answers in the foreseeable future.

The third strategy is to look at the degree and types of employee governance that actually exist in markets which neither require nor forbid it, and assume that evolutionary pressures have led to the optimal forms of corporate governance. The theoretical arguments can then be used to explain why those forms are optimal. This is Rock and Wachter’s strategy, and a widespread one in the economics literature. Unfortunately, we simply do not have a theory of the evolution of corporate forms which allows us to feel confident that free markets will necessarily give rise to a global optimum. This is particularly true if one accepts the sorts of arguments concerning path dependence and institutional complementarity, which are advanced in the next Section. We are caught in a bind. If we had an adequate theory of efficient corporate forms, we could test the theory of corporate evolution by checking whether the efficient forms have actually evolved. If we had a convincing theory of corporate evolution which told us that efficient forms will develop under certain conditions, we could test our theories

148. See id. at 50.
149. See Baums & Frick, supra note 111, at 206-35.
151. For a recent critique of econometrics along these lines, see Charles F. Manski, Economic Analysis of Social Interactions, 14 J. ECON. PERSP. 115 (2000) and the works cited therein.
152. See Rock & Wachter, supra note 74, at 121.
about efficiency by observing which corporate forms have evolved under the conditions guaranteeing efficient evolution. However, we lack adequately powerful theories of either efficient corporate forms or of corporate evolution. This bind, moreover, reinforces the extreme difficulty of empirically testing our ideas.153

Thus, corporate law scholars should not expect definitive answers from economists any time soon as to the most efficient role for employees in corporate governance. That is not to say that the whole enterprise of an economic analysis of these issues is futile.154 Economics can raise a whole host of fascinating questions which we might not otherwise have thought of, and provide much insight into various ways that law may affect those questions. The contributions to this volume illustrate both points. Just do not expect definite answers.

B. There Is More to Corporate Governance than Just the Corporation Itself

How well an individual firm involves employees in corporate governance may well depend on more than the individual characteristics of that firm. A variety of complementary institutions may encourage or discourage employee involvement. These institutions include, among others, corporate and other law, the stock market, banking institutions, the labor market, and cultural beliefs and norms. Once established, these various institutions may reinforce each other and make it difficult for individual firms within that system to move to a different form of corporate governance. It may be an accident unrelated to considerations of best corporate governance that explains why institutions initially evolved the way they did, but given that history, it is hard to move from a particular path once that path has been well-enough trod. To use the jargon, corporate governance forms are part of a path-dependent system. Charny, Roe, Gilson and Roe, and Hiwatari all make arguments along these lines.155

153. The point is similar to Eugene Fama's observation that in order to test the efficient markets hypothesis, one requires an adequate theory regarding the valuation of securities, but in order to test theories of securities valuation, one needs a theory as to the efficiency of securities markets. See Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383, 384 (1970).

154. Or most other issues in law and economics, for that matter.

155. These sorts of arguments have become common in economics. See, e.g., AOKI, supra note 115, at 100; W. BRIAN ARTHUR, INCREASING RETURNS AND PATH DEPENDENCE IN THE ECONOMY 13-32 (1994). But see S.J. Liebowitz & Stephen E. Margolis, Path Dependence, Lock-In, and History, 11 J.L. Econ. & Org. 205 (1995) (arguing that proponents of path dependence have not produced any clear cases of lock-in to an inferior alternative).
If these or similar arguments are correct, then it may be quite hard to make efficiency comparisons across different national systems of corporate governance. One cannot simply single out one aspect of corporate governance and compare it across countries, as each aspect may be tied to a host of other factors. One has to compare systems as a whole, which is a formidable task, as the different systems will have their own strengths and weaknesses in a variety of areas, and diverse constituencies will be affected in quite varying ways in the different systems. Making overall efficiency judgments out of such a tangle is very possibly beyond the resources of economics. Moreover, reform ideas drawn from one system may be hard to transplant to different systems, as the complementary institutions which support an idea in its original system may be absent elsewhere.

As mentioned in the previous Section, the presence of path dependence and complementary institutions also complicate the task of developing a theory of the evolution of forms of corporate governance. Path-dependent systems typically exhibit multiple equilibria with possible lock-in to inefficient equilibria. If this story is correct, we have no general reason to believe that corporations allowed to compete in corporate form within a more or less free market will necessarily develop toward a globally optimum form of corporate governance. The difficulty of coaxing definitive results out of economic theory and econometrics thereby becomes more extreme. Alternatively, one may define transaction costs to mean that any observed outcome is Pareto efficient—if it were not, bargaining would move to a superior outcome, and the fact that such bargaining does not occur shows that there are transaction costs preventing it, and those costs should be included in calculating efficiency. On this approach, efficiency becomes an empty standard.

