Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool

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This paper argues that changes in corporate governance in the United States, including relaxing the profit maximization norm, broadening management's fiduciary duties to include workers, and including worker representatives on boards of directors, are likely to be efficient means of reaching certain preferred policy outcomes, such as an increase in the wages of working people and a decrease in income inequality. Instead of seeing corporate law as "private law," policy makers and academics should instead regard it as a regulatory tool and judge it on that basis. Thus, rather than focusing on whether changes in corporate governance would be beneficial or harmful to the firm, the discussion should take account of the likelihood that certain changes in corporate governance, even if costly to shareholders, might nevertheless have a net social benefit. Moreover, because of the nature of the proposed changes, there is reason to believe that the suggested adjustments in corporate governance would not only be powerful in achieving certain policy goals but also relatively efficient in achieving them. This paper will use insights from behavioral economics to advance these arguments.

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INTRODUCTION

If one could invest in areas of legal scholarship, "behavioral law and economics" (BLE) would be a growth stock. During the last several years, BLE has become the hottest area of legal scholarship. While adopting some of the conventional premises of law and economics, such as the belief that legal rules affect behavior, BLE distances itself from many of the traditional assumptions of law and economics, such as a dependence on individual economic "rationality" as the determinant of behavior.[1] BLE does this in part by using insights from psychology, which provide an account of human behavior that is more sophisticated than typically used in economics. BLE scholars have given scholarly weight to the common sense insight that individuals make decisions and act in the world on many different bases, only some of which can be described as economic. Utility maximization is only one rationale for action; certain behaviors are much more readily explained by psychological and behavioral phenomena that have little to do with personal utility maximization.

The contributions of BLE to legal scholarship are already significant, mostly in bringing into question the nearly canonical assumption that individuals are utility maximizing.[2] Thus far, most of the advances of BLE are critical. As BLE advances, however, scholars will better learn how to predict and affect deviations from economic rationality, and the normative and predictive consequences of BLE will become clearer.

The potential impact of BLE is particularly striking in corporate law, traditionally an intellectual bastion of economic conventionalism.[3] The

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[1] As Ernst Fehr and Simon Gächter have stated, "A long standing tradition in economics views human beings as exclusively self-interested. In most economic accounts of individual behavior and aggregate social phenomena, the 'vast forces of greed' are put at the center of the explanation. In economic models human actors are typically portrayed as 'self-interest seeking with guile (which) includes . . . more blatant forms, such as lying, stealing, and cheating . . . (but) more often involves subtle forms of deceit.'" ERNST FEHR & SIMON GÄCHTER, FAIRNESS AND RETALIATION: THE ECONOMICS OF RECIPROCITY 1 (CESifo, Working Paper No. 336, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=260736 (quoting Kenneth Arrow, *Discrimination in the Labour Market*, *in* READINGS IN LABOUR ECONOMICS (J.E. King ed., 1980); *see* OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985)).

[2] For reviews of the literature, *see* BEHAVIORAL LAW AND ECONOMICS (Cass Sunstein ed., 2000); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Donald Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499 (1998).

[3] *See* JENNIFER ARLEN ET AL., ENDOWMENT EFFECTS WITHIN CORPORATE AGENCY RELATIONSHIPS (USC CLEO, Research Paper No. C01-1, 2001, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=276110 at 1 (noting that behavioral

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dominant contemporary view of corporate law is contractarian, meaning that corporate constituencies are assumed to be best able to determine their mutual rights and obligations by way of voluntary arrangement. Corporate law should thus provide "off-the-rack" rules that are primarily enabling, rather than prescriptive, and that can be easily contracted around.[4] Law should not dictate the details of the obligations among the parties because each party is assumed to know her own interests and to protect them best through bargaining and exchange. In this way, developments in corporate charters and, indeed, in corporate law, will trend toward efficiency, because inefficient arrangements will cause participants in those arrangements to change the terms of the bargain over time in order to avoid losses. Moreover, because people know and protect their own interests, terms of the corporate "contract" in charters and state incorporation statutes are correctly "priced" through an efficient capital market. The fact that the terms all have a price associated with them means that the contractarians can call the complete contract "consensual" in that any shareholder who buys the security can be said to have agreed completely to the contract. "All the terms in corporate governance are contractual in the sense that they are fully priced in transactions among the interested parties."[5] Terms need not be actually negotiated. "The pricing and testing mechanisms are all that matter."[6] The assumption is that "[t]he price [of a company's securities] reflects the effects, good or bad, of corporate law and contracts, just as it reflects the effects of good and bad products."[7]

This view of corporate law, then, depends fundamentally on the notion that the participants in the corporate contract are economically rational actors. If they do not know their best interest, or do not act so as to maximize their utility, the arrangement will differ, perhaps substantially, from what would be efficient. In certain circumstances, such divergence from efficiency is an important and serious public policy problem. For example, if certain cognitive biases among investors make capital markets less efficient in pricing securities, significant

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economics raises "fundamental doubts" about traditional law-and-economics approach to business law) ; *see* Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule*, 63 BROOK. L. REV. 799, 813 (1998) (arguing that corporate law is "closest living relative" of classic utilitarianism).

[4] *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) (describing the contractarian perspective on corporate law).

[5] EASTERBROOK & FISCHEL, *supra* note 4, at 17.

[6] *Id.*

[7] *Id.* at 19.

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misallocations of capital will result, imposing costs on society as a whole.[8] So one important potential contribution of BLE to corporate law is to help predict in what contexts individuals' behavior diverges from an efficient outcome and to suggest ways for law to correct for such biases in some way. The potential for BLE to make these kinds of contributions to corporate law has driven much of the recent and impressive scholarship in this area.[9]

Another potential contribution of BLE to corporate law is to question the contractarian argument that the positive law reflects efficiency. As noted above, contractarians believe that corporations are voluntary arrangements and that the capital markets generally do an accurate job of pricing the terms of the corporate contract. Thus, it is crucial to the contractarian argument that there are no meaningful perceptual biases in the pricing of the terms of corporate governance.[10] Because they believe that share prices are not subject to such biases, contractarians can assert that what one actually observes in the marketplace reflects the most efficient outcome, the outcome that maximizes social utility. If, however, BLE research reveals that investors or other stakeholders in the firm systematically underestimate certain risks or overestimate the chances of beneficial outcomes, or if parties are unaccustomed to certain problems or risks, the chance of mistake is high.[11] Such mistakes would in turn

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[8] *See* LAWRENCE A. CUNNINGHAM, BEHAVIORAL FINANCE AND INVESTOR GOVERNANCE (Cardozo Law Sch., Jacob Burns Inst. for Advanced Legal Studies, Working Paper No. 32, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=255778.

[9] Recent efforts discussing the relevance of BLE for corporate law and securities law include ARLEN ET AL., *supra* note 3; Stephen M. Bainbridge, *A Behavioral Economic Analysis of Mandatory Disclosure: A Thought Experiment Turned Cautionary Tale* (Jan. 2000), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=204110 (last visited Nov. 4, 2001); Margaret M. Blair & Lynn A. Stout, Symposium, *Norms and Corporate Law: Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001); James Cox & Harry Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONT. PROB. 83 (Summer 1985); CUNNINGHAM, *supra* note 8; Robert Haft, *Business Decisions By the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981); Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277 (1990); Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629 (1997); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law From Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992); Lawrence E. Mitchell, *Trust and Team Production in Post-Capitalist Society*, 24 J. CORP. L. 869 (1999).

[10] *See* EASTERBROOK & FISCHEL, *supra* note 4, at 22-24.

[11] The risk of mistake would likely be particularly high for non-shareholder parties to the corporate contract. For example, the labor market is much less efficient than the securities market, so one would expect the "pricing mechanism" of the labor market to be

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cause corporate "contracts" to fail to reflect the actual preferences of parties to the corporate contract.

Perhaps the most important area of potential BLE contribution to corporate law is within the debate about the role of corporations in society and whether corporate governance should include consideration of interests other than those of shareholders.[12] BLE scholarship has noted that people act not only on the basis of biases and mistake but also on the basis of seemingly non-economic values and beliefs. If a corporation's stakeholders make decisions on the basis of values other than utility maximization, the normative justifications for an efficiency-focused corporate law become more difficult to make. That is, because one of the reasons to have enabling corporate law is to facilitate efficient exchanges, the justification for such "enablingism"[13] is lessened if individuals within the enterprise care less about efficiency than traditional theory supposes.

Moreover, BLE could help weaken the contractarian arguments against legal and regulatory intervention to protect various stakeholders in the firm. Under contractarian theory, because each person is assumed to be able and willing to protect her own interests, the role of government is understandably minimized.[14] And, more profoundly, when government seeks to help participants in the corporate enterprise, contractarian analysis supposes that such efforts are in fact hurtful to the intended beneficiaries of the government protection. Because of the enabling nature of corporate law, contractarians believe that if regulations are enacted in order to protect a certain stakeholder (for

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much less dependable. Moreover, cognitive biases may actually be stronger in the labor market than in the capital market, making the pricing mechanism even less trustworthy. *See* Robert C. Ellickson, *Symposium on Post-Chicago Law and Economics: Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23, 42-43 (1989).

[12] For one such effort, *see* Mitchell, *supra* note 9.

[13] *See* LEWIS D. SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 7 (3d ed. 1994) (noting that "enablingism" is "dominant statutory mode" for corporate law).

[14] *See* EASTERBROOK & FISCHEL, *supra* note 4 at 23 (stating that all parties to corporate "contract" can protect themselves through negotiation); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 36, 42 (1991) (arguing that workers and other non-shareholder constituencies can protect themselves through contract or through political process); *cf.* Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 322-26 (1998) (arguing that market defects make contracts between labor and corporation inefficient and criticizing assumption that contract norms should be basis for public policy since "the ability of parties to bargain is a function of their preexisting entitlements and wealth"); Joseph W. Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 649 (1988) (arguing that because contract outcomes depend on pre-existing entitlements, bargained-for outcomes are just only if pre-existing circumstances are fair and just).

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example, by requiring managers to owe fiduciary duties to workers) the other parties to the corporate "contract" will simply readjust other terms of the contract (for example, by reducing wages paid to employees).[15] Whichever party to the contract has superior bargaining power will simply force other parties to the contract to pay for whatever regulatory benefit bestowed upon them.

Insights from BLE could provide some responses to these anti-regulation contractarian arguments. First, it might be the case that people do not know their interests well at all, and government regulation could help protect those interests nevertheless or help individuals learn what their own interests are.[16] Second, if there is some "stickiness" in bargaining terms because of endowment effects or some other cognitive bias toward the status quo, government intervention on behalf of one party to the corporate contract might indeed provide real benefits to that party because it will be difficult for other elements of the contract to be adjusted to compensate.[17] Third, if BLE indicates that people, even people within corporations, concern themselves with more than efficiency, defined narrowly, then government regulation in furtherance of other values or to encourage behavior based on other values might not cause a renegotiation of unrelated terms in the corporate contract.[18]

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[15] *See* Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 174-75 (explaining that "the private contracting process . . . generates outcomes superior to the outcomes generated by government regulation").

[16] *See* CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 326-30 (1997) (discussing that information has value as tool to help people learn what their interests are).

[17] *See* Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 746-59 (1991) (discussing legal implications of high costs of parties contracting around default rules); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 631 (1998) (describing that status quo bias prevents contracting parties from bargaining around default rules, even when doing so is in their best interests).

[18] In research performed by Larry Soderquist and Robert Vecchio, shareholders of large, publicly traded corporations were presented with the suggestion that "[i]f corporate profits could be increased by moving a plant, the corporate managers of a large, publicly held corporation should weigh the effect the move would have on its employees, customers, suppliers and people in the community it presently is in before deciding to move." Larry D. Soderquist & Robert P. Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management*, 1978 DUKE L.J. 819, 841 (1978). Almost ninety percent (88.5%) of the shareholders agreed with that statement, 41.3% strongly so. *Id.* Shareholders were also asked to respond to the following statement: "[w]hen making corporate decisions, corporate managers of large, publicly held corporations should consider the interests of shareholders, bondholders, customers, employees and perhaps others." *Id.* Six percent agreed "somewhat," and almost 16% agreed "moderately." But more than 75% of shareholders *strongly* agreed with that statement, making it clear that shareholders do not expect their interests to be considered

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The potential implications of BLE for corporate law and scholarship are thus significant. It is probably correct to say, however, that so far the contributions have been in a critical mode, bringing into question the fundamental premises of economic rationality that underlie the contemporary view of corporate law and the theory of the firm. BLE insights may prove to weaken conventional corporate law theory sufficiently so that much of it will have to be reconsidered and replaced.

But BLE scholars have generally not yet used BLE insights as bases for positive arguments in favor of what might replace conventional corporate law theory. To be sure, a number of corporate law scholars have for some time been proposing different modes of conceptualizing the firm and of organizing corporate governance.[19] Those scholars have been criticized as providing thin theoretical justifications for their positive prescriptions.[20] The criticism has been that the "progressive" corporate law scholars have only provided a critique and have not been successful in providing a genuine alternative on which corporate law could be based. If this criticism is partly accurate, it is not surprising that theoretical justifications for new arrangements of corporate governance would arrive later than critiques of the dominant model of corporate governance. In any event, the need to flesh out theoretical justifications for a different model of corporate governance continues to be quite

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to the exclusion of those of all other stakeholders. *Id.* at 840. While this research was performed over twenty years ago, it nevertheless shows that scholars and courts cannot easily assume that shareholders believe that profit should be maximized at all costs.

[19] *See, e.g.*, PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995); Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409 (1993); Greenfield & Nilsson, *supra* note 3; Greenfield, *Place of Workers*, *supra* note 14; David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993); Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality*, 73 TEX. L. REV. 477 (1995); Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263 (1992); Lawrence E. Mitchell, *Groundwork of the Metaphysics of Corporate Law*, 50 WASH. & LEE L. REV. 1477 (1993); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992); Karen L. Newman, *The Just Organization: Creating and Maintaining Justice in Work Environments*, 50 WASH. & LEE L. REV. 1489 (1993); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993); 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 (1991); Marleen A. O'Connor, *A Socio-Economic Approach to the Japanese Corporate Governance Structure*, 50 WASH. & LEE L. REV. 1529 (1993); Lewis D. Solomon, *On the Frontier of Capitalism: Implementation of Humanomics by Modern Publicly Held Corporations: A Critical Assessment*, 50 WASH. & LEE L. REV. 1625 (1993).

[20] Stephen M. Bainbridge, *Community and Statism: Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 873-75 (1997).

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pressing. BLE insights may provide an important tool in building such justifications.

The purpose of this paper is to begin such an effort, using BLE insights as positive justifications for different modes of corporate governance. This article advances this argument in several steps. Part I explains the theoretical starting point, that corporate law should be considered as any other regulatory tool and evaluated on the basis of whether it can bring about preferred policy outcomes in a cost-effective way. This is admittedly a different starting point than most corporate law scholarship, so the Article begins by reviewing the reasons for believing the traditional view of corporate law as private law is outmoded. Once corporate law is considered as public law, one can evaluate the regulatory tools it has to offer as other regulatory tools are evaluated.

Part II presents the second step in the argument, highlighting two public policy problems that have been the subject of much recent attention as being serious, entrenched, and seemingly resistant to other public policy initiatives in the United States. The problems the Article focuses on, stagnant real income for hourly-wage workers and wide income inequality, are not the only public policy concerns that changes in corporate law might conceivably address efficiently. But they are good starting places because they are so intractable and so serious, and because corporate law is generally assumed to have little to say about them. Indeed, corporate law is generally considered to have little useful to say about anything other than the relationships among shareholders, managers, and the firm itself.[21] If it could be argued persuasively that a reconceptualization of corporate law could result in real improvements in satisfying important public policy goals outside the traditionally narrow focus of corporate law doctrine, such an argument could have serious implications for the way corporate law is taught and studied in the United States.

Also, Part II outlines three regulatory tools that corporate law has to offer and explains why these might have positive impacts on the two public policy problems identified. The Article focuses on three possible tools in corporate governance: relaxing the profit maximization norm; including workers among those to whom corporate managers and directors owe fiduciary duties; and adding some kind of worker

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[21] Greenfield, *Place of Workers*, *supra* note 14 (noting that corporate law is extremely limited in focus); Kent Greenfield, *There's a Forest in Those Trees: Teaching About the Role of Corporations in Society*, 34 GA. L. REV. 1011, 1011-14 (2000) (noting that traditional focus of corporate law is extremely limited).

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representation on boards of directors. These are three of the changes in corporate governance law that progressive scholars have most often proposed over the last decades.

