Redistribution Within Collective Organizations: What Corporations, Condominiums and Unions Tell Us about the Proper Use of Government Power

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COLLECTIVE ORGANIZATIONS

What Corporations, Condominiums and Unions Tell Us about the
Proper Use of Government Power

Richard A. Epstein*

Collective organizations are common in all areas of human endeavor. In this essay, I shall take a look at the various rules that
govern three different types of private collective ventures: the corporation, the condominium or cooperative, and the labor union (es-
pecially as it is constituted under the National Labor Relations Act
of 1935 and its successor statutes). Once that is done, I shall reflect
on the implications of that analysis on the proper scope and func-
tion of the largest collective venture of them all—government.

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The order in which I consider these organizations is not randomly chosen. The first organization on the list, the corporation, is an entity which is initially controlled by a single party, but later becomes a vehicle in which multiple parties have discrete stakes. The emergence of the corporation can usefully be considered an exercise in voluntary contracting between the original founder of the corporation and its subsequent shareholders—both those who buy in at the original offering and those who purchase shares from previous shareholders. The condominium and cooperative exhibit similar structures in which the developer, like the corporate founder, is the fulcrum for the future organization with its highly dispersed membership. The two relationships differ from each other in this important feature: in the corporate structure, each individual shareholder has a partial claim on the assets that are in corporate solution (i.e., held directly by the corporation), but only on those assets. However, with a condominium or a cooperative each member of the organization has a private interest—the house or apartment unit—as well as a share in all the common elements of the overall facility. The interplay between the private and public elements creates a conflict of interest that does not arise in corporate settings, where no such private assets exist.

The third entity, the labor union, is quite different from both the corporation and the condominium, because these unions never arise through unanimous consent of their members. There is no single founder of the institution who sells off shares to others. Instead, there is typically an electoral process which includes the employees within the confines of an appropriate bargaining unit. That election can result in the selection of a union to serve as the exclusive bargaining representative for all unit members, including those individuals who were opposed to the creation of the union. The governance structure therefore takes a larger bound, given that major conflicts of interest are built-in on the ground floor.

It follows that we can place these three types of organization in an implicit hierarchy. All things considered, corporations are on average likely to have lower levels of conflict than a condominium.
or cooperative, which in turn will have lower levels of internal conflict than a union. This generalization is subject to one key qualification, which is that the level of conflict does not depend exclusively on the nature of the entity and its mode of organization. It also depends on the divergence of preferences of the individual members of that organization. The greater the homogeneity in tastes, the easier it is to make collective governance decisions. At the extreme, if all individuals have identical preferences with respect to the common operation of the organization, then in principle all conflicts of interest disappear, as the preferences of each person are a mirror image of the collective preferences of the group. But by the same token, for any given distribution of preferences, it is likely that conflicts of interest will materialize in the order I have presented. The corporate situation will be the easiest, then the condominium or cooperative, and last the union. Needless to say the large form of any political association, be it the town, the state or the nation, raises conflict of interest issues that could easily dwarf those found in union type settings. For these reasons, it is easiest to start with the corporation and then work outward.

I. THE CORPORATION

The central challenge for the founder of a new corporation is to persuade potential investors to put their wealth into corporate solution, over which they will have very attenuated control. The individual shareholders will make that decision, either separately or together, if they expect the value of their investment in the corporation to be greater than the value of the cash and other assets that they are asked to contribute. Making that determination is not easy, because of the inherent difficulty in valuing rights that are tied up in complex business organizations.

The actual determination of whether to invest depends on the interaction of two related vectors. The first is the nature of the productive activity that the entity proposes to engage in. That activity must promise a rate of return that is equal to or greater than that
associated with other activities. As a matter of legal theory, there is little that lawyers can do to ensure that these business decisions make sense. They are normally not experts in the particular technologies that a new firm will use or the markets that they wish to enter. For those issues, firms typically rely on ordinary line personnel. Lawyers of course must understand these activities to do their own work. But where lawyers and legal structure come into their own is in crafting and interpreting the legal rules that allocate the return of profit, whether by dividend or liquidation to various stockholders. In this connection, the key pieces are the governance structures that are put in place to secure each investor an appropriate return on investment.

These structures are of two types. The first takes the form of explicit protections against expropriation of the investment, e.g. by majority vote of the shareholders. Thus a policy that allows the corporation to sell off all corporate assets and distribute the proceeds of sale only to a fraction of the shareholders will be dead on arrival. Those individuals who think they are outside the control group will never put themselves at risk, any more than (outside the corporate context) they would give their money or property to another individual who announced in advance that he would never return them.

