Convergence of Neo-Classical and Stakeholder Models of the Firm?
A Case Study of Buy Out Attempts at United Airlines

by

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ABSTRACT

The generally accepted theory of the firm hails from the economics discipline. Until fifteen years ago, the assumptions of the theory and model were not questioned to any great extent. Recent changes in societal expectations and turmoil in the economy have caused these assumptions to be questioned. In other disciplines, alternative theories of the firm have emerged. A relatively new yet predominant model asserts that the corporation should be managed as though it were a community of interests rather than solely for the benefit of shareholders.

The nature of the American corporation has been heavily influenced by the neo-classical assumptions that dominated until these debates began in the 1970s. As of now, the traditional model of the firm is the operative form. Yet, changes have begun to occur in the economy and the realm of theory that indicate a new theory of the firm is needed in order to reestablish stability in the corporate world.

This thesis presents the predominant lines of thought regarding the theory of the firm, and speculates about what the future will hold. An extensive review of the theoretical literature provides the basis for an analysis of the strengths and weaknesses of the available models of the firm. A case study of the Untied Airlines buy out attempts is presented and analyzed using the two models as a tool to compare and contrast their applicability. Finally, the thesis explores the possibility of a convergence of the two predominant lines of thought into a new model of the firm.

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Chapter 1

Introduction

The corporation as an institution of the American economy been a topic of considerable debate over the last two decades. In prior years the nature of the firm was not questioned; it was an entity that existed to make production easier, and was not analyzed to any great extent. The turmoil of the 1960s brought many American institutions up for review, and the corporation was no exception. Just as citizens were disillusioned with their inability to influence political institutions, many expressed anger at their inability to affect the operations of corporations. The desire for increased participation in political institutions extended to a desire to influence policies of corporations. As a result, numerous consumer, ethics, and environmental advocacy organizations began pressuring for corporate reform. Companies responded in a variety of ways; some ignored the "hullabaloo" while others tried to accommodate it. Concurrent with these broad societal changes there has been turmoil in our underlying economic structure.

> "The times are troubled indeed when the good news is almost indistinguishable for the bad. Economic downturns no longer seem interruptions in the march to greater prosperity; rather, they threaten to destroy the world markets on which economic success has depended since the end of WWII. Meanwhile, upturns avert disaster without solving the problems of unemployment and slow growth, which have become chronic in almost all the advanced countries." (Piore and Sabel, 1984, p. 3)

Academics have been struggling to understand the transformation that is underway. In the realm of the theory of the firm, traditional neo-classical assumptions about the corporation began to be questioned in the 1970s. Up to this point, it was a assumed that the firm was a "production function" in which costs were minimized and prices were set above marginal cost. It was assumed that the firm was a more efficient organizational forı . than dispersed individuals working alone. Since theorists do not exist in a vacuum, and since companies began to respond to the pressures upon them, academics were forced to begin to rethink their assumptions about the nature and purpose of the firm. Within the field of economics the debate revolved around attempts to better understand why firms exist in the first place, and how they function. Economists began to question the gospel that firms all maximized profits, and that the firm exists because coordination allows for lowered costs. Several new theories emerged, all of which retain the classical economic assumptions about actors within the firm, but which questions the traditional assumptions about behavior between firms. Within industrial relations, there arose a need to grapple with questions of declining unionization and increasing worker participation. As a result of watching the dynamics of the last decades, academics in this field have also begun to question the guiding assumptions of classical economics and to search for new models. In a variety of business related disciplines, discussions about how the effects of the external and internal environment upon firm behavior arose. This has led to the development of a new conception of the firm, in which it is recognized that a corporation is a community of interests which must be balanced in order for the firm to succeed. The questioning has begun seems to indicate that our assumptions may need to change in order to allow for the creation of a more stable corporate form.

It is still too early to conclude that we are on the verge of developing a comprehensive new theory of the firm. It is possible, though, to say that the debate has begun, and that the lines of thought seem to have begun to converge. Agency theory in economics and the stakeholder model both acknowledge that the firm is the sum of its parts. Agency theory holds that the firm is a set of contracts among factors of production, where each actor is motivated by self-interest. While agency theory exists to explain the economic motivations in and between firms, stakeholder theory was developed to understand the effects of the internal and external environment on actors within a firm. Economics may be only one piece of the puzzle in this formulation. The models converge in that they recognize that different parties have different interests and power, and in that they recognize the ability of the various parties to influence the firm They differ in their purpose, and therefore in their areas of emphasis and concern. The objective of this thesis is to understand the challenges confronting a transformation of the concept of the American firm as influenced by the theory of the firm.

This thesis does not attempt to suggest an appropriate reformulation of the models of the firm. It does operate under the assumption that our current assumptions are inadequate, and that the stakeholder model can provide some useful insight. In order to create a new model, it would require an analysis of points of view of all the different stakeholders,and then a synthesis of all the interests and goals into a coherent framework. This might be a useful exercise, but this thesis does not aim to undertake such an ambitious project. Due to the nature of this particular case, it might seem that the thesis advocates a particular model of the firm based on the point of view of the employees as stakeholders. This is simply due to the nature of the case, and the fact that the lack of an adequate voice mechanism for important stakeholders can lead to instability for the firm.

Structure of the Thesis

Chapter Two of this thesis will present the current theories of the firm. This body of literature comes from the discipline of economics/finance, and from a variety of other business related fields. Most of the theoretical work which challenges older traditional assumptions, and lays the groundwork for this analysis, was written since the mid 1970s. This theoretical summary will provide the basis for analysis of the United Airlines case study to be presented in Chapter Three. The case study explores the airline industry and the events at United in the 1980s. Chapter Four will be use the theories presented in the second chapter to interpret the events at United. This will provide the basis to begin to assess the strengths and weaknesses of the current theories. Chapter Five will conclude by exploring the challenges that will arise if a convergence of the theories does take place. This thesis evaluates the theories of the firm and the prospects for the future by first establishing a theoretical foundation and analyzing a case study to understand the limits and prospects regarding theories of the firm.

Chapter 2

Theories of the Firm

In order to evaluate the appropriateness of the various theories of the firm, it is first necessary to examine the current theories and literature on this topic. This chapter will be about the nature of the firm and the theories prevalent today that guide our understanding of the corporate form. In order to provide a sense of context, the chapter will first provide a brief history of the corporation. It will then address the basic relationships of the firm, and proceed to discuss the academic debates regarding the theory of the corporation. These debates revolve around two basic lines of thinking in a variety of disciplines: the traditional neoclassical formulation which tries to explain why the firm exists and assumes that the proper purpose is maximization of shareholder value, and the stakeholder concept which sees the firm as a community of interests which must be balanced in order to achieve stability and success.

History of the Corporation

The corporate form in America has been greatly influenced by developments that took place before the nation existed. In order to understand the firm as it is in America today, it helps to look back to its roots. The firm as the unit of organization and production has existed since the 1300s; it developed from ecclesiastical roots in Roman times through the feudal manor and plantation systems to the municipalities of the 13th and 14th centuries. By the 15th century monarches had begun the practice of issuing charters to individuals and groups to pursue specific political, educational, scientific, religious, and economic objectives. By the 18th century, "private corporations were commonly chartered, but were mainly monopolistic in nature." Even into the first part of the 19th century, "it was not considered justifiable to create corporations for any purpose not clearly public in nature." By the 1880s most American states had adopted general incorporation laws that permitted the incorporators to define their purpose. (Williams and Chapman, 1984, p.23)

Early "firms" were mainly engaged in agricultural production, but as the economy became more complex, merchants appeared. Most commerce was transacted by the family business, the most pervasive of which was the family farm. A small amount of manufacturing was carried on outside the home by artisans in small shops. Even natural resources such as iron were exploited based on the family farm model (plantation model, actually) operating in a largely rural setting using indentured servants and slaves for the benefit of the owner and his family. By the 1790s, the general merchant had developed into the main business person in most American towns. He performed a number of roles: he was an exporter, wholesaler, importer, retailer, shipowner, banker, and insurer. (Chandler, 1977, p. 17) By the 1840s these tasks were being carried out by different types of specialized enterprises. Banks, insurance companies and common carriers had appeared. Merchants had begun to specialize in one or two lines of goods, and concentrated more and more on a single function.

The structure of such firms was relatively simple; the owner was the provider of capital and manager of the operations. As economic transactions grew more complex and expansive in geographic terms, corporations began to develop out of the need to obtain outside financing and to organize markets. (Chandler, 1977)

The American corporate form and industrial relations were influenced by the original forms borrowed from the Italian, British, and Dutch, and modified by developments particular to America. Italians of 1390s used the partnership form and double entry bookkeeping methods, they sold on account and on consignment for standardized commissions. The British developed the first joint stock companies, largely as a means to obtain financing for overseas trade and colonization. The Dutch and British used rather sophisticated instruments of credit and commercial law, which were also borrowed by the Americans.

The advent of political independence changed the nature of commerce in America. The break with Britain interrupted old trading patterns and led to the opening of new areas for trade. The country expanded westward, increasing in size, resources and population. Trade with Europe and the West Indies began to boom after the French Revolution. Then came the industrial revolution in Britain. The U.S. rapidly became their major supplier of raw materials, and the major market for new machine made textiles. (Chandler, 1977)

The use of the joint stock company grew due to specialization in finance and transportation. Merchants continued to use the partnership as the legal form for shipping and trading. When they found it advantageous to pool large sums of capital to improve transportation mediums (turnpikes, canals), and when more sophisticated financing mechanisms were needed (banks) they began to look to the public as a source for funds. (Chandler, 1977, p. 28)

The mechanisms of equity and debt developed to allow businesses access to capital so that they could expand beyond the means provided by their own individual financial capacity. The right to control the corporation has historically been accorded to those who gave money to the firm. To some, control was simply a right that went along with the provision of financing. Some writers point out the developing legitimacy of representative institutions required some mechanism for control. "As the economics of the time went this was justifiable. They had sacrificed, risked and to some extent, worked at the development of the product. Presumably they had done something useful for the community, since it was prepared to pay for the product. (Berle and Means, 1932, p. xv) Although there seems to be a dearth of literature that describes the development of the reasons for the particular rights of control that go along with equity and debt, it seems that the development of democratic institutions coincided with the development of the corporate form. Edward Mason points out that the concept of agency (representation) had developed legally and politically in 16th century Britain; that members of Parliament were seen as agents for their communities. In the 17th century the concept of agency became linked with the institution of democracy and matters of right. (Williams and Findlay, 1984, p. 22) Furthermore, Williams and Findlay point out that the legitimacy of prevailing social systems required that corporations be representative in nature.

> "The shareholders were the electorate, the directors the legislature, enacting general policies and committing them to the officers for execution. A judiciary was unnecessary, since the State had kindly permitted the use of its own. Shareholders and directors each had functions which could not be exercised by the other. The directors managed. Shareholders could not directly affect most business decisions. The prescribed mode of review of directorial decisions was by the ballot. Only when proposed changes reached constitutional dimensions--charter amendments, merger, dissolution--was the shareholder given a direct voice in decisions. Only where a director's conduct was grounds for impeachment could the body of shareholders recall its representatives before the appointed term." (Williams and Findlay, 1984, p.24).

