Comment: untoward neutral principles: market failure, implicit contract, and economic adjustment injuries

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Superb papers by Ronald Daniels¹ and Katherine Stone² discuss the appropriate social and legal response to generic problems of injury to non-shareholder constituencies, particularly workers, occasioned by adjustments in corporate structure or strategy. Both authors insist that significant adjustment injuries such as employee displacement can be triggered by a wide range of changes in firms' competitive strategies and investment decisions, not just takeovers and other change-of-control events on which the literature has focused. The authors suggest an array of well-conceived proposals for law reform, with which I largely agree. This brief note probes the authors' conceptual framework rather than their specific conclusions and policy prescriptions. Several difficulties limit the scope and effectiveness of their approaches.

The authors adopt the model that conceives the firm as a nexus of contractual relations between its various constituencies (the NCR model). In Stone's analysis, management induces employees to make a long-term investment of human capital in the firm by internal promotion schemes and implicit promises of deferred compensation and job security. The problem she discloses is that management often has strong incentives to renege, and the law affords employees entirely inadequate instruments with which to enforce the implicit contract and prevent end-game betrayal. For Stone, the adjustment injuries problem is primarily a question of expropriation, and her solution is to enable employees to make and enforce more effective contractual guarantees against such misbehaviour. Stone accepts the contracting model of the firm only provisionally, treating it as a medium in which to advance her democratic and egalitarian commitments. She advances other approaches to law reform, including the idea of revising the background legal rules of the economic game so as to redistribute power from employers to workers.

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¹ Ronald Daniels 'Stakeholders and Takeovers: Can Contractarianism Be Compassionate?' this issue
² Katherine Van Wezel Stone 'Policing Employment Contracts Within the Nexus-of-Contracts Firm' this issue
Daniels is much more committed to the NCR model. But where Stone sees opportunistic wealth diversion in violation of implicit contract, Daniels emphasizes the absence of contractual protections. Employees and some other stakeholders systematically underprotect themselves from adjustment harms due to a pervasive problem of market failure. Employees possess imperfect information about the likelihood and risks that unpredictable market forces (notably the globalization of competition) will devalue stakeholders' firm-specific capital. His solution is to correct for contracting failure by positing and enacting the outcome that would have been bargained for in the presence of perfect information. Because the problem stems from mistake rather than misconduct, arguably society should shoulder some of the assistance burden.

II Preliminary points

1. EXTERNALITIES
In practice, NCR discussions of adjustment injuries pay insufficient attention to significant externalities and third-party effects emanating from the corporate contractual nexus. Capital mobility can generate severe third-party dislocation costs for which firms bear no liability (increases in domestic violence, alcohol abuse, and suicide; community decline; and loss of the social and political contributions of labour unions). Because they externalize these costs onto the community, firms are likely to overvalue alternative uses of capital and therefore to overproduce disinvestment. This supplies an additional argument for legal reform and specifically for firm liability for adjustment injuries.3

2. INDUSTRIAL RELATIONS
The NCR model is sociologically unsophisticated; it has no organizational theory. Specifically, NCR discussions of economic adjustment often ignore the findings of industrial relations theory. The tendency is to regard non-contractual stakeholder protections as an inhibiting tax on wealth generation, but this view disregards considerable evidence that job security protections can enhance productivity (by creating an industrial relations climate more conducive to technological innovation), and that junking our senior, experienced workforce robs the economy of productive capability. In this respect, the implicit contract model is superior to the market failure analysis because it offers a theory of why heightened protections can lead to joint gains. In general, we should complement the

NCR approach with a theory of the firm as a bureaucratic institution in need of democratization.⁴

3. REPUTATIONAL LOSS
Some NCR theorists argue that the risk of reputational loss deters opportunistic breach of contracts with non-shareholder constituencies, obviating the need for heightened legal protections. Stone questions, but Daniels sees merit in this view, with qualifications. The reputational loss argument for legal abstention is incoherent. Harm to a firm’s reputation (and deterrent impact on others) arises only in the case of conduct widely judged to be inappropriate and therefore worthy of censure. If, in the prevailing view, an uncompensated mass layoff is not understood to be a wrong but ‘a curse of fate’ or ‘just bad luck,’ then downsizing firms risk no injury to reputation. Legal values and practices significantly affect the prevailing cultural messages. When the law and the culture are fatalistic about worker dislocation, employees adapt to preferences that undervalue job security because they internalize the view that they cannot realistically expect to have it. Conversely, there is a greater risk of reputational damage when the law teaches that junking employees is wrong. Thus, the risk of reputational loss can only function as a deterrent when the background legal rules and the dominant cultural understandings stigmatize unilateral action causing adjustment injuries.

4. ATYPICAL WORKERS
The implicit contract theory is undermined by the problem of labour market segmentation. The theory is most persuasive regarding the primary labour market, where long-term employment is the norm. But a crucial development of recent years has been the dramatic expansion of secondary or contingent labour markets, in which employers negate expectations of continuity, job security, and deferred compensation. Many employers see maintenance of low-commitment (and frequently low-wage) relationships as a viable profit-seeking strategy. Sometimes employees will prefer low-commitment or part-time work, but often low-commitment employment is accepted reluctantly and only because the job-seeker lacks the bargaining power to do better. The destructive consequence for the economy as a whole of the proliferation of contingent employment is the long-run degradation of human capital.

