Vicious Spirals in Corporate Governance: Mandatory Rules for Systemic (Re)Balancing?

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Abstract - Until recently, as market forces gradually prevailed over government intervention, the contractarian view had emerged as a preferred method of economic governance due to its attractiveness for business. Following the recent collapse of financial markets and the resulting recession, however, this structural form is now being called into question as the calls for more regulation and government intervention increase. In this context, this article revisits the law versus contract debate in the field of corporate law and governance. Following a theoretical framework utilising elements of game and resource-based theory of the firm, the company is envisaged as a central counterparty in repeated bargains with its stakeholders. It is shown that power dynamics which are inherent in the repeated bargains between stakeholders and the company are prone to imbalance rather than balance by causing cumulative increases in the relative power of stronger parties and vicious spirals of relative power loss for weaker ones. This cumulative power imbalance is then reflected in the organisational rent appropriation process, as weaker parties are eventually expropriated by stronger ones. It is therefore argued that, since the contractual model is inherently prone to instability, mandatory power-balancing rules are necessary. Such (re)balancing regulation, however, would need to follow a systemic approach, because stakeholder and company power is drawn from and affected by numerous structural arrangements in the legal and economic system.

Keywords: Corporate governance, contractual governance, company law, bargaining power, stakeholders.

1. Introduction

One of the fundamental theoretical debates in economic science, directly affecting other disciplines such as law, politics and sociology, concerns the nature and role of institutions in the operation of markets. Should formal institutions, such as mandatory legal rules, be entrusted to govern economic activity or should privately negotiated governance mechanisms prevail. In other words, should the state intervene to regulate market transacting or would this impede the proper functioning of markets? And to turn to the field of corporate governance, how should corporate relationships be governed, through law or contract?

The academic debate in the corporate law context has been intense, especially in the US.1 Inter-state competition for corporate charters in that particular market, as a result of the right of incorporation granted to American corporations, provided the basis for arguments about a ‘race to the bottom’ or to the top with regard to the regulation of corporate activity. Subsequently, the lowering of market barriers during the process of globalisation over the past three decades elevated such arguments to the

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international stage regarding global convergence or persistence of national regulatory systems in a process of global competition between different regulatory forms. As economic barriers were dismantled and globalisation deepened, especially during the past two decades, market-based governance gained in significance as a result of an increasingly deregulatory approach in financial markets followed by many governments who sought to attract business. In this deregulatory environment, contractual (de)regulation claims became also influential in corporate governance or law and economics academia mainly in the US, but elsewhere too.

However, contrary to some scholars’ predictions, corporate laws have to a great extent withstood these pressures for change as path dependence forces seem to render them rather rigid institutions. Nonetheless corporate governance has not remained unaffected by the new structure of globalised markets, which altered the power relations between major stakeholder groups. Was the rigidity of corporate law in an adverse environment detrimental or conducive to efficiency? Contractarians would argue the latter as, in their view, organizational rules should be responsive to market forces by losing their sticky mandatory character.

Following the collapse of financial markets and the resulting global recession, however, what was formerly regarded as ‘best practice’ is now being called into question if not rejected. The calls for more regulation and government intervention have been increasing, showing a general disbelief in the ability of the business world to restrain itself, ie a disbelief in (self-)governance by privately negotiated contracting. It seems as if this crisis is feeding the apparently never-ending law versus contract debate in corporate governance once again.

Given this context, this article examines whether privately derived governance mechanisms opposed to mandatory institutions, are sufficient to create an efficient corporate governance regime. It seeks to throw some new light onto the debate by introducing stakeholder power asymmetry and its dynamics in corporate governance. Following a theoretical framework utilizing elements from game and resource-based theory of the firm, the company is envisaged as a central counterparty in repeated bargains with its stakeholders. The ideal corporate governance outcome is the product of a cooperative solution, where stakeholder interests are balanced out and simultaneously synthesized in a way that creates competitive advantage for the company and therefore organizational rent. Part of this process is that all stakeholders

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6 Dignam and Galanis (n 2).

receive a share of the organizational rent created in exchange for their contribution of resources to the company.

However, power dynamics which are inherent in the repeated bargains between stakeholders and the company are prone to causing cumulative increases in the relative power of stronger parties and to vicious circles of relative power loss for weaker ones respectively. This process can ultimately lead to the expropriation of parties with an initial power disadvantage irrespectively of their input. It is, therefore, argued that contract-derived corporate governance mechanisms alone are inherently unstable and unable to balance and synthesize divergent intra-corporate interests. They tend to be inefficient, as they cannot ensure correspondence between resource inputs and appropriated rent. This not only leaves higher input providers unprotected and vulnerable to expropriation by lower input providers, but also discourages cooperative solutions. As a result, instead of performing a power-balancing function which ensures allocational efficiency, the corporation may exacerbate power and allocation imbalances. These theoretical predictions are exemplified by case-studies involving power spirals in company-shareholder and company-labour bargains.

So this article supports the claim that, to overcome these inherent inefficiencies of contractual corporate governance, legally prescribed power balancing institutions are necessary. However, achieving this can be a challenging task. Stakeholder and company power is drawn from numerous interweaved institutional arrangements in the economy, so that piecemeal regulatory changes or company law alone would be insufficient to resolve power imbalances. We, therefore, conclude that a systemic approach to corporate governance regulation is needed. There is no intention to prescribe specific measures herein since institutional choices need to reflect the particularities of each country. Our goals are more modest: to identify the problem and the factors that need to be accounted for when regulators design an institutional order for corporate governance.

In the second section we present the theoretical context within which the contractual model of corporate law and governance is embedded in order to view the company as a part of a private institutional order established by contract. The third section will sketch the corporate ideal that an institutional order, public or private, would have implement. The fourth section will argue that corporate bargains are inherently unstable due to spiralling power imbalances in contracting and thus hinder the institutionalisation of the corporate ideal merely by private means. This will be followed by three exemplars illustrating how these bargaining spirals evolve in practice. In the sixth section we will then propose that a systemic approach towards establishing power balancing mandatory rules is necessary to achieve the corporate ideal. We will conclude with an overview and some projections about current and future systemic developments.

2. The Company as a Tool of Private Ordering

While influential for several decades, deregulatory contractarian voices gained gradual acceptance especially among practitioners and policy-makers during the era of globalisation. ‘Self-regulation’, ‘light-touch regulation’ or ‘principles-based regulation’, all terms reflecting a retreat of government intervention, emerged as the

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8 See J Black, ‘Forms and Paradoxes of Principles-Based Regulation’ (2008) 3 CMLJ 425-457, reporting the widespread adoption of this non-interventionist approach by many national and supranational financial regulators and policy-makers.
preferred methods of economic coordination due to their attractiveness for business. It seems that even where the law vested regulators with wide powers, these were not used very often, in recognition of the ability of the market to provide those incentives for participants therein that lead to rational choices.\(^9\)

The belief in the self-regulatory capability of the market is not new, at least in economic theory. Founded on the efficient market hypothesis, neoclassical economics has provided a theoretical basis for a self-regulatory model of governance by contract rather than mandatory rules drafted by the legislature. Information asymmetries do not arise or are eliminated between transacting parties who thus have rational expectations, ie they always identify and make the most efficient choices in the absence of uncertainty, provided the market is allowed to operate freely. This global rationality postulate means that transacting parties’ opportunism is eliminated and power differentials are also irrelevant.

In his highly influential work Hayek\(^10\) claims that no single party, be that the state or other regulating body, can obtain all the information required to create efficient rules binding for all. This information is possessed and processed collectively by the market as a whole and therefore it is the market mechanism that should write, enforce and amend the rules through private negotiations between transacting parties in a process giving rise to a ‘spontaneous order [resulting] from the individual elements adapting themselves to circumstances’\(^11\) rather than a legal order established by authority. In Hayek’s order, best practice emerges and prevails provided the market mechanism is allowed to operate free from outside intervention.

Coase’s transaction cost economics took issue with this approach and claimed that much economic activity is taken out of the market and placed within hierarchical organisations, such firms, the reason being that using the market mechanism is costly.\(^12\) Organising at least some economic activity within the firm is efficient as it serves economising on the costs of transacting in the market. Following this, Williamson’s analysis of markets and hierarchies concluded that a combination of these two types of coordination, or between ‘spontaneous’ and ‘intentional governance’ as he calls them,\(^13\) can produce optimal results - the main concern then being to find the right mix of the two governance types. This mix is found by economic agents after a cost-benefit analysis where the cost of running a hierarchy is compared with the cost of transacting in the market. In other words, market failure is corrected by hierarchies’ success and vice versa so as to produce an efficient economic system.

The corporate hierarchy’s effectiveness in dealing with transaction costs, according to Williamson, is founded on the premise that all interested parties, the

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\(^12\) R Coase, ‘The Nature of the Firm’ (1937) 4 *Economica* 386-405.

\(^13\) O Williamson, ‘Economic Institutions: Spontaneous and Intentional Governance’ (1991) 7 J Law Econ Organ 159-187. Williamson in fact also identifies hybrid forms of governance, which lie between market and hierarchical organization. However, for our purposes the distinction between markets and firms is more relevant.
stakeholders, have an incentive to design a governance mechanism that protects against each other’s opportunism. The corporate hierarchy operates as a system of interest alignment incentives, a stakeholder dispute resolution mechanism and an intention-signalling transmitter for further transactions.\footnote{O Williamson, ‘Corporate Governance’ (1984) 93 Yale LJ 1197-1230, 1204-05.}

While, by acknowledging the existence and \textit{fiat} of the corporate organisation, Williamson’s model is an improvement on the economic theorising of the company, it still closely associated and to a great extent dependent on a Hayekian thinking. An efficient economic order is established through spontaneous transacting either in the market or within hierarchies created by contracting parties in order to deal effectively with future contingencies resulting to contract incompleteness. So in a sense Williamson’s theory is critical but also complementary to Hayek’s spontaneous order as it corrects market transacting deficiencies with the establishment of efficient governance mechanisms to which private parties agree to subject themselves. Therefore economic order may not be as ‘spontaneous’ as Hayek had envisaged it, but it nonetheless remains a private one based on contractual freedom where transacting parties themselves design, establish and use their mediating hierarchies when they so choose, in a manner not too different from using the price mechanism in market contracting.