The exploration of why these corporate governance initiatives are likely to have beneficial impacts is the heart of the paper and where BLE insights will be brought to bear. The Article argues that the three proposed changes in corporate governance are likely to create beneficial regulatory effects by way of two mechanisms. Part III addresses what this Article refers to as the first power of corporate law, the ability of the suggested changes to build a norm of fairness within the firm. This ethic of fairness, which in turn builds trust and cooperation, is associated with lower monitoring costs and with incomplete, "relational" contracts between the firm and its employees. Low monitoring costs and relational contracts are associated with higher wages and lower income inequality. Part IV focuses on what this Article refers to as the second power of corporate law, its ability to facilitate a more equitable sharing of the corporate surplus. Numerous studies have shown that people tend to share with others and to contribute to public goods when they are able to talk with others involved, create group identifications with them, and make commitments. The changes in corporate law suggested here would make discussion, group identification, and the making of commitments more possible among the firm's stakeholders. This would in turn expand the sharing of the corporate surplus to workers.

Finally, Part V offers reasons to believe that these beneficial regulatory effects can be brought about relatively efficiently. Generally, the beneficial effects depend on, and build on, the reality of positive reciprocity among the various parties to the corporate "contract." As a result, workers will receive benefits that will tend to engender positive, reciprocal acts on the part of labor in the form of increased effort, attention, and loyalty; and it is likely that some firms will be better off as well. In contrast to many of the other possible regulatory initiatives intended to benefit workers, the changes in corporate governance suggested in this Article would not be redistributive only. Because of the potential of positive reciprocity to increase the size of the corporate surplus, all parties may end up in an improved position. This is not a zero-sum game.

The purpose of this Article is to explore the power and efficiency of corporate governance as a regulatory tool.[22] If changes in corporate

[22] It is worth emphasizing that the efficiency I am focusing on is not the efficiency of corporate profit making or the efficiency of the corporation itself. Rather, the argument

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governance proposed by "progressive" corporate law scholars can be shown to have likely beneficial effects on public policy problems, then such a showing will go a long way to providing a strong affirmative case for those changes. Such arguments would move the onus back to those who oppose such changes to show why society should forgo the use of corporate governance as a powerful and efficient regulatory tool.

I. CORPORATE LAW AS PUBLIC LAW

As a preliminary matter, it is necessary to explain the reasons it is appropriate to consider corporate law as the source of public policy initiatives. Corporate law is generally considered "private" law and is narrowly focused on the rights and responsibilities of management and shareholders. Upon analysis, however, this view rests on a controversial notion of rights and largely unstated assumptions about the distinction between the public and private. Corporate law theorists who try to restrict corporate law from public law concerns make the same mistake, I believe, that *Lochner v. New York*[23] made in constitutional law. They assume that the common law and the laissez-faire market place are pre-political and neutral. The New Deal changed those assumptions by recognizing that the market is a creature of government and that even so-called private market relationships can be the proper subject of government regulation. These New Deal insights, which were crucial for the development of modern constitutional law, should also be applied to corporate law. I have explored this question in more detail in other articles,[24] so the argument that follows will be brief.

A. *The Corporate "Contract" and* Lochner

There is little question that the dominant view of corporate law for at least the past century has been that it is private law. The early twentieth century view of the corporation was that it was defined by agency relationships and that the obligations of the management were dictated by fiduciary duties akin to those present in private principal/agent

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here is that, in comparison to other public policy tools, corporate law might provide policy options that would be relatively efficient in satisfying certain regulatory objectives. *See* discussion *infra* Parts IV and V.

[23] 198 U.S. 45 (1905).

[24] *See* Kent Greenfield, *From Rights to Regulation in Corporate Law*, *in* 2 PERSPECTIVES ON COMPANY LAW 1 (Fiona M. Patfield ed., 1997); Kent Greenfield, *From Metaphor to Reality in Corporate Law*, 2 STAN. AGORA 1, *at* http://www.law.stanford.edu/agora/cgi-bin/article2_corp.cgi?library=greenfield (last visited Nov. 4, 2001).

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relationships such as those of trustee and beneficiary.[25] The latter quarter of the century saw the rise of the "nexus of contracts" interpretation of the corporation,[26] which was an even more vehemently private view of the corporation than the traditional view. Because corporations were only an embodiment of private arrangements, they were seen as "incapable of having social or moral obligations much in the same way that inanimate objects are incapable of having these obligations."[27]

The private law of contract is now the dominant, and quite powerful, metaphor used to explain corporate law. "The corporation is thus [seen as] nothing more than an arena in which suppliers of capital, labor, services, materials, and other necessary contributions come together to pursue their own interests through bargain and exchange."[28] The contractual model sees corporate law essentially as private, rather than public, law. The corporate form is not a juridical legal person created by the legislature but a legal form created through a multitude of private contractual relationships. As Daniel Fischel has argued, "[b]ecause the corporation is a particular type of firm formed by individuals acting voluntarily and for their mutual benefit, it can far more reasonably be viewed as the product of private contract than as a creature of the state."[29]

Put another way, corporate law is considered to be outside politics. Those who are concerned with corporate misdeeds should "seek redress through the political process and [should] not . . . attempt to disrupt the voluntary arrangements that private parties have entered into in forming corporations."[30] Fischel admits, "when a restriction on corporate conduct is embodied in a statute, it should be obeyed."[31] Apparently, Fischel

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[25] This view of the corporation in fact has a long history. Courts used the legal analogies of trusts and partnerships to analyze corporation problems as early as the first years of the nineteenth century. *See* Gray v. Portland Bank, 3 Mass. (1 Tyng) 364, 378-79 (1807) (opinion of Sewell, J.) (analogizing corporation to trust for shareholders); *id.* at 381 (opinion of Sedgwick, J.) (analogizing corporation to partnership); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 301-04 (1998) (discussing early conceptions of corporation).

[26] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 4; Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[27] Fischel, *Corporate Governance Movement*, *supra* note 26, at 1273.

[28] *See* David Millon, *Personifying the Corporate Body*, *in* 2 GRAVEN IMAGES 116, 123 (1995).

[29] Fischel, *Corporate Governance Movement*, *supra* note 26, at 1273-74.

[30] *Id.* at 1271.

[31] *Id.*

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means only those statutes (such as environmental statutes and laws restricting corporate payments) that go to something other than corporate governance, because the "solution" to the problem of corporate social irresponsibility, "assuming one exists," is to be found in the "political process, not in changing the governance of corporations."[32] But many of the proposals to change corporate governance he cites as illegitimate are statutory in nature.[33] It is as if corporations should be held to obey public law, but that statutes having to do with corporate governance are illegitimate because they invade the private law sphere or "disrupt . . . voluntary arrangements."[34] Corporate law is private, and the adjustment of these voluntary relationships, even through statutes, is illegitimate. The corporate responsibility debate is misguided, according to the contractarians, because participants have failed to acknowledge that "the issue is not one of public policy but of contract law."[35]

In Fischel's view, if social activists want to reform the activities of corporations, they must seek redress through the political process, and their options are limited to public law options, not rules of corporate governance. Fischel accuses social reformers of focusing on rules of corporate governance only because they have "largely failed in implementing their objectives through the political processes."[36] Only because of their failure have they "attempt[ed] to achieve these same objectives by altering the governance of corporations."[37] These comments only make sense if Fischel believes corporate governance is a matter of private agreement rather than public law.[38]

In this light, the rights-based nature of the contractarian theory is obvious. There is a set of relationships, namely those between shareholders and managers, that should be insulated from the political process. Corporate law, as contract, is separate from public law.

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[32] *Id.*

[33] *See id.* at 1260 (noting proposals to require public interest directors, and to increase enforcement of fiduciary duties, and pointing out that "[b]ills have been introduced in Congress that would implement many of the reform proposals.").

[34] *Id.* at 1271.

[35] *Id.* at 1273.

[36] *Id.* at 1271.

[37] *Id.*

[38] Other commentators make the same assumption. Jonathan Macey, for example, has argued that expanding the scope of a firm's fiduciary duties to include local communities is unnecessary because such communities "can appeal to their elected representatives in state and local government for redress." Macey, *Economic Analysis*, *supra* note 14, at 42-43. Macey's comment is valid only if one assumes that changes in the rules of corporate governance are not a way for communities to seek redress.

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Contractual relationships maintain a pre-legal, pre-political, and perhaps even super-constitutional status.[39] Corporate law, because it is contract law, is private. It is not, and should not, be subject to the political and legal processes.

Other public policy debates affecting business enterprises are not subject to a similar fixation on the public/private distinction, and this difference helps to highlight the rights-based nature of some of the discussions about corporate governance. The minimum wage provides a good example. Several years ago, the U.S. Congress increased the minimum wage from $4.25 to something over $5 per hour.[40] Note the similarities with a progressive proposal to have corporations balance the needs and interests of non-shareholder constituencies in making corporate decisions. Both proposals impose costs on the corporation that might result in a decrease in shareholder return.[41] Both proposals restrict the internal decision making of the corporation, the minimum wage statute by disallowing labor contracts offering wages below the statutory minimum, and the stakeholder statute by disallowing agreements between management and shareholders that include a promise by management to maximize returns without concern for other constituencies. Both proposals impose mandates on the corporation that were not necessarily assumed by the shareholders when they purchased their shares.

In the debate about the minimum wage, however, an argument that a legislated increase is impermissible because it is inconsistent with the shareholders' property or contract rights would seem out of place, unresponsive, or a throw-back to *Lochner*. People seem to understand that the debate about an increase in the minimum wage turns on, and should turn on, the effect of such an increase on workers, companies, and the economy as a whole. Few serious commentators would argue that raising the minimum wage is impermissible because it forces managers to give away money that "belongs" to the shareholders, and no one would find it persuasive (after the New Deal) that increasing the

[39] *See* Lynda J. Oswald, *Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause*, 24 J. CORP. L. 1 (1998) (arguing that because corporations belong to shareholders, stakeholder statutes are constitutional takings); *see also* Fischel, *Corporate Governance Movement*, *supra* note 26, at 1286.

[40] Sarah Anderson et al., *Executive Excess 2001, Layoffs, Tax Rebates, The Gender Gap*, EIGHTH ANN. CEO COMPENSATION SUR. (Inst. for Policy Studies, Washington, D.C., and United For a Fair Econ., Boston, Mass.), Aug. 28, 2001, at 4 fig.1.2.

[41] How much of a loss will depend in large part on how much of the costs can be passed on to consumers or suppliers of capital and labor. This will in turn depend on the elasticity of supply and demand in the various markets.

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minimum wage violates a "contract" between managers and shareholders. The "rights" of the shareholders are simply beside the point in the debate. In contrast, when a proposal is made to change the rules of corporate governance, rights-based arguments become a common part of the discourse.

It is no coincidence that the legal metaphors chosen by those who oppose corporate social responsibility come from the common law. Common law "rights" have long had significant rhetorical power. Much of this persuasiveness depends on the fact that people view them as neutral, pre-political, and pre-legal.[42]

This private law, contractarian perspective thus makes the same mistake for corporate law that *Lochner* made for constitutional law.[43] In *Lochner*, the Supreme Court struck down a New York law establishing maximum work hours for bakers, interpreting the U.S. Constitution's Fourteenth Amendment to create a category of impermissible legislative ends that used a laissez-faire conception of government as its theoretical basis.[44] What was seen as liberty was the framework of common law rights. The common law was seen as private and non-coercive, as "resistant to the dangers of political influence."[45] The market was viewed as a "self-executing system that justly distributed rewards through voluntary agreements among individuals."[46] Under this conception of liberty and government neutrality, the Court struck down the New York law restricting the work hours of bakers as a violation of the "right of free contract."[47] The institution of contract was seen as "the legal expression of free market principles and every interference with the contract . . . was treated as an attack on the very idea of the market as a natural and neutral institution for distributing awards."[48]

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[42] In this context consider Fischel's assertion that reformers should not disturb the nexus of contracts imbedded in corporate governance but should focus instead on imposing political restrictions from outside the corporation. Fischel, *Corporate Governance Movement*, *supra* note 26, at 1271 (noting that those who are concerned with corporate misdeeds should "seek redress through the political process and [should] not . . . attempt to disrupt the voluntary arrangements that private parties have entered into in forming corporations").

[43] 198 U.S. 45 (1905).

[44] *See* Cass R. Sunstein, *Naked Preferences and the Constitution*, 84 COLUM. L. REV. 1689, 1697 (1984).

[45] MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860 11 (1992).

[46] *Id.* at 33.

[47] *Lochner*, 198 U.S. at 45.

[48] HORWITZ, *supra* note 45, at 33. As history rarely falls into neat categories, it is important to note here that, while commentators often invoke *Lochner* to characterize turn-of-the-century jurisprudence, the Supreme Court was quite inconsistent in its adherence to

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Much of the rights-based discourse in present-day corporate law hearkens back to *Lochnerian* justifications. Corporate law is private law, defined by common law principles, and therefore neutral. To change it is impermissible.

Constitutional scholars now recognize, however, that *Lochner* came at the Supreme Court's "nadir of competence"[49] and the Supreme Court repudiated it long ago.[50] One of the mistakes of the *Lochner*-era Court was to believe that the marketplace was neutral, existing outside the realm of politics and law.[51] Public regulation pervades even the so-called laissez-faire marketplace and even the most basic common law entitlements are functions of legal rules.[52] "[T]he market status quo [is] itself the product of government choices,"[53] and had long been so, even at the time of *Lochner*. Morton Horwitz tells us that as contract law became more formalized and generalized after the Civil War, "the legal rules came to bear a more and more tenuous relationship to the actual intent of the parties."[54] Instead, judgments in common law courts came to "depend upon the notions of the court as to policy, welfare, justice, [and] right and wrong."[55] As Cass Sunstein explains, it was the law that "created property and contract rights, and . . . imposed various limits on those rights."[56] The so-called free market was a creation of law, not of nature, and "[t]he common law could not be regarded as a natural or unchosen baseline."[57] Thus, *Lochner*'s defense of the common law as

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freedom of contract even during the "*Lochner* era." *See* Aviam Soifer, *The Paradox of Paternalism and Laissez-Faire Constitutionalism, United States Supreme Court, 1888-1921*, 5 LAW & HIST. REV. 249, 250 n.4 (1987).

[49] Seminole Tribe of Florida v. Florida, 517 U.S. 44, 166 (1996) (Souter, J., dissenting).

[50] West Coast Hotel Co. v. Parrish, 300 U.S. 379, 392 (1937).

[51] *See* Seminole Tribe of Florida, 517 U.S. at 166, (Souter, J., dissenting) ("It was the characteristic of the *Lochner* era, and its characteristic vice, that the Court treated the common law background (in those days, common-law property rights and contractual autonomy) as paramount, while regarding congressional legislation to abrogate the common law on these economic matters as constitutionally suspect.").

[52] *See* CASS R. SUNSTEIN, AFTER THE RIGHTS REVOLUTION 41 (1990).

[53] Sunstein, *supra* note 44, at 1697.

[54] HORWITZ, *supra* note 45, at 35.

[55] *See id.* (citing Arthur L. Corbin, *Offer and Acceptance, and Some of the Resulting Legal Relations*, 26 YALE L.J. 169, 206 (1917)); *see also* Oliver W. Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 466 (1897) ("Why do you imply [a condition in a contract]? It is because of some belief as to the practice of the community or of a class, or because of some opinion as to policy, or, in short, because of some attitude of yours upon a matter not capable of exact quantitative measurement, and therefore not capable of founding exact logical conclusions.").

[56] CASS R. SUNSTEIN, THE PARTIAL CONSTITUTION 50 (1993).

[57] *Id.*

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private law was indefensible, and the courts eventually came to recognize it as such.[58] Contract and property law are no more neutral, private, or pre-legal than statutory law.

Recognizing the public nature of the common law does not mean that a legal regime should refuse to protect a bundle of common law entitlements. On the contrary, contract and property rights are correctly seen as essential to economic development and, in many respects, to social justice. The point, rather, is that these rights are not best perceived as natural, pre-legal, or non-political, but rather should be seen as tools to be utilized in furtherance of social good, however defined. Applied to the setting of corporate law, the language of rights may be used as a descriptive matter but is out of place in a normative discussion. One cannot justify the present make-up of corporate law as non-political or pre-legal because it is based on common law principles any more than *Lochner* could justify common law itself as non-political or pre-legal. Corporate law scholars who make this mistake are thus subject to Roscoe Pound's criticism of *Lochner* and its progeny: they "exaggerate the importance of property and contract . . . [and] exaggerate private right at the expense of public interest."[59]

If society wishes to recognize the "rights" of shareholders, it should do so as a result of a detailed normative conversation. But such "rights," themselves a function of law, cannot provide a normative basis for the law or a normative basis against changing the legal framework. Entitlements must find their normative basis outside of their own existence. In other words, such rights ought to come at the end of the conversation, not at the beginning.

B. New Deal Insights for Corporate Law

Once corporate law scholars "jettison[] our obsession"[60] with the various rights-based metaphors used to understand and explain the corporate form, the question arises of how the discussion should move forward. In other words, the issue is how we engage in a conversation about possible changes in corporate governance if the language of rights

[58] *See* GEOFFREY R. STONE ET AL., CONSTITUTIONAL LAW 739 (1986) (describing that *Lochner* "turned on an indefensible distinction between the 'public' and 'private' spheres, defined in terms of common law categories.").

[59] Roscoe Pound, *Liberty of Contract*, 18 YALE L.J. 454, 460-61 (1909).

