My aim today is to discuss corporate governance in a broader context than is typically provided by articles in corporate finance and the area known as “law and finance.” I view corporate governance as a process of designing and implementing various implicit and explicit contracts among capital providers, corporate managers, workers, and other important stakeholders. In my talk today, I will thus try to expand the scope of the typical shareholder value focus to consider the design and implementation of contracts with other stakeholders, particularly employees and organized labor.

In the standard corporate finance discussion, an effective contract design is one that aims to maximize shareholder value while preventing expropriations of value by particular groups of stakeholders through excessive compensation or use of corporate resources for “private benefit.” Because controlling shareholders and top managers are in a position to have the greatest impact on firm value, they naturally receive the most attention in any discussion of corporate governance. But my intent here is to expand this discussion to include the firm’s contractual dealings with non-investor stakeholders, and with a special focus on labor.

The effectiveness of contracts in encouraging value-maximizing behavior depends on the internal governance systems of individual companies as well as the political and legal institutions that interact with both internal and external governance mechanisms. Effective internal governance consists of features such as reliable disclosure practices, independent boards with accountability, and careful alignment of managerial compensation with shareholder value. Chief among external governance mechanisms are institutional investors that monitor corporate performance and markets for corporate control that discipline—and, when necessary, change the ownership of—underperforming companies. And if these two forces fail to bring about the necessary change, old-fashioned product market competition should work to restore value in unprofitable industries by eliminating inefficient producers.

Shareholder value maximization also has received considerable attention in the field of law and finance. Whereas most discussions of corporate finance assume that value maximization is the overriding corporate objective, research in law and finance focuses heavily on the relation between legal institutions and shareholder value. In my remarks today, I want to start by describing the rationale for the corporate finance focus on shareholder value maximization, and then combine the traditional corporate finance approach with the law and finance paradigm. By so doing, I hope to demonstrate the importance of the interaction between certain corporate characteristics and legal institutions in determining within-country variation in individual companies’ governance and disclosure practices. This analysis also leads to important insights into the international flow of capital and helps explain why foreign acquirers tend to “cherry pick” when making cross-border acquisitions in emerging markets.

Having laid this groundwork, I will devote most of the remainder of this talk to discussing the role other stakeholders play in shaping governance. More specifically, I plan to focus on the economic incentives of workers, managers, and investors—and on how the interaction of such incentives affects corporate decision-making and value creation. Let me also tell you that much of this discussion reflects the findings of two recent studies I collaborated on with Paige Ouimet and Julian Atanassov. The goal of these studies was to try to answer two important questions: What are the effects of employee stock ownership on worker productivity? And what are the effects on productivity and value of worker-management alliances that are formed under a variety of circumstances: when strong unions are combined with weak investor protection, when strong unions are combined with strong investors, and so forth. Given the problems facing some U.S. corporations today, these effects could have important implications for policy makers as well as corporate managers.

Shareholder Value

The focus on shareholder value is typically justified on the grounds that shareholders are the residual claimholders. They stand at the end of the line to take whatever value is left after the claims of all other stakeholders’ claims have been satisfied. The main reason for making shareholder value maximization the overarching goal of public companies is that, precisely because they are the residual claimholders, shareholders—or their representatives, top management and corporate boards (if we ignore agency problems)—are in the best position to make the value-maximizing tradeoffs that all companies confront. Do we pay another dollar to labor? How many price
Consequences of Shareholder Value Destruction

A rather drastic example of shareholder value destruction stemming from the misalignment of interests between those in control and shareholders can be found in pre-crisis Korea. Prior to its 1997 financial crisis, the large family-controlled business groups known as chaebol were managed in “imperial” fashion by their controlling shareholders. These shareholders were empowered in part by voting or control rights that were disproportionately larger than their cash flow rights. To give you a sense of this disparity, a recent study by Woochen Kim and I found that, during the period 1997-2005, the controlling families held an average of only 22% of the outstanding shares of their group companies while controlling an average of 69% of the voting rights through various forms of cross- and circular holdings in affiliated companies. 1

Such a large disparity between control and cash flow rights, which was likely even larger prior to 1997, played a major role in the vast destruction of shareholder wealth prior to the crisis. In a study commissioned by the Korea Stock Exchange, 2 my co-authors and I estimated that, from 1992 through 1996 (and thus the five-year period preceding the 1997 crisis), only 27% of the companies listed on the Korea Stock Exchange produced a positive cumulative economic value added (EVA) for the entire period. 3 In other words, only about one-in-four listed Korean companies managed to create shareholder value. The rest, nearly three-quarters of all listed firms, did not earn sufficient operating profits to cover the costs of capital. This destruction of shareholder value has been widely blamed for the massive flight of capital from Korea and the sharp decline in the value of the Korean won.

