

EMPLOYEE REPRESENTATION AND CORPORATE GOVERNANCE: A MISSING LINK

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The publication of Freeman and Rogers' *What Workers Want*¹ is a major contribution to the debate over employee representation in America. The authors have answered the basic question of what workers and managers want. Now we must reconsider how public policy can be designed to help these preferences be realized. Although Freeman and Rogers have on other occasions contributed ideas for closing the representation gap,² the present study maintains a curious silence on solutions.

Most of the recent policy proposals on employee representation attempt to tweak the National Labor Relations Act to permit greater experimentation with nonunion employee participation plans. For example, the so-called Dunlop Commission of the mid-1990s outlined the following four principal policy options, all of which focused on labor law: (1) to retain the law in its present form; (2) to revise section 8(a)(2) to permit employers to create employee involvement plans and even company unions, so long as they do not bargain collectively with the employer (the approach contained in the so-called TEAM Act); (3) to modify the TEAM approach to permit employers to establish employee involvement plans but require that they meet certain standards for employee selection, access to information, and protection against reprisals; and (4) to legally require the establishment of employee participation committees,³ as in the plan put forth in 1990 by Professor Paul Weiler to require every company above a certain size to establish elected committees to address the firm's human resource policies

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1. RICHARD B. FREEMAN & JOEL ROGERS, *WHAT WORKERS WANT* (1999).

2. Joel Rogers, *Reforming U.S. Labor Relations*, 69 *CHI.-KENT L. REV.* 97, 112-26 (1993).

3. Sanford M. Jacoby, *Current Prospects for Employee Representation in the U.S.: Old Wine in New Bottles?*, 16 *J. LAB. RES.* 387, 391-97 (1995) (describing interim and final reports of the Dunlop Commission).

and its administration of workplace laws.⁴

Seeking to remedy the representation gap by focusing only on labor law is to omit a key impediment to realizing the parties' preferences: our system of corporate governance. This paper attempts to supply that missing link. It first analyzes the development of the present U.S. model of corporate governance, noting changes over the course of the twentieth century. Next, it compares this model to corporate governance models found in continental Europe and in Japan, where greater weight is given to employee interests relative to those of shareholders. Costs and benefits are considered in the Japanese, European, and American governance models. In an effort to reduce costs in recent years, there has been substantial borrowing on all sides, rather than convergence on a single model. To propel these changes in the United States, policy recommendations are advanced that would simultaneously reform corporate governance practices while creating a more favorable climate for employee representation.

I. CORPORATE GOVERNANCE IN THE U.S.

One of Freeman and Rogers' most interesting findings is that a majority of workers, as well as nearly half of surveyed managers, including managers from nonunion firms, report that they would prefer to deal with elected employee representatives if their workplace had some form of employee organization.⁵ According to the authors, these managers tend to be dissatisfied with their influence on workplace decisions and are less trustful of their company than the managers who oppose the election of employee representatives.⁶

That some managers are distrustful, dissatisfied, and inclined to favor strong forms of employee representation should not come as a surprise. The last twenty years have seen a shift of power inside the American corporation, away from managers and toward shareholders. One significant factor was the appearance in the 1970s of new financial instruments, like junk bonds, that made it much easier to engage in hostile takeovers, divestitures, restructurings, and other methods of changing corporate management and squeezing out higher returns from companies.⁷ The rise of active institutional investors in the 1970s, partly as a result of changes in securities laws requiring these investors to disclose financial results and thus to seek

4. PAUL C. WEILER, GOVERNING THE WORKPLACE: THE FUTURE OF LABOR AND EMPLOYMENT LAW 285 (1990) (outlining Paul Weiler's plan).

5. FREEMAN & ROGERS, *supra* note 1, at 59, 144.

6. *Id.* at 145, 218.

7. MARY ZEY, BANKING ON FRAUD: DREXEL, JUNK BONDS, AND BUYOUTS 15-20 (1993).

higher returns, also contributed to this shift.⁸

Institutional investors, lacking inside information about the companies they invest in, and having minimal ability to directly influence management behavior, base their buying and selling decisions on short-term movements in stock price. Institutional investors have high rates of portfolio turnover, certainly higher in the 1980s and 1990s than in earlier years.⁹ These investors were either exempt from capital gains taxes, as in the case of pension plans, or somewhat indifferent to them, as in the case of mutual funds. There has also been a move toward more speculative investments.¹⁰ In the 1980s, pension and mutual funds became major buyers of the junk bonds and LBO funds that financed takeovers.¹¹ Conversely, the concentration of ownership associated with institutional holdings made it easier for raiders to assemble a majority coalition.¹²

A variety of recent innovations have induced individual investors to enter the market, to trade rapidly and cheaply, and to speculate on short-term price movements. The innovations include the spread of defined-contribution pension plans controlled by individuals (e.g., 401(k) plans that started in the early 1980s), the rise of discount brokerages, and the ability to trade on the Internet.¹³ Together these changes have reduced the average amount of time a share is held and the turnover rate of individual portfolios.¹⁴ Again, the result is greater pressure on management to produce short-term results and a quasi-speculative atmosphere in the equity markets.¹⁵

A vast literature in economics seeks to explain why principals and

8. Brian P. Smith, *The SEC Presses for Disclosure of Mutual Fund Performance*, 108 SAVINGS INSTITUTIONS 172, 172-73 (1987).

9. Stephen A. Berkowitz & Dennis E. Logue, *The Portfolio Turnover Explosion Explored*, 12 J. PORTFOLIO MGMT. 38, 38-45 (1987).

10. ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 39, 60-64 (2000).

11. CONNIE BRUCK, *THE PREDATOR'S BALL: THE INSIDE STORY OF DREXEL BURNHAM AND THE RISE OF THE JUNK BOND* 45-46 (1989).

12. GORDON DONALDSON, *CORPORATE RESTRUCTURING: MANAGING THE CHANGE PROCESS FROM WITHIN* 162-68 (1994); MICHAEL T. JACOBS, *SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA* 120 (1991); MICHAEL USEEM, *INVESTOR CAPITALISM* 38-69 (1996). Institutional ownership of all U.S. corporate equities increased from twenty-nine percent in 1970 to forty-five percent in 1990, and to sixty percent or more in some large companies. Much of this was driven by the growth of pension funds. MARGARET M. BLAIR, *OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY* 45-46 (1995).

13. BLAIR, *supra* note 12, at 160-64; JOSEPH BLASI & DOUGLAS KRUSE, *THE NEW OWNERS* 24 (1991); SHILLER, *supra* note 10, at 206.

14. Terrance Odean, *Do Investors Trade Too Much?*, 89 AM. ECON. REV. 1279, 1280 (1999). The turnover rate for NYSE stocks nearly doubled between 1982 and 1999 and nearly tripled for NASDAQ stocks. SHILLER, *supra* note 10, at 39.

15. SHILLER, *supra* note 10, at 60-64.

agents—owners and managers—have divergent interests.¹⁶ As compared with institutional investors, managers are relatively risk-averse. The reason is that institutional investors have large, diversified portfolios whereas managers' assets are less diversified due to a heavy investment in firm-specific human capital and in the stock of the company that employs them. Their over-investment makes managers cautious and inclined to pursue long-term growth policies that minimize risk by providing them with career opportunities should one of the company's units encounter problems.¹⁷

As power shifted in the 1980s, managers found themselves having to take on higher risk and produce higher returns to satisfy investors and avoid takeovers.¹⁸ Some senior managers gave up on public ownership and took their firms private; other, more middling managers, lost their jobs entirely.¹⁹ Indeed, middle-level managers discovered that the elimination of their jobs was often the chief goal of industrial restructuring.²⁰ Much of the decline in aggregate job stability in the late 1980s and 1990s was concentrated among long-tenure males in managerial occupations.²¹ The shredding of implicit managerial contracts is one reason why some managers today are wary of their employers.²²

Here we find a reason why dissatisfied managers, and even some satisfied managers, might look favorably upon elected employee representatives. They may see employee representation as a way of taking power back from shareholders and moving away from policies that require them to bear more risk than they would otherwise prefer. After all, workers, like managers, are less diversified and more risk-averse than shareholders. When managers pursue risk-minimizing policies such as growth, diversification, and earnings retention, workers benefit by receiving more firm-specific training, career opportunities, stable employment, and higher wages. Thus workers and managers have common interests, which do not always align neatly with shareholder objectives.

There is even recent empirical evidence indicating that managers, when minimally monitored, will let wages rise and not fight as strongly for shareholders as they would when monitored more closely.²³ Evidence

16. See, e.g., BERNARD SALANIE, *THE ECONOMICS OF CONTRACTS passim* (1997).

17. John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, in KNIGHTS, RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 77 (John C. Coffee, Jr. et al. eds., 1988).

18. *Id.*; USEEM, *supra* note 12, at 149-54.

19. Sanford M. Jacoby, *Are Career Jobs Headed for Extinction?*, 42 CAL. MGMT. REV. 123, 126 (1999).

20. *Id.* at 172.

21. *Id.*

22. USEEM, *supra* note 12, at 166.

23. MARIANNE BERTRAND & SENDHIL MULLAINATHAN, IS THERE DISCRETION IN WAGE SETTING?: A TEST USING TAKEOVER LEGISLATION 5 (Nat'l Bureau of Econ. Research,

comes from the thirty or so states that adopted anti-takeover statutes in response to concerns that non-shareholder constituents needed protection from hostile takeovers and restructuring. The data show that, after passage of anti-takeover laws, managers pay higher annual wages to employees—about one to two percent more each year.²⁴

The trick for managers is getting workers to perceive that their common interests with management transcend any short-term conflict over the division of economic rents. To the extent that participation persuades employees to support the firm's long-term health—by expanding employee time horizons, encouraging firm-specific investments in skills and intellectual capital, restraining wage demands, or simply creating a sense that the division of economic rents is fair—managers, left to their own devices, will be inclined to support employee participation.²⁵

Even before Drexel Burnham and the takeover wave of the 1980s, American managers were never entirely left to their own devices. Then, as now, managers' actions were coordinated with shareholder interests by use of instruments such as stock options, stock ownership, and outside directors.²⁶ Also, a credo has been reinforced by neoclassical economists and corporate attorneys that the purpose of management is to maximize wealth for shareholders, who ostensibly are the corporation's sole residual claimants.²⁷

Nevertheless, during the first six or seven decades of the twentieth century, management and shareholder interests were less aligned, both in thought and deed, than they are today. As Berle and Means observed in the 1930s, the separation of ownership and control had left American managers with substantial discretion.²⁸ Fragmented and distant shareholders could not easily monitor management.²⁹ The rise of more sophisticated and concentrated institutional investors was, therefore, considered to be a major

Working Paper No. 6807, 1998).

24. *Id.*; see also Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 23-30 (1992) (examining constituency statutes); Mark J. Roe, *Takeover Politics*, in *THE DEAL DECADE* 321, 338-42 (Margaret M. Blair ed., 1993).

25. Common interests of workers and managers, and the desire of managers to bolster their status vis-à-vis shareholders, explains why employee representation so often has been a key part of welfare capitalist regimes. This is different than the efficiency wage story. See PETER J. SWENSON, *LABOR MARKETS AND WELFARE STATES: EMPLOYERS IN THE MAKING OF THE AMERICAN AND SWEDISH SYSTEMS* (forthcoming 2001).

26. ROBIN MARRIS, *THE ECONOMIC THEORY OF MANAGERIAL CAPITALISM passim* (1964); WILLIAM ROY, *SOCIALIZING CAPITAL: THE RISE OF THE LARGE INDUSTRIAL CORPORATION IN AMERICA* 154-58 (1997).

27. BLAIR, *supra* note 12, at 227-29.

28. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY passim* (1932).

29. *Id.*

change.

At the ideological level, American managers had a mindset that was at variance with the neoclassical credo that maximizing shareholder value was the primary objective of the business corporation. Instead, managers were imbued with the ethos of what was called "welfare capitalism."³⁰ They conceived of the corporation as a social institution, a corporate community whose members included employees and suppliers, and saw themselves as stewards who balanced the institution's multiple interests.³¹ The medical company Johnson & Johnson even carved a credo in stone at its New Jersey headquarters, stating that shareholders would get a fair return only after the company had ensured outstanding value to customers, employees, suppliers, and the communities where the company operated.³²

If one goes back to the classic study, *The American Business Creed*,³³ one finds striking evidence of a managerial philosophy that would today be considered heretical. As the authors observed:

corporation managers generally claim that they have four broad responsibilities: to consumers, to employees, to stockholders, and to the general public . . . each group is on an equal footing; the function of management is to secure justice for all and unconditional maxima for none. Stockholders have no special priority; they are entitled to a fair return on their investment, but profits above a so-called fair level are an economic sin.³⁴

While labor scholars usually think of management rights as an area management first defended against union encroachments, post-war managers actually had a broader conception of the term, one that included managerial autonomy from shareholder pressure. "Management rights," then, was intended to be "a sphere of unhampered discretion and authority which is not merely derivative from the property rights of owners."³⁵ These rights included the authority to plow profits back into the enterprise, a practice that the National Association of Manufacturers defended as "the way the American system works."³⁶ Apportioning profits between dividends

30. SANFORD JACOBY, *MODERN MANORS: WELFARE CAPITALISM SINCE THE NEW DEAL* 4 (1997).

31. *Id.* at 156.

32. FREDERICK F. REICHHELD, *THE LOYALTY EFFECT: THE HIDDEN FORCE BEHIND GROWTH, PROFITS AND LASTING VALUE* 293 (1996). In the nineteenth century too, there was a similar conception of the corporation as being endowed with societal responsibilities. ROY, *supra* note 26, at 45-51 (1997).

