

# **Inherit the Firm**

**Noel Lukic Kegel  
171846**

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## **THE “MONKEY TRIAL”**

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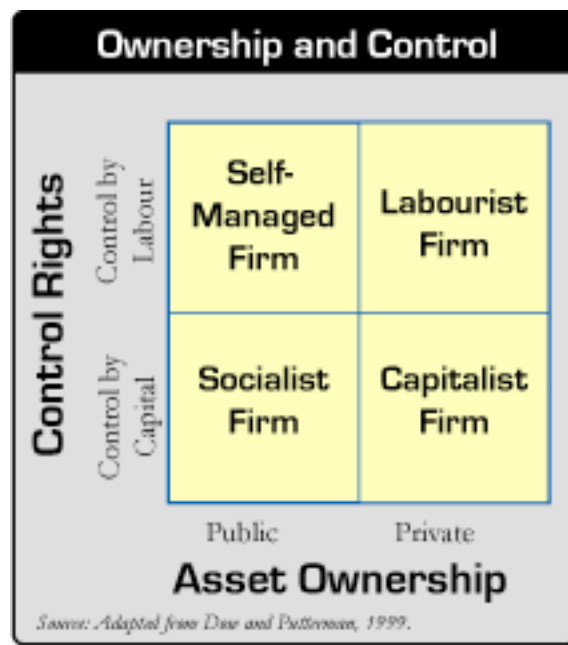
In the middle of a hot summer in 1925, the world descended on the small town of Dayton, Tennessee. Inside the sweltering courtroom stood John Scopes, accused of teaching evolution in a state that explicitly forbade it. The prosecutor was William Jennings Bryant, a celebrated orator, three-time presidential nominee and household name; on the defence was Clarence Darrow, a well-known corporate lawyer turned criminal lawyer. This “monkey trial” was dramatized some years later in the play “Inherit the Wind” by Jerome Lawrence and Robert Lee. In the unforgettable film version, Spencer Tracy plays the Darrow character and though slightly fictionalized, finds himself battling against tradition and dogma that listens to no reason. At that trial, the immutable “truth” was Creationism as dictated by the Bible and held to be above question, certainly incompatible with Darwin’s evolution. Clarence Darrow, the man who defended the right to teach evolution in 1925 made another visionary statement some fifteen years previously as a corporate lawyer, “the employer puts his money into ... business and the workman his life. The one has as much right as the other to regulate that business”. Nearly one hundred years ago before any notions of corporate governance and theories of the firm existed, Mr. Darrow highlighted one of the most pressing issues in today’s corporate governance debate. For some time now, it has become the immutable “truth” that corporations are owned and controlled by suppliers of capital, and the objective of the firm is to maximize the wealth of these investors. But as we will see, there is no a priori theoretical truth that necessitates such a system and alternative corporate governance systems that involve a firm’s labour are at least as relevant and maybe more so than this conventional wisdom.

## **THE FIRM AND GOVERNANCE**

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Since the very beginning, societies have concerned themselves with how to organize themselves for a common purpose. The Renaissance in the 16<sup>th</sup> century brought the joint stock company into being allowing a pool of capital and risk to be assembled and granted a charter (usually by the state) to undertake specific ventures, though each stockholder was still liable for the activities of the company. With the passage of the 1855 Limited Liabilities Act in the UK, the joint stock company was now a separate legal person and opened the floodgates for the creation of the modern corporation (Charkham, 2005: 2). In the context of the Industrial Revolution when the financing of projects such as mines, railroads, factories, and mills could not be met by individuals’ own means, the corporation became the de facto norm for almost all large businesses. By pooling the capital resources of many people, and dividing the risk among them, this organizational form has continued to be a dominant form of business to this day. Clearly there must be overriding benefits to such a system that has left alternative forms behind, but what are these alternatives? Indeed, the 20<sup>th</sup> century witnessed a tremendous struggle between two alternative socioeconomic systems: capitalism and socialism. The primary distinction between the two economic systems lies in the dimension of asset ownership; in capitalism, private investors own the physical assets of production, while under socialism they are owned by the state. But economic systems vary along another dimension that is quite distinct from asset ownership: control over production activities. Here the dissimilarity is between enterprises controlled by capital suppliers and those controlled by labour suppliers. Thus the crux of the issue is with what balance do input suppliers have the rights over the ownership and control of the firm.