But Korea, of course, was not the only country hit by the Asian crisis of 1997-1998. The crisis also hit Thailand, the Philippines, Malaysia, and Indonesia—all countries with relatively weak corporate governance systems. Those nations with more effective corporate governance—Hong Kong and Singapore, for example—were able to weather the storm that swept through the region. Although Japan did not suffer a sudden crisis, its steadily declining stock prices and sluggish economy throughout the 1990s—the so-called “lost decade”—have been blamed at least in part on a corporate governance system that has long given low priority to shareholder value.

Law and Finance

The Asian crises were a wake-up call for policy makers and regulators, who saw regulatory reforms as a possible solution to governance-related problems. 4 Governance reforms were also triggered by large business scandals; as just one example, the Sarbanes-Oxley Act of 2002 was triggered in large part by the Enron and WorldCom scandals. Most of the major reforms appeared to follow governance principles set forth by the OECD—first in 1999 and substantially revised in 2004—with adjustments to suit their local environment. 5

The intellectual underpinnings of the OECD and IMF guidelines were provided by the newly emerging field of law and finance. Within this paradigm, financial economists and legal scholars explore the role of legal institutions in protecting investors against expropriation by controlling stockholders and management. The work of such scholars has furnished evidence of a number of important economic benefits from having strong legal investor protection, including higher stock market valuations, greater reliance on security markets as a source of external financing, and greater financial and economic development. 6


1. E. H. Kim and W. Kim, “Changes in Korean Corporate Governance: A Response to Crisis,” Journal of Applied Corporate Finance (2008), pp. 1-12. Moreover, although the statistics are not available before 1997, it is widely believed that the wedge between control and cash flow rights was even greater before the governance reform triggered by the crisis. The reforms mandated by the IMF in 1998 and put into effect by the government in 1999 targeted chaebol and included various measures to reduce the wedge.


3. Measured as net operating (pre-interest) profits after taxes minus the cost of capital.


5. For an account of such reforms, see Lu (2009).
But one limitation of the law and finance paradigm has been the scant attention paid to the significant differences in the quality of governance among companies operating within the same national jurisdiction. In other words, the discipline appears to assume that the law of the land is all that matters, and all else is inconsequential. If that assumption were true, all companies in weak legal regimes would suffer from poor governance, and all companies in strong legal regimes would practice uniformly high-quality governance. The reality, of course, is that there are dramatic differences in governance among companies located in the same country and subject to the same rules and regulations.

**Joint Effects of Corporate Characteristics and Legal Institutions**

In a study entitled, “To Steal or Not to Steal,” Art Durnev and I gathered data on nearly 900 companies in 27 countries that revealed significant same-country variation in corporate governance and disclosure practices. To explain this variation, we provided a theoretical framework that combines the traditional corporate finance approach with the law and finance paradigm to show how differences in certain corporate characteristics help explain the variation among individual companies.

Our study identified three corporate attributes that were strongly associated with better governance and disclosure practices:

1. more profitable investment opportunities
2. greater need for external financing and
3. higher concentration of share ownership.

The “intuition” behind these results is fairly straightforward: (1) When investment opportunities are more profitable, the controlling shareholders’ expected return from new investment is likely to be larger, providing them with stronger incentives to make value-maximizing uses of investor capital; (2) companies more reliant on external financing can use a reputation for effective governance to raise equity and debt at lower cost; and (3) concentrated ownership makes it less likely for the controlling shareholders to divert corporate resources for private benefit since those owners bear a higher percentage of the costs associated with such misuse of assets.

Our study also provided evidence that good governance is reflected in corporate valuations, and that this positive effect is larger in countries with less investor-friendly regulatory oversight. This finding has an important message for corporate managers: good governance pays in all countries, but the payoffs are even larger in countries where good governance is scarce.

Attention to the interplay of legal institutions and corporate characteristics also yields important insights into the international flow of capital. In a recent working paper, my colleague Yao Lu uses the positive correlation between profitable investment opportunities and the quality of governance to explain the practice of “cherry picking” in cross-border acquisitions. Cherry picking is the tendency of foreign acquirers from advanced countries to target mainly just the most reputable and best-performing companies in emerging markets. In explaining her finding, Lu starts by pointing to the disparity in the levels of investor protection provided by the countries of the acquirer and the target. The best-performing companies with the highest valuations have the strongest incentives—as Durnev and I argued in our study—to develop effective governance systems, which means that their controlling shareholders have less inclination to consume private benefits. While the values of these companies (relative to their earnings power) are likely to be higher to reflect their strong governance, their controlling owners are likely to demand lower “control premium” when selling. Thus, they are more palatable targets for acquirers domiciled in countries with strong legal investor protection and thus tougher restrictions on private benefits.