C. Efficiency Is Not All There Is in Life, or in Corporate Governance

When economists ponder normative questions, they ask what alternative is most efficient. The contributors to Employees and Corporate Governance are economists or legal scholars drawing on economics. Hence, they generally focus on efficiency as the guiding value in their inquiries. Charny briefly discusses other values, and Pistor,
Gilson and Roe, and Hiwatari all note that the institutions which they consider in their papers developed for reasons other than efficiency. However, efficiency is clearly the dominant value studied here.

Efficiency is a value worth pursuing. Economists have a comparative advantage over other social scientists, political philosophers, and traditional legal scholars in discussing efficiency, so it makes sense to pay a great deal of attention to it when analyzing in an economic mode. However, we care about more than just efficiency. For one, economic actors pursue other values, and their pursuit of those values helps shape the institutions that economists and legal scholars study. According to Pistor, Germans instituted codetermination as a way of guaranteeing social peace between labor and capital. Similarly, both Gilson and Roe and Hiwatari argue that key Japanese institutions, such as lifetime employment and employee unions, developed as part of the political struggle between businesses and radical unions which sought employee control in the post-World War II years.

Moreover, efficiency is not the only value we should care about. Economists commonly note that a fair distribution of goods is a separate value worth pursuing, although one may often face a tradeoff between fairness and efficiency. Social peace is also valuable. Many would argue that economic democracy within companies is also of value in and of itself. All of these values, and perhaps others as well, are relevant in considering the desirability of employee involvement in corporate governance.

Given these points, perhaps the goal of analysis in this area should be to give a rough sense of which actors are likely to gain and to lose under alternative governance arrangements, what problems are likely to arise under the arrangements, and the net social costs of the alternatives. Given the best guess as to the likely consequences of different alternatives, one can then ask which alternative is best, according to the various goals one would like to pursue. If different alternatives emerge as best for different goals, we then face the further problem of compromising between the various values.

159. See Pistor, supra note 88, at 165.
161. See ROBERT A. DAHL, A PREFACE TO ECONOMIC DEMOCRACY (1985).
D. What Should We Do When We Do Not Know What to Do?

Finally, we face a problem which may be common within law and economic analysis. Economic theory and empirical evidence do not provide anything close to definite conclusions about the effects of different forms of corporate governance. The forms of corporate governance are tied to a wide variety of complementary institutions, which makes the analysis even more difficult. Deciding what form of corporate governance is most efficient under varying circumstances is a tremendously difficult question to which we have no clear answers. Adding in other social values and goals which also matter, and which may lead to conflicting recommendations, if any of them lead to any definite recommendations at all, makes the issue worse.

The analysis of *Employees and Corporate Governance*, and all other analysis on this question, provides no definite and persuasive answers as to what forms of corporate governance we should prefer. This situation is not likely to change in the foreseeable future. What, then, can we say to judges and legislators if any of them should choose to look to scholarly analysis as an aid to policy making in this area? What should we do when we do not know what to do?

One possibility is to make sure that laws allow for the competing forms of corporate governance, and then let survival in the marketplace dictate which forms come to dominate. This is essentially the recommendation made by most contractarians who formed the initial wave of the economic invasion into corporate law scholarship. Unfortunately, if the above points are correct, we have much less reason than the contractarians believe to be confident that the best, or at least the most efficient, alternatives will win out in the free market. Still, if we have no good reason to believe we can better the market, perhaps we ought to follow Hippocrates and first do no harm. Moreover, the presence of myriad complementary institutions will often make governmental intervention more difficult—often, to effectively change one element, one would need to make corresponding changes in a range of other institutions as well.

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162. Not to mention law analysis generally, and economic analysis generally.

Another possibility is to attempt to nudge institutions in directions which look promising, without requiring any particular alternative. Tax breaks, subsidies, and simply providing more information about little-known alternatives are relatively non-intrusive interventions in the market which do not disrupt already evolved patterns, but give a push to private actors to try out alternatives. Federal tax incentives for employee stock ownership plans ("ESOPs") are an example of this approach, although at least certain elements of that policy are troubling.164

Actually requiring companies to adopt a specific form of corporate governance, as in German codetermination, is harder to defend, unless one has darn good reasons to explain both why it is desirable and why it has nonetheless failed to flourish within the market. No such case has been made for codetermination.165

Even if suggestions for state intervention are limited, the scholarship in *Employees and Corporate Governance* also provides a number of suggestions for experimentation by private actors. Indeed, employee involvement in ownership and governance is already growing, not only through expanded use of ESOPs, but more importantly through widespread use of stock options. One can expect, or at least hope for, further experimentation.

At any rate, *Employees and Corporate Governance* should help make clear that the silent voice of employees in corporate law and corporate governance scholarship is problematic. Perhaps in the future we will be able to hear this dog barking away happily.

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165. These thoughts on what should be done when we do not know what should be done are painfully limited, and they provide little consolation. If this Author is right that the problem is indeed pervasive, it would behoove us to think a lot more about this sort of quandary. That goes beyond—way beyond—the point of this Review, however.