The second constraint is one that assures to each shareholder a rate of return that is proportional to the size of his or her investment. If this constraint is not observed inside the corporation, its key officers and directors will be allowed to allocate the gains from corporate operations to different shareholders in whatever proportion they think appropriate. Thus in a group of 10 shareholders, each of whom has contributed $100, the corporate directors could take a gain of $500 and allocate it to a tiny fraction of the overall group, leaving others out in the cold. The common requirement of a pro rata distribution of the gains on a per share basis is meant to foreclose that possibility. By guaranteeing that fixed rate of return, both large and small investors can live together in relative harmony, each knowing that the other group will be powerless to make
dividend distributions or liquidation payments that are skewed in favor of one group or the other. The greater certainty in distribution thus removes an important risk of factional struggle, which from the ex ante perspective is in the interest of no party. The expenses of litigation, and the uncertainty that litigation has to resolve, are costs that no one wants to bear at the time of corporate formation. These simple legal rules are intended to forestall the risks of implicit redistribution within the corporate form, which reduce the rate of return to all participants in the common venture.

In dealing with this form of stability, it is important to distinguish between public and private corporations. In the former, corporations have large numbers of shareholders, most of whom share no common personal interest with their coinvestors. With private corporations, the parties in question are often members of the same family or a close group of business associates. The risk of redistribution through improper actions by corporate officials is greater in the public corporation than in the private one, because the affective ties among the shareholders, and their greater ability to monitor each other's conduct, reduce the risk of systematic expropriation. In these private, or closed, arrangements, there is often heavy overlap between the shareholder population and the officers and directors of the corporation. At this point the relationships are deeply personal, and all members of the corporation have strong knowledge of the preferences, abilities and intentions of the other. Given this higher knowledge base, it is often advisable to have multiple classes of stock—voting and nonvoting, common and preferred—to reflect the different risk positions of the various individuals. The senior generation, after it turns over the control of the corporation to the next generation, may well receive a preferred stock that sits between the common and any outside debt. The control generation may receive common stock whose value is more responsive to changes in corporate value, which in turn is driven by the decisions of the controlling group.

In the public corporation, the overlap between officers and directors on the one hand, and shareholders on the other, is likely to
be far less complete. Even in those cases where officers and directors have substantial financial stakes, they amount to only a small fraction of the overall capitalization of the firm. Similarly, the ability of individual shareholders to monitor the operation of a vast enterprise is weaker in public corporations, because of the diffuse and diversified holdings. Accordingly, simplification of the capital structure is far more important in these settings, because it reduces the risk of financial manipulation which could short change the holders of either the common or preferred stock at the expense of the other. One example of this systematic risk involves the choice of investment projects. Common shareholders will be more willing to enter into risky projects, knowing that if those projects fail, the preferred shareholders will take a disproportionate share of the loss. Yet on the gain side, the common shareholders will profit as the preferred shareholders are limited to the extent of their participation. It is very difficult to police these conflicts, and much more expedient in many cases simply to adopt a single class of shares in order to eliminate this conflict of interest.

To be sure, similar conflicts can arise with creditors of the firm, who are not shareholders and to whom no fiduciary duties are owed. But in this context, the solution rests in explicit covenants which give the creditors as a class some control over the way in which funds are used and the way in which the creditors can monitor firm activity, displacing management if certain prespecified conditions are satisfied. And this difference matters, for fiduciary duties are hard to discharge when there is a conflict of interest between two different classes of beneficiaries. The debt/covenant structure eliminates those conflicts of interest by substituting strict legal obligations to the outsiders and leaving the fiduciary duty to the insiders. It should be clear that the entire system would collapse if the roles of the shareholders and creditors were reversed. It could not work if those persons who had the fixed return were in control of the operation of the business, for they would have no interest in its upside. Likewise it would be impossible to attract equity investment if these shareholders did not have, either directly or
through their voting rights, some say in the control of the business. Indeed one of the most delicate transitions occurs when the equity is compromised so that a credible (but not certain) claim could be made that control rights should shift in whole (and rarely in part because of the risk of divided control) from the old equity holders to the former creditors who are now the new equity holders.

Overall, therefore, the simpler capital structure (with or without debt) increases the practical alienability of corporate shares, as the common shareholders do not have to worry about determining the prior uncertain claims of the preferred shareholders when making their own judgment on whether to buy or sell the shares in question. That element of alienability is of great importance if shareholders need cash in order to tend to their own personal needs: Stock originally acquired to save up for children's college must eventually be turned into tuition payments. Selling shares is often a better way of doing that than mortgaging the stocks because it avoids the problem of leverage that borrowing necessarily creates. But by the same token, sometimes people do prefer to mortgage stocks because (even when the transaction is nonrecourse) the loan does not generate any immediate tax liability. Yet the ability to mortgage depends in large measure on the variation in value of the shares. High variation in asset value presents greater risks to lenders than does low variation. The flat capital structure reduces any variance in share capitalization, so that shareholders in public corporations are often unambiguously better with simple corporate structures, regardless of whether they choose to sell or mortgage their shares.

It follows therefore that the greater the certainty in valuation, the more likely it is that shareholders as a group can realize the full value of their fractional interest in the corporation. To be sure, this alienability will not be as effective in stopping corporate abuses by management, because the purchaser of the shares in question will mark them down in value to take into account the potential conflicts in the firm. But even here there is some modest protection because of the differential tolerance for these conflicts across potential
shareholders. Those individuals who dislike risk will sell their shares to individuals who are more comfortable working in a risky environment, perhaps because of their greater institutional willingness to exercise voice in the operation of the corporation.