Lu finds clear evidence of such cherry picking by foreign acquirers of companies in countries with weak investor protection, but no evidence of it when their targets are domiciled in countries with strong investor protection. Even more suggestive, Lu also finds that when governance reforms in weak investor protection countries narrow the gap in investor protection between the acquirer and target countries, the evidence of such cherry-picking becomes considerably weaker. In other words, in the wake of governance reforms, foreign acquirers from developed markets tend to show greater willingness to pursue underperforming companies in less developed markets. And these findings have an important implication for policy makers: Corporate governance reforms undertaken by countries with limited investor protection can improve their economies by guiding international capital flows to companies with more room to improve the productivity of their assets.

**Labor’s Role in Shaping Governance and Value Creation**

Although these studies provide valuable insights and important implications for both policy makers and corporate managers, an exclusive focus on shareholder value largely ignores an important stakeholder—employees. With the exception of the U.K. and its former colonies where legal institutions have

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9. This finding is based on Lu’s study of cross-border acquisitions in 21 weak-protection countries by acquirers from 17 strong-protection countries. See Lu (2009), cited earlier.
common law origins, most countries consider employees to be at least as important stakeholders as shareholders.

The idea that employees are a primary stakeholder has clear intuitive appeal. After all, it is employees, not investors, who are involved in the daily operations and whose livelihoods depend most directly on the company. Shareholders and other investors can reduce the risk associated with a firm’s bad performance by holding diversified portfolios, but employees are largely unable to diversify their earnings from the firm. In other words, although financial capital can be readily diversified, human capital cannot—and that makes the welfare of a company’s employees much more dependent than its shareholders on the firm’s performance and value.

The corporation is the place where capital meets labor, a symbiotic relationship in which one cannot function without the other. Workers influence governance through several channels. Workers or unions—or in some cases both—have the right to appoint members to the board of directors in countries like Austria, China, Czech Republic, Denmark, Egypt, Germany, Norway, Slovenia, and Sweden. Workers also own company shares through employee stock ownership plans, retirement accounts, and personal accounts. These are the official channels through which workers participate in governance.

There are also a number of unofficial channels whereby those who are governed inevitably influence the process of governing through their actions. Workers, of course, affect operating performance—and through its effects on the performance evaluation of those who govern, worker performance can end up affecting governance practices. Workers also engage in collective activities such as strikes and political lobbying that affect governance—for example, striking to thwart potential acquirers that are likely to cut payrolls more than the incumbent management, lobbying for government bailouts, and so on. Furthermore, labor unions often pressure governmental agencies and politicians to enact rules and regulations that are more protective of worker welfare. In some instances, the mere possibility of worker activism will be enough to influence the corporate decision-making process.

To illustrate these official and unofficial channels of worker influence, I now discuss three cases of worker influence on governance—cases that show (1) the potential role of union activism in achieving greater transparency; (2) the effect of management’s desire to maintain good labor relations in restraining managerial compensation; and (3) the possible effects of worker control rights on corporate performance.

**Mutual Fund Transparency: Unions as Shareholder Activists**

In 2000, the AFL-CIO started its push to require mutual funds disclose their proxy votes by sending a written request to the Securities and Exchange Commission. Union pressure prompted the SEC to examine the proxy vote disclosure issue, eventually leading to its 2003 decision to mandate disclosure of proxy voting policies and actual votes cast by mutual funds and other registered investment management companies. During the 2002 comment period, opposition to the proposed regulation from the mutual fund industry was unanimous. Even TIAA-CREF came out against the proposal, arguing that it would discourage “institutional shareholders from voting independently.” To counter the opposition, the labor group held rallies in several cities and flooded the SEC with letters asking for mandatory disclosure of the votes.

Why did the unions care about how mutual funds vote? Because some 38% of the labor federation’s 13 million members participated in defined-contribution plans managed by mutual funds. Unions demanded their rights to know how those funds were voting on their behalf.10

The new SEC disclosure rule allows public scrutiny of proxy votes cast by investment management companies, thereby putting pressure on mutual funds to vote in accordance with shareholder interest. Public monitoring of mutual fund proxy voting is important because business ties mutual funds have with their portfolio firms often create conflicts of interest in their proxy voting. As reported in a recently published paper in the *Journal of Financial Economics*,11 Gerry Davis and I found that most large mutual fund companies manage corporate benefits (such as 401(k) plans) at the behest of management and derive substantial fees. FMR (parent of the Fidelity funds), for example, earned one-quarter of its 2001 revenues from administering employee benefit plans.