Despite the variety of firm structures and industries, the basic relationships between players in the firm were developed without much thought to theory and purpose. They seem to have developed as the expedient way to solve problems at hand, and to have endured through many changes in the underlying economic environment. "There is no basis for the assumption of intrinisic rights and entitlements in the corporate strucutre. The Anglo-American corporate form is a creation of hte state, concived as a privelge to be conferred on specified entities for the public good and welfare." (Lipton, 1991, p. 188) As we observe the landscape of corporate America in the 1990's we see that the fundamental relationships developed as the nation evolved still exist today.

The Basic Nature of the Firm

In this section I will briefly describe the nature of relationships between the various participants in the governance of a corporation as it is currently formulated in the United States.

The most common type of corporation is owned collectively by the investors, who purchase stock, and receive in return the right to a proportionate share of the future profits of the corporation. "Owners" share two formal rights: the right to control firm, and the right to appropriate the firm's residual earnings. Chandler formulated a useful description of the "modern corporation" in The Visible Hand: "the multiunit type of firm administered by a set of salaried middle and top managers." This corporate form has created the dynamic of the separation of ownership from control first pointed out by Berle and Means in 1937.

Firm Responsibility is to the Shareholder

Under the traditional conception of the corporation which is codified in American corporate law, the primary purpose of the firm is the maximization of shareholder wealth. This model of the firm rests on the principal that the shareholder is the owner of the corporation and as the owner of that item of private property is entitled to the benefits that it generates. "Once one accepts the premise that stockholders own the corporation in the same manner as they own any other private property, the conclusion that the wishes of the stockholders must be the paramount focus of the corporation follows, constrained only by the limitation on injuring third parties embodied in concepts such as environmental or products liability tort principles." (Lipton, 1991, p. 192) The primary fiduciary responsibility of the managers and board is to promote shareholder interests. Internal and external firm relations have been constructed under the prevailing belief that "relations among different organization participants and relations across organizations are dominated by self-interested behaviors. Controlling self interest is an important function of organization and contractual relations. For this reason, organizations are designed with hierarchical structures, clear boundaries, and sharp divisions of labor, authority, and functional expertise and responsibility" (Kochan and Useem, 1990, p.3).

Beyond the common corporate form there exist a variety of other ownership patterns: firms owned by customers, by workers, and those not really owned by anyone. Customer owned companies range from retail cooperatives of all sizes, to business owned wholesale and supply cooperatives, public utility cooperatives, mutual insurance companies, mutual banking institutions, and cooperative and condominium housing. Worker ownership arrangements generally allow control to investors that have contributed something to the firm other than simply capital (although some amount of capital is usually required). These firms predominate in professional services such as law and accounting, as well as in agriculture and marketing cooperatives. A limited form of worker ownership, employee stock ownership plans, was legislated into existence in 1974. Non-profits are the final corporate form. These are organizations in which the "owners" are prohibited from receiving any of the earnings of the firm. (Hansmann, 1988, p. 267)

Internal firm dynamics are dictated by the various levels of power and authority asserted by the participants in the firm. Each player has a specific role to play and value to bring to the table. The Board of Directors is meant to provide access to resources and expertise, advice with regard to long term strategy, and a voice for shareholders. Managers are intended to provide technical expertise, lower transactions costs, and attention to efficiency. Employees bring their skills and commitment to perform. Despite the debates over the effectiveness of the various parties, it is clear that each role is important to the balanced functioning of a firm.

Firm Responsibilities to Lenders

Rather than hold equity in a firm, many individuals and institutions choose to lend capital to a corporation. They are entitled to a fixed regular payment and the final repayment of interest. If the firm goes bankrupt, then the debt holders are transformed into the shareholders who take over and manage the assets of the company by liquidation or continued operation. They have control over the firm in exchange for their capital in the form of collateral and covenants which can limit management in specific ways. Under modern corporate law it is useful to view shareholders, unsecured creditors, and secured creditors as the owners of the firm. They have different packages of rights to the assets at different times, but they all have the right to call on the firm's assets under one set of circumstances or another (Jackson, 1986, p. 32). The Board of Directors is traditionally a voice mechanism for shareholders, yet in recent leveraged buy out deals, significant lenders have been securing seats on the Board in order to influence management.

Bankruptcy law governs asset distribution if a firm becomes financially distressed. It is intended to be a collective debt collection device. The goal is to permit owners of assets to use the assets in a way that is most productive to them as a group in the face of incentives by individual owners to maximize their own positions. A further goal is to transfer the assets from the debtor to the creditor while minimizing the costs of the conversion process. (Jackson, 1986, p. 5) Payment to creditors follows a "fundamental ordering principle" in which they are paid according to their place in line for assets dependent on when they acquired an interest in the assets. Secured creditors have first claim on certain assets, shareholders have residual claims on all the assets, and unsecured creditors come in between.

Workers are entitled to a certain wage level, but as labor law is currently formulated, they have no control over the assets of a corporation. They have no say as to whether the assets should remain doing what they are doing or not. They may have claims on the assets to secure future wages or the future terms of their collective bargaining agreement at the point of financial distress (up to a limit of $2,000 per worker). Current authors suggest that, during bankruptcy, it is better to think of workers as creditors rather than as workers (Jackson, 1988, p. 32).

The relationships described here have developed largely out of expediency. Over time, academics have attempted to understand and describe the reasons for these particular formulations. There are many lines of thought which depend on the paradigm and purpose of the writer. This thesis is concerned with the structure of organizational governance, and the relations between important parties in the firm. Economists have been interested in these issues and have had a significant impact on the development of corporate behavior, and it is for this reason that this thesis focuses on the theories proposed by this paradigm. A variety of other disciplines have begun to address these issues over the last decade, and it is under the heading of the stakeholder model of community of interests model, that I focus on their theories. Since a review of the literature about the firm reveals that these two lines of thought are predominant today, and since each has contributed to the debates about the future of the corporation, the next section will describe these two predominant theories of the firm.

Theories of the Firm

Neoclassical Theories

Within the paradigm of neoclassical economics, two basic schools of thought have developed regarding the firm. The debate revolves around the traditional economic explanation of the firm as a "production function" mainly concerned with the efficient determination of prices and output, versus a variety of ideas that are gathered under the term "economics of organization" theory. In this section will discuss the history of thought of the traditional and emerging "organization" theories, and outline the basic assumptions of both schools.

It is worth noting that neo-classical theories have had significant influence on American corporate development. While some economists like to think that they are simply creating theories that explain the way the world works, in reality their theories have been interpreted and codified into law, and into norms of behavior. The basic underlying assumptions of neoclassical economic thinking about the firm have influenced the development of thought in other disciplines leading to a rather coherent set of notions about how firms operate, and should operate.

Traditional Theory of the Firm

The traditional "black box" view of the firm assumes that each shareholder owns only a very small percentage of a company's stock, they evaluate management in terms of short term capital gains, and express dissatisfaction by selling their shares. They are assumed to exchange the right to intervene directly in formulating or monitoring strategies for the easy marketability of their shares , while the Board of Directors is supposed to do its best to express and implement the interests of the shareholders. Furthermore, "the allocation of economic activity as between firms and markets was taken as a datum; firms were characterized as production functions; markets served as signalling devices; contracting was accomplished through an auction; and disputes were disregarded because of the presumed efficacy of court adjudication." (Williamson, 1984, p.7) In this view of the firm, labor is simply a commodity supplied and a cost to be minimized dependent on the strategy of the firm. Workers in this case are similar to customers and suppliers, who contract with the firm, and whose interests are renegotiated through the mechanism of collective bargaining.

Theoretical writing about the nature of the firm seems to have originated with Berle and Means in 1937 with the publication of <u>The Modern Corporation and Private Property</u>. This book introduced the notion that control in the modern corporation had separated from ownership; that managers were hired to run a firm on behalf of numerous shareholders who often lacked the ability to exercise meaningful control.

Since most students of business and industrial relations are familiar with neoclassical economic theory, I will simply outline some of the basic assumptions regarding firm behavior prevalent in this model. It assumes that the firm is only one small player unable to influence the wider economy and that it is a "single minded agent" interacting with similar customers and suppliers in the market. The economy, organized into a market form, and the price mechanism, regulated by the laws of supply and demand, are the only necessary mechanisms for resource allocation and economic coordination. Labor is assumed to be a variable cost, and is further assumed to be able to relocate if called for by the market. With regard to labor, it is also generally assumed that a conflict of interest is inherent between workers and owners in the sense that workers will find it in their interest to work less while managers and owners want them to work more. It is also accepted that shareholders must institute some form of managerial discipline in order to ensure compliance with their goals. This is just a sample of the basic assumptions guiding the neo-classical model of the firm.

"Economics of Organization" Theory

Thinking about the firm as a unit of economic organization was not vogue in the economics discipline for about thirty years since there did not seem to be any problem with the theories at hand. In the 1970s, economists began to debate the assumptions of neoclassical economics with more vigor, and questions regarding the firm rose to the surface. "Looking over this spectrum in historical perspective, we might say, with some simplification, that contemporary economists rediscovered the firm, after it had faded into some obscurity in the refinements of neoclassical theory, as something of an embarrassment." (Putterman, 1986, p. 24) There is not yet a coherent set of beliefs that encompasses current thinking about the firm, but they share a basic questioning of traditional neo-classical thought. The writers differ in their acceptance of the assumption that the market economy is efficient, producing optimal outcomes for all involved. They also differ with traditional theory in two basic ways: 1. they are preoccupied with institutions and question their tendency toward optimality, and 2. they tend to reject the assumption of costless acquisition of information, thereby allowing for the existence of market imperfections. They reject neo-classical theory to this extent, but assume classical forms of economic behavior pertain to agents within the firm.

There are three basic theories which challenge the traditional assumptions. They are:

- "transactions cost analysis".
- "agency theory", a.k.a. "nexus of contracts", and "contractual theory of the firm".
- an emerging "stakeholder" conception.