[60] David Millon, *The Ambiguous Significance of Corporate Personhood*, 2 STAN. AGORA 39, 58, *at* http://www.law.stanford.edu/agora/cgi-bin/article2_corp.cgi?library=millon (last visited Nov. 4, 2001).

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is temporarily off limits.

One useful way to think of these issues is to look at corporate law as regulation. *Lochner*'s mistake was to consider the employment relationship as private. With the New Deal came the insight that such a relationship was not private at all and was instead the proper subject of government attention. This New Deal insight should be applied to corporate law as well. Instead of being seen as a set of statutory and common law rules contained within itself, corporate law should be subject to the same analysis as environmental law, labor law, tax law, communications law, and the like. There are a number of ways to characterize what this analysis should be, of course, and there are many grounds for vigorous disagreement about what "counts" in regulatory theory. But behind all the complexity, at a high level of generality, the analysis with regard to corporate law rules should be the same as the analysis for other kinds of statutes and regulations. That is, one should ask what we want our society to look like. Then we should craft a bundle of legal rules and regulatory programs that are likely to move us in that direction.

Though this construction is admittedly at a high level of abstraction, note that it forces the conversation about corporate governance to start quite differently than how it usually begins. Instead of looking at the outset to common law principles and notions of property and contract (or, for that matter, the rights of people in some kind of community), we are forced to state our assumptions about the purposes of law and our vision for society. Thus, David Engel is correct in his claim that the issues of corporate social responsibility "cannot be debated except against the background of a general political theory."[61] Then, the project of constructing corporate law ought to depend on a broader and ongoing project that sets social goals and analyzes the capacity of law, including corporate law, to get us closer to those ideals.

Of course, once we move away from rights-based arguments toward more hard-nosed empirical judgments about the effects of corporate governance on public policy goals, one would not expect much initial consensus about either the goals or the value of corporate law to help meet them. But this is the debate we need to have. Perhaps there is reason to believe that corporate law should remain focused primarily on

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[61] David L. Engel, *An Approach to Corporate Responsibility*, 32 STAN. L. REV. 1, 1 (1979). Even Fischel, at times, seems to admit as much when he says that the "proper comparison is between the costs and benefits of existing arrangements and the alternatives being proposed." Fischel, *Corporate Governance Movement*, *supra* note 26, at 1272.

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shareholder profit. Shareholders might belong on the pinnacle of corporate law in order to facilitate raising capital and to maximize the incentives for making profit.[62] And perhaps when profits are maximized, social utility is maximized.

But once corporate law moves from the realm of metaphor and rights-based debate to the terrain of regulatory theory, reasons to doubt this simple, profit-oriented utilitarian argument abound. It cannot seriously be claimed that social utility will be maximized if corporations are unrestrained by law. Even if one assumes that a maximization of utility should be the end goal, government intervention is often necessary to repair market defects and thereby to maximize utility. Externalities, collective action problems, "prisoners' dilemmas," inadequate information, tragedies of the common, and natural monopolies may all result from market forces and can make it impossible to maximize social utility.[63] Thus, government regulation of corporations is necessary even under a utilitarian social calculus. Additionally, if we expand our view of the permissible grounds for regulation to include public-regarding reasons not based in utilitarianism,[64] the presumption in favor of "laissez-faire" government falls away further. That is, non-utilitarian values such as equality or human dignity should influence and inform corporate law just as they inform and influence other areas of the law.

The implications of this point for corporate social responsibility and corporate governance may not be immediately obvious. Critics of the corporate social responsibility movement will admit the occasional need for regulation to correct market defects, and some may even allow for other regulatory rationales as well. But they would almost certainly argue that such regulation should be external to the corporate form (such as regulations requiring plant closing notification), rather than internal to it (such as a requirement that employees have representatives on boards of directors).[65] Yet if this is the critics' argument, it cannot be based on a general presumption against government regulation, which relies in turn on the notion that the absence of government regulation will bring about maximization of utility. Rather, the argument that government should not encourage corporate social responsibility by regulating internal corporate governance must be based on arguments about how "internal"

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[62] *See* EASTERBROOK & FISCHEL, *supra* note 4, at 6-7.

[63] *See, e.g.*, STEPHEN G. BREYER & RICHARD B. STEWART, ADMINISTRATIVE LAW AND REGULATORY POLICY 5-11 (3d ed. 1992); SUNSTEIN, *supra* note 52, at 48-55.

[64] *See* SUNSTEIN, *supra* note 52, at 55-71.

[65] *See* EASTERBROOK & FISCHEL, *supra* note 4, at 37-39.

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interventions are less beneficial in ameliorating market defects than "external" requirements.

Legitimate arguments might support such a distinction. To give corporate managers more than one legal duty may increase the agency costs of their supervision; it is less costly to monitor the performance of an agent if the agent has one task than if the agent has two, especially if the second is as seemingly abstract and immeasurable as the pursuit of corporate citizenship.[66] Perhaps managers have no expertise with regard to social concerns, so giving them more power in that regard is unlikely to have a significant positive effect and will provide a deadweight cost on the corporation and its shareholders.[67] Perhaps a loosening of management's fiduciary duty to shareholders will make shareholders less likely to invest, because they will lose some of their legal power to monitor and constrain management. Moreover, perhaps these corporate social responsibility reforms will be pointless, because shareholders will simply invest their capital in companies organized in states and countries that still require profit maximization.

These points may end up being persuasive. If they are, however, it will not be because of the use of the language of rights and duties. Rather, the success of such arguments turns on relative costs and benefits, effectiveness, the existence of other options, and similar analyses. In other words, the discussion depends not on rights and duties but on regulatory theory.

Once regulatory theory becomes the battleground, however, the victor is not so obvious. There are also reasons to believe that changes in corporate law should be part of the bundle of legal responses to market defects. Indeed, corporate law may have comparative advantages over other kinds of law in addressing certain kinds of concerns.[68] Corporate managers may in fact have expertise in areas that government bureaucrats do not. Corporate managers may have a great deal more information about certain matters than a government official charged with monitoring corporate behavior.[69] There may be economies of scale and other efficiencies in a corporate setting that do not exist in a

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[66] *See id.* at 38; ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2269 (1990); ROBERT CLARK, CORPORATE LAW 20 (1986) *But see* Macey, *Economic Analysis*, *supra* note 14, at 33 (arguing that "too many masters" argument is overstated, since corporate managers have long had to balance sometimes conflicting fiduciary duties to holders of different classes of stock).

[67] *See* Fischel, *Corporate Governance Movement*, *supra* note 26, at 1269.

[68] *See* CHRISTOPHER STONE, WHERE THE LAW ENDS 134 (1975).

[69] *See id.* at 160-70.

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governmental setting. There may be a closer fit between a problem and an "internal" solution rather than an "external" one. External regulations to reach certain ends may require greater ongoing enforcement costs than would changes in internal governance procedures intended to move toward the same ends. Changes in corporate governance and expansion of legal duties to include more than profit maximization may allow corporations to be proactive in addressing issues of social concern, which in turn might be more efficient than relying on the mostly reactive power of government regulation. Reforms within the corporation might create more trust among the various stakeholders, thereby encouraging reciprocal actions (such as workers being more productive because they feel they are being fairly treated) so as to reduce the costs of the regulatory initiative. Finally, reforms within corporate law would follow the corporation wherever it goes, whereas regulatory reforms largely stop at the border.

There are good reasons, therefore, to think hard about the possibility of using corporate law as a regulatory tool. The remainder of this Article takes this possibility seriously. Part II discusses two serious problems that corporate law might be particularly suited to address and the specific changes in corporate governance that might be used to address them.

II. THE PUBLIC POLICY OBJECTIVES AND THE REGULATORY TOOLS

To test the idea of using corporate law as a regulatory tool, this Article focuses on two grave and seemingly intractable public policy problems and three possible regulatory initiatives within corporate law that might be used to address those problems. This Part briefly describes the problems and the possible regulatory tools corporate law can offer.

A. The Problems: Stagnant Wages and High Income Inequality

While corporate profits were until recently at an all time high, wage rates for workers have been stagnant or falling. Though corporations enjoyed double-digit profit increases for five years in a row from 1993 through 1997,[70] hourly wages fell for the bottom 80% of workers over

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[70] Economic Policy Institute, *Profits Picture* (Mar. 26, 1998), *at* http://epinet.org/webfeatures/econindicators/profitspichd.html; *see* Press Release, U.S. Department of Commerce, Bureau of Economic Analysis, Gross Domestic Product: Fourth Quarter 1998 & Corporate Profits: Fourth Quarter 1998 (Mar. 31, 1999), *at* http://www.bea.doc.gov/bea/newsrel/gdp498f.htm.

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roughly the same period.[71] Indeed, the hourly earnings of the typical United States production worker, in constant dollars, were almost twenty cents less in 1999 than they were in 1973.[72] In other words, workers at the end of the century earned less per hour than their parents did during the Nixon Administration.

The gains from the multi-year boom in the stock market that lasted until early 2000 went mostly to the very rich. The richest 1% of the population earned 35% of the gains, and over 70% of the gains went to the richest 10%.[73] Typical Americans, meanwhile, were working more hours for less and losing ground.[74] By some accounts, the typical American family was worse off at the end of the 1990s than it was at the end of the 1980s or 1970s.[75] These losses are notwithstanding the fact that worker productivity in the United States has risen about 2% per year over the last 25 years.[76] But over 25% of workers earn wages that do not lift them out of poverty.[77] This percentage of workers earning poverty wages is higher than it was in the 1970s.[78] Indeed, "despite the popular notion that few of the poor work, . . . [the data show that] in 1998, 75.6% of the employable, prime-age poor either worked (70.3%) or sought work (5.3%)."[79] The wages of many low-wage workers are so low that they would not rise out of poverty even if they were to double the hours they worked.[80]

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[71] LAWRENCE MISHEL ET AL., STATE OF WORKING AMERICA 2000-2001 124 tbl. (2001) (detailing drop in real hourly wage for bottom 80% of wage earners from 1989 to 1995)

[72] *Id.* at 124.

[73] *Id.* at 270 fig.4D.

[74] *See* Claude S. Fischer, Inequality and the Corporation 8-9, (Oct. 5, 1999) (unpublished paper, on file with author) ("It is clear that middle Americans have, in net, not gained much, if anything, and, given increased work hours, may well have lost much during this era of widening inequality."). Fischer notes that between 1977 and 1997, the percentage of American households in which both adults worked increased from 66% to 78%, and both working men and working women worked more hours per week. *Id.* at 8-9, n.24. The Economic Policy Institute reports that married couple families, in the middle quintile for income, worked, incredibly, 18.4 more weeks per year in 1998 than they did in 1969. MISHEL ET AL., *supra* note 71, at 97 tbl.1.28.

[75] MISHEL ET AL., THE STATE OF WORKING AMERICA 1998-99 2 (1999).

[76] MISHEL ET AL., *supra* note 71, at 150.

[77] *Id.* at 130-31 tbl.2.10.

[78] *Id.* The Economic Policy Institute observes that 26.8% of the workforce earned poverty-level wages in 1999, an increase from 23.7% in 1979. Worse, in 1979, only 4.2% of the workforce fell into the "very low earner" category, earning wages at least 25% below the poverty-level wage, but by 1999, 10.8% of the workforce earned such wages. *Id.* at 129-32.

[79] *Id.* at 318.

[80] *Id.* at 286-87.

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The difference in compensation between the workers and management is growing as well. Twenty years ago, pay for corporate chief executive officers (CEOs) was less than thirty times that of the average worker.[81] Now, the typical CEO makes over 400 times that of the average worker.[82] CEO compensation rose almost 600% between 1990 and 2000.[83] Pay for executives rose even during 2000, when the S&P 500 suffered a 10% loss. If the pay for the average production worker had grown at the same rate since 1990, her 2000 earnings would have been $120,491 instead of $24,668.[84]

Income inequality is at historically high levels and is becoming worse.[85] The wealthiest 1% of the United States population has 38% of the nation's personal wealth.[86] This is almost a third more wealth than is possessed by the poorest 90% of Americans combined.[87] Since the early 1980s, the richest 5% have seen their share of national wealth grow, from about 56% in 1983 to almost 60% in 1998,[88] while the poorest 95% of Americans have seen their share of wealth fall from roughly 44% to 40%.[89] Income inequality is at its highest level since the Census Bureau began tracking these data in 1947.[90]

Many other industrialized nations do a better job at addressing these issues. The United States has the highest overall poverty rate among the

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[81] *Id.* at 211 (stating that CEOs working for major companies in United States earned 28.5 times more than average worker in 1978).

[82] Fischer, *supra* note 74, at 1; *see* MISHEL ET AL., *supra* note 71, at 211-12 (providing that in United States CEOs earned 106.9 times as much as average worker in 1995)

[83] Anderson, *supra* note 40, at 1; *see* MISHEL ET AL., *supra* note 71, at 210 fig.2W.

[84] Anderson et al., *supra* note 40, at 1.

[85] *See* CHARLES DERBER, CORPORATION NATION: HOW CORPORATIONS ARE TAKING OVER OTHER LIVES AND WHAT WE CAN DO ABOUT IT (1998) (noting that until recent downturn in share prices of technology stocks, Bill Gates alone had personal wealth equal to poorest 40% of Americans). For a real time counter of Bill Gates's wealth based on the price of Microsoft stock, see Phillip Greenspun, *Why Bill Gates is Richer Than You, Bill Gates Personal Wealth Clock, at* http://www.webho.com/WealthClock (last visited Nov. 5, 2001).

[86] MISHEL ET AL., *supra* note 71, at 257.

[87] The top 1% of Americans has 38.1% of the wealth; the next 9% has 32.9%. *Id.* As a result, only the remaining 29.0% of wealth is left for the bottom 90% of the population. *Id.* at 259 tbl.4.1.

[88] *Id.* at 260 tbl.4.2.

[89] *Id.*

[90] DANIEL H. WEINBERG, U.S. CENSUS BUREAU, CURRENT POPULATION REPORTS: A BRIEF LOOK AT U.S. INCOME INEQUALITY (1996), *available at* http://www.census.gov/ftp/pub/hhes/www/p60191.html (June 1996); *see* Jared Bernstein & Lawrence Mishel, *Income Picture: Household Income Fails to Grow in 2000*, Econ. Pol'y Inst. (Sept. 25, 1999), *at* http://epinet.org/webfeatures/econindicators/income.html.

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sixteen advanced economies in a recent study;[91] and among these countries, only the United Kingdom has an inequality rate that comes close to that of the United States.[92] The poverty rate for children in France is 7%; the poverty rate for children in the United States is 25%.[93] In fact, inequality in the United States is so severe that poor families in the United States are worse off than poor families in all other advanced countries for which data exists.[94] Other advanced countries pay their workers more and their CEOs less (in fact, CEOs are paid about half as much).[95] Also, other countries do a better job of providing opportunities to move up the economic ladder. People in Canada, Germany, Holland, and Sweden realize the "American Dream" of moving out of poverty and into the middle class more often than in the United States.[96] The fact that other countries have different priorities does not seem to be driving them into an economic abyss. Most industrialized countries have higher labor productivity growth than the United States, including the four countries just mentioned: Canada, Germany, Holland, and Sweden.[97] In addition, a number of others including France, Belgium, Holland, Norway, and Germany in its western region, have higher productivity than the United States even in absolute terms.[98]

B. *The Tools of Corporate Law*

For a number of years, so-called "progressive" corporate scholars have argued for a range of changes in corporate governance. Heretofore, these changes have been discussed primarily as a way to improve the fairness of the firm, or as a way to mitigate the harmful effects of corporate activities, or occasionally as a way to benefit the firm financially. Parts III and IV will seek to do what scholarship has not generally done to date, that is, to describe the power of corporate law as a regulatory tool to address broader social problems. This section briefly discusses the specific regulatory tools this Article envisions: relaxing the profit maximization norm; requiring firms to owe fiduciary duties to workers; and adding worker representatives to the board and other

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[91] MISHEL ET AL., *supra* note 71, at 391 (noting that nine of sixteen countries have poverty rates less than half United State's rate).

[92] *Id.* at 391.

[93] *Id.* at 393 tbl.7.14

[94] MISHEL ET AL., *supra* note 71, at 392.

[95] *Id.* at 212.

[96] *Id.* at 396.

[97] *Id.* at 376.

[98] *Id.* at 375.

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company decision making bodies.

1. Relaxing the Profit Maximization Norm

Since the early-twentieth century case of *Dodge v Ford*,[99] corporations have been deemed to have an "unyielding" duty to look after the interests of the shareholders, which has been translated into a duty to maximize profits.[100] This norm of profit maximization constrains the directors by requiring them to act so as to take care of the financial interests of the shareholders, first and foremost.[101] Nobel Laureate Milton Friedman authored the most famous assertion of this duty: "In a free-enterprise, private-property system a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much

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[99] 170 N.W. 668, 682 (Mich. 1919) (holding that corporation's withholding of large accumulated earnings violated shareholders' expectations to obtain profits from their investment).