When mutual funds receive fees for providing services to their portfolio companies, all the fees accrue to the fund company, whereas the potential benefits from value enhancements of portfolio firms through governance improvement are uncertain, small, and indirect. Thus for the conflicted mutual funds, the risk of alienating corporate clients and losing their business is more compelling than the forgone opportunity to increase portfolio values through shareholder activism. So, when mutual funds did not have to disclose their votes on shareholder proposals, funds with business ties may well have been less hesitant to vote against shareholder proposals to improve governance that were opposed by the management.12

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12. Numerous anecdotes, prior to the new disclosure rule, describe conflicts of interest compromising mutual funds’ stance on governance issues and proxy votes. For example, Black (1990) states: “The conflict of interest is illustrated by episodes such as the decision by Armstrong World Industries, a principal supporter of the recent Pennsylvania anti-takeover law, to switch its $180 million employee savings plan to Fidelity Investments from Vanguard Group, after Fidelity withdrew its opposition to the new law” (p. 602). B. Black, “Shareholder Passivity Reexamined,” *Michigan Law Review* (1990), pp. 520-608. Gretchen Morgenson, a New York Times financial writer, notes that several mutual funds voted in favor of options expensing, but Fidelity did not; indeed, Fidelity was in the minority in voting against options expensing at Intel, perhaps because “Fidelity is the record-keeper for Intel’s 401(k) plan, which held eight Fidelity funds worth $1 billion at the end of 2003.” A door opens. The view is ugly,” *New York Times*, 12 September 2004.
Limiting Executive Pay: The Case of POSCO

Even when workers do not take an active stand on governance issues, they may still influence the corporate decision-making process. While serving on the board of directors of POSCO, a large Korean steel company listed on the NYSE, I witnessed how top management’s concern about labor activism can affect managerial compensation and dividend payout decisions. Although Korea is known for militant labor unions, POSCO has been able to maintain a relatively smooth and amicable working relationship with its union. During the fiscal years of 2005-06 and 2006-07, POSCO had consecutive record net profits of over $4 billion. At the end of both fiscal years, the board of directors decided that the top executives were vastly underpaid relative to their industry peers and recommended compensation increases that were deemed appropriate for their performance.

On both occasions, the top management declined the recommended increases, opting instead for a substantially smaller increase that kept their percentage increase on par with those of plant workers. These managers worried that a large disparity in compensation increases between management and workers would hurt workers’ morale and jeopardize the good working relationship it enjoyed with its union.13 Similar considerations also led to dividend increases that, in my opinion, were too low relative to the record profits. In other words, management’s desire to signal to labor that workers, management, and stockholders are all in the same boat —effectively capped dividend payouts as well as managerial compensation.

To an American audience, this case may sound as foreign as the country in which POSCO is headquartered. Korea is a country with a strong egalitarian tradition that is less tolerant of income disparity than the U.S. But even in Korea, it is rare to read a media story of top executives declining compensation increases offered by their boards. Good deeds often fail to read a media story of top executives declining compensation increases offered by their boards. Good deeds often fail to get coverage—and the POSCO story was, in fact, never mentioned in the Korean media.

Labor concerns may well also have had an influence on managerial compensation and dividend payouts even in the U.S., especially among companies that place a high value on good labor relations. One famous example is Lee Iacocca taking a $1 annual salary in his successful attempt to rally union workers and creditors around his effort to obtain Federal loan guarantees in 1980. And during the current financial crisis, the CEOs of several troubled companies have volunteered to take pay cuts, a move attributable in part to the increasing public criticism of the huge disparity in compensation between CEOs and average workers.

Employee Ownership: The Case of United Airlines

To establish good labor relations and encourage worker cooperation, some companies may decide to make workers part owners of the firm. A much-publicized case was United Airlines (UAL) in 1994, in which the firm’s employees were granted equity shares with an aggregate claim to 55% of the firm’s cash flow rights. They were also given the right to elect three members to its 12-director board, thereby giving employees considerable influence in electing the CEO. The plan was implemented with the idea of bringing about a dramatic change of culture that would help transform United into a more competitive firm.

The first CEO brought in after the deal, Gerald Goodwald, had a long history of labor-friendliness. The plan appeared to succeed during the first few years. Employee absenteeism and turnover declined, while United’s stock performed significantly better than the market.

But, in the third year, these favorable effects began to dissipate when the market price began to underperform the market. When Goodwald retired after four years in the CEO office, employees supported and subsequently elected James Goodwin as CEO. Shortly thereafter, the pilot union began contract renegotiations with their handpicked CEO. The pilots walked away with a generous deal, making them the highest paid in the industry.

But after 9/11, the financial situation became particularly dire, and Goodwin wrote an open letter to employees acknowledging the current troubles and asking for help. Presumably, this letter was directed at the mechanics union, which was about to begin contract negotiations. In response, the mechanics union demanded Goodwin’s resignation and two weeks later he did. As before, John Creighton, the next CEO approved by the employee-owners, had a reputation for being labor friendly. As expected, the mechanics union obtained a favorable deal, making United the most expensive airline to operate on a per mile basis. The firm declared bankruptcy in December 2002, hurting investors and employees alike.

13. POSCO workers already were being paid substantially higher than other similarly skilled workers in the region (Pohang, Korea) where one of its two main plants is located. The large discrepancy in pay between POSCO and non-POSCO workers in the region led to serious social tension, which resulted in a riot by non-POSCO steel workers, who unlawfully occupied the POSCO headquarters building and inflicted serious damage to it. This social unrest prevented POSCO from giving its own workers substantial wage increases.
General Effects of Employee Stock Ownership on Value Creation

The employee stock ownership plan adopted by United Airlines, in which UAL employees were granted majority ownership of the firm, is often cited as a failed experiment in corporate socialism. But this case is far from representative of the many employee stock ownership plans (ESOP) adopted by U.S. companies in the past two decades. 14 In a study of 418 ESOPs initiated by U.S. public companies during the period 1980 through 2004, 15 Page Ouimet and I found that the median ESOP held only about 6% of total shares outstanding, much less than the 55% cash flow rights granted to UAL employees.

ESOPs provide workers with both cash flow rights and voting or other forms of control rights. Cash flow rights tie workers’ self-interest to shareholder value and improve worker incentives, thereby increasing worker productivity through improved team effects and collective employee behavior. Skeptics, however, argue that individual workers may feel they have little impact on stock price and so are unlikely to alter their behavior in tasks requiring additional effort or sacrifice. Therefore, the benefits from an incentive effect, if any, will arise only to the extent that ESOPs succeed in improving group-based incentives.

One study has argued that such free-rider problems can be managed by educating new employees about workplace norms in ways designed to create a work environment in which peer pressure enforces the group-based incentive. 16 In this sense, group-based incentive schemes can be seen as resulting in effective co-monitoring, which reduces the need for costly monitoring by managers. 17 ESOPs may also help employees develop a sense of identity and loyalty to their company and participate more actively in productivity-enhancing activities such as quality-control circles. 18 In addition, ESOPs may help prevent labor disputes by creating incentives for unions to refrain from costly strikes. 19

But giving workers voting or other forms of control rights can also work to the detriment of investors. One study argues that managers worried about hostile takeover threats may seek an alliance with workers in which they pay above-market wages in return for workers’ votes against hostile bids. 20 Because ESOPs provide a means by which management can give workers voting rights, some ESOPs may have been created by management as an anti-takeover device. 21 And even when ESOPs are not created with such intentions, workers with substantial voting rights may use their influence to obtain higher compensation. In the extreme, as the UAL case seems to illustrate, workers can become so powerful that they extract excessive compensation at the expense of other stakeholders. Such excessive worker compensation erodes the value of corporate growth opportunities by raising labor costs to an unsustainable level, causing the firm to invest less, suffer poor performance, and have a lower value. To the extent this scenario is representative, it reflects the potential of corporate socialism to destroy value for all stakeholders.

What, then, are the net effects of employee ownership plans on corporate values? Providing a contrast to the performance of UAL, our study of over 400 ESOPs from 1980 through 2004 showed that, on average, both employees and shareholders were significantly better off following the adoption of ESOPs. Employees experienced a permanent increase in total compensation and benefits per employee, while shareholders enjoyed permanent increases in firm valuation. The combined positive effect for both stakeholders seems to be due to increases in worker productivity.

How the gains were divided between the two stakeholders was shown to depend on the size of the ESOP. When companies adopted small ESOPs—defined as those with less than 5% 22 of the shares outstanding—firm value increased by an average 16% relative to the industry median. And in such cases, the average employee compensation increase was small (0.8%) (albeit statistically significant). So, in the case of smaller ESOPs, shareholders appear to reap the lion’s share of the gains, with relatively modest gains for employees.