The matrix at right shows how we might plot the four economic systems based on the distribution of asset ownership and control rights. The terms ‘capitalist firm’ and ‘socialist’ firm are standard and in both cases, while asset ownership differs, the control is ultimately in the hands of capital, whether provided by private investors or the state. The ‘self-managed firm’ is a unique term used to describe a firm where the assets are owned by the state, but workers within each firm had discretion over their use; this organizational form is rare and the only example is that of the former Yugoslavia (George, 1997). Public asset ownership is irrelevant for our discussion because of its empirical non-viability, and the left side of the matrix should be ignored. This leaves the ‘labourist’ firm as defined by Dow (2003): a firm whereby the assets are privately held, but control of them rests with the workforce as opposed to investors. It is important to note at this stage that private asset ownership does not necessarily imply that assets are actively managed by the suppliers of capital, or their agents. For example, in principle a firm could lease all its physical assets from their owners without ceding control over their productive functions. Thus private ownership does not have to result in ‘capitalism,’ and therefore the decoupling of ownership and control is vital to explore alternative governance frameworks. The fact that capital often does exercise control over workers’ activities is not a logical necessity, but an empirical fact requiring further explanation. While there are examples of companies owned and managed by the employees themselves (American North-western plywood coops, the Basque Mondragon group, and La Lega in Italy), they exist anecdotally and in numbers dwarfed by the number of firms owned and controlled by capital. Although human capital is widely acknowledged to be the most important asset of many firms, its role has not been treated as a central concern of corporate governance (Blair and Roe, 1999). Thus, the purpose of this paper will be to explore the nature between capital and labour and why capital has usually trumped labour in corporate governance theory and corporate practice. The aim will then be to present alternative visions of a governance structure that gives labour a more optimal role in the firm, and that the changing nature of modern commerce requires such governance rethinking.



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## **THEORY OF THE FIRM**

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As Zingales (2000) notes, “the word governance implies some notion of authority, but in a free market economy, isn’t the market supposed to allocate all resources efficiently? Coase (1937) taught us that using the market has its costs, and firms alleviate these costs by substituting the price mechanism with the exercise of authority. But to understand how this authority is allocated and exercised, we first need to know why it is needed in the first place. We need, thus, a theory of the firm” (p. 1630). The matter may seem trivial but it becomes clear when surveying the literature that there is hardly any consensus on what exactly a firm is. While some theories explain very well certain aspects, they ignore others; for example, “if agency theory is

useful in highlighting the self-interested economic inclination of agents, it misses the essential basis of trust upon which all human relations are based. At the same time, reducing economic relations to a series of contracts fails to comprehend the complexity of corporate relationships and the need to continually adapt to changing market environments" (Clarke, 2004: 19). In lieu of summarizing the debate, we will simply adopt the view that "the distinguishing characteristic of a firm is not the pattern of asset ownership but the substitution of centralized authority for the relatively unfettered negotiations that characterize market transactions" (Milgrom and Roberts, 1990: 72). Because we are ultimately concerned with authority, other more prevalent theories, such as the "nexus of contracts" (Jensen and Meckling, 1976) are less useful because it becomes difficult to separate this framework from control and authority structures in the firm.

The authority structure is a coherent plan for deploying inputs and once formulated is modified over time in response to changes in the firm's environment. The plan is "enforceable in the sense that agents have suitable incentives to implement the tasks assigned to them" (Dow, 2003: 93). Compliance with authority can be either contractual or self-enforced by firm members monitor and reprimand those who deviate. The agents that ultimately control the firm or those delegated with authority need not renegotiate compensation of the other agents for each new task; in other words, an employee's wage rate does not vary from minute to minute or task to task. Authority therefore is the control over behaviour that is exercised in the absence of continual repricing (Dow, 2003). Agents in the firm and subject to the authority structure remain free to renegotiate their relationship with the firm at any time; an employee can always quit or refuse a certain task unless given proper compensation. Because this right is not usually exercised means that the employees usually do submit to the authority structure. Also, authority is unidirectional because the agent with authority can expel the subordinate but not vice versa. In a market, agents bargain with each other and neither has authority over the other as each can walk away without repercussion. Thus what distinguishes firms from markets is the presence of authority.