To be sure, once all the complications are accounted for, shareholders in a public corporation may well find that the riskiness of this corporate venture does not quite align with their own individual preferences. But that downward pressure on value can be handled by putting the shares of these public corporations into a portfolio that also contains other common stock and other forms of debt instruments. Diversification of the portfolio is an effective way in which to control the risk, without having to compromise on the efficiency of capital structure within any particular firm. Therefore a transparent capital structure can have a very powerful influence on the way that people think about whether or not to go into these ventures. Of course, the success of the venture itself may hang in the balance: Unless a promoter can get individuals to subscribe in large numbers, they will not be able to amass the amount of capital needed to launch some major project.

A second device that allows corporate promoters to avoid the risk of redistribution within the firm is the simple device of limited liability. Without that protection, there will be individuals with vast amounts of personal wealth who, under a standard partnership model, could be liable for the entire debt of the corporate ventures, especially if other investors have no private wealth to answer for these claims. If a venture capitalist wants to amalgamate large sums of wealth from powerful and rich individuals, it has to give them some assurance against confiscation, which means that they must have guarantees that the amount of money that they stand to lose is no greater than the amount that they commit in the first place. The promoter can increase that amount above the original contribution by subjecting shareholders by contract to various calls to the corporation for additional contributions, or guarantees of one sort or another. The key trick in all of these relationships is to limit the public
exposure of shareholders, which the corporation or the limited partnership does.

There is also an additional benefit from limited liability that is less commonly appreciated. Limited liability takes all shareholders who are not officers or directors out of the management structure. This means that each individual shareholder has far less reason to worry about who else has become a shareholder in the firm, given that none of those other people will have any say in its day to day operations. In effect, limited liability works a grand bargain of mutual noninterference of shareholders (or limited partners) in the operation of the business. Each shareholder or limited partner in effect has said to the others: "I won't involve myself in management so long as you don't involve yourself in management." The gains from higher competence, ease of monitoring, and the reduction of factional intrigue make this conventional division of power the dominant solution in a wide class of cooperative arrangements.

Shareholders also enjoy another form of protection against illicit forms of redistribution in the form of the entire fairness rule, which in critical conflict of interest situations replaces the more lenient business judgment rule. In many cases, shareholders and the corporation work in the same line of business. The extensive overlap in business interest means that there are often gains from trade between a corporation and its individual shareholders. The question arises as to the standards by which these transactions should be evaluated, given the obvious risk of conflicts of interest. One possibility is to deem the potential conflict of interest so serious that it is better not to carry out any transaction at all. In some cases, that result may indeed make sense, at which point explicit prohibitions may well be in order. But that extreme position is often a case of overkill if the individual shareholder has distinct complementary skills.

A far better response in most cases is to allow the transaction but to subject it to higher levels of scrutiny in order to guard against the risk that an unfair balance of trade will siphon off firm assets for the benefit of individual shareholders. The so-called "fair-value"
rule in effect provides that when any such transaction is challenged, the firm is required to show that the gains to the corporation in either goods or services are equal to or greater than the value of the cash or other property surrendered in the deal. In these self-dealing transactions, all bets are off because the institution in question is dealing with one of its key officers or shareholders, and there is a great temptation on the part of management to overpay related parties for services they render or to sell things to them at a price which does not reflect their full market value. These behaviors increase the extent of involuntary redistribution, which in turn calls for high levels of supervision, which if neglected will raise the cost of new investment and thus reduce its extent.

In practice the fair value rule is yet another variation of an all purpose "just compensation" rule, which says that when a corporation buys or sells, it must make the corporation richer than it would have been beforehand, in approximate proportion to what would be likely to occur in an arm's length transaction. The last point is always sensitive because of the inherent difficulty in finding devices to see how best to allocate the joint surplus between the parties in those cases where the transaction properly goes forward. Since these deals are asymmetrical, it is not possible to rely on a proration rule to split surplus, which makes the burdens on alternative modes of valuation even greater. But it is critical to note that this difficulty is not a fatal objection to the enterprise. Just knowing that the transaction is subject to scrutiny could easily move the two parties closer together.

A less obvious benefit of the "fair value" rule is that the higher cost of oversight with respect to self-dealing transactions will often induce the firm to seek out an independent contractor to whom the softer business judgment rule applies. Now that the conflict of interest risk is abated, the general duty is one of loyalty, and so the reviewing court will not normally second guess a business transaction entered in good faith, even if it goes bad. In contexts to which the business judgment rule applies, the individual officers and directors who are negotiating these transactions have personal inter-
ests that on average are relatively non-distinguishable from that of the shareholders. What the business judgment rule says is that once those interests are properly (but never perfectly) aligned, the only way that key officers and directors can profit with respect to their own holdings is to extend like profits to other shareholders or partners as well, so that in the typical case the basic stock or partnership structure generates pro rata gