Corporate Governance of Closed Corporations: Leveraged-Buyouts versus Employee-Ownership

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Abstract

The corporate governance systems of closed corporations (CCs), i.e. leveraged buyouts (LBOs) and employee-owned (EOs) firms need to provide ex ante and ex post safeguards against opportunistic and unethical business decisions. In other words the corporate governance system of CCs need to justly assign, protect, enforce and distribute the (alienable and inalienable) rights, obligations, benefits and costs associated with incomplete labour contracts to all insider stakeholders so as to maximize the bundle of contributory value to society. This paper finds employee-owned corporate governance systems of John Lewis Partnership, Scott Bader Commonwealth and the Mondragon Cooperative have democratic voting systems, representation on boards for all insider stakeholders, multi-tier boards for sharing of power and a written constitution that provide the required ex ante and ex post safeguards. Thus, maximizing the CCs bundle of contributory value to society is better achieved through the above EOs corporate governance designed and implemented on a partner-owner framework that goes beyond incomplete labour contract and weak labour contract laws. This is because such EOs with their corporate governance systems provide better ex post safeguards against powerful elites expropriating rights (benefits) of less powerful insider stakeholders (workers) by breaching ex ante implicit contract agreements compared to LBOs.

1. **Introduction**

There now seems to be a thriving market for non-tradable closed corporations (CCs) such as Leveraged Buy Outs (LBOs), which include management buyouts (MBOs), employee buyouts (EBOs), management and employee buyouts (MEBO) financed by private equity (PE) firms as well as other more just employee-owned closed corporations (EOs) [1]. These EOs have corporate governance systems[2] similar to Scott Bader Commonwealth (SBC), John Lewis Partnership (JLP) and Mondragon Cooperative**.** In recent years there has been a paradigm and a practical shift away from open corporations (OCs) towards CCs. As Cheffins and Armour (2007, p1) observe “the rise of private equity has been characterized as a signpost on the way to a new financial order we can barely even recognize right now. The taking private of public companies by private equity indeed has potentially crucial ramifications for the shape of capitalism...The surge in public-to-private buyout activity occurring over the past few years’ calls into question the continued pre-eminence of the public company.” It has been argued that external non-market forces in the US have led to less effective capital markets for OCs whose corporate governance system design is based on principal agency framework with its separation of ownership and control rights that leaves managers increasingly unmonitored due to weak market governance and poor internal corporate governance through e.g. regulations set by US Congress, ineffective Courts, and ineffective regulatory body intervention by US Security Exchange Commission (Johnson and Kwak, 2010; Stiglitz, 2009; Marnet, 2007; Jensen, 2007, 2001, 1989a, 1989b; Covaleski et al., 2003).

It is argued that LBOs corporate governance system will help reform internal corporate control mechanisms through: effective decentralization; higher pay-for-performance; smaller, more active, and better informed boards; and significant equity ownership by board members as well as managers (Jensen and Chew, 2003; Jensen, 1989b). For instance, increasing equity ownership for executives as an appropriate incentive schemes ultimately increases shareholders’ wealth and firm’s performance through these new organizational forms, i.e. PE and their LBOs (Jensen, 1989a, 1986). Thus, it seems that the capital markets’ solutions to poor external regulations, ineffective courts and ineffective regulatory bodies to support the weak OCs corporate governance system in dealing with the internal control problems means that open corporations need become closed corporations (Gadhoum et al., 2005). Furthermore, PEs and their LBOs have become popular with investors in recent years because they have achieved good returns compared with traditional investments in publicly quoted shares, although in most recent decades there has been a decline in their financial returns (Kaplan and Schoar, 2005; Wright et al., 2006; Metrick and Yasuda, 2007; Renneboog et al., 2007; Wright and Bacon, 2009).

Large amounts of capital have and are being invested in PEs: for example, in 2005 the total invested in European PE funds was nearly €60 billion – more than double the amount in 2004. Private Equity funds have grown from a tiny part of the financial market in the early 1980s to an important global force today. For instance, Morgan Stanley estimated that in 2007 in the USA there were 2,700 Private Equity funds, which represented 25% of global mergers and acquisition activity, where $40 billion of buyouts represented new size records (Jensen, 2007). Globally, even though from 2007 to 2008 there was a decline in LBOs from over $500 billion to around $125 billion, it still accounts for a substantial amount of monetary value (Wruck, 2008; Acharya et al., 2007). Also, EOs are a growing phenomenon in business. For example, in the UK alone EOs account for around £20bn to £25bn worth of turnover and one of the largest is John Lewis Partnership (JLP), which employs around 70,000 partners with a turnover of around £5bn per year (Guidi et al., 2010; JLP, 2010).

It is important to know if LBOs or EOs corporate governance systems is better at maximizing their bundle of contributory value[3] to society. For instance, Bruining et al. (2009, p346) observe that "the main aim of a buy-out is to improve organizational performance through ownership change creating new opportunities for strategic reorientation and restructuring of the firm...This fundamental change in the structure of ownership [corporate governance] may affect the way employee relations develop within an organization ...Little is known about the impact of buy-outs upon employee relations... suggest that buy-outs provide an opportunity for managers to reassess and change employee relations using two different perspectives that may explain these changes: a cost reduction and an investment perspective." It can be argued that the corporate governance systems of EOs enables management to focus on the long term investment rather than solely cost reduction perspective because they can provide (ex ante and ex post) safeguards against opportunistic[4] and unethical decision, which can make some insider stakeholders, e.g. employees, worse off. For instance, during the credit crisis in 2008 the chairman of JLP Charlie Mayfield stated that “there will be no job cuts. We are a business, we believe in pursuing a long-term approach to growing the business – we’re not into making knee-jerk cuts in staff costs[5] just to protect short-term profit. Our ownership structure [corporate governance system] is key here, because we’re owned by our partners [employees], they want us to take a long-term not a short-term approach. Our structure means that at these times we might take a different approach to some other businesses” (Peacock, 2008, p1).

It is important to recognize that there is an interrelationship between the measurement function of the market and the corporate governance system of the firm where individuals have developed firm specific skills (labour capital). This interrelationship is between “the governance branch and the measurement branch. The former is concerned mainly with organizing transactions in such a way as to facilitate efficient adaption. The latter is concerned with the ways by which to assure a closer correspondence between deeds and awards (or value and price). To be sure, these are not independent. The difference in emphasis is nevertheless real and needs to be highlighted. It is furthermore noteworthy that the problems of governance and measurement both vanish if *either* bounds on rationality *or* opportunism[6] are presumed to be absent” (Williamson, 1985, p80-81; see also Ostrom, 2005, 2003, 2000; Marnet, 2007, on limitations of rationality). In other words, an individual implicitly (unwritten, legally unenforceable) and explicitly (written, legally enforceable) enters into a set of incomplete contracts that tries to delineate (alienable and inalienable) rights, obligations[7], benefits and costs associated with the jointly owned assets[8] of the corporation (Zingales, 2000; Guidi et al., 2008; Ellerman, 1986, 2005; Williamson, 2002, 1985; Holderness, 2003, 1985; Ostrom, 2003; Shleifer and Summers, 1991).