At the base level, a corporation is a group of individuals working together to serve a variety of objectives, the primary one of which is earning large, legal, sustained returns for the people that own the business. The prototypical capitalist firm which has come to dominate the economic scene could be described as a large firm with dispersed shareholders who are the legal owners of the firm and are entitled to all residual claims (in the form of profit) who in turn elect a board of directors to hire and monitor management that oversee the daily operations of the firm. Because the firm's owners are dispersed, they cannot actively run the firm and need to hire managers to do so; this resulting separation of ownership and control lies at the foundation of corporate governance theory. In the modern Anglo-American firm, it is legally bound to put the interests of its shareholders above all other interests that may be involved in a firm and this shareholder primacy in the modern corporation is somewhat contentious. This debate over the primary corporate objective includes agency theory which suggests that shareholders are the 'principles' in whose interests the firm should be run because shareholders bear the firm's residual risk because they are the only economic actor to make an investment without any contractual guarantee of return (Jensen and Meckling, 1976). In this theory therefore the main purpose of governance mechanisms is to provide shareholders with some assurance that managers will act in the fiduciary interest of the shareholders. However, stewardship theory recognizes human psychological needs and posits that managers can choose to be agents, and hence in conflict with owners, or stewards who act in the best interest of the enterprise to the reward of most economic participants including the principles (Clarke, 2004: 9). Building slightly on this is stakeholder theory which sees the firm as a

confluence of relationships between various economic actors, all of whose interests need to be balanced and accounted for; a more detailed discussion will appear in the penultimate section.

## **THE BIAS OF CAPITAL IN THE FIRM**

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In the basic model of the firm, let us say there are two inputs of production, labour and capital. Let us further suppose that there is no difference between these inputs and that there is no reason why a firm should favour one or the other in its productive processes. This is an assumption many macroeconomic textbooks make but clearly does not reflect the reality. Therefore there must be some fundamental asymmetry between these two inputs which allows suppliers of capital to control the firm. This fundamental difference is the alienability of capital; that is, the ownership of physical assets can be transferred from one person to another, while the capacity to supply labour services cannot be. This has many implications: capital inputs can be either owned as a stock or as a leased flow, but labour is only a flow (Dow, 2003). Furthermore, a worker's time and skill are discrete and finite, but there is no upper limit on an investor's wealth. Capital is divisible and can be spread across infinite projects whereas a person's labour generally cannot be at more than one place at one time. Lastly, labour inputs are highly personalized and vary according to the person supplying them, while financial capital is not. Because capital is so uniform, it has gained many market efficiencies as summarized briefly by Dow and Putterman (1999). The first is based on work incentives and monitoring with the premise that teamwork is more productive than work done by individuals alone. Unless rewards are tied to individual performance however, there will be no productivity increase as workers will attempt to free-ride on the work of others. The solution is to have one participant monitor and apportion compensation in the form of wages; furthermore, this participant should be the owner of the firm's physical assets because they will be abused without monitoring by the owner. The second reason is that workers tend to be poor in relation to the firm's capital requirements and therefore cannot finance the creation or operation of the firm. The third reason given for the tendency for firms to be run by capital suppliers is risk aversion and insurance. Workers are typically more risk averse than investors because investors are better able to diversify across firms and are wealthier. Workers would rather keep steady wages today rather than a share of the residual profits tomorrow. The fourth reason, and last we will explore, is collective choice and managerial decision-making. Because employees have heterogeneous objectives such as preferences for pay, workplace safety, holidays, etc., the costs of reaching consensus in decision-making is prohibitively slow and inefficient to the detriment of the firm. Capital suppliers on the other hand have one unified objective: maximizing the present value of future returns (Hansmann, 1996).

With the dominance of capital suppliers theoretically and empirically (though not definitively) entrenched in the conception of the firm, let us notice that a firm can hire capital in two ways: equity and debt. Debt is hired as a relatively simple contractual agreement with fixed disbursement, repayment, interest and conditions for use. Equity is hired in a more complicated way; it is hired for an indefinite term and receives the residual returns of the firm, that is, what is left after all other claimants of the firm are paid off (i.e. material suppliers, wages, expenses, etc). In the classic sense, equity shareholders receive a bundle of rights and returns for their investment: residual profits, election of the board of directors, and decision making for "extraordinary"

business matters (Rock and Wachter, 1999: 136). Thus capital is an efficient mechanism for assigning ownership right the suppliers of capital are established as owners.