Along these lines contractual theories, such as the influential agency model, have also relied on contract to establish a type of private ordering in corporate governance, either with one stakeholder as a principal who designs incentive mechanisms for aligning managers’ conduct with her interests,\footnote{Jensen and Meckling (n 3).} or with all stakeholders in the same position as principals.\footnote{C Hill and T Jones, ‘Stakeholder-Agency Theory’ (1992) 19 J Manage Stud 131-154.} Similarly, contract constitutes the basis of the ‘team production’ model proposed by Alchian and Demsetz where one stakeholder controls production team members’ opportunism by establishing appropriate contractual relationships with them.\footnote{A Alchian and H Demsetz, ‘Production, Information Costs, and Economic Organization’ (1972) 62 Amer Econ Rev 777-795.} Expanding this model along broadly Coasean lines, Blair and Stout have suggested that contracting stakeholders agree to submit themselves to the corporate hierarchy as an efficient contractual arrangement, a ‘\textit{pactum subjectionis}’, dealing with their coordination uncertainties.\footnote{M Blair and L Stout, ‘A Team Production Theory of Corporate Law’ (1999) 85 Virginia LR 247-32, 278. This proposition in fact resembles the ‘ideal company’ as envisaged in the following section, but is subject to the same limitations of private ordering identified below.}

Within this general theoretical framework of contractual private ordering many scholars have argued against the mandatory character of most corporate governance rules.\footnote{Romano (n 3) 85; R Campbell, ‘Opportunistic Amendment of the Corporate Governance Contract’ (1996) 14 CSLJ 200; F Easterbrook and D Fischel, \textit{The Economic Structure of Corporate Law} (Harvard University Press, Cambridge, Mass 1991); J Gordon, ‘The mandatory structure of corporate law’ (1989) 89 Columbia L Rev 1549.} They prefer to give governance mechanisms no more regulatory strength than privately negotiated contractual terms, which can be freely negotiated away by stakeholders. After all, they claim, the company is no more than a nexus of voluntary agreements between various participants who should be able to choose freely the terms of their contracts and the mechanisms that govern their transactions.\footnote{Alchian and Demsetz (n 17); Jensen and Meckling (n 3).} Any intervention which is not agreed between stakeholders in a private bargain, including...
the imposition of mandatory governance rules and mechanisms, would distort the efficient private order of contractual governance.

However, approaching the corporate organisation in this way, that is simply as a tool for instituting and enforcing a private order by contract, has an analytical deficiency. The company’s operation is treated as a zero-sum game between stakeholders and as nothing more than a facilitator for clearing the market for stakeholders’ resources. The inescapable outcome of this is that little comparison guidance is provided for distinguishing effective companies from ineffective ones. This deficiency is more compelling where performance differences occur between companies competing in exactly the same product market. Dealing with this issue is of great analytical significance because it is crucial for identifying the actual goal to be achieved by the institutional order of corporate governance, whether that is a private order or not. So before proceeding with our assessment of the means to achieving the order of the model company the next section will seek to identify what this corporate governance ideal actually is.

3. The Ideal Company

By adopting the aforementioned zero-sum game approach, which leaves nothing for the corporation itself after stakeholder contracts have been performed and cleared, the contractual models fail to grasp the dynamic continuum the company really is. They offer no insight about the different business approaches firms adopt to compete with each other or to enhance their capabilities, and second, they seem to disregard the fact that both actually and legally the company is itself the counter party of each stakeholder, that is, it acts as a legal person which is the central counterparty. It has a legal personality and through its organs a will of its own based on which it chooses its stakeholders and the types, degrees and direction of investments flows. We argue here that these are critical issues that deserve analysis if one is to explain where a company’s success or competitive advantage comes from, and thus to define the goal to be achieved by corporate governance.

One influential theoretical approach which does explore the relationship between dynamic capabilities and competitive advantage is the resource-based theory of the firm (RBT). This perspective argues that the company’s central organisational function is the amalgamation or synthesis of resources, some of which may be unique or rare. It is this latter type of resources that can lead to the creation competitive

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21 Blair and Stout are quite unclear in this respect by maintaining the somewhat inconsistent position that the company is an entity separate from its stakeholders, and therefore not a zero-sum game, but simultaneously that directors are pursuing a corporate interest that is identical with the aggregation of all stakeholders, which is in fact a zero-sum game claim; See Blair and Stout (n 18) esp. 285-6. It seems that their contractual framework does not offer them enough flexibility to pursue their non zero-sum game argument effectively and they treat the company as a clearing mechanism for stakeholder resources.

22 Indeed, the law seems to recognize this interpolation of the company between stakeholders as it generally awards them rights to sue the corporate entity an vice versa rather than bring actions against each other. The Salomon v Salomon rule in English company law is an illustration of this; eg see A Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71 MLR 663-698, 679-684, for a concise overview of the arguments for the legal standing of the company as a distinct entity. But even in those exceptional circumstances where stakeholders may owe duties to each other that right may be claimed to exist outside the corporate relationship as corporate personality is artificially taken out of the picture.
advantage vis-à-vis other companies and this advantage can be maintained so long as such resources are not imitated by or transferred to other firms. As a result of this competitive advantage the company may face lower costs or its products may be unique or superior to others, so that it enjoys ‘rents’ or higher exchange value for its products compared to available substitutes.

One corporate goal is then to continually identify and acquire as well as develop resources, such as stakeholder inputs, that can be combined in a way that will generate rent. One characteristic of RBT, therefore, is that it emphasizes the dynamic function of the company as an organization and the role of managerial choices between stakeholder input combinations. So, management is a central feature of this resource amalgamation process, in that a lot of these choices are made by managers, who could also be regarded as stakeholders contributing their managerial skill of identifying strategic capabilities and complementarities between different stakeholder resources. However, this is just one type of decision-making, since many decisions, even those of management, are determined by choices that are developed tacitly throughout the corporate organization in a way that it is difficult to identify where they actually originate before they crystallize as managerial decisions. This is an example illustrating the way the organizational mind of the company emerges and operates as a dynamic and continuous process, as past decisions affect present and future ones, which is independent from the decision-making process of resource providers. Identifying and developing these tacitly generated resources is simultaneously the second corporate goal and the determinant of the company’s existence and viability as a separate entity.

It needs to be emphasized here that this process, which as we saw is often but not necessarily undertaken by management, is very different from the mere aggregation of individual stakeholder inputs. So, the resource amalgamation process is about creating a new value that springs out of the combination of complementary interests, which is very different from the value of aggregated input. The combination of blue and yellow creates for the painter a new value, the green colour, which is totally different from its

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25 Economic rent is a measure of market power and is defined as the difference between what a production input is paid and how much it would need to be paid to remain in its current use.


27 The role of tacit knowledge, or know-how that is irreproducible outside one particular organisation, in organisational development was originally conceived by M Polanyi, The Tacit Dimension (Chicago University Press, Chicago 2009 reissue edition), esp. ch 1, and further pursued by many others, such as eg B Levitt and J March, ‘Organisational Learning’ (1988) 14 Ann Rev Sociol 319-338, I Nonaka and H Takeuchi, The Knowledge Creating Company: How Japanese Companies Create the Dynamics of Innovation, (OUP, Oxford 1995); P Baumard, Tacit Knowledge in Organizations (Sage, London 1999).
components. In the same fashion, corporate value is not the same as the aggregation of the value of stakeholder inputs. Inputs are combined because some added or different value is created. After all, some inputs may even have little value outside the company but become particularly valuable when they are combined with other inputs within it. The way such added value is created is not fully explored in organizational theory, but some have proposed that knowledge or know-how on finding and creating complementarities between scarce resources is the source of competitive advantage.  

Nonetheless, there have also been propositions put forward attempting to explain competitive advantage on a different basis. Coff, for instance, uses the nexus-of-contracts approach to depart from the typical RBT model and decompose the corporate organization into numerous bargains between stakeholders who seek to capture as much rent as possible. He expressly claims that ‘organizations do not appropriate rent, people do’, because the corporation, as a non-person, cannot own resources, and therefore what he calls ‘nexus rent’ is the sum of all the rent appropriated by stakeholders through bargaining between them. However, the very resource amalgamation process of value creation by the corporate organization as described above automatically refutes Coff’s aggregation proposition. As it was shown above the company is a know-how generator and therefore resource provider too. If then one follows Coff’s model, the company would have to be regarded as a stakeholder too; this would be a tautological paradox, because the company would then be holding a stake in itself. Moreover, how could one then explain the reality that many resource-contributing stakeholders are in fact companies themselves? So, although it is outside this article’s scope to construct a full theory of the firm, it is nonetheless more accurate to treat the company not only as an entity with existence, mind and assets separate from those of its resource providers, but also as a central counter-party to each stakeholder bargain. In fact, apart from the organization theory arguments presented above, this conception of the company also fits the legal personality model adopted in (corporate) law. It is the company who is the employer hiring and firing employees, borrowing from lenders, issuing stocks to shareholders, paying tax to the state, selling products to customers and so on. 