Transaction cost theory originated with Ronald Coase who wrote "The Nature of the Firm" in 1937. Although it was not received with much acclaim, it has provided a basis for transaction cost theorist of recent years. Starting in the 1970s economists began to grapple with the problems of explaining the organization of industry, and have utilized Coase's work. (Aghion-Bolton 1988, Hart-Moore 1989, Bolton-Scharfstein 1990, Diamond 1989, Harris-Raviv 1989, Zender 1989, Klein, Crawford, Alchian, Hannsmann, Schleifer and Summer 1987, and Williamson)

Whereas markets were ordinarily regarded as the principal means by which coordination is realized, Coase insisted that firms often supplanted markets in performing coordination functions. (Coase, 1988, p.3) "All that was needed was to recognize that there were costs of carrying out market transactions and to incorporate them into the analysis, something which economists had failed to do. A firm had therefore a role to play in the economic system if it were possible for transactions to be organized within the firm at less cost than would be incurred if the same transactions were carried out through the market. The limit to the size of the firm would be set when the scope of its operations had expanded to the point at which the costs of organizing additional transactions within the firm exceeded the costs of carrying out the same transactions through the market or in another firm." (Coase, 1988, p. 19)

Recent authors have developed the ideas introduced by Coase further. Debates have emerged about the usefulness of transaction costs as an explanation of the firm, and another line of thinking has developed which characterizes the firm as a device for dividing up control between various claimant groups. This approach, known as agency theory or the "nexus of contracts," originated with a 1976 paper by Michael Jensen and William Meckling. They argued that a firm consists of nothing more than a bundle of contractual arrangements among a variety of parties--customers, suppliers, lenders, investors, managers, and workers. All parties attempt to use their own particular inputs and leverage to strike the best bargain for themselves that is possible. (Jensen and Meckling, 1976) In effect, they suggest that the firm should be viewed as a set of contracts among the factors of production who work together as a team. Based on this reasoning Oliver Williamson points out that the firm is more usefully regarded as a "governance structure" rather than a "production function." (Williamson, 1985, p. 13)

In the contractual theory of the firm the large corporation is viewed as a nexus of contracts among self-interested providers of productive resources. The contractual relationship among shareholders and senior management is a form of agency. Managers provide decision making services for a fee, but rarely own more than an insignificant proportion of the firm's equity; shareholders bear the residual risks associated with resource allocation decisions by managers, but rarely take an active role in the decision making process itself. (Baysinger and Butler, 1985, p. 1270)

The role of labor is rarely addressed in transactions cost theories. It assumes, though, that labor stands on an equal footing with all other contenders for power. Recently, Oliver Williamson has begun to address the role of the worker; he believes that the corporate framework allows unions to protect the investment of workers adequately, so that Board representation is unnecessary, and perhaps undesirable.

The stakeholder conception of the firm will be fully developed in a later section of this chapter, but at this point it is worth noting that the "stakeholder" concept is beginning to appear in the more mainstream economic/finance literature. The concept originated totally outside the academic world, and has developed in other disciplines. It is only recently that the terminology has begun to creep into economics debates. A 1987 paper by Andrei Schleifer and Lawrence Summers argues that "hostile takeovers facilitate opportunistic behavior at the expense of stakeholders. In this way, hostile takeovers enable shareholders to transfer wealth from stakeholders to themselves more so than to create it." (Schleifer and Summers, 1987, p. 2) They go on to state that "firms will find it value maximizing to seek out, train, and entrench individuals capable of commitment to the stakeholders." (Schleifer and Summers, 1987, p. 11) The nexus of contracts approach has created the framework which allows a rethinking of the purpose of the firm in the economics discipline and has created a potential basis upon which theories of the firm in a variety of disciplines might converge to develop a new model for the firm.

Stakeholder Model or Corporation as Community of Interests

Thinking about the nature of the firm has not been confined to the disciplines of economics and finance. In a number of arenas, people have been questioning the neoclassical assumptions about the firm. A compelling line of thought has emerged from a number of disciplines which suggests that it would be useful to view the firm as a community of interests which are mediated by management in order to reach the most efficient outcome. In this section the ideas behind this concept will be explored.

Before embarking on that task, though, it is important to note that the motivation for the stakeholder model in these disciplines differs from the explanations developed in the economics discipline. The mainstream theories tend to look at the world as it is functioning and find economically oriented explanations for the status quo. They also try to understand why firms chose their particular capital structures. On the other hand, ideas about the firm as a community of interests initially developed as a tool to help managers understand the environment within which they operate. It has also found adherents among those concerned with the broader community within which a firm operates.

The term stakeholder in relation to the corporation first appeared in an internal memo within the Stanford Research Institute in 1963. The term was meant to generalize the notion of stockholders as the only group to whom management must be responsive. SRI researchers argued that unless executives understood the needs and concerns of the various stakeholding groups, they would not be able to formulate corporate objectives which would receive the necessary support for the continued survival of the firm. (Freeman, 1984, p. 31) The term provides a simple and compelling way in which to view the firm, and can be a powerful tool for managers.

The notion encompassed within this term has been around for quite awhile, yet had not previously been utilized as a theoretical model which could be used toward understanding the nature of the firm. Berle and Means recognized the diverse interests that influence the firm in their 1937 book that is known for popularizing the notion of the separation of ownership from control. "It is conceivable--indeed it seems almost essential if the corporate system is to survive--that "control" of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity." (Berle and Means, 1937, p. 312)

A useful definition of the term stakeholder was developed by R. Edward Freeman and modified by Adam Klein. As defined by Freeman, a "stakeholder" is <u>any</u> group or individual who can affect, or is affected by, the achievement of a corporation's purpose. This includes employees, customers, suppliers, stockholders, banks, environmentalists, government, and other groups that can help or hurt the corporation. (Freeman, 1984, p. vi.)

Adam Klein has suggested that it is useful to curtail the definition to include only those individuals or groups with the "<u>real</u> power to significantly affect the performance of a company." He points out that this limited definition, which differentiates between those who have the power to influence strategic decisions, and those who are simply "advisory" and are therefore only "marginal influencers," more accurately reflects the constraints faced by managers. (Klein, 1987, p. 94)

(For a comprehensive history of the development of the model in a variety of disciplines--organization theory, systems theory, corporate planning and corporate social responsibility-- see R. Edward Freeman, p. 31-43)

Masahiko Aoki, in his article "The Japanese Firm in Transition," asserts that Japanese corporations can best be understood using this model. He points out that the goal of profit maximization for the benefit of the shareholder is not the "guiding principle" of a Japanese firm. He has developed a framework for analyzing and interpreting the structure and behavior of the modern firm on the premise that the firm is a complex organization within which the partly harmonious and partly conflicting interests of diverse constituents, including employees, are brought into equilibrium. (Aoki, 1987, p.265):

•The body of employees is, together with the body of shareholders, explicitly or implicitly recognized as a constituent of the firm, and it's interests are considered in the formation of managerial policy.

•Management acts as a mediator in the policy making process, striking a balance between the interests of shareholders and those of employees. The enterprise functions as a substructure of the firm and represents employees in the decision making process. Management is a "mediator" that weighs and equilibrates both the implicit and explicit bargaining powers of the firm's constituents.

In a recent article in the University of Chicago Law Review, Martin Lipton made the case for a totally new configuration of the firm. He suggested that the ultimate goal of the corporate governance structure is the creation of a healthy economy through the development of business operations that operated for the long term and compete successfully in the world economy. To further this goal, he suggested that the governance structure should be reformulated to encourage the ordering of the relationships of the firms major constituents around the long term interests of the firm. (Lipton, 1991, p.189)

The most basic difference of the stakeholder notion from traditional conceptions of the firm lies in the fact that the model defines as legitimate groups which management has generally regarded as those making inappropriate demands on the corporation.

> "'Stakeholder' connotes legitimacy, and while managers may not think that certain groups are 'legitimate' in the sense that their demands on the firm are inappropriate, they had better give "legitimacy" to these groups in terms of their ability to affect the direction of the firm. Hence,"legitimacy" can be understood in a managerial sense implying that it is 'legitimate to spend time and resources' on stakeholders, regardless of the appropriateness of their demands." (Freeman, 1984, p. 45)

Convergence of Neo-Classical and Stakeholder Models

Neo-classical economic theory has both described and prescribed much about the way modern business is conducted. The preceding discussion pointed out the basic assumptions of traditional and emerging lines of thought within the paradigm, as well as the ideas behind the increasingly popular stakeholder model. It is necessary to keep in mind that, at this point in time, the stakeholder model is much less developed than are neo-classical theories, and that it tends to be used as a tool for managers to analyze the environment, rather than as a comprehensive theory of the firm. Chapter Four will explore the effect of this fact by attempting to utilize the theory to analyze the United Airlines case study.

It is interesting that writers in the realm of economics and finance are beginning to utilize not only some of the language of the community of interests line of thought, but also the ideas. I think that it is quite useful to conceive of the firm as a community of interests since this approach allows all the parties affected by a firm a legitimate place in the decision making process of management. Economists are beginning to question the profit maximizing nature of firms. The "nexus of contracts" approach to the firm allows room for the tools created by the stakeholder model to be introduced into mainstream economic thought. It seems that we may be on the way toward development of a new theory of the firm based on a combination of the ideas of the two predominant theories of the firm.

This chapter has outlined the basic assumptions of the two predominant theories of the firm which will provide the framework to evaluate the United Airlines case study presented in Chapter Three. The theories provide the base necessary to evaluate the case study and to speculate as to the shortcomings and advantages of each.

Chapter 3

United Airlines Case Study

Captain Rick Dubinsky, who had led the 1985 strike and was Chair of the Greiveance Committee, won the 1987 election to be Chairman of the United Airlines Master Executive Council of the Airline Pilots' Association. Within hours, the departing Chair, Captain Roger Hall, explained that a confidential research program was currently in the works. They were quietly researching the feasibility of the pilots buying the airline. A line pilot with a personal interest in employee ownership had suggested to Captain Hall that the pilots should buy the airline from current shareholders in order to replace management and redirect corporate strategy. The idea had been floating around since the lawyer F. Lee Bailey had suggested it during an "inspirational" teleconference with the membership during the 1985 strike over the two tier wage proposal, but it had not been seriously considered.

The idea was attractive. The pilots felt insecure watching the United management lose routes and gates all over the country to carriers who were more aggressively expanding. They also felt that management would constantly try to eat away at their salaries and work rules, trying to lower costs at their expense. The corporate strategy since deregulation had been somewhat unclear, but lately had developed diversification plan that caused the pilots great concern. They feared that cash flow from the airline would be used to expand the other businesses, and to create the "one stop travel shop" that management wanted. They also feared that the talent and skills to succeed as an integrated travel services business just did not exist in the current management.

The demise of the airline held a special threat to the pilots. They liked their jobs. They liked to fly, they liked the autonomy and independence that came with the territory of being pilots. Most importantly they feared losing their seniority if the airline was to go under or drastically decrease the number of flights. The long accepted seniority system in the airline industry held that a pilot only accrued seniority in one airline and was prohibited from transferring seniority to another airline if he had to move. This meant that if United quit flying planes the pilots would have to start over at the bottom of the ladder at another airline. If any jobs were available at all.

All the pilots were aware of the problems and had been casting about for solutions. They had recently begun to realize that traditional means would not work. The Reagan White House was anti-labor, and had given airline managers the confidence to take labor on with the PATCO episode. Traditional methods would be slow and probably inadequate to influence management strategy.

The United Airlines case study is particularly helpful as a tool to explore the theories of the firm because it can be fully interpreted by both of the models presented in Chapter Two. The fact that the airline was part of the leveraged buy out "craze" of the 1980s means that neo-classical economic theory can be used to provide a basis for understanding the ownership debates. The fact stakeholder interests became of particular importance to the airline as it struggled to reformulate it's strategy in response to deregulation means that the case study also lends itself to a full analysis with the tools of the stakeholder model. There are many lessons that can be learned by applying each model, but there are some lessons which can be learned only by utilizing one or the other of the theories. This fact makes the United Airlines situation particularly useful as a tool to grapple with the prospects for the future.

In order to understand why the pilots were interested in becoming the owners of United Airlines it is necessary to understand what was going on in the industry prior to this time. This chapter will therefore describe the development of the industry, and the history and effect of deregulation. It will then explain how United responded to the changing industry dynamics and then tell the story of the ownership struggles which began in 1987.

The Industry

Passage of the Airline Deregulation Act of 1978 brought major and rapid transformation to the airline industry. Previously regulated by the Civil Aeronautics Board (CAB), the industry was dominated by several large airlines that provided primarily long haul service, and regional airlines that provided short haul service. None of the airlines competed upon the basis of price since the CAB regulated the fares, subsidizing the short haul routes operated by local carriers and leaving the long haul routes to the larger airlines. Deregulation lowered the barriers to entry and created the possibility for new airlines to compete on the basis of price. Within three years 22 new carriers entered the industry. With lower labor costs, lower fares, and cut rate service, they took the incumbent airlines by surprise.

History

The modern airline industry has its roots in mail delivery. Passenger air transportation had a hard time competing with other forms of transport because it was less safe, slow, and of limited range. In 1918, the Post Office began to use planes and pilots supplied by the U.S. Army to deliver mail. By 1926, a rather extensive system of landing fields had been created across the country. The Kelly Act, passed in 1925, set the basis for future developments in the industry. The Act authorized the Postmaster General to award contracts to private airlines. A later amendment made it hard for new entrants to start up by limiting who the government would contract with to those with six months of operating history and a daily schedule of 250 miles. By 1933, United, American, TWA, and Eastern collected 94% of the contract revenues. "Irregularities" in the Postmaster's contract awards led President Roosevelt to abolish the Kelly Act and give the responsibility for mail delivery to the Army Corp of Engineers. This proved to be a short lived solution since the Corp provided poor service and a number of their pilots were killed in accidents. This, along with an increasing demand for passenger service created motivation for passaged of The Civil Aeronautics Act of 1938. The legislation created the basis for CAB authority and policy, while the overall structure remained that which had been created under the Postmaster General. "On the shorter routes new companies entered the field, but the longer routes were kept by the "Big Four," mainly because only they had the equipment and training to fly them." (Meyer, 1981, p. 17)

Part of the purpose of the CAB was nurturance of the fledgling industry. It's policies were designed to ensure that competition did not lead to fares consistently below costs, threatening the viability of the industry. A phrase from a report by the Federal Aviation Commission nicely sums up CAB policies until deregulation.

> "On the other hand, too much competition can be as bad as too little. To allow half a dozen airlines to eke out a hand-to-mouth existence where there is enough traffic to support on really first class service and one alone would be a piece of folly." (Meyer,1985, p.19)

In this light, the policies were successful since air passenger traffic increased 14% a year from 1949 to 1969. (Weiss and Klass, 1986, p. 41) Larger, faster planes also helped increase growth of the industry while reducing costs by 22% during the same 20 year time period.

Until the 1960's, entry of new carriers was not allowed if they would compete with any part of the established trunk system. Local service carriers grew due to the CAB's efforts to increase service to smaller population areas. Feeder routes were given to new carriers largely due to the fact that subsidies to the trunk carriers were high, and it was felt to be politically unacceptable to give them even more money to encourage local service. It was also based on knowledge that costs and performance levels would vary between the types of service. As the trunk air lines grew stronger and more profitable, they relied less and less on subsidies, using them only intermittently after 1959. As new technologies developed, the cost of servicing long and short haul routes became increasingly disparate, generating substantial subsidies for local service carriers. CAB kept fares on long haul routes above cost and short haul below cost in order to promote air service.

Since fares were set by CAB, the trunk lines competed on the basis of capacity, schedule frequency, and equipment type. The CAB did try to reduce the number of monopoly routes held by the trunk lines. It also tried to strengthen weak carriers by awarding them good routes. In the 1960's they began to allow some competition from the smaller airlines in the trunk's traditional markets. At the same time they tried to lower subsidies to the local carriers. Profits fell and the CAB reversed its policies.

Securing additional routes was costly and time-consuming. CAB awarded them on a case by case basis; the carrier seeking a new route had to show that the proposed service was in the public interest and that it would not harm other carriers. If more than one airline wanted the same route, it would take two years to be resolved. The Board apparently had unofficial limits on number of carriers it would authorize to serve a given route.

By the 1970s CAB policies had helped to create a national passenger airline industry The structure of a few large carriers and numerous small regional carriers was largely continued from the mail carrying era. The fact that the CAB set acceptable fares, and authorized routes with an eye toward maintaining airline profitability meant that the carriers were largely unconcerned with issues of price and competed on other factors. The same "Big Four" airlines continued to operate largely free from competition from start-ups or regionals.

Deregulation

Discussions about regulatory reform for many industries began among academics in the 1950s, and became a serious public policy question in the 1970s. The airline industry was one of the first to be scrutinized because the CAB's policies had so clearly effected the nature of competition. Proponents of deregulation argued that it would result in lower fares and more efficient, profitable airline service. Opponents argued that it would result in serious operating and financial instability, reduction in the variety and quality of service, and lead to increased industry concentration with higher fares and less service to smaller communities.

Interestingly, United Airlines was the only major carrier in support of deregulation. In September 1976, it broke ranks with the other airlines, claiming that the CAB was responsible for unstable industry earnings, and that deregulation would address this problem.

The provisions of the 1978 Airline Deregulation Act (ADA) allowed airlines to raise or lower fares, and made it easier for carriers to service new routes. Fares could increase up to 5% above the standard industry fare level or lower 50% below without needing CAB approval. Carriers could serve new routes if another carrier holding the certificate to that route had not been providing at least five round trips a week for thirteen weeks. Under an automatic entry program carriers were allowed to begin non-stop service between any pair of points.

Response to Deregulation

The next phase of activity in the industry was influenced by the combination of deregulation, rising fuel prices and two mild recessions. Despite quickly escalating fuel costs, twenty two new low-cost, low-price carriers entered the market within three years. They operated at significantly lower costs than the traditional carriers due to lower labor expenses and smaller more fuel efficient planes. Customers flocked to the new low fare competitors. Most of the large airlines were not prepared when deregulation took effect, and struggled to cope. The combination of events led to financial difficulty for most airlines, bankruptcy for Braniff, and reorganization for Continental.

The structure of the industry changed significantly as a result of new competition:

- Trunk airlines had 90% of the domestic traffic in 1978. By 1984 this had fallen to 75%. Dense markets formerly serviced exclusively by trunk lines attracted new entrants.
- Former local carriers increased their presence in the domestic market by 70%, accounting for 12% of air passenger traffic by 1984.
- New entrants expanded to 12% of industry traffic in 1984 from 2.4% in 1978.

Formerly regulated carriers responded to deregulation in a variety of ways. Strategy choices included the following combinations: pursuit of low-cost, low price position requiring concessions from labor, high quality service without major labor concessions, growth through acquisition or growth of hub-and-spoke network and feeder airlines, niche market development, and diversification.

Those who sought to reduce costs generally did so by seeking labor cost cuts. Since labor represented an average of 45% of operating profits through the 1960s and 70s, cuts in labor costs became the focus of much activity. Managers tried to renegotiate labor contracts, increase the number of part time workers, relax restrictive work rules, and increase productivity. Over one weekend, Continental Airlines transformed itself into a low-cost, low-price competitor by abrogating it's labor contracts, firing employees and rehiring them at substantially lower wages. The big push for wage concessions arrived after the recession in the early 1980's. Airlines pushed for concessions not to compete with low fare competitors, but to keep themselves out of bankruptcy due to the fare wares waged between trunk airlines hungry for the few passengers. Wage concessions began with airlines near bankruptcy (Braniff, Western, Pan Am), and after a year or so, spread to the healthy carriers. These carriers argued that they needed concessions in order to compete with the trunk carriers who had successfully lowered their labor costs. (McKersie, 1989, p. III-5)

By the end of 1990, deregulation had effectively created an even more concentrated industry than had existed prior to passage of ADA. Through mergers and acquisitions eight companies have come to control 93% of the domestic market, whereas before deregulation 15 carriers serviced 80% of the market. The major carriers proved to be able to hold on to their traditional routes, and swamp small airlines where they chose to compete.
Development of hub-and-spoke system has enabled large airlines to increase

their service while improving their economies by cutting down on their number of long non-stops, keeping planes flying for more hours each day, and filling a higher percentage of seats while providing more convenient connections. It also created a disadvantage for small airlines since people do not like to change airlines mid route. Regional carriers seem to be able to survive by not confronting the major airlines. Computerized reservations systems allowed United and American to keep track of rivals and charge large fees from competitors while juggling fares and capacities in order to maximize revenue on each flight. Frequent flyer programs were designed to create customer loyalty.

The future of the airline industry is uncertain at this point in time. There are three big remaining airlines; United, American and Delta, and a few strong regionals; Northwest, USAir, and Continental. Most recent activity seems to indicate that a global consolidation may be underway, and that a few super carriers may emerge. The decline in passengers due to the Gulf War had a destabilizing on many airlines, and US carriers are taking advantage of this to buy up foreign routes. United and American have begun to expand into overseas market, yet this expansion will be mitigated by the need to replace existing airplanes before buying more.

United Airlines: Strategy in a Deregulated Environment

The managers at United claimed to be ready for deregulation. They followed a strategy which included abandonment of short haul service, attempts to lower labor costs, increase productivity, and diversification. With hindsight, it is possible to see that officials at United were inconsistent in most of their strategies, except where labor costs were concerned.

After passage of the ADA, United announced it's intention to drop many of their short haul feeder routes and to sell the planes that serviced those routes. The intent seems to have been to concentrate on more profitable long haul service, to solidify their position relative to the other national airlines, and to abandon low-cost, low-price local service to the new entrants and former local carriers. This did not prove successful, as the airline lost hold of the traffic needed to feed the longer routes. In 1981, the airline reversed itself, decided to keep the planes it had put on the block, and introduced "Friendship Express," a no-frills short haul service.

Also in 1981, United tried to improve its profitability by entering the express package business. They invested $10 million for advertising of the service, and set prices lower than those of Federal Express. The early years after deregulation were tough for United; they lost $65 million in 1980, and $70 million in 1981. Traffic fell in 1981 by almost 10%.

In addition to other efforts, United attempted to lower labor costs. They took the industry initiative at two different points in time, and were able to extract significant concessions from their employees:

- **1981 Pilot Contract:** United cut pilot labor costs by millions. Pilots agreed to fly with two pilots rather than three on 737s, increase "hard time" on planes by 30% to 81-85 hours a month, do away with "duty rigs," and premiums for flying at night or over water. In return United agreed to a no lay-off clause, promised not to start a non-union airline, and to keep the 4,539 pilots during the 26 month life of the contract.

• **1985 Two Tier Wage Scale:** United wanted to institute a two tier wage scale that would allow new pilots to be paid 40% less than incumbents. A strike by the pilots ensued and the company agreed to allow an arbitrator to review the policy after 5 years. The strike would have ended after 8 days, but continued for 28 due to disagreements over punitive issues.

In 1986, Chairman Richard Ferris announced his intention for UAL, Inc. to become an "integrated travel services corporation." The name was changed to Allegis in order to create a new identity and the company began to look into purchasing travel service companies that would complement air travel. The airline already owned Westin Hotels which it had purchased in the 1960s, and it added Hilton Hotels to its portfolio. Allegis also bought Hertz Rental Cars for $600 million. The notion was to provide a full-service travel experience for customers; for example, a Hilton visitor could check her bag for a United flight as she checked out of the hotel.

Within a year, the company abandoned the diversification strategy. The pressure was due to the stock market response to the first pilot offer to buy the airline. They maintained that the company should abandon diversification, and their offer was based on following this strategy. The stock market responded positively to the news of the offer, and the Board took note. It seemed to mean that investors thought that the company was not following the right strategy. Under pressure from institutional investors who had not received dividends for a few years, the Board responded by divesting of the travel related businesses, returning to the core airline business, and ousting Richard Ferris as CEO.

The next three years were ones of turmoil surrounding ownership, with a declining focus on strategic issues. In 1989, two years after the failure of the first pilot buy out attempt, the company entertained buy out offers from two outside parties. Neither offer was accepted. The Board also entertained two more proposals involving employee ownership. One entailed a management/pilot leveraged buy out and the other entailed a union coalition leveraged buy out. Again, neither scenario succeeded. In the next section, I will detail the events surrounding the buy out offers.

Ownership Negotiations

This brings us back to the story commenced at the beginning of this chapter since the pilots offer to buy the company was the first of several offers to purchase United Airlines. The research for this section of the thesis combined the utilization of media sources and interviews with participants in the buy out process. The contacts are listed in Appendix One.

First Employee Buy Out Offer--1987

The pilots decided to launch an effort to take over the airline for a number of reasons. As mentioned earlier, the pilots were concerned about the effect of diversification on the airline. They relied upon airline industry analysts at the international headquarters of the Airline Pilots' Association for information regarding the state of the industry. They had seen how airlines that attempted diversification in the 1960s had faltered, and were concerned that airline cash flow would be siphoned off to the other businesses. Since the airline had only recently returned to profitability after the mid-80s recession and had a low return on investment anyway, they felt this meant trouble for the future. "Experience has shown that diversification has hurt airlines in general and United in particular." (ALPA, 1987, p. 2) They also saw how aggressively other airlines were expanding into the hub-and spoke system, they noticed Pan Am and Delta planes where United had once been, and they were afraid of being left behind in the competitive marketplace. Furthermore, they thought that management lacked the skills and talent to successfully integrate the new businesses into the company. They saw costs at United increase due to arrangements that corporate made with the other businesses; for instance, employees were directed to stay at Hilton Hotels during layovers despite the fact that lower cost alternatives might be available. For an airline trying to keep costs down this did not seem sensible (especially to members of the labor force that had been the source of many cuts).

In addition, they felt that they had been double-crossed by Chairman Ferris. In the 1981 contract negotiations, Ferris had threatened that he would move into other businesses if the employees did not give him the concessions he wanted. He did get his concessions, and the employees felt that they had been promised that the company would remain only in its core business. When Ferris announced his "Allegis" plan in 1986, they felt as though they had been betrayed.

They also thought that the concept of employee ownership made sense in a service industry and in return for concessions. They had long wanted something in return for concessions in wages and work rules. They felt that stock was appropriate since it would allow them access in the future to the wealth generated by their sacrifices today. From their research, they gleaned that employee ownership could generate productivity and quality improvements in a service industry. The combination of reasons motivated the Pilots to make their first offer for United on April 5, 1987.

It is worth noting at this point, the nature of employee ownership envisioned by the employee buy out group. The three possible levels of participation are generally seen to be at the strategic level through board representation, at the corporate policy level, and at the job level. Since airline employees are widely dispersed around the globe, they felt that communication between employees and managers was difficult to achieve. They therefore choose to limit their participation to control over the "quality of management." They mainly confined their concern to issues of strategy, allowing the unions to participate in the selection of top management and to veto decisions under certain circumstances. Job control did not seem to become an issue.

This first offer of $4.5 million entailed financing $2.3 billion and assumption of $2.2 billion in outstanding debt, 80% employee ownership, 25% wage cuts for pilots, along with selling off the travel related businesses and returning the proceeds to shareholders. Since the membership of the association had been kept in the dark about the plans, the Master Executive Committee had to do some work to ensure that the membership would back the idea of employee ownership and accept wage cuts. Individual pilots showed their support by collectively contributing $14 million toward completion of the deal. (See Appendix Two for outline of the employee buy out scenarios).

Initially, management responded to the offer with amusement, thinking that the offer was a publicity stunt to further collective bargaining goals. When the market responded positively, the company began to take the situation more seriously. "There's pressure on the company to do something that will achieve higher shareholder value," says one investment banker. "The business as usual approach at UAL might not be good enough." (WSJ, 4/8/87)

Although the Board of Directors did not accept this offer, they did proceed with to divest the corporation of businesses other than the airline. They also forced Richard Ferris from the position of Chair and replaced him with an interim manager until selecting Stephen Wolf as the permanent replacement the following year. The Board hoped with these changes that employee interest in buying the airline would fade. The pilots continued to be interested, though. "Through majority ownership United will be better protected against the Icahns and Lorenzos of this world, and can have a management committed to productive employee relations. Minority ownership provides no such benefits." (ALPA, June 1987,p. 5)

After the failure of the first bid, things became complicated for the pilot team interested in buying the airline. The complications came from another employee group, the International Association of Machinists. Their 30,000 members had not been part of the pilot offer because they were philosophically opposed the blurring the lines between management and labor by creating an ESOP to buy the company. They also felt that it was an inefficient way to represent their members. In 1988, they completed an agreement with United that effectively stalled the pilots' efforts for a year and a half. Their contract that year stipulated that IAM would have the ability to determine the wages and stock ownership percentages of other employee groups if the company was taken over. It also gave IAM the right of first refusal regarding any purchase, as well as the right ask for a 10% pay increase or to strike immediately if the company was sold. After a court fight these measures were struck down as being a poison pill and board entrenchment device.

Outside Buy Out Offers--1989

In January 1989, an outside takeover attempt was launched by Saul Steinberg. It was generally viewed as friendly because Mr. Steinberg was a friend of Stephen Wolf. The offer was opposed by the unions who would not agree to concessions if Mr. Steinberg bough the airline, and was opposed by others on the Board. The offer was rejected.

In August of 1989, United became the target of another takeover attempt, this time by an investor by the name of Marvin Davis from Los Angeles. The pilots had been in contact with Mr. Davis, and had entertained the idea of working with him on a joint buy out. The relationship went sour after a public meeting with Mr. Davis in which he said, "When I was a boy, I liked to play with toys. I still like toys. They've just gotten more expensive." He then cupped Rick Dubinsky's cheeks in his hands and is reported to have said, "So, let's have some fun." Rick summed his reaction up by commenting, "We weren't about to be trifled with as some rich kids toy." (WSJ, 9/18/89) The Board rejected his offer because it was too low. Davis then improved his price, but had to wait because a new attractive proposal was placed before the Board of UAL.

Joint Labor/Management Buy Out Proposal--late 1989

The distasteful prospect of ownership by Marvin Davis led the pilots and management to begin talking about an alliance to buy the airline. This seems to have entailed a significant change of heart by Mr. Wolf, who in the previous round of discussions regarding employee ownership had maintained a position in opposition because he did not want the Pilots' Association as his boss. Additionally he had stated, "We do not see how [employee] ownership...of a debt laden United benefits our pilots or other employees. We believe that a costly adviser group to our pilots has done them a disservice." (WSJ, 9/18/89) As the proposal was in development, management demonstrated its new good faith by agreeing to reimburse the union for up to $120 million for costs associated with the buy out negotiations.

In September 1989, UAL Board of Directors approved a $6.75 billion offer submitted by the senior managers, Ariline Pilots Association, and British Airways. This offer entailed borrowing $7 billion, 75% employee ownership, 3 union board seats, 3 management board seats with 9 outside directors, and monthly meetings regarding corporate policy with labor representatives. Pilot concessions included a 10% paycut, fewer vacation days, more flying hours, lower medical deductibles, and an agreement not to strike for seven years.

The negotiations were complicated again by the Machinists who refused to back the buy out and asked the Labor Department to block it on the grounds that it violated the federal standards regarding employee investment funds. Then trouble arose with the financing; British Airways balked at a reformulation proposed by Citibank and Chase Manhattan, causing the stock price to fall. The joint team proposed a new lower bid, but it was rejected by the Board which said that it preferred for the company to remain independent.

Stephen Wolf then declared himself out of any further negotiations for two reasons. He had to return his attention to managing the airline in order to retain the confidence of the Board and shareholders. He also had to deal with the fact that his reputation became somewhat tarnished due to the fact that he would have become quite rich under the buy out scenario he had helped to create. When this fact was realized by the Machinists, they began to question Wolf's motives, and became more amenable to the notion of a full employee buy out.

The Third Round; Joint Union Buy Out Attempt--1990

Failure to obtain financing did not deter the pilots, who had become dedicated to employee ownership. Management and the association continued to discuss their options, but the talks ended when it became clear that management wanted stiffer concessions than the pilots were willing to give. Simultaneously, the pilots had begun discussions with the other UAL unions. The Association of Flight Attendants was crucial to the development of a working coalition, because their support could sway the Machinists. They had been sitting on the sidelines for the most part, but became increasingly interested in the idea as time went on. As a union they have limited leverage because their members are not very highly paid, and are relatively easy to replace. The Machinists had begun to analyze the effect of Marvin Davis' leveraged buy out offer, and realized that the debt burden would preclude them from hanging onto their current wages, let alone get increases in the foreseeable future. They began to think that if they had to give concessions it would be better to do so if they had stock, so that they would end up better off once the debt was paid off. Otherwise they faced pay cuts and no security with regard to wages in the future.

In November 1989, the Conistan Partners, an investor group from New York, disclosed that they owned 9.8% of the airline. Along with that piece of news, they announced that they intended to seek control of the Board. The directors of UAL responded by clearing Mr. Wolf to begin to look again into ways to sell the airline or proceed with a recapitalization. The pilots were looking around for a cooperative outside equity investor at the same time. They met with Conistan, as well as with Saul Steinberg. Conistan Partners gave the unions until January to come up with an offer. All of these events encouraged the flight attendants to express their support for an employee buy out, and the Machinists followed suit. On January 25, 1990 the unions announced the creation of the United Employee Acquisition Corporation (UEAC) intended to accomplish the buy out.

Long negotiations ensued regarding the level of stock and participation for each union. ALPA felt that it had come up with the idea and that it was the driving force behind it, so the pilots wanted to retain their power in a newly formed employee owned company. The final agreement allowed this due to the fact that the pilots agreed to give up more in concessions, so despite their lower membership they contributed more in economic terms.

In March of 1990, the UEAC made an offer of $4.3 billion with 75% employee ownership. The deal included participation by Conistan partners and would have entailed firing Stephen Wolf as CEO. The unions had begun looking for a CEO that would be acceptable to them and to lenders. The Board did not like the offer, but agreed to negotiate with them in order to avoid a protracted proxy fight. In April, UAL the unions raised the price they were willing to pay for the shares, and the Board accepted the offer contingent on securing financing.

At this point the selection of CEO gained importance. The unions knew that they would have to choose someone acceptable to Wall Street, as well as to themselves. Financiers were concerned that a company with significant union influence on the Board would incapacitate a CEO. The unions needed to placate this concern in order to secure funds for the buy out. At the same time, they wanted some one in whom they had confidence and with whom they felt comfortable. They were opposed to taking a top manager from another airline, because they felt that top management was responsible for screw ups all along. They felt that middle management was competent to run the airline, and what they needed at the top was a strong leader to set tone and direction, rather than a micromanager. For these reasons, they looked outside the airline industry, and eventually settled on Gerald Greenwald, Vice President at Chrysler. He had developed a reputation for successful turn-arounds and had a track record of working well with unionized labor.

Wall Street seemed to be comfortable with this choice, and Mr. Greenwald came to the UEAC in May as chief negotiator.

Non-unionized employees became an issue as negotiations proceeded. About 36% of the workforce was non-union or management. The non-union workers organized themselves and announced that they did not support an employee buy out. Speculation was that they were being financed by management. By July, the non-union employees had agreed to participate in the deal and had settled on the wage concessions they would be willing to contribute.

The UEAC also faced a significant challenge in trying to accumulate financing for the deal. The market for LBO debt was skittish, and it was difficult to put together and keep together a coalition of banks willing to participate. In July, Standard and Poor downgraded UAL's outstanding debt. Then, on August 2, Iraq invaded Kuwait destabilizing oil markets and causing great uncertainty for the airlines regarding fuel prices and future passenger loads. CitiCorp Bank and Chase Manhattan both withdrew as part of the financing team. The Board extended the deadline to October, but most parties were not confident that an arrangement could be worked out under the circumstances. The unions lowered their offer. Marvin Davis showed up again, offering to help the unions acquire the airline if the current negotiations fell through. Apparently, they did not take him up on the offer. On October 9, the UEAC had three proposals prepared for the Board. All three were rejected and the Board announced that it would begin negotiations to purchase $22 billion worth of new airplanes.

Conclusion

Upon rejection of the employee buy out proposal, labor negotiations commenced for two of the unions. At this writing, negotiations are still in progress for the Association of Flight Attendents, while ALPA's contract has gone to the membership for ratification. The pilots were able to negotiate an agreement that puts them back to where they were in economic terms before they gave concessions. Despite their success at forcing the company to divest of other businesses, and regaining ground lost during concessionary bargaining periods, the pilots are still interested in owning the company. "Dubinsky hasn't given up hope; 'I'm always interested in a buyout.'" (Business Week, April 1991)

This chapter has provided the basis needed to begin to assess the theories of the firm outlined in the second chapter. The rest of the thesis will return to analysis and theoretical discussion, and will refer to the events described in this chapter.

Exhibit One: Basics of the Employee Buy Out Scenarios

Round One: Pilots Only 1987

Price
$206 per share
$4.5 billion

Share Percentages

80%	Employees (Pilots)
20%	Public

Concessions
25% wage cut for pilots
Unspecified wage cuts for others, but total would be 15% cut.

Other Arrangements
Union participation in selection of first Board of Directors

Round Two: Pilots and Management 1989

Price
$300 per share
$6.75 billion

Share Percentages

75%	Employees
10%	Management
15%	British Airways

Concessions
10% pay cut for Pilots, fewer vacation days, more flying hours,
No Strike Clause for 7 years

Other Arrangements
15 member Board of Directors
3 Union Representatives
3 Management Representatives
9 Outside Directors

Monthly meetings between management and labor representatives

Round Three: Union Coalition 1990

Price
$201 per share
$4.4 billion

Share Percentages

100%	Employees
37.86	Pilots
35.86	Machinists
12.2	Flight Attendants
14.26	Non Union Employees

Concessions
$2 billion in wage concessions over 5 years, starting with $300 million in 1990 increasing to $500 million in 1994.

-ALPA	11% pay cut, decreased pension contributions
-AFA	7.6% pay cut
-IAM	4% pay increase, then wage freeze for 5 years
-Non Union	$55 million contribution

No Strike Clause

Other Arrangements
15 member Board of Directors:
3 Union Representatives, one from each
1 Non Union Employee Representative
CEO
2 Chosen by CEO
8 Independent

Special Voting Provisions:
Union Representatives had power to block certain proposals since major economic matters required approval by 2 of 3 union directors and majority of the Board. If approval was unobtainable, the CEO could try to gain approval of 75% of shareholders (who happened to be employees).

The topics of concern were: amendments to the Articles of Incorporation, a merger, a sale of assets, liquidation, consolidation, any substantial amendments to the by-laws, and recapitalization proposals, stock issuance.

Chapter 4

Interpretations of the United Airlines Case

The last two chapters laid the groundwork for the analysis which follows. This chapter will use the basic models of the firm outlined in Chapter Two to analyze the events of the United Airlines case study described in Chapter Three. I will first interpret the events using the traditional neoclassical models of the firm. Then I will interpret them utilizing the tools of the stakeholder model. As part of this discussion, I will address some the weaknesses in both models and set the stage for a discussion of the future prospects regarding the development of the theory of the firm.

Interpretation Utilizing the Traditional Model of the Firm

In this section of the paper will use the traditional neo-classical theories of the firm to analyze the situation of United Airlines in the 1980s. For simplicity sake, it will interpret the scenarios assuming the general neo-classical approach. I will consider the lessons to be learned from the "economics of organization" approach after the more general interpretation has been completed.

Analysis of the mergers and acquisitions of the 1980s indicates that most of them were undertaken for a certain set of reasons. Those that were intended to increase shareholder value rather than simply redistribute wealth from one set of owners to another usually added value and were attractive for one or more of the following reasons:

- Efficiency gains due to:
  - -Improved management as a result of the pressure of operating with increased debt burden.
  - -Change in management.
  - -Improved incentives for management.
  - -"Synergy" if bring entities that "fit" together.
  - -Ability to cut capital expenditures made by self-interested management that had invested in non-NPV projects in order to be in a particular line of business.
- Tax savings possible due to:
  - -Interest deductions.
  - -ESOP incentives.
  - -Reorganization into trust or partnership to avoid double taxation.
- Outside Investor is interested in undervalued assets.
- Raiders interested in company in order to squeeze value out by cutting wages, firing people, and/or selling off parts of the business
- Acquisition to force "bust ups" in order to create more specialized and efficient firms.
- "Deconglomerization"-place peripheral businesses in better hands.
- ESOP as anti-takeover mechanism.

If one accepts these as the basic motivations behind leveraged buy outs under traditional assumptions about the firm, then it is possible to look at the various buy out attempts at United and assign the motivations for each offer.

Using the traditional assumptions regarding the firm, and the previous listing of reasons for the attractiveness of leveraged buy outs, one could see that the first buy out offer was generated, considered and rejected based on simple economic considerations. The employees made the offer because they deemed it to be a wise investment. The Board would have been interested in the offer due to the chance it would provide shareholders who would be bought out to receive a higher value for their shares than was currently available on the public market. They would have been interested due to the increased value that would be available to remaining and future shareholders due to the improvements that could be made with a new strategy, and due to the increase in value that would arise due to wage concessions. Additionally, they were probably interested in the tax savings and therefore increased firm value that would be generated by utilization of the Employee Stock Ownership mechanism. They might have been further interested in the increased value that might occur due to the "deconglomerization" effort, which would put other businesses in better hands, and allow the cash from those sales to be dispersed to shareholders as a one time dividend.

This second round of offers, by outside investors, would best be explained using a different set of reasons than in the previous case. The outside offers seem to have been made by people who thought that the airline was undervalued and who felt that they could increase shareholder value by improved management of the carrier. One could also see that the offers might not be as attractive as possible because the outsider buyers were unable to extract much in the way of concessions from the unions, and there would be potential for future contention between the parties which might hurt the corporation.

This third scenario in which management and ALPA teamed up to attempt to buy the company can best be explained as an attempt to use an ESOP to divert a hostile takeover. Marvin Davis intended to dismantle the airline. Clearly, this would violate the job security interests of the pilots, as well as of the managers. Some of the other benefits would also accrue to shareholders: improved cashflow due to wage concessions, possible productivity and efficiency improvements due to employee stock ownership, and increased management efficiency due to stock incentives.

The explanations for the final joint union buy out offer would be similar to the ones in the first two cases. Again, the board might be interested in the extra value that might accrue due to improved management under Gerald Greenwald, they liked the tax advantages of an ESOP, they liked the offered price, and they liked the wage concessions.

In general, the neoclassical models allow one to interpret the activities surrounding ownership in economic terms only. One would look to what extra value is created for various parties and could then anticipate what choice they might make. It provides a rational model upon which to make such choices, but it does not allow one to factor other issues into the analysis. For instance, consider the fact that an employee union made the leveraged buy out offer. The traditional neo-classical model of the corporation would not help explain *why* a union would be the party interested in purchasing the corporation for which they work; it does not allow one to understand that job security could be the driving force behind acquisition attempts. It would simply tell you that they see an investment opportunity that would provide them with positive net present value. But, then you would be left to wonder why they chose to organize to buy the whole firm, rather than simply individually investing in stock and creating an appropriately diversified portfolio.

Furthermore, the traditional model does not help one to understand the dynamics that drove management and unions into a coalition to avoid a buy out by Marvin Davis. The traditional explanation would tell you that the Board should have been interested if he offered a good price, and decent prospects with regard to management. You would be hard pressed to explain why his offer was so distasteful as to drive management to accept the prospect of significant employee ownership, nor why labor would trust the management.

Transaction cost theory would provide virtually nothing toward an understanding of the reasons for an employee initiated buy out.

Agency theory would be of the most use in understanding the United Airlines case. It would point out that the firm is made up of a variety of interested parties who use their own particular forms of leverage to get their way. This theory might begin to point out that the employee group felt that its contract was being violated by management, and that it felt action of some sort was needed. It would stop short of understanding that employee ownership would be a tactic that would fall under consideration. This is because agency theorists tend to think that unions provide adequate means for the representation of employee interests and that board representation is unnecessary.

Theories based on neo-classical assumptions regarding the firm provide useful insight into ownership negotiations. Unfortunately, they do not explain the myriad of events that are motivated by reasons other than economics and choices that will maximize shareholder value. This short coming has motivated the search for alternative models that would be of use in understanding the dynamics of firm behavior.