This paper critically investigates whether EOs corporate governance systems, similar to JLP, SBC and the Mondragon Cooperative**,** compared to LBOs with their different corporate governance systems, are better at maximizing their bundle of contributory value to society through (ex ante and ex post) safeguarding of (explicit and implicit) incomplete contracts of insider stakeholders’. In other words, do

EOs corporate governance system design and implementation maximize their value to society more than LBOs by 'justly' and efficiently allocating, protecting, enforcing and distributing of rights, obligations, benefits and costs associated with (implicit and explicit) incomplete contracts[9] of insider stakeholders? This paper is structured as follows. Section 2, critically discusses CCs, i.e. LBOs and EOs, corporate governance systems in dealing with incomplete contracts, trust and production function problems and maximizing their bundle of contributory value to society. Section 3, critically discusses the differences between EOs and LBOs corporate governance systems including voting rights, board representation, written constitution, power sharing and the ability to go beyond the labour contract so as to maximize their bundle of contributory value to society. Section 4, concludes.

2. Critical discussion on EOs and LBOs corporate governance systems.

It is argued that three important things happen when open corporations are "transferred out of the market and…placed under unified ownership: ownership changes, incentives change and corporate governance change...New governance structure will appear...to support the integrity of the exchange relation" (Williamson, 1985, p393). However, neoclassical finance arguments against closed corporations mainly come from the very limited and specific incentive-based production function determinant problems.[10] The arguments tend to follow JM (1979): the horizon problem - induced by the truncated (non-perpetual) claims on a firm's cash flows; the common-property problem - induced by equal sharing of the firm's cash flows among all employees; the non-transferability problem - induced by the fact that employees' claims on the firm's cash flows are contingent on employment with a firm and are non-marketable; and the control problem - induced by the specification of the political procedures within a firm by which the employees arrive at decisions and control the managers. In the case of SBC and JLP they have a corporate governance system that actually allows in practice to overcome all the production function problems and provide other solutions that production function arguments ignore (see Guidi et al., 2010, for an in-depth analysis for evidence on SBC and JLP. See Ellerman, 1986, for a theoretical discussion on how the Mondragon Cooperative and labour managed firms in general overcome the production function problems especially the horizon problem). Other related arguments against CCs, especially LBOs, include higher than expected agency costs due to intensified conflicts of interest among firm (Masulis and Thomas, 2009). However, contrary evidence shows a key feature of LBOs is that they generally reduce agency costs by having key decision-makers, i.e. executives and managers, as well less key decision makers, i.e. employees, hold substantial equity (Wright et al., 2009; Wright et al., 1989). Therefore, in general economic terms it can be argued that CCs corporate governance system provides more economically efficient use of the jointly owned assets of the firm.

The OCs with their separation of ownership and control rights rely very heavily on the weak market governance system[11] to offset their poor internal corporate governance system is ineffective, inefficient and does not support ethical decision making or controlling opportunistic behaviour (Williamson, 2005, 2002, 1996, 1985; Stiglitz, 2009, 2006; Guidi et al., 2008; Marnet, 2007; Littler, 2006). The arguments that PEs and their LBOs can rely heavily on debt market to reduce moral hazard problems through tighter and more restrictive debt governance, better monitoring by banks, especially e.g. for MBOs, to reduce free cash flow problems does not seem to be supported by more recent evidence (see Demiroglu and James, 2010). As Guidi et al. (2010, p321) observe "theoretically increasing insider ownership should reduce conflicts of interest that arise with the separation of the risk-bearing and decision-making rights. This reduction in agency costs is due to exposing inside stakeholders to the up-side benefits as well as to the downside costs of all business decisions undertaken by a firm." That is, the principal agency framework of separating ownership and control rights used by OCs is ineffective, inefficient and non-Pareto optimal due to increasing the 'moral debt'[12] of the firm through increases in e.g. externalities, opportunism, expropriation, managerial discretion, conflicts of interests, and asymmetry of information (Stiglitz, 2006, 2002, 1882, 1981; Williamson, 2005, 2002, 1996, 1985; Guidi et al., 2008).

It is important to society that all stakeholders and not just elite groups[13] benefit when the OCs become CCs. Society benefits when moving from OCs with their corporate governance system design based on a principal agency framework to CCs with their corporate governance system design based on a partner-owner framework. A corporate governance system design based on a partner-owner framework will result in the CC being in a better position to justly assign, protect, enforce and distribute all insider stakeholders' rights (obligations) and benefits (costs). This type of corporate governance design will be better at providing safeguards against opportunism and unethical business decision-making. The CCs good corporate governance design will reduce conflict of interest and hopefully provide opportunity for CCs to internalize their obligations (costs) thus reducing their 'moral debt'. For instance, empirical evidence finds that an increase in insider concentration of private equity ownership improves a firm's performance through better governance and incentives schemes (Wruck, 1989; Mikkelson and Ruback, 1985). For example, Jensen (2010, 1995) finds that LBOs with their corporate governance system reduce substantially agency costs. Thus, allowing greater insider ownership will reduce conflicts of interest that arise because there is less separation of the ownership (residual rights) and control (decision-making rights). This reduction in agency costs should expose insider stakeholders to the up-side benefits as well as to the downside costs of the business decisions undertaken by the firm (Stiglitz, 2006; Arnold and De Lange, 2004; Stultz, 1999).

Will changing from OCs with its weak corporate governance to CCs with their stronger corporate governance system designed will better maximize the firm's bundle of contributory value[14] to society? Figure 1 shows the value to society, old OC shareholders and New CC shareholders of the firm when it moves from being an OC to a CC with its stronger corporate governance system. The CC increases its financial debt (D_{F1} to D_{F2}) to purchase the OC for converting to either LBO or EO and the new market value of the CC increases from MV_1 to MV_2. The assumption is that increase in economic efficiency moving from OC to CC is due to the corporate governance system, which will in turn show an increase in market value that is greater than the increase in market debt, i.e. MV_2 - MV_1 > D_{F2} - D_{F1}. This increase in economic efficiency is due to a large reduction of agency costs as well as the CC being in a better position to make positive NPV investments, all else being equal. The other important assumption in all of this is that there is no increase in 'moral debt' of the firm, i.e. social costs to society do not increase, thus (D_{T1}– D_{F1}) = (D_{T2}– D_{F2}). Since 'moral debt' does not increase then there is no increase in externalities, expropriation of rights (benefits), reneging on obligations (costs), and opportunistic behaviour ex-post. Thus, the value of the CC to new shareholders increases from V_{sh1} (old OC shareholders value) to V_{sh2} (new CC shareholders value), all else being equal. Furthermore, the bundle of overall value of the CC to society increases from V_{soc1} to $V_{soc2,}$ all else being equal. In other words, the CC with its stronger corporate governance benefits society more by justly and efficiently assign, protect, enforce and distribute rights, obligations, benefits, and costs.