33. FRANCIS X. SUTTON ET AL., *THE AMERICAN BUSINESS CREED* (1956).

34. *Id.* at 64-65.

35. *Id.* at 65; *see also* NEIL W. CHAMBERLAIN, *THE UNION CHALLENGE TO MANAGEMENT CONTROL* 7 (1948); HOWELL JOHN HARRIS, *THE RIGHT TO MANAGE: INDUSTRIAL RELATIONS POLICIES OF AMERICAN BUSINESS IN THE 1940s* 28-29 (1982).

36. SUTTON ET AL., *supra* note 33, at 85.

and retained earnings (and other spending purposes) was seen in those days as “one aspect of the general function of balancing competing economic interests which devolve on corporate management.”³⁷

This philosophy continued to hold sway in the 1960s and 1970s. As described by Gordon Donaldson, the typical mindset of senior management in those years was:

an introverted corporate view . . . focused on growth, diversification and opportunity for the “corporate family.” It was a period when the social and legal climate encouraged management to adopt a pluralistic view of their responsibility to the various corporate constituencies. As career employees themselves, it was natural for management to identify with all constituents who were long-term investors in the enterprise and to view shareholders in the same light.³⁸

The 1960s and 1970s were the highpoint of corporate social and community responsibility, as evidenced by laws passed in forty-eight states during this period which permitted corporations to give funds to charities without specific charter provisions.³⁹ While courts conceded that these social activities might hurt shareholders in the short run, responding to the needs of various stakeholders was alleged to be “good for the shareholders ‘in the long run,’ because the good health and well-being of the communities in which companies operate was considered important for business.”⁴⁰

Did the looser coupling of management and shareholders that prevailed prior to the 1980s have consequences for labor-management relations? I do not wish to paint the postwar decades as the golden age of industrial democracy. However, it is hardly a coincidence that the era was one in which corporations willingly treated workers as stakeholders in the enterprise—not on a par with shareholders, to be sure, but definitely having a status in the corporate family.⁴¹ Employment was construed as a quasi-permanent relationship that endured through both good and bad times. Benefits and other emoluments served to underscore management’s common interests with employees.⁴² As Donaldson says of the 1960s, “‘Loyalty’ was the key word—commitment to the success of an enterprise within which each constituent found economic and social fulfillment.”⁴³

As shareholders grew assertive in the 1970s, one began to see more

37. *Id.* at 87.

38. DONALDSON, *supra* note 12, at 19.

39. BLAIR, *supra* note 12, at 214.

40. *Id.* at 215.

41. SUTTON ET AL., *supra* note 33, at 135-36.

42. SANFORD JACOBY, *EMPLOYING BUREAUCRACY: MANAGERS, UNIONS, AND THE TRANSFORMATION OF WORK IN AMERICAN INDUSTRY, 1900-1945* 276-78 (1985).

43. DONALDSON, *supra* note 12, at 19.

hostile management behavior toward unions such as a rise in employer unfair labor practices, firings for union activity, and the use of tougher dispute tactics such as striker replacement and sustaining operations during strikes.⁴⁴ Precisely to what extent these changes were due to shifts in corporate governance is difficult to assess. Concurrent events, including a rise in union-nonunion wage gaps and an intensification of domestic and global competition, also contributed to managerial hardening.⁴⁵ Thus it is important to be wary of fallacious reasoning on the lines of *post hoc, ergo propter hoc*. At the very least, however, increasing dominance of a credo that privileged shareholders made it easier for companies to justify anti-union policies. In other words, changes in corporate governance facilitated the growing resistance to union legitimacy.

As has been suggested, not all managers are happy with the new emphasis on shareholders, share prices, and quarterly performance. Certainly some managers are motivated by pure self-interest. They would like to devolve power to employees because this would weaken shareholder influence and permit greater autonomy, career opportunities, and compensation for themselves. Other managers are more concerned with the corporation's long-term health.⁴⁶ Their reluctance to privilege myopic shareholder interests stems from a belief that recognizing multiple stakeholders—including customers and employees—can better facilitate the accumulation of human capital, relational capital, and other investments that enhance corporate performance and value over the long term.⁴⁷ The proponents of this view range from managers associated with the corporate responsibility movement to business executives and consultants who endorse a resource-based perspective on corporate strategy that is different from the neoclassical view.⁴⁸

44. RICHARD B. FREEMAN & JAMES L. MEDOFF, WHAT DO UNIONS DO? 230-33 (1984); CHARLES R. PERRY ET AL., OPERATING DURING STRIKES: COMPANY EXPERIENCE, NLRB POLICIES, AND GOVERNMENTAL REGULATIONS *passim* (1982).

45. JACOBY, *supra* note 30, at 256.

46. MARTY SCOTT & HOWARD ROTHMAN, COMPANIES WITH A CONSCIENCE: INTIMATE PORTRAITS OF TWELVE FIRMS THAT MAKE A DIFFERENCE *passim* (1994).

47. JACOBS, *supra* note 12, at 73, 223.

48. See GARY HAMEL & C.K. PRAHALAD, COMPETING FOR THE FUTURE *passim* (1994). The argument sometimes is made that there is no such thing as myopia. Share prices allegedly reflect all information presently available about a company; maximizing long-run value is equivalent to maximizing today's share price. This is the efficient markets hypothesis. The evidence for efficient markets, however, is less compelling than one might think. After all, if prices were at their appropriate level yesterday, why did the NASDAQ market come crashing down today? Moreover, institutional frameworks for trading equities affect managers' time horizons. High stock turnover rates create greater volatility and uncertainty in equity prices than exist under a system of more patient capital. If this is the case, and if uncertainty works against long-term projects, then it is possible that there exists a capital-market bias against long-term investments, a bias that would be heightened by the sensitivity of equity prices to near-term information. In fact, the evidence is ambiguous—much of

The neoclassical (Anglo-American) perspective is that the goal of the enterprise is to maximize shareholder value because shareholders have the greatest incentive to see that management runs the enterprise efficiently.⁴⁹ From this traditional perspective, shareholders are viewed as the sole residual claimants—although last to be paid, any surplus belongs to them.⁵⁰ Shareholders, therefore, have a direct interest in maximizing that surplus.

However, one can question whether shareholders are, in fact, the only residual claimants. After all, employees have substantial firm-specific investments that put them at risk and give them an incentive to see that the enterprise is efficiently managed.⁵¹ Unlike shareholders, employees lack the protection of portfolio diversification and limited liability. Hence, they may have an even greater incentive than shareholders to ensure that the enterprise is properly managed. Furthermore, because they are close to the action, employees often know more about what is going on inside the firm than do shareholders. Thus, giving employees a role in governance can be justified on efficiency grounds. Empowering employees has other positive consequences as well, a fact recognized in the governance systems of other nations.

II. THE COMPARATIVE PERSPECTIVE

A. *Germany and Japan*

In the American governance model, ownership is separated from control, shareholders are diffuse and relatively diversified as compared to other stakeholders, strong legal protections for shareholders are present, and there is a presumption—in law and in business norms—that management ought to maximize shareholder value.⁵² The situation in continental Europe and Japan is, to put it mildly, rather different. There are close ties

it based on Research & Development figures that are not a reliable measure of the “long term”—and one can find empirical support on both sides of the issue. *See generally* Kevin J. Lavery, *Economic “Short-Termism”: The Debate, the Unresolved Issues, and the Implications for Management Practice and Research*, 21 *ACAD. MGMT. REV.* 825 (1996) (providing a balanced overview of the evidence for and against the efficient markets hypothesis).

49. For an overview, see EDWARD J. EPSTEIN, *WHO OWNS THE CORPORATION?* (1986).

50. BLAIR, *supra* note 12, at 227-29.

51. JOHN ROBERTS & ERIC VAN DEN STEEN, *SHAREHOLDER INTERESTS, HUMAN CAPITAL INVESTMENT, AND CORPORATE GOVERNANCE* 18-24 (Graduate Sch. of Bus. Stan. U., Working Paper, Apr. 30, 2000). Participation may restrain employees from pursuing short-term self-interest in favor of long-term behaviors that are advantageous both to them and to the firm. Trade-offs arise when, for example, employees are asked to train junior employees who might someday replace them or when employees bargain with management over the division of rents between investment and wages.

52. *See* EPSTEIN, *supra* note 49, *passim*.

between creditors, owners, and managers.⁵³ Other comparative differences include block shareholding that persists over time due to an inability or reluctance to exit, relatively greater reliance on debt financing and on bank control, and a different conception of management's relationship to shareholders.⁵⁴

In Europe and Japan, corporate governance takes into account the interests not only of shareholders but of suppliers, customers, and employees, as well.⁵⁵ As the head of a major German company recently told *Der Spiegel*, German companies are unlikely to accept "Anglo-Saxon cold capitalism, which exclusively focuses on maximizing profits, [because it] will lead to a crisis in our system and to a decline of acceptance for the pillars of the social free market economy."⁵⁶ In Japan, despite the long recession and some recent reforms, corporate managers continue to assert the virtues of their governance system and the need to balance shareholder interests with those of other stakeholders.⁵⁷ Cross-shareholding, while declining, still remains dense, and downsizing proceeds at a pace that would seem excruciatingly slow by American standards.⁵⁸ Last fall, Toyota's chairman told an audience including Jack Welch of General Electric that his company is not going to abandon lifetime employment and pursue mass layoffs just because Standard and Poor's (which cut Toyota's credit rating) thinks this is the right approach.⁵⁹

To what extent do European and Japanese corporate governance systems influence labor and employment practices? Again, it is difficult to calibrate this with precision, but there definitely is a relationship. The fact that every European country, except the United Kingdom, has legally mandated works councils, and that some European countries even have mandatory health and safety councils and employee representation on corporate boards, provide evidence of this.⁶⁰ In Japan, there is an extensive system of enterprise unions and joint consultation committees.⁶¹ Conversely, nei-

53. RONALD DORE, STOCK MARKET CAPITALISM: WELFARE CAPITALISM—JAPAN AND GERMANY VERSUS THE ANGLO-SAXONS 79, 175 (2000).

54. *Id.* at 26-32.

55. Ronald Dore et al., *Varieties of Capitalism in the Twentieth Century*, 15 OXFORD REV. ECON. POL'Y 102, 104-17 (1999).

56. *Der Spiegel*, May 21, 1999, quoted in Dore et al., *supra* note 55, at 116-17.

57. Dore et al., *supra* note 55, at 116-17.

58. *Id.*

59. *Nikkei Wkly.*, Oct. 8, 1999, quoted in Dore et al., *supra* note 52, at 116.

60. DAVID CHARNY, WORKERS AND CORPORATE GOVERNANCE: THE ROLE OF POLITICAL CULTURE 91-120 (Margaret M. Blair & Mark J. Roe eds., 1999); Joel Rogers & Wolfgang Streeck, *Workplace Representation Overseas: The Works Councils Story*, in WORKING UNDER DIFFERENT RULES 97, 99 (Richard B. Freeman ed., 1994).

61. Keisuke Nakamura & Michio Nitta, *Developments in Industrial Relations and Human Resource Practices in Japan*, in EMPLOYMENT RELATIONS IN A CHANGING WORLD ECONOMY 325, 325-58 (Richard Locke et al. eds., 1995).

ther the United States nor the United Kingdom have anything remotely similar.⁶² Yet these enterprise-based forms of representation offer precisely what Freeman and Rogers say American workers want but do not have—localized and cooperative representation with acceptance by management.

In Germany, corporate governance includes a mix of market-generated and statutory institutions. There is concentrated ownership via horizontal and vertical cross-holdings.⁶³ Banks play a key role by holding their own shares, as well as depositary shares of other owners.⁶⁴ Various stakeholders are represented on corporate boards, including employees who are stakeholders not only due to firm-specific investments but also through pension fund assets that are heavily invested in the employer.⁶⁵ Codetermination laws give employee representatives half of the seats on a company's supervisory board.⁶⁶ Works councils, which exist at most companies, may consider strategic issues (although this is not their strongest feature) and the law requires consultation on specified matters.⁶⁷ Thus employees actively monitor management and are especially well informed on the state of company affairs.⁶⁸

Also included on boards are representatives of banks, suppliers, and other firms that have ties to the company via shareholding, debt, or business relationships.⁶⁹ While German managers are constrained to satisfy these various stakeholders, mechanisms exist to ensure that they give substantial weight to shareholder interests.⁷⁰ First, shareholders control the tie-breaking vote on the supervisory board.⁷¹ Second, banks often have voting rights for a majority of shares through their own and their depositary holdings.⁷² There is a close monitoring of managers by financial institutions because the banks are represented on corporate boards.⁷³ If dissatis-

62. Rogers & Streeck, *supra* note 60, at 98.

63. DORE, *supra* note 53, at 175.

64. David Charny, *The German Corporate Governance System*, 1 COLUM. BUS. L. REV. 145, 151-57 (1998).

65. *Id.* at 149.

66. *Id.*

67. Wendy Carlin & David Soskice, *Shocks to the System: The German Political Economy Under Stress*, 159 NAT'L INST. ECON. REV. 57, 65 (1997); Rogers & Streeck, *supra* note 60, at 115.

68. *Id.*

69. Charny, *supra* note 64, at 149.

70. *Id.* at 149-50.

71. MARK ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 170-77 (1994).

72. Charny, *supra* note 64, at 149; GARY GORTON & FRANK A. SCHMID, UNIVERSAL BANKING AND THE PERFORMANCE OF GERMAN FIRMS (Nat'l Bureau of Econ. Research, Working Paper No. 5453, 1996).

73. Charny, *supra* note 64, at 151-57.

fied with executive performance, corporate boards can and do fire and hire new executives.⁷⁴

The persistence in continental Europe of a governance model at variance with United States practices is a conundrum for those who think that technical conditions generate an optimal or one-best approach to corporate governance. The suspicion is that the European model entails substantial inefficiencies and would not be sustainable in the absence of extra-economic legal constraints and social norms. Mark Roe, whose research emphasizes the political origins of corporate governance structures, recently suggested that European managers give weight to employee interests, even when they do not have to, because they fear violating deeply-held social democratic norms regarding the corporation's responsibilities to its employees.⁷⁵ Similarly, Roe argues that European companies are leery of stock options because they violate the norm that managers should not be bound too tightly to any single stakeholder.⁷⁶ An American union official involved with the recent Chrysler-Daimler merger said, "it is amazing to me that in Europe . . . the corporations feel that they have [an ethical] obligation to their employees Th[is] come[s] naturally in the European culture."⁷⁷

While social norms definitely matter, the problem with attributing European governance structures to a social democratic ethos is simple: Japan. Japan is not a social democracy, yet its system of corporate governance is similar to the German model. In Japan there is patient capital: an inability or unwillingness of shareholders to easily exit the firm, concentrated shareholding (shares are held by a company's banks and by its affiliated suppliers and industrial group members), long managerial time horizons, and legal, as well as social expectations that a company should be responsible to employees, customers, suppliers, and local communities.⁷⁸ There are, in other words, strong social norms regarding stakeholders but they stem from sources other than social democracy, at least as the term is

74. Steven N. Kaplan, *Top Executives, Turnover, and Firm Performance in Germany*, 10 J. LAW ECON. & ORG. 142, 148-55 (1994).

75. Mark J. Roe, *Political Preconditions to Separating Ownership from Control: The Incompatibility of the American Public Firm with Social Democracy* STAN. L. REV. (forthcoming 2001).

76. *Id.* at 18.

77. *Id.* at 16.

78. Takashi Araki, *Japan, in THE PROCESS OF INDUSTRIALIZATION & THE ROLE OF LABOUR LAW IN ASIAN COUNTRIES* 49, 68 (R. Blanpain et al. eds., 1999); ULRIKE SCHAEDE, *CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL INVESTORS, MANAGEMENT MONITORING, AND CORPORATE STAKEHOLDERS* 31 (CCC Working Paper No. 92-12, 1992). When the presidents of one hundred top Japanese companies were asked in 1990 to whom the firm should belong, they said: shareholders (87%), employees (80%), and society (69%). Sam Beldona et al., *Are Japanese Managers More Long-term Oriented than U.S. Managers?*, 38 MGMT. INT'L REV. 239, 239-56 (1998).

usually understood.⁷⁹

Another difference from the German approach is the lack of board representation for major Japanese shareholders. Directors are former senior managers, usually appointed by current board members or by the CEO.⁸⁰ However, there is another group—the President's Council, made up of the heads of major companies within the business group (*keiretsu*)—which functions much like the German supervisory board in that it includes major shareholders and monitors corporate decisions of *keiretsu* firms.⁸¹ Even more important is a company's main bank, which has the power to review internal budgets and to replace poorly performing managers or otherwise resolve serious operating problems.⁸² As in the German system, banks have access to high-quality, inside information about corporate performance that is usually unavailable to major shareholders in the United States (although Japanese banks and the companies they own may collude in not disclosing this information to third parties).⁸³ When a company is performing poorly, the bank can, and occasionally does, appoint its own directors.⁸⁴ Also consistent with banks playing a monitoring role is the fact that, in crisis situations where banks have stepped in, one sees higher rates of executive turnover.⁸⁵

However it is not only banks and business group affiliates that monitor Japanese managements; employees also keep an eye on corporate affairs so as to protect their firm-specific investments. One of the first to note the consequences for employees of Japanese governance practices was the economist, Masahiko Aoki. In Aoki's model, the firm is divided between shareholders and employees, with management playing the role of media-

79. ANDREW D. GORDON, *THE EVOLUTION OF LABOR RELATIONS IN JAPAN: HEAVY INDUSTRY* 332-42 (1985). A common source for Japanese and German social norms is the "all in one boat" mentality that prevailed at the end of the war, as ethnically homogeneous societies with a discredited business class sought to rebuild along new and more inclusive lines. See KATHLEEN A. THELEN, *UNION OF PARTS: LABOR POLITICS IN POSTWAR GERMANY passim* (1991). See generally Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 *passim* (1996) (analyzing the place of law in managing behavioral norms).

80. JONATHAN CLARKHAM, *KEEPING GOOD COMPANY* 87 (1995).

81. MICHAEL GERLACH, *ALLIANCE CAPITALISM: THE SOCIAL ORGANIZATION OF JAPANESE BUSINESS* 81-89, 237-38; KENICHI MIYASHITA & DAVID W. RUSSELL, *KEIRETSU: INSIDE THE HIDDEN JAPANESE CONGLOMERATES* 61-66 (1994).

82. Masahiko Aoki et al., *The Japanese Main Bank System*, in *THE JAPANESE MAIN BANK SYSTEM* 3, 3-50 (Masahiko Aoki & Hugh Patrick eds., 1994).

83. CLARKHAM, *supra* note 80, at 107.

84. MARI SAKO, *PRICES, QUALITY, AND TRUST: INTERFIRM RELATIONS IN BRITAIN AND JAPAN* 81 (1992); Mark Gilson, *Reflections in a Distant Mirror: Japanese Governance Through American Eyes*, 1 COLUM. BUS. L. REV. 203, 210 (1998); Steven N. Kaplan & Bernadette A. Minton, *Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers*, 36 J. FIN. ECON. 225, 230 (1994).

85. Steven Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States*, 102 J. POL. ECON. 510, 516 (1994).

tor.⁸⁶ To create and retain firm-specific human capital, managers pursue policies that, in the U.S. system, would be viewed as inimical to shareholder interests.⁸⁷ The key policy is preserving the employment of core employees or *shain*.⁸⁸ During the oil shocks of the 1970s and again during the depression of the 1990s, large Japanese companies bent over backwards to avoid mass layoffs, preferring instead to rely on attrition, reduced hiring, early retirement, and on intra-firm and inter-firm transfers.⁸⁹ Whenever possible, the companies favored growth policies—reinvesting profits to expand market share or to pursue unrelated diversification—which generated employment opportunities for corporate *shain*.⁹⁰ Empirical research shows that top executives care as much about safeguarding employment as they do about raising dividends and share prices.⁹¹ Yet employees are not entirely shielded from risk. When the company experiences difficulty, they are expected to accept any job assignment that comes their way, even if it means transferring to a different company or a different facility far from home.⁹² Also a substantial portion of compensation is paid as a bonus that fluctuates with annual firm performance.⁹³ Therefore, when the bonus increases, so does directors' pay, which is one way that company directors are aligned with employee interests. Thus employees act and are treated like other owners, sharing in risks and returns, blocked from exit, and possessing a voice in corporate governance.⁹⁴

Employee voice is achieved through informal processes as well as formal representation. Although neither employees nor their unions are formally represented on corporate boards, there are other mechanisms for insuring that senior management pays attention to employee concerns. First, most senior corporate managers are "lifers" who not only have spent their entire career with the firm but also have held positions in the company

86. MASAHIKO AOKI, INFORMATION, INCENTIVES, AND BARGAINING IN THE JAPANESE ECONOMY 181-92 (1988).

87. *Id.* at 146.

88. Ryuichi Yamakawa, *The Silence of Stockholders: Japanese Labor Law from the Viewpoint of Corporate Governance*, JAPAN LAB. BULL., Nov. 1999, at 6, 8-9. *Shain* is an interesting word because in a legal context it refers to shareholders, whereas in the corporate world it means core employees, thus suggesting some ambiguity as to who is the Japanese corporation's residual claimant. *Id.*

89. Yoshio Higuchi, *Trends in Japanese Labour Markets*, in JAPANESE LABOUR AND MANAGEMENT IN TRANSITION 32, 32-39 (Mari Sako & Hiroki Sato eds., 1997).

90. MICHAEL E. PORTER ET AL., CAN JAPAN COMPETE? 73-75 (2000).

91. Toshiaki Tachibanaki, *Road to the Top and Executive Management Goals*, in WHO RUNS JAPANESE BUSINESS: MANAGEMENT AND MOTIVATION IN THE FIRM 20, 20-21 (Toshiaki Tachibanaki ed., 1998).

92. CLAIR BROWN ET AL., WORK AND PAY IN THE UNITED STATES AND JAPAN 32 (1997).

93. *Id.* at 29-30.

94. KATSUYUKI KUBO, THE DETERMINANTS OF EXECUTIVE COMPENSATION IN JAPAN AND THE UK 6 (Hitotsubashi University, Working Paper, 2000).

union earlier in their ascent up the corporate ladder.⁹⁵ The prevailing ethos in top management is to give heavy priority to layoff avoidance and, in fact, managers who safeguard employee jobs are rewarded with higher salaries.⁹⁶ Second, enterprise unions—which exist in most large companies—are involved to a varying extent in considering strategic issues that affect employment, such as restructuring and technological change.⁹⁷ Third, at most companies there are Joint Consultation Committees (“JCCs”), composed of senior union officials (or nonunion employees) and top corporate executives, that can be a vehicle for two-way communication of employee concerns and of confidential information about corporate plans and performance.⁹⁸

B. Accounting for Similarities

What might explain the parallels between Japanese and German governance structures and their dissimilarity from the U.S. model? An answer lies in the relative timing and sequence of the institutions that constitute a nation’s economic system. In a nutshell, Japan and Germany had big governments before big business; they had economic liberalization before political liberalization; and they were late developers governed by powerful states committed to catch-up industrialization.⁹⁹

Having big government before big business meant that corporate law at an early stage limited shareholder rights so as to promote various national interests. Those interests include a strong military, regional development, and the establishment of rudimentary worker rights—via enterprise representation and industrial welfare schemes—as a substitute for political rights. Workplace representation along these lines started in Germany and Japan around the time of World War I, with strong support from

95. HIDEO IOHARA, *THE JAPANESE PERSONNEL DEPARTMENT* 11-12 (1990).

96. Tomohiko Noda, *Determinants of Top Executives’ Promotion and Remuneration*, in *WHO RUNS JAPANESE BUSINESS?*, in *supra* note 91, at 36.

97. Nakamura & Nitta, *supra* note 61, at 347-50; Christoph Deutschmann, *Economic Restructuring and Company Unionism—The Japanese Model*, 8 *ECON. & INDUS. DEMOCRACY* 463, 470 (1987).

98. Motohiro Morishima, *Use of Joint Consultation Committees by Large Japanese Firms*, 30 *BRIT. J. INDUS. REL.* 405, 420 (1992); T. Tsuru & James Rebitzer, *The Limits of Enterprise Unionism* 33 *BRIT. J. INDUS. REL.* 459, 482 (1995). Note that forty percent of nonunion Japanese firms have JCCs, which reduces the attractiveness of enterprise unions. Morishima, *supra*, at 420.

99. REINHARD BENDIX, *WORK AND AUTHORITY IN INDUSTRY: IDEOLOGIES OF MANAGEMENT IN THE COURSE OF INDUSTRIALIZATION* 5-21 (1956); RONALD DORE, *BRITISH FACTORY-JAPANESE FACTORY: THE ORIGINS OF DIVERSITY IN INDUSTRIAL RELATIONS* 404-20 (1973); Thomas K. McCraw, *Business & Government: The Origins of the Adversary Relationship*, 26 *CAL. MGMT. REV.* 33, 45 (1984).

government.¹⁰⁰ With the state playing a major role in the nurturance of domestic industry, there was little patience for Anglo-American doctrines of laissez-faire, which the Germans had long derogated as “Smithianism.” Industrial policies for catching up with the Americans and the British focused on fostering scale economies while preserving scarce capital.¹⁰¹ Hence Japan and Germany encouraged the formation of economic cartels, discouraged bankruptcies, and gave banks a key role to play in corporate governance.¹⁰² Concerned that their national companies might be acquired by foreign first-movers, Germany and, especially, Japan erected barriers to hostile takeovers in a conscious effort to restrain the market for corporate control.¹⁰³ During World War II, military governments restrained shareholders’ rights and asserted their right to select senior managers. Businessmen’s concern with the public interest persisted after the war.¹⁰⁴

The situation in the United States was completely different. At the beginning of the twentieth century, the United States had the weakest national government in the developed world: small, constrained by federalism, and with relatively little directive power over economic development.¹⁰⁵ On the other hand, American corporations were the largest in the world, enjoying access to a huge home market and to cheap resources.¹⁰⁶ Hence big business was deeply suspicious and resentful as the federal government gradually expanded its regulatory power during the first half of the twentieth century.¹⁰⁷ The driving force behind economic regulation was not a developmental state, but rather a citizenry—including farmers and the middle class—that resented concentrated economic power and had little faith in business’ efforts to regulate itself, especially after the Great Depression.¹⁰⁸ Anti-corporate populism led to the nation’s strong anti-trust

100. GERALD D. FELDMAN, *ARMY, INDUSTRY, AND LABOR IN GERMANY, 1914-1918* 6 (1966); SHELDON GARON, *THE STATE AND LABOR IN MODERN JAPAN* 47-55 (1987); GORDON, *supra* note 79, at 235-46.

101. ALFRED D. CHANDLER, JR., *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* 224-33 (1990).

102. KAREL VAN WOLFEREN, *THE ENIGMA OF JAPANESE POWER* 356 (1990); GARY HERRIGEL, *INDUSTRIAL CONSTRUCTIONS: THE SOURCES OF GERMAN INDUSTRIAL POWER* 60-68, 170-74 (1996).

103. Tetsuji Okazaki, *The Japanese Firm Under the Wartime Planned Economy*, 7 *J. JAPANESE & INT’L. ECON.* 175 (1993).

104. For a recent treatment of these issues, see GREGORY JACKSON, *THE ORIGINS OF NON-LIBERAL CORPORATE GOVERNANCE IN GERMANY AND JAPAN passim* (Max Planck Institute, Cologne, Working Paper, Apr. 1999).

105. STEPHEN SKOWRONEK, *BUILDING A NEW AMERICAN STATE: THE EXPANSION OF NATIONAL ADMINISTRATIVE CAPACITIES, 1877-1920* 4-10 (1982).

106. CHANDLER, *supra* note 101, at 20.

107. David Vogel, *Why Businessmen Distrust Their State: The Political Consciousness of American Corporate Executives* 8 *BRIT. J. POL. SCI.* 45, 63 (1978).

108. Sanford M. Jacoby, *American Exceptionalism Revisited: The Case of Management*, in *MASTERS TO MANAGERS: HISTORICAL AND COMPARATIVE PERSPECTIVES ON AMERICAN*

laws, weak national banks, and its division between investment and commercial banking, all of which had the effect of fragmenting and dispersing corporate ownership.¹⁰⁹

In short, peculiarities of sequencing and development—accidents of time and place—intermingled with political power and market incentives to generate the diverse institutions of corporate governance we observe today. This kind of adaptive, path-dependent process does not produce a global optimum: a single model of corporate governance that is clearly superior, in an efficiency sense, to other models. Instead, what is generated are second bests or local maxima: systems that each come with a particular set of costs and benefits that produce strengths in certain areas of economic activity and weaknesses in others.¹¹⁰

It makes sense for one country to learn from another by imitating its institutional strengths and avoiding its weaknesses (this is what Gerschenkron saw as the chief advantage of backwardness).¹¹¹ However after an initial set of institutions is in place, that is, after a country is no longer backwards, institutional imitation becomes increasingly difficult. The examples that follow refer to corporate governance, but they could apply to other kinds of institutions as well. First, the institutions of corporate governance affect a nation's comparative advantage, creating niches in which to compete. The Japanese, for example, have consistently exploited a niche whereby they commercialize technologies that have been developed in other countries, an approach that is facilitated by long-term relations between employees, creditors, and firms.¹¹² Second, a practice that is beneficial in one institutional complex may derive its advantages from the fact that it compliments other practices; slicing it off and transplanting it may not generate the same benefits in another context. Thus the U.S. venture capital industry depends on a set of supportive legal and professional institutions that make it difficult for other countries to create a United States style venture capital market.¹¹³ Instead, those countries might do better achieving the same effect through their own institutional specificities,

EMPLOYERS 173, 173-200 (Sanford M. Jacoby ed., 1991).

109. ROE, *supra* note 71, at 34-49.

110. The same point has been made about national wage-setting institutions. Although they differ greatly, there is no evidence that one set of institutions is unambiguously superior to another. Richard B. Freeman, *War of the Models: Which Labour Market Institutions for the 21st Century?*, 5 LAB. ECON. 1 (1998).

111. ALEXANDER GERSCHENKRON, ECONOMIC BACKWARDNESS IN HISTORICAL PERSPECTIVE 33 (1965).

112. HENRY CHESBROUGH, THE ORGANIZATIONAL IMPACT OF TECHNOLOGICAL CHANGE: A COMPARATIVE THEORY OF NATIONAL INSTITUTIONAL FACTORS 21-28 (Harv. Bus. School, Working Paper, 1999), available at http://papers.ssrn.com/paper.taf?ABSTRACT_ID=200809 (last visited Nov. 13, 2000).

113. *Id.* at 18-21.

which in the case of Japan or South Korea entails a relatively greater role for big companies as incubators and capital providers.¹¹⁴

Third, institutions are context-dependent because they adapt to the political and economic environment within a particular country. For example, the U.S. employment system—with high rates of turnover and specialized jobs—is well suited to an unstable macroeconomic environment and to technologies based on economies of scale that are themselves adaptations to the huge U.S. market.¹¹⁵ Macroeconomic turbulence puts a premium on the ability to rapidly create jobs and to rapidly downsize, while standardized products allow for high levels of job specialization, which in turn facilitates rapid job creation.¹¹⁶ Conversely, a Japanese-type employment system is better suited to the environment obtaining in Japan, with a less volatile macro-economy, even in the 1990s, and more customized production practices. Also, in the United States, there are low unionization rates and decentralized wage bargaining.¹¹⁷ Hence companies compete against each other on labor costs, which can create friction between cost-cutting managers and local unions. This is one reason for adversarial labor relations in the United States.¹¹⁸ However, in Germany, unionization rates are higher and industry-level bargaining helps to standardize wages across firms.¹¹⁹ Annual *shunto* wage norms achieve the same effect in Japan.¹²⁰ With a substantial portion of wages fixed outside the workplace, both management and unions—works councils or enterprise unions—can focus on more cooperative, integrative issues.¹²¹

Finally, there is the point made by theorists of path dependency: There are huge sunk costs in a given set of institutions, including incremental adaptations made over long periods of time as well as vested political interests.¹²² Given high switching costs—and assuming that economic performance is satisfactory (i.e., that the benefits of change are small relative to the costs)—it makes more sense to incrementally adjust a given set of

114. *Id.* at 21.

115. BROWN ET AL., *supra* note 92, at 28-34; MICHAEL PIORE & CHARLES SABEL, THE SECOND INDUSTRIAL DIVIDE 73-104 (1984).

116. BROWN ET AL., *supra* note 92, at 28-34.

117. Jacoby, *supra* note 108, at 176.

118. *Id.* at 178.

119. However, localized cooperation can include the negotiation of “black wages,” that is, wage cuts that depart from national or industry norms, much to the annoyance of union members in other firms. HARRY KATZ & OWEN DARBISHIRE, CONVERGING DIVERGENCES: WORLDWIDE CHANGES IN EMPLOYMENT SYSTEMS 169-228 (1999).

120. BROWN ET AL., *supra* note 92, at 164-85.

121. Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LITERATURE 1, 23-24 (1990).

122. Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Governance and Ownership*, 52 STAN. L. REV. 775, 781-86 (1999).

institutions than to pursue a synoptic institutional overhaul.¹²³ Furthermore, as trade theory would suggest, because each nation gains from imitating another system evolving along a different path, there is a net cross-national advantage to sustaining organizational diversity.¹²⁴

III. COSTS, BENEFITS, AND BORROWING

A. *Europe and Japan*

None of this is intended to gainsay the fact that there are costs attached to the Euro-Asian approach to corporate governance as compared to the American model. First, the cost of capital is higher insofar as it is less liquid and, consequently, riskier than in the United States. This higher capital cost is especially evident in Japan.¹²⁵ Second, because Euro-Asian companies give weight to stakeholders other than shareholders, they are prone to over-invest cash that might more sensibly be returned to shareholders.¹²⁶ Hence, they sometimes produce too many products, excessively diversify into unrelated industries, and stretch out restructuring over very long periods or even avoid it altogether.¹²⁷ Such measures thus cause these companies to produce substantial excess capacity. This is the downside of “long termism.” On the other hand, reinvested cash and the slowness of restructuring can be beneficial to employees, and, in turn, employee

123. Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 329-34 (1996) (examining the link between corporate governance and economic efficiency through the lens of path dependency); DAVID BRAYBROOKE & CHARLES E. LINDBLOM, *A STRATEGY OF DECISION passim* (1970) (outlining and advocating for incremental adjustment of institutions).

124. Masahiko Aoki, *Unintended Fit: Organizational Evolution and Government Design of Institutions in Japan*, in *THE ROLE OF GOVERNMENT IN EAST ASIAN ECONOMIC DEVELOPMENT* 233, 233-53 (Masahiko Aoki et al. eds., 1997). Of course, if economic results are not meeting the threshold, as in the former Soviet Union or the United States in the early 1930s, there is a case for a more drastic institutional change in an effort to punctuate an equilibrium.

125. Carl W. Kester & Timothy A. Luehman, *The Myth of Japan's Low Cost Capital*, 70 HARV. BUS. REV. 130, 130-38 (1992). See generally CARL W. KESTER, *JAPANESE TAKEOVERS passim* (1991) (detailing the present state of flux in Japanese merger and acquisition activity).

126. John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641, 649 (1999) (advocating a legal theory to explain why the United States and the United Kingdom have been better able to develop active equity markets than the Euro-Asian markets).

127. Michael E. Porter & Hirotaka Takeuchi, *Fixing What Really Ails Japan*, FOREIGN AFF., May-June 1999, at 80 (discussing government policies and common corporate management techniques to explain Japan's meteoric economic rise in the last decade).

voice can have beneficial effects on productivity.¹²⁸ In effect, the company is balancing competing interests, whereas in the United States, shareholders come first.

To mitigate these costs, Japan and the European nations are implementing reforms intended to restructure corporate governance more along American lines.¹²⁹ In Japan, for example, financial deregulation takes full effect in 2001, and this, together with the recent growth of foreign ownership, is expected to force managers to be more sensitive to shareholders.¹³⁰ Recent surveys indicate that Japanese executives are already beginning to measure performance by return on equity rather than sales or cash flow.¹³¹ By opening up new sources of capital, deregulation will likely reduce the importance of main banks and promote the unwinding of cross-shareholding.

Other changes include laws enacted in the mid-1990s to permit shareholder class action suits against management and to allow board members to be sued for neglecting statutory duties.¹³² A 1997 law permits companies to purchase their own stock, thus creating a channel for returning excess cash to shareholders.¹³³ Other regulatory changes seek to facilitate corporate restructuring by reducing the number of board meetings needed to approve mergers and by permitting companies to merge operations through equity swaps.¹³⁴ Finally, to align manager and shareholder interests, there has been a liberalization of laws regarding stock options. Some of these laws have even been introduced by old-economy companies such as Toyota and Komatsu.¹³⁵

As befits an economy in which corporate governance patterns were stamped by the state, many recent changes have been the result of statutory deregulation. However, there also have been some voluntary changes, no-

128. FREEMAN & MEDOFF, *supra* note 44, at 14-16; Giorgio Brunello, *The Effect of Unions on Firm Performance in Japanese Manufacturing*, 45 INDUS. & LAB. REL. REV. 471, 484 (1992). Employees are not the only insiders who derive benefits from their stakeholder status. Banks also use inside information and long-term relationships to secure higher interest rates in Japan and Germany. Jeffrey N. Gordon, *Deutsche Telekom, German Corporate Governance, and the Transition Costs of Capitalism*, 1 COLUM. BUS. L. REV. 186, 199 (1998); Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 759 (1997).

129. ANDREW KAKABADSE ET AL., JAPANESE BUSINESS LEADERS 52 (1996); ROE, *supra* note 71, at 228-29. See generally Randall Jones & Kotaro Tsuru, *Japan Corporate Governance: A System in Evolution*, 204 OECD OBSERVER 40, 41 (1997) (noting the changes in Japan's system of corporate governance that have resulted from recent financial liberalism).

130. *Business in Japan*, ECONOMIST, Nov. 27, 1999, at 8-9.

131. *Stocks Generating Interest for Japan Execs*, NIKKEI WKLY., Mar. 27, 2000, at 16.

132. Hiroyuki Takahashi, *Corporate Governance in Japan: Reform of Top Corporate Management Structure*, 28A JEI REP. 2, July 23, 1999.

133. DORE, *supra* note 53, at 98-100.

134. Jones & Tsuru, *supra* note 129, at 42.

135. *Ban Lifted on Stock Option Systems*, JAPAN LAB. BULL., Aug. 1997, at 2.

tably in the size and composition of corporate boards. Boards swelled to an unwieldy size, some as large as forty or fifty members, in the 1970s and 1980s.¹³⁶ Since these boards included many operating managers, there was a blurring of the distinction between strategic and operational responsibilities.¹³⁷ Nonetheless, in a much-noticed 1997 move, Sony decreased the size of its board from thirty-eight to ten members, added three outsiders, and created a separate body of executive officers to handle operational matters, leaving the board free to focus on strategic issues.¹³⁸ Two years later, Sony split itself into four divisions in an effort to decentralize and to bring to management what one Sony executive called “a small venture capital spirit.”¹³⁹

Much to the frustration of those who wish to see an institutional overhaul, change is proceeding at a glacial pace. Cross-shareholding remains an important characteristic of the Japanese economy. The percentage of shares held by financial institutions (banks and insurance companies) fell from a post-1970 peak of forty-two percent in 1988 to thirty-nine percent in 1997, which is about where it stood in the early 1980s.¹⁴⁰ Many of these bank sales had less to do with changes in governance than a need to raise cash.¹⁴¹ Corporate cross-share ownership also has fallen, but again, the decline is modest, falling only from a peak of twenty-six percent in 1976 to twenty-four percent in 1997.¹⁴² Shareholding within the “Big Six” *keiretsu* actually was higher in 1999 than in the early 1980s.¹⁴³ The proportion of companies with any cross-holdings currently stands at around ninety-five percent, the same level observed in the late 1980s.¹⁴⁴ Finally, cross-shareholding continues to be used as a way of cementing business relationships and technology transfers, as is the case in a recent deal between Toyota and Yamaha Motor.¹⁴⁵

136. Takahashi, *supra* note 132, at 3.

137. *Id.* at 6.

138. *Id.* at 4.

139. *Sony's Yoshida Nakamura on Structure and Decision Making*, 13 ACAD. MGMT. EXECUTIVE 12, 13 (1999); Barbara Wanner, *Sokaiya Scandals: Economic Woes Spotlight Japanese Corporate Governance*, 3A JEI REP., Jan. 23, 1998 (discussing how the *Sokaiya*, or corporate extortionist, scandals led Japanese leaders to reexamine how businesses should be run, who should oversee their operations, and who the principal beneficiaries of the enterprises should be).

140. *Tokyo Stock Exchange Annual Report* (1999), in ULRIKE SCHAEDE, *THE JAPANESE FINANCIAL SYSTEM: FROM POSTWAR TO THE NEW MILLENNIUM 21* (Harv. Bus. Sch., Working Paper No. 9-700-049, Jan. 5, 2000).

141. Douglas Ostrom, *The Keiretsu System: Cracking or Crumbling?*, 14A JEI REP., Apr. 7, 2000, at 10.

142. SCHAEDE, *supra* note 140, at 21.

143. Ostrom, *supra* note 141, at 11.

144. Hideaki Inoue, *The Accelerating Dissolution of Stock Crossholding*, NLI RESEARCH, NO. 133, Mar. 2000, at 39.

145. *Toyota Buys Five Percent Stake in Yamaha Motor*, 74 AUTOMOTIVE NEWS, Mar. 13,

Many companies have reduced the size of their corporate boards, but this is, in fact, a return to previous practice. Corporate presidents remain firmly in control and continue to appoint directors; outside directors remain rare.¹⁴⁶ Few companies have followed Sony's lead in restructuring their corporate boards; only eighteen percent of listed companies have adopted the Sony approach.¹⁴⁷

While mergers and acquisitions ("M & A") have increased, M & A levels remain extremely low as compared to the United States.¹⁴⁸ Since Japanese companies are reluctant to pursue each other, hostile takeovers remain rare.¹⁴⁹ Attention was aroused early in 2000 when a German company successfully completed an unwelcome bid to take over a Japanese pharmaceutical company.¹⁵⁰ This, however, was shortly followed by another hostile takeover attempt—one of a Japanese electronics firm, Shoei, by another Japanese company—that failed to win the support of Shoei's *keiretsu* and bank shareholders.¹⁵¹

Legal reforms that permit new forms of activity have induced only minor changes in behavior. The law regarding management buy-outs ("MBOs") has been made less restrictive, but they remain rare.¹⁵² In addition, despite an easing of rules on stock options, few companies have adopted them and, where they exist, they remain quite modest.¹⁵³ Thus, there is little evidence to show that deregulation is unleashing a pent-up demand for governance reform, which suggests, in turn, that governance structures are not held in place merely by extra-economic compulsion.

Finally, despite the longest economic slump since the Second World War, permanent employment remains substantially in place at large companies.¹⁵⁴ Part-time and temporary employment have increased, and there

2000, at 58.

146. Takahashi, *supra* note 132, at 10.

147. Yamakawa, *supra* note 88, at 7; *Nikkei Sangyo Shimbum*, Sept. 25, 2000, at 3.

148. Arthur J. Alexander, *Trading Places-Again: Japan Confronts Corporate Restructuring*, 20 JEI REP., May 1999, at 10.

149. Robert Neff, *Japan: Land of the Hostile Takeover?* BUS. WK., Apr. 10, 2000, at 66 E2.

150. *Boehringer Takeover Sign of the Times*, NIKKEI WKLY., Feb. 21, 2000, at 3.

151. Jon Choy, *Win or Lose, More Players Join Mergers and Acquisitions Game*, 9B JEI REP., Mar. 3, 2000, at 1-2.

152. Jon Choy, *Tokyo Backs Controversial Industry Revival Bills*, 29 JEI REP., July 1999, at 1.

153. *The Amazing Portable Sarariman*, ECONOMIST, Nov. 20, 1999, at 71; *An Exercise in Shareholder Capitalism*, NIKKEI WKLY., Jan. 31, 2000, at 14.

154. Hiroyuki Chuma, *Is Japan's Long-Term Employment System Changing?*, in INTERNAL LABOR MARKETS, INCENTIVES, AND EMPLOYMENT 225, 225-68 (Isao Ohashi & Toshiaki Tachibanaki eds., 1998); Edward J. Lincoln, *Job Security in Japan: Is Lifetime Employment on the Way Out?*, BROOKINGS REV., 1999, at 44-45; Sandra Sugawara, *Japan Holding on to Lifetime-Job System Despite Crisis*, WASH. POST, June 17, 1998, at C-15.

has been a gradual decline in the number of core jobs.¹⁵⁵ However, there has been little decline in employee retention rates and few mass layoffs.¹⁵⁶ Even troubled Nissan, which is planning to close five car plants employing 16,000 workers, will spread the downsizing over three years and rely on attrition and transfers to avoid layoffs (although it remains to be seen how the company will do this, probably by putting the onus on its subcontractors).¹⁵⁷ As in years past, current restructuring disproportionately affects workers in Japan's smaller companies.¹⁵⁸

Continental Europe presents a similar mixture of inertia and incremental change. Stock markets are still not as important as in the United States, as evidenced by some Italian firms' decisions to de-list their shares.¹⁵⁹ German banks have increased the number of shares they own in the nation's largest companies, and eighty-five percent of these companies continue to have concentrated ownership.¹⁶⁰ As in Japan, there have been some highly publicized hostile takeovers, but they remain rare and, unlike in the United States, often have banks playing a decisive role.¹⁶¹ Thus concentrated ownership—including shares held by banks and by family members—remains largely in place.

B. *Explaining Inertia*

Why has governance reform occurred on such a modest scale? One important reason is that the Europeans and Japanese are skeptical that their economic malaise is primarily due to flaws in their corporate governance systems. After all, the systems were compatible with high growth rates not

155. *Japan Awash in Temp Workers*, NIKKEI WKLY., Feb. 28, 2000, at 4. Consistent with these changes are employment law reforms that make it easier for temporary agencies to operate, and for companies to hire employees from them. As in the United States, the growth of temps is partly a way for big companies to screen new employees before offering them full-time employment. Takashi Araki, *1999 Revisions of Employment Security Law and Worker Dispatching Law*, JAPAN LAB. BULL., Sept. 1999, at 1.

156. Keiko Okazaki, *Measurement of Japanese Lifetime Employment System*, in FRONTIERS OF JAPANESE HUMAN RESOURCE PRACTICES 216, 216-18 (Yoko Sano et. al. eds., 1997).

157. Andrew D. Gordon, *Scaring the Salaryman Isn't the Japanese Way*, N.Y. TIMES, Oct. 30, 1999, at A-27.

158. Over the past three years, forty-seven percent of the employees dismissed due to restructuring were employed by companies with thirty or fewer employees. Thus, although the law continues to restrict economic layoffs, smaller companies that want to shed workers are able to do so. *Workers at Small Firms Bear Brunt of Job Losses*, NIKKEI WKLY., Dec. 6, 1999, at 6.

159. Bebchuk & Roe, *supra* note 122, at 785; Julian Franks & Colin Mayer, *Bank Control, Takeover and Corporate Governance in Germany*, 22 J. BANKING & FIN. 1385 (1998).

160. Bebchuk & Roe, *supra* note 122, at 786.

161. Carol J. Williams, *Vodafone AirTouch Overcomes Mannesman's Resistance*, L.A. TIMES, Feb. 14, 2000, at C-1.

very long ago, and there are other, chiefly macroeconomic, factors that correlate more closely with the onset of economic problems. In Japan's case, these include a financial industry damaged by easy credit and the subsequent collapse of asset prices, slow-moving government recovery efforts, and the recent economic meltdown in southeast Asia, a major market for Japan.¹⁶² In Europe, there have been extremely high interest rates since German unification.¹⁶³ Monetary stringency has been exacerbated by the fiscally restrictive Maastricht criteria for a common European currency.¹⁶⁴

Moreover, the Europeans and the Japanese recognize that their governance systems bring benefits as well as burdens, so there is a wariness of tossing the baby out with the bath water. One benefit is the high level of human capital formation inside enterprises, both firm-specific and general skills. Comparative studies show the United States to be laggard in this regard, with employer training expenditures far below European and Japanese levels.¹⁶⁵ When employees are being trained in firm-specific skills, they typically receive below-market wages and later on split the training returns with their employer. Employees will, therefore, seek assurances that future returns will be fairly divided and that they will be around to receive them.¹⁶⁶ Treating employees as stakeholders—through participation, representation, and stable employment—makes it easier for them to obtain these assurances.¹⁶⁷ The results are the high training and high quality levels associated with Japanese and German enterprises.¹⁶⁸

162. See generally Paul Krugman, *Thinking About the Liquidity Trap*, at <http://www.web.mit.edu/krugman/www/trioshr.html> (Dec. 1999) (outlining a macro-economic perspective on Japan's economic problems).

163. Richard W. Stevenson, *Europe's Currencies Wobble On*, N.Y. TIMES, Nov. 23, 1992, at D-1.

164. *France and Italy: Pain There Too*, ECONOMIST, June 22, 1996, at 50.

165. Peter Berg, *Strategic Adjustments in Training: A Comparative Analysis of the U.S. and German Automobile Industries*, in TRAINING AND THE PRIVATE SECTOR: INTERNATIONAL COMPARISONS 77, *passim* (Lisa M. Lynch ed., 1994); John Paul MacDuffie & Thomas A. Kochan, *Do U.S. Firms Invest Less in Human Resources? Training in the World Auto Industry*, 34 INDUS. REL. 147, *passim* (1995).

166. See DARON ACEMOGLU & JÖRN-STEFFEN PISCHKE, BEYOND BECKER: TRAINING IN IMPERFECT LABOR MARKET 19-24 (Nat'l Bureau of Econ. Research, Working Paper No. 6740, 1998).

167. Consistent with the thesis that employee voice and human capital formation are related is the finding that, in the United States, both unionization and employee involvement are positively associated with corporate training expenditures. JOHN BISHOP, THE INCIDENCE OF AND PAYOFF TO EMPLOYER TRAINING 8 (Center for Advanced Human Res. Studies, Sch. of Indus. & Lab. Rel., Cornell University, Working Paper No. 94-17, 1994).

168. Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508, 552-53 (1999). Gilson and Roe argue that high levels of training investments in Japan are due not to lifetime employment practices but to the inhibition of labor mobility, which they describe as the "dark side" of the Japanese system. That is, lifetime employment contributes little or nothing to high levels of human capital investment, which instead are due to managerial devices that

Another advantage of the Euro-Asian governance approach is its facilitation of cooperative, long-term relations between the firm and its suppliers and customers. The risk in long-term business relations is that of opportunistic behavior; of “hold up” over the rents from relation-specific assets. Having financial stakes in each other’s business builds trust and reduces opportunism by providing inside information to assure that the division of rents is fair.¹⁶⁹ The result is lower monitoring costs, smoother negotiations, possibilities for risk sharing on new ventures, and improved quality based on sharing of confidential information.¹⁷⁰ The fact that suppliers do not have to worry about a company being acquired adds to the credibility of the company’s long-term commitments in such areas as purchasing and technology transfer.¹⁷¹

Training expenditures and a relational approach to business contracting are supported by the longer time horizons that concentrated ownership permits.¹⁷² Even critics of the Japanese governance model recognize the

discourage inter-firm mobility. However this argument has both logical and historical problems. Once a company offers firm-specific training to employees, its value is enhanced if employees are assured that they will not be dismissed later in their careers, when other employers will be less likely to train them. Moreover, even if firms do not initially offer training, some companies may underpay workers in early years and overpay later in their careers as a way of screening out workers who are unstable or judge themselves unlikely to survive a probationary review. In this world, employees will seek lifetime employment promises (and also seek promises that vacancies will be given to incumbent employees) as a way of ensuring that they will still be employed when their training returns come due.

As a growing number of companies adopt these policies, other firms will defensively follow suit. The end result is that there is low inter-firm mobility (in the core sector where internal labor markets are located) and outsiders are often frozen out of core-sector jobs. At this point, employers do have an incentive to make training investments, although such training is an unintended consequence of pressures from employees to rigidify internal labor markets. Historically, Japanese internal labor markets had pre-war roots, as skilled workers gave up the freedom and potentially high returns of the open market in return for the security and predictability of corporate employment. After the war, internal labor markets were codified by enterprise unions and by legal decisions establishing dismissal limitations. In Japan today, the bulk of training is directed at a company’s most mobile employees—workers under the age of thirty-five, rather than at older workers for whom permanent employment has more meaning. Thus there is both a “laborist” as well as a capitalist (“dark side”) logic to the reduction of inter-firm mobility; the decision to make—instead of buy—skills is hardly an unconstrained choice by employers. *See id.*; RODNEY CLARK, *THE JAPANESE COMPANY* 140-96 (1979); PETER B. DOERINGER & MICHAEL J. PIRE, *INTERNAL LABOR MARKETS AND MANPOWER ANALYSIS passim* (1971); GORDON, *supra* note 79, at 330-50; Araki, *supra* note 78, at 102; Edward Lazear, *Pensions as Severance Pay*, in *FINANCIAL ASPECTS OF U.S. PENSION SYSTEMS* (Zvi Bodie & John Shoven eds., 1983); Sanford Jacoby, *The Origins of Internal Labor Markets in Japan*, 18 *INDUS. REL.* 184, 190-91 (1979).

169. RONALD DORE, *FLEXIBLE RIGIDITIES: INDUSTRIAL POLICY AND STRUCTURAL ADJUSTMENT IN THE JAPANESE ECONOMY* 72-85 (1986).

170. SAKO, *supra* note 84, at 180-89.

171. *Id.* at 51-58; Carlin & Soskice, *supra* note 67, at 66-67.

172. Gerald Garvey & Peter Swan, *The Interaction Between Financial and Employment*

advantages of a longer time horizon for corporate decision-making.¹⁷³ It permits ongoing investments in projects that do not pay off immediately, or in technologies—including employee education and training—where learning is incremental and cumulative.¹⁷⁴ In the United States, however, capital budgeting and other control systems are oriented to the short-term, which (along with low trust levels) leads to a focus on numbers, whose accuracy is most plausible in the short-term. Hence, managers are inclined to de-emphasize long-term processes that cannot easily be quantified, especially those related to intangible assets like human capital, trust, and good will.¹⁷⁵

Concentrated ownership also permits close monitoring of corporate managers, who are scrutinized by bankers and other insiders. There is evidence that the existence of block shareholders is associated, *ceteris paribus*, with improved corporate performance and faster replacement of managers.¹⁷⁶ That is, Japanese and German executives are more likely than United States managers to lose their jobs when there is poor stock performance or earnings losses.¹⁷⁷ Employees also perform a monitoring role via their enterprise unions, as in Japan, or via works councils and co-determination, as in Germany.¹⁷⁸ Monitoring by employees and by banks and other block holders is a substitute for a U.S.-style market for corporate control.¹⁷⁹ As one study concludes, Euro-Asian governance provides “effective ways of disciplining poor managers and otherwise promoting efficiency.”¹⁸⁰ In short, in spite of different institutions, the results are similar.

Efficiency is only one criterion by which to judge economic performance; equity also matters. Governance systems that give weight to multiple stakeholders are associated with a broader distribution of economic rewards. In continental Europe and Japan, there is less wage inequality than

Contracts: A Formal Model of Japanese Governance, 6 JAPAN & INT'L ECON. 247, 248-51 (1992).

173. Michael E. Porter, *Capital Choices: Changing the Way America Invests in Industry*, in STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS 5, 5 (Donald H. Chew ed., 1997).

174. KIRSTEN WEVER, NEGOTIATING COMPETITIVENESS: EMPLOYMENT RELATIONS AND ORGANIZATIONAL INNOVATION IN GERMANY AND THE UNITED STATES 103-05 (1995).

175. Jeffrey Pfeffer, *Pitfalls on the Road to Measurement: The Dangerous Liaison of Human Resources with the Ideas of Accounting and Finance*, 36 HUM. RESOURCE MGMT. 357, 360 (1997), available at <http://www.interscience.wiley.com/cgi-bin/jtoc?ID=46161>.

176. DAVID L. KANG, THE IMPACT OF ACTIVIST INSTITUTIONAL INVESTORS ON PERFORMANCE IN PUBLIC CORPORATIONS 1 (Harv. Bus. Sch., Working Paper No. 00-49, 2000).

177. Kaplan, *supra* note 85, at 540; Kaplan, *supra* note 74, at 150.

178. ROBERTS & VAN DEN STEEN, *supra* note 51, at 18-24.

179. Shleifer & Vishny, *supra* note 128, at 755.

180. Julian Franks & Colin Mayer, *Corporate Ownership and Control in the U.K., Germany, and France*, in STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS 281, 296 (Donald H. Chew ed., 1997).

in the United States, including a smaller gap between the pay of executives and front-line workers.¹⁸¹ While we are used to thinking of an equity-efficiency tradeoff—meaning that the Japanese and the Europeans are indulging a taste for equity whose cost is inefficiency and slower growth—the evidence shows that, in fact, social equity is associated with higher long-term growth rates.¹⁸² Similarly, at the micro-level, there is evidence that firm performance can be improved by employee participation and representation. This is hardly surprising given that employees possess inside information about inefficient processes and ineffectual managers.¹⁸³ While there is always a risk of the participatory enterprise becoming an island—a fortress of insiders guarding against outsiders—it is also possible that habits of inclusion and voice spill over from the firm into the larger society in which it is embedded. The data on social welfare spending, which is more inclusive and more egalitarian in Europe and Japan than in the United States, suggest this is the case.¹⁸⁴

IV. COSTS, BENEFITS, AND BORROWING: THE UNITED STATES

Despite the hubris of Wall Street and The City, it is important to remember that the Anglo-American model comes with its own set of costs. It disenfranchises stakeholders other than shareholders, thereby removing a potential source of productivity gains. Ignoring other stakeholders also tilts the economy away from societal preferences regarding risk, thereby creating a more volatile economy than most people want. Moreover, the Anglo-American model performs far better in the United States than Britain. British per capita GDP levels remain well below those in Japan and Germany.¹⁸⁵ British growth rates lagged behind Japan's in the 1970s and

181. Richard B. Freeman & Lawrence F. Katz, *Introduction and Summary*, in *DIFFERENCES AND CHANGES IN WAGE STRUCTURE* 1, 1-21 (Richard B. Freeman & Lawrence F. Katz eds., 1995).

182. Philippe Aghion et al., *Inequality and Economic Growth: The Perspective of the New Growth Theories*, 37 *J. ECON. LITERATURE* 1615, 1615-60 (1999); Alberto Alesina & Dani Rodrik, *Distributive Politics and Economic Growth*, 109 *Q. J. ECON.* 465, 465-90 (1994).

183. Chris Doucouliagos, *Worker Participation and Productivity in Labor-Managed and Participatory Capitalist Firms: A Meta-Analysis*, 49 *INDUS. & LAB. REL. REV.* 58, 63 (1995). Note, however, that Doucouliagos found a negative association between co-determination and productivity but found that works councils had a positive effect, a finding replicated in John T. Addison et al., *Worker Participation and Firm Performance: Evidence from Germany and Britain*, 38 *BRIT. J. INDUS. REL.* 7, 7-48 (2000).

184. Sanford M. Jacoby, *Risk and the Labor Market: Societal Past as Economic Prologue*, in *SOURCEBOOK ON LABOR MARKETS: EVOLVING STRUCTURES AND PROCESSES* 36, 36-43 (Ivar Berg & Arne Kalleberg eds., forthcoming 2001).

185. *A British Miracle?*, *ECONOMIST*, Mar. 25-31, 2000, at 57.

1980s and lagged behind Germany's in the 1990s.¹⁸⁶ Hence any attribution of America's economic performance to shareholder sovereignty, which also exists in Britain, is based more on faith than on facts.

Moreover, while U.S. economic performance in the 1990s was better than Britain's, it was nevertheless spotty. The good news is that the stock market boomed and that job creation was higher and unemployment lower than in other advanced countries.¹⁸⁷ On the other hand, pay growth was relatively slow and unevenly distributed. Output per hour in the United States was about the same as levels observed in western Europe, and neither productivity growth rates nor per capita growth rates were higher than in other advanced countries, including Japan and Germany.¹⁸⁸ True, productivity has recently improved in the United States, and if this turns out to be a cumulative phenomenon related to the "new economy" the United States might have something to crow about. However, at this moment much remains unclear, including how much of the productivity improvement is related to the new economy, and the extent to which the new economy is driven by corporate governance factors, including venture capital and ease of layoffs, or first-mover advantages that may not be sustainable, as was the case with semiconductor, flat panel, and disk-drive technologies in the 1980s.¹⁸⁹ Hence, caution is warranted. Three years does not a long-term trend make. Economic history is filled with examples of "new eras," forecasting a brilliant future that never arrived.¹⁹⁰

Another shortcoming of the Anglo-American governance model is the thin information possessed by dispersed shareholders, which causes them to over-focus on stock price movements.¹⁹¹ Managers respond by emphasizing activities that bolster quarterly results, which, as noted, leads them to give short shrift to activities that are not easily quantified or whose payoff is long-term in nature.¹⁹² While the U.S. approach excels at funding new ventures and new industries, short-termism causes a failure to invest

186. *Id.*

187. *Desperately Seeking a Perfect Model*, ECONOMIST, Apr. 10-16, 1999, at 67; RICHARD B. FREEMAN, SINGLE-PEAKED VS. DIVERSIFIED CAPITALISM: THE RELATION BETWEEN ECONOMIC INSTITUTIONS AND OUTCOMES 24 (Nat'l Bureau of Econ. Research, Working Paper No. 7556, 2000), available at <http://www.nber.org/papers/W7556> (last visited Jan. 30, 2001).

188. FREEMAN, *supra* note 187, at 43. If one looks only at the former West Germany, its per capita GDP growth and productivity growth outstripped the United States in the 1990s. *Id.*

189. Jeffrey Macher, David C. Mowery & David Hodges, *Reversal of Fortune? The Recovery of the U.S. Semiconductor Industry*, 41 CAL. MGMT. REV. 107 (1998).

190. SHILLER, *supra* note 10, at 96-132; *Debating the New Economy*, BUS. WK., July 12, 1999, at 26.

191. REICHHELD, *supra* note 32, at 155.

192. JACOBS, *supra* note 12, at 9-29; John Grinyer, et al., *Evidence of Managerial Short-Termism in the U.K.*, 9 BRIT. J. MGMT. 13, 15-20 (1998).

enough to secure competitive positions in existing industries.¹⁹³ The consequences of short-term restructuring in the 1980s became apparent in the next decade as corporations with patient owners—either private firms with long-term owners or publicly-held firms with one or several dominant owners—outperformed companies with more dispersed and fickle owners.¹⁹⁴

The market for corporate control did permit the United States to move faster than other countries, to shrink unprofitable “sunset” industries, to reduce over-capacity, and to curb excessive corporate diversification through de-conglomeration. However, restructurings were driven not only by efficiency concerns but also by pressure to finance debt-laden LBOs.¹⁹⁵ Hence, LBOs were associated with cuts in plant expenditures and sharp reductions in Research and Development spending.¹⁹⁶ Moreover, part of the value unleashed by takeovers was merely a transfer of income to shareholders from workers and managers, whose implicit pay contracts were aborted, and from pensioners, whose pension plans were raided. The only stakeholders driving the process were shareholders. As a result, adjustment costs were disproportionately shouldered by employees, managers, and communities—the least diversified stakeholders.¹⁹⁷

While a chief virtue of American governance is the liquidity of equity markets, the downside is instability. During the last few years, consumption and business investment have been buoyed by a surge of new investors in U.S. equity markets.¹⁹⁸ However, with this has come an increase in speculative trading behavior, a jump in stock turnover rates, and greater market volatility. With the market not well anchored by fundamentals, it becomes increasingly difficult to accept the neoclassical claim that capital markets are the primary source of discipline directing managerial behavior. Just as herd behavior can lead to a sharp rise in equity prices, so, too, can a stampede for the exit cause a market collapse. If this occurs, it would

193. Andrei Shleifer & Robert Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148, 148-53 (1990).

194. KANG, *supra* note 176, at 20; REICHELLED *supra* note 32, at 159, 169.

195. William F. Long & David J. Ravenscraft, *Decade of Debt: Lessons from LBOs in the 1980s*, in THE DEAL DECADE 205 (Margaret M. Blair ed., 1993).

196. Partly to avoid the myopic constraints of public ownership, some LBOs in the 1980s were management buyouts (“MBOs”) which were associated with higher performance that was not due to layoffs or to reductions in Research & Development expenditures. Steven Kaplan, *The Effect of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217, 217 (1989).

197. Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33(Alan J. Auerbach ed., 1988). Bondholders also suffer during LBOs as a result of the increased risk associated with LBO debt financing. Abbie J. Smith, *Corporate Ownership Structure and Performance*, 27 J. FIN. ECON. 143, 143 (1990).

198. SHILLER, *supra* note 10, at 135-68.

wreak havoc on the real economy because so much of the economy is now linked to equity prices. The same forces that heretofore have driven growth would shift into reverse, causing investment and consumption to decline and venture capital to dry up.

To reiterate, it would be an oversimplification to say that recent U.S. economic success is due chiefly to its governance model, or that recent Japanese and European problems are due chiefly to their governance models. To conclude, therefore, that Japan and Europe can remedy their problems by emulating the U.S. governance model is a further oversimplification. Rather, each system comes with costs and benefits. The U.S. advantage is the liquidity of its capital markets where capital is widely available to finance both restructuring and emerging industries. On the other side of the ledger is pervasive short-termism, excessive volatility, and inequality that results from failure to include legitimate stakeholders in corporate decisions. The virtues of the Euro-Asian model come from concentrated ownership, which permits close monitoring of managers and attention to long-term growth factors, and also from a stakeholder approach that gives employees and others a voice in corporate affairs.¹⁹⁹ However, the pace of change, both for restructuring and new ventures, is slow.

A. *The United States as Borrower*

Back in the late 1980s, liberal pundits urged the United States to shed its institutions in favor of Euro-Asian practices.²⁰⁰ Today, conservatives make the reverse argument.²⁰¹ Both sides fail to realize that neither set of institutions is unambiguously superior to the other. One should not promote the wholesale replacement of one governance model with the other, but instead pragmatic experimentation and incremental adaptation on both sides should be encouraged. Governance institutions are complex, path-dependent, and embedded in complex social systems. Therefore, borrowing is not as easy as it sounds, but, as noted, it is occurring in Europe and Japan.²⁰² Borrowing is also taking place in the United States, although it is not as widely perceived or acknowledged.

199. John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999); Franks & Mayer, *supra* note 159, at 1390.

200. See, e.g., Lester Thurow, *Let's Learn from the Japanese*, FORTUNE, Nov. 18, 1991, at 183-86.

201. See, e.g., Gary Becker, *Only Labor Reform Will Get Europe Working Again*, BUS. WK., Nov. 18, 1998, at 22.

202. The Japanese have a long history of borrowing institutions and ideas from the West. It is, indeed, easier to borrow new institutions or make incremental adaptations to existing institutions than it is to do a top-down makeover. For examples of the former, see ELEANOR WESTNEY, *IMITATION AND INNOVATION passim* (1987).

A telling example can be found in the corporate strategies of large U.S. companies. Traditional precepts of strategy were built around two elements: an external orientation associated with product market considerations and an internal orientation concerned with the problems of administering a multidivisional company. To achieve a competitive advantage, external strategies either were focused on product differentiation through design or marketing, or on creating market power through scale economies and entry-barrier pricing.²⁰³ As companies grew and developed financial resources and management skills in one industry, they followed an internal strategy of diversifying into other industries with market opportunities. The diversified company functioned like an internal capital market, allocating funds to businesses with the most promising market returns.²⁰⁴ At the limit, as in the case of a conglomerate, a company might be completely diversified with little synergy holding its units together other than offsetting risks and a mechanism for allocating capital across units.

Today, a growing number of U.S. companies emphasize competition based on internal strengths. This is sometimes called a resource-based competitive strategy, a concept familiar to Japanese and European companies, which tend to be less diversified and more focused than traditional U.S. firms.²⁰⁵ A resource-based strategy aims to develop inimitable resources that other companies do not possess.²⁰⁶ These resources could include a firm's human capital and other intellectual property, its organizational structure (including a distinctive corporate culture or approach to innovation), and unique physical assets. While a resource-based corporate strategy is not a substitute for the traditional approach, it is more inward-looking and, therefore, more concerned with strengthening organizational processes that make the company distinct. The resource-based approach eschews unrelated diversification based purely on financial considerations in favor of diversification guided by core competency and potential synergies.²⁰⁷

Ironically, one reason the 1990s saw an increase in resource-based or

203. MICHAEL PORTER, *COMPETITIVE STRATEGY: TECHNIQUES FOR ANALYZING INDUSTRIES* 16-19 (1980).

204. ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 455-76 (1977).

205. CHANDLER, *supra* note 101, at 622-23; TOYOHIRO KANO, *STRATEGY AND STRUCTURE OF JAPANESE ENTERPRISES* 99-149 (1984); Jay Barney, *Firm Resources and Sustained Competitive Advantage*, 17 *J. MGMT.* 99, 101-03 (1991).

206. Barney, *supra* note 205, at 107.

207. For an overview, see the essays in *RESOURCES, FIRMS, AND STRATEGIES passim* (Nicolai J. Foss ed., 1997). There is evidence of a modest increase in median industrial concentration since 1980, which is consistent with de-conglomeration and relatively greater emphasis on internal strategies. Julia Porter Liebeskind et al., *Corporate Restructuring and the Consolidation of U.S. Industry*, 44 *J. INDUS. ECON.* 53, 58-64 (1996).

core-competence approaches to business strategy was the tendency, in the 1980s, for LBOs to split up diversified conglomerates into smaller, more concentrated units.²⁰⁸ A second reason these strategies are increasing is the growing importance of intangible assets and the relative decline of financial capital as a source of competitive advantage. In the technology and service industries that increasingly dominate the economy, intellectual capital is a company's chief competitive advantage. Hence, "[i]t is no longer in product markets but in intangible assets where advantage is built and defended."²⁰⁹ With this change has come greater attention to the internal corporate policies that facilitate employee morale, creativity, and retention. As the head of human resources at a software company recently put it: "[a]t 6 P.M., 95% of our assets walk out the door We have to have an environment that makes them want to walk back in the door the next morning."²¹⁰

A third factor behind the strategic shift in U.S. firms was a managerial perception that international competitors, such as the Germans and Japanese, were stealing market share, not because of market power, but because they offered products that were superior in their intrinsic characteristics, especially in quality and innovation.²¹¹ American managers realized that to compete on the basis of quality or innovation required attention to a company's internal resources, including everything from work organization to corporate culture.²¹² Hence the 1980s and 1990s saw a vast effort to borrow from the Japanese and Germans. United States companies borrowed their quality-oriented production techniques, *keiretsu*-style relations with a limited number of suppliers, team-based forms of organization, and employee involvement plans.²¹³ Efforts were also made to create or strengthen distinctive and inimitable corporate cultures.²¹⁴ In addition to specific organizational practices, the Euro-Japanese ethos that human resources are a strategic asset began to develop inside some, albeit few,

208. See generally Sanjai Bhagat et al., *The Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 1 (Martin Neil Baily & Clifford Winston eds., 1990).

209. David J. Teece, *Capturing Value from Knowledge Assets: The New Economy, Markets for Know-How, and Intangible Assets*, 40 CAL. MGMT. REV. 55, 77 (1998). "As recently as 1978, the book value of property, plant, and equipment of publicly-traded corporations . . . accounted for eighty three percent of the market value of financial claims on firms By the end of 1997 . . . [these factors] accounted for less than one-third of the market value of firms' financial claims." Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 744 n.5 (1999).

210. Martha Groves, *In Tight Job Market, Software Firm Develops Programs to Keep Employees*, L.A. TIMES, June 14, 1998, at D-5.

211. ROBERT E. COLE, *MANAGING QUALITY FADS passim* (1999).

212. *Id.*

213. *Id.*

214. H.M. TRICE & J.M. BEYER, *THE CULTURES OF WORK ORGANIZATIONS* 5-30 (1993).

American companies.²¹⁵ Today, there are U.S. companies that place as much, if not more, emphasis on human resources than large Japanese companies.²¹⁶

The transformation is striking, especially with respect to so-called "high-performance work practices."²¹⁷ Employer surveys show that, for establishments with fifty or more employees, thirty-two percent have self-directed work teams, twenty-four percent utilize job rotation, eighteen percent have peer review of employee performance, and forty-six percent utilize total quality management techniques.²¹⁸ These figures suggest that, depending on the practice, somewhere between one-fifth to two-fifths of mid-to-large-sized U.S. establishments are utilizing at least one high performance practice.²¹⁹ Associated with these practices are larger investments in training.²²⁰ Also, there is greater linkage of individual compensation to organizational performance, as with employee stock ownership plans ("ESOPs") and stock options.²²¹ Currently, around thirteen percent of private-sector workers own stock in firms in which employee ownership exceeds four percent of the company's total market value.²²² ESOPs were especially popular in the 1980s because they were a way of inducing wage concessions or making a company more resistant to hostile takeovers.²²³ Some of their popularity was also due to a belief that they create more cooperative employee relations.²²⁴ Empirical research validates these suppositions. Employee ownership has been shown to stabilize employment, while modestly improving performance.²²⁵ Since the early 1990s, the big growth in employee ownership has come through stock options, which are now granted to an increasingly large proportion of company employees.²²⁶ These plans seek to give employees a share of the value they create and to align their interests with those of shareholders.²²⁷

215. JEFFREY PFEFFER, *THE HUMAN EQUATION: BUILDING PROFITS BY PUTTING PEOPLE FIRST* 64-98 (1998).

216. *Id.* at 293-306.

217. PAUL OSTERMAN, *SECURING PROSPERITY* 94 (1999).

218. Maury Gittleman et al., "Flexible Workplace" Practices: Evidence from a Nationally Representative Survey, 52 *INDUS. & LAB. REL. REV.* 99, 105 (1998).

219. *Id.* at 105.

220. *Id.* at 108.

221. Michael Hiltzik, *More Firms Giving a Stake to Employees*, *L.A. TIMES*, June 15, 1996, at A-1.

222. BLASI & KRUSE, *supra* note 13, at 12.

223. *Id.* at 155-81.

224. Susan J. Stabile, *Pension Plan Investments in Employer Securities: More is Not Always Better*, 15 *YALE J. ON REG.* 61, 65-68 (1998).

225. Margaret M. Blair et al., *Employee Ownership: An Unstable Form or a Stabilizing Force*, in *THE NEW RELATIONSHIP: HUMAN CAPITAL IN THE AMERICAN CORPORATION* 241, 278-79 (Margaret M. Blair & Thomas A. Kochan eds., 2000).

226. Hiltzik, *supra* note 221, at A-1.

227. PFEFFER, *supra* note 215, at 218-22. Despite the proliferation of options, senior

These changes in work organization are associated with modest increases in employee influence at strategic levels. Some companies, particularly those with substantial employee stock ownership, have created mechanisms for bringing employee views to senior management and to the board. Examples of such mechanisms include formal representation systems and board seats for employee or union representatives.²²⁸ Combining ESOPs with strategic employee influence has been shown to improve corporate performance.²²⁹ Another route to strategic voice is to have senior human resource managers act as employee advocates. In Britain, the presence of a senior human resource (“HR”) manager on a company board has been shown to increase the likelihood that human resource issues will be considered in corporate strategy.²³⁰

B. Barriers

Efforts to increase employee voice in U.S. companies bump up against barriers, not only in labor law, but also in corporate law, structure, and governance. In corporate governance, for example, creating new forms of work organization is an expensive, protracted endeavor.²³¹ The advantages are difficult to quantify and are not well captured by existing accounting techniques. Investment analysts and shareholders, as well as financial officers within corporations, fail to appreciate the advantages of work reform and employee influence.²³² Studies have shown that investors “ignore in-

management still receives the lion’s share. In 1998, the top managers of the Fortune 500 companies received an average of 279 times the number of options given to each of the firm’s other employees. Widespread use of options can have the effect of intensifying managerial myopia because options create an incentive for managers to “do everything they can to boost share prices [and] . . . to undertake corporate initiatives whenever they think the market will respond to them, even if they themselves are doubtful of the value of these initiatives.” SHILLER, *supra* note 10, at 23. Moreover, rather than aligning interests, options may drive a wedge between employee owners and shareholders because companies often step in to protect employees when share prices fall, while nothing is done to cover shareholder losses. *Employee Stock Options, Financial Markets Center, Background Report*, Apr. 2000.

228. BLASI & KRUSE, *supra* note 13, at 227-34.

229. Michael A. Conte & Jan Svejnar, *The Performance Effects of Employee Ownership Plans*, in *PAYING FOR PRODUCTIVITY* 143 (Alan S. Blinder ed., 1990).

230. John Purcell, *Corporate Strategy and Its Link with Human Resource Management Strategy*, in *HUMAN RESOURCE MANAGEMENT* 63 (John Storey ed., 1995). Despite potential labor law violations, some twenty percent of U.S. companies with employee involvement plans also had a formal system of nonunion employee representation. Bruce E. Kaufman, *Does the NLRA Constrain Employee Involvement and Participation Programs in Nonunion Companies? A Reassessment*, 17 *YALE L. & POL’Y REV.* 729, 749 (1999).

231. Fritz Pil & John Paul MacDuffie, *The Adoption of High-Performance Work Practices*, 35 *INDUS. REL.* 423, 425-40 (1996).

232. Pfeffer, *supra* note 175, at 359.

formation related to the degree to which firms value their employees [and] react negatively if firms use compensation to link pay to organizational performance.”²³³

Giving employees a role in strategic decisions is also deterred by the legal presumption that boards represent the interests of shareholders.²³⁴ Despite the substantial investments that employees make in firm-specific assets, employees are not considered residual claimants with a justifiable basis for control.²³⁵ As noted, in some British and Japanese companies the senior human resource manager acts as an advocate for employee interests.²³⁶ However, because of the presumption that employees are not stakeholders, the role of human resource managers on corporate boards remains extremely limited in the United States. Of the Fortune 1000 companies in the United States, only three have their own senior HR manager on their corporate board, which is an astoundingly small proportion.²³⁷

These governance barriers deter companies from adopting a high-performance approach, and are one of the reasons that nearly thirty percent of establishments employing fifty or more employees have not adopted a single high-performance practice.²³⁸ Even in companies that have gone this route and combined it with employee participation, participation typically is limited to the workgroup level.²³⁹ Employee voice is much less common at strategic levels.²⁴⁰ Companies with significant employee ownership do not usually provide for employee representation on corporate boards, nor do they give employee owners influence in strategic decisions.²⁴¹

V. GOVERNANCE REFORM

The following are recommendations intended to nudge U.S. companies in the direction of giving employees more influence in corporate governance. Some of these proposals are permissive. They do not mandate

233. *Id.* at 263.

234. BLAIR, *supra* note 12, at 227-29.

235. *Id.*

236. Purcell, *supra* note 230, at 65.

237. Data on corporate boards were kindly supplied by Henrietta Davis of KornFerry.

238. Christopher L. Erickson & Sanford M. Jacoby, *Training and Work Organization Practices of Private Employers in California*, in CALIFORNIA POLICY SEMINAR REPORT 17, 17-18 (1998); Gittleman, *supra* note 218, at 105.

239. THOMAS A. KOCHAN ET AL., *THE TRANSFORMATION OF AMERICAN INDUSTRIAL RELATIONS* 179 (1994).

240. *Id.* at 240-45.

241. Margaret M. Blair & Douglas L. Kruse, *Worker Capitalists? Giving Employees an Ownership Stake*, BROOKINGS REV., Fall 1999, at 23; Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation* 78 CORNELL L. REV. 899, 947-50 (1993).

new corporate practices but instead make it easier for the parties to pursue institutional reform by changing the premises, including incentives and information, of their decisions (as with proposals to encourage long-term investing or to require human resource accounting). Other recommendations are more direct efforts to expand employee influence, consistent with employees' status as residual claimants and essential members of the corporate "team."