Interpretation Utilizing the Stakeholder Model

The nature of the stakeholder model allows one to analyze the employee buy out attempts from a strategic viewpoint rather than from a purely economic stance. This model does not directly confront economic issues, but looks to what factors influence strategic behavior which includes economic motivation. In an effort to avoid redundancy, I will not analyze each individual scenario, but will simply offer an explanation for the reasons an employee buy out was considered by the unions, and by the lenders.

In order to better understand the dynamics at play in this situation, it is helpful to utilize the notions of exit, voice and loyalty as described by Albert O. Hirschman. His lesson is very simple and will assist in the analysis of the United case.

Exit, Voice and Loyalty Defined

In an effort to understand how individuals deal with lapses of functional behavior by individuals, firms and organizations, Hirschman points out that people respond by exiting a situation or attempting to influence it. The choice of response will depend to some degree upon the amount of loyalty felt by the individual to the organization in question. Exit is uniquely powerful and is generally the manner in which the economic system functions; customers leave a firm, inflicting revenue losses which prompt management to repair its failings.

The voice option generally seen as a political tool. The opposite of the impersonal exit mechanism, voice can be messy as people attempt to communicate their dissatisfaction to some authority who will listen. Voice is defined as any attempt at all to change, rather than to escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge, through appeal to a higher authority with the intention of forcing a change in management, or through various types of actions and protests, including those that are meant to mobilize public opinion. (Hirschman, 1970, p.30)

Hirschman goes on to point out that a member with considerable attachment to an organization will search for ways to make himself influential, especially when the organization moves what he believes to be the wrong direction. "As a rule, then, loyalty holds exit at bay, and activates voice." (Hirschman, 1970, p. 78) The catch is that the effectiveness of voice is strengthened by the option of exit. Furthermore, institutions are not particularly interested in promoting voice mechanisms.

> "It must be realized that loyalty-promoting institutions and devices are not only uninterested in stimulating voice at the expense of exit;

> indeed they are often meant to repress voice alongside exit. While feedback through exit or voice is in the long-run interest of organization managers, their short-run interest is to entrench themselves and to enhance their freedom to act as they wish, unmolested as far as possible by either desertions or complaints of members. Hence management can be relied on to think of a variety of institutional devices aiming at anything but the combination of exit and voice which may be ideal from the point of view of society." (Hirschman, 1970, p. 93)

He goes on to point out that tendencies toward exclusive reliance on one mode will lead to a decline in its effectiveness, and that another mode will be injected again when the inadequacy of the dominant mode is revealed.

These ideas will be particularly instructive as I turn to a basic stakeholder analysis of the case of United Airlines. At this point, I would again like to remind the reader that the stakeholder model has been created as a tool for managers to think about and respond to events in their external and internal environment, rather than as a fully developed theory of the firm. Despite this, I will attempt to use it in this case as an analytic tool to help understand the motivations behind some of the events surrounding the buy out attempts at United.

The Stakeholders

Using the definition suggested by Adam Klein, in which stakeholders are those individuals or groups with the real power to significantly affect the performance of a company, the stakeholders and their interests in this case can be defined as:

- Shareholders as represented by the Board of Directors. They are interested in creating and maintaining a healthy company, and maximum shareholder value. This group is a stakeholder by virtue of the rights afforded under corporate law.

- Senior Management. They are interested in achieving the goals of the shareholders, and in retaining their jobs or keeping good enough reputations to allow them to move to a position elsewhere. This group is a stakeholder due to their ability to direct day to day activities of the firm, and to suggest policy to the Board.

- Debt Holders; Current and Potential. They are concerned with the company's ability to meet its debt obligations. They are stakeholders by virtue of this role; their ability to influence the firm arises from the right to enact restrictive covenants, to call debt, and to influence the choice of managers selected by the union buy out coalition.

- Labor. United has almost 72,000 employees, 63% of which are unionized. Labor makes up approximately 40% of the costs of running an airline.

  Air Line Pilots' Association (ALPA)--7,000 members at United; highly skilled and therefore difficult for airline to replace, highest paid of all airline employees, tend to view union as a professional organization.

Seniority rights are non-transferable, so a laid off pilot starts at the bottom of the heap if he goes to another airline.

International Association of Machinists (IAM)--30,000 members at United; highly skilled but more easily replaced than pilots.

Association of Flight Attendants (AFA)--15,000 members at United; least skilled of the union groups, replaceable with relative ease.

•Government. Sets regulatory policy; interested in healthy competitive industry. Also influenced general labor relations atmosphere in the industry.

As the next step in this analysis, I would like to sketch out the exit, voice and loyalty issues surrounding the various stakeholders. Understanding these issues will clarify they reasons for the attempts to accomplish an employee buy out where workers could control the "quality" of management.

The corporation as formulated under current corporate law, allows for clear exit and voice mechanisms for most parties involved with the firm. Shareholders choose what firms they would like to invest in, and are free to sell those shares on the market when they would like. The Board of Directors is the mechanism which allows them to voice their preferences regarding how the firm is run. Some shareholders may be constrained by feelings of loyalty, and are less prone toward selling shares that simply decline in value. The Board, and annual shareholder meetings provide an avenue for these shareholders to be heard. If they continue to be displeased with the actions of the firm, then they are free to divest of those shares. See Table One (next page) for outline of the exit and voice mechanisms of the major stakeholders.

Debt holders also have legal exit and voice mechanisms. Lenders have the option not to lend to firms which they think will not perform adequately enough to pay back their loans, and they have the right to encumber the loans with covenants meant to limit the activities of management and ensure that funds can be paid back.

Management also has recourse to the exit and voice options. If managers are displeased with actions of the Board, or performance of the company, they are free to look for alternative employment. They can exercise their voice through day to day operations, and often through seats on the board.

Employees, under the current formulation of the firm, have the option of quitting if they are unhappy. Unionized employees have the collective bargaining mechanism for expression of voice, while non-unionized employees rely on more informal modes of communication.

In the United Airlines case, it is possible to see how the dynamics of exit, voice and loyalty created the prerequisites for interest in an employee buy out. The government set the stage for turmoil through deregulation, and creation of an anti-labor environment. The company responded to deregulation with a confused strategy, and with demands for labor concessions. The unions, particularly the pilots, were concerned about the implications this would

TABLE ONE: EXIT AND VOICE MECHANISMS IN TRADITIONAL FIRM

	SHAREHOLDERS	DEBT HOLDERS	MANAGERS	EMPLOYEES
EXIT OPTIONS	Freedom to sell shares	Authority to call debt	Option to resign (recognize that other options usually exist)	Quit
VOICE	Refuse to invest Board Representation Authority over management incentives	Option to refuse to lend Ability to design covenants Perogative to charge interest dependent upon perceived risk	Control over day to day operations Significant influence over board	Power to bargain collectively with regard to wages and working conditions if work force is unionized

have for their long term future. They were concerned that management might mismanage or run the airline down, so that it was no longer a viable business. This directly threatened the pilots job and income security since the seniority system for pilots limits their ability to transfer to another airline at the same point on the career ladder. Unions at United had agreed to significant concessions in the early 1980s, but had all along voiced concern about the implications of this. They had definite opinions about corporate strategy, and felt that they were being ignored, even betrayed. The exit option for pilots is extremely limited due to the seniority system and economic situation of other airlines. Loyalty also runs deep in pilots. As Hank Krakowsky mentioned, pilots had always felt it was "our airline," and they resented the monopoly game they felt was played by senior management. These dynamics led the pilots to search for ways to have their voice heard by the corporation. Since they felt that most traditional avenues were inadequate, when the idea of employee ownership came along, they grabbed it. Not only would it provide them with the voice they wanted, it would allow them to benefit in the future for concessions most thought were necessary today.

Management did not realize the extent to which the pilots would go to be heard, and did not seem to understand the leverage available to them. The high wages of pilots meant that they had "deep pockets" if and when they choose to dig into them. Lenders recognized the power in this, and were therefore willing to discuss a leveraged buy out. Furthermore, lenders felt that in the employee ownership scenario, their voice had been heard with regard to the selection of strong management. It is unusual for a party initiating a leveraged buy out to provide names of future managers to the lenders, but in this case, the unions needed to do so in order to achieve the confidence of potential lenders.

These notions also help one to understand the position of the other unions to a certain degree. The Flight Attendants and the Machinists earn lower wages and are easier to replace. They therefore have less leverage in brokering to have their voice heard, and are somewhat resigned to that fact. The Machinists had a philosophical opposition to the blurring of labor and management that comes with employee ownership, and were, furthermore, uncomfortable with the notion of an airline owned solely by the Pilots. A plan that included adequate voice mechanisms for all employees was attractive, once they realized the other inherent advantages of stock ownership.

The United Airlines case presents an interesting paradox for the stakeholder interpretation. On the one hand, it can be seen as a case in which the voice and exit mechanisms of powerful stakeholders were curtailed, and thereby created motivation to reassert their voice. On the other hand, it can be seen as a situation in which not even the newly activist stakeholders understood the firm as a community of interests.

The proposed structure for the Board of Directors in the last phase would have created the potential for a limited form of stakeholder control of the firm. Granted, it would have been a limited form, since only employees as shareholders, management and investors would have been represented. Other stakeholders, such as suppliers, customers, government, and the general public would have continued to relate to the firm in the traditional manner.

The pilots set the stage for the ownership negotiations of the 1980s. They did not perceive the corporation as a set of relations between parties which could be balanced through a new governance structure. On the contrary, they viewed employee ownership as the best way to reap the economic benefit tomorrow of their concessions today. The reticence of the other unions could be attributed to the limited nature of employee ownership proposed by the Airline Pilots Association. The other unions were excluded from the first two offers, and had to undertake lengthy negotiations to ensure that there voice would be heard in the 100% employee owned firm.

Additionally, the parties did not change their profit time horizon in the manner Aoki suggests occurs in Japanese firms which act as though they are a community of interests. He points out that such firms have a long term time horizon with regard to profits. That does not seem to have been the case in the United Airlines situation. The issue does not seem to have been brought up for discussion, most likely because the employees wanted profits to be maximized for themselves once they were the shareholders.

Some proponents of the stakeholder model see the approach as one that allows for increased participation of workers in strategy, policy and daily work life. The model is attractive because it creates the leeway for issues other than short term profit maximization guide the actions of the firm. In the United case, the desire by employee stakeholders for increased participation was limited to the strategic level, and did not extend to day to day work life questions. Again, the pilots seem to have set the stage for this; they determined, after researching other employee ownership success stories, that increased participation in daily work life simply would not adapt well to an airline. They did think that productivity would improve due to ownership, and they were interested in having a continued voice in strategic issues. It seems that interest in work life control might be less in this industry due to the fact that many jobs allow for relative independence, especially for the pilots who set much of the agenda for the negotiations.

The ways in which the United case does not represent the community of interests model will help to point out the many changes which will need to take place before we realize a transformed model of the firm.

