

Articles

Corporate Governance

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After a long hiatus, the study of corporate governance has recently enjoyed a revival,¹ but few points of consensus have emerged. Political differences are sometimes responsible for this impasse,² but failure to address the economics of corporate governance in microanalytic terms is also a factor. Lacking a framework that permits detailed analysis of transactions among the various constituencies of the corporation—labor, owners, suppliers, customers, the community, and management—commentators have presented their arguments at such a high level of generality that an assessment of the merits of the alternative positions is very difficult. This Article

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1. The revival results partly from European efforts to implement co-determination. For recent discussions of co-determination, see M. AOKI, *THE COOPERATIVE GAME THEORY OF THE FIRM* chs. 10–11 (1984); Jensen & Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Co-determination*, 52 J. BUS. 469 (1979); Summers, *Worker Participation in the U.S. and West Germany: A Comparative Study from an American Perspective*, 28 AM. J. COMP. L. 367 (1980).

The year 1982 was also the fiftieth anniversary of Adolf Berle and G.C. Means' celebrated book, A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932), and hence a natural time to reexamine the issues. See *Corporations and Private Property: A Conference Sponsored by the Hoover Institute*, 26 J.L. & ECON. 235 (1983) (papers presented at conference celebrating fiftieth anniversary of A. BERLE & G. MEANS, *supra*). The on-going Corporate Governance Project of the American Law Institute has also provoked commentary. A draft of its work has been in progress for four years. See *PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS* (Tent. Draft No. 1 1982). The Business Roundtable's response appears in *THE BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS"* (1983). The Business Roundtable's response also includes an appendix with papers by Kenneth Andrews, Harold Demsetz, and Paul MacAvoy. See also Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983) (another critique of ALI proposal).

2. See R. Romano, *Metapolitics and Corporate Law Reform* (Sept. 1983) (Working Paper No. 13, Stan. L. & Econ. Program).

is meant to address that shortcoming. The focus throughout is on publicly held corporations in the manufacturing sector.³

Section I briefly sketches the dilemma of corporate control, originally posed as a tension between ownership (stockholders) and control (managers), but since expanded to refer to the condition of control among all "relevant" constituencies. Section II sets out a contractual framework for assessing the merits of the claims of various constituencies to representation on the board of directors. Section III then examines whether board representation is warranted for each constituency. Section IV discusses the corporate governance concerns of an often unmentioned constituency, the management. Section V treats the subject of managerial discretion and ways of controlling it. Finally, problems of funding worker-managed enterprises are examined in Section VI.

The premises of this Article are: First, the relation between each constituency and the firm needs to be evaluated in contractual terms. Second, special-purpose governance structures (of which the board of directors is one) arise in response to the needs of an exchange relation for contractual integrity. And third, lest the design benefits be dissipated, the special purpose character of each governance structure must be respected.

Although the board of directors is potentially a broadly representative governance structure, I conclude, upon assessing the relation between the firm and each constituency in terms of the contractual framework set out in Section II, that access to the board of directors should be strictly limited. The board is mainly a general purpose control instrument designed to safeguard the investments of those who have taken an equity position in the firm. Management participation on the board can often facilitate shareholder monitoring of the management, however, and can also help to safeguard the employment relation between firm and management. Other constituencies may sometimes be invited onto the board for the limited purpose of sharing information in a timely and credible manner. To assign other and larger purposes to the board risks impairing its quality and yields doubtful benefits.

I. THE DILEMMA OF CORPORATE CONTROL

Observers of the corporate scene have long struggled with the dilemma of corporate control. This was originally expressed in terms of the strain between diffuse ownership and management. It has subsequently been enlarged to consider the problems of creating a mechanism to ensure that corporate management does right by "labor, suppliers, customers, and

3. It is thus more limited in scope than the ambitious and insightful treatment of trusteeship issues by Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

owners while simultaneously serving the public interests.”⁴ As set out below, the dilemma is largely attributable to misconceptions that beset the study of contract. Although these have theoretical origins, the sheer complexity of the modern firm is also a contributing factor. Matters would be vastly simplified if firms were small and if contracts between the corporation and each of its constituencies satisfied the paradigm of contracting within discrete markets, where each exchange can accurately be described as “sharp in by clear agreement; sharp out by clear performance.”⁵ Plainly, many corporations have become very large: Sales and assets in some of these firms run to tens of billions of dollars, and employment numbers in the hundreds of thousands. Contracts between the corporation and many of its constituencies routinely deviate from idealized discrete contracting.

Large corporate size was mainly responsible for Berle and Means’ challenge to the view that the shareholders controlled the modern corporation. Since the large size of modern firms often resulted in diffuse ownership, management purportedly assumed effective control. Berle and Means thus inquired whether, under these circumstances, there was “any justification for assuming that those in control of a modern corporation will also choose to operate it in the interests of the owners.”⁶ The possibility that management might operate the corporation in its own interests could scarcely be dismissed.

Other writers broadened the inquiry and argued that the interests of other constituencies were frequently undervalued. If transactions between these constituencies and the firm are not of the classical, self-liquidating kind described by Macneil,⁷ then additional support for those interests may be required. A response that appeals to many students of the corporation is to safeguard the interests of all constituencies who have a continuing stake in the affairs of the firm, by awarding them representation on the board of directors.

This activist approach to corporate governance goes well beyond the early concern of Berle and Means about the separation of ownership and control. It assumes that a condition of “contractual failure” is widespread. Thus, L.C.B. Gower observes that “the workers form an integral part of the company,” and laments that company law in Britain overlooks this condition.⁸ He contends that legal theory maintains a master-servant fiction that “ignores the undoubted fact that the employees are members of

4. Mason, *The Apologetics of “Managerialism,”* 31 J. BUS. 1, 7 (1958).

5. Macneil, *The Many Futures of Contract*, 47 S. CAL. L. REV. 691, 738 (1974).

6. A. BERLE & G. MEANS, *supra* note 1, at 121.

7. Macneil, *supra* note 5, at 720–25.

8. L. GOWER, *THE PRINCIPLES OF MODERN COMPANY LAW* 10 (3d ed. 1969).

the company for which they work to a far greater extent than are the shareholders whom the law persists in regarding as its proprietors."⁹ Masahiko Aoki similarly observes that "the association of individual shareholders . . . may not be enduring" and holds that the "employees form an integral part of the firm for which they work to a far greater extent than [most shareholders]."¹⁰ Clyde Summers concurs:

If the corporation is conceived . . . as an operating institution combining all factors of production to conduct an on-going business, then the employees who provide the labor are as much members of that enterprise as the shareholders who provide the capital. Indeed, the employees may have made a much greater investment in the enterprise by their years of service, may have much less ability to withdraw, and may have a greater stake in the future of the enterprise than many of the stockholders. In a corporation, so conceived, employee directors have no more conflict of interest than shareholder directors.¹¹

Application of this logic suggests that other constituencies with a long-term stake in the enterprise also deserve representation on the board of directors. This would go beyond E. Merrick Dodd's proposal that the directors of a corporation should serve as trustees for all the constituencies—shareholders, customers, suppliers, community—that have a stake in the corporation.¹² What Robert Dahl has referred to as "interest group management" would expressly apportion seats on the board of directors to corporate constituencies: "Thus the board of directors might consist of one-third representatives elected by employees, one-third consumer representatives, one-third delegates of federal, state and local governments."¹³

II. FRAMEWORK

The microanalytic approach within which I propose to examine the issue of corporate governance is that of "transaction cost economics." I have set out the attributes of this approach elsewhere.¹⁴ In essence, the ap-

9. *Id.* at 10-11.

10. M. AOKI, *supra* note 1, ch. 1.

11. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, J. COMP. CORP. L. & SEC. REG. 155, 170 (1982).

12. Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

13. Dahl, *Power to the Workers?*, N.Y. REV. BOOKS, Nov. 19, 1970, at 20. Dahl does not favor this solution to corporate governance. His preferred solution is worker self-management. He nevertheless argues that "interest group management would be an improvement over the present arrangements, and it may be what Americans will be content with, if the corporation is to be reformed at all." *Id.* at 23.

14. Williamson, *Credible Commitments: Using Hostages To Support Exchange*, 73 AM. ECON. REV. 519 (1983) [hereinafter cited as Williamson, *Credible Commitments*]; Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979) [hereinafter

proach regards the transaction as the basic unit of analysis and contends that a leading but widely neglected purpose of economic organization is to economize on the costs of transacting over time. Applications include intermediate product market organization,¹⁵ labor market organization,¹⁶ and regulation.¹⁷

Neoclassical economics, which regards the firm as a production function, holds that nonstandard forms of organization have monopoly purpose and effect.¹⁸ Transaction cost economics, which regards firms, markets, and hybrid "mixed modes" as alternative governance structures, maintains instead that the institutions of contract ought mainly to be regarded in economizing terms. Assigning transactions to governance structures in such a way as to accomplish an economizing result is what transaction cost economics is all about. Since any issue that can be posed as a contracting problem is usefully addressed in transaction cost economizing terms,¹⁹ and since corporate governance falls within this description, the subject of corporate governance becomes grist for the transaction cost economics mill.

The study of corporate contracting is complicated by interdependencies within and between contracts; changes in one set of terms commonly require realignments in others. It will nevertheless be instructive to examine the contracts of corporate constituencies in a sequential rather than fully interactive way. This Article uses a three-part approach to contracting. First, I set out a simple schema focusing on the attributes of transactions and their needs for governance. Then, I examine measurement issues that arise in conjunction with informational asymmetries. Although governance and information are not independent,²⁰ it is useful to deal with them sequentially. Finally, I approach several problems of piecemeal intervention by examining "contracting in its entirety."

cited as Williamson, *Transaction Cost Economics*].