Insert Figure 1 about Here

However, is there any difference between LBOs and EOs corporate governance system design in providing (ex ante and ex post) safeguards for the just assignment, protection, enforcement and distribution of rights (obligations) and benefits (costs)? Schwab and Ostrom (2008, p221) observe "the consequence of incorrect institutional design are so well known in contemporary society. In the private market, the Enron scandal demonstrates the potential for harm when powerful actors manipulate rules for their own gain at the expense of the weak. There are also devastating consequences in public economies when institutions fail...This leads not only to economic inefficiency but to a pervasive distrust of private and public institutions...to prevent future economic disasters, we must understand the basic principles of successful institutional design...we must understand that institutional solutions, if poorly implemented, can crowd out trust rather than enhance it" (see also Marnet, 2007; Littler, 2006). Williamson (1985, p64) argues corporate governance system are designed in part because "some individuals are opportunistic some of the time and that differential trustworthiness is rarely transparent ex ante. As a consequence, ex ante screening efforts are made and ex post safeguards are created." Furthermore, on the "principles of justice or competition that look at the relation between the parties at the execution stage without examining the ex ante bargaining relation are at best incomplete and frequently mistaken" (Williamson, 1985, p205).

It's important that the corporate governance system of CCs need to build a reputation that supports trust within and out with the firm. For instance, "many trust-enhancing institutions may evolve through the efforts of participants in long-term, repeated market exchange environments or when they are linked together as providers and consumers of public goods or common-pool resources. These trust-enhancing institutions make it easier to establish a reputation as a trustworthy participant as well as making exchange less costly, more stable, and more effective than would be possible without institutions. Furthermore, efforts to design such institutions without understanding the context of relationships can sometimes crowd out trust rather than enhance it" (Schwab and Ostrom, 2008, p207). For example, when external market governance is lax, e.g. PEs can use their reputation (trust) to reduce costs and take advantage of market timing (Demiroglu and James, 2009). However, it has been found that private-equity and LBOs corporate governance system is less effective at controlling moral hazard when participating in syndicated loans that rely heavily on the market governance system. The reliance on market governance facilitates PEs and LBOs insiders to pre-takeover trading, to ex post fee payments and 'club deals' that "create additional conflicts of interest between LBO sponsors" (Masulis and Thomas, 2009, p22; Acharya and Johnson, 2007). As Williamson (1996, 178) argues the need to look deeper in to incomplete contracts perspective where problems arise "in conjunction with efforts to replicate incentives found to be effective in one contractual/ownership mode upon transferring transactions to another. Such problems would not arise but for contractual incompleteness, since, if contracts were complete, then, asymmetric information notwithstanding, 'each party's obligation [will be] fully specified in all eventualities; and hence it will be possible [to replicate] any rights' associated with one contracting mode in another…[in] that the high-powered incentives found to be effective in market organization give rise to dysfunctional consequence if introduced into the firm…The upshot is that whereas market organization is associated with higher powered incentives and lesser controls, internal organization join lower power incentives with greater control."

In other words, weak market governance and poor corporate governance design and implementation contribute to an increase in social costs. For example, Pagano and Volpin (2005, p843) observe for various types of LBOs that “managers will set up an employee share ownership plan (ESOP) as a defensive device when they themselves have only a small stake in the company and their private benefits of control are high.” There is a large body of finance literature that details market governance failures that contribute to increase of social costs due to weak corporate governance due to, e.g. managerial opportunism and entrenchment (see Shliefer and Vishny, 1997, for an overview of all the different types of managerial opportunisms; see Faleye, 2007; Freeman et al., 2004; Edlin and Stiglitz, 1995; Mais, 1994; Shleifer and Vishny, 1989; and Stulz, 1988, on management entrenchment). Furthermore, LBOs can lead to expropriation if their corporate governance systems allow “the allocative efficiency losses of moving from a high trust to a low-trust culture [which] must be counted as a social cost of takeovers... [in relation to ex post wage cuts, however,] the managerial discretion hypothesis treats the high wages in the pre takeover era as a bribe. The lucky beneficiaries realize a windfall that evaporates upon takeover. But possibly the situation is more complicated than this. The beneficiaries are workers who have made special efforts to qualify for high-paying jobs through pre-positioning...The welfare ramifications of takeovers are therefore complicated under the managerial discretion hypothesis...Workers here may also feel a justifiable sense of expropriation” (Williamson, 1991, p66).

Therefore, it can be argued that the LBOs can redistribute wealth (capital) to the detriment of certain insider stakeholders by expropriating rights and benefits. It can be reasonably argued that the market governance system that relies mainly on external regulations and the courts cannot deal effectively with incomplete contracts sufficiently to constrain opportunistic/unethical business decision-making. As Reiter (1997, p 624) observes “even if a total [target/bidder] gain is produced by takeover activity, the distribution in society could be inequitable. This is the concern of distributive justice”. Or as Shleifer and Summers (SS, 1989) argue there is a need to look at value-redistribution (wealth transfers) due to expropriation by going beyond just looking at firm (bidder/target) performance due to breach of implicit agreement problems[15] between the firm and employees. Some argue that there are no such expropriation problems, e.g. due to compulsory layoffs (see Kaplan, 1989a, 1989b). However, Herzel (1990) argues that Kaplan's research is statistically and interpretatively very limited. Quite interestingly, Haigh (2006, p1004) observes that the supposedly more ethical social funds that rely on weak market governance promote "a weak ascetic 'ethical self-transformation'... which self interest appears other-directed", which inevitably leads to expropriations of rights and benefits of the less powerful by the more powerful elites. As Adam Smith "would complain about those who gain wealth by abandoning [ ] virtue only to try and make up for their lack of virtue by latter more virtuous conduct...In short, we are beset by many influences that will form our ethic. More now than in Smith's time it seems. Smith's prescription for morality requires us to be connected to each other in a societal moral code...This does not eliminate the neoclassical idea of self-interest as a motive rather it offers a broader set of motives for ethical action and judges the self-interested motive as an inferior reason for acting ethically. Compare this with the Chicago/Austrian School where all human activity is exchange, where gains and losses are calculated,'. . . to maximize the excess of the utility of the gain over the disutility of the cost' ... therefore no other motive is recognized" (Keller, 2007, p175). Thus, there is a need to go beyond solely maximizing economic monistic utility value to maximizing the bundle of (monetary/economic and moral/intrinsic) contributory value to society where the costs of expropriation of rights (benefits) from others (usually the less powerful) are incorporated.

LBOs corporate governance designed on a principal-agent framework can have a superficial adherence to their moral obligations since they are underpinned by weak labour contract laws. For instance, when LBOs use weak market governance underpinned by labour contract laws they can enforce an "unconditional Hobson's choice" in which false moral obligations are put on to employees to the 'firm's Way' or be laid-off (Macintosh et al., 2009, p760). Furthermore, historically such false 'duty of accountability' arguments were also used by slave-owners to expropriate rights (benefits) from slaves (Power, 1991, p32). As Ellerman (2009, p22) citing Elliot (1860, vii) a pro-slavery writer who falsely argues "slavery is the duty and obligation of the slave to labor for the mutual benefit of both master and slave, under a warrant to the slave of protection, and a comfortable subsistence, under all circumstances.