A. Change Investor Time Horizons

To discourage short-term churning of stock portfolios, a number of simple steps can be taken. First, there ought to be a capital-gains tax consequence for the sale of assets held in tax-deferred pension funds, whether institutional funds or employee-controlled defined-contribution accounts, including 401(k) plans, IRAs, and Keoghs. The tax could be waived if the assets are held longer than a year, which is not an unreasonable requirement for what is, or should be, an account managed with the long-term objective of providing retirement income. Second, for non-retirement investments an incentive could be provided for long-term holdings by introducing a sliding-scale capital gains tax. That is, rather than having two rates—short and long—there should be a steady decline in rates over time, stretching beyond the one-year point that is presently the lowest rate at the federal level. Some states, notably Massachusetts, currently utilize this approach.²⁴²

Some mutual fund companies recently tried to raise redemption fees to discourage short-term trading, with the fees going back into the fund to benefit long-term shareholders.²⁴³ However, this attempt to raise redemption fees to more than two percent was rebuffed by the Securities and Exchange Commission ("SEC"). The peculiar reasoning used by the SEC was that this would damage the mutual fund industry, even though some of the most successful companies in the industry have, in the past, sought the higher fees.²⁴⁴

Closely related to this approach is the proposal first made some twenty-five years ago by economist James Tobin to "throw sand in the

242. LAWRENCE H. SELTZER, *THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES* 315-17 (1951). Massachusetts applies different long-term rates varying from .05% for one-year holdings to .02% for four-or-more year holdings. At the federal level, a five-rate sliding scale approach was in effect during the late 1930s, a time when the belief was prevalent that speculation had contributed to the 1929 crash. This approach gradually gave way to the present two-rate system. *See id.*

243. REICHHELD, *supra* note 32, at 182.

244. Frank Stanton, *SEC Stands Firm Against Raising Redemption Fees*, at <http://news.morningstar.com/news/Wire/0,1230,903,00.html> (Feb. 28, 2000).

wheels” of currency speculators by levying a transaction tax on them.²⁴⁵ This idea was extended to stocks and bond trading by other economists and considered by Congress in 1990.²⁴⁶ Although the proposed Securities Transaction Excise Tax was never enacted, there is evidence to support the notion that speculators would, in fact, be inhibited by a transaction tax.²⁴⁷

B. Information for Stakeholders

Presently, few U.S. employers provide information to employees that is relevant to their position as corporate stakeholders. Just as disclosure of information permits shareholders to monitor management, protect investments, and boost corporate efficiency, the same is true for employees. Employees should regularly be provided data on financial performance, operating results, strategic plans, and business risk factors. Moreover, as the OECD recently recommended, employees also should receive information relevant to the employment relationship, such as disclosure of current and intended human resource policies—including training opportunities, details of compensation practices, and health and safety records.²⁴⁸ Conversely, shareholders and potential investors should be apprised of a company’s human resource investments and practices. Despite the growing importance to corporate performance of a company’s intellectual capital, a recent study finds that “little systematic high-quality information about the impact and value of firms’ human capital investments exists.”²⁴⁹ Although a few companies are beginning to take more steps to systematically analyze and manage their human capital, the vast majority of

245. James Tobin, *The New Economics One Decade Older*, in THE ELIOT LECTURES IN HONOR OF JOSEPH A. SCHUMPETER (1974).

246. SHILLER, *supra* note 10, at 226-28; Philip Arestis & Malcolm Sawyer, *How Many Cheers for the Tobin Tax?*, 21 CAMBRIDGE J. ECON. 753, 755-60 (1997).

247. Economists have weighed in on both sides of the transaction tax issue, though the empirical evidence is limited to a single comparative study by Richard Roll. Richard Roll, *Price Volatility, International Market Links, and Their Implications for Regulatory Policies*, 3 J. FIN. SERVICES RES. 211, 233-40 (1989). This study found that transaction taxes dampen share-price volatility, although the significance of the result is sensitive to specification of the model. *Id.* at 233-40. Some authors see both the pros and cons of the implementation of a transaction tax. See Joseph A. Grundfest & John Shoven, *Adverse Implications of a Securities Transaction Excise Tax*, 6 J. ACCT. AUDITING & FIN. 409, 409-45 (1991); John Karl Scholz, *Comments on “Adverse Implications of a Securities Transactions Excise Tax” by Joseph A. Grundfest and John B. Shoven*, 6 J. ACCT. AUDITING & FIN. 443, 443-45 (1991); Lawrence Summers & Victoria Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax*, 3 J. FIN. SERVICES RES. 163, 163-88 (1989).

248. Directorate for Financial, Fiscal and Enterprise Affairs, *OECD Principles of Corporate Governance*, OECD, 19-22 (1999), available at <http://www.oecd.org/daf/governance/principles.htm> (last visited Jan. 30, 2001) [hereinafter *OECD Principles*].

249. Laurie J. Bassi et al., *Measuring Corporate Investments in Human Capital*, in THE NEW RELATIONSHIP 335 (Margaret M. Blair & Thomas A. Kochan eds., 2000).

companies continue to ignore their investments and returns in training and other personnel management practices.²⁵⁰ Minimal information is reported to shareholders, either on an ongoing basis or during mergers and acquisitions, when such information is of particular importance.²⁵¹

Creating systems for measuring human-capital investments and relating them to performance has multiple benefits. Measurement is a precursor to management in that it makes these investments more salient and impels managers to be more aware. Another benefit of measuring corporate human capital and returns is that this would cause investors to more accurately evaluate factors contributing to corporate performance and thereby give greater credit to companies that are making investments in employees.²⁵² This may be a heroic assumption, though, because there is the risk that either investors will react negatively to companies making these investments, or that positive returns to training cannot be demonstrated in the short-run.²⁵³

C. *Link Ownership to Governance.*

Employee share ownership has grown in recent years, not only through the creation of ESOPs and employee stock options but also through huge investments in employer stock by employee pension plans, including employee-controlled defined contribution plans.²⁵⁴ While a few ESOPs provide for employee representation on company boards, it is fair to say that the vast majority of employee owners have no governance mechanisms available to express their unique interests as both employees and owners.²⁵⁵ Unlike other stakeholders, employee-owners lack board representation. Moreover, trustees of defined-benefit pension plans that have substantial employee ownership in the employing company are required as fiduciaries to ignore any special interests of employee-owners and focus only on general shareholder concerns.²⁵⁶

250. ERIC FLAMHOLTZ, HUMAN RESOURCE ACCOUNTING *passim* (1974); Russell W. Coff, Corporate Acquisitions of Human-Asset Intensive Firms: Let the Buyer Beware, *passim* (June 1991) (unpublished Ph.D. dissertation, Anderson School of Management) (on file with the University of California at Los Angeles Library).

251. Marleen A. O'Connor, *Rethinking Corporate Financial Disclosure of Human Resource Values for the Knowledge-Based Economy*, 1 U. PA. J. LAB. & EMP. L. 527, 538-39 (1998).

252. Marleen O'Connor, Comment, *in* THE NEW RELATIONSHIP 370-80 (Margaret M. Blair & Thomas A. Kochan, eds., 2000).

253. *Id.*

254. Stabile, *supra* note 224, at n.106. Among the thousand largest U.S. pension funds, the total share of investments in employer stock ranges between one-fifth and one-quarter of the total plan assets, an astounding figure. *Id.*

255. BLASI & KRUSE, *supra* note 13, at 227-304.

256. BLAIR, *supra* note 12, at 316-18 (1995). One of the most famous ESOPs, United

What is the best way to proceed? First, employee-owners should be given board representation. This is consistent with their heavy investments—both financial and human capital—in the employing company. Second, trustees of pension and ESOP plans should be legally permitted to give weight to the special concerns of employee-owners. Third, policy-makers should encourage the adoption of other innovative mechanisms for bringing employee concerns to a company's strategic decision-makers. Some of these can be found in the annals of American corporate history. Back in the 1940s and 1950s, for example, Sears Roebuck had an employee profitsharing plan that owned over a quarter of the company's stock.²⁵⁷ The company created a Profitsharing Advisory Council ("PSAC") that was comprised of nineteen delegates elected on a regional basis by employees throughout the country.²⁵⁸ The PSAC met twice yearly with the profitsharing fund's trustees to convey nonbinding suggestions.²⁵⁹ While the PSAC was more symbol than substance, it would not be difficult to design more effective structures for conveying the concerns of employee owners to pension trustees and corporate directors.²⁶⁰

D. Corporate Boards.

Following from the previous suggestion, corporate boards—like other fiduciaries—should be required to take into account the interests of major corporate stakeholders, including employees. There are two models for doing this: either public directors act as mediators between conflicting stakeholder interests, or they act as optimizers who seek to maximize the joint welfare of all stakeholders contributing firm-specific resources to the corporation. The Japanese utilize both approaches.²⁶¹ These models are consistent with state anti-takeover laws that grant directors broad fiduciary discretion to consider stakeholder interests when assessing takeovers or other business decisions.²⁶² The courts have been less sensitive than legislatures to stakeholder concerns, but there are some notable recent exceptions.²⁶³

Airlines, does have employee board representation. This ESOP, however, is currently being questioned and criticized by its employee-owners. Michael Arndt & Aaron Bernstein, *From Milestone to Millstone? UAL's Employees are Rethinking Their Landmark ESOP*, BUS. WK., Mar. 20, 2000, at 120.

257. JACOBY, *supra* note 30, at 110.

258. *Id.*

259. *Id.*

260. *Id.* at 122.

261. BLAIR, *supra* note 12, at 298; *OECD Principles of Corporate Governance*, *supra* note 248.

262. Orts, *supra* note 24, at 31-39.

263. In Delaware, a bastion of traditional corporate law, the courts permitted Time

Consistent with this approach is the proposal to give employees and other stakeholders the right to legally challenge directorial decisions made on their behalf when those decisions breach implied fiduciary duties, as, for example, when layoffs occur without the provision of adequate financial compensation.²⁶⁴ While the proposal may seem to have a utopian quality, bear in mind that in recent years similar challenges have been mounted via shareholder resolutions on behalf of employees and other stakeholders.²⁶⁵ Although rarely approved, these resolutions serve to put a board on notice that problems exist and that shareholders are concerned about them. For example, IBM recently converted to a cash-balance pension plan that cuts pension benefits for thousands of mid-career IBM employees.²⁶⁶ In response, employees mounted a national protest and developed a shareholder resolution opposing the change.²⁶⁷ Major institutional investors supported the proposal, including several multi-employer pension funds from the union sector as well as the giant California Public Employees' Retirement System ("CalPERS"), which has more than a billion dollars invested in IBM shares.²⁶⁸ The head of CalPERS said that it was "bad business policy" for IBM to cut pensions because the productivity of IBM's workers was positively affected by having dependable and secure pensions.²⁶⁹ The proposal did not pass, but over twenty-eight percent of shares were voted in favor of it, insuring that the proposal can be brought up again next year.²⁷⁰

Magazine to reject a hostile bid from Paramount and merge with Warner so as to preserve Time's culture of editorial integrity, even though a majority of shareholders preferred Paramount over Warner. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1152-55 (Del. 1989). Bagley and Page call on boards to exercise corporate stewardship—a phrase redolent of traditional welfare capitalism. They propose that the SEC require companies to disclose in annual reports all board-level decisions that have a material impact on any stakeholder constituency, whether employees, management, customers, suppliers, creditors, the community, or the environment. Constance E. Bagley & Karen L. Page, *The Devil Made Me Do It: Replacing Corporate Directors' Veil of Secrecy with the Mantle of Stewardship*, 36 SAN DIEGO L. REV. 897, 901-10 (1999).

264. Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 636 (1992); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1254 (1991).

265. Colleen T. Congel, *CALPERS, Electrical Workers Support IBM Shareholder Proposal on Benefits*, DAILY LAB. REP., Mar. 28, 2000, at A-08.

266. *Id.*

267. *Id.*

268. *Id.*

269. *Id.*

270. *IBM Shareholders Fend Off Bid to Revise Pension Plan*, L.A. TIMES, Apr. 26, 2000, at C3.

VI. CONCLUSION

The IBM case demonstrates that pressure on corporate boards and litigation can serve as substitutes for the representational structures that Freeman and Rogers tell us American workers want but do not have. Ultimately, the most consistent way of giving voice to employees is through mutually reinforcing influence structures at the workplace level—which is the focus of the Freeman and Rogers book—and at strategic levels where the corporation is governed. To handle quotidian workplace problems that workers are concerned about, there ought to be greater availability of representational structures through, for example, unionization, councils, and committees. At the same time, attention must be given to corporate governance. Governance reform opens up additional voice channels in situations where representational structures are ineffective or unsuited to handling strategic, company-wide concerns. Conversely, effective workplace representation provides an ongoing basis for monitoring employee influence at strategic levels.

The other very important reason to transform U.S. corporate governance practices is to change the current anti-employee attitudes of managers. If the logjam in labor law reform is ever to be broken, it will happen only if managements shift from their single-minded obeisance to shareholders, and give greater weight to other corporate stakeholders. Companies in other countries do it, we have done it before, and it can happen again in the United States.

Unlike some “third way” proponents of stakeholder capitalism, I do not see employee-ownership and changes in corporate governance as substitutes for more extensive employee representation. Instead, reform of corporate governance and of employee representation are best conceived of as complements. Creating a presumption that workers have a legitimate voice in the enterprise opens up possibilities in politics, the courts, and in labor markets for giving workers what they want in the way of workplace representation. In the meantime, we should remain skeptical of American triumphalism and recognize that there is no one best way of corporate governance. We can learn from our trading partners, just as they are learning from us.