Moreover, the establishment of the company as a counter party, which is common in all stakeholder bargains, also serves an economizing purpose. Instead of many contracts between different stakeholders wishing to be involved in the production process, each stakeholder has to negotiate just one with the company as a central counter-party. In a Coasean manner this is (transaction) cost-effective as it replaces the uncertainty of contracting several (even hundreds or thousands of) times with just one. And most importantly, the company’s central position as that proposed here has a further implication that confirms its capacity as a mechanism against market

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30 Ibid 120-121.  
31 See text to n 23-28 above.  
32 See also Blair and Stout (n 18) on this.
uncertainty. Since informational asymmetries exist in all bargaining negotiations, the company, due to its position as a party to all bargains, will be in a better informational position than any stakeholder alone. So, as Aoki argues, the company is a ‘risk sharing contrivance’ in stakeholder contracting, which encourages risk taking in the economy through a combination of ‘collective risk-pooling’ and ‘individual risk-spreading’ leading to overall cost-saving. Indeed risk-taking is an integral part of a growing business enterprise and this cost-saving is in fact the value created by the firm, or what organization theorists call organizational rent. In the absence of risk sharing, activities such as R&D which are necessary for rent creation but are characterized by significant uncertainties and therefore involve risk would not be undertaken. In fact, the net contribution of each stakeholder can be regarded as an insurance premium against its individual market risk. The corporate objective then is to maximize organizational rent as the means of keeping the company a going concern.

So having rejected the transactional and nexus-of-contracts approach as a tool for explaining organizational rent creation, and having reinstated the corporate entity as a party to all stakeholder bargains and as an efficient mechanism for pursuing growth opportunities, we have described how the company offers itself as a rent creation mechanism through capability development and cost economizing. We have also defended the company’s ability as a legal subject to own and control its own assets. Stakeholders do not or should not have a claim in those assets, whether they are intangible and non-transferable, such as know-how and corporate culture, or tangible, such as financial and other means for creating intangible assets. These belong to the company itself and are crucial for its competitive advantage.

However, stakeholders do have claims against the company. These are the object of negotiation of each one of them individually with the company as a central counter party and concern the return for each individual stakeholder input. The notion of economic rent by definition entails a process of rent appropriation by the input provider or, for the purposes of this article, the stakeholder. Each stakeholder then is entitled to receive acceptable portions of the organizational rent resulting from the company as a business concern, in return for the provision of their resources. Acceptable rent is such that is enough to keep stakeholders providing their resource for as long as the company requires it, and thus rent appropriation is the actual objective of each stakeholder and its extent determines the willingness of the latter to remain a resource provider.

Accordingly, Aoki using a game theoretic framework incorporating some RBT elements characterises the firm as

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34 He states accordingly: ‘When both an employer and employees are risk-avers, some kind of well-designed risk-sharing device within the firm would be a better arrangement for both parties than either the spot market or fixed wage contracts’ (M Aoki, The Co-operative Game Theory of the Firm, (Clarendon Press, Oxford 1984) 18-19 and 30-31).

35 Eg see Ibid 31.

36 Keay (n 22).

37 See definition of economic rent in n 25.

38 This follows Simon’s contention that boundedly rational economic agents are only capable of ‘satisficing’ rather than optimising their choices; see H Simon, Models of Man: Social and Rational: Mathematical Essays on Rational Human Behavior in a Social Setting (Wiley, New York 1957) 204.
a field of bargaining among the firm-specific resource-holders [...] rather than simply a bundle of individual exchange relationships supplemented by the existence of marketable residual claims (equity). There does not seem to exist, therefore, a single objective of the firm such as the maximization of residual (profits); rather, the firm internalizes a bargaining process in which conflicting objectives of the firm-specific resource-holders are brought into equilibrium, within a framework of co-operative relations.39

This theoretical exploration of the corporate organisation provides certain useful insights into stakeholder rent appropriation. Its main argument is that co-operative equilibria as opposed to non-co-operative ones are superior, since it is only the former that are associated with the risk-economising, rent-generating function of the company.40 In other words, the ideal company is that which manages the rent appropriation process in a way that fosters stakeholder cooperation with it. This cooperative equilibrium is achieved when stakeholder-company bargains are resolved in a way that all necessary stakeholders receive portions of organisational rent that they regard as acceptable, while the company retains adequate rent for sustaining its competitive advantage as described above.

But, while Aoki’s model is useful in assessing bargaining outcomes in terms of organisational efficiency, it does not adequately explore how such superior co-operative solutions emerge. This leads to the fundamental issue that this article seeks to explore. Can this corporate governance ideal be achieved as part of a private order? This will be discussed next.

4. Power Spirals and Governance Instability

The analysis in the previous section has provided a description of the ideal function of the company as a rent generator. It was also claimed that after the input amalgamation stage is complete and organisational rent has been generated, what follows is an allocation process, that is, a function of value/rent distribution according the organisational needs of the company. This sequence is of course presented here as a matter of convenience, since in practice it may not always be possible to identify when rent is generated or appropriated. The two stages are equally important and interlinked.

In accordance with what was argued earlier, Peteraf observes that for the company to succeed it is not sufficient to generate organisational rent from acquired resources; it will have to be in a position to capture at least some of it, otherwise only the resource providers will benefit from the production process and profit will be nil.41 It follows from this that those resource providers who capture organisational rent above what should be acceptable for them relatively to their contribution, expropriate the company directly and usually other stakeholders indirectly with a corresponding efficiency loss.

39 Aoki (n 34) 33.
40 Ibid.
RBT and some other theoretical frameworks associated with it, such as resource dependency theory (RDT),\textsuperscript{42} have certain useful insights to offer about this distributional stage where organisational rent is being ‘passed on in the production process’.\textsuperscript{43} What all these theories seem to have in common is that they recognise the role of bargaining power differentials between negotiating parties in determining the distribution of organisational rent.\textsuperscript{44} This is as element missing from the contractual model, which is of course based on the assumptions of market efficiency, even if that is of the ‘second best’ type, precluding the exercise of power between economic actors.\textsuperscript{45} Based on the analysis in the previous section, the bargaining parties are each individual stakeholder on the one hand and the company as a central counter-party on the other. The power relations and their dynamic character between those bargaining parties is the key element that will determine our answer to the contractual question whether the corporate organisation can serve as a mediating hierarchy.

Examining the role of power within organisations such as the company has its roots in the work of social theorists and especially of Max Weber, who has provided the classic definition of power as ‘the probability that one actor in a social relationship will be in a position to carry out his own will despite resistance, regardless of the basis on which this probability rests’.\textsuperscript{46} Within the resource dependency framework actors, such as the company, lacking in essential but scarce resources engage with and are dependent on others, eg stakeholders, who own them. The company’s dependency on its stakeholders gives the latter power in the bargain and allows for opportunistic behaviour as envisaged by Coase and Williamson.\textsuperscript{47} In the context of stakeholder-company bargains within the current theoretical framework opportunism translates into excessive rent appropriation by one party, which means the capture of organisational rent portions above the level that allows other stakeholders and the company to capture acceptable rent. So a power advantage can be used by any party to an intra-corporate bargain to appropriate excessive rent.

In his analysis of the rent appropriation process, Coff identifies four determinants of stakeholder bargaining power:\textsuperscript{48} first, the ability to act collectively, which is of course subject to cost of the free-riding problem;\textsuperscript{49} second, the access to key information the release of which can be manipulated by informed stakeholders in a

\textsuperscript{42} J Pfeffer and G Salancik, The External Control of Organizations: A Resource Dependence Perspective (Harper & Row, New York 1978) is the seminal work formalising resource dependency theory. The main proposition of the theory is that actors lacking in essential resources will seek to be dependent upon those who possess them, but they simultaneously attempt to minimise their own dependency on resource providers or to increase the dependence of others on them by acquiring critical resources. All these resource exchange transactions are seen as sets of power relations between actors.

\textsuperscript{43} Bowman and Ambrosini (n 26) 4, and Coff (n 29). See also Aoki (n 34) 31 and 98-99, and N Argyres and J Porter Liebeskind, ‘Contractual Commitments, Bargaining Power, and Governance Inseparability: Incorporating History into Transaction Cost Theory’ (1999) 24 Acad Manage Rev 49-63 addressing bargaining power in a game-theoretic and transaction cost context respectively.


\textsuperscript{45} See for example Alchian and Demsetz (n 17), who completely reject the existence of any power element in corporate relationships.


\textsuperscript{47} Eg Coase (n 12) and Williamson (n 13 and 14).

\textsuperscript{48} Coff (n 29) 122.

way that desired outcomes are achieved; third, the exit cost for the stakeholder, which is the classic hold-up problem of asset specificity identified by transaction cost economists\(^{50}\) - the lower the cost of exit the higher the power of the stakeholder; and fourth, the resource replacement cost for the company, ie the cost the company would have to bear in order to replace the withdrawn stakeholder’s resource - the higher this cost the lower the company’s bargaining power.\(^{51}\) All these factors should not be seen in isolation from each other, as they are often interconnected and mutually dependent. So stakeholder exit costs are the flip side of the company’s resource replacement cost,\(^{52}\) whereas collective action can facilitate access to information.

Overall, these elements determining the power potential of each party in the bargaining process influence its ability to make credible power use tactics to its counterpart. According to Lawler, such tactics can be conciliatory, such coordination or collaboration efforts, or hostile, involving competition, intimidation or resistance threats.\(^{53}\) However, the existence of power inequality between the bargaining parties, Lawler observes, makes the use of hostile tactics more likely due to a disagreement between negotiators over the legitimacy of such inequality.

One problem in the rent appropriation bargain is that in conditions of uncertainty and informational asymmetries, the terms ‘excessive’ and ‘acceptable’ rent, as well as the power potential are based on perceived rather than rational expectations of the company and its stakeholders.\(^{54}\) This is inherently a cause of instability in stakeholder bargains, which is in fact ignored, and rightly so given their equilibrium assumptions, by those adopting the contractual governance model. In rejecting the efficient market hypothesis, power in stakeholder bargains can be a source of instability rather than balance in the rent appropriation process and as a result in corporate relationships.\(^{55}\) So the consequences of stakeholder power dynamics for corporate contracting governance in general deserve our attention.

Aoki’s theoretical framework for examining the corporate organisation mentioned above\(^ {56} \) introduces stakeholder bargains into the formula and provides certain useful insights into stakeholder rent appropriation, but its main argument concerns the superiority of co-operative equilibria as opposed to non-cooperative solutions. So, while it is useful in assessing and comparing bargaining outcomes in terms of organisational efficiency, it does not adequately explore how such superior co-operative solutions actually emerge in the context of corporate bargaining, where stakeholders have different perceptions about the efficient balance of rent appropriation and different bargaining power. Coff’s\(^ {57} \) and others’\(^ {58} \) power-based models of organisational rent appropriation by stakeholders also suffer from a similar problem as they throw little light on how stakeholder bargains evolve. Thus a more dynamic approach is more appropriate for this purpose.

50 See text to n 12-14 above.
51 The third and fourth determinants are directly associated with the notion of ‘BATNA’ in the bargaining power dynamics literature; see text to n 61 below.
52 Identifying the similarity of these costs with the well-known notion of ‘sunk costs’ is inescapable here. Eg see J Sutton, *Sunk Costs and Market Structure* (.MIT Press, Cambridge, Mass 1991).
54 D Wrong, ‘Some Problems in Defining Social Power’ (1968) 73 Am J Sociol 673-681; Aoki (n 34) 69.
55 The role of unequal bargaining power as a source of instability has also been emphasized by Lawler, n 53 above.
56 Aoki (n 34).
57 Coff (n 29).
58 Eg Bowman and Ambrosini,(n 26).
Social as well as organisational theorists’ work on the dynamics of bargains at the presence of power imbalances between negotiating parties has provided several interesting propositions and methodological tools. A crucial factor determining bargaining outcomes is the concept of ‘best alternative to the negotiated agreement’ (BATNA). A party to a bargain will be willing to co-operate if, according to its perception, the value of its BATNA is lower than that of the agreement being negotiated. That is, the higher the benefits from the party’s BATNA, the lower the hold-ups this party may face and the lower its counterpart’s relative power and ability to behave opportunistically.

From a dynamic perspective then, bargaining parties will have the incentive to use power tactics to improve their relative power position either by reducing their dependence on their counterparty or by increasing the latter’s dependence on them. These tactics may take the form of improving the quality of their BATNA, decreasing the quality of the counterparty’s BATNA, decreasing the value of the counterparty’s contributed resource, or increasing the value of their contributed resource. Kim, Pinkley and Fragale take this observation a step further to claim that bargaining parties and more likely to employ power tactics when they perceive their own power to be higher than their counterpart. The significance of this observation is that it sets the stage for a spiralling bargaining process, especially where repeated bargains are involved such as those in corporate relationships, where the stronger party seeks to improve its bargaining position either directly by increasing its relative power or indirectly by reducing the counterparty’s power. It is only reasonable to assume that, once the benefits of increased power in terms of appropriated rent have been achieved by the strongest stakeholder, the incentives will be there for it to make further use of power tactics to gain additional benefits. Such self-perpetuating spirals within the corporate organisation, nevertheless, have a self-terminating dynamic in that they continue up to the critical point where there are no more benefits to be gained by the stronger party eg because there is no rent to be appropriated, or because the weaker party’s cost from the bargain has pushed the value of the negotiated agreement below

\[59\] S Bacharach and E Lawler, Power and Politics in Organizations (Jossey-Bass, San Francisco 1980), and Bargaining: Power, Tactics, and Outcome (Jossey-Bass, San Francisco 1981), for instance, have attempted to formulate a comprehensive theoretical framework of power in negotiations.
that of its BATNA. Beyond such critical point bargaining dynamics can bring the spiral to an end. In either case, however, the loss in efficiency is considerable as the end result is a choice for the weaker party between either total loss of anticipated rent or partial loss by accepting an inferior BATNA. Of course, in spite of these internal dynamics, bargaining spirals may also come to an end or be reversed as a result of an exogenous event upsetting the power dynamics of the bargain.

The consequences of these spiralling dynamics of power and the opportunistic use of it by stronger stakeholders can be further amplified by the adverse effects of what Lindenberg terms ‘myopia’.66 Using insights from social psychology and behavioural economics, Lindenberg claims that a common form of opportunism is the choice of actors to respond to short-term opportunities and pressures as opposed to long-term ones, so that this opportunistic behaviour is myopic rather than strategic.67 Moreover, he recognises that myopic opportunism is more likely to arise when there are power asymmetries between the parties in a bargain. Such power differentials undermine the quintessence of efficient co-operative solutions to bargains, which is ‘the partial suspension of gain-driven behaviour’68 or, for our purposes, the limiting of rent-appropriation to the acceptable level rather than the level a power advantage allows.

So, one can only infer that the combination of myopic opportunism and spiralling power dynamics in corporate bargains are the explosive ingredients of vicious circles of rent expropriation by the most powerful parties irrespectively of their contribution. This possibility has significant adverse consequences resulting from the fact that rent expropriation spirals in the bargains between stronger stakeholders and the company as a central counter-party, undermine the latter’s function as a risk-sharing and value creation device. The first consequence of this is that weaker stakeholders fail to appropriate acceptable rent so that the value of their BATNA increases and thus their incentive to co-operate decreases. However, those stakeholders who face the highest risk of expropriation will often be those with the most firm-specific resources and, therefore, those subject to the highest lock-ins, who nonetheless most often hold the most critical resources. The second consequence is that excessive organisational rent loss on the part of the company as a central counterparty or its most critical stakeholders is destructive for the company’s future competitiveness, as it translates into diminishing capabilities for either creating or accessing those resources that would help it develop and sustain competitive advantage. Thus, it is argued here that due to stakeholder bargaining dynamics there is an inherent tendency in the rent appropriation process towards disequilibrium expressed as vicious circles of power amplification and organisational rent expropriation by stronger bargaining parties, a phenomenon with a potentially destructive impact on the company as a going concern.

So contrary to the classic ‘private order’ argument, that due to market uncertainty as a source of transaction costs and power asymmetries, corporate hierarchies replace market transacting in order to restore the balance of power between transacting parties, the claim here is that the corporate organisation does not perform this equilibration function by default. On the contrary, the dynamics in bargaining

68 Ibid.
between stakeholders and the company can lead to inefficiencies, due to power increase spirals that can ultimately lead to rent expropriation. More powerful stakeholders may use their advantage to further improve their position vis-à-vis the company and through this vis-à-vis weaker stakeholders to appropriate organisational rent beyond the levels anticipated in an efficient co-operative solution. As a result, depending on the degree of hold-ups they face, weaker resource providers may either withdraw their resources or corporate competitive advantage may be lost, as insufficient resources are invested in developing the critical capabilities of the company, or both. This power-driven instability, which is inherent in contractual corporate governance, is a significant problem that needs to be dealt with when contemplating the role, nature and design of corporate regulation concerning the contracts negotiated between stakeholders and the company. Before exploring these normative consequences of stakeholder power spirals further, some illustrations of how these spirals develop in business practice can be useful.

5 Bargaining Spirals in Practice: Some Exemplars

At the initial stages of this research we were concerned that there would be difficulties in identifying practical illustrations of stakeholder-company bargaining spirals, mostly due to the implicit character this type of bargains usually has. However, to our surprise we discovered that business life is so full of examples of spiralling expropriation by strong parties as to be able to argue that such practices are worryingly considered usual and acceptable. The exemplars that follow are drawn from two types of bargains, those between shareholders and the company, and those between the company and its employees. This choice is made on the ground that no company can operate without stock or labour, which makes shareholders and employees the two most important corporate stakeholders. This should by no means lead to conclusions that spiralling bargaining does not occur in bargains with other stakeholders. For instance, Argyres’ and Porter Liebeskind’s observation that company-supplier relationships follow trajectories determined by consecutive contractual hold-ups may provide some elementary evidence that such a phenomenon is also common in such bargains too.

A. Corporate Raider Tactics and Rent Expropriation

i. Carl Icahn v ImClone Inc.
ImClone Inc. was a pharmaceutical corporation that first hit the news in 2001 when, Sam Waksal, its founder and chief executive at the time, traded his shares on inside information about the US regulators initial refusal to approve cancer drug Erbitux, the company’s only product, and was eventually jailed for seven years. Ironically, Erbitux gained approval in 2004 and ImClone enjoyed steady monopoly rent from its sale as a drug initially against colon cancer and since march 2006 as a treatment for head and neck tumours too. Given the success of Erbitux, the pharmaceuticals giant Bristol-Mayers acquired a 17 per cent stake in ImClone and undertook to market the drug in the US for a royalty fee to ImClone. In 2006, however, the company faced a crisis when it lost its patent for Erbitux following litigation by an Israeli company which as

69 Argyres and Porter Liebeskind (n 43).
a result tapped into the sales revenue from the product. This event was a direct hit to the core of ImClone, as it threatened to reduce the company’s organizational rent considerably unless other products were developed and won approval.

It was during that difficult time that one of ImClone’s shareholders, the renowned hedge fund activist and Waksal’s friend, Carl Icahn, stepped in to exploit the opportunity to gain control of the company which was in a weak bargaining position. The company’s future prospects seemed rather dire in terms of organisational rent creation, which meant that the benefits to investors from their relationship with it were expected to decline. It is only reasonable to assume that those investors, such as small minority shareholders, who did not face significant lock-ins would be in a better bargaining position as the value of their BATNAs increased following the expected value decline of appropriated rent. And this would come when ImClone needed its resource providers most in order to develop new organisational capabilities, that is when it was most resource dependent and vulnerable to opportunism. In fact the company did have the potential to continue growing as its cash position and pipeline was strong and Erbitux sales were still growing significantly.\(^{70}\)

Nonetheless, Icahn immediately started putting pressure on ImClone first by building a 10 per cent stake in 2006 and then using the power arising from this investment to further increase his influence in order to extract value. By using the threat of orchestrating a proxy contest, he got the management to agree on the appointment of one of his allies as an additional independent director on the board and on the removal of a poison pill in the company’s articles so that Icahn could have the option of raising his stake to 19.9 per cent, if he so wished.\(^{71}\) The first change improved Icahn’s access to privileged information which enhanced his ability to form his expectations and his future power use tactics. The second change opened the way for such tactics in the future as it gave more credibility to his threat of power use and also increased the potential of orchestrating collective action with other shareholders – the latter would be more likely to follow a better-informed proposal by Icahn who now had access to inside information. This informational advantage laid the foundations for the next round of the bargaining spiral.

Within weeks after this first power enhancing bargain was over and following further intimidating statements against management, Icahn demanded and got three additional seats on the twelve-member board that would give him one third of ImClone board’s control while still holding just 13.85 per cent of the shares.\(^{72}\) Only a few days later he accelerated his intimidation tactics by addressing the company’s shareholders arguing that the incumbent management team was unable to safeguard their investment and demanded the chairmanship for himself. The management tried to fight back with a seven to five vote of confidence to the company’s incumbent chairman but Icahn turned this to his advantage by asking for six board members who


\(^{71}\) Ibid. ImClone’s poison pill was a common form of managerial defence in US corporations which takes advantage of state takeover rules, in this case s.912(b) N.Y.Bus.Corp.L.1985, which stipulates that after a bidder acquires 20 per cent of the target’s outstanding shares no merger can take place between the two companies for a five year period without the approval of the target’s board. The fact that this rule did not affect the power balance between Icahn and ImClone shows the impact of power dynamics in this type of bargains.

voted against him to be removed.\textsuperscript{73} Under the threat of a proxy fight, the company’s chairman and one more director resigned.\textsuperscript{74} This eventually gave Icahn full control of the company merely through a minority holding of just under 14 per cent.

This outcome is a perfect indication of how power tactics can transform an initial bargaining advantage of one party into a complete capture of the corporate counterparty’s control through a series of spiralling bargains and equivalent power additions for the stronger party or concessions by the weaker one. Indeed, Icahn with a small initial power advantage vis-à-vis ImClone and a mere 13.85 per cent of the shares, which notably made him only the second largest blockholder after Bristol-Mayers, managed to capture the chairmanship and the majority of the board. This is a de facto hostile takeover without the cost of paying either for a majority shareholding or a control premium - a highly disproportionate outcome that can nevertheless be explained by the theoretical predictions of the previous section on the power dynamics of stakeholder bargains.

Having gained full control of the board Icahn was able to stir the rent appropriation process in accordance with his and his supporting minority shareholders’ interests. It is noteworthy that ImClone continued to grow and create rent while its dynamic capabilities were still valuable, something that Icahn himself did not fail to advertise once he took over the board.\textsuperscript{76} He was reported stating that ‘I know enough to know that [Erbitux] and the pipeline are very valuable’.\textsuperscript{77} Indeed, in October 2006 when Icahn gained control, ImClone’s net annual income had almost doubled from $30.9 million to $57.3 million and annual revenue, including royalties, had increased from $106.5 million to $150.7 million, a trend that also continued in 2007 with sales of 1.4 billion\textsuperscript{78} and two years on the prospects for Erbitux were still reported to be good\textsuperscript{79}. So the benefit that Icahn expected from his bargaining with ImClone was the capturing of the largest possible value from the company’s current operations through a takeover. So long- or even medium-term organisational rent creation was an irrelevant concern and immediate return on the investment in ImClone’s stock was preferred; a typical example of myopic opportunism combined with power tactics. This takeover did not take long to materialise as in October 2008 the pharmaceutical giant Eli Lilly & Co. agreed to acquire ImClone for $6.5 billion or $70 per share following a prior rejection of a $62 per share bid by Bristol-Mayers.

Thus, after the sale, Icahn more than doubled the value of his investment in ImClone as he had bought his stake in the company for an average price of $33.46.\textsuperscript{80} Bristol-Mayers was also on the winners’ camp as it not only received $1 billion in cash for its shares, but also continued to market Erbitux in return for a royalty fee.

\textsuperscript{75} In his motions Icahn had the support of CAM North America, Smith Barney Fund Management and Salomon Brothers Asset Management collectively holding 11.3 per cent of the shares.
\textsuperscript{76} A Zimm, ‘Icahn Wins Control of ImClone’ \textit{International Herald Tribune} (New York 26 October 2006) 18.
\textsuperscript{80} Ibid.
So it would appear that shareholders and most of all Carl Icahn were the absolute winners in the rent appropriation process. Eli Lilly also appropriated some of ImClone’s future rent by gaining access to its pipeline which had five other cancer drugs in clinical trials, the three of which were closing the final stages of testing. However, the biggest loser appears to be the workforce of the combined companies due to a still on-going staff reduction programme. In order to meet the high cost of the transaction, almost immediately after the sale transaction Eli Lilly dismissed 20 per cent of its executives by eliminating more than six of its fourteen administrative layers. So in 2008, the year of the acquisition, the company’s net workforce, despite accounting for 1600 new staff mainly coming from ImClone, was reduced by 150, and a voluntary exit programme mainly for the manufacturing workforce. To this should be added the staff that had already left ImClone during the control turmoil before it was taken over by Eli Lilly, including critical staff like its chief scientific officer. Thus, it becomes clear that the combined effect of the transaction has been the expropriation of value by ImClone’s shareholders with substantial costs for the workforce. Moreover, Eli Lilly’s financial position after the takeover of ImClone has been precarious turning its focus on cost-cutting and depended almost exclusively on the success of its existing pipeline. It is indeed a difficult task to synthesise a focus on cost-reductions with high risk investment in drug development, and failure to do so may have a big impact on rent creation in the future.

While an excellent illustration of bargaining spirals’ progression, one could choose to regard the case of ImClone as an extreme example of myopic opportunism by one particular powerful stakeholder against a medium-sized company, which is worth ignoring. However, the next exemplar demonstrates how even powerful and generally successful companies can get trapped in power spirals as the size factor can be easily overcome by use of divide and rule tactics.

ii. Nelson Peltz v Cadbury Schweppes Plc

Starting from a small shop establishment in the 19th century Cadbury Plc grew to become one of the most successful and competitive companies in the confectionaries industry. One of the company’s landmark events took place in 1969 when Cadbury merged with the soft drinks maker Schweppes and since then the combined company evolved into one of the largest packed food and drinks manufacturer worldwide. Overall the company had been trying to maintain an ethical profile with good industrial relations, community involvement and fair trade policies.

Nonetheless, in 2006 the company faced successive crises due to a salmonella outbreak in one of its plants in Herefordshire that caused a 14 per cent decrease in its chocolate sales and a 10 per cent profit fall, a nut allergy-labelling error on one of its popular products and an accounting scandal in a Nigerian subsidiary. Moreover, there was an underlying stock market dissatisfaction with Cadbury Schweppes’ refusal to issue earnings and profits targets and a perception that its two main

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84 See Wall (n 81).
divisions, drinks and confectionary, of the company could achieve higher valuation if separated. These market expectations by no means reflected a competitive disadvantage of either division or of the combined company. In fact, the company had been following a steady growth strategy with the drinks division providing distribution channels in the US and a good cash flow and the confectionary division on a relatively higher growth path being the largest in the sector with a 10 per cent global market share. But in 2006 as a result of the aforementioned events Cadbury Schweppes’ share price briefly under-performed its competitors.\(^{86}\)

Given the company’s overall potential, the undervaluation of its shares was a perfect opportunity for veteran activist investor Nelson Peltz to build a three per cent shareholding at a low price average of around £5.50 per share through his hedge fund Trian.\(^{87}\) Cadbury Schweppes’ bargaining position vis-à-vis the market, at least temporarily, had diminished along with its stock market valuation which in turn increased shareholders’ responsiveness to a potential proposal against management. Indeed, the disclosure of Peltz’ minority shareholding was warmly received by the market as the company’s share price automatically jumped by eleven per cent in one day. The market reaction to Peltz’ move indicated the initiation of a betting on the possibility of a restructuring or takeover -with a corresponding profit for shareholders- merely on the basis of the American financier’s activist reputation. The appearance of Trian on Cadbury Schweppes’ share register signalled the possibility of a restructuring that would allow shareholders to extract abnormal returns. This signal attracted short-term investors, such as hedge fund arbitrageurs\(^{88}\), who expected a gain from the upcoming restructuring, which as a result was turned into a self-fulfilling prophecy as the expectations of a growing number of shareholders started to shape the future. This is an empirically proven phenomenon caused by arbitrageurs acting on restructuring signals who alone often determine the final outcome.\(^{89}\)

So, the power game here was rather different from that in ImClone, in that the power spiral was not driven by direct bargains between one shareholder and the company. Instead, all Peltz had to do was show a stable commitment to a restructuring plan, which in this case involved the break-up of the company by splitting the confectionary and soft-drink businesses. Power accumulation was achieved indirectly through stock market signalling and reaction with Peltz giving the rhythm and the market playing the tune that Cadbury Schweppes management had to follow as the company’s dependence on market valuation and therefore to shareholders expectations increased. This increasing dependence automatically signified a decrease of all Cadbury Schweppes’ BATNAs – the negotiated agreement here being the company’ split - and thus negatively affected its bargaining position.


\(^{87}\) Walsh and Wearden (n 85); J Finch, ‘Union Anger as American Corporate Raider Takes a Bite out of Cadbury Schweppes: Shares Hit All-Time High On Takeover Speculation: Analysts Suggest Peltz Wants To Break Up Firm’ Guardian (financial pages) (London 14 March 2007) 27. Peltz is a renowned corporate raider, who started his career as such in the US during 1980s with a series of junk-bond financed takeovers of companies which he repackaged and subsequently resold for whopping profits.

\(^{88}\) According to press reports hedge fund holdings rose up to 25 per cent of the company’s outstanding shares and it is only reasonable to assume that most of them if not all were arbitrageurs; D. Prosser, ‘Cadbury’s Owners Make their Decision’, Independent (business section) (London 20 January 2010) 44.