The person of the slave is not property, no matter what the fictions of the law may say; but the right to his labor is property, and may be transferred like any other property, or as the right to the services of a minor or apprentice may be transferred...Such is American slavery, or as Mr. Henry Hughes happily terms it, 'Warranteeism'." Furthermore, Fleischman and Tyson (2004); Alawattage and Wickramastnghe (2009, 2008) also historically find enterprises that used slavery had corporate governance designed on principal-agent (master-slave) framework that developed accounting practices to control, dehumanize and monetize the slave labour (Marx also thought accounting was used to control labour, see Bryers, 2006). In other words, LBOs corporate governance system designed on principal agent framework can more readily lead to expropriation of stakeholders rights (benefits) than corporate governance of EOs designed on partner-owner framework.

3. EOs versus LBOs Corporate Governance: voting rights, board representation and power sharing.

"Power in the Partnership is shared between three governing authorities, the Partnership Council, the Partnership Board and the Chairman" (JLP Constitution, 2009, p7)

Williams (1985, p259) observes there are power dynamics within the firm where, e.g. "workers who accept employment of a firm-specific kind will presumably recognize the risks and insist upon surrounding such jobs with protective governance structures. One labour power and one job regarded nakedly and one labour power and one job embedded in a protective governance structure have very different connotations". Furthermore, the reputation/trust problems can be due to the exploiting the specific investments of myopic employees through exposure to end games, intergenerational expropriation and inability to deal justly with employees because the lack of employee power in incomplete contract bargaining (Williamson, 2006, 1996). The imbalance of "[p]ower was also an issue for [Adam] Smith, with the concern being that employers would use their power to abuse workers"

(Keller, 2007, p174). It is important that CCs corporate governance design and implementation provide solutions to shared strategies (aims), norms and rules to enhance trust (Schwab and Ostrom, 2008; Littler, 2006). For this to happen, it is importance that corporate governance systems of CCs allow, e.g., employee voting rights and board representation for power sharing purposes.

In other words, the CCs corporate governance systems' design is to provide (ex-ante and ex-post) safeguards in screening, incentivizing, bargaining and administrating the (alienable and inalienable) rights, obligations, benefits and costs to all insider stakeholders. CCs can better achieve this by having a written constitution, democratic process to elect less powerful stakeholders (employees) on to boards and move from unitary- to multi- tiered boards to share power. The corporate governance systems of EOs, similar to SBC, JLP and the Mondragon Cooperative, have such democratic and economic efficient corporate governance systems (Guidi, 2010; Ellerman, 2007; Turnbull, 1997; Turnbull and Pirson, 2010). For example, for the enhancement of trust and sharing of power JLP has three governing authorities: the Partnership Council, the Partnership Board, and the Chairman where elections to the Partnership council are every three years and every partner has a single vote in elections to the Partnership Council (JLP, 2009b). Furthermore, SBC newly adapted their corporate governance system to encompass international employees (members/partners) to be elected on to its multi-tiered boards, which were voted on by all the Commonwealth members (employees) worldwide in April 2010 AGM (SBC, 2010). As Godric Bader (1986, p71) argues a corporate governance system must include a written constitution, voting rights, board representation and multi-tiered boards because "it is our belief that democracy, including industrial democracy, is not about concentrating power to an Executive, even if that Executive is elected; in our view, it is about diffusing power and control among those who have the right to share it."

Generally, LBOs corporate governance systems do not allow voting rights or board representation for employees, which can lead to opportunistic and unethical decision making. For example, LBOs in the form of EBOs do not allow employees to be represented on the board of directors because bondholders (the powerful elite group of PE financiers) do not want this by falsely arguing that this will increase conflicts of interest (Chaplinsky et al., 1998). This false argument by bondholder elite may be due to the fact that they want to expropriate ex-post the rights (benefits) by reneging on ex ante implicit agreements as argued by Shleifer and Summers (1991). For example, ex-post expropriation by powerful LBO elites that controlled Medway Ports board[16] saw management break ex-ante implicit agreements by changing employees, i.e. partners, working terms and conditions. This led to the dismissal of around half of the employees who then had to sell their shares in the firm at a low price back to Medway management under articles of association (Arnold and Cooper, 1999). The main beneficiaries in Medway were the "managing directors of the management buy-out team and banking interests that financed the buy-out" since Medway Ports was initially sold by the UK government for only £13.1 million to the LBO and 18 months later, after half the workforce was dismissed, was sold in a capital market flotation for £103.7 million (Arnold and Cooper, 1999, p145). In other words, Medway Ports decision to expropriate rights (benefits) of other insider stakeholders does not maximize the bundle of contributory value of Medway Ports to society but only maximize its monetary value to a few elite groups. Unfortunately, this does not seem like an isolated incident since LBOs and their PE financiers because as argued before "this banking fraternity with their LDCs, S&Ls, REITs, Repos... are all-too-readily beguiled by the big bucks" (Briloff, 1990, p16). Thus, it is important to balance the powers of elites to expropriate rights (benefits) by having well designed and implemented corporate governance systems (Schwab and Ostrom, 2008).

Can SBC, JLP and the Mondragon Cooperative more democratic corporate governance system through partner-ownership framework for all insider stakeholders maximize their bundle of contributory values to society? EOs similar to SBC, JLP and Mondragon Cooperative have corporate governance designed on a partner-owner framework with the emphasis on voting rights, board representation and power sharing that goes beyond labour contracts. Whereas, LBOs rely on corporate governance designed on a principal-agent framework that relies on labour contracts and external labour law. As Ellerman (2008, p20-21, italics his) argues the principal-agent framework with its reliance weak labour contract law when he states "in spite of the abundance of legal precedent in the historical alienation contracts such as the selfsale contract, the *pactum subjectionis,* and the *coverture* marriage contract, today's employment contract... All these contracts have the same scheme. An adult person with full capacity voluntarily agrees for whatever reason and in return for whatever consideration to accepting a lesser legal role. But they do not in fact alienate their capacity as a person in order to fulfill that diminished legal role. Instead the law accepts their (non-criminous) obedience to the master as "fulfilling" the contract. Then the rights and obligations follow the legal role (e.g., the slave of a master, the subject of a sovereign, the *femme covert* of her baron, the employee of the employer, and so forth)—*as if* the person were not in fact a person of full capacity. The whole scheme amounts to a fiction and fraud on an institutional scale that nonetheless parades upon the historical stage as a contractual institution based on consent."

In other words, if CCs corporate governance design is to maximize the bundle of contributory value to society it needs to overcome the 'despotic' control of capital, including labour capital, by elites through labour contracts (See Bryer, 2006 similar argument focusing on Marx, capital and multiple value concepts; See also Wilken, 1969, 1982; Toms, 2002; Ellerman, 2007, 2009b, Hodgson, 1999). SBC, JLP and the Mondragon corporate governance is designed and implemented to go beyond weak labour contract laws that allow for expropriation of rights (benefits). As Ellerman (2009a, p22) argues "when boiled down to the basic economics, the difference between a civilized slavery system based on implicit or explicit contracts (which is how historical slavery found its sophisticated defense) and the current economic system based on renting people (which is so taken for granted that liberal-contractarian philosophers of justice do not even take notice of it) is in the different durations of the labor contracts" (see also Bryer, 2006; Fleischman and Tyson, 2004; Alawattage and Wickramastnghe, 2009, 2008). Thus, poor corporate governance systems designed on principal-agent framework ensures weak (ex-ante and ex-post) safeguards due to the reliance on limited labour contract law in providing these safeguards for insider stakeholders (workers).

LBOs corporate governance system still rely mainly on market and external legal governance and so will not stop powerful elite stakeholders arbitrarily deciding to lay-off other less powerful stakeholders through compulsorily redundancies whilst providing only the minimum legal redundancy package, if even that. This is because the labour contract costs "are asymmetrically concentrated on the employee side of the transaction. They mainly arise in conjunction with disruptive effects on family and social life that job termination and reemployment sometimes produces. Protection against arbitrary dismissals is thus warranted even for nonspecific jobs. Provided, however, that short notice requirements are respected, the firm cannot be said to have symmetrical interest in preventing unexplained quits" (Williams, 1985, p243).

Furthermore, it is vitally important that inalienable rights (benefits), e.g. the inalienable right to work, be justly and efficiently assigned, protected, enforced and distributed so as to maximize value to society. However, as Ellerman (2009, p28) observes "perhaps the biggest surprise in the recovery of inalienable rights theory is that it clearly applies to the contract for the renting of persons, today's employment [labour] contract...Since the employment contract is the basis for our present economic system, it should perhaps not be a surprise that the inalienability theory is neglected by modern economists, legal theorists, and philosophers. As each of the three historical contracts of subjection (personal, political, and sexual) were outlawed as a result of the efforts of the antislavery, democratic, and feminist movements, liberal-contractarian philosophy recasts each of the historical debates into a discourse of coercion versus consent...Hence there is no need to countenance any potentially troublesome theory about certain voluntary contracts being inherently invalid and certain rights being inherently inalienable even with consent...Yet in his considerable writings about justice, Rawls never raised the question of there being any inherent justice problem in this whole system of renting human beings" (See also Toms, 2002, for a similar argument).

Insert Figure 2 about Here

It has been argued that powerful elites within LBOs can expropriate rights (benefits) of other less powerful insider stakeholders, e.g. through compulsory redundancies. Does this lead to maximizing the LBOs bundle of contributory value to society? Figure 2 shows the value to society and to powerful elite shareholders when an OC becomes a LBO where there is poor corporate governance, e.g. which allows opportunistic and unethical compulsory layoffs. Figure 2 shows that the LBO's value to the new elite shareholders' increases from SH1 to SH3 but decreases to society from Soc1 to Soc3. The decrease in value to society is because the substantial increase in total debt, i.e. from D_{T1} to D_{T3}, is mainly due to the increase in 'moral debt', i.e. $(D_{T3}– D_{F3}) > (D_{T1}– D_{F1})$. This increase in 'moral debt', i.e. in social cost, is due to the undemocratic corporate governance system of the LBO not being able to justly assign, protect, enforce and distribute (alienable and inalienable) rights, obligations, benefits and costs to all insider stakeholders but unjustly redistribute them so has the elite shareholders gain. Thus, even though there is monistic monetary gain from compulsory redundancies in that the LBO's market value as it increases from MV_1 to MV_3 it only benefits elites shareholders but this is mainly due to the increase in 'moral debt', i.e. the social cost to society.

In other words, LBOs corporate governance designed on principal-agent framework and relying on unjust labour contracts provide powerful elites the opportunity to transfer wealth from the less powerful insider stakeholders. Therefore, it is reasonable to argue that not all insider stakeholders may benefit from LBOs because of ex post breach of implicit agreements. As Masulis and Thomas (2007, p17) observe the "less well-documented reason why shareholders can benefit from LBOs is wealth transfers from other corporate stakeholders. Such transfers can occur if firms breach their 'implicit' contracts, as part of post-LBO restructuring…employees have an implicit, unwritten agreement with their firms who promise to provide them with long-term (lifetime) employment in exchange for lower wages. These agreements are breached if the company fires many of its workers after going private. However, workers are unable to recoup these losses from the firm because these implicit agreements with their firms are legally unenforceable" (see also Shleifer and Summers, 1991; Zingales, 2000; Arnold and Cooper, 1999). For example, this type of unethical and opportunistic decision-making is reinforced by the PE Terra Firma chief executive when he stated in an interview during global financial crisis of 2008 "Yes I believe the number of people employed in private equity will substantially fall and those who remain will be paid substantially less" (Arnold, 2008, p19). Thus, it can be argued that such LBOs with their poorly designed undemocratic corporate governance systems will not maximize their bundle of contributory value to society.

Furthermore, the type of CCs corporate governance design is also important for markets. As Williamson (1996, p184) observes the debt market as a governance system means that "debt is unforgiving if things go poorly. Failure to make scheduled payments thus result in liquidation…since the value of-emptive claims declines as the degree of asset specificity [labour capital] deepens, the terms of debt financing will be adjusted adversely. Confronted with the prospect that specialized investments will be financed on adverse terms, the firm might respond by sacrificing some of the specialized investment [labour] features in favor of greater redeployability. But this entails tradeoffs: production costs may increase or quality decrease as a result. Might it be possible to avoid these by inventing a new governance structure to which suppliers of finance would attach more confidence? In degree to which this is feasible, value-enhancing investments in specific [labour] assets could thereby be preserved."

The corporate governance systems of EOs such as SBC, JLP and the Mondragon Cooperative are the new governance structures/systems that will attract trust/confidence (see Bader, 1986, 1983; Schumacher, 1993; Ellerman, 2007; Turnbull, 1997; Turnbull and Pirson, 2010; Guidi et al., 2010). It has been shown earlier LBOs governance systems on the other hand because they do not provide adequate safeguards, e.g. not providing written constitutions, voting rights for less powerful stakeholders, and employee representation multi-tiered boards for power sharing purposes, will erode trust/confidence. This is due to the expropriation of rights (benefits) by the powerful elites from other less powerful stakeholders. Thus, it can be argued that corporate governance systems of EOs similar to JLP, SBC, and Mondragon Cooperative, which are more just and efficient at assigning, protecting, enforcing and distributing (alienable and inalienable) rights, obligations, benefits and costs to all insider stakeholders will maximize their bundle of (monetary and moral) contributory value to society better than LBOs.

4. Conclusion

There is a thriving market for non-tradable closed corporations (CCs) such as LBOs including MBOs, EBOs, MEBOs as well as other more just fully employee-owned closed corporations (EOs). There has been a shift away from OCs since managers have become increasingly unmonitored due to weak market governance and poor internal corporate governance system designed on principal agent framework that does not support ethical or control opportunistic decision making (Johnson and Kwak, 2010; Stiglitz, 2009; Marnet, 2007; Jensen, 2007, 2001, 1989a, 1989b; Covaleski et al., 2003; Williamson, 2005, 2002, 1996, 1985; Stiglitz, 2009, 2006; Guidi et al., 2008; Marnet, 2007; Littler, 2006).

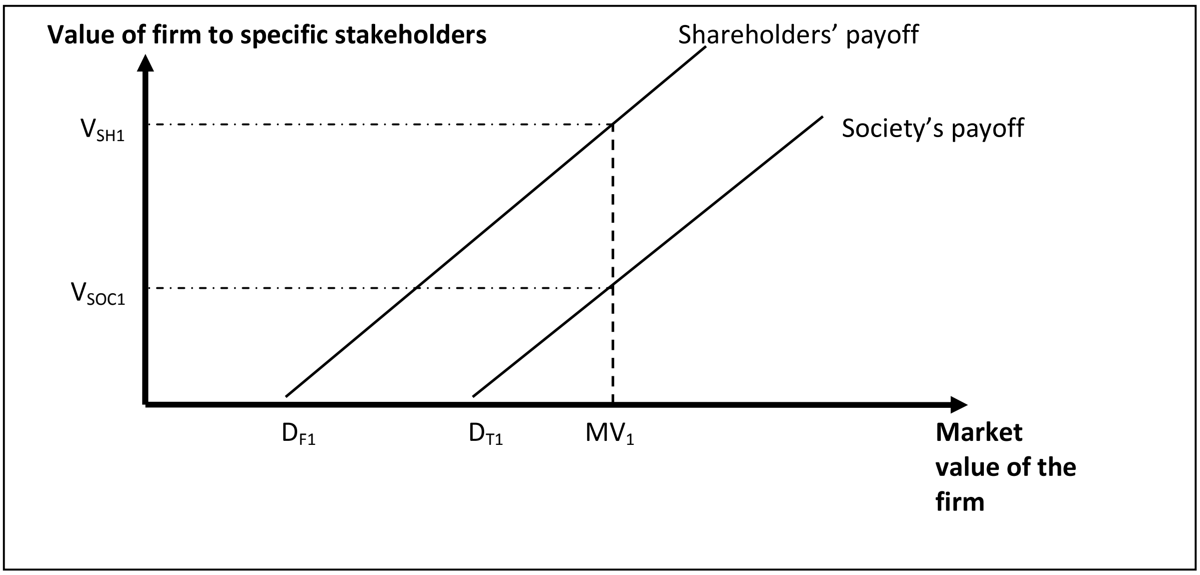
However, not all CCs corporate governance systems design and implementation provides (ex ante and ex post) safeguards for the just assignment, protection, enforcement and distribution of (alienable and inalienable) rights, obligations, benefits and costs. There can be devastating consequences where corporate governance design which is poorly implemented allows powerful elites to ex post manipulate rules and agreements for their own gain at the expense of the less powerful stakeholders (Schwab and Ostrom, 2008; Marnet, 2007; Littler, 2006; Williamson, 2002, 1996, 1985). It has been shown that LBOs can redistribute wealth to the detriment of certain stakeholders by expropriating rights and benefits, e.g. unjust wealth transfer/redistribution, due to breach of implicit agreements which increases costs to society (Shleifer and Summers, 1989; Reiter, 1997; Arnold and Cooper, 1999; Zingales, 2000; Williamson, 1991, 1985). Thus, we need to go beyond the Chicago/Austrian School where all human activity is solely valued as exchange in benefits and costs, which e.g. ignore inalienable rights. In other words, we need to go beyond solely focussing on the maximizing of monistic utility value, which ignores the affect of unjust redistribution of wealth (capital) and thus does not maximize the bundle of contributory value of the CC to society through efficient and effective corporate governance systems.

The paper shows that this is achieved the corporate governance design and implementation of EOs such as SBC, JLP and the Mondragon Cooperative, which provide (ex-ante and ex-post) safeguards to all insider stakeholders through a written constitution, democratic process to elect less powerful stakeholders (employees) on to boards and having multi- tiered boards for power sharing that go beyond the incomplete labour contract and weak labour contract laws (Guidi, 2010; Ellerman, 2007; Turnbull, 1997; Turnbull and Pirson, 2010. These EOs corporate governance design overcome the ‘despotic’ control of capital especially labour capital through the labour contract by elites (Bryer, 2006 Wilken, 1969, xxxx; Toms, 2002; Ellerman, 2007, 2009b; Hodgson, 1999). EOs such as SBC, JLP and the Mondragon have corporate governance systems designed on partner-owner framework that does not rely on weak labour contract laws that allows the expropriation of rights (benefits) and where the labour contract costs are asymmetrically concentrated on the employee not the firm (Williams, 1985; Ellerman, 2009a; Bryer, 2006; Fleischman and Tyson, 2004; Alawattage and Wickramastnghe, 2009, 2008). Unfortunately, LBOs corporate governance systems are designed on principal-agent framework and rely on unjust labour contracts and labour contract laws, which provide powerful elites the opportunity to unjustly redistribute wealth from the less powerful insider stakeholders (Masulis and Thomas, 2007; Shleifer and Summers, 1991; Zingales, 2000; Arnold and Cooper, 1999). Therefore, there is a world of difference between EOs and LBOs corporate governance design and implementation in that the latter more easily allows expropriation of alienable and inalienable rights (benefits), breaching of implicit labour contract agreements, increases opportunistic and unethical decision-making, which does not maximize the bundle of contributory value to society.

Appendix A

The 'Moral Debt' Distribution Payoff Graph

This graph represents the value of the corporation to shareholders and society. Here we consider the case where some of the corporation's business decisions are (non-Pareto efficient) unethical business decisions, which do not justly assign, protect, enforce and distribute residual, labour and decision rights to all stakeholders but such decisions are within market and legal but not moral acceptability. Then, MV = Market value of the firm = Equity + Total Debt, V_{SH}= Value of the firm to shareholders, V_{SOC} = Value of the firm to society (i.e. all stakeholders), D_F = Financial debt claim, D_T = Total 'debt' claim where 'Moral debt' claim is given by, $D_M = D_T - D_F$



To maximize the value of the firm to society requires $D_{T1} = D_{F1}$. When this happens, the firm has 'internalized' all 'externalities' so that all social costs attributable to the business decisions of the firm are borne by the firm. In other words, the firm's business decisions are ethical business decisions such that they have 'justly' assigned, protected, enforced, and distributed all alienable and inalienable rights obligations) and benefits (costs) to all 'active' stakeholders and to society.

Figure 1 **The 'Moral Debt' Distribution Payoff Graph moving from an open to a closed corporation using leverage, e.g. LBOs, and without increasing 'moral debt'.**

This graph represents the value of the closed corporation to old (external) OC shareholders, new CC shareholders and society (all stakeholders). Here we consider open corporations that become closed corporation using debt to help finance the takeover, whilst at the same time not increasing 'moral debt', e.g. not externalizing costs, through justly assigning, protecting, enforcing, and distributing residual, labour and decision rights to all stakeholders. Then, MV = Market value of the firm = Equity + Total Debt, V_{SH}= Value of the firm to shareholders, V_{SOC} = Value of the firm to society (i.e. all stakeholders), D_F = Financial debt claim, D_T = Total 'debt' claim where 'Moral debt' claim is, $D_M = D_T - D_F$

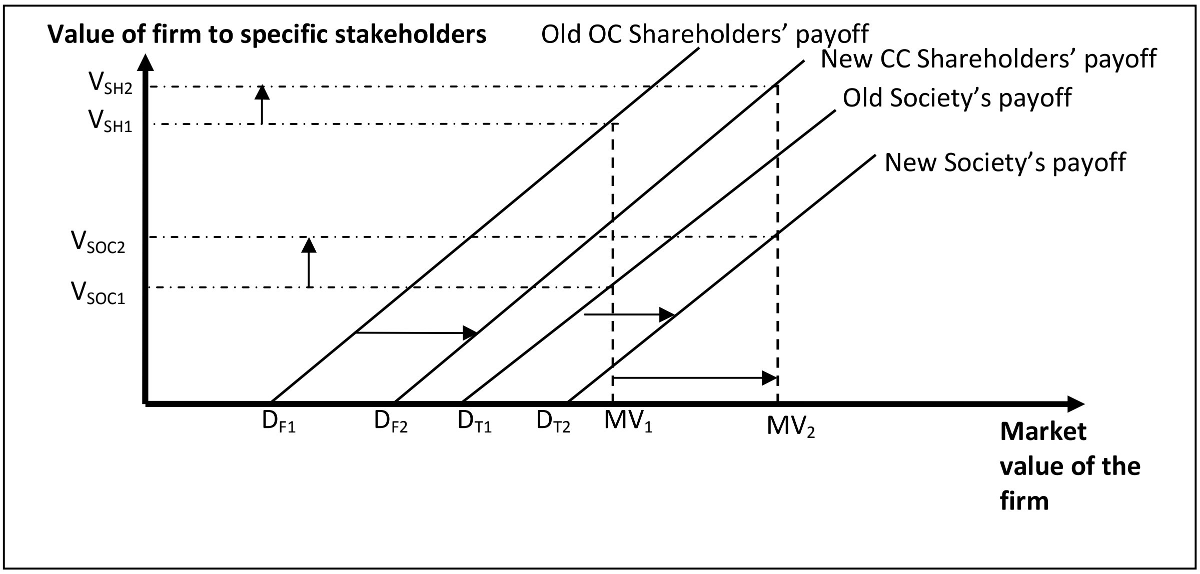
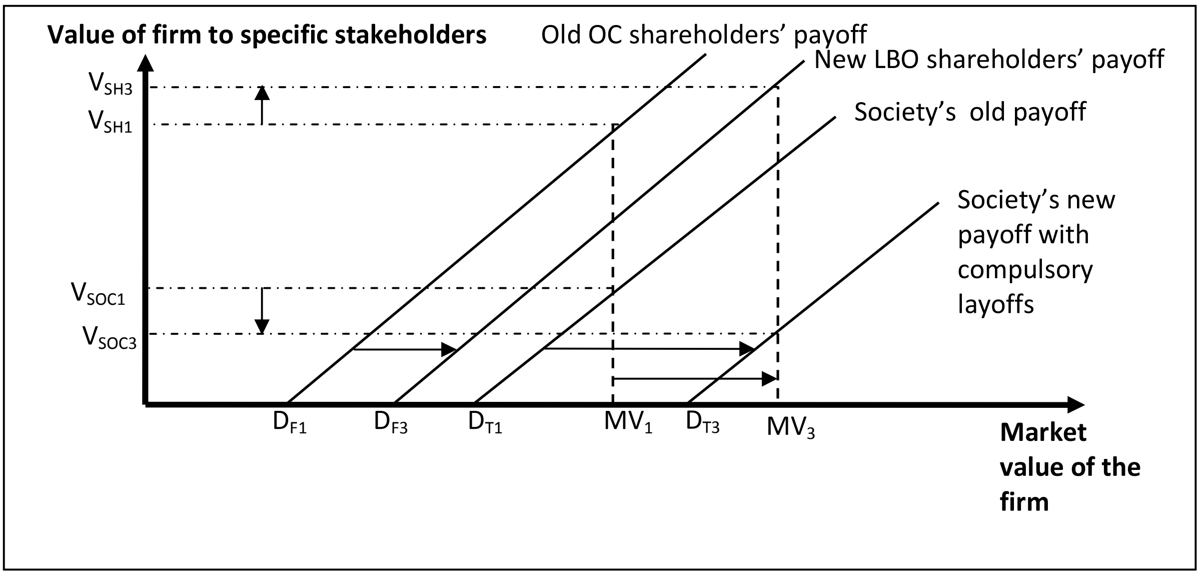

Value of firm to specific stakeholders
Old OC Shareholders' payoff
New CC Shareholders' payoff
Old Society's payoff
New Society's payoff
V_{SH2}
V_{SH1}
V_{SOC2}
V_{SOC1}
D_{F1}
D_{F2}
D_{T1}
D_{T2}
MV_1
MV_2
Market value of the firm

Figure 2 The 'Moral Debt' Distribution Payoff Graph of a LBO that increases 'moral debt' due to compulsory layoffs due to poor corporate governance design allowing expropriation of rights (benefits) from less powerful insider stakeholders by elites.

This graph represents the value of the CC to old (OC) shareholders, new LBO shareholders and society (all stakeholders). Here we consider an OC that becomes a CC using debt to help finance the takeover, whilst at the same time increasing 'moral debt' through compulsory layoffs by unjustly redistributing residual, labour and decision-making rights of internal stakeholders (i.e. employees). Note, MV = Market value of the firm = Equity + Total Debt, V_{SH}= Value of the firm to shareholders, V_{SOC} = Value of the firm to society (i.e. all stakeholders), D_F = Financial debt claim, D_T = Total 'debt' claim where 'Moral debt' claim is, D_M = D_T - D_F



Value of firm to specific stakeholders
Old OC shareholders' payoff
New LBO shareholders' payoff
Society's old payoff
Society's new payoff with compulsory layoffs
V_{SH3}
V_{SH1}
V_{SOC1}
V_{SOC3}
D_{F1}
D_{F3}
D_{T1}
MV_1
D_{T3}
MV_3
Market value of the firm

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[1] There is a need to clarify the difference between EBOs and EOs. For instance, EBOs are usually not 100% owned by the employees, they also have a large proportion of the employee ownership through share purchased from ESOPs that are not allocated voting rights, and employees do not usually have board representation (Chaplinsky, et al., 1998). Whilst, EOs in this paper are assumed to be similar to, SBC, JLP and the Mondragon Cooperative, which are 100% owned by insider stakeholders (i.e. employees), where these stakeholders also have voting rights and board representation.