[100] *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (holding that "[i]n carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders."); *see also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1985) (concluding that concern for "various corporate constituencies" may be taken into consideration by directors only if there are "rationally related benefits accruing to the stockholders."); Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (Allen, C.) (emphasizing that "It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders; that they may sometimes do so 'at the expense' of others . . . does not for that reason constitute a breach of duty.").

[101] *See* David Millon, *A New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1010 (2000) ("It is common coin among commentators to speak of corporate law and its fiduciary doctrines as mandating management regard for shareholder interests over those of other corporate constituencies."); *see also* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 97 (1995) ("[I]t is generally agreed that management's principal fiduciary duty is to maximize the return to common shareholders."); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1921 (1996) ("The efficiency goal of maximizing the company's value to investors remains, in our view, the principal function of corporate law."). Margaret Blair and Lynn Stout have recently championed a re-thinking of this description of the basic fiduciary duty within corporate law. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 251-52 (1999). Blair and Stout argue that, as a matter of positive law, corporate directors have a duty to the firm as a whole rather than any particular stakeholder. While I remain skeptical that their "team production model" is an accurate description of existing corporate law, the implicit normative implications for their work appear to be largely consistent with the normative thesis of this Article, namely that relaxing the profit maximization norm would make the board a better, rather than worse, decision maker. *See* Millon at 1010-23.

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money as possible. . . ."[102]

Even though the strength of the norm is weakened, perhaps considerably, by the business judgment rule (BJR), in my view it is incorrect to say that the business judgment rule does away with the profit maximization norm. The business judgment rule certainly establishes a very deferential presumption in favor of management when shareholders challenge management decisions in court. But while the BJR guarantees flexibility with regard to the means management can use, the end of serving shareholder interests is not changed. The maximization of profit, even under the BJR, is the objective to be served.[103] As William Klein and John Coffee have stated, "directors have great discretion over how to maximize the return to shareholders, but not whether to."[104]

The most popular way to relax the profit maximization norm is by way of so-called "constituency statutes" or "stakeholder statutes."[105] These statutes, adopted in nearly thirty states, allow corporate

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[102] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32. Over a century earlier, Herman Melville provided a dramatization of this principle in *Moby-Dick*. When that novel's narrator, Ishmael, joins the Pequod's crew for its infamous voyage he is assigned a "lay," a share of the voyage's profits. In figuring Ishmael's lay, one of the ship's "directors" (Captain Bildad) proposes an apparently modest share, but the other (Captain Peleg) objects, "thou must consider the duty thou owest to the owners of this ship—widoes [sic] and orphans, many of them—and that if we too abundantly reward the labors of this young man, we may be taking the bread from those widows and those orphans." HERMAN MELVILLE, MOBY-DICK OR THE WHALE 69 (Albert & Charles Boni, Inc. 1933) (1851).

[103] *See Dodge*, 170 N.W. at 684 ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.").

[104] *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 127 (5th ed. 1993).

[105] The scholarship on these statutes is extensive. *See* David Millon, *Communitarianism in Corporate Law, in* PROGRESSIVE CORPORATE LAW 1, 11-13 (Lawrence E. Mitchell ed., 1995); William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385 (1990); James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 103-09 (1991); Macey, *Economic Analysis supra* note 14, at 31-32; Morey W. McDaniel, *Shareholders and Stakeholders*, 21 STETSON L. REV. 121 (1991); Mitchell, *Theoretical and Practical Framework*, *supra* note 19, at 630-43 (stating that stakeholders should have standing to sue directors when corporate action harms them); Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 161, 161-163 (1991) (describing various statutes). For a compilation of stakeholder statutes, see the Appendix to *Symposium: Corporate Malaise—Stakeholder Statutes: Cause or Cure*, 21 STETSON L. REV. 279 (1991).

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management, when making decisions for the firm, to take into consideration the interests of non-shareholder "stakeholders" in the firm.[106] These statutes take a variety of forms, but their key element is that they release management from the traditional legal duty to look after the interests of the shareholders first and foremost. In other words, stakeholder statutes release management from the legal duty to maximize profits. Management is of course still subject to the duties of loyalty and care, but the statutes give them the power to defend against shareholder derivative suits by showing that they acted on behalf of some non-shareholder constituency.

2. Including Workers Within Management's Fiduciary Duties

While relaxing the profit maximization norm is primarily permissive, a more profound change in corporate governance would be to broaden the fiduciary duties of the corporation's management, including the board of directors, to include a duty to the employees of the firm. This regulatory change could be accomplished in a number of ways, including by way of statute or by common law.

The leading modern advocate of this view is Marleen O'Connor, who has written extensively about the importance of management owing fiduciary duties to workers.[107] The components of fiduciary duty are

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[106] *See* Appendix to *Symposium*, *supra* note 105, at 279. While a majority of states have adopted some form of these statutes, only Connecticut's statute includes language that requires, rather than permits, directors to consider non-shareholder stakeholders. CONN. GEN. STAT. § 33-756(d) (West 1997). According to Charles Hansen, only Iowa, Indiana, and Pennsylvania (in addition to Connecticut) permit directors to place other constituencies on the same footing as stockholders. Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1370, 1375 (1991); *see* Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1411-12 (1993); Wallman, *supra* note 105, at 194-96.

[107] *See, e.g.*, Marleen A. O'Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements*, *in* PROGRESSIVE CORPORATE LAW 219 (Lawrence E. Mitchell ed., 1995); 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 (1991). *See* MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 56-61, 158 (1995) (arguing that management should take into account effect of corporate decisions and actions on all stakeholders who contribute firm-specific assets that are at risk in enterprise); Greenfield, *Place of Workers*, *supra* note 14, at 287-88 (arguing for fiduciary duty toward workers); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45 (1991) (arguing for creation of fiduciary duties on behalf of employees but suggesting that state stakeholders statutes do not create such duties); *cf.* Blair & Stout, *Team Production Theory*, *supra* note 101, at 253-54 (arguing that corporate law, as positive matter, recognizes directors' duties to non-shareholder stakeholders).

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notoriously fuzzy, but at the very least the duty would include an obligation to be truthful in communications, to disclose material information, and to consider in good faith the interests of workers in making important decisions.

3. Adding Worker Representatives to the Board

The final possible change in corporate governance relevant here is a form of "co-determination," the addition of worker representatives on the company's board of directors. While a few large companies in the United States have one or a few employee representatives, they remain the rare exception rather than the rule. Though co-determination is accepted in some other nations, particularly Germany,[108] a move toward worker involvement at the highest level of the firm would represent a profound shift in the relations between capital and labor in the United States.[109]

The fact that it would represent a big change is not to imply that some kind of co-determination does not have its supporters. As long as fifty years ago, Abram Chayes argued that workers should be considered a part of the "membership" of the firm and that "[t]heir rightful share in decisions on the exercise of corporate power [should] be exercised through an institutional arrangement appropriately designed to represent the interests of a constituency of members having a significant common relation to the corporation and its power."[110] Thirty years ago, Robert Dahl wrote in support of employee-elected boards of directors,[111] and more recently a number of corporate scholars have taken up the cause of labor representation on company boards.[112]

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[108] *See* PETER NUNNENKAMP, THE GERMAN MODEL OF CORPORATE GOVERNANCE: BASIC FEATURES, CRITICAL ISSUES, AND APPLICABILITY TO TRANSITION ECONOMIES 5-7 (Kiel Inst. of World Econ., Working Paper No. 713, 1995); THE GERMAN MODEL OF CODETERMINATION AND COOPERATIVE GOVERNANCE: AN EVALUATION OF CURRENT PRACTICE AND FUTURE PROSPECTS (Bertelsmann Foundation & Hans-Böckler-Foundation eds., 1998).

[109] *See* Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. & SEC. REG. 155, 155 (1982) (noting that United States has "no experience" with employee representation on corporate boards, apart from few employee-owned companies).

[110] Abram Chayes, *The Modern Corporation and the Rule of Law*, *in* THE CORPORATION IN MODERN SOCIETY 25, 41 (Edward S. Mason ed., 1959).

[111] ROBERT A. DAHL, AFTER THE REVOLUTION? AUTHORITY IN A GOOD SOCIETY 133 (1970); *cf.* STONE, *supra* note 68, at 152-83 (recommending public interest directors for boards of major public corporations).

[112] *See* Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 MICH. J. L. REFORM 19, 73-77 (1988); Greenfield, *Place of Workers*, *supra* note 14, at 287; Mitchell, *Critical Look at Corporate Governance*, *supra* note 19, at 1303; *see also* Alfred F.

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For the purposes of this Article, it is not important to articulate the details of how co-determination might work in the United States.[113] It is sufficient for present purposes to recognize that adding worker representatives to the highest level of corporate governance would likely affect the way other corporate managers consider worker interests, facilitate discussion among the important stakeholders of the firm, and ensure that important information flows to labor as well as capital.

4. A Note About the Likely Power of These Regulatory Tools

In the two Parts that follow, this Article analyzes whether these three tools of corporate law might be expected to have some utility in achieving the policy goals outlined above, raising wages for workers and reducing income inequality. These Parts contend that corporate law would be powerful for two principal reasons: it has a distinctive role in encouraging fairness among the various parties to the corporate contract, and it has the power to facilitate the sharing of economic surplus. First, it is worth noting that the ubiquity of corporate law and of corporations themselves will tend to magnify whatever positive impact these tools have. Indeed, corporate law is pervasive. It governs the actions, behaviors and activities of huge economic institutions that are immensely powerful and spread throughout the globe. The largest corporations are at least as economically strong as many nations.[114]

Conard, *Reflections on Public Interest Directors*, 75 MICH. L. REV. 941, 952 (1977) (arguing that most effective means of protecting employee interests is to provide them with seats on board of directors); Katherine Van Wezel Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 U. CHI. L. REV. 73, 158-59 (1988) (noting "compelling case for expanded labor participation on corporate boards").

[113] It is also beyond the scope of this Article to analyze and discuss the relative merits of board representation as opposed to a work council model, which offers workers a more consultative role at a lower level within the firm hierarchy. Of course, these ideas are not mutually exclusive.. *See also* O'Connor, *Human Capital Era, supra* note 71, at 936-40 (1993) (discussing relative value of codetermination and cooperative work councils). Work councils are the norm in large firms in Germany and some other countries in Europe. Even the United Kingdom has introduced measures to implement a 1994 European Union directive encouraging work councils. *See* Mark Carley & Mark Hall, *The Implementation of the European Works Councils Directive*, 29 INDUS. L.J. 103 (2000); *cf. You're Fired: Unemployment, Law and Society: The Likely Revival of Unemployment in Europe is Bringing to the Fore Deep Differences About the Role of the Employee*, THE ECONOMIST, Apr. 14, 2001 (describing tensions within European Union over work councils).

[114] *See* Gretchen Morgenson, *A Company Worth More Than Spain?*, N.Y. TIMES, Dec. 26, 1999, §3, at 1 tbl. (describing companies with market capitalizations equal to various countries). As of late 1999, the market capitalization of I.B.M. was roughly equal to the gross domestic product of Columbia; Wal-Mart Stores's capitalization was equal to the GDP of Argentina; and Microsoft's market capitalization was equal to the GDP of Spain.

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Not only are corporations powerful and pervasive in the macro sense, they are significantly influential in the lives of individuals. The day-to-day lives of many citizens in the United States are affected much more by the corporations for which they work than by any governmental entity. If corporations treat individuals poorly then individuals suffer. If corporations treat individuals well then individuals tend to be well off, or at least more well off than they otherwise would be. This is not to say that government does not have a role in protecting our rights, both political and economic. This is merely to say that the day-to-day lives of most people are affected more by corporations than by governments.

Therefore, if the power of corporations could be harnessed for positive social change, one could expect to see significant results. These positive results would not be limited to the incorporating state alone. Rather, because the internal affairs doctrine states that the law of the incorporating state determines a corporation's governance rules, any change in the law of the incorporating state would affect the corporation in total. This means that the corporate governance rules of the incorporating state will follow the corporation wherever the corporation does business, even in other states or foreign jurisdictions.[115] Accordingly, from a public law prospective, corporate law should be expected to be a very powerful tool. It governs large, powerful economic actors; and it governs the behavior of those large economic actors whenever those actors conduct business. For example, if some kind of co-determination became the norm in the United States, it would affect corporations' decisions not only with regard to their dealings in the incorporating state, which may be minimal, but also with regard to their world wide business activities. Or, if corporations were released from the duty to maximize profit in all circumstances, a decision to withdraw business from China or Burma in order to protest the human rights records of those nations would not be subject to a shareholder derivative suit, even if such a withdrawal was clearly not the most profit maximizing decision.

Once the law of corporate governance is seen as public rather than private law, one can recognize that because it governs hugely powerful

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Id. Cisco could be equated with Iran, Qualcomm with Singapore, and American Express with New Zealand. *Id.*

[115] For one application of this point, see Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1248, 1279 (2001) (arguing that illegal acts are ultra vires for corporations and that shareholders can sue to enjoin such acts, even if such illegalities occur overseas).

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institutions it has extraordinary potential as regulatory tool. Of course the dangers of misuse are similarly great. But correctly harnessed, corporate governance law could be an extremely important branch of regulatory law. There are two distinctive powers of corporate law, building cooperation through fairness and facilitating the equitable sharing of surplus, that if utilized as regulatory tools could have great usefulness in addressing important policy goals such as stagnant wages and high income inequality.

III. THE FIRST POWER OF CORPORATE LAW: BUILDING COOPERATION THROUGH FAIRNESS

A. The Expertise of Corporate Law with Regard to Fairness

Much time in the basic corporate law course is spent on the existence and meaning of the legal requirement of "fairness." Someone not steeped in corporate law doctrine might find it surprising that fairness is a concern in corporate law at all, given the reputation of corporate lawyers and corporate law itself as focusing exclusively on profit and hard-nosed business concerns. The seeming incongruity melts away, at least in part, when one recognizes that "fairness" is somewhat of a term of art in corporate law, describing the measure by which judges evaluate whether managers or directors have violated their duty of loyalty to the firm.[116] According to the cases, when a court is faced with an allegation that a manager has engaged in some behavior that would arguably violate the duty of loyalty (usually some involvement in a self-dealing transaction), the court will measure the "fairness" of the transaction on both substantive and procedural grounds. This means that the court will look both at the substance of the transaction, to ensure the firm received fair value, and at the process by which the transaction was approved, to ensure that the firm had the information it needed to evaluate whether it should go forward with the transaction despite the putative conflict of interest.[117] The procedural component includes attention to things such

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[116] *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366, 1369-70 (Del. 1993) (describing requirements of fairness); Wilkes v. Springside Nursing Home, Inc, 353 N.E.2d 657, 661-62 (Mass. 1976) (describing elements of fairness); Bayer v. Beran, 49 N.Y.S.2d 2, 7 (N.Y. Sup. Ct. 1944) (discussing how director accused of violating duty of loyalty must show "inherent fairness" of transaction in question).

[117] *See, e.g.*, Weinberger v. UOP. Inc., 457 A.2d 701, 711 (Del. 1983) ("The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed

as whether the allegedly interested manager informed the other decision makers of her interest; whether the firm received information from sources untainted by an interest in the transaction, and whether the decision was approved or ratified by a body of decision makers that did not include the interested party.[118]

Concerns about procedural integrity also inform the way courts evaluate claims that managers violated their fiduciary duty of care. Even though the underlying duty of corporate managers to maximize the value of the company to the shareholders is quite substantive, courts reviewing corporate decisions generally focus on process. Ostensibly because of courts' stated hesitancy to substitute their own judgment for the judgment of management, courts have moved toward using procedural standards as proxies for the underlying substance. Courts look to procedural issues such as whether the board took its time in making the decision; whether the views of experts were considered; and whether the board had appropriate notice of the decision they were to make.[119]

For the purposes of this Article, the important point is that corporate law has a long history of taking account of fairness, especially procedural fairness. Because corporate lawyers and judges evaluating corporate law cases are accustomed to making these kinds of judgments, corporate law may indeed have something of a comparative advantage when it comes to determining fair process. Because these concerns about fairness have only been applied to the firm and its shareholders, it may be easy to overlook the possibility that they might be generalized. But a practice of arranging rules of decision making to ensure a fair process builds expertise within the firm and its management that could easily be expanded to take account of other interests and stakeholders.

Because of this tradition of fairness within corporate law, if corporate law required managers to owe fiduciary duties to employees as well as to shareholders, there is reason to be confident that corporate law over time would craft rules that did a respectable job of protecting employee interests. In contrast, existing corporate law does not require any

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to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger. . .").

[118] *See* WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 684-88 (7th ed. 1995); *cf.*, Alison G. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 776-78 (1978); Gregory C. Keating, *The Idea of Fairness in the Law of Enterprise Liability*, 95 MICH. L. REV. 1266 (1997).

[119] The paradigm case is Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). *See* CARY & EISENBERG, *supra* note 118, at 602-05, 631.

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procedural protections of employee interests, at least at the level of firm decision making. A heightened concern for the fairness of decisions affecting employees would also be an inevitable result of including worker representatives on the board of directors. Studies show that how an institution treats people appears to be a much more important determinant of trustworthiness than whether the institution delivers favorable decisions.[120] "[T]rustworthiness is primarily determined by neutral and unbiased decision making and by the degree to which individuals feel they are treated with respect."[121]

The goal of this Article is not satisfied, however, merely by pointing out the near-tautology that corporations would be more fair to their employees if corporations were required to be more fair. Rather, the argument is that an increased concern for fairness would have beneficial effects beyond people's feelings, and that these beneficial effects relate to the public policy goals set out above. Section B argues that an increased concern for fairness vis-à-vis employees will result in decreased monitoring costs, which will tend to increase wages and decrease income inequality. Section C argues that an attention to fairness will allow for more "relational" contracts between employees and firms and that such contracts are correlated with increased wage rates.

B. Fairness in the Workplace

1. The Effects of Fairness

The leading authority on the effects of fairness and trust within organizations is Tom Tyler. He has written extensively about the power of fair procedures to engender trust, and the effects of trust on compliance with laws, the legitimacy of political institutions, and the behavior of employees within firms.[122] It is the latter research that bears emphasis here. Tyler is a psychologist, so his research is individualistic

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[120] Tom R. Tyler & Peter Degoey, *Trust in Organizational Authorities: The Influence of Motive Attributions on Willingness to Accept Decisions*, *in* TRUST IN ORGANIZATIONS: FRONTIERS OF THEORY AND RESEARCH 331, 346 (Roderick M. Kramer & Tom R. Tyler eds., 1996).

[121] *Id.* at 342.

[122] *See* Tom R. Tyler, *Citizen Discontent with Legal Procedures*, 45 AM. J. COMP. L. 871 (1997) (noting power of procedures to foster trust in legal system); Tom R. Tyler, *Compliance with Intellectual Property Laws: A Psychological Perspective*, 29. N.Y.U. J. INT'L L. & POL. 219 (1997) (discussing power of fair procedures to engender voluntary compliance with laws); Tom R. Tyler, *Procedural Fairness and Compliance with the Law*, 133 SWISS J. ECON. & STAT. 219 (1997).

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and micro in focus. He also focuses on the descriptive rather than the normative. My effort here is to propose macro implications for his work and to suggest some normative points that flow from his findings.

To begin, one should recognize that Tyler's work contrasts with the traditional theories of how people behave within firms. The contractarian notion of corporate law (and the law and economics view of most law) assumes that individuals respond to incentives and penalties. Employees, for example, decide whether to work conscientiously — with care, effort, and honesty — on the basis of what they will receive in return for such conscientiousness. If they will receive some part of the surplus created by their greater effort, they will be more likely to work harder than if they receive nothing. If they fear their employer will terminate them for failing to perform, they will work harder to avoid such an outcome. A concern about employee or managerial shirking and dishonesty animates much of the doctrine and theory of corporate, employment, and labor law. For example, the need for a managerial class at all is in part based on the need to monitor the performance of employees of the firm. Managers monitor employees to ensure they do their job; senior managers monitor middle managers for the same reason; executives monitor senior managers; the board monitors executives; the shareholders monitor (or are supposed to monitor) the board. It is assumed that such monitoring is necessary in order to maintain the performance of the person being monitored.

Tyler contests much of these typical assumptions by exploring the impact of fairness norms within firms. He recognizes, of course, that in order to be effective in producing wealth, firms need the participants in the firm to follow rules and policies and to work conscientiously.[123] The question is whether there is a way to motivate individuals to follow corporate rules and policies that is more powerful and efficient than the typical incentive system. Tyler's seminal insight is that individuals' compliance with rules and productivity improve with their feelings of being treated fairly, and that individuals' beliefs about the fairness of the institution are better predictors for rule compliance and productivity

[123] Tom R. Tyler, *Psychological Perspectives on the Behavior of Corporate Actors* 2 (Aug. 17, 1999) (unpublished manuscript, on file with author). Tyler includes a broad range of behaviors in his account of rule compliance. He includes "issues as broad ranging as coming to work on time, dressing appropriately for work, and following company mandates and policy directives" as well as the rules that say that "employees should not use office supplies for personal use, should not use sick leave when not sick, should not take too long for lunch or on breaks, should not steal equipment from the company, and should not otherwise break organizational rules." *Id.* at 2-3.

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than their exposure to material incentives and penalties.

As Tyler notes, "organizations gain when people voluntarily defer to organizational rules," that is, when they are willing to "take the responsibility for rule-following onto themselves" and obey rules even when "they believe noncompliance is not likely to be detected," and when they "accept decisions and policies even when they could contest and appeal them."[124] In a number of studies, Tyler has shown that an individual's beliefs about the legitimacy of the rules are the key predictor of rule compliance, and that "legitimacy judgments dominate both compliance and deference decisions."[125] That is, "compliance behavior . . . is more strongly influenced by legitimacy than it is by estimates of the gain or loss associated with that behavior."[126] In particular, Tyler has shown this to be true in business settings, where employees' compliance behavior depends on the legitimacy of the "organizational structure" of the firm.[127]

2. The Determinants of Fairness

What is important for present purposes are the determinants of this legitimacy on which employees' rule compliance is largely based. In Tyler's words, "[w]e need to determine whether there is a relationship between organizational characteristics and legitimacy to establish that there is a relationship between workplace characteristics and worker behavior."[128] From an employee perspective, one obvious characteristic of an organization is the "favorability of the organization's rules and the decisions of its authorities."[129] The traditional law and economics analysis of the workplace emphasizes this perspective. Tyler contrasts the traditional perspective with what he terms "a procedural justice-based model of authority." This model "argues that people evaluate authorities and institutions by evaluating the fairness of their decision making procedures."[130]

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[124] *Id.* at 4.

[125] *Id.* at 7.

[126] *Id.* at 8.

[127] *Id.* at 8.

[128] *Id.* at 9.

[129] *Id.* at 10.

[130] *Id.* at 10. Tyler measured employees' views about procedural justice by surveying them with questions such as "How fair are the rules and procedures for decision-making used in your organization?" and "Overall, how often do you feel your organization makes decisions in fair ways?" and "How fairly does your work supervisor make decisions?" *Id.* at 10-11

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Tyler's studies show that "employee views about the legitimacy of authority are strongly influenced by employee judgments about the fairness of organizational procedures. Interestingly, neither legitimacy nor rule-related behavior is linked to the favorability of the outcomes that employees believe that they receive through organizational rules and the decisions of organizational authorities."[131] Thus, these studies support the notion that "in organizational settings people are more concerned about experiencing justice than they are about receiving favorable outcomes or avoiding punishments."[132]

In firms, from the perspective of management, "[t]he key to creating a rule-following organization is to make decisions in ways that employees will view as fair."[133] Of course that begs the question of what leads employees to believe that the organization is fair. Tyler offers meaningful suggestions on this question as well. He reports that, as common sense would suggest, employees are influenced to believe the organization is fair if their personal supervisor treated them fairly and with dignity.[134] But more important for the purposes of this argument, Tyler has also found that employees are significantly influenced in their beliefs about the fairness of their firms by organizational traits such as: the existence of fair formal decision making rules and procedures, and the quality of treatment they receive under the formal rules.[135] This means, at least in part, that the organization affords them "equal treatment under the rules," "unbiased decision making, "and "respect" for their "rights."[136] Tyler also notes that employees' judgments about "distributive justice" tend to influence their assessments of procedural justice. In Tyler's words, "one of the way[s] that employees judge the fairness of procedures is through assessments of the fairness of those procedures."[137]

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[131] *Id.* at 11.

[132] *Id.* at 12.

[133] *Id.* at 13.

[134] *See id.* at 18.

[135] *See id.* at 18.

[136] *Id.* at 18-19.

[137] *Id.* at 17; *see id.* at 19 ("One factor that employees consider when they are determining the fairness of procedures is the fairness of the outcomes those procedures produce. Interestingly, outcome fairness does not directly influence either the social value of legitimacy or rule-related behavior. Distributive fairness has an indirect influence on behavior through its influence on procedural justice judgments.").

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C. The Regulatory Impact of Fairness Within the Firm

The potential implications of Tyler's work for corporate law are significant. How employees feel about the legitimacy of the firm's rules and authority structure will depend in large part on whether the firm treats them fairly, which means in turn whether the firm has an unbiased, neutral structure for making decisions that affect the employees. In other words, whether employees trust the organization will turn on, in large part, whether they believe the firm cares about their well being — whether the employees believe the organization's authorities act as if they owe something akin to a fiduciary-type duty to treat them fairly. If employees believe the firm has legitimacy, meaning they believe the firm treats them "fairly," they will obey firm rules at much higher rates than if they do not hold that belief. This will lower monitoring costs and thus increase firm productivity.

As discussed above, much of corporate law doctrine is self-consciously about the importance of fairness, especially fair procedures. Traditionally, such concerns for fairness have related only to shareholder interests. There is reason to be optimistic, however, that corporate law's particular knowledge of what constitutes fairness, including elements of both substantive and procedural fairness, could be expanded to workers easily. Many of the important elements of fairness toward workers — an unbiased decision making structure, a fiduciary-type care for workers' interests, the sharing of information, and dignified treatment — could be bolstered by implementing the corporate governance initiatives outlined above.[138]

The purpose of this article is not to argue for fair procedures within corporate governance on grounds of justice or fairness, though a powerful argument could undoubtedly be made to that effect. Instead, this Article makes an instrumentalist argument. There are two ways that an increased attention to fairness could have a positive effect on the identified public policy problems. The first is that a lower level of monitoring is associated with higher wages for non-managerial employees. The second is that a higher level of trust makes more "relational" contracts possible, which in turn are associated with higher wages rates.

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[138] *See* discussion *supra* Part III.B.1-3 (relaxing profit maximization norm, including workers within management's fiduciary duties, and adding worker representatives to board).

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1. Fair Procedures and Monitoring Costs

Traditional corporate law scholarship has focused on the agency costs arising from the separation of ownership and control.[139] This problem of agency costs is a continuing issue as one dives deeper into the corporate hierarchy, because line employees' interests diverge from shareholders' interests even more than managers' interests diverge from shareholders' interests. The solution, in traditional corporate and employment law, is to increase the monitoring of employees in any number of ways, including increasing the number of managers to oversee the work of the lower level employees.

In large part, however, monitoring costs are dead weight losses, not only for individual firms but also for the economy as a whole.[140] The costs of monitoring the production of others is not itself a productive activity, except in the most indirect sense.[141] A concern for fairness, it appears, would cause employees to internalize the norms of the firm with regard to productivity and rule compliance, improving overall firm performance at lower levels of monitoring. If the firm had a greater concern for fairness, the level of trust between the firm and its employees would likely be much higher; and this trust will have the positive effect of allowing for productivity increases and lower levels of monitoring.

The answer to how this lower level of monitoring can have positive effects on the policy problems identified, namely stagnant wages for the working class, and grossly unequal income inequality, lies in two phenomena associated with lower levels of monitoring. The first phenomenon, identified by economists Daron Acemoglu and Andrew F. Newman, is that lower monitoring is associated with higher wages.[142] Acemoglu and Newman have modeled the relationship between

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[139] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[140] *See* DARON ACEMOGLU & ANDREW F. NEWMAN, THE LABOR MARKET AND CORPORATE STRUCTURE 5 (MIT Dept. of Econ., Working Paper No. 97-8, 1997) ("An economy that spends a large fraction of its productive resources on monitoring should have relatively low productivity, because monitoring is partly unproductive."); *id.* ("Monitoring is at some level a type of 'rent-seeking' activity: it enables the firm to reduce wages, transferring resources from workers to firms.").

[141] *See id.* at 3 (noting that structure of firms that requires high levels of monitoring will affect "state of the macroeconomy . . . because firms [will] spend considerable resources on monitoring, which could otherwise be used for directly productive activities. . .").

[142] *See* id. at 4. This relationship is also shown in the research revealing the rise in employees' theft rates after firms have cut employee wages. *See* Jerald Greenberg, *Employee Theft as a Reaction to Underpayment Inequity: The Hidden Cost of Pay Cuts*, 75 J. APPLIED PSYCH. 561, 561-68 (1990).

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monitoring, measured by the ratio of managerial to production workers, and wage rates. They note three forces that describe how wage rates interact with the need to monitor employees. The first force, what they call the "ex ante utility" effect, is described as the positive effect that high wages have on the incentives of workers to work conscientiously.[143] With high wages, workers are motivated by the wages themselves to work in such a way as to retain their jobs. The second force, the "ex-post reservation utility" effect, describes the notion that "[w]hen labor demand is high, workers know that being fired is not a harsh punishment because they can get a new job relatively easily."[144] Acemoglu and Newman state, "[t]his implies that firms will need to monitor their employees closely when labor demand is high,"[145] which tends to create a negative correlation between wage rates and the need for monitoring. The "cost of monitoring" effect, the third force they describe, acts like the first effect in that it also tends to reduce monitoring when wages are high. This effect is simply the fact that when firms monitor employees with other employees, including employees of managerial rank, the cost of monitoring will increase with the wage level. And "when the cost of monitoring is high . . . firms will want to use less of it."[146] Acemoglu and Newman show that "the first and third effects always dominate the second: when higher labor demand increases wages, the amount [of] monitoring is reduced."[147]

In using Acemoglu and Newman's work in the present context, one must note that they use wages as the independent variable, not the level of monitoring. In other words, they have asked whether levels of monitoring would be different if wages were higher or lower, not whether wages would adjust if the level of monitoring were changed. Nevertheless, their work is important in that it recognizes what appears to be negative correlation between levels of monitoring and wage levels. This makes sense. As they point out, monitoring costs are frequently dead-weight losses from a social perspective. Thus, if firms are able to decrease monitoring costs, for example through an increased concern for fairness and the building of trust within firms, then the economy as a whole will enjoy productivity increases.[148] Framed negatively, "an

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[143] ACEMOGLU & NEWMAN, *supra* note 140, at 4.

[144] *Id.*

[145] *Id.* (citing Carl Shapiro & Joseph Stiglitz, *Unemployment as a Worker Discipline Device*, 74 AM. ECON. REV. 433 (1984)).

[146] *Id.*

[147] *Id.*

[148] *See id.* at 5-6 (citing Susan N. Houseman, Special Issue, *Job Growth and the Quality of*

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economy that spends a large fraction of its productive resources on monitoring should have relatively low productivity because monitoring is partly unproductive."[149]

These macroeconomic productivity increases can be translated into wage rate increases for productive workers. This translation may indeed happen quite naturally as a function of market forces. With higher productivity, productive workers can demand higher wages. As the dead-weight losses of monitoring costs are decreased, the national surplus grows. This surplus adds to the "pot" that is allocated among the various factors of production such as capital and labor. Wage rates will thus tend to rise.[150]

Of course, one must be careful to avoid the common mistake of confusing association with causation. The mere fact of association is insufficient to show that lower levels of monitoring will necessarily result in higher wages and lower income inequality. Certainly more work needs to be done on this issue, but Acemoglu and Newman's work counsels cautious optimism that a causal relationship will be observed.

The second phenomenon, identified by David Gordon, as well as by Acemoglu and Newman, is that the lower manager-to-production worker ratio that derives from decreased levels of monitoring is in turn associated with lower income inequality.[151] This association has been noticed at macroeconomic levels across nations. For example, in the United States and the United Kingdom, the ratio of managers to workers is quite high — ranging up to 25% in the United States.[152] The ratio in the

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Jobs in the U.S. Economy, 1995 LABOUR S93) (explaining why, "despite the more intense wage pressure and the stagnant employment, output has grown at the same rate in Europe [which has a lower manager-to-production worker ratio than the United States] as in the U.S., and labor productivity has grown faster.").

[149] *Id.* at 5.

[150] Moreover, higher productivity generally leads to higher wages. *See* GREGORY N. MANKIW, MACROECONOMICS 52-53 (3d ed. 1997).

[151] DAVID M. GORDON, FAT AND MEAN: THE CORPORATE SQUEEZE OF WORKING AMERICANS AND THE MYTH OF MANAGERIAL DOWNSIZING 80-81 (1996) (noting decrease in percentage of national income going to production workers in United States, as corporate bureaucracy has grown); *id.* at 85 (comparing nations' corporate bureaucracies and real wage growth); *id.* at 100-01 (discussing growth of income inequality in United States).

[152] *See* ACEMOGLU & NEWMAN, *supra* note 140, at 2 tbl. "In 1994, according to the Bureau of Labor Statistics, 17.3 million private non farm employees worked in non production and supervisory jobs." GORDON, FAT AND MEAN, *supra* note 151, at 35 n.9. This was almost as many employees as those working in the entire public sector — federal, state, and local. *Id.*, at 35. In 1994, these supervisory employees were paid $1.3 trillion in total compensation, which "amounted for almost a quarter of all national income received by all income recipients." *Id.* at 35 n.12.