15. See Williamson, *Credible Commitments*, *supra* note 14; Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 *AM. ECON. REV.* 112 (1971).

16. See Williamson, *Efficient Labor Organization* (Apr. 1982) (U. Pa. Center for the Study of Org. Innovation, Discussion Paper No. 123).

17. See Williamson, *Franchise Bidding for Natural Monopolies—In General and with Respect to CATV*, 7 *BELL J. ECON.* 73 (1976).

18. Coase, *Industrial Organization: A Proposal for Research*, in *POLICY ISSUES AND RESEARCH OPPORTUNITIES IN INDUSTRIAL ORGANIZATION* 59, 61-67 (V. Fuchs ed. 1972).

19. As Friedrich Hayek has observed, "whenever the capacity of recognizing an abstract rule which the arrangement of these attributes follows has been acquired in one field, the same master mould will apply when the signs for those abstract attributes are evoked by altogether different elements." F. HAYEK, *STUDIES IN PHILOSOPHY, POLITICS AND ECONOMICS* 50 (1967).

20. See O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 31-37 (1975); Williamson, *Credible Commitments*, *supra* note 14, at 526-28.

A. *A Contractual Schema*

The most important attribute for assessing whether a transaction requires a special governance structure is the degree to which the parties must invest in transaction-specific assets to facilitate the proposed exchange of goods or services.²¹ Transaction-specific assets are ones whose value is much greater in the given transaction than in their next-best use or by their next-best user. Failure to distinguish among transactions with respect to asset specificity has been responsible for much confusion and error in public policy.

Economists of all persuasions recognize that the terms of an initial bargain depend on whether qualified suppliers will submit noncollusive bids. If there is only a single highly qualified supplier, then the terms of the contract will be monopolistic; if there are many such suppliers, then the terms will be competitive. Transaction cost economics fully accepts this description of pre-contract bidding competition, but also insists that the study of contracting be extended to include post-contract features. Thus, initial bidding merely sets the contracting process in motion. A full assessment requires scrutiny of both contract execution and competition at the contract renewal interval.

In contrast to earlier theories, transaction cost economics suggests that a large number of bidders at the outset does not necessarily imply that there will be a large number thereafter. The efficacy of competition after the initial period depends on whether the good or service in question requires durable investments in transaction-specific assets, either human or physical. An initial winning bidder who makes no specialized investments realizes no advantage over rivals. Although it may continue to supply for a long period of time, this is only because, in effect, it is continuously meeting competitive bids from qualified rivals.

There is no longer parity with rivals, however, once the initial supplier undertakes substantial investments in durable transaction-specific assets. In such cases, both buyers and suppliers have a strong interest in preserving the continuity of the exchange, since economic values would be sacrificed if the ongoing supply relation were to be terminated. Rivals who lose the bid are unavoidably at a disadvantage if it is important to preserve the particular buyer/seller relation once the original contract has been awarded. Accordingly, what was a competitive market with a large num-

21. See Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Williamson, *Transaction Costs*, *supra* note 14, at 522-26, 537. Cf. O. WILLIAMSON, *supra* note 20, at 20-40 (discussing idiosyncratic investments).

ber of bidders at the outset is effectively transformed into one of bilateral monopoly thereafter.

The convenient fiction of faceless contracting is thereby upset. Adapting to changing circumstances in bilateral trading poses a serious dilemma in contracting. Joined as they are in a condition of bilateral monopoly, both buyer and seller can bargain over the disposition of any incremental gain whenever a proposal to alter the contract is made by the other party. Although buyer and seller have a long-term interest in effecting adaptations that make both parties better off, each party also has an interest in appropriating as much of the gain as he can from each adaptation. Efficient adaptations may thus be made only with costly haggling or may even go unmentioned because one party fears that the other's opportunism will dissipate the gains. The parties therefore have an incentive to develop governance structures that help prevent opportunism and infuse confidence.

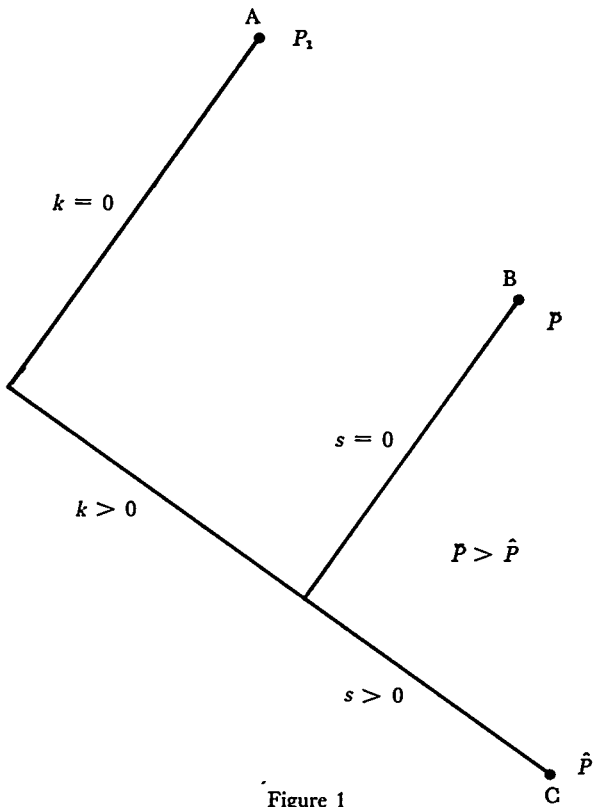


Figure 1

The two-technology schema set out in Figure 1 helps to illustrate the issues. Suppose that there are two types of technology, one of which is more appropriate for a given transaction. One is general-purpose technology—technology that is useful over a broad range of transactions and therefore involves no exposure of transaction-specific assets. These resources can be redeployed easily, should either party terminate the contract. Special purpose technology, by contrast, incorporates transaction-specific assets. These cannot be redeployed easily or costlessly if the contract is prematurely terminated or if continuity of the exchange relation is otherwise upset. Using k as a measure of transaction specific assets, transactions that use the general-purpose technology are ones for which $k=0$. When transactions use special-purpose technology, by contrast, $k>0$. This state takes on the attributes of a bilateral monopoly.

Although classical market contracting suffices for transactions when $k=0$, unassisted market governance poses hazards whenever transaction-specific assets are placed at risk. Parties here have an incentive to develop investment safeguards. Let s denote the magnitude of any such safeguards. A situation in which $s=0$ is one in which no safeguards are provided. A condition of complete safeguard will obtain if $s=k$. A refusal to provide a contractual safeguard will, of course, show up in the price. If \bar{p} is the price at which the firm procures a good or service when $s=0$, and if \hat{p} is the price for the same good or service when $s>0$, then $\bar{p}>\hat{p}$, *ceteris paribus*.

By way of summary, transactions that are efficiently supported by general purpose assets ($k=0$) are located at node *A* and do not need protective governance structures. Discrete market contracting suffices. Transactions that involve significant investments of a transaction-specific kind ($k>0$) are ones for which the parties are effectively engaged in bilateral trade. Transactions located at node *B* enjoy no safeguards ($s=0$) and thus carry a risk premium. Such transactions are apt to be contractually unstable. They may revert to node *A* (in which event the special purpose technology would be replaced by general purpose ($k=0$) technology) or be relocated to node *C* (by introducing contractual safeguards that would permit the continued use of the $k>0$ technology). Transactions located at node *C* incorporate safeguards ($s=k$) and thus are protected against the hazards of expropriation.

The safeguards to which I refer normally take one or more of three forms. The first is the realignment of incentives, commonly through some type of penalty for premature termination.²² The second is the creation of a specialized governance structure to resolve disputes. "Private ordering,"

22. See Mortensen, *Specific Capital and Labor Turnover*, 9 BELL J. ECON. 572, 579-85 (1978).

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rather than litigation in the courts, is thus characteristic of node C governance.²³ The third is the introduction of trading regularities that support and signal intentions of continuity.²⁴

B. *Informational Asymmetries*

Despite safeguards of these kinds, there may be special circumstances where additional benefits would accrue if information pertinent to the exchange were more fully disclosed. Sometimes this disclosure will enable the recipient more successfully to anticipate future developments and plan accordingly. Sometimes such disclosure will reduce informational asymmetries that, if unrelieved, could lead to disbelief and a costly contractual impasse.

It bears repeating, however, that such disclosures are not needed if assets are nonspecific. Investment plans do not turn on bilateral trading in these circumstances. And where neither party values continuity in its relationship with the other, a costly effort to reduce informational asymmetries serves no useful veracity purposes either.

C. *Application to the Board of Directors Generally*

This Article investigates whether constituencies realize net gains by having representatives on the board of directors and, if so, in what membership capacity. The Article considers two classes of membership: voting membership and participation only to secure information. Voting membership invites a constituency to participate in what Eugene Fama and Michael Jensen refer to as the ratification of corporate decisions and the follow-on monitoring of corporate performance.²⁵ Informational participation allows a constituency to observe strategic planning and to know the information on which decisions are based, but allows no vote on investments or management. These responsibilities are reserved for the voting subset of the board.²⁶

The question whether there is a *prima facie* case for representation on the board of directors will be assessed for each nodal position. If such a

23. Galanter, *Justice in Many Rooms: Courts, Private Ordering, and Indigenous Law*, 19 J. LEGAL PLURALISM 1 (1981).

24. Williamson, *Credible Commitments*, *supra* note 14, at 530-33.

25. Fama & Jensen, *supra* note 3, at 301, 303 (1983).

26. Allowing only informational participation to a constituency could be implemented through two-tier boards, but more often it takes the form of implicit understandings among the members of the board. In principle, members are equals, but a subset understands that its useful participation is limited to supplying and receiving information. As Oliver Hart observes, complete information sharing is not assured by such a practice. Hart, *Optimal Labour Contracts under Asymmetric Information: An Introduction*, 50 REV. ECON. STUD. 3, 23 (1983). However, this form of participation arguably assures more complete information sharing than nonparticipation.

case is found, the next question is: What type of membership is most appropriate? The Article argues that representation on the board is never warranted for constituencies located at node *A*, but may be warranted for constituencies located at node *B*. The question of why a node *B* constituency has not successfully forged a bilateral governance structure (thereby moving to node *C*) is germane. Finally, constituencies that have forged a viable governance structure at node *C* do not require voting representation on the board but sometimes should be included for informational purposes.

Representation is unwarranted for constituencies at node *A* because of the negligible exposure of their transaction-specific assets. Moreover, their legitimate interests are adequately safeguarded through neoclassical market contracting. Such constituencies have neither informational nor decisional needs to be served through board membership. Constituencies located at node *B*, however, have exposed assets and will charge a higher price (\bar{p}) unless safeguards can be devised. If parties cannot devise effective bilateral safeguards, generalized safeguards through voting board membership may be warranted.

Constituencies located at node *C* do not normally need membership on the board of directors to safeguard their interests. Such constituencies have devised a structure of bilateral governance to safeguard their interests. Such specialized structures will normally be better attuned to the adaptive needs and dispute settlement requirements of a constituency than will access to a generalized instrument. If board membership is warranted at all, participation should normally be limited to informational access only.

D. *Contracting in Its Entirety*

Suppose, *arguendo*, that voting membership for node *B* constituencies is granted. Suppose further that constituencies located at node *C* ask for voting participation. Two arguments might be advanced in support of this proposal: A spirit of generosity warrants node *C* inclusion and democratic purposes would be served by broadening the board in this way. What are the costs?

One obvious cost is that of supplying information. Huge educational needs arise if specialized constituencies are to be informed participants on the board. Representatives of each specialized constituency would need to learn a great deal about the overall character and agenda of the corporation. Such participation also risks deflecting strategic decisionmakers from their main purposes by forcing them to redress operating-level complaints. This squanders a valuable resource. More serious, however, is the problem of opportunism that inclusion of partisan constituencies on the board invites. A constituency that had reached a bilateral bargain with the cor-

poration would, if it participated in board-level decisions, gain leverage to extract additional concessions from the corporation during the execution of the contract.²⁷ Opportunism is especially likely where many partisan constituencies are represented on the board and logrolling is feasible.²⁸

“Unwarranted” participation in the decisions of the board of directors by such poorly suited constituencies will, moreover, cause subsequent adaptation by other parties who deal with the firm. For one thing, those who are asked to provide general purpose corporate funding will adversely adjust the terms under which corporate finance will be made available. Moreover, the bilateral contracts affected by the deflection, distortion, and dissipation of corporate assets will be realigned. Not only will the original terms differ in anticipation of later efforts to strike “better” deals, but bilateral safeguards are also apt to be reduced. Node C governance will thus move toward node B. In extreme cases, special purpose technologies and involvements will give way to general purpose ones, and node A governance will result. Since membership on the board of directors by constituencies located at node A lacks economic purpose,²⁹ it is naive to believe that the board of directors’ franchise can be extended without cost.

III. APPLICATIONS

These principles can be used to assess the claims to representation on the board by labor, owners, suppliers, customers, the community, and management.

A. Labor

Enthusiasts of co-determination regard participation for informational purposes as inadequate. They maintain that co-determination should extend the influence of workers to include “general issues of investments, market planning, decisions about output, and so forth.”³⁰

This argument is clearly mistaken as applied to workers with general purpose skills and knowledge (node A). Such workers can quit and be replaced without productive loss to either worker or firm.³¹ Consider,

27. This asymmetrical statement appears to ignore the concern of individual constituencies that the corporation will make decisions during a contract’s execution that are contrary to the spirit of the agreement. The concern is real and is discussed *infra* p. 1227.

28. There is a related hazard that corporate assets will be dissipated in support of “worthy causes” with which specialized constituencies sympathize. Charles Morris’s pithy phrase “the cost of good intentions” is apposite. C. MORRIS, *THE COST OF GOOD INTENTIONS: NEW YORK CITY AND THE LIBERAL EXPERIMENT, 1960–1975* (1980).

29. See *supra* p. 1201.

30. Schauer, *Critique of Co-Determination*, in *WORKERS CONTROL* 215 (G. Hunnius ed. 1973). I do not mean to implicate Schauer, Gower, Aoki, and Summers in this expansive view of labor participation.

31. This is an oversimplification. It assumes easy re-employment and ignores transitional costs,

therefore, workers that make firm-specific investments and are located at nodes *B* or *C*. Ordinarily, it can be presumed that workers and firms will recognize the benefits of creating specialized structures of governance to safeguard firm-specific assets. Failure to provide such safeguards will cause demands for higher wages. Workers located at node *B* will demand a wage \bar{w} that exceeds what would be required at node *C* (\hat{w}). Although workers who are paid a wage \bar{w} will be less ready to quit, firms that pay such a wage premium will terminate prematurely.³² If firms are required to make lump-sum payments upon dismissal and if workers who quit voluntarily are required to make similar sacrifices, a lesser wage (\hat{w}) and a more efficient termination criterion will result. As Dale Mortensen observes: Severance pay serves to rectify firm incentives, while sacrificing "paid vacations and nonvested pension plans . . . serve[s] to raise the cost of quitting to the worker."³³

Efficient governance, however, requires more than realignment of incentives. The institutions of contract also matter. Machinery for settling disputes and for adapting to changed circumstances is needed if continuing relations between the firm and workers located at node *C* are to operate smoothly. The grievance machinery and associated job structures—ports of entry, promotion ladders, bumping, and so forth³⁴—are thus important parts of efficient governance.

Another important factor is asymmetric information. A chronic difficulty with long-term labor agreements is that misallocation will result if wages are set first and employment levels are unilaterally determined by management later. The inefficiency was first noted by Wassily Leontief³⁵ and has since been elaborated upon by Robert Hall and David Lilien³⁶ and by Masahiko Aoki.³⁷ Even if wages and employment are both established at the outset, the agreement may drift out of alignment during the contract's execution to the disadvantage of the less informed member of the contracting pair.³⁸ Such a result might be avoided by imparting more

including the impact on the family. Unemployment insurance may provide a necessary buffer. We may want to create some barriers to deter termination without cause and reduce transition costs. The basic point, however, is comparative. Workers located at node *A* have the least concern over expropriation.

32. Mortensen, *supra* note 22, at 582.

33. *Id.* at 581.

34. See P. DOERINGER & M. PIORE, INTERNAL LABOR MARKETS AND MANPOWER ANALYSIS 43, 55, 79, 99-100 (1971).

35. Leontief, *The Pure Theory of the Guaranteed Annual Wage Contract*, 54 J. POL. ECON. 76, 78-79 (1946).

36. Hall & Lilien, *Efficient Wage Bargains Under Uncertain Supply and Demand*, 69 AM. ECON. REV. 868 (1979).

37. M. AOKI, *supra* note 1, at ch. 9.

38. *Id.*

information to labor. Labor membership on the board of directors for informational purposes is one means of achieving this result.³⁹

Labor membership on boards of directors can be especially important during periods of actual or alleged adversity, especially when firms are asking workers for give-backs. Labor's board membership might mitigate worker skepticism by promoting the exchange of credible information.⁴⁰ Douglas Fraser's inclusion on the Chrysler board during the company's recovery is an illustration.

This practice does not, however, enjoy widespread support. Some opponents fear that it will be difficult to resist the transformation of informational roles into decisionmaking participation. It is also possible, however, that the informational benefits of labor membership are not adequately appreciated.⁴¹

B. Owners

The term "owners" is usually reserved for stockholders, but debt-holders may also assume this status. However described, suppliers of finance bear a unique relation to the firm: The whole of their investment in the firm is potentially placed at hazard. By contrast, the productive assets (plant and equipment; human capital) of suppliers of raw material, labor, intermediate products, electric power, and the like normally remain in the suppliers' possession. If located at node *A*, therefore, these suppliers of finance must secure repayment or otherwise repossess their investments to effect redeployment. Accordingly, the suppliers of finance are, in effect, always located on the $k > 0$ branch. The only question is whether their investments are protected well (node *C*) or poorly (node *B*).

39. "[The] true value of codetermination is to be found in its being an instrument through which important and accurate information [is shared]." *Id.* at ch. 10.

40. As Hart observes, if only the firm and not workers can observe state of the world realizations, their "wages cannot be made to depend on the state directly. For if the contract says that wages should fall in bad times, then it is in the interest of the firm always to claim that times are bad." Hart, *supra* note 26, at 3. To be sure, there are limits. As ex post information becomes available, firms which egregiously understate true conditions will become known and will thereafter carry a stigma. Ex ante terms will thereafter be adjusted to their disadvantage.

41. A recent law review note contends that informational benefits would accrue to the stockholders by including union membership on the board of directors. Note, *An Economic and Legal Analysis of Union Representation on Corporate Boards of Directors*, 130 U. PA. L. REV. 919 (1982). The author claims that such membership would "reduce the ability of management to run the corporation so as to further their own interests rather than those of the shareholders." *Id.* at 956. If true, the question arises why some perceptive shareholders have not recognized the benefits and made provision for union participation. Is it ignorance of the gains? Are incumbent managements so well entrenched that they can defeat any such efforts? Or are the gains offset by unacknowledged costs?

1. *Stockholders*

Although a well-developed market in shares permits individual stockholders to terminate ownership easily by selling their shares, it does not follow that stockholders as a group have a limited stake in the firm. What is available to individual stockholders may be unavailable to stockholders in the aggregate. Although some students of governance see only an attenuated relation between stockholders and the corporation, this view is based on a fallacy of composition. Stockholders as a group bear a unique relation to the firm. They are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal.⁴² Labor, suppliers in the intermediate product market, debt-holders, and consumers all have opportunities to renegotiate terms when contracts are renewed. Stockholders, by contrast, invest for the life of the firm and their claims are located at the end of the queue should liquidation occur.

Stockholders are also unique in that their investments are not associated with particular assets. The diffuse character of their investments puts shareholders at an enormous disadvantage in crafting the kind of bilateral safeguards normally associated with node *C*. Unless, therefore, a governance structure of broad scope is somehow devised, stockholders are unavoidably located at node *B*.

Recall that the critical attributes of suppliers located at node *B* are their investments in specific assets and the premium they require for their services because of the hazard of expropriation. This premium can be regarded as a penalty imposed on the firm for its failure to craft node *C* safeguards. The incentive for the firm to secure relief from this penalty is clear.⁴³ This Article considers the board of directors to be a governance structure whose principal purpose is to safeguard those who face a diffuse but significant risk of expropriation because the assets in question are numerous and ill-defined, and cannot be protected in a well-focused, transaction-specific way.⁴⁴ Thus regarded, the board of directors should be seen as a governance instrument of the stockholders. Whether other constituencies also qualify depends upon their contracting relation with the firm.

Such protection for stockholders can be and often is supplemented by other measures. Corporate charter restrictions and informational disclosure requirements are examples. Firms recognize stockholders' needs for

42. The public may be regarded as an involuntary constituency whose relation to the corporation is indefinite.

43. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure*, 3 J. FIN. ECON. 305 (1976).

44. My use of "diffuse" is different from that of Fama & Jensen, *supra* note 3. They refer to the diffuseness of decisions among many agents in the corporation. My concern is with the diffuseness of the investments that are supported by equity finance.

controls and many attempt responsibly to provide them.⁴⁵ Some managements, however, play “end games” (undisclosed strategic decisions to cut and run before corrective measures can be taken) and individual managers commonly disclose information selectively or distort data. Additional checks against such concealment and distortion can be devised to give shareholders greater confidence. Arguably, an audit committee composed of outside directors and the certification of financial reports by an accredited accounting firm promote these purposes. Another possibility is the required disclosure of financial reports to a public agency with powers of investigation. The efficacy of these devices is difficult to gauge.⁴⁶

2. *Lenders*

In certain atypical circumstances, lenders may deserve board representation. Unlike stockholders, lenders commonly make short-term loans for general business purposes or longer term loans against ear-marked assets. Proof that the firm is currently financially sound, coupled with short maturity, places short-term lenders at node *C*. Lenders who make longer term loans commonly place pre-emptive claims against durable assets. If the assets cannot be easily redeployed, lenders usually require partial financing through equity collateral. Thus, long-term lenders usually carefully align incentives and protect themselves with safeguards of the sort associated with node *C*.

As Mervyn King observes, however, firms in countries where the stock market is poorly developed are forced to rely more extensively on debt.⁴⁷ Adequate safeguards are more difficult to provide in these circumstances.

45. Diamond, Optimal Release Information by Firms (U. Chi. Center for Research in Security Prices, Working Paper No. 102) (1983) (discussing traders' interests in disclosure of information). Corporate charter abuses are discussed in Williamson, *On the Governance of the Modern Corporation*, 8 *HOFSTRA L. REV.* 63, 74-75 (1979).

46. George Stigler has nevertheless made an interesting attempt to assess the impact of the SEC. Stigler, *Public Regulation of the Securities Markets*, 37 *J. Bus.* 117 (1964). Stigler describes the basic test as “simplicity itself We take all the new issues of industrial stocks with a value exceeding \$2.5 million in 1923-28, and exceeding \$5 million in 1949-55, and measure the values of these issues . . . in five subsequent years . . . relative to the market average.” *Id.* at 120. The pre-SEC versus post-SEC performance of new issues in relation to the market at one-year intervals is as follows (where the first figure is the pre-SEC mean and the second is post-SEC): after one year, 81.9 versus 81.6; after two years, 65.1 versus 73.3; after three years, 56.2 versus 72.6; after four years, 52.8 versus 71.9; and after five years, 58.5 versus 69.6. Stigler declares that since these differences are statistically significant only in the third and fourth years, the SEC had no effect.

There are, however, two problems with this argument. First, tests of statistical significance are not needed—indeed, are unwarranted—where, as in Stigler's case, the attributes of an entire population, rather than a sample thereof, are measured. Second, a more interesting test would be to ascertain whether rates of return on equity changed with regulation. Improved information disclosure should lead to lower average rates, *ceteris paribus*.

47. M. KING, *PUBLIC POLICY AND THE CORPORATION* 156 (1966). Small firms in developed economies may be similarly situated if capital markets are well developed only in the sale of shares of large, established firms.

As the exposure to risk increases, these debt holders become more concerned with the details of the firm's operating decisions and strategic plans: With high debt-equity ratios the creditors become more like shareholders and greater consultation between the management and its major creditors results.⁴⁸ A banking presence in a voting capacity on the board of directors may be warranted in these circumstances. More generally, a banking presence may be appropriate for firms experiencing adversity, but this should change as evidence of recovery accumulates.

C. *Suppliers*

Whether suppliers have a stake in a firm depends upon whether they have made substantial investments in durable assets that could not be redeployed without sacrificing productive value if the relationship with the firm were to be terminated prematurely. The mere fact that one firm does a considerable amount of business with another, however, does not establish that specific assets have thereby been exposed. At worst, suppliers located at node *A* experience modest transitional expenses if the relation is terminated. Neither specialized bilateral governance nor membership on the board of directors is needed to safeguard their interests. The protection afforded by the market suffices.

Suppliers who make substantial firm-specific investments in support of an exchange will demand either a price premium (as at node *B*, where the projected break-even price is \bar{p}) or special governance safeguards (as at node *C*). Progress payments and the use of hostages (i.e., credible commitments) to support exchange are illustrations of node *C* safeguards.⁴⁹ An agreement to settle disputes through arbitration, rather than through litigation, is also in the spirit of node *C* governance.

Considering the variety of widely applicable governance devices to which firms and their suppliers have access, there is little need to accord suppliers additional protection through membership on the board of directors. There could be exceptions, of course, where a large volume of business is at stake and a common information base is needed to coordinate investment planning.⁵⁰ Ordinarily, however, the governance structure that firm and supplier devise at the time of contract (and help to support

48. *Id.*

49. See Williamson, *Credible Commitments*, *supra* note 14, at 522-26 (applying "hostage model" to clarify unilateral and bilateral exchange).

50. The information advantage is that the supplier is made privy to the plans of the buyer and can satisfy himself on the merits of the internal decisionmaking process. One large Japanese manufacturer volunteered that it had a major supplier (who was close to a co-venturer) on the board for information sharing but not decisionmaking purposes. Voting membership on the board of directors is apt to be an ineffectual safeguard for a supplier, since it can be ignored or cut off should a firm decide to terminate a contract prematurely.

through a web of interfirm relationships) will afford adequate protection. Membership on the board, if it occurs at all, should be restricted to informational participation.

D. Customers

The main protection for customers located at node *A* is generally the option to take their trade elsewhere. Products that have delayed health effects are an exception, and consumer durables can also pose special problems. Membership on the board of directors is not, however, clearly indicated for either reason.

Health hazards pose problems if consumers are poorly organized in relation to the firm and lack the relevant information. If consumers can organize only with difficulty, because they are unknown to one another, or because of the ease of free-riding, then a bilateral governance structure between firm and consumers may fail to materialize. Protection by third parties may be warranted instead. A regulatory agency equipped to receive complaints and screen products for health hazards could serve to infuse confidence in such markets.⁵¹

Whether consumer membership on the board would afford additional protection is problematic. Who are representative consumers? How do they communicate with their constituency? Token representation may create only unwarranted confidence.⁵²

Similar problems of consumer organization and ignorance arise in conjunction with consumer durables. This is true whether the consumer durable requires no follow-up service or a great deal of such service.⁵³ Among the available types of consumer protection are brand names, warranties, and arbitration panels. Shoppers who choose node *B* are presumably looking for bargains. They will spurn these additional protections in favor of a lower price.⁵⁴ Such customers implicitly accept a higher risk

51. To be sure, regulation is never without cost. For an overall assessment of the costs and justifications for regulation, see S. BREYER, *REGULATION AND ITS REFORM* (1982). For a discussion of the regulatory mentality of the FDA in its efforts to deal with saccharin, see Williamson, *Saccharin: An Economist's View*, in *THE SCIENTIFIC BASIS OF HEALTH AND SAFETY REGULATIONS* 131 (R. Crandall & L. Lave eds. 1981).

52. As Reinier Kraakman observes on a related matter of director selection: Since "corporate managers are . . . largely free to control the selection and tenure of outside directors, lawyers, and accountants . . . it may be child's play for would-be offenders to select corrupt or captive outsiders who are only too willing to assume personal liability for a price." Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 *YALE L.J.* 857, 892 (1984). The appointment of recognized "professional" consumer representatives—those with reputations for being informed and objective and who can be penalized for capture or corruption—could mitigate tokenism. But such a solution is not unproblematic.

53. A solid state radio that is replaced rather than repaired when it becomes defective is an example of the former; an automobile of the latter.

54. In comparing node *B* with node *C* in upstream dealings (between a firm and its suppliers), $\bar{p} > \hat{p}$. In downstream dealings, by contrast, $\bar{p} < \hat{p}$, since for parties at node *C*, the firm must

and should accept occasional disappointments. There are other consumers, however, who value protections at node *C*. Some are prepared to pay a premium for a brand-name item. Brand names effectively extend a firm's planning horizon and create incentives for the firm to behave "more responsibly."⁵⁵ (To be sure, these assumptions merit qualification. Firms sometimes build up a reputation and thereafter expend it by taking advantage of lagging consumer perceptions.⁵⁶) Warranties are explicit forms of follow-on protection, and many are available on optional terms. The recent introduction of consumer arbitration panels is likewise responsive to concerns over consumer protection. Consumers concerned about fair play in the post-sales service period will presumably concentrate their purchases on brands for which arbitration is available.

Further innovations to offer consumer protection on a discriminating basis may be needed. With the possible exception of large customers with special informational needs, however, a general case for inclusion of consumers on the board of directors is not compelling.

E. *The Community*

Community interest in the corporation is a very large subject. I consider two concerns here—externalities and the hazards of appropriation.

Externalities commonly arise where the parties in question do not bear a contracting relation to each other. Pollution is one example. Corrections can be interpreted as an effort by the community to impose a contract where none existed. For example, the community may place a pollution tax (price) on the firm, or it may stipulate that pollution abatement regulations must be satisfied as a condition for doing business.

A chronic problem in this area is to secure the knowledge on which to base an informed pollution control policy. Firms often possess the neces-

provide additional protection for which it expects to recover its costs. Although workers will accept a lesser wage to locate at node *C*, customers must therefore pay a higher price.

55. Problems arise when established firms with apparent commitments to an industry decide to cut losses and terminate. The home computer market is a recent illustration. Andrew Pollack describes Texas Instruments' decision to terminate:

The losing battle of Texas Instruments Inc. in the home computer market has taken a severe toll on the company's finances, its reputation and its employees. Yet more than one million other people—the owners of the Texas Instruments 99/4A home computers—will suffer as well.

They are likely to find it much more difficult to get their machines repaired and to find new programs and peripheral equipment, such as data storage devices and printers, to use with the machines.

Texas Instruments' Pullout, N.Y. Times, Oct. 31, 1983, at D1, col. 3. The purchasers of the TI99/4A, who had struck an implicit bargain with Texas Instruments but went uncompensated when the decision to terminate was made, were the losers.

56. Cf. Beales, Craswell & Salop, *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 501-13 (1981) (surveying generally the impact of market forces on the dissemination of consumer information).

sary knowledge and may disclose it only in a selective or distorted manner. Public membership on the board of directors could conceivably reduce misinformation. But the remedy would come at a high cost if the corporation were thereby politicized or deflected from its chief purpose of serving as an economizing instrument. Penalties against misinformation coupled with moral suasion may be more effective. This is an area in which there may simply be no unambiguously good choices.

The hazards of expropriation are even less of a justification for public membership on boards. Communities often construct durable infrastructures to support a new plant or renewal investments by old firms. Expropriation is possible if the firm is able to capitalize these public investments and realize a gain upon selling off the facility. Such concerns are much greater if the firm makes general-purpose rather than special investments. Communities that make investments in support of a firm should therefore scrutinize the character of the investments that the firm itself makes.

As elsewhere, expropriation hazards will be mitigated if the parties can locate themselves at node *C*. Insistence that the firm make specialized investments is akin to the use of hostages to support exchange. In general, specially crafted node *C* protection, rather than public membership on the board of directors, has much to commend it as the main basis for safeguarding community investments.

IV. MANAGEMENT AS A CONSTITUENCY

There is one constituency that curiously goes unmentioned in most discussions of corporate governance: the management. Perhaps analysts assume that management is appropriately assigned a mediation role between contesting constituencies.⁵⁷ And some critics maintain that management is already over-represented in the affairs of the firm: Management participation on the board of directors is the problem, not the solution. This Article's contracting framework, however, allows us to view management as a separate constituency whose relation to the firm can be evaluated like that of other constituencies.

A. *Management Contracting*

A major difficulty in treating management's contract with the corporation like those of other constituencies is that management is thought to be in effective control of the corporation. Rather than being responsive agents of the stockholders, managers may operate the firm with a keen eye to their own interests. Any proposal to improve their terms of employment is

57. See M. AOKI, *supra* note 1, ch. 8; A. BERLE, *POWER WITHOUT PROPERTY* 8 (1959) (comparing businessmen to politicians who must respond to multiple constituencies).

automatically suspect, because managers are presumed merely to be adding another layer of down to their already well-feathered nests. This section will suspend judgment on this matter and treat managers like other constituencies: What attributes does the management-corporation contract have and what ones should it have?

Since no firm-specific human assets are exposed by managers located at node *A*, no specialized governance is needed. Like any other constituency with attributes of node *A*, such managers look to the market for basic protection. Managers who develop a firm-specific asset relationship with the firm, however, are located at nodes *B* or *C*.

Those managers who contract with the firm in a node *B* manner will receive higher current compensation than those who are accorded internal governance protection of a node *C* kind. This is the familiar $\bar{p} > \hat{p}$ result. To what types of governance protection do managers located at node *C* have access? The answers are unclear, partly because the proposition that governance structures can and do promote the mutual interest of contracting parties is relatively novel. Such structures have either been ignored or, as in the case of labor unions, treated as instruments of power whereby labor improves the wage bargain *at the expense of the firm*. To be sure, this sometimes occurs. But the collective organization of workers can also reduce hazards of contracting, to the benefit of both parties, if workers develop firm-specific skills during the course of their employment.

We can take the same analytical approach to understanding contractual relations between management and firm, but the job is more difficult than understanding labor-firm contracting. Labor organization has been the subject of repeated studies, and much of the relevant microanalytics there has been carefully described,⁵⁸ but contracting by management has received much less systematic attention. There are several reasons for this. Management contracts tend to be crafted individually rather than collectively, and they are not subject to public scrutiny. The protections or procedures to which an aggrieved manager turns are usually not formally organized and are more difficult to study for this reason. Further, treating the firm and its management as separate contracting entities is admittedly more difficult with the highest echelons of management. Unless an independent compensation committee exists, for example, our understanding of the contract between firm and manager is complicated by the fact that managers apparently write their own contracts with one hand and sign them with the other. Also, management is often encouraged, for good reason, to think of itself and the firm as one. It would not sit well with this

58. See P. DOERINGER & M. PIORE, *supra* note 34.

conception for managers to develop a formal grievance machinery to which they can turn for relief and redress.⁵⁹

It is nonetheless true that managers who are asked to make firm-specific investments will presumably strike different (better) terms if they locate at node *C* than at node *B*.⁶⁰ What kinds of protection are available?

B. *Compensation Schemes*

Both the firm and its managers should recognize the merits of drafting compensation packages that deter both hasty dismissals and unwanted departures. Requiring firms to make severance payments upon dismissal and managers to sacrifice nonvested rights should they quit would help safeguard specific assets. The recent phenomenon of “golden parachutes,” for example, illustrates both the right and the wrong way to craft protections for managers.

Golden parachutes are severance payments to senior managers that are contingent upon an “adverse” change in the ownership of common shares in the firm, usually as a result of unfriendly takeovers. Since the appearance and refinement of takeover techniques expose managers to new risks, some response is arguably warranted. Senior managers are often dismissed after takeovers. Even if the managers are kept on, the takeover often upsets their career expectations. Upon recognizing these hazards, managers will attempt to renegotiate their contracts to reflect these risks.

The golden parachute can be thought of as such a response. If an adverse change of ownership occurs, the senior management does not have to wait to be dismissed in order to receive severance pay. Instead, the management can trigger the award itself. Managers are thus given the option to “bail out” and collect a larger severance award than they would be entitled to after a “normal” dismissal (one that is independent of an ownership change). Without this safeguard, the post-takeover management could give demeaning assignments to incumbent managers and force them to quit, thus denying them any severance award.

59. As Alan Fox puts it, “High level managers and administrators whose decisions cannot be easily or quickly monitored are treated as members of a high-trust fraternity,” lest their moral involvement deteriorate. A. FOX, *BEYOND CONTRACT: WORK, POWER AND TRUST RELATIONS* 170–71 (1974).

60. In principle, either of two contractual adaptations could be made in response to the added risk that takeover poses. One is that managers who have made firm-specific investments could demand and receive higher salaries. Golden parachutes are the second alternative. The first is a node *B* (\bar{m}) response; the second is a node *C* (\hat{p}) response whereby the added risk elicits added safeguards. If the efficiency properties of the latter are superior, as they arguably are, see Williamson, *Credible Commitments*, *supra* note 14, at 537–38, the golden parachute is appropriate. Indeed, since managers who receive a salary premium rather than added severance payments will expend supranormal efforts to defeat a takeover attempt and save their high paying jobs, the stockholders will presumably prefer a node *C* solution.

Granting the merit of self-initiated severance pay, what explains the severance premium? The defense for such a premium presumably resides in the differences between dismissals from normal employment and dismissals that occur in conjunction with takeovers. Dismissals from normal employment are generally for cause, and they activate some protection (albeit diffuse) under an internal due process machinery.⁶¹ After takeovers, an atmosphere of mutual suspicion and hostility often exists, and the successful bidders are concerned that incumbents will sabotage the transition. Dismissals after takeovers are commonly unrelated to job performance and relatively unprotected by any internal machinery.⁶² Because of these added risks, larger severance awards for terminations that occur in conjunction with takeovers are arguably warranted.

This explanation, however, merely establishes that golden parachute awards will exceed those for termination from normal employment. Some perspective on the magnitude of golden parachutes is needed. Golden parachutes ought to vary directly with the extent of the firm-specific investment that a manager has placed at risk. The absolute value of the pension and other benefits that an executive sacrifices should he voluntarily quit is one measure of these investments. Absence of penalties for voluntary quitting is *prima facie* evidence that the management skills are general purpose rather than firm-specific. Golden parachute protection for these managers is unwarranted and probably reflects self-dealing.⁶³

61. Informal organizations may provide due process protection. *Cf.* C. BARNARD, *THE FUNCTIONS OF THE EXECUTIVE* 122 (1938) (discussing how informal organization functions to maintain feelings of personal integrity and self-respect among executives).

62. Takeover effectively suspends many of the due process benefits of internal organization until a new set of implicit bargains is struck.

63. Executives in specialized firms (monopolies or firms that are serving very special niches) are more apt to qualify for golden parachutes than those in competitively organized industries where experience in one firm easily transfers to another.

A systematic assessment of the variety of golden parachute terms is sorely needed. Considerable variety in golden parachute provisions is evident from the following Wall Street Journal article:

The modest plan of AVX Corp., a Great Neck, N.Y. electronic components maker, would provide Chairman Marshall Butler with nine months pay of about \$100,000 if he is ousted in a takeover. Beneficial Corp.'s plan, on the other hand, covers 250 "key" executives and provides each with three years' pay and benefits if they determine their jobs have been altered after a change of control; the diversified financial services concern refuses to estimate the potential total cost of its plan but its five top executives alone earned almost \$1.6 million in fiscal 1982 and it could easily exceed \$40 million.

A few plans cover directors as well as executives. Just before Brunswick Corp. fought off a takeover bid by Whitaker Corp. earlier this year, its board approved parachutes for outside directors 55 years of age or older with five years' service. It voted to pay them their annual retainers (\$22,000) and company benefits for life if they chose to "retire" in connection with a hostile acquisition; the health, recreation and technology company's 11 top officers, some of whom also were directors, received parachutes guaranteeing them up to five years' pay in the same package

Companies give various reasons for instituting golden parachutes. While most at least imply that their plans will ensure that top executives won't arbitrarily oppose takeover bids that would reward shareholders, a few advance them frankly as anti-takeover measures. For exam-

C. *Board Membership*

Suppose that the appropriate alignments of incentive have been worked out. Can the firm realize additional improvements by including the management on the board of directors? Putting the issue this way presumes that the central function of the board is to safeguard the interests of the stockholders. Such a conception of the board has been described by others as the “monitoring model.” Kenneth Andrews characterizes the monitoring model as simplistic, overformal, and self-defeating.⁶⁴ Paul MacAvoy and his collaborators contend that serious efforts to implement the monitoring model could have a “pervasive negative effect . . . on risk taking.”⁶⁵

Both, of course, may be correct. But neither Andrews nor MacAvoy and his collaborators advance an alternative conception of the board in which a clear sense of contractual purpose is described. Andrews’ favored model is what he refers to as the “participative board.” The outside board members are invited to join with the management to enhance the quality of strategic decisions.⁶⁶ Such involvement can come at a high cost, however, if objectivity is thereby sacrificed. As Donald Campbell remarks, if an “administrative system has committed itself in advance to the correctness and efficacy of its reforms, it cannot tolerate to learn of failure.”⁶⁷ This defensive propensity is the origin of the tendency to throw good money after bad. A less informed but more skeptical posture by outsiders may well be superior.

Since managers enjoy huge informational advantages because of their full-time status and inside knowledge, the participating board easily becomes an instrument of the management. Notwithstanding the variety of checks against managerial discretion described by MacAvoy and his collaborators, the interests of the stockholders—indeed, of all major constituencies⁶⁸—are apt to be sacrificed as a consequence.

ple, last year directors of Grey Advertising Inc. gave its chairman and president, Edward H. Meyer, a \$3 million parachute as part of a number of changes it said, “may make the company less susceptible to a successful takeover attempt” by making a takeover more expensive. At the time it was adopted, Mr. Meyer’s parachute was worth about 8% of the value of all the company’s common stock.

Klein, *A Golden Parachute Protects Executives, But Does it Hinder or Foster Takeovers?*, Wall St. J., Dec. 8, 1982, at 56, col. 1.

64. Andrews, *Rigid Rules Will Not Make Good Boards*, HARV. BUS. REV., Nov.–Dec. 1982, at 34, 44–46.

65. MacAvoy, Cantor, Dana & Peck, *ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis*, in THE BUSINESS ROUNDTABLE, *supra* note 1, Exhibit C, at C-24.

66. Andrews, *supra* note 64, at 44.

67. Campbell, *Reforms as Experiments*, 24 AM. PSYCHOLOGIST 409, 410 (1969).

68. This result depends upon viewing the contracting process in its entirety. A narrow slice-of-time approach is likely to reach a different result. Barnard recognized that employment relations have

Rejection of the participating model in favor of a control model of the decision ratification and monitoring kind does not, however, imply that the management should be excluded altogether. So long as the basic control relation of the board to the corporation is not upset, management's participation on the board affords three benefits. First, it permits the board to observe and evaluate the process of decisionmaking as well as the outcomes. The board thereby gains superior knowledge of management's competence which can help it to avoid appointment errors or to correct them more quickly. Second, the board must make choices among competing investment proposals. Management's participation may elicit more and better information than a formal presentation would permit. Finally, management's participation may help safeguard the employment relation between management and the firm—an important function in view of the inadequacy of formal grievance procedures.

According to the contractual conception advanced here, however, these are supplemental purposes. To the extent that management participation permits reviews on the merits to be done more responsibly and serves to safeguard an employment relationship that would otherwise be exposed to excessive risk, management may be added to the core membership. But the principal function of the board remains that of providing governance structure protection for the stockholders. Management participation should not become so extensive as to upset this basic board purpose.

V. MANAGERIAL DISCRETION

A. *The Inadequacies of Neoclassical Models*

Enthusiasts of laissez-faire capitalism are loath to confront, and are sometimes schizophrenic on, the subject of managerial discretion. Focusing on any given time, they commonly deny the existence of managerial discretion. Taking a long-term perspective, however, these same enthusiasts

mutual enforcement effects:

Since the efficiency of organization is affected by the degree to which individuals assent to orders, denying the authority of an organization communication is a threat to the interests of all individuals who derive a net advantage from their connection with the organization, unless the orders are unacceptable to them also. Accordingly, at any given time there is among most of the contributors an active personal interest in the maintenance of the authority of all orders which to them are within the zone of indifference. The maintenance of this interest is largely a function of informal organization.

C. BARNARD, *supra* note 61, at 169.

Alchian puts the same argument in more general terms:

[A]nyone vulnerable to [a] threat of loss [if the coalition is impaired] will seek to preserve not only the coalition but also to reduce the possibility of that threat from the other members of the coalition to expropriate the quasi-rent of the specific resource.

A. Alchian, *Specificity, Specialization and Coalitions* 9 (June 1983) (presented at Seminar on New Inst. Econ., W. Ger.).

point with pride to the development of new techniques that have brought managerial discretion under more effective control.

To be sure, the earlier condition may have been irremediable: The corrective instruments to which investors had access at that time could have been, indeed arguably were, fully deployed. But it is inconsistent to employ the *very same* neoclassical model—whereby the firm is characterized as a production function to which a profit maximization objective is ascribed—at both the earlier and later dates. A conception of the firm in which opportunities for managerial discretion are expressed as a function of the control instruments is needed instead. Such a conception leads to greater respect for successive organizational innovations that have superior control properties and that squeeze out managerial discretion.

The assumption of single-minded profit maximization is disputed by recent treatments that regard the firm as a contracting entity. Participants need to agree upon terms and implement the contracts. Since contracts are rarely self-enforcing, the possibility of managerial discretion must at least be admitted. What, then, is the machinery by which managerial discretion is held in check? MacAvoy and his co-authors maintain that it is the “interplay” of a variety of instruments:

Corporate chartering laws of the states limit corporate activities and procedures, and state laws of duty of care and loyalty, along with the business judgment rule, restrict self-dealing and negligence amongst management and the board of directors.

Market incentives also exist to discipline behavior. Efficiency is forced on the corporation by competition in the capital markets, the markets for management resources, and the market for corporate control, and the general market for selling the company’s goods and services.

In addition to these external constraints, there is internal overseeing. Formally, this is embodied in the board of directors and corporate by-laws. However, almost all internal overseeing takes place more informally, within management. Fama and Alchian-Demsetz have articulated a view of the firm as a group of team players with each player acting in his or her own self interest. Yet, each player’s ability to achieve his or her individual objectives is likely to be a positive function of other team players’ productivity, including those both above and below in the hierarchical level.⁶⁹

These authors do not indicate the relative importance of the various processes or describe the interplay between them. They evidently believe, however, that the *ex post* settling up processes described by Fama are

69. MacAvoy, Cantor, Dana & Peck, *supra* note 65, at C-13 to C-14 (citations omitted).

important;⁷⁰ and they are specifically attracted to the Alchian-Demsetz formulation. They observe with respect to the latter:

. . . [T]he firm in effect is organized into a set of team players with some one or group in a central position of making contractual arrangements with the others. Overseeing takes the form of both measuring productivity (organization of the inputs) and handing out additional rewards for higher productivity. Team players act to oversee themselves in achieving a common goal with the implicit understanding that the productivity of the team as a whole is tied to each individual player's reward. At a certain point, though, leisure will become preferable to pecuniary rewards and "shirking" will result. An employer or manager of a division then acts as an overseer to prevent this shirking. The overseer, himself, is given incentive not to shirk by receiving rewards for additional productivity of his team. For example, managers of divisions often receive a bonus for reaching a certain level of sales or production.⁷¹

Useful though this team conception of economic organization may be for some purposes, it is very limited for others.⁷² Whatever model of the board of directors is adopted, an accurate assessment of managerial discretion requires that organizational form be taken into consideration.

B. *The Transformation of the Modern Corporation: 1930-1960*

Managerial discretion can take numerous forms, some very subtle. Individual managers may run slack operations; they may pursue subgoals that are at variance with corporate purposes; they may engage in self-dealing. Such distortions become more severe where there is logrolling.⁷³ These and other manifestations of managerial discretion were well-known to Berle and Means, Mason, and other observers of the corporate scene. What went unnoticed, however, was the vast transformation of the corporate form between 1930 and 1960 and the consequences for managerial discretion. The earlier, centralized, functionally organized, unitary (or U-

70. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

71. MacAvoy, Cantor, Dana, & Peck, *supra* note 65, at C-19.

72. At the very time that MacAvoy and his colleagues were embracing the team formulation, Alchian acknowledged that the firm is more usefully regarded in the contractual terms described above. Although he and Demsetz had earlier asserted that "Long term contracts between employer and employee are not the essence of the organization we call a firm," he admitted in 1983 that "[i]n the light of Williamson's [1975] analysis that assertion is incorrect." A. Alchian, *supra* note 68, at 14. He goes on to observe with respect to the board of directors that "[d]irectors need not *direct* managers; instead they *detect* and *evaluate* managers' performance and may replace them." *Id.* at 26. This is plainly closer to the monitoring model of the board than it is to the participative model favored by Andrews or to the interplay (or free-style) model of MacAvoy and his colleagues.

73. See A. CHANDLER, *STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF INDUSTRIAL ENTERPRISE* 127 (1962) (discussing logrolling by GM management in pre-Chandler era).

form) structure of the corporation was progressively supplanted by the multidivisional (or M-form) structure.

The direct effects of the M-form innovation on corporate performance were two-fold. First, the shift from a functional to a divisional form served to rationalize decisionmaking. The confusion of purposes that characterized the U-form firm, where everything was treated as though it were connected with everything else, was supplanted by a divisionalized structure where separability among quasi-autonomous parts was emphasized. Restructured corporations realized sharper definition of purpose and savings in informational costs, and economies of bounded rationality resulted.

Disengaging the general office from operating affairs also improved incentives. As Chandler put it, "the psychological commitment" of the firm's top executives was changed.⁷⁴ What had been short-run, partisan involvements by top executives who had previously been heads of functional activities (e.g., manufacturing, marketing, finance) gave way to longer-run, strategic decisionmaking. Executives gave precedence to objectives of the enterprise over functional responsibilities. The general office of the multidivisional structure monitored the performance of the divisions, allocated resources to high-valued uses, and used internal incentives and controls in a discriminating way. M-form organization thereby attenuated managerial discretion in what had previously been U-form firms.

These organizational innovations also had indirect effects in product and capital markets that changed managerial discretion in many firms. The immediate beneficiaries of the M-form structure were the firms that first implemented the changes. The benefits showed up on their income statements as profits. But as such cost savings continue, the initial bulge in profits is normally dissipated by the "handing on" forces discussed by Schumpeter.⁷⁵ Competitors adopt innovations and the forces of competition in the product market restore rates of return to competitive (or pre-innovative) levels. Cost savings are thereby transferred to the public at large. To be sure, patents can delay the spread of technological innovations, and the merits of organizational innovations are often difficult to recognize so that imitation is delayed. But the forces of rivalry eventually intrude.⁷⁶ The effects are not limited to forces of competition in the product market; competition in the capital market is also affected.

Two kinds of effects of competition in the capital market can be distin-

74. *Id.* at 309.

75. See J. SCHUMPETER, *THE THEORY OF ECONOMIC DEVELOPMENT* 3-56 (1934).

76. Even if price-to-cost ratios are not fully restored to pre-innovative levels, the cost savings realized by innovations release productive resources to be employed elsewhere in the economy. Net welfare gains commonly result. Cf. Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 *AM. ECON. REV.* 18 (1968) (cost savings associated with modest price effects yield welfare gains).

guished. The first kind applies to all innovations, technological and organizational alike. The second applies to a particular subset of organizational changes, of which the M-form innovation is one. The general argument is that unrealized profit opportunities—from whatever source—always invite corrective action. Of course, redress may be costly to effectuate. But if incumbent managers have already pressed managerial discretion beyond the threshold of stockholder discontent, failure to adopt a new innovation that would bring large savings invites an effort to displace management.

It has often been noted that tender offers increasingly replaced proxy contests as a takeover technique beginning in the late 1950's.⁷⁷ What explains this? Gregg Jarrell and Michael Bradley contend that the costs of proxy contests were increased by new regulations:⁷⁸ Takeovers are a regulation-induced change in the relative price of the methods for gaining control.

This is an interesting hypothesis, but it would be more compelling if proxy contests actually had been widely and successfully used to challenge incumbent managements before these rule changes. In fact, proxy contests were never numerous and were usually unsuccessful. Moreover, although regulations on proxy contests could help to elicit a takeover response, why should a switch to this (previously inferior) device be associated with a larger number of contests for corporate control and a greater degree of success?

In principle, takeover by tender offer was always feasible. I submit that the reason why it was not employed earlier is that a corporate structure conducive to takeover was not yet in place. Specifically, reorganization of the corporation from a functionally departmentalized to a divisionalized structure had profound consequences for corporate control. Conceiving of

77. As Gregg Jarrell and Michael Bradley observe: "Cash takeover bids were very rare in the United States prior to the 1960's, but they burst onto the financial scene in the mid-1960's, a period of much corporate conglomeration." Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371, 371 n.1 (1980).

78. They cite the work of Peter Dodd, who associated the sudden emergence of cash tender offers as a takeover device with the successive expansions in 1955 and 1964 (Securities Acts Amendment) by the SEC of its rules governing proxy contents [sic] . . . [T]hese changes in proxy rules increased insurgents' costs of assuming corporate control via the proxy and, therefore, increased usage of the cash tender offer to achieve a change in management.

Id.

As Henry Manne puts it: "The most dramatic and publicized of the take-over devices is the proxy fight; it is also the most expensive, the most uncertain, and the least used of the various techniques." Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 114 (1965). From 1956 to 1960, only nine of the 28 proxy fights for control were fully successful. Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV. 135, 137 (1967). Proxy contests that aim less for control than for bargaining advantages seem to have come into vogue more recently.

the firm as a governance structure rather than as a production function is the key to understanding the phenomenon of takeover by tender offer.

In takeovers, the main advantage of an M-form firm over a U-form enterprise is the ability of an M-form acquiror to “digest” its acquisition. The acquired firm is normally assigned profit center status and thereafter becomes subject to the corporation’s internal incentive, control, and resource allocation processes. The firm does not attempt comprehensively to integrate the new assets with the old. Inasmuch as M-form firms separate operating from strategic decisionmaking, the general office neither seeks nor requires the same familiarity with the operating parts that managers in U-form firms must have. The greater competence of the large M-form firm to manage extant assets thus applies to the management of acquired assets as well.

For the reasons sketched out above and elaborated elsewhere,⁷⁹ the reorganization of a U-form firm into an M-form enterprise has beneficial effects on pursuit of goals, monitoring, staffing, and resource allocation. Since the general management of an M-form firm is disengaged from routine operations, there is a presumption that the general office favors profits over functional goals. The general office can be regarded as an agency of the stockholders that monitors the operations of the constituent parts. Monitoring benefits are realized because internal monitors enjoy advantages over external monitors in access to information.⁸⁰ The differential ease with which the general office can change ineffectual or recalcitrant managers and reassign duties helps to effect superior staffing. There are also benefits from better resource allocation because cash flows no longer return automatically to their origins but instead revert to the center, from which they can be allocated among competing uses in accordance with prospective yields.

Plainly, the M-form firm takes on many of the features that are normally associated with capital markets. Indeed, the M-form firm is usefully regarded as a miniature capital market. Such a corporate structure nevertheless poses a tradeoff of breadth for depth. As Alchian and Demsetz put it, “[e]fficient production with heterogeneous resources is a result not of having *better* resources but in *knowing more accurately* the relative productive performances of those resources.”⁸¹ Diversification can, however, be taken to excess—in which case the M-form’s competence to manage assets breaks down. Voluntary divestiture in the form of spin-offs or buy-

79. O. WILLIAMSON, *supra* note 20, at 132–75. The major condition is that the acquiring M-form firm does not diversify to excess—i.e., in a way that prevents it from competently evaluating and allocating funds among the diverse activities.

80. *See id.* at 145–48.

81. Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 793 (1972).

outs of subsidiaries is a manifestation of this condition. Absent such strains on managerial competence, internal capital markets both extend benefits to and receive benefits from the external capital markets.

The managerial discretion that was of concern to Berle and Means in 1932 was thus vastly transformed by *organizational innovations* and associated capital market effects over the next thirty years. Students of the corporation, however, were reluctant to concede the importance of organizational form. Disputes between skeptics and enthusiasts of Berle and Means thus continued without reference to intervening organizational changes.⁸²

VI. WORKERS' COOPERATIVES

A robust approach to the study of economic organization will apply equally well to both capitalist and noncapitalist forms. A brief sketch of the contracting approach to the problems of financing workers' cooperatives is set out here. Branko Horvat poses the dilemma directly: "If labor-managed firms are really more efficient than their capitalist . . . counterparts, . . . why do they not outcompete the latter firms in the market?"⁸³ His answer: "[A] labor-managed firm cannot easily survive in a capitalist environment regardless of its *potential* efficiency."⁸⁴ A principal reason for this difficulty is the inability of workers' cooperatives to secure adequate bank and trade credit.⁸⁵ Horvat offers a biological analogy: "[The capitalist economy behaves like an organism that has undergone an organ transplant: it spontaneously rejects the alien tissue."⁸⁶ This is a class-interest explanation.

I submit however that, at least in the short term, bank and trade credit are more accurately described by a physical analogy. They are more nearly akin to iron filings in a magnetic field. The prospect of high (risk-adjusted) returns presents a well-nigh irresistible attraction to liquid reserves. To be sure, local exhortations to discriminate can be temporarily effective. But venture capitalists are unprincipled in their search for profit. Capital displays an inexorable tendency to equalize returns at the margin.

Consider, therefore, the possibility that an objective assessment of economic risks, rather than political hostility, is responsible for the difficulties to which Horvat refers. If financial dealings with a workers' cooperative

82. This section follows the argument earlier set out in Williamson, *Credible Commitments*, *supra* note 14.

83. B. HORVAT, *THE POLITICAL ECONOMY OF SOCIALISM* 455 (1982).

84. *Id.*

85. *Id.* at 456.

86. *Id.*

are subject to a greater hazard, then such cooperatives will face adverse terms. And although short-term bank and trade credit for workers' cooperatives involve limited risk exposure, long-term bank financing and equity capital will almost surely carry a risk premium.

The cooperative firm and the capitalist firm pose distinguishably different expropriation hazards for holders of long-term finance, especially for holders of equity. The dilemma for workers' cooperatives is that workers cannot simultaneously ask for long-term financing to purchase firm-specific durable assets and refuse those who provide such funding the opportunity to intervene if the management of the cooperative thereafter dissipates (expropriates) these investments. Louis Putterman correctly perceives the dilemma when he observes that "if equity-owners value their voting control over firm policies, and if worker-run firms cannot (on principle) share such control with their equity owners, then the costs of raising equity-capital will be higher for the worker-run firm."⁸⁷ Inasmuch as rational equity owners will insist on such safeguards, and because the sharing of control to which Putterman refers is antithetical to the worker-managed enterprise, the statement would read more accurately if the two uses of "if" were replaced by "since."⁸⁸ Problems of workers' cooperatives thus fall into clearer relief under the light of the contractual schema.⁸⁹

CONCLUSION

Some commentators maintain that the corporation is made up of many constituencies—owners, suppliers, employees, customers, community, and managers—all of whom deserve a voice in corporate governance and therefore a place on the board of directors. Others regard this proposal as

87. Putterman, *Some Behavioral Perspectives on the Dominance of Hierarchical over Democratic Forms of Enterprise*, 3 J. ECON. BEHAV. & ORG. 139, 158 (1982).

88. Robert Dahl holds contrary views on this matter:

I do not see why a board of directors elected by the employees could not select managers as competent as those selected by a board of directors chosen by banks, insurance companies, or the managers themselves. The board of a self-governing firm might hire a management team on a term contract in the way that a board of directors of a mutual fund often does now—and also fire them if they are incompetent. If the "profit motive" is all that it has been touted to be, who would have more at stake in improving the earnings of a firm than employees, if the management were responsible to them rather than to stockholders?

Dahl, *supra* note 13, at 21. The differences between Dahl's assessment and mine are: (1) The assets of a mutual fund can be instantly liquidated at objective market values; (2) Comparative assessments of mutual fund managers are easy; (3) Dahl makes no provision for the use of specialized node C governance to protect the interests of employees; and (4) Dahl appears to ignore the expropriation risks which his procedures would pose if applied where stockholders are located at node B. An economic assessment of the microanalytic details of economic organization is needed to bring out the strain between his assessment and mine.

89. Jensen & Meckling, *supra* note 1, reach a similar conclusion.

too sweeping, but a systematic assessment of which constituencies have stronger claims and why has been missing.⁹⁰

Transaction cost economics regards the board of directors as a governance structure, but only one of several. Whether a constituency should be actively represented on the board is examined with reference to the contracting model. The main implications are these:

First, those who are associated with the firm in a node *A* relation have no need for supportive governance, whether it be of a board-connected kind or otherwise. Instead, market mediation suffices for these parties.

Second, those who are associated with the firm in a node *C* relation have already crafted bilateral governance that is attuned to the idiosyncratic needs of the transaction. Unless there are significant gaps or defects in this bilateral governance, board participation is unnecessary. The main occasion for those with node *C* governance to be included on the board of directors is for information purposes. Labor may sometimes qualify, especially when a firm is experiencing difficulties and is asking for givebacks. Suppliers who are engaged in a major firm-specific project and very large customers may also qualify.

Third, those whose contracting relation is otherwise of a node *B* kind are in the greatest need of remedial governance. By its very nature, the contractual relationship between the shareholders and firm is difficult to safeguard. Providing stockholders with an ability to monitor the affairs of the firm and to replace the management in a crisis will arguably facilitate obtaining equity financing on superior terms. For this reason, the board of directors should be regarded principally as a governance instrument of the shareholders. Viewed in the context of the entire range of contractual relations, moreover, it is in the interests of all constituencies that voting board membership be reserved for those whose contractual relation to the firm is of a node *B* kind.

It is difficult to craft governance structures for managers whose relation to the firm is highly specific. Management's presence on the board can improve the amount and quality of information and lead to superior decisions. But such a presence should not upset the board's basic control relation with the corporation.

The manner in which boards of directors in most major corporations are constituted and operated is broadly consonant with the efficient governance principles set out in this Article. Yet there are major differences. Management often plays a larger role in governance than the contractual framework dictates; boards are often pressed to go beyond a monitoring

90. The treatment by Fama & Jensen, *supra* note 3, is an exception. It makes important headway in advancing the analysis of these matters. See Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978) for an instructive discussion.

role to adopt a participative one; and corporations have been under economic and political pressure to extend board membership to various interest groups. In theory, the first two of these phenomena may result from the ex post settling-up processes. An alternative explanation is that these deviations are a reflection of the continuing presence of managerial discretion: Incumbent managements feel more secure and have greater latitude in participative boards which they dominate.

Although the approach set out in this Article locates corporate governance issues in a more general framework and permits the merits of the arguments that have been advanced on behalf of voting board representation for the various constituencies to be evaluated in a more systematic way than earlier treatments, it is nevertheless limited in three respects. First, the binary treatment of safeguards into all ($s=k$) or none ($s=0$) categories is a simplifying but arbitrary device. A more general treatment would recognize that safeguards are costly to provide and that s is a continuous, rather than a discrete, variable. If the optimal choice of s is less than k , then a residual degree of risk remains. The possibility that membership should be awarded to such constituencies at least warrants further discussion. Additionally, the entire argument proceeds within the conventional context of a "one-tier" board. In a two-tier board, one level is concerned with operating rules and practices while the second deals with overall resource allocation and the assessment of strategic decisionmaking and control. Efforts to effect co-determination using such a board have not been addressed.

Finally, the discussion assumes throughout that, once struck, all node C bargains will thereafter be respected. This ignores the possibility that circumstances will change and that departure from the spirit, if not the letter, of the contract will sometimes follow. For example, the resolve of a regulatory commission to set rates at a level that yields a fair rate of return may weaken if regulated firms do not have recurring needs to resort to capital markets for expansion and renewal capital.⁹¹ The same applies to stockholders in a firm that has no need for equity financing. Although management may have enthusiastically supported governance structure safeguards for the stockholders at the time the initial equity financing was secured in order to benefit from more favorable terms, it may subsequently prefer relief from the monitoring pressures that such a node C bargain implies. If additional equity capital is not needed, the composition of the board may be altered to the disadvantage of the shareholders. To be

91. Accordingly, a public utility that is financed by intermediate-term debt that is continuously rolled over is less subject to punitive rate setting than is an otherwise equivalent public utility that uses very long-term debt and has no need for renewal financing. In other words, how the rate setting process will be affected is a factor that should enter the calculus of the public utility.

sure, there are checks against such distortions, but assertions that “ex post settling-up” processes are always fully efficacious strain credulity.