Is there a way to reconcile the efficiencies of capital control with principles of fairness and democracy in the firm? One mechanism that intends to give workers greater participation in firm governance is German 'codetermination'. In principle, German corporate law mandates firms of a certain size to have a two-tiered board structure with both a 'management board' and a 'supervisory board'. The supervisory board monitors the financial health of the firm, decides important strategic investments and acquisitions, approves the annual statement, approves dividends and appoints the management board which directly operates the firm. In large firms, this supervisory board must have half of its seats occupied by employee representatives and thus in principle, employees can influence firm policy at the highest level (Charkham, 2005: 40-63). This sounds like a viable way of including employee participation without ceding any ownership rights. However, in practice, as Hansmann (1996) and Dow (2003) have pointed out, codetermination may not actually function as initially intended because the heterogeneous preferences among the supervisory board members results in frequent impasse. The result of which is that "the board is not used for making the particular types of decisions where workers and shareholders have the most strongly conflicted issues" (Hansmann, 1996: 122). Ironically, codetermination has in a way perverted corporate governance by the weakness and fractionalization witnessed in supervisory boards which has increased the difficulty in monitoring management (Pistor, 1999: 188-191). Whereas German codetermination aims to give employees some measure of control without ownership, employee stock ownership plans (ESOPs) aim to give employees some measure of firm ownership without ceding additional control rights. With an ESOP, the employee becomes a common stock owner and thus is theoretically part of the ownership and control group, but the empirical evidence reveals that they are "inherently messy from a control perspective, primarily because the allocation of shares and therefore voting rights among employees is highly flexible, but also because the true incidence of a firm's ESOP contribution is hard to pin down" (Dow, 2003: 82). We will explore ESOPs in further detail as a component of a new governance paradigm in a later section.

## **ARGUMENTS FOR WORKFORCE'S ROLE IN GOVERNANCE**

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Throughout history, many philosophical and moral appeals have been made on the behalf of workers' control. A casual survey of the literature of worker's control reveals justification based on egalitarianism, property rights, democratic theory, and ideas of dignity and community. One of the strongest arguments for increased worker control stems from democratic theory that states that a firm resembles a state and that justifications for political democracy carry over to democracy at work. "If democracy is justified in governing the state, then it is also justified in governing economic enterprises" (Dahl, 1985: 135). Workplace democracy is further justified by Bowles and Gintis (1993) stating, "any compelling argument for democratic governance of the state entails democratic governance of the firm as well; and arguments that deny the legitimacy of democratic governance of firms equally oppose democratic governance of the state (p. 87). Ultimately they conclude that shared firm control between labour and capital is needed. It should be noted the difference between participatory democracy and representative democracy; in the former, each member of the group casts a vote in decision making, in the latter members elect a small group of representatives to vote on behalf

of their constituents. Hansmann (1996) adopts a transaction cost approach and cites the costs of collective decision making as a major barrier to the democratic process in the firm. Because employees are far more likely to have heterogeneous preferences for nearly all firm-level decisions, the costs associated with aligning interests and forging consensus is onerous to the firm and hence is rare. "If costs associated with collective self-governance were not a problem, employee ownership would be far more widespread than it is." (p. 92). Therefore some sort of representative structure is preferable to direct participation.

Walzer (1983) builds on this maintaining that since ownership is not an acceptable basis for political power [control], it is likewise unacceptable in firms. "What democracy requires is that property should have no political currency, that it shouldn't convert into anything like sovereignty or authoritative command" (1983: 298). While this analogy may not be perfect, i.e. the state makes decisions that affect a wide range of issues affecting life night and day, whereas a firm's authority is more limited in scope, duration and location, the argument is nonetheless compelling. There are not only moral justifications to increased employee governance, but also efficiency arguments as well. As Hansmann (1996) has pointed out, there can be significant inefficiencies associated with agency costs between owners and managers. When employees in a firm have highly aligned interests there may be significant cost advantages to employee rather than investor control and are indeed common in many professional service organizations such as law, accounting, medicine and taxi coops. Because employees at such organizations have very similar job tasks, it is easy to self-monitor and productivity gains can be real in certain industries (Dow, 2003). Thus, recognizing the importance of a firm's workforce, can we devise a system that reflects more fairly their contribution?

## **INHERIT THE FIRM: A MORE OPTIMAL ROLE**

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In searching for a more optimal governance structure that better accounts for labour's contributions to the firm, there are two paths to go down: the first leads to direct employee ownership and the second retains investors as ultimate owners but stresses that increased employee governance actually improves shareholder wealth. In the first proposal, Dow (2003) acknowledges that creating a labour owned and managed firm *de novo* is difficult given employee wealth restrictions, but provides an insightful mechanism whereby a traditional investor owned firm can be transformed into an employee owned one. His general strategy is to expand workers' control by facilitating employee buyouts of publicly listed companies through three central elements: a labour trust, labour directors, and labour shares. In its metamorphosis to a labour owned firm, a labour trust is created through which employee's buy a firm's equity shares on the stock market. The trust purchases shares at the market rates and is funded by taking an equal percentage of the employee's wages. Dividends accrue in the same way to employee shareholders and outside shareholders except rather than being paid in cash to employees, they are used to buy additional shares from outside investors. Eventually with time, the trust will hold a larger and larger percentage of the firm's shares and eventually can acquire the remaining shares in one transaction, perhaps by converting it into debt. As Dow points out, this is analogous to the procedures through which publicly listed firms are taken private in leveraged buyouts (2003: 263). Once outside shareholders are bought out, "the distinction between labour and capital income is abolished by replacing the dividend stream with wages" (p. 264). The labour trust is administered by its own board of

directors who are elected by employees on a one vote per person basis. In the transition period the growing percentage of shares owned by the labour trust should translate to the number of seats on the board elected on behalf of labour. Because the trust continues to buy shares during the transition the fraction of labour directors on the board will increase over time. Eventually, when all the outside shares are purchased, the firm's capital stock is owned and managed by its workforce. The last element, labour shares, owes its roots to employee coops such as those in the plywood cooperatives in northwestern America. When the labour trust is created, each employee regardless of wage, position or tenure, receives a labour share that carries one vote free of charge. The labour share entitles its owner to work in the firm, receive income, and vote for directors of the labour trust; the shares must be transferred when the employee leaves the firm and is replaced by someone else. One way is to let the departing worker sell his share to a replacement with suitable skills and wants the job; alternatively, the firm itself could buy back the labour share at publicly announced price and resell it when a suitable replacement comes along. (p. 262-272). This proposal combines three features historically found in worker-controlled firms: ESOPs (for the concept of the labour trust), German codetermination (for the role of labour directors), and the plywood coops (for the use of labour shares). This is just a cursory summary and Dow (2003) reasons through many potential pitfalls and challenges including outside shareholder expropriation, employee resignation during the transition period, and labour heterogeneity, but in the end concludes that such a mechanism could be viable for those firms that wish to pursue it. Such a structure would lead the firm to be a 'labourist' firm described earlier where the workforce are the owners and controllers of the firms assets and represents an ideal from the perspective of labour. However it is questionable how realistic such an ideal is given the strong historical precedence against such arrangements.

The second path towards increased employee governance is not as radical as employee ownership but plays well into two growing trends: the primacy of shareholders and the importance of human capital. The dominance of Anglo-American shareholder value seems to be spreading across the globe as investors are converging in their preferences in seeking global opportunities; "In 1999, the OECD issued [its] principles of corporate governance that emphasizes that corporations should be run, first and foremost, in the interest of shareholders" (Lazonick and O'Sullivan, 2000: 13). The increasing importance of intangible assets is another distinct rising trend. Knowledge, all of which is created by humans and much of which is embedded in peoples' heads, is asserted to be the key to competitive advantage and business success (Stewart, 2001). How do these apparent trends fit together? Does the pursuit of shareholder interest mean that other potential claimants on the corporation – most notably employees – should have no role in governance? Or, instead, does the increasing importance of human capital imply an increasing need to account for and protect employees' interests? If so, does this mean that employees ought to have a role in governance? Should shareholders be willing to grant them this role? The answer provided by Roberts and Van den Steen (2000) suggests that given the importance of the employee's intangible assets, shareholder value will ultimately increase when employees are more productive and have a stake in their professional destiny. In such a scenario, governance is perhaps better served not by agency theory, but by stakeholder theory whereby managers adopt an inclusive concern and grapple with the imperative to satisfy the interests of all the firms stakeholders (owners, employees, customers, community, etc.) In this more holistic approach, the assumption is that the interests of the shareholders are not negatively affected because shareholders benefit when the company performs well. "Only by creating stronger relationships with employees, customers, suppliers, investors and the community will companies learn fast enough and change fast enough...only by

giving due weight to all the key stakeholders can shareholder value be assured (Clarke, 2004: 197).

## **LESSONS FROM THE “MONKEY TRIAL”**

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Traditional Anglo-American notions of the firm and corporate governance have served quite well in lubricating the economy and building societies' wealth and prosperity. However, as the nature of business seems to be changing to increasingly value the contribution of human assets, there is room for labour in firm governance. This phenomenon along with globalization should encourage countries and firms to be different, to look for distinctive ways to govern themselves inline with their circumstances and environment rather than converging on a best model. The proposals outlined in this essay highlight a few of the convincing mechanisms for including suppliers of labour in the control systems of the firms they work for; indeed under Dow's (2003) scenario, the employees themselves inherit the firm. In the final scene of "Inherit the Wind" Darrow's character, alone in the courtroom sees copies of Darwin and the Bible on the bench. He holds Darwin's volume of *Origin of Species* in one hand, and the Bible in his other hand - thoughtfully weighing them and balancing them against each other in the air. He half-smiles, shrugs, claps them together, and then jams them side-by-side into his briefcase and exits. The symbolic effect of the scene seems to suggest that there is room for more than one theory; and thus this is a fitting conclusion to this discussion of corporate governance.

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