But in the case of the larger ESOPs in our sample—in which percentage share ownership ranged from 5% to as high as 65.4%—the increases in employee compensation were substantially higher. Even ignoring the value of ESOP shares granted, studies estimate that employees experienced, on average, a permanent 4.5% increase in compensation. Stockholders, by contrast, appeared to neither win nor lose, with such companies producing returns roughly equal to their peers.

These results have two important implications. First, employee share ownership is usually a positive-sum game—

14. According to the National Center for Employee Ownership, in 2007, 10.5 million employees participated in 9,650 ESOPs, with combined assets over $675 billion at public and private firms. This represents an increase of over 100% in the number of participants from 1990, when 5 million participated in ESOPs.
22. We chose 5% as the demarcation point between small and large ESOPs because proxy statements only detail the size if the ESOP has more than 5% of the firm’s equity. In addition, 5% is often used as a threshold for various disclosure requirements, presumably because it signifies an important source of control rights.
one in which moderate levels of employee ownership generate worker productivity gains that benefit both investors and workers. Second, when employees have control rights, they use them to their advantage. When employees are given a dominant position in governance and decision-making, as in the extreme case of UAL, companies appear to become vulnerable to a kind of corporate socialism in which total value is destroyed.

Relative Power of Workers vis-à-vis Investors

How much influence workers exert on governance depends on the power they possess relative to investors. In a paper published recently in the *Journal of Finance*, Julian Atanassov and I argue that when workers are more powerful than investors, management may do more than simply acquiesce to worker demands. They may form a management-worker alliance designed to “protect” them from the firm’s investors. Our study documents the prevalence of such alliances under a particular set of circumstances—namely, when top management is facing possible dismissal due to underperformance and union power is combined with limited investor protection.

The focus of our study was restructuring decisions by companies suffering a sudden sharp drop in operating performance. In such cases, conflicts between the interests of workers and investors become more acute as the economic pie to be divided between them shrinks. Our aim was to obtain insights into how worker influence on governance affects the resolution of such conflicts and the long-run welfare of both workers and investors. Although previous studies suggest that restructuring by poorly performing companies generally leads to improvements in stock-price and operating performance,24 the evidence says little about the combined welfare impact on workers and investors. And this raises the possibility that part or all of the gains to investors may come at the expense of workers and other stakeholders.25

When a company suffers a sharp drop in operating performance and underperforms its industry rivals, investors are likely to demand the removal of management. In response to such pressure, management may behave opportunistically, weighing the relative influence of investors and workers, and then siding with the group that can best help them retain their jobs. In those cases where shareholders carry more weight than workers in managerial retention decisions, management is thus likely to pursue value-enhancing restructuring decisions. But, in cases where the socio-political environment and legal institutions give labor greater power in managerial retention decisions, are likely to form alliances with workers, and minimize layoffs and wage cuts to garner worker support. What’s more, because poorly performing firms tend to be short on cash, they may be forced to sell valuable assets even if the asset sales are expected to destroy value instead of preserving it.

How likely are such management-worker alliances? The recent Volkswagen scandal in Germany, a country with strong union laws, provides a convenient example. Volkswagen’s EBITDA-to-total assets ratio was the lowest among the four major automakers in Germany during the period 2002-2005, and ranked 13th among 17 major automakers worldwide over the period 2003 to 2005. In 2005, German state prosecutors accused the Volkswagen top managers of bribing labor representatives on its supervisory board with payments of as much as $36,000 per individual for pleasure trips to Brazil in return for their support. According to a *BusinessWeek* article,27 “CEOs and top managers depend on votes from the labor reps to be reappointed. Instead of making tough decisions on restructuring or job cuts, German managers are inclined to delay or avoid change and instead curry favor with union bosses sitting on their boards, often to the detriment of their companies.”

Does this case represent an isolated instance of abuse, or does strong union power generally lead to value-reducing restructuring decisions? To address this issue, Atanassov and I investigated how the relative power of labor versus investors affects the likelihood of management-worker alliances and the restructuring decisions of poorly performing companies. More specifically, we related measures of the relative power of labor and investors to the probability of large-scale employee layoffs, top management turnover, and major asset sales by companies having experienced sharp declines in operating performance.

We started by identifying almost 10,000 such companies in 41 developing and developed countries during the period 1993 to 2004. The relative power of the two stakeholders was assessed using widely accepted indicators of the relative strength of legal institutions protecting labor vis-à-vis investors.28,29 And using these legal variables as the key explanatory

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26. According to our tabulation, German union law ranks seventh in our sample of 41 countries, while the strength of its investor protection is slightly below the median.
variables, we then used regression analysis to estimate their effects on the probability of employee layoffs, management turnover, and asset sales.

The Findings on Layoffs, Turnovers, and Asset Sales
We found, first of all, that strong investor protection makes employee layoffs and top management turnover more likely when companies’ operating performance declines, while strong union laws reduce the likelihood of both layoffs and turnover. This finding about union laws and layoffs is completely expected since layoffs provide cost savings for investors that come at the expense of the laid-off workers. The surprise finding here was that strong union laws were associated also with less management turnover—and this provided us with the first hint of a worker-management alliance at the expense of investors.

Since, as stated earlier, such alliances often require asset sales to forestall layoffs and wage cuts, we next examined major asset sales and found a peculiar pattern: Asset sales were more likely in cases where investor protection was either very strong or very weak. More precisely, the likelihood of asset sales increased along with the strength of investor protection in cases where investor protection was already relatively strong. And there is a ready explanation for this finding: Studies of asset sales by U.S. companies show that major asset sales by poorly performing companies tend to increase value, presumably because assets are transferred to new owners who can redeplore them into higher-valued uses. And as investors’ influence increases, we would accordingly expect more asset sales by distressed companies.

But what about the negative correlation between asset sales and investor protection—that is, more sales as protection declines—in countries where such protection is already weak? This somewhat surprising finding can be viewed as providing further support for our worker-management alliance hypothesis. That is, in weak investor protection countries, asset sales by declining companies become a means of protecting employee and management jobs that typically ends up reducing value; and such value-reducing sales become more frequent as investor protection gets weaker.

In an attempt to confirm our hypothesis that such asset sales were undertaken for a fundamentally different reason—namely, to save employee and management jobs rather than increasing value—we compared the post-sale changes in operating performance of companies with asset sales to that of companies without asset sales. The change in performance was measured by subtracting the distress year’s performance from the average performance in the two-year period following the year of distress. The purpose was to see whether asset sales improved performance—and whether these effects differed for countries in the top and bottom quartile in terms of investor protection.

Our results provided clear confirmation of the hypothesis. Companies with asset sales in the strong investor protection countries showed significant increases in their post-distress operating profit (EBITDA divided by total assets), and the increases were significantly larger than those for companies without asset sales. By contrast, in the countries with weak investor protection, companies with asset sales experienced further deterioration in performance, whereas firms without asset sales showed improvements in post-distress performance.

Furthermore, we found sharply different effects of union laws on the frequency of asset sales between strong and weak investor protection countries. In the case of strong investor protection, strong union laws discouraged asset sales, which is what one would normally expect because asset sales tend to decrease employment opportunities. But, in countries with weak investor protection, stronger union laws led to more asset sales, suggesting they are encouraged or sanctioned by labor unions.

More on Worker-Management Alliances
Why would unions encourage, or even countenance asset sales? Because asset sales benefit them in some way. Workers will support asset sales provided the proceeds are expected to be used to forestall employee layoffs and wage cuts.

To investigate this possibility, we examined how asset sales in the year of distress affect layoffs in the year following distress. The results were revealing. In strong investor protection countries, asset sales led, as expected, to more large-scale layoffs. But no such relation was observed in weak investor protection countries; that is, asset sales did not lead to layoffs.

Why would management engage in value-reducing asset sales to forestall employee layoffs? Because management forms an alliance with workers that is motivated by their mutual desire to retain jobs. For such an alliance to work, management needs funds to minimize layoffs and wage cuts. Lacking other means to raise the necessary funds, poorly performing firms sell assets to forestall layoffs even when doing so hurts subsequent operating performance.

But does this type of alliance really help underperforming managers keep their jobs? That would be true only if labor were strong enough to override objections from investors.

To test this possibility, we investigated the relation between the strength of union laws and management turnover. The results confirmed our suspicion. Underperforming top managers were less likely to be dismissed in cases where union power is strong and investor protection weak.


31. Comparisons of performance based on the asset utilization rate (sales revenue divided by total assets) yielded the same pattern. Selling assets improved asset utilization (relative to firms without asset sales) in the strong investor protection countries, but worsened asset utilization in the weak investor protection countries.
But in cases where investor protection is strong, we found no evidence that union power helped underperforming top managers retain their jobs.

In sum, strong union power induces management to shift allegiance from investors to workers. Labor, when armed with strong union power, can protect underperforming top managers both directly and indirectly. To win the support of labor, managers avoid layoffs and wage cuts by selling assets even when such sales hurt subsequent operating performance. But because value destruction reduces the size of the economic pie that can be shared by all corporate stakeholders, management-worker alliances are ultimately harmful to the long-run welfare of both workers and investors.

The Management-worker Relationship in American Companies

Do we observe similar labor-management alliances in the U.S.? According to the measure of investor protection used in the study, the strength of investor protection in America is slightly above the median among the 41 developed and emerging countries we examined. It is weaker than those of countries like Australia, Hong Kong, New Zealand, Singapore, and the U.K. Thus, it is conceivable that worker-management alliances are also at work in the U.S.

The UAL case discussed earlier is one such example, and I believe there are more. I do not have any tangible direct evidence, but similar alliances may be partly responsible for the current demise of General Motors, which has its roots in past failures to implement value-enhancing restructuring decisions. I do not know whether GM ever sold off valuable assets to maintain its high worker payroll and benefits. But the UAW was very powerful at least until the 1980s, when the Big Three automakers started to face fierce competition from Japanese automobile makers and needed major restructuring measures. Furthermore, until 1991, when CalPERS pressured GM board members to take a more active role in monitoring the management and urged Chairman Stempel to make the board more independent, diffuse share ownership rendered shareholders virtually powerless. This power structure may have induced the past GM management to curry the favor of its powerful union workers with generous benefits and wages. Similar management-worker alliances may have taken place in other mature industries past their glory days, perhaps more often than we will ever know.

Back to Shareholder Value

Now we have come full circle. I started out by exploring the possibility that, for some companies, employee influence on governance could be beneficial for the long-run welfare of stakeholders. But the story that emerges from our analysis is a more complicated one: although significant employee ownership has the potential to improve worker morale and productivity, systems like “co-determination” that give labor a major say on governance issues can lead to worker-management alliances that end up hurting the firm’s investors—and, in the longer run, the workers themselves—by jeopardizing its competitiveness.

Having said this, I also believe a traditional, single-minded focus on shareholder value at the expense of all other stakeholders is shortsighted. Such an approach is likely to cause conflicts between stakeholders that may impose greater long-run costs than the marginal efficiency and shareholder value that can be extracted at the expense of other stakeholders. In view of the evidence that moderate employee share ownership improves worker productivity, I believe that governance should be designed and implemented to increase the long-run efficiency and value of the total enterprise—that is, the value that can be divided among all stakeholders, employees and suppliers and customers, as well as stockholders.

As Michael Jensen has argued, the employees of large organizations are a repository of valuable “institutional memory” about the firm’s markets and customers and production processes. One of the most important functions of corporate leadership is to design the organization in such a way that employees are motivated to use their specific knowledge to increase productivity. And it goes without saying that any organization intent on making long-run increases in productivity must not only treat its employees fairly and pay them competitive wages—it must also encourage and reward their active participation while seeking to gain their emotional commitment to the firm’s success.

Implications for Policy Makers and Researchers

For researchers and policy makers concerned with the labor aspects of corporate governance, one implication of the work reviewed in this article is that good governance is associated with effective legal protection for investors and higher corporate values. But perhaps less well understood, this association between good governance and high values is even more pronounced in countries where good governance is scarce—namely, where legal protection of investors is weak.

A second policy implication is that strong investor protection discourages management-worker alliances, thereby improving governance and increasing corporate productivity and values. By contrast, strong labor protection has a number of undesirable consequences. Strong union laws help underperforming managers avoid dismissal through worker-management alliances, eventually hurting workers.

32. As mentioned earlier, the measure of investor protection is the sum of normalized values of the revised Anti-director index and the Anti-self-dealing index in Djankov et al. (2008), the creditor index in Djankov et al. (2007), and the Law and Order index of International Country Risk.

33. All these countries share common law origins.

by exacerbating poor performance. It is also well documented that highly protective employment contract laws, another important facet of labor laws, discourage corporate investments.\(^35\) For the companies suffering poor performance in our sample, we found that the resulting scarcity of capital and investment worsens the plight of workers by forcing major asset sales under duress.

Finally, investor protection and labor laws cannot be studied in isolation. Their effects are too intertwined in determining how companies respond to the competing incentives of investors, labor, and management. Furthermore, laws concerning consumer protection, environment, and taxes, which are intended to protect other stakeholders, may also have important unintended effects on corporate governance. Perhaps the biggest challenge facing corporate governance researchers is to understand the interplay among the various political, social, and legal institutions to prescribe appropriate policies for countries and companies that are subject to different environments.

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