Indeed, given the market’s reaction to Peltz’ involvement, the company realised almost immediately that the bargain had already tilted against it and reacted by immediately reversing its structural strategy with an announcement that it would spin off the soft-drinks division surprising even its largest shareholders.90 The goal of the company’ management was to implement an aggressive share price boosting strategy in order to increase the cost of a potential takeover; a clear BATNA manipulation tactic as a rising share price would make existing shareholders’ alternatives – eg cashing out their stakes – less attractive than keeping their shares.91 In addition to a promise of channelling most of the proceeds from the spin-off to the shareholders, the new focus on the share price also involved significant cost-cuttings through the redundancy of 7,800 employees in the confectionary division in order to improve it profit margins92 - a clear diversion of rent from the workforce to the shareholders. Indeed, Cadbury Schweppes’ defense appeared to work as within a few months its share price saw a rise of around 30 per cent.93

However, this strategy was a double-edged sword, as the sale of the soft-drinks division would simultaneously render the company a takeover target so that the BATNA effect could not in fact materialize. Cadbury Schweppes was trapped in Peltz’s ‘divide and rule’ tactic; the balancing act between the preferences of its long-term shareholders and those of takeover arbitrageurs was too difficult to maintain in a speculative market. On the other hand, Peltz could only improve his bargaining position: his investment had already a secure high return due to a rising share price and a potential for an even larger profit from a takeover premium. He faced no significant opportunity cost and therefore all he had to do was continue signaling his commitment to the restructuring in order to feed speculation. He did this with three moves: he increased his original stake in the company, he formed a coalition with Qatar Investment Authority’s fund so that he now controlled a 4.5 per cent stake that increased the credibility of his demands and issued a threatening letter with his own ambitious performance targets for Cadbury Schweppes.94 This in effect heightened market speculation, which diluted even further the bargaining power of the company which was trapped in a power spiral where Peltz sent restructuring signals to the market, which in turn increased market speculation and takeover arbitrage and thus further strengthened Peltz’s position. This made the demerger an inevitable prospect that took place with the floatation of the soft-drinks division on the New York Stock Exchange while the confectionary business continued to trade on the London Stock Exchange as Cadbury Plc.

Following the demerger Peltz’ ‘divide and rule’ tactic was accomplished and it was now inevitable that a bid for Cadbury was a matter of time. Indeed, after a one-year delay due to the ‘credit crunch’, by the end of 2009 Peltz and other shareholders had the opportunity to capitalize on their successful bargain as the American food

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90 M Milner and J Treanor, ‘Cadbury to Split Confectionary and Drinks Businesses after Peltz Buys Stake’, *Guardian* (financial pages) (London 16 March 2007) 30. Ironically, it was Peltz himself who had sold the American part of the drinks division to Cadbury ten years earlier at a record profit.

91 See also J Coffee, ‘Shareholders versus Managers: The Strain in the Corporate Web’ (1986) 85 Mich Law R 1-110, 56, observing that such split-ups by large corporations constitute defensive moves seeking to prevent ‘bust-up’ takeover bid.


company Kraft launched a leveraged hostile bid for Cadbury. The transaction was finalized and accepted for 8.50 pounds per share, which translated into a 50 per cent average return on Peltz’s initial investment in Cadbury Schweppes. On the other hand, the high leverage of the combined entity led to a downgrade of its debt to just above ‘junk-bond’ status infuriating Kraft’s major shareholders and left the labour force in a precarious position as a result of the vast cost-cuts necessary for servicing the debt that funded the takeover. Cadbury’s long-term shareholders were also unsatisfied as they valued the company’s future rent creation and therefore their investment more highly than their myopic peers who undervalued long-term performance.

Overall the Cadbury Schweppes’ affair constitutes a clear case of rent extraction after a power spiral in a multistage bargain between a small shareholder and a large corporation with the former taking advantage of stock market dynamics. It started with a small stake that would normally confer a low power value to its holder, but which was magnified by market speculation that assisted the implementation of a ‘divide and rule’ tactic which further increased the power of the initial stake and ended with rent extraction through the medium of the takeover. The cost of rent loss was mainly borne by the merged entity, as well as its shareholders, creditors and workforce due to the cost of Cadbury’s takeover.

This type of rent extraction should by no means be taken as an exceptional case. On the contrary, after a break due to the ‘credit crunch’ in 2008, it now seems that ‘divide and rule’ raids against giant companies are becoming common not only in the Anglo-Saxon world, but also on the European continent which is traditionally unaccustomed to such practices; the latest targets being the Italian state-controlled oil and gas giant Eni and the Dutch TNT. The overall efficiency cost of rent extraction by corporate raiders seems to be considerable, as empirical evidence shows a considerable drop of targets’ capital investment ratios following an activism incident. Moreover, this type of rent extraction through the use of the market for corporate control, either as an actuality or as a threat, has also been directly linked with substantial rent loss for the labour side as a bargaining party. In a study of the 1980s takeover wave in the US Becker has estimated this cost for unionised labour to approximately eight per cent of annual earnings or 50 per cent of the premium

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95 This should be balanced against a reduction in overall returns because Peltz also held a 5.5 per cent stake in Kraft and the fact that, due to a general restructuring of its portfolio, his fund had in fact reduced its stake in Cadbury by 0.35 per cent after Kraft’s bid - nonetheless Cadbury’s share price was already over eight pounds so that this reduction was not of minor significance; A Frean, ‘Investor Sells 3.5m Cadbury Shares amid Bid Intrigue’, Times (business section) (London 26 November 2009) 54.


97 Indeed, nearly 30 per cent of Cadbury’s shareholders voted against Kraft’s bid, while some of them publicized their dissatisfaction with one of them stating: ‘the final offer for Cadbury by Kraft Foods fails to fully reflect the long-term value of the company’; J Treanor, ‘Cadbury Takeover: Banks Share $390m in Fees as Criticism Mounts over Deal’, Guardian (financial pages) (London 20 January 2010) 28.


conferred by union membership. But the labour aspect will be better illustrated by the next exemplar of company-stakeholder bargain dynamics.

B. Employee Concession Bargaining Spirals - GM Europe v Employees

Before its highly symbolic collapse and Chapter 11 restructuring following the credit crunch of 2008, General Motors (GM) was the world’s largest car manufacturer in terms of total sales. The company has a long presence in Europe dating back to the 1920s when it acquired Vauxhall and Opel in 1925 and 1929 respectively, which operated autonomously until General Motors Europe (GME) was established in 1986 in Zurich. GME, under the guidance of the group’s central headquarters in the US, sought the international integration of its production facilities and increasingly interfered with the European subsidiaries’ management, a process that intensified in the early 1990s. Over the years, GME became one of GM’s most important subsidiaries operating semi-autonomously within the European continent marketing significant brands such as Opel and Vauxhall, Saab, Chevrolet and Hummer, contributing 24.4 per cent of the group’s total sales in 2008, and being one of the most significant design and engineering innovation contributors to the group. GME had 10 production and assembly plants in seven countries with a total workforce of approximately 54,500 in 2008.

As GME’s internationalisation of production evolved, the industrial relations model adopted was ‘competitive benchmarking’, where successful experimentation in single plants was followed by a transfer of best practices to all other production units. The bargaining forum was each individual plant, though corporate decision-making was taking place in Zurich. This constituted a clear power tactic that gave the company as an employer a dual power advantage over its workforce. First, as bargaining decentralisation increased, employee representatives’ access to crucial information from the company’s headquarters was restricted. Second, it rendered collective action by the workforce extremely difficult, since each plant had a strong incentive to undercut other plants’ agreements in order to prevent the allocation of production elsewhere. Thus, GME could link its production investment decisions on working practices in each individual plant so that the workforce of all production units were placed in a competitive position with each other in a ‘divide and rule’ game of consecutive concession bargains. The company offered to a single plant’s workforce investment and production guarantees that gave employment security for the immediate future in exchange for working-time flexibility, below average wage increases and other cost-cutting benchmarks. Hancké describes the process as follows:

Management would start by singling out one plant as a pilot bargaining arena for changes in working time or work organization. The agreement concluded in this

101 GM Europe was not included in the Chapter 11 proceedings of 2009.
104 Hancké (n 102) 48.
‘most favourable’ setting (for management) was then, in the next round, presented to every other plant in the company as a minimum standard. These other plants had no alternative but to follow suit, since they might otherwise find themselves in an unfavourable position in the next round of model planning.\textsuperscript{106}

In order to deal with this power imbalance and following the establishment of the GME European Employee Forum pursuant to the European Works Council (EWC) Directive\textsuperscript{107}, GME’s employee representatives attempted to bridge their differences resulting from the structure of the company’s production process in order to attain a more unified reaction to corporate policy. Initially, the Forum was to some extent successful in unifying workforce’s response to cost-cutting and ‘divide and rule’ measures and even in achieving some moderation and standardization of labour concessions through European-wide agreements with GME.\textsuperscript{108} However, the Forum’s bargaining power could not match that of the company, which responded with the implementation of a new power tactic to enhance its position; it restructured the integrated manufacturing process through the development of a small number of ‘production platforms’ with standardized components and plants, so that in effect plants were duplicates rather than complementary. In this way, GME increased its BATNA in each plant-level bargain, because it could move production between plants more easily and at no risk of its integrated production being held up by a strike in one plant that manufactured a component that was critical for the continuation of production elsewhere. Once again different plants operating under the same platform had to bid in a process of internal tendering for the same production work and the Forum has only proven capable of mitigating the social consequences of cost-cutting policies.

So, in effect, GME has been able to exploit employees’ co-ordination costs and lower value BATNAs -it is empirically established that in aggregate unemployment conditions the value of a new job after redundancy is on average considerably lower than that of he job lost\textsuperscript{109} for rent expropriation purposes. This has given enormous weight to its threat of moving production to another plant with the equivalent cost for the negotiating plant’s workforce. This power disadvantage of the employees in one plant brings about a concession to a corporate demand, which in turn damages the bargaining position of all other plants and thus sets the stage for further concessions there -a spiral that can continue for several rounds. In effect, these spiralling bargaining rounds result in increasingly disproportionate benefits being extracted by the company as a party to each round, whereas its cost, in terms of capital investment, remains that unilaterally set according to its priorities before the bargain, which are, of course, also shaped by the power of other stakeholders to extract rent.