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United Kingdom is even higher.[153] Both nations also suffer from extremely high income inequality. In fact, these two countries are the two industrialized nations with the highest level of economic inequality in the world.[154] In contrast, Japan and Germany have much lower ratios of managers to workers. By 1989, the managerial burden in the United States had grown to more than three times the levels in Japan and Germany.[155] The countries of Japan and Germany also boast much lower income inequality.[156]

David Gordon explains why there is a relationship between high levels of monitoring and income inequality. Gordon explains that lower wages require "intensive managerial supervision of frontline employees" because employees who do not share in the "fruits of the enterprise" do not have the correct incentives to work as hard or as conscientiously as their managers would like.[157] The corporations "need to monitor the workers' effort and be able to threaten credibly to punish them if they do not perform."[158] In turn, this need for monitoring creates "top-heavy corporate bureaucracies," which "acquire their own, virtually ineluctable expansionary dynamic."[159] These bureaucracies cost money, and the most obvious place for the corporations to find this money is from the compensation of lower level employees.[160] As Gordon argues, "[t]he more powerful the corporate bureaucracy becomes, and the weaker the pressure with which employees can counter, the greater the downward pressure on production workers' wages."[161] In fact, among twelve leading advanced economies in a recent study,[162] the United States had the "slowest real wage growth and the top-heaviest corporate bureaucracies."[163]

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[153] *See* ACEMOGLU & NEWMAN, *supra* note 140, at 1 n.1 ("[W]ith the exception of the U.K., all other countries appear to have lower ratios of managerial workers in their workforces than the U.S. and Canada.").

[154] *See* MISHEL ET AL., *supra* note 71, at 391.

[155] GORDON, FAT AND MEAN, *supra* note 151, at 44.

[156] MISHEL ET AL., *supra* note 71, at 388-89 tbl. 7.13.

[157] GORDON, FAT AND MEAN, *supra* note 151, at 5.

[158] *Id.*

[159] *Id.*

[160] *See id.* at 78-83 (explaining why costs of managerial bureaucracy will tend to come from decreased wages rather than shareholder return).

[161] *Id.* at 6.

[162] The United States, Canada, Japan, France, Italy, the United Kingdom, Canada, Belgium, Denmark, Norway, the Netherlands, and Sweden. *See id.* at 26.

[163] *Id.* at 86. David Gordon found that the simple correlation coefficient between the "bureaucratic burden" and real wage growth is -0.50. If the somewhat anomalous case of the U.K. is excluded, the simple correlation is -0.78. *Id.* at 85.

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The importance of Gordon's point is to highlight the relationship between corporate governance mechanisms that would reduce the need for monitoring and a fairer distribution of income between workers and managers. When a corporate environment is characterized by a lack of trust among the various stakeholders of the firm, particularly workers and management, the firm will need to find and use resources to monitor the workers' performance. These resources will often come from the workers' themselves, in the form of lower wages. This in turn creates a downward spiral of wages and widens the gap between the economic fortunes of workers and of higher-level supervisors and managers. These trends show up in macroeconomic data. As Gordon points out, "there has been a massive income shift, within the total category of wage-and-salary employee compensation, from production and non-supervisory earnings to non-production and supervisory salaries."[164] Gordon notes that in 1973, just over 40% of total national income went to private non-farm production workers while the remainder of total employee compensation, a little over 16% of national income, was paid to supervisory employees.[165] Twenty years later, however, "top-level employees had immensely increased their share," to over 24% of national income, while the percentage of national income going to production workers fell to less than 35%.[166]

The story can be told from a positive perspective as well. When trust can be engendered among the stakeholders of the firm, the company will need to spend less money on monitoring and will need a smaller bureaucratic class of supervisors and managers. As noted above, this will improve the economic efficiency of the firm, which can inure to the employees' benefit through increased wages. It will also have the effect of easing income inequality because there will be fewer managers at the top end and more workers (making more) at the bottom end.

2. Fairness and Relational Contracts

Fairness engendered by changes in corporate governance will have beneficial regulatory effects through one additional mechanism, allowing for the creation of more "relational" contracts between employees and the firm. Relational contracts leave some terms and conditions unspecified. Because relational contracts require higher levels of trust, they are associated with higher levels of productivity, effort, and

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[164] *Id.* at 81.

[165] *Id.*

[166] *Id.* at 81-82.

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wage rates.

a. The Connection Between Relational Contracts and Fiduciary Duties

Much of traditional corporate law scholarship justifies the shareholder primacy norm by reference to the notion that the contract between shareholders and the firm is so "relational" that many of its most important terms are irreducible to specific contract terminology.[167] Shareholders hold residual claims, and it is difficult to foresee and resolve ahead of time all the potential contingencies that might affect those claims.[168] "The only promise that makes sense in such an open-ended relation," according to contractarians, "is to work hard and honestly."[169] To enforce such a vague promise, the shareholders receive in return the mechanisms of shareholder primacy — the norm of profit maximization, the fiduciary duties of management to the shareholders, and shareholder voting rights. These protections are deemed necessary to protect the shareholders from managerial shirking and self-dealing. The law finds it necessary (i.e., efficient) to impose these protections because that is how most firms would be organized explicitly but for obstacles to actual negotiation. That is, contractarians believe that these duties would be a product of explicit contracts if the parties "could have been bargained . . . at no cost."[170] As Fischel asserts, "[f]iduciary duties serve . . . as a standard form contractual term in every agency [corporate] contract."[171]

Contractarians view shareholders as the exclusive beneficiaries of managers' fiduciary duties because "shareholders face more daunting contracting problems than other constituencies."[172] Workers and other stakeholders do not need fiduciary duties in their contracts because their contracts can be specific enough to make the imposition of fiduciary duties inefficient.[173] Workers' rights can be specified, so workers must depend on contracts for their rights rather than invoking fiduciary claims.[174] If employees bargain for a certain contract with only limited

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[167] EASTERBROOK & FISCHEL, *supra* note 4, at 90; *see id.* at 93 ("[T]he reason for having a fiduciary principle . . . is the high cost of specifying things by (express) contract.").

[168] *See* Fischel, *Corporate Governance Movement*, *supra* note 26, at 1264.

[169] EASTERBROOK & FISCHEL, *supra* note 4, at 91.

[170] *Id.* at 92.

[171] Fischel, *Corporate Governance Movement*, *supra* note 26, at 1264.

[172] Macey, *Economic Analysis*, *supra* note 14, at 36.

[173] *See* EASTERBROOK & FISCHEL, *supra* note 4, at 90.

[174] *Id.* at 91; *see* Macey, *Economic Analysis*, *supra* note 14, at 36; Macey, *Externalities*, *supra* note 15, at 197.

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contractual protections from, for example, shocks in the labor market, "they ought not grumble if they are held to their bargains when business goes bad. Each investor must live with the structure of risks built into the firm.... it is all a matter of enforcing the contracts. And for any employee . . . that means the explicit negotiated contract."[175]

These contractarian assumptions about the power of workers to protect themselves through contract and market forces are certainly open to challenge, both on positive and normative grounds.[176] While it may be difficult for shareholders and managers to anticipate the various contingencies that might affect shareholders' claims, and to define contractual protections that would specify the rights and responsibilities of the parties in those situations, this will be true for workers as well.[177] Factors that could affect the relationship between workers and management are multitudinous. As Marleen O'Connor has persuasively written, the implicit and explicit contracts between management and workers are long-term, relational, and impossible to reduce to even a detailed writing.[178] O'Connor argues that the contractual relationship between employers and employees is doomed to vagueness because neither side "can credibly commit . . . [through] traditional explicit and implicit contractual safeguards" to a bargain in which the workers provide the highest level of effort in return for the best working conditions.[179] Indeed, there is a strong argument that the relationship between workers and the firm is even more relational than between shareholders and the firm. Fiduciary duties are thus arguably more important in the worker/management relationship than in the shareholder/management relationship.[180]

b. The Benefits of Relational Contracts

There is an implicit assumption among contractarians and its critics that fiduciary duties and other legal protections are second best to definitive, complete contracts. Fiduciary duties are only necessary, as the argument is made, because fully-termed contracts are largely impossible or highly costly to negotiate.

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[175] Macey, *Economic Analysis*, *supra* note 14, at 37.

[176] For a more detailed critique of the contractarian analysis on this point, see Greenfield, *Place of Workers*, *supra* note 14, at 313-21.

[177] *See* FEHR & GÄCHTER, *supra* note 1, at 10 ("The employment relationship, in particular, is characterized by incomplete contracts.").

[178] *See* O'Connor, *Human Capital Era*, *supra* note 19, at 918-19.

[179] *Id.* at 918.

[180] *See* Greenfield, *Place of Workers*, *supra* note 14, at 313-21.

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There is a growing body of scholarship, however, that argues persuasively that relational, incomplete contracts are more efficient and socially optimal. Such contracts enable parties to build trust and cooperation and to engage in reciprocal behavior, which often has materially positive effects in comparison to exchanges rigorously defined by contract.[181] Some research has shown that the presence of highly complete contracts in a business relationship "crowds out" trust and cooperation, which leaves both parties worse off.[182] In this view, fiduciary duties are not an ameliorative, a replacement for full contract terms. Rather, fiduciary duties and other mechanisms to build trust are the first-best strategy to maximize the return from an exchange, a series of exchanges, or a business relationship.

The implications of this insight are straightforward. The changes in corporate governance identified above, particularly the broadening of management's fiduciary duties to include workers and the creation of some mechanism to include workers in firm decision making, will build into corporate governance a concern for fairness that will engender trust and cooperation between workers and the firm. This in turn will make it possible for the contracts defining the employment relation to be less complete. And less complete, "relational" contracts are associated with both higher wages and higher levels of worker effort.

Fehr and Gächter have explained how this works. As they point out, "[t]he employment relationship, in particular, is characterized by incomplete contracts."[183] In practice, this means "labor contracts often take the form of a fixed wage contract without explicit performance incentives and in which workers have a considerable degree of worker discretion over effort levels."[184] In such a context, the "generally cooperative job attitude" of workers becomes crucial.[185] The elements of

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[181] *See* IRIS BOHNET ET AL., , MORE ORDER WITH LESS LAW: ON CONTRACT ENFORCEMENT, TRUST, AND CROWDING 1 (John F. Kennedy Sch. of Gov't, Harvard Univ., Faculty Research Working Paper No. 00-009, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236476 ("Trust can increase efficiency in the economic and political spheres.").

[182] *See* FEHR & GÄCHTER, *supra* note 1, at 2 (describing that explicit financial incentives may have counterproductive effects by destroying reciprocity-based cooperative responses of agents in principal-agent relationship); *see id.* at 15 (noting that there may also be explicit incentives that reduce willingness to cooperate voluntarily because explicit incentives may cause atmosphere of threat and distrust).

[183] *Id.* at 12.

[184] *Id.*

[185] *Id.* at 12-13 (citing WILLIAMSON, *supra* note 1).

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general job attitude — including "initiative" and "good judgment"[186] — are very difficult unambiguously to describe, assess, and enforce through explicit contracts. The importance of a cooperative job attitude "renders reciprocal motivations potentially very important in the labor process,"[187] and is probably as important as any condition that a labor contract can spell out successfully.

Several studies have indicated that employee effort tends to be higher when they are subject to contracts that are incomplete in important ways, such as contracts that do not contain explicit performance requirements.[188] In a typical study design, experimental employers are asked to offer a wage contract that stipulates a wage and a desired effort level. If the worker accepts the offer, she is free to choose any effort level without affecting the wage received. Any desired effort level above the minimum is simply unenforceable. If study participants were selfish, the workers would never choose an effort level above the minimum and thus the employers would never offer more than the minimum wage. The typical result in these experiments, however, is that neither participant acts selfishly. Generally, the relationship between wage offers and effort levels is highly positive.[189] If the employer offers a high wage, the employee responds with higher effort, even when the employer is unable to penalize the employee for offering less. "[I]n response to generous job offers, people are on average willing to put forward extra effort above what is implied by purely pecuniary considerations."[190] Because of this positive correlation, it may be more profitable for firms to pay higher-than-competitive wages.[191]

Thus, incomplete contracts are associated with higher wages. Fehr and Falk conducted a study in which both employers and employees could make wage bids; and if a bid was accepted, a labor contract was concluded.[192] Workers then had to choose an effort level, which the firm could neither demand nor enforce above a minimum level, making the

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[186] *Id.* at 13.

[187] *Id.*

[188] *See id.* at 13 (citing Ernst Fehr et al., *Reciprocity as a Contract Enforcement Device*, 65 ECONOMETRICA 833 (1997)).

[189] *Id.* at 11 (noting that in response to generous wage offers workers are "on average willing to put forward extra effort above what is implied by purely pecuniary considerations").

[190] *Id.* at 13.

[191] *Id.* at 17 (citing George A. Akerlof, *Labor Contracts as Partial Gift Exchange*, 97 Q.J. ECON. 543 (1982)).

[192] Ernst Fehr & Armin Falk, *Wage Rigidity in a Competitive Incomplete Contract Market*, 107 J. POL'Y & ECON. 106, 113 (1999).

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contract incomplete. In such a situation, employers were very reluctant to accept low wage offers from employees. Over time, wage rates consistently moved away from what a traditional economic theorist would deem competitive. "[E]mployers' high wage policy in the market with incomplete contracts was quite rational, because in this way they could sustain higher effort levels and increase profits relative to a low wage policy."[193] These studies indicate that the presence of reciprocity generates relatively high wage levels even despite competition among workers for scarce jobs.[194] In contrast, fully-termed contracts are associated with lower effort levels, probably because explicit contracts "crowd out positive reciprocity, and perhaps even induce negative reciprocity."[195] Thus, the presence of reciprocity renders implicit contracts more profitable and explicit contracts less profitable than what a model based on self-interest would predict.[196]

This research into the benefits of relational, incomplete contracts offers an additional reason to be optimistic about the potential regulatory effects of using fairness in corporate governance to engender trust and cooperation within the firm. If workers believe that they are being fairly treated and that their interests are being protected through the structure of the firm, they will have little cause to insist on fully-termed contracts. Rather, they and other parties to the corporate "contract" can rely on the positive reciprocity of the others, which will in turn improve the fortunes of the firm as a whole and increase wage rates in particular.

IV. THE SECOND POWER OF CORPORATE LAW: FACILITATING THE EQUITABLE SHARING OF SURPLUS

The second way corporate law can have a positive effect on the public policy issues of stagnant wages for working people and income inequality is that corporate law can facilitate more equitable sharing of the wealth created by the firm. One might believe that the management of the firm is essentially a referee allocating the firm's surplus among the firm's stakeholders[197] or that management is an agent of the shareholder-owners and is meaningfully constrained by a legal duty to maximize profits. Under either model, changes in corporate governance could bring about substantial improvements in the relative and absolute

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[193] FEHR & GÄCHTER, *supra* note 1, at 18.

[194] *Id.* at 16.

[195] *Id.* at 21.

[196] *Id.* at 22-23.

[197] *See* Blair & Stout, *Team Production Theory*, *supra* note 101, at 284.

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allocation of the corporate surplus to workers. These improvements would be achieved if policy makers adjusted corporate governance in ways that make it more likely that management will share the surplus more equitably. This Part describes research that has explored the strength of altruism and reciprocity in economic relationships and studied the behavioral influences on these phenomena. Subsequently, the implications of this research for corporate governance are explored.

A. Reciprocity and "Sharing" in Economic Relationships

1. BLE Experiments

Contrary to what much traditional economic theory assumes, a growing number of studies and experiments show that even in economic exchanges people are not purely self-interested. Two kinds of experiments, ultimatum and public good games, provide insights that are particularly relevant to the discussion here.[198]

a. Ultimatum Games

The ultimatum game is an experiment that is typically played with two parties.[199] The experimenter gives the first person, the proposer, a pot of real or fictional money. The proposer must propose an allocation of the money between herself and the other party, the responder. The proposer can keep all the money for herself, give the responder a little, or give the responder a lot. In response, the responder can only make one move. She can either accept or reject the deal. If the responder accepts the deal, each party will receive the amount the proposer allocates to her. If the responder rejects the deal, neither party will receive anything.

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[198] *See* Robyn M. Dawes & Richard H. Thaler, *Cooperation*, *in* THE WINNER'S CURSE 9-11 (1992) (describing public goods games); Jolls et al., *Behavioral Approach*, *supra* note 2, at 1489-93 (describing ultimatum games).

[199] The scholarship on ultimatum games is extensive. The Jolls, Sunstein, and Thaler article cited above is probably among the most accessible introductions for the legal scholar. Jolls et al., *Behavioral Approach*, *supra* note 2. Also, there are numerous articles with more rigorous descriptions and analyses from an economic perspective. *See, e.g.*, Gary E. Bolton, *Anonymity versus Punishment in Ultimatum Bargaining*, 10 GAMES & ECON. BEHAV. 95 (1995); Rachel T.A. Croson, *Information in Ultimatum Games: An Experimental Study*, 30 J. ECON. BEHAV. & ORG. 197 (1996); David Dickinson, *Ultimatum Decision-Making: A Test of Reciprocal Kindness*, 48 THEORY & DECISION 151 (2000); Glenn W. Harrison & Kevin A. McCabe, *Expectations and Fairness in a Simple Bargaining Experiment*, 25 INT'L J. GAME THEORY 303 (1996); Vesna Prasnikar & Alvin E. Roth, *Considerations of Fairness and Strategy: Experimental Data from Sequential Games*, Q.J. ECON. 865 (Aug. 1992); Ramzi Suleiman, *Expectations and Fairness in a Modified Ultimatum Game*, 17 J. ECON. PSYCH. 531 (1996).