Conclusion

This chapter utilized the predominant theories of the firm to analyze the situation of United Airlines in the 1980s. The different lessons pointed out due to the different emphasis of the theories indicates that each one has shortcomings that limit our understanding of the firm, and which help create the instability faced today. Agency theory and the stakeholder model point out similar lessons since they have a common understanding that a number of parties are affected by the firm and have the power to effect the firm. It is this commonality that indicates a convergence of theories is underway. A new model based on the combination of these approaches may allow for the development of more stable firm relations. The prospects for a convergence of the theories and practice will be discussed next, in the final chapter.

Chapter 5
Conclusion

The theory of the firm to which a society subscribes influences a great many behaviors. Theories are developed as an attempt to describe the world, yet they also provide guidelines by which people learn to behave. The traditional theory of the firm to which Americans subscribe has its roots in classical economic theory. The emerging theories question some of the basic assumptions of the traditional model, and seem to indicate that the traditional model no longer adequately describes the world. The objective of this thesis has been to explore the theories and to suggest some of the issues which will be important in the future if the two predominant models continue to merge. This chapter will critique both models and discuss the challenges that will face the creation of a transformation of the theory of the firm.

Critique of the Neo-Classical and Stakeholder Models

As currently formulated, the neo-classical theories and the stakeholder model do not seem to provide an adequate, stable model of the firm. Neither set of concepts presents a formulation which is full enough to function in the future given the fact that the values of Americans are changing, the economy is in turmoil, and people expect more of corporations than they did in the past.

The neo-classical models explain the economic nature of the firm, and allow one to anticipate and analyze actions only on the basis of economics. The theories were created for the purpose of understanding why the corporate form exists and how they function internally and externally. The classical assumptions about human behavior are extended to the firm, and have provided a compelling descriptive and prescriptive model that has been widely accepted.

The theories which view the firm as a community of interests, on the other hand, are largely still tools used by managers to assist them in management. Aoki asserts that the Japanese view the firm in this way, but it is clear that most American firms do not operate under the assumptions of this model. The stakeholder model was developed for the purpose of understanding how parties will interact in the external and internal environment. This model differs most basically from neo-classical theories by acknowledging the legitimacy of parties that are generally not recognized as such in traditional formulations. The stakeholder concept allows one to develop a strong understanding of the dynamics of a firm especially when combined with a full understanding of the current traditional assumptions regarding firm behavior.

Unfortunately, both models have shortcomings in theory and in practice. While the economic models do not help one decipher non-rational, non-economic behaviors, the stakeholder model is generally silent on economic issues. It seems to assume that the traditional model will hold. Additionally, the community of interests model seems to posit that long term rather than short term profit maximization is the goal of the corporation. This allows firms to take actions that may be expensive in the short term, but which will benefit the firm over the long haul.

With regard to industrial relations, the neo-classical model assumes that our current system of labor relations, as codified by our laws, are adequate and appropriate. Katherine Stone points out that this assumption is no longer operative, because our labor laws do not allow for the forms of participation which have been negotiated into practice in many industries across the country. (Stone, 1988, 1990) She points out that the definition of labor in the traditional model is a tautology since it assumes that employees are "people who by definition do not exercise power through stockownership, board membership or collective participation." (Stone, 1988, p. 138) Yet, in practice employees are becoming owners and representatives on Boards of Directors. The traditional assumption that there is a conflict between the narrow interests of the union and the general interest of the firm does not reflect reality given changes that have been taking place in the operation of firms. (Stone, 1988, p. 150) Furthermore, the neo-classical model of the firm misses the fact that employees might become powerful stakeholders, able to influence corporate strategy through means other than collective bargaining if their voice is not heard. An additional problem lies in the fact that the economists assume that the rights afforded to employees under collective bargaining laws provides an adequate tool for protecting their interests. This ignores the fact that the majority of workers are not organized into unions and therefore do not have this protections. It also ignores the dynamics of exit, voice and loyalty described by Hirshman. The neo-classical model assumes that labor is free to move around dependent upon the demands of the market, which ignores the fact that the exit mechanism is not always an attractive option to employees. They develop loyalty to firms and to geographic locations, they may be trained in a non-generalizable skill, they may be too old to be attractive in the job market, they may not be aware of opportunities elsewhere. For all these reasons, and dozens more, the dynamics of exit, voice, and loyalty impact upon the firm. Yet the neo-classical model does not provide the tools necessary to understand or cope with this. The neo-classical model simplifies the world to a great extent. This makes the theory useful only for economic interpretations of behavior, and ignores other influences.

The stakeholder model also has shortcomings. It does not address issues of economics since it assumes that classical economics holds. It provides the tools for analysis, but is not yet a full fledged theory of firm behavior or model which can be replicated. The stakeholder model does provide a powerful way to analyze and anticipate the actions of players in the firm. It does not discuss how players become powerful enough to be true stakeholders, nor does it prescribe a way to codify the fact of the continued existence of strong stakeholders.

Despite the fact that the models were developed with different purposes in mind, it seems that a convergence of the models has begun. The notion that there are legitimate stakeholders in a firm beyond shareholders has begun to appear in the mainstream economics/finance literature. The term "stakeholder" has gained wide acceptance in strategy and most other business oriented academic disciplines. The notion of legitimacy for employees as stakeholders melds well with the changes that are taking place in the practice of American industrial relations. Changes in corporate governance that incorporated the stakeholder notion could allow for more direct public input into corporate policy, a development advocated today by many. As it stands today, neo-classical theories shape corporate America, while the stakeholder model can help managers understand the dynamics within which they operate. The concepts of the stakeholder model seem to be developing into a full theory, but it seems that a true convergence is possible only in the distant future.

Prospects for the Future

Although the stakeholder model is advocated by some as a better alternative to the traditional model of the firm, there are many challenges that stand in the way of widespread acceptance of a transformed model of the firm which incorporates some economic assumptions and the concepts of the firm as a community of interests. The fact that the stakeholder ideas are undeveloped as a theory and are mainly a tool for analysis means that the notions need to be developed. Thought needs to go into how to create a model that internalizes and balances all the interests present in a firm, in such a way that they may evolve and shift over time. It is necessary to recognize that the constituencies will change over time, and the model needs the flexibility to avoid stagnation and instability.

This means that the representation structure currently utilized by firms would need to be rethought, and altered if it is deemed inadequate. There are many questions to debate before a structure could be agreed upon. As it stands now, board members have a fiduciary responsibility to act on behalf of shareholders. In those few situations where employees are represented on the board, the members can not act on behalf of only their constituency, but on behalf of all shareholders. Would a Board of Directors with representatives of different constituencies be advisable? How will representation of constituencies change the way a board functions? What parties should be represented; is it appropriate for suppliers, customers, and the general public to have representation on the board? Should another voice mechanism be considered for lesser stakeholders? Should the current role of the board be altered so that representatives can consistently and creditably add value to the operation of the corporation? At what levels of a company would stakeholder representation be appropriate? Should a multi-national have various levels of input so that local voices can be heard? Should other internal voice mechanisms be created to address micro level issues? What would be the advantages and disadvantages of such a situation. Another related set of challenges emerges around the issues to be addressed by the stakeholders. Should they be limited to purely strategic questions, policy matters, or simply day to day questions? Clearly, there are many practical questions which might impede the development of a new model of the firm.

Direct stakeholder representation of any sort presents another set of problems. How would representatives be selected? This presents a particularly difficult dilemma with regard to employees and the public. Granted, there are numerous definitions of what a stakeholder is, but this thesis utilized the one developed by Adam Klein which holds that a stakeholder is a party that has the power to significantly impact the operation of the firm. This poses an interesting problem. What about situations in which employees are not organized, and do not play a role in the firm beyond supplying labor power. Should these employees not receive access to voice, or should a mechanism be designed to allow them to organize and express their opinions? It is possible that Adam Klein's definition is adequate for the current situation where stakeholder analysis is a tool, but that the definition would need to be thought through with the new purpose in mind.

The situation with regard to representation of the general public would also pose an interesting problem. Who could legitimately represent their interests--local elected officials, professionals within the government, or new parties altogether? It seems that local government officials may not be appropriate representatives since they are directly impacted through the tax base by corporate policy. Furthermore, what should the qualifications be, how should they communicate with their constituency, and who should bear the costs?

Beyond the questions of representation, are questions about process. How should conflicts among the stakeholders be resolved? Who should have the final say; should management perogative still hold? To whom should management ultimately be responsible?

Before these issues could be addressed, a more basic problem would come into play. How would such a debate take place in the first place? How will some sort of concensus be reached with regard to these issues? It seems that we are in the very early stages of rethinking the nature and purpose of the firm, but that the debate has a long way to go in academic circles before it would make its way to a public forum for debate and resolution.

Resistance to this sort of transformation would come from all sides, even those that might benefit by a reformulation. Shareholders would definitely oppose any proposal that would result in diminished power. Lenders would probably oppose any proposals that make the ability of management to follow their covenants more ambiguous. Managers would oppose codification of a system that would by nature probably be somewhat ambiguous, and which might limit their authority to act independently. Unions would oppose a structure where they perceive that they would have a diminished purpose or role. Direct stakeholder representation could be interpreted by unions as a threat since employees might have more direct avenues of communication with management. Philosophically, most unions oppose any blurring of the lines between themselves and management, so mandated employee representation would be anathema to many unions. All parties and branches of society would have something to say about the role of profit maximization. Should long term profit be the goal, should the healthy functioning of the economy be the goal, or should short term profit continue to guide managers. What are the pros and cons of each formulation?

Another impediment to change lies in the fact that only widespread dissatisfaction would provide a catalyst for such basic change. It is not clear that the problems we are forced to grapple with today will be solved by transforming our model of the firm. It is clear that a debate is raging in academic circles, and that the legal world is also grappling with these issues. But it is not clear that altering the corporate form would fix the problems that currently exist. Even if some sort of concensus evolved in academic circles, it is not at all certain that the practitioners would agree and follow. It also seems relevant to ask if this debate will even take place. Since it is likely that institutions would resist this type of transformation, it may be that only a crisis would be the catalyst for a debate and resolution.

Conclusion

The objective of this thesis was to explore some of the challenges confronting a transformation of the theory of the firm. This thesis accepted that the neo-classical theories of the firm have become inadequate to fully guide our understanding of the corporation, and that they no longer provide the guidance necessary to maintain a stable firm atmosphere. It recognized that new notions of the firm have emerged in numerous disciplines, and that these ideas perceive of the firm as balancing a community of interests of a variety of stakeholders. Theses ideas exist only in the form of models or tools to assist managers, rather than as a full fledged theory of the firm. Yet, the economics discipline seems to have begun to accept some of the ideas of other disciplines. The transformation is in early stages, and does not indicate that a new theory of the firm will actually develop, but it does provide the groundwork necessary to allow a new theory to emerge. This final chapter points out that there are numerous factors to be considered before a new theory would be widely accepted. The challenges do not make one hopeful about the possibility of a transformation, but they also do not mean that it will not happen. Given the turmoil in our society and economy it is possible that a transformation may occur before the academic world has fully debated the ideas. The work up to this point does provide a basis upon which new models can emerge in the real world.

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