\textsuperscript{106} Hancké (n 102) 45.
\textsuperscript{107} Directive 94/45/EC with two subsequent extensions pursuant to Directives 97/74/EC and 2007/14/EC. The Directive applies to all companies with 1,000 or more employees, at least 150 of which have to be in each of two or more EU Member States and creates an obligation for the establishment of employee representative bodies (EWCs) for worker information and consultation purposes.
\textsuperscript{108} Banyuls et al., (n 105) 538-540.
It is worth noting that this type of rent extraction may have had significant efficiency costs for GME. One indication of this is that the cost-based approach that mainly concentrated on the financials of production did not seem to produce adequate returns, as the company made constant annual losses for several years since 1999. It was only in 2006, two years after an overhaul of this strategy took place, that GME improved its performance by refocusing on quality through investment in innovation and design.\textsuperscript{110} It is nonetheless ironic but not surprising given the preceding discussion that this change of strategy was indirectly financed by labour cost cuttings in the form of job-cuts.\textsuperscript{111} The refocusing of goals, however, came too late and was interrupted by the impact of the credit crunch of 2008 that brought the collapse and restructuring of General Motors that affected GME’s fate too.

Once again, just like in the cases of ImClone and Cadbury Schweppes above, the tactics adopted by GME in its industrial relations are not unique. In fact, where they can, most companies will follow similar bargaining strategies the extent and form of which, of course, differs according to the regulatory constraints in each particular case. This phenomenon of bargaining decentralization, which aims to exploit performance and regulatory differences through the threat of production relocation, has indeed been a major power enhancement instrument used by multinational companies with production operations in several jurisdictions and locations.\textsuperscript{112}

6. Normative Implications for Corporate Governance Regulation

A. The Need for Mandatory Power Balancing Rules

The theoretical analysis and exemplars in the previous sections have demonstrated how the efficient private ordering thesis crumbles with the introduction of uncertainty and bargaining power differentials in the equation. By using a theoretical framework of power driven tactics we have been able to predict and explain the dynamics in stakeholder-company bargaining. Indeed, we have confirmed that a private order that derives from contractual bargaining alone is not necessarily a process towards efficiency. Contractual governance is driven by bargaining dynamics, which often lead to spirals of power accumulation (loss) for powerful (weak) negotiating parties. This is then reflected in the rent appropriation process, as it can lead to outcomes where contractual governance allows for and leads to corporate control capture and/or rent expropriation of weak parties, including the company, by powerful ones as instances of private disorder. Instead of working as a stabilising factor that curbs opportunism, as the contractarian argument goes, the company may in fact become a transmission mechanism for market inefficiency in the production process.

Since markets are unable to balance bargaining power differentials, contractual governance will have the tendency to create winners and losers, ie instead of equilibrating power it will create continually weaker and stronger parties. It was with this in mind that Commons distinguished between the concepts of power and property

\textsuperscript{111} In 2004 about 12,000 jobs were eliminated.
\textsuperscript{112} For a study of this phenomenon see F Mueller and J Purcell, ‘The Europeanization of Manufacturing ad the Decentralization of Bargaining: Multinational Management Strategies in the European Automobile Industry’ (1992) 3 Int J Hum Res Man 15-34.
to claim that the role of legal property rights is to protect weak parties from powerful ones who do not need to be protected. An inference from this distinction between power and property (in the light of the previous discussion) is that the existence of property rights presupposes a hierarchy above the contractual exchange to protect them or in other words to allocate power in order to correct power differentials between contracting parties. So contrary to the Hayekian and Coasean contention, this hierarchy, ie the state or other non-private governance mechanisms, is needed to enforce rights and thus allocate power. Thus, there is a need for mandatory rules observed by (or enforced upon) contracting parties. In the same fashion, there is a need for mandatory rules allocating power in contracts bargained between the company and its stakeholders. Otherwise power differentials leading to spiralling bargaining dynamics result in rent expropriation by powerful stakeholders or the company.

Once this need for mandatory regulation is established, the question then is about what should be its means and ends. Regarding the latter, ie the goal to be achieved, the discussion so far has already identified the need for institutions balancing stakeholder and corporate power in order to neutralise bargaining dynamics. The term ‘balancing’ should mean to allocate power in a way that it reflects the value of contributed resources in order to prevent bargaining spirals and the resulting rent expropriation. Nevertheless, constructing a theoretical regulatory objective is one thing; identifying the tools for implementing it is another very different and perhaps more demanding process. To this we turn next.

B. Structural (Re)Balancing: A Systemic Problem?

Having argued for the need of a power-balancing ‘public order’ in corporate governance, this section will examine the basic structural issues that would have to be resolved for an effective bargaining system. Certainly, we do not intend to provide comprehensive governance solutions dealing with the rent expropriation dynamics identified above. Structural forms influencing the value of BATNAs and power dynamics - eg. collective action, information flows, asset specificity hold-ups and resource replacement costs - not only are diverse in each legal and economic context but they also tend to change over time. Rather, this section will focus on regulatory methodology by arguing that corporate governance concerns not only the corporate structure but also other institutions, which fall outside the limits of the strict corporate law framework. Bargaining dynamics can only be effectively regulated if corporate structure ‘manipulation’ is combined with a more systemic regulatory approach.

i. Manipulating the corporate structure
The most obvious and direct method for regulating the power of the company and its stakeholders would certainly involve the manipulation of the former’s internal structure in order to give it enough power and incentives as a central counter party to prevent bargaining spirals. Indeed, a number of company law scholars have suggested this approach with a remodeling of the illusive concept of the corporate objective and its relevance for the formulation of directors’ duties.

114 See n 49-52 and relevant text.
In the UK, several scholars, including Kay\textsuperscript{115} and Goyder\textsuperscript{116} for instance, have suggested that the Companies Act’s provisions concerning the interests and objective of the company should reflect the balancing act of various stakeholder interests, while Keay\textsuperscript{117} has advocated that the sole objective that directors must pursue is that of maximizing the company’s wealth as an entity, ie organizational rent for our purposes. As a point following from this reconception of the company’s interests, Hill has emphasized the need for a redefinition of directors’ fiduciary duties, due to the capture of corporate governance mechanisms by powerful shareholders, which creates and imbalance in corporate decision-making.\textsuperscript{118} In this fashion, the adoption of ‘constituency statutes’ by many states in the US, and to a lesser extent section 172 of the Companies Act 2006 in the UK, have sought to enact a more balanced version of the corporate interest.

While seemingly in the right direction, these proposals have a serious defect that in practice can defeat their purpose. This defect is one that has been following the legal prescription of the company’s objective since its inception, namely the difficulty of enforcing it.\textsuperscript{119} The dubious impact of the US ‘constituency statutes’ is the clearest illustration of the regulatory limitations of manipulating the corporate objective.\textsuperscript{120} There have been some legislative proposals seeking to resolve this problem. Du Plesis and Dine have suggested that the medium of the derivative action should be exploited by giving shareholders, employees and lenders, as critical stakeholders, the same rights to petition the courts in the company’s name where their associative interests are disregarded.\textsuperscript{121}

However, this proposition has been criticized as rather impracticable, because it involves significant procedural hurdles and that stakeholders may lack the incentive or the resources to pursue a derivative action when it would be the company that would directly benefit from its success.\textsuperscript{122} But most importantly, by giving various stakeholders equal enforcement weapons, any (im)balance of power between them and/or the company would remain unaffected. Critical information for establishing such claims may not be available where and when it is needed and thus informational asymmetry as a source of power imbalance would not be dealt with. Not to mention, of course that an out-of-court enforcement of the corporate objective by any disadvantaged party through the available corporate structure - eg. by a resolution of


\textsuperscript{117} Keay (n 36).


\textsuperscript{119} For a recent assessment of the impact of US and UK enactments on the corporate objective see A Keay, ‘Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value and All That: Much Ado About Little?’, working paper, School of Law, University of Leeds, 4 January 2010.


the general meeting or any other company organ - would need to overcome the collective action problem. This seems to have been a basic and long-standing governance problem in the so-called ‘outsider’ corporate model.123

One method for resolving the informational problem could be the adoption of the representational model where stakeholders are granted the right to appoint their representatives on the company’s board. In practice, this amounts to a partial internalization of the bargaining process and is operated - at least as far as shareholders and labour are concerned - in several European countries, while it is also included in the legislation for the European Company and the eventually abandoned draft Fifth Directive on Company Law.124 This ‘insider’ structure supposedly provides stakeholders access to the main information and power hub of the company, the board, as representation may facilitate not only an extensive and timely flow of information125 to and from stakeholders, but also access to power through the decision-making process itself. In fact, the board may serve as a forum for institutionalized bargaining between stakeholder representatives on a face-to-face basis, which could be associated with co-operation rather than conflict between board members.126 So board representation is generally associated with a co-operative model of corporate governance,127 which in itself is an indication of power-balancing.

However, in large hierarchical organizations representation may have a negative effect on the information flow towards the board and thus shift the information barrier to a different level.128 Certainly, if this could be the case with any board, a representational board would be even more vulnerable. Arguably, this information-blocking may not necessarily be a structural defect. In fact, the hierarchical filtering of information may constitute the defensive mechanism of the corporation itself as a central counterparty in bargains with its stakeholders. It can serve as a mechanism allowing the lower layers of management to influence corporate decision-making in order to protect the company’s capability generators from stakeholder myopic opportunism or to stir decision-making. While this may be a crucial defense for the resource amalgamation process and the creation of competitive advantage, it can also lead to excessive corporate power that would need to be balanced against that of

127 J Helm, ‘Codetermination in Germany: What Difference Has It Made?’ (1986) 9 WEP 32-53, 37, reports that virtually all co-determined supervisory board decisions are unanimous and that co-determination contributes to the low incidence of strikes in Germany.
major stakeholders. So, while board representation may at first glance appear as a power-balancing solution, it may in fact merely transform the bargaining spiral problem from an external to an exacerbated internal one due to the direct access it provides to corporate decision-making.

Thus, irrespectively of whether an outsider or representational model is operated, power balancing cannot normally be achieved merely by manipulating the corporate structure. Structural conditions outside the company must also be conducive to alleviating power dynamics among stakeholders and/or the corporate hierarchy.

**ii. The need for systemic (re)balancing**

If the bargaining problem cannot be resolved by the corporate structure alone, one would then also have to look outside of it and identify the key structural sources of power within the legal and economic system where companies operate.

For several decades we have been witnessing a dramatic structural transformation at both national and international levels of the economy which seems to have certain clearly visible characteristics. Successive world trade agreements since the 1960s and the abolition of capital controls since the abandonment of the Bretton Woods framework, have virtually liberalized capital flows and led to the denationalization of corporate and financial geography. 129 Industrial production has been reorganized on a global scale in order to reap available resources and gain competitive advantages, while financial capital is now allowed to flow virtually freely within and across borders guided by differentials in investment returns. This largely unrestricted mobility has altered the power dynamics not only in private bargaining between the key parties in production - corporations, financial capital and labour - but also in the regulatory bargaining between governments and private economic actors.

On the one hand, labour organizations have been unable to influence institution building during the transformation process sufficiently or at least as much as investor and employer representative bodies have. 130 It was hinted earlier that labour seems to be the weaker party given the current circumstances of free capital flows and the international division of labour. 131 This claim is discussed exhaustively in the industrial relations literature 132 so it is sufficient for our purposes to state that, as the GME exemplar illustrated earlier, increased capital mobility combined with the relative lack of mobility of labour due to spatial hold-ups has decreased the relative value of labour’s BATNAs. What is more important is the ‘deunionization’ phenomenon of recent years, which has significantly limited the coverage of employees by collective bargaining and simultaneously undermined the bargaining power of unions. 133 So, the combination capital mobility and labour hold-ups

translated in bargaining spirals between companies and their workforce and resulted to the latter’s expropriation. For instance empirical evidence from the US shows that this systemic disempowerment of labour has allowed corporate profitability to be largely supported by the slowdown of real wage increases.\footnote{E Wolff, ‘What’s Behind the Rise in Profitability in the US in the 1980s and 1990s?’ (2003) 27 Cambridge J Econ 479-499.}

On the other hand, the regulatory function has also been affected as government regulators have found it difficult to impose restrictions on volatile capital flows and thus to level-out bargaining power differentials. On the contrary some governments have had to go down the opposite path, by retreating from their regulatory and distributional functions, with the abolition of the Glass-Steagall\footnote{This is how the Banking Act of 1933, which segregated commercial and investment banking to contain speculation, became known after its two legislative sponsors. The Act was repealed by the Gramm-Leach-Bliley Act of 1999.} banking restrictions in the US and the semi-privatization of pension systems in many western economies being highly significant examples of this, as they led the transformation of the financial landscape. As deregulation increased competition in the financial sector, it fueled risk-taking and speculative investments by banks who sought to exploit lucrative investment banking opportunities such as mergers and acquisitions to remain competitive. Simultaneously, the emergence of institutional investors as major private savings vehicles, who thus became the most active securities traders and a dominant shareholder group, joined financial institutions in the corporate restructuring speculation that led to the entrenchment of shareholder value often through ‘downsize and distribute’ policies.\footnote{W Lazonick and M O’Sullivan, ‘Maximising Shareholder Value: a New Ideology for Corporate Governance’ (2000) 29(1) Econ Soc 13-35, documenting a managerial shift towards “downsize and distribute” strategies maximising returns to shareholders.} This resulted in the redirection of corporate objectives with the market for corporate control and managers’ pay schemes tied to the share price playing the role of the stick and the carrot.\footnote{E Stockhammer, ‘Financialisation and the Slowdown of Accumulation’ (2004) 28 Cambridge J Econ 719-741, 726.} This explains the inability or even unwillingness of the management of even a seemingly powerful corporation like Cadbury to prevent a small activist investor from directing the market so as to implement his rent expropriation strategy. So, the blend of financial power, stock market speculation and investor herd behavior has been operating as a power lever for spiraling bargains between shareholders and companies.

More importantly this shareholder-driven corporate governance model became an integral component of a dominant economic system, which Boyer terms “finance-led accumulation regime”\footnote{R Boyer, ‘Is a Finance-led Growth Regime a Viable Alternative to Fordism: a Preliminary Analysis’ (2000) 29(1) Econ Soc 111-145.}. In this system, rent extraction by shareholders boosts stock markets which form the basis for consumption expenditure. This led to an increased transfer of earnings from the real economy to financial markets, either through takeover premia or increased payments such as interest, dividend or stock repurchases.\footnote{O Orhangazi, ‘Financialisation and Capital Accumulation in the Non-Financial Corporate Sector: A Theoretical and Empirical Investigation on the US Economy: 1973-2003’ (2008) 32 Cambridge J Econ 863-886.} Thus corporate governance structure is deeply embedded in the...
economic system and its reform is a very complex process that as argued above goes beyond the corporate structure.

So overall, piecemeal institutional arrangements in single areas of economic activity seem unlikely to effectively address the problem of bargaining power spirals in stakeholder contracting. Different sectors of the economic system interact with each other and are interdependent due to institutional complementarities in a way that a single institutional change may prove to be insufficient or even damaging.\textsuperscript{140} The systemic approach to corporate governance shows that the nature of corporate decision-making and stakeholder relationships are governed and thus determined by a whole network of institutions regulating corporate activity. So, while corporate law can be a useful power-balancing tool, it simply represents the tip of the iceberg in corporate governance regulation, since institutions in other areas such as finance, industrial relations, competition policy as well as national and international macroeconomic policy\textsuperscript{141} would also have to be considered. The stakeholder power structure mostly lies outside the corporation and it is there where regulators should focus their balancing effort.

To be sure, private order tools such as contractual governance and ‘light touch’ oversight through enabling rules or soft law will not be adequate to alleviate power imbalances in the economic system. Systemic re-balancing is a demanding process that requires careful and extensive planning by regulators and governments who will have to implement and enforce mandatory rules that protect weaker parties. This is obviously a daunting project requiring multi-level efforts at both national and international levels and its complexity makes it one that is not likely to be pursued unless a significant systemic crisis induces it.

7. Conclusion: On the Way to Systemic Change?

The preceding analysis has shown that bargaining power differentials push contracts’ renegotiation between stakeholders towards imbalance rather than balance. Contrary to what contractarians have argued over the years, under realistic economic conditions the inclusion of bargaining power in the contract negotiation equation leads to an outcome very different from what could be described as a ‘spontaneous order’. Without some kind of non-market intervention, stakeholder contracting not only leads to imbalanced rent appropriation, but also in a cumulative process of rent expropriation of stakeholders with a power disadvantage; a state of affairs which could more accurately be described as a ‘spontaneous disorder’ of spiralling power imbalances.

The purpose of this article is not to suggest the best possible institutional design for corporate law and governance. However, we do suggest that, whichever design policy-makers choose, it will need to have certain characteristics. First, it will need to


take into account that contractual governance of stakeholder bargaining with the company is inherently unstable and prone to spiralling negotiations towards rent expropriation by stronger stakeholders. Secondly, mandatory rules rather than contractarian arrangements are necessary to mitigate power differentials among various stakeholders and the company. Third, a systemic approach will have to be followed, since institutional complementarities affect the balancing effect of piecemeal reforms in one area only; the stakeholder balancing regulation should not necessarily or exclusively be treated as a corporate law issue.

So, as mentioned above, what is required is admittedly an intimidating exercise, which in some cases could mean a redirection of a whole political economy system. However, it is by no means impossible as it has been done before in times of crisis, like the Great Depression or the 1970s stagflationary environment. After all, as Veblen and his institutionalist followers argue, social systems do not resemble static equilibria but dynamically evolving ‘organisms’ subject to constant change.

In fact, we may be witnessing the beginning of such movement. In the aftermath of the ‘credit crunch’ and the world recession that followed it, large corporate reorganisations in both the financial and the manufacturing sector are now being executed with the sponsorship and under the guidance of governments, who have suddenly become large stakeholders. It seems that the width and depth of the recession has made governments less fearful of assuming control of sections of the economy. In fact, the market itself necessitated this, which is in itself an indication that the crisis is a systemic one.

But government intervention simply in the form of financing reorganisation will be insufficient, if institutional structures remain unchanged. Distributional structures, including corporate governance bargaining processes, will have to be rebalanced; otherwise governments will be financing the bailout of a failed system. For this to happen, public regulators will have to regain at least some of the formal governance role they have been divesting over the past few decades.

Indeed, there is now some preliminary evidence of such government re-empowerment over financial markets. As we write, the Obama administration in the US seems committed to re-introducing Glass-Steagall regulatory elements such as the ‘Volcker Rule’ and the EU is introducing rules affecting the role of hedge funds in takeovers while considering further measures which would aim to limit the speculative effect of signalling on share prices following a similar move by Germany. Moreover, at the macroeconomic level, while as recently as a year ago no head of government would think of suggesting the implementation of measures affecting capital flows, such as the Tobin tax, now several western officials have

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142 T Veblen, ‘Why is Economics Not an Evolutionary Science?’ (1898) 12 Quart J Econ 373-397.
made this proposal,\textsuperscript{146} one country has already decided to implement it unilaterally,\textsuperscript{147} and those who disagree rely on its enforcement problems rather than its usefulness in rebalancing the power between finance and the real economy. While it is still early to predict the outcome of this reaction, it seems that the width and depth of the crisis has re-ignited a regulatory debate, which for several decades seemed resolved in favour of a private order. Ironically, the progress of systemic rebalancing as a positive development seems dependent on economic catastrophe.

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\textsuperscript{147} J Wheatley and A Beattie, ‘Brazil Imposes Tax on Foreign Investments’ \textit{Financial Times} (London 20 October 2009) 1.