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Typically, neither party knows the identity of her counterpart, and the parties play the game against each other only once, so reputational effects and the possibility of retaliation are eliminated as factors.

According to traditional economic theory, there is only one rational outcome for the game. Whatever the proposer offers, as long as it is greater than nothing, it is rational for the responder to accept the deal. The economically rational offer for the proposer to make is the smallest unit of currency available because it is expected that the responder will accept any offer greater than zero. But "[t]his turns out to be a very bad prediction about how the game is actually played."[200] The numbers vary, but it is quite common for responders to reject offers of less than twenty percent of the total amount available. In fact, the average minimum amount that responders say they would accept is between 20% and 30% of the total sum.[201] In other words, responders would sometimes prefer no deal rather than an unfair one, even if the unfair deal would make them better off financially.[202]

Interestingly, proposers tend to offer somewhere between 40% and 50% of the pot to the responders.[203] This effect could be based on a belief that the responder is not a rational economic actor, so the amount the proposer offered reflects a judgment about what the responder's reservation price is likely to be. On the other hand, the proposer's offer might be based on an altruistic motive. The proposer may suggest an allocation based not on a rational judgment about what the proposer would likely accept, but on the basis of what would be a fair amount to allocate to the responder. The latter explanation gains credence from data showing that participants' behavior is affected by their relationships with the other parties in the game. If the participants know and care about the other players of the game, their bargaining behavior is more likely to be fair than economically rational.[204]

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[200] Jolls et al., *Behavioral Approach*, *supra* note 2, at 1490.

[201] *Id.* Fehr and Gächter summarize the major studies saying that "proposals that give the Responder less than 30 percent of the available sum are rejected with a very high probability." FEHR & GÄCHTER, *supra* note 1, at 5.

[202] Fehr and Gächter report that this kind of "negative" reciprocity "is observed in a wide variety of cultures, and high monetary stakes do not change or have only a minor impact on these experimental results." *Id.*

[203] Jolls et al., *Behavioral Approach*, *supra* note 2, at 1490.

[204] *See* Jason F. Shogren, *Fairness in Bargaining Requires a Context*, 31 ECON. LETTERS 319, 322 (1989) ("A bargainer will be fair to the group with whom his loyalties lie."); Richard Thaler, *The Ultimatum Game*, 2 J. ECON. PERSP. 195, 205 (1988) (noting that more generous offers in ultimatum game were made between bargainers within same group, while least generous offers were made across groups); *cf.* Roy Radner & Andrew Schutter, *The Sealed-Bid Mechanism: An Experimental Study*, 48 J. ECON. THEORY 179, 209-10 (1989) (describing

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Note the presence of "good" behavior as well as "bad" or spiteful behavior. The proposer offers more than she needs to offer, but the responder rejects deals that would benefit both parties if the offer is too unfair. The issue, of course, is what is "fair." In the context of ultimatum games, "[p]eople judge outcomes to be 'unfair' if they depart substantially from the terms of a 'reference transaction' — a transaction that defines the benchmark for the parties' interactions."[205] If parties are dividing an amount of money that neither party is more entitled to than the other, such as when the experimenter in the game provided the money, the reference transaction is typically an even split among the parties, or close to it.[206] If there is some reason both parties consider one party to be more entitled to the money, then the reference transaction favors the person the parties see as having a greater entitlement.

b. Public Goods Games

Another type of experiment that demonstrates the power of altruism in economic settings is the so-called "public goods" games. One version provides a group of between four and ten subjects with some amount of money. The subjects can keep or invest the money in a public good. This part of the game is often called a "group exchange."[207] Money that subjects invest in the group exchange is multiplied by some factor and then distributed to all the subjects in the game, regardless of whether they contributed to the group exchange or not.[208] The group as a whole is better off financially the more everyone contributes, but each individual's share of the total group contribution is less than the amount they invest, unless everyone invests. Each individual is always better off if they contribute nothing, because each player can retain the money they refuse to contribute but share equally in the money contributed by other members of the group. Accordingly, the economically rational strategy is for each individual to retain their money and hope other players invest

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non-ultimatum game bargaining experiment and noting success of face-to-face bargaining in achieving transactions, but noting high variance in prices formed, suggesting that "while the face-to-face mechanism may exhibit high efficiency levels, it may be lacking in terms of equity").

[205] Jolls et al., *Behavioral Approach*, *supra* note 2, at 1496 (citing Daniel Kahneman et al., *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728, 729-30 (1986)).

[206] *Id.*

[207] Dawes & Thaler, *supra* note 198, at 10.

[208] For the game to work correctly, the multiplication factor must be greater than one but less than the number of people in the experiment. For example, if there are five people in the group, the factor that the investment will be multiplied by will be two, three, or four.

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their money in the public good. But these experiments reveal that people tend to reject the economically rational choice.

The results of single play, one shot, public goods experiments commonly show that a substantial number of people contribute, and that the public good typically receives 40% to 60% of the total money available in the game.[209] When the experiment is repeated a number of times the results become more complicated. Some researchers have found that rates of cooperation fall over the course of the repeated games.[210] Others have shown that in certain circumstances players increase the amounts they contribute to the group exchange over time. Unsurprisingly, the key to increased group contributions is the actions of others in the group. If others in the group cooperate, then each individual tends to cooperate, and the amount players contribute to the public good approaches the optimal amount. If others in the group do not cooperate, individuals tend to reduce their own level of cooperation. In other words, "people have a tendency to cooperate until experience shows that those with whom they're interacting are taking advantage of them."[211] No one wants to be a chump.

Another version of a public goods experiment tests the existence and strength of altruistic sentiments.[212] In one version, seven strangers each receive $5. If enough people contribute their $5 to the public good (either three or five, depending on the experiment), then every person in the group receives a $10 bonus, regardless of whether they contributed. Thus, if the required number of players contributes, each contributor leaves with $10 and each non-contributor leaves with $15. If the number of players who contributed is less than required, non-contributors leave with $5 and contributors receive nothing. Even in this game, where each individual can expect to receive more money if they do not contribute than if they do, players contributed about 50% of the time.[213]

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[209] *Id.* at 10.

[210] *See id.* at 11

[211] *Id.* at 14.

[212] *Id.* at 16 (citing Robyn Dawes et al., *Organizing Groups for Collective Action*, 80 AM.. POL. SCI. REV. 80, 1171-85 (1986)).

[213] *Id.* at 16. These contributions increased under certain changed conditions, such as offering those who contributed their money back if too few people contributed or offering everyone in the group the same total amount, for example, $10, if enough people contributed so that free riders did not end up with more (although free riders would still end up with more money if too few people contributed).

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2. Behavioral Influences on Sharing and Reciprocity

These experiments are important for offering analytical strength to the common sense notion that individuals do not act solely on the basis of financial considerations. People certainly care about material goods, but they also act on the basis of other impulses, both positive and negative. These experiments are particularly helpful because they identify the influences on the parties that foster the tendency to share, cooperate, and act altruistically.

Experimenters have discovered that one of the most powerful methods for inducing cooperation in these games is to allow people to talk to one another. In a series of twelve public goods experiments, discussions among participants were allowed, and the "effect of this discussion was remarkable."[214] In every one of the experiments, the subjects used the discussion period to specify a group of people who were designated to cooperate, either by lottery or through volunteering. In each of the twelve experiments, the required number of players contributed to the public good.

Why would discussion be so powerful? First, discussion triggers ethical concerns. Jon Elster suggests that group discussions in public goods situations yield arguments for group-regarding behavior and these arguments have an effect on those who hear them and on those who make them.[215] It is difficult for people in a group setting to argue in favor of bald self-interest, even when it is economically rational to do so.

Second, discussion increases group identity. A person who identifies as a member of a group receives personal satisfaction from benefits that flow to other members. Indeed, the power of group identity has been demonstrated in a number of experiments, and "group identity appears to be a crucial factor in eschewing the dominating [economically rational] strategy."[216]

Third, discussion gives people the opportunity to make promises about their future behavior. In public goods games, when discussion was permitted, it was "very common for people to make promises to contribute."[217] People in these experiments reported that they felt bound to keep their promises and believed that others were bound by their

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[214] *Id.* at 17 (citing Alphons van de Kragt et al., *The Minimal Contributing Set as a Solution to Public Goods Problems*, 77 AM. POL. SCI. REV. 112 (1983)).

[215] Jon Elster, *The Market and the Forum: Three Varieties of Political Theory*, *in* FOUNDATIONS OF SOCIAL CHOICE THEORY: STUDIES IN RATIONALITY AND SOCIAL CHANGE 103 (Jon Elster & Aanund Hylland eds., 1986).

[216] Dawes & Thaler, *supra* note 198, at 18.

[217] *Id.* at 19.

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promises. The power of promises broke down when some group members failed to make promises. If everyone in the group promised to cooperate, the rate of cooperation was substantially higher than in other groups. Although if participants failed to promise to cooperate, there was no relationship between each person's choice to cooperate and whether even they themselves had made a promise.[218] Perhaps this is simply another way to say that group identity matters a great deal, because it is reasonable to believe that "universal promising creates — or reflects — group identity."[219]

"Reciprocal altruism" is a popular explanation for parties' willingness to cooperate in public goods games and in the real world.[220] People tend to reciprocate — "kindness with kindness, cooperation with cooperation, hostility with hostility, and defection with defection."[221] Thus, a party who refuses to contribute and takes advantage of others' investments in the public goods game — or free rides in other situations more generally — may not be using the best long-term strategy because others will negatively react to their refusal to cooperate. In contrast, cooperation has a high probability of being reciprocated with cooperation and may thus be the most beneficial strategy. While traditional economic theory has problems explaining or predicting this phenomenon, people have a pronounced intuitive understanding of it.[222]

The bottom line is that people are frequently motivated by their sense of connection to others, fairness, and even duty. Additionally, the games reveal that there are several ways to activate these cooperative sensibilities: facilitating discussion; increasing group identity among the actors; and allowing or encouraging the actors to make commitments and promises to one another.

B. Implications of Behavioral Incentives to Share and Cooperate for Corporate Governance

It is of course prudent to be skeptical of efforts to extrapolate real world conclusions from psychological and economic experiments involving individuals in limited and controlled testing situations. The circumstances of large institutions such as corporations are varied,

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[218] *Id.*

[219] *Id.*

[220] *Id.* at 12 (citing ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984)).

[221] *Id.*; *see* Dickinson, *supra* note 199, at 153 ("results suggest that individuals will be fair and kind to those that show them kindness, and unkind to those that show them malice").

[222] *See* Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U. L. REV. 333, 333-36 (2001).

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frequently inscrutable, and difficult to analyze or comprehend. Nevertheless, corporate law has long been informed by economic scholarship and analysis, much of which suffers from the defects of being either too theoretical or too detailed and mathematical. The insights of the psychological and behavioral economic literature add significant insights to the contributions of economic theory. On the basis of the research regarding reciprocity and sharing, there are several proposed changes to corporate governance law that policy makers should consider to effect real changes in stagnant wages and income inequality.

1. Relaxation of the Profit Maximization Norm

The directors of a corporation, those in control of the corporation's profit, can be viewed as the proposers in a complicated ultimatum game. The directors control a certain pot of money, and they have the option of allocating it among the firm's various stakeholders. Each stakeholder can make it difficult for the enterprise to succeed by withdrawing its support. The directors' main goal is to allocate the corporation's resources so none of the shareholders withdraw from the firm.[223]

Also, the ultimatum game implies that without any legal prohibitions, the directors would tend to consider norms of fairness and just desert in allocating the corporation's surplus. As the data from ultimatum games show, people tend to allocate resources according to a hypothetical reference transaction determined in light of what is fair and what each participant contributed to the pot. The data show that what the participants consider to be the reference transaction also depends on the level of group identification between the proposer and the respondent. It is impossible to know exactly what this "reference transaction" would look like in any particular corporation, and much more difficult to define what its contours would be across any number of corporations. But, ultimatum game experiments suggest that directors, unconstrained by laws of profit maximization, would consider the fairness of their decisions. For example, directors would set employee compensation not only on the basis of a consideration of what would ensure the employees' continued commitment to the firm but also on the basis of fairness.

[223] *Cf.* Blair & Stout, *Team Production Theory*, *supra* note 101, at 283 (arguing that directors seek to maintain corporate coalition).

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But under existing law, directors may not take such considerations of fairness into account, at least not easily. Because of the shareholder primacy norm, existing corporate law affirmatively discourages (and may even make actionable) the directors taking into account any considerations of fairness, equity, just desert, or group identity, other than those necessary to maximize the shareholders' wealth. Essentially, corporate law issues the following command to managers and directors: "Allocate the 'pot' in the corporate ultimatum game in such a way as to maximize the expected value of the amount retained for the corporation. Do not give any more to the responder than is necessary to ensure the deal goes forward." If directors increase wages because they believe the increase is fair rather than because the increase will ensure employee commitment, the directors have violated their fiduciary duties to maximize corporate wealth.[224] A number of states have authorized changes to corporate law to soften the effect of the traditional profit maximization rule. These stakeholder statutes, which release directors from the legal obligation to maximize profits, ostensibly create a legal context for directors to consider norms of fairness and altruistic urges when they allocate the corporation's surplus. As Lawrence Mitchell has suggested, existing law has allowed corporate managers to consider themselves bound by the "role morality" of the profit maximization norm.[225] Stakeholder statutes eliminate the legal duty that gives rise to the limited role morality that requires directors to allocate the smallest amount possible to non-shareholder stakeholders. Free of such role morality, directors and managers would likely make judgments for the firm using a broader, more natural style of decision making.[226] From

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[224] Directors might be able to avoid liability by lying about the reasons for their decision. If they say that the wage increase was in the long-term interests of the firm, the decision would likely be protected by the business judgment rule. *See* Greenfield & Nilsson, *supra* note 3, at 838-40. But if they were honest about their reasons, then the decision would likely be voided as contrary to the profit maximization norm. In any event, it is not correct to say that the legal norm has no effect even if easily avoided. One thing that is clear in the research of individuals' adherence to law is that the fear of liability is only one of many reasons why people obey the law. It may in fact be one of the weakest reasons for obedience to law. *See* Tyler, *Procedural Fairness*, *supra* note 122, at 220 (punishment is "at best [] a minor influence on law breaking behavior").

[225] Mitchell, *Cooperation and Constraint*, *supra* note 19, at 522.

[226] *See* Greenfield & Nilsson, *supra* note 3, at 816 (arguing that profit maximization norm asks corporate managers to make decisions in impoverished, irrational way); Dale T. Miller, *The Norm of Self-Interest*, 54 AM. PSYCH. 1053, (1999) (noting that "norm exists in Western cultures that specifies self-interest both is and ought to be a powerful determinant of behavior" and that this norm "influences people's actions and opinions as well as the accounts they give for their actions and opinions").

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what we know about human nature from ultimatum game experiments, one would predict that in states governed by stakeholder statutes a larger percentage of the corporate surplus goes to workers than would be the case in states without such stakeholder statutes. The human nature revealed in ultimatum games suggests that in states with stakeholder statutes corporations will distribute more of their surplus to workers than in states governed by the traditional rule of profit maximization.

Thus, it is reasonable to expect that a weakening of the profit maximization norm, through stakeholder statutes or other mechanisms, would result in workers receiving more of the corporate surplus than they currently receive. Without the legal duty to look after the interests of shareholders only, directors and managers will be able to allocate the corporate surplus with an eye to principles of fairness, equity, and just desert, which they are legally prohibited from considering now.[227] If workers receive more of the corporate surplus their incomes will rise, and the difference between their incomes and the incomes of their managers and that of the shareholders will decrease.[228] Thus, if policy makers want to make real progress on the problems of stagnant wages and income inequality, they should institute changes in corporate governance to weaken the legal duty of corporate actors to maximize profits for shareholders.

A recent study conducted by Marianne Bertrand and Sendhil Mullainathan supports this argument.[229] They studied the impact on wages of state anti-takeover legislation, which many states passed during the 1980s. On the basis of their findings, they argue that anti-takeover legislation decreased the threat of takeovers and, thus, expanded managerial discretion. Using firm-level data, Bertrand and Mullainathan found that anti-takeover laws increased non-management

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[227] This view that the law constrains the behavior of directors and managers is consistent with the writings of Lawrence Mitchell. *See, e.g.*, LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT (2001).