Often the case is exactly as Stone describes. An employer has implicitly (or even expressly) promised job security and deferred compensation,

and the feeling of betrayal among dismissed workers is authentic and appropriate. But it must be acknowledged that this is not always so. Particularly (though not exclusively) in the secondary labour market, there may be no promise of job security. Employees, even unionized employees, often fail to bargain for job security and adjustment protections, not because they do not value these things or because they lack pertinent information, but because they simply do not have enough market strength to achieve protections. As to such employees, the case for enhanced protections cannot be made solely in contractual reliance terms. An efficiency case can be made for adjustment protections (discouraging involuntary low-wage/low-commitment employment upgrades societal productivity), but in the end, an argument from the standpoint of distributive equity is required.

III Critique: Neutral principles?

The NCR model does not and cannot fulfil the hope of some proponents, notably Daniels, to avoid controversial normative judgments. Accordingly, discussion of adjustment harms should openly debate questions of distributioanl equity towards affected constituencies and the question of democratization of the firm regarded as a political institution.

Professor Daniels is admirably candid about his agenda to get beyond the 'highly contestable normative and empirical claims' characteristic of the 'paralysing terms' of political debate between individualists and communitarians. He seeks a way to keep law and politics separate, while justifying 'humane and compassionate assistance to deserving victims of economic transitions, without forgoing the wealth-creating benefits that these transitions confer on society at large.' He hopes that a sophisticated efficiency analysis of the contractual ties binding various social constituencies will provide a neutral, apolitical rhetoric in which to justify a dynamic but socially softened capitalism. The normative glue of the theory is supplied by 'capacious, fair-minded interpretations of widely shared contractarian values.' Stone shares none of Daniels's beyond-ideology agenda. Indeed, her goal is 'to contest the normative message contained in the contractual theory of the firm.' But Daniels perceptively notes that a great appeal of implicit contract theory for progressives is

5 Supra note 1, text following note 26
6 Ibid., text following note 93
7 Ibid.
8 Ibid.
9 Supra note 2, text following note 11
that it accomplishes the feat of justifying communitarian policies by
reference to autonomy-based contractarian premises. Expanding the
point, NCR theory apparently enables progressives to use efficiency talk
or, as in Stone's case, contractual reliance arguments, to advance an
egalitarian and empowerment program.

In pursuit of his objectives, Daniels skilfully deploys a theoretical
manoeuvre launched by Guido Calabresi years ago in his work on
accident law. Calabresi, too, sought a neutral rhetoric that would
consistently generate pro-compensation tort results. He achieved this by
linking the prestige of neoclassical welfare economics to the old enter-
prise liability tradition. The latter had advanced the frankly redistributive
and therefore always politically suspect principle of using the price system
to 'socialize' accident costs. To this contestable normative premise
Calabresi added an efficiency argument. Unless enterprises are liable for
accident costs they generate, externalities will distort proper market
functioning and unsafety will be overproduced. Ronald Coase advised us
that free bargaining automatically eliminates the allocation problem, but
Calabresi quickly responded that this is true only in the absence of
significant transaction and information costs and other forms of market
failure. These debates produced a generation of legal scholars who have
treated 'tort law as a high transaction cost exception to a contract
paradigm ...'

But even within its own terms the market failure approach to liability
rules has not succeeded in banishing controversial judgments implicating
political controversy. All the key working concepts - 'enterprise,'
'transaction cost,' 'externality,' and so on - have been shown to be too
indeterminate to permit value-neutral elaboration of the theory. That is
true here as well. Daniels perceptively surfaces a key ambiguity in the
implicit contract theory. Even in the primary sector where employees
often justifiably rely on implicit promises of job security and deferred
compensation, the implicit contract does not always and obviously include
a continuity guarantee even when intervening events have rendered con-
tinuance of the relationship economically irrational. And in many, par-
ticularly secondary-sector, settings, it is not always clear whether there
was an assurance of continuity at all. Inevitably, value judgments and
moral sensibilities will ground interpretations regarding the existence and
content of implicit promises of job security. But this same observation

10 Supra note 1, text following note 8
11 Morton Horwitz 'Law and Economics: Science or Politics?' (1980) 8 Hofstra LR 905, 908. This paragraph is drawn from the Horwitz article and Duncan Kennedy 'Cost-
applies to Daniels's own hypothetical contract approach. Without reference to controversial background normative assumptions and intuitions, one cannot determine what protections would have been negotiated by employees in the presence of perfect information (and 'equal bargaining power,' he throws in intriguingly at one point). Although Daniels attempts to 'discipline' the inquiry, he virtually concedes the indeterminate and ultimately value-laden character of the hypothetical contract exercise. Daniels's hypothetical contract, like Stone's implicit contract, combines a recognition of authentic needs and expectations of the parties, a fundamental sense of fairness and justice, and a certain amount of wishful thinking. In the end, he invokes the classic fall-back rubric of legal argument, 'widely shared values,' to sustain the neutrality of the enterprise. In reference to a question as politically charged as adjustment entitlements, this is unconvincing.

I emphasize again that I share many of Daniels's moral intuitions and policy goals. My hesitation is about whether we can justify humane and compassionate assistance to victims of economic dislocation without getting into matters of normative and political controversy. I strongly believe that adjustment assistance is conducive to societal well-being and specifically to long-run economic productivity because it protects and enhances human capital. But at the end of the day, the most compelling argument for adjustment assistance is not that it is efficient or that it has been or hypothetically would be bargained for or relied upon. The strongest argument invokes claims of equity, namely that it is just that we all share in the misfortunes occasioned to innocent victims by economic growth policies from which we all benefit, and that a particular burden to assist rightfully falls upon those who profit directly from social policies that enhance capital mobility.

IV Conclusion: Equity and empowerment

The Daniels and Stone papers demonstrate that the NCR model is not riveted to a particular social or political outlook, and that its frame of reference can be invoked to ground a progressive social curbing of capitalism. This is a considerable achievement. Contrary to many liberal and leftist sceptics, I share the Daniels/Stone view that rational-choice theory and transaction-cost economics are politically open-ended, not intrinsically apologetic or legitimationist discourses. Socially concerned scholars should draw upon the insights of and pursue projects within the medium of these theories. I attempt to do so in my own work.

12 Supra note 1, text following note 86
But the endeavour is not without risks. To provide insight regarding and support for humane reform, the gaps and silences in the NCR model must be corrected. Like all bargaining-focused approaches to social choice, the NCR model is limited by a tendency to privilege the existing distribution of wealth, income, and power, that is, the existing social subordination of working people. The NCR model is a classic instance of a theory designed to represent socially constructed power relationships as the product of 'consent,' with a consequent tendency (a mission for some theorists, though not these authors) to efface power from the analysis.\textsuperscript{13}

One way the NCR model in practice suppresses questions of equity and power is to obscure and deflect attention from the role of law in setting the background rules of the game of economic conflict.\textsuperscript{14} Because law has this role, it is partially responsible for determining the relative bargaining power of economic actors and therefore the sorts of contracts they are likely to conclude about things like adjustment injuries. That is, the law is implicated in and at least partially responsible for determining the substantive content of the contracts that make up the firm as nexus.

The NCR discourse takes for granted the existence and justice of many background rules that enhance the power of capital vis-à-vis that of other constituencies. For example, NCR discourse is complacent about the legal assumptions that the employer may discharge at will (absent contrary contractual protections), and that capital disinvestment that destroys communities is not a compensable tort. That is, NCR discourse assumes as a starting point of legal analysis that the owners of capital may externalize the costs of adjustment injuries onto affected constituencies. Nothing in the nature of things requires a society to operate on these assumptions. These rules of law represent politically chosen and mandated subsidies to capital formation. Perhaps these subsidies are wise, but that case needs to be made. By hypothesis, it cannot be made solely in efficiency terms. Thus, ultimately the adjustment injury inquiry must come back to and candidly address questions of distributional equity and

\textsuperscript{13} Alan Hyde argues that a central motivation for some NCR theorists was to eliminate the question of power from the analysis of the corporation, specifically any power of the firm over others. See Alan Hyde "In Defense of Employee Ownership" (1991) 67 Chi.-Kent LR 159, 180 n66. If the corporation is a bundle of freely chosen contracts, 'it' cannot have power over anyone. This pre-empts the argument that corporations are quasi-governmental entities suitable for statutory or constitutional regulation. Hyde insists, however, that although some influential NCR theorists may have had apologetic ambitions, this is not an intrinsic feature of the theory. He urges that socially concerned scholars remain open to dialogue with the school. Ibid.

\textsuperscript{14} See generally Duncan Kennedy 'The Stakes of Law, or Hale and Foucault!' (1991) 15 Legal Studies Forum 327.
power, and this in turn requires us to examine the fairness of the background legal rules that set the terms of conflict and negotiation between the various constituents of the firm. The clear superiority of Stone's approach is that she constantly reminds us of this point.

Have we achieved a just, socially defensible allocation of the costs and benefits of economic flexibility and capital mobility? Are the substantial subsidies to capital formation that are such a prominent feature of Canadian and US law really justified by their contribution to economic development, seen in the light of the often tragic human and social consequences of uncompensated and unassisted dislocation? Theoretical economics cannot provide answers to these questions. The answers depend on highly contextualized, empirical inquiries and at least partly on controversial normative judgments. The view of the firm as constituted by inter-constituency bargaining can yield insights, so long as we are careful to appreciate that the bargaining takes place on a field of legally set background rules that affect the parties' relative power. But we should also enlarge our vision of the firm to see it as a political and social institution with its own organizational and industrial relations dynamics. This enlarged conception of the firm appropriately opens the door to debate about questions of equity and democratic empowerment.