Corporations, Shareholders, Workers

Plan of the Lecture

- Proprietary model of the Firm
- Why the Proprietary Model is wrong
- ‘Nexus of Contracts’ approach: another way of defending shareholder primacy.
- Defense and criticism of ‘Nexus of Contracts’ perspective.
- Alternatives and implications for employees and stakeholders.

Types of business

Regulated by private law primarily:

- Sole proprietorship.
- Partnership

Regulated by statutes, law of corporations:

- Chartered corporations.
- Publicly traded firms

Proprietary Model of Firm

- Firm as private property of shareholders.
- Firm managed to maximize shareholder value (S.V.).
- Shrhldr’s should have ultimate control.
- Society’s interest best served by maximizing s.v.
- Employees & stakeholders as outsiders (no representation in governance)

Problems with Proprietary model

- Firm, shareholder rights, created by law (not natural).
  - Statutory rights of shareholders (voting, transparency).
- Corporate charters = Social institution?
- Limited liability.
- Entity status of firm: legal person, owns itself!

Dropping the proprietary model

- Shareholders own/control shares, not the firm or its assets.
  - Entity status allows long-term investment, etc.
  - Problem with partnerships.

Separation of ownership and control (Berle and Means).

- Dispersed, rationally ignorant shareholders.
- Managers do and should have discretion.

  - Professionals, trustees for social interests, balance interests of stakeholders, employees.

Principal - Agent Problems
(Agency costs)

- Information assymetries.
- Decision makers don't bear the main effects of their actions.
- Other people's money.
- Efficient specialization?

Nexus of Contracts Approach

- Firm's existence = convergence of implicit and explicit contracts.
- Contracting parties = providers of specialized inputs.
  - Shareholders
  - Managers
  - Employees

Shareholders

- Providers of capital
- Residual claimants –
  - appropriate surplus after firm's bills paid.
  - Variable, open-ended returns and risk.
  - Don't own the 'corporation' rather, own a right to share in 'residual' assets and profits
  - Board of Directors decides the allocation.
- Can diversify risk

Managers and Employees

Managers

- Operational decision makers.
- Fixed claimants + performance rewards
- Undiversified risks (can be fired).

Employees

- Fixed claimants + performance rewards.
- Undiversified risks.

Implications of Nexus of Contracts

- Shareholders need governance rights (elect the board, etc.).
  - Uncertain returns, incomplete contracts.

- Share prices will decline when mgrs aren’t successful.
- Mgrs will want to satisfy shareholders – high share prices prevent takeovers.
- Employees – get no-risk fixed returns rather than control rights

How the Nexus of Contracts view supports Shareholder Primacy

- Maximizing bottom-line is better for all stakeholders…and efficient.
- Banks, Mgrs, employees are (too) risk-averse.
- Shareholders have greatest incentive to monitor mgrs.
- Stakeholders, employees have multiple interests – how to make mgrs accountable?
- Social & worker interests: responsibility of gov’t

Cont’d

- Too much accountability **by** firms to stakeholders or employees stretches mgmt competence.

Why Nexus of Contracts is wrong.

- Other corporate governance systems are stakeholder based.
- Profit-max not always efficient.
  - Other goals: job security, environment, etc.
- Stock options: managerial incentive that can fail. (Enron)

Cont’d

- Social Institution view:
  - Mgrs as trustees for broader social interests.
  - Firms are creatures of law.
- Short vs. long term s.v.
- Common Law contradictions:

Shareholder rights (lawsuits)

Vs.

Business judgment rule: Board-appointed Mgrs have authority to decide well-being of firm. (Dodge vs. Ford Motor Co.)

Bringing Employees back in

- Employees’ input more than ‘generic’ units of contractually compensated work.
- Employee input can’t be measured by market, specified in contracts.
- Employees: bearers of firm-specific assets.
  - Their value to firm depends upon learning, trust, expectation of sharing benefit of future success of firm.

Examples

- Seniority-based pay.
  - Why is it more efficient to pay junior employees less than their opportunity cost, senior employees more?
- Shortcoming of strict & direct performance based pay
  - High transaction costs (turnover rate) of performance/dismissal approach.
  - Enron’s ‘tournament’ culture – created myopia.

…more examples

- Team production
  - Value of joint employee input greater than sum of its parts. (producer surplus)
  - Why? Because employees cooperate less when individually rewarded.
  - Can’t monitor or reward individual performance w/o sacrificing producer surplus.

Examples cont’d

- Training dilemma for firms:
  - If employer trains me I can work for someone else.
  - Free-rider problem means ‘too little training’ unless employees have other incentives to stay.

Parkinson:

- Where possible: give employees more control rights, residual rights or representation in governance.
- Industrial democracy isn’t necessarily inefficient:
  - Workers on German company boards.
  - Better for some industries than others.

Reforms

- Don’t see social / labour issues as external to governance.
- Example: More independent Boards of Directors.