[228] These assertions would be weakened if it could be shown that the total amount of corporate surplus would fall appreciably if profit maximization were weakened. That is, even if workers captured a greater percentage of a smaller surplus, their total income might fall. This possibility is addressed below, where this Article argues that changes in corporate governance would actually be an efficient method of making these policy gains, because there is reason to expect corporate surpluses to increase under these policies rather than fall.

[229] Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999).

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wages 1% to 2% or about $500 per year.[230] This study bolsters the proposition that managers, if given more legal discretion to allocate the firm's surplus without fear of legal challenge, would allocate more to labor.[231]

2. Other Changes in Corporate Governance

The data from ultimatum and public goods games is useful in evaluating other proposed changes in corporate governance. The games reveal that the urge to "share" and the tendency to create public goods are greater when there is group identity among the participants, participants can discuss the game, and commitments and promises are

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[230] *Id.* at 535.

[231] The proposition that a fiduciary duty to one party weakens the ability to be fair to other parties has not been widely tested in experimental settings. One relevant test was conducted a number of years ago by Helmut Lamm. *See* Helmut Lamm, *Group Related Influences on Negotiation Behavior: Two-Person Negotiation as a Function of Representation and Election, in* BARGAINING BEHAVIOR 284 (Heinz Sauermann ed., 1978). Lamm conducted experiments testing how negotiation behavior would be affected when both negotiators acted for others as representatives rather than acting only for themselves. Lamm reported that "elected representatives, as compared to non-representatives, negotiated with greater toughness but less success: negotiations were broken off more frequently, less profit was obtained, and [their] (own) satisfaction was lower. Thus, social role demands, while presumably creating pressure for superior outcomes, had the 'ironic' effect of inferior outcomes." *Id.*

Peter Kostant and I are presently preparing a series of empirical tests of the possible efficacy of stakeholder statutes, using ultimatum game experiments. *See* Kent Greenfield & Peter Kostant, *An Experimental Test of Fairness in Bargaining Among Stakeholders of Corporate Organizations* (work in progress). In one iteration of the experiment, the game will be run in the traditional manner, with both proposers and responders acting on their own behalf. In a second iteration, the facilitator will instruct the proposers to consider themselves a fiduciary agent of some third party and act to maximize the return to that third party. In pilot experiments Kostant and I have conducted thus far, the proposers have offered less to the respondents when they were constrained by a fiduciary duty. That finding, if substantiated in further experiments, would be consistent with the argument that the profit maximization norm affects the allocation of the corporate surplus between capital and labor. Perhaps more interesting, in some pilots the responders' reservation prices increased when they knew the proposers owed a fiduciary duty to a third party. Thus, fewer deals were reached. One hypothesis for this result is that once the deal becomes less relational, both parties become tougher negotiators. If, for example, workers believed that the board was an agent of the shareholders rather than a referee, then the workers will deal with the firm on more of an adversarial basis. Thus, in a regime in which the board is an agent of the shareholders, the workers will tend to demand a higher wage than in a regime in which the board is a referee. Of course, these pilots do not themselves provide good data. These results are preliminary and suggestive only. Note, however, that they are consistent with Lamm's results described above and do seem to indicate that an agent's fiduciary duty to one party will decrease altruistic impulses to those with whom the agent does not owe a duty and may decrease the level of trust that others who are not the beneficiaries of the duty have vis-a-vis the agent.

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allowed. The issue is whether these behaviors can be encouraged within corporations and whether changes in corporate law can encourage these cooperative behaviors.

First, consider that existing corporate law doctrine hardly encourages any of these behaviors. The shareholder primacy norm encourages managers to identify with shareholders rather than employees, and the thought that shareholders who hold a company's stock for mere months, weeks, or even hours will care about, much less identify with, the company's workers seems unlikely if not ridiculous.[232] Similarly, there is nothing in the fabric of corporate law that would encourage real discussions between management and workers or other constituents. Labor law requires bargaining with duly elected union representatives, and even unenlightened managers recognize situations necessitating a discussion of the firm's business plans with its employees. But, it is the rare and exceptional company in which the top management appears genuinely to identify with the company's employees. Those examples can best be explained not by reference to law or attention to the market, but instead to idiosyncratic histories, unique personalities of senior managers, and often a distinct effort to shield themselves from the legal and market pressures toward shareholder primacy.[233] Under the current regime, some managers and directors in some companies may identify with employees, talk with employees, and make commitments to employees. They do so, however, not *because* of corporate law but *in*

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[232] For a review of the high level of turnover in share ownership in today's capital markets, see MITCHELL, *supra* note 227, at 5.

[233] My own experience colors my view here. During the 1980s, I worked in the Community Affairs Department of Levi Strauss & Co. (LS & Co.). LS & Co. had and still has a reputation for social responsibility and concern for its employees. *See* Jane Palley Katz, *Levi Strauss & Co.: Global Sourcing (A)*, Harv. Bus. Sch. Case Study (1995); Jane Palley Katz, *Levi Strauss & Co.: Global Sourcing (B)*, Harv. Bus. Sch. Case Study (1995) (discussing LS & Co.'s process to make decision to withdraw from doing business in China). Even in times of economic hardship, when the company closed some of its facilities to maintain its competitiveness, the company went out of its way to do so in a way that revealed real concern for its employees. For example, long before federal law required advance notification of plant closings, LS & Co. had a company policy of announcing such layoffs far in advance. Another powerful way the company's concern for its employees was revealed was the practice of senior management going to the plants to be closed and announcing the shutdowns themselves, rather than leaving it to lower management to announce. This made the damages caused by the plant closings concrete to the managers who had had to make the decisions to close the plants. *Cf.* MITCHELL, *supra* note 227, at 64 (arguing that one reason companies can commit wrongs easily is because managers can insulate themselves from effects of their decisions.) Importantly, LS & Co. underwent a leveraged buy-out in the mid-1980s so it could become privately held and insulate itself from market pressures that would make it more difficult to do business in accordance with its beliefs about social responsibility.

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spite of corporate law.[234]

Policy makers could successfully adjust corporate law to encourage the behaviors of group identification, discussion, and the facilitation of commitment. Two of the proposed changes in corporate law discussed earlier in this Article, enacting a fiduciary duty of the board to workers and adding worker representatives to corporate boards, could be expected to have beneficial effects on the policy problems of wage stagnation and income inequality.

Enlarging management's fiduciary duties to include a concern for workers would require managers to take workers' interests into account when making decisions. A fiduciary duty is in many ways an amorphous obligation. At the very least, however, it would require managers to tell the truth to employees and to disclose information material to them. In essence, a fiduciary duty requires basic and reliable communication. Moreover, because a fiduciary duty would require directors to consider workers' interests in making important decisions, directors would have to learn what those interests are. In fulfilling the analogous duty to shareholders, directors have a duty of investigation and full consideration of all relevant information.[235] In fulfilling a duty to the firm's employees, investigation and consideration would undoubtedly require directors to learn what the workers care about. Thus, discussion would be crucial in satisfying the directors' fiduciary duty.

Commitments among managers and employees would also be facilitated. Directors' obligations to be truthful to employees would lead directors to make believable commitments and promises, because untruths would be actionable as fraud.[236] Firms that want to make believable commitments to their employees could, in effect, bond the reliability of the commitments through law. Also, it would be more costly for a corporation to mislead employees about any commitments the firm appeared to be making to employees.

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[234] Other areas of law also make it difficult for companies and their managers to act responsibly toward employees. As I have analyzed elsewhere, because federal law does not make it unlawful for corporations to make fraudulent representations to their employees, the reasonable response for employees is to assume that any commitment made by employers is unreliable unless otherwise bonded (which is expensive). Thus, the law affirmatively disadvantages those companies that seek to make commitments to employees. *See* Kent Greenfield, *The Unjustified Absence of Federal Fraud Protection in the Labor Market*, 107 YALE L.J. 715, 743-44 (1997).

[235] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (holding that directors must be informed in order to satisfy duty of care).

[236] *See* Greenfield, *Unjustified Absence*, *supra* note 234, at 787.

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Similarly, including worker representatives in the highest decision making body of the firm would also facilitate communication among management, workers, and shareholders. Co-determination would make it possible for the board itself to become the situs of discussion and negotiation among the principal stakeholders of the firm. Assuming the BLE experiments reveal real phenomena applicable in corporate settings, discussion at the level of the board would likely result in the corporation allocating more surplus to labor. Moreover, discussion would facilitate commitments among the various stakeholders and would magnify the positive effects flowing from commitments.

Whether a fiduciary duty and co-determination would produce a group identity among managers and employees is difficult to predict. The divide between senior executives and lower level employees is quite wide[237] and the goal of developing this identification may be elusive indeed. But, as the ultimatum and public goods experiments reveal, the kind of group identity that increases sharing in ultimatum games and contribution to a joint surplus in public goods games can develop remarkably quickly.[238] One would expect that the kind of discussion, information sharing, and consideration of interests that would arise from a fiduciary duty or from working together to make decisions for the firm would indeed cause directors and managers to identify more with the firm's employees, at least over time. Such identification, if achieved, would likely have real implications for the level of labor compensation. If managers consider themselves part of a team with workers rather than their adversaries, it is inevitable that managers will use their discretion within market and legal conditions in part to raise workers' compensation.

V. NOTES ON THE EFFICIENCY OF CORPORATE LAW TOOLS IN ACHIEVING REGULATORY OBJECTIVES

The value of proposed regulatory initiatives depends not only on their power to achieve the policy objectives, but also on their efficiency in achieving such objectives. The evaluation of efficiency is most meaningfully a comparative judgment. The question is whether the

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[237] The typical CEO earns over 400 times that of the average worker. Fischer, *supra* note 74, at 1.

[238] *See* Roberick M. Kramer et al., *Collective Trust and Collective Action: The Decision to Trust as a Social Decision*, *in* TRUST IN ORGANIZATIONS 357 (Roderick M. Kramer & Tom R. Tyler eds., 1996); Blair & Stout, *Trust*, *supra* note 9, at 44 (noting that group identity can be easily fostered).

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initiative satisfies the objectives more effectively and at a lower cost than other possible regulatory options. For the purposes of this Article, the key question is whether changes in corporate governance will likely be more effective in increasing wages and decreasing income inequality than other policy tools now available.

A thorough comparison of corporate law tools with other possible regulatory initiatives is beyond the scope of this Article. Note, however, that stagnant wages for hourly-wage workers and pronounced income inequality are problems that appear to be remarkably intractable. While other policy initiatives should hardly be abandoned, the durability of the problems implies that new initiatives, perhaps from corporate law, could prove at least as effective.[239]

In addition, it is likely that changes in corporate governance would be particularly cost effective in achieving the policy objectives at issue. In contrast to other policy tools aimed at raising wage rates and decreasing income inequality, the corporate law initiatives suggested here have the potential to engender corollary benefits to the firm and to other stakeholders because they depend in large part on reciprocity. Therefore, the costs of these efforts will be mitigated by the presence of these corollary benefits. While other regulatory initiatives aimed at these problems (increases in the minimum wage, for example) are essentially redistributive strategies only, changes in corporate governance are likely to be both effective and efficient in part because they expand the corporate surplus rather than simply redistribute it.

Consider the first power of corporate law, the mechanism of fairness explored above. The argument is that the suggested changes in corporate governance will likely weave a respect for fairness into the fabric of the firm. In turn, fairness will build trust, which will decrease the need for monitoring and allow more relational contracts. Lower monitoring and relational employment contracts are both associated with higher wage rates for workers. Therefore, changes in corporate governance will be effective in addressing public policy problems.

Note that both effects, lower monitoring and relational contracts, will tend to create beneficial effects for other stakeholders and the firm

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[239] Income inequality may be particularly intransigent. Though many people might assume that improving education has positive effects on economic equality, recent research shows the contrary. In developed countries, income equality is negatively correlated with average educational attainment. *See* Daniele Checchi, *Does Educational Achievement Help To Explain Income Inequality?* (unpublished manuscript, on file with author) (noting that average educational achievement is positively related to income inequality in developed countries).

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generally. Trust created by fairness improves workers' compliance with firm rules, which lowers firm costs and improves productivity, which in turn raises corporate profits.[240] Some monitoring costs are simply deadweight losses.[241] Trust allows companies to avoid these costs. Indeed, it is likely that the procedural justice perspective offers a much more efficient way to encourage conscientious employee behavior. This perspective "suggests that people will comply with, and more strikingly, defer to rules when they feel the rules and authorities within their organizations are following fair procedures when making decisions."[242] To be sure, fair process is not free. There may be material costs to the firm of complying with guidelines of procedural fairness. But Tyler's studies indicate that these costs are likely to be small in comparison to those borne in organizations that depend on the instrumental perspective of rewards and penalties.

The reciprocity that relational agreements make possible is beneficial to both workers and firms. Incomplete contracts encourage workers to respond to higher wage offers with higher effort levels.[243] This result allows Fehr and Gächter credibly to insist that implicit, relational contracts are more profitable for firms than complete, fully termed contracts.[244] Explicit contracts destroy positive reciprocity, making everybody worse off.[245]

Consider also the second power of corporate law, the ability of corporations to facilitate the sharing of the corporate surplus in an equitable way. Though ultimatum game experiments would seem to imply that the corporation's stakeholders are engaged in a zero-sum transaction, stakeholders can also be analogized to participants in a complex public goods game. As in the experimental context, the value of

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[240] *See* discussion *supra* Part IV.C.1.

[241] If gaining the obedience, conscientiousness, and honesty of employees depends on material rewards or penalties, it will be unlikely that organizations will be able to encourage such behavior at low cost. *See* Tyler, *Psychological Perspectives, supra* note 123, at 12. Rewards are by definition costly, and credible penalties require the surveillance of monitors and some process through which to impose them. Moreover, as Tyler reminds us, these instrumental strategies are not so effective in any event. "Deterrence strategies . . . are consistently found to have, at best, a minor influence on rule-breaking behavior." *Id.* at 3 (citing Tyler, *Citizen Discontent, supra* note 122; Tyler, *Procedural Fairness, supra* note 122; Tyler, *Compliance with Intellectual Property Laws, supra* note 122).

[242] Tyler, *Psychological Perspectives, supra* note 123, at 17.

[243] FEHR & GÄCHTER, *supra* note 1, at 10-12 (arguing that wage increases translate into productivity improvements as long as wage increases are not based on performance reward).

[244] *Id.* at 21.

[245] *Id.*

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the firm is maximized when all the stakeholders contribute. Yet it is not rational for any stakeholder to contribute if they believe the other stakeholders will not contribute.[246]

In summary, the changes in corporate governance intended to bring about discussion, group identity, and commitments among the firm's stakeholders will allow them to build trust and thereby overcome the collective action problems inherent in using the firm to create wealth. Again, reciprocity is the key. The participants in the firm have inputs that they will contribute if they believe others will reciprocate. Relaxing the profit maximization norm, enlarging management's fiduciary duty to include workers, and adding worker representatives to the board would likely induce reciprocal behavior on the part of workers in the form of increased effort, attention, and loyalty. This worker reciprocity would tend to improve the firm's productivity and profit.

Bertrand and Mullainathan recognize the possibility that worker reciprocity improves corporate productivity and profit in their study showing wage increases of 1% to 2% in states passing anti-takeover statutes. They note that wage increases could induce workers to offer higher levels of effort in response to higher wages.[247] They also recognize the likelihood that higher wages induce workers to invest in firm-specific human capital, which will tend to inure to the shareholders' benefit.[248] Indeed, Bertrand and Mullainathan point to the relative efficiency of these wage increases by comparing the much lower level of shareholder loss generally attributed to anti-takeover statutes. "The average stock price reaction to these laws (about – 0.5[%] . . .) does not appear to be large enough to explain a 1% to 2% pure increase in labor cost. Assuming labor costs are about four times profits, a permanent 1% to 2% increase in wages will imply a 4% to 8% drop in profits, which in turn implies a 4% to 8% drop in firm value."[249] In other words, the increased wages brought about by additional managerial discretion are not outweighed by decreases in shareholder profit. This is *not* a zero-sum game. In this context, worker reciprocity provides the firm enough

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[246] *See* Kahan, *supra* note 222, at 335-37.

[247] Bertrand & Mullainathan, *supra* note 229, at 551.

[248] *Id.*

[249] *Id.* (citing J.M. Karpoff & P.H. Maltesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J. FIN. ECON. 291 (1989) (finding that anti-takeover statutes had approximately 0.5% negative effect on value of firms subject to laws)). For a table summarizing the various studies of the effect of takeover statutes on shareholder value, *see* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 62-65 (1993). Most of the studies Romano lists show either no significant effect or only a slight negative effect on stock prices.

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benefits so that wage increases are almost cost-free.

CONCLUSION

If one takes seriously the notion that corporate law may be a regulatory tool, there are reasons to believe that it would be an effective public policy instrument. Changes in corporate law could be used to address some of the most intractable economic ills of our day: stagnant wages and deeply entrenched income inequality. Indeed, fairness, trust, cooperation, and reciprocity can be powerful. Not only do these behaviors make it possible to create real improvements in the lives of workers, they also offer the chance to do so at a relatively low cost.

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