[2] Corporate governance systems need to provide safeguards for ex ante screening/incentives and ex post bargaining/administration of (explicit and implicit) incomplete contracts (Williamson, 2005, 2002, 1996, 1985).

[3] This paper does not treat value as monistic but as pluristic in that it encompasses both monetary and moral (e.g. intrinsic) value. As Alan Carter (2010a, p26-27; see also Carter, 2010b) argues "the presumption of value-monism can prevent utilitarians, for example, from seeing that (1) the total number of worthwhile lives, (2) the level of average happiness *and* (3) equality (at the very least) must all be of value. And it appears that there must be a plurality of such core values… But if this is so, then we should reject the presumption of monism...*establishing* certain values as contributory values, and, thereby, of justifying a form of value-pluralism. Once we have grounds for accepting some form of value-pluralism, the key axiological question becomes: What is the relationship between the core values—including those of quantity, quality and distribution?...a practicable bundle of contributory values…would represent the bundle of greatest overall value. Thus, abandoning value-monism does not necessarily entail that there would no longer be a determinate answer to any moral questions—even if the answer is only one in principle." As Ostrom (2005, p11) observes "many of the values pursued by individuals are intrinsic values that may not be represented by external material objects, and their presence and strength are important parts of the individual to be examined. Building on top of the single individual are structures composed of multiple individuals – families, firms, industries, nations, and many other units- themselves composed of many parts and, in turn parts of still larger structures." See also Dworkin (2006) and Turnbull (1975) on monetary and nonmonetary value. See also Carter (2004) for a survey on the problems facing monistic egalitarianism and Brown (2009) argument on "democratizing accounting technologies requires a move from monologic to dialogic accounting principles...the importance of avoiding 'monetary reductionism'..."

[4] "The fundamental issue of opportunism in the contracting problem is inherent in Commons' work that essentially defines institutional change as emerging from resolutions to strategic problems in social relationships among willful and conflicting individuals. Williamson (1996, p. 50) recognized Commons' appreciation for the subtlety and significance of the role of opportunism in the governance of economic activity: John R. Commons anticipated much of this in his insistence that 'the ultimate unit of activity . . . must contain in itself the three principles of conflict, mutuality, and order'. This unit is the transaction...Not only do proponents of transaction cost economics concur that the transaction is the basic unit of analysis, but to them, governance is the means by which order is accomplished in a relation where potential conflict threatens to undo or upset opportunities to realize mutual gains. Transaction cost economics attempts to operationalize that prescient message" (Covaleski et al., 2003, p424).

[5] JLP annual report and accounts (JLP, 2009a) show that the John Lewis and Waitrose operations respectively lost 500 jobs and gained 900 jobs. In other words, during 2009 John Lewis lost 730 partners whilst Waitrose gained 900 partners and other operations gained 100 partners. Thus, JLP overall gained 500 partners between 2008/2009 an increase from 68,200 to 68,700 and during 2010 partners increased from 68,700 to 70,000 (JLP, 2010).

[6] As Williamson (1996, p48, italics his) observes "Transactions that are subject to ex-post opportunism will benefit if appropriate safeguards can be devised ex ante. Rather than reply to opportunism in kind, therefore, the wise prince is one who seeks both to give and to receive 'credible commitments.' Incentives may be realigned, or superior governance structures within which to organize may be devised...To assume, moreover, that human agents are opportunistic does not mean that all are continually given to opportunism. Rather, the assumption is that *some* individuals are opportunistic *some* of the time and that it is costly to ascertain differential trustworthiness ex ante...Lest the world be reorganized to the advantage of the more opportunistic agents, checks against opportunism are needed."

[7] Including moral obligations, i.e. to minimize 'moral debt' and opportunistic behavior.

[8] Sharing of jointly-owned assets problem is defined as problems in jointly-owned property-rights that arise, for example, if a group of people have the right to eat any crops grown in the same field whilst the sharing of these property rights is not (physically) inevitable (Holderness, 2003). See also Ostrom (2000) on common property rights and common-pool resources arguments that are similar to the sharing of jointly-owned assets arguments. The jointly-owned assets discussion is beyond the scope of this paper.

[9] Transaction costs of incomplete contracts follow Commons (1933) ultimate unit of activity which correlates law, economics and ethics, which there are three types - bargaining, managerial and rationing: bargaining transaction is measured in monetary value (e.g. dollars); managerial transactions are through rights and duties; rationing transaction apportions benefits and burdens (see Williamson, 1985, 1996, for in depth discussion on this matter).

[10] See Ostrom (2003) and Williamson (1985) for an excellent discussion on the limitation of the production function argument

[11] For instance, Williamson (2005, 2002, 1996, 1985) argues that markets for debt and equity can be thought of as external governance systems and not solely as external sources of finance.

[12] See Appendix A for an illustration of moral debt distribution payoff graph based on work by Guidi et al. (2008).

[13] The relation between elites, plurality of values and (Pareto) efficiency is that decision-making is not the problem of reason versus sentiment. That is, "it is neither reason nor sentiment that should be maximized to insure the survival of an elite, but [Pareto] efficiency. And efficiency is produced through a delicate balanced mixture of reason and sentiment, working not against one another , but in harness...it is only efficient elites-whether elected, appointed, or self-chosen-that gain substantial support from those who are on the receiving end of their decrees...It is the over-all efficiency in the task of generating and distributing order, riches, knowledge, beauty, sacredness, and virtue that makes the elites perceived as 'legitimate,' and thus helps their tenure (Zetterberg, 1991, p20-21).

[14] Zingales (2000, p1635) argues on implications for valuation "the presence of implicit contracts in the nexus also raises two important issues for valuation. First, the members of the nexus can be paid above or below their opportunity cost in different moments of their relationship. This creates a wedge between market prices and the opportunity cost of inputs, which makes it impossible to identify the value created by a firm with the payoff accruing to equity holders. As a result, stock price changes are not reliable indicators of welfare changes even when the market is perfectly efficient. This possibility warns us against drawing any welfare conclusion from event study analysis. Second, this view of the firm recognizes the existence of hidden organizational assets (and liabilities). Understanding and valuing them is a major challenge for future research."

[15] Williamson (1991) discussion of Shleifer and Summers (1991) paper offers another perspective, i.e. Instead of breach of implicit agreement problems there are managerial discretion problems. In other words, management have Hicksian preference for an 'easy life' where management over pay themselves and workers, which leads to economic inefficiency. It is argued that this economic inefficiency is a possible reason for LBO activity. The managerial discretion problem should be less of a problem for EOs because of their corporate governance design, e.g. because remuneration in these EOs are not decided by the boards of directors but by other boards (multi-tiered boards are discussed in section 3 of the paper) thus the lessoning the opportunity for managerial discretion. Also EOs like JLP restrict the differential in pay between top and bottom earners, e.g. for JLP it is 75:1 where as FTSE firms it's more in the region of 250:1 (JLP, 2010; Guidi et al., 2010).

[16] In a recent conversation with Christine Cooper (Arnold and Cooper, 1999) confirmed that even though employees co-owned the firm they did not have votes to elect anyone to the Medway's board and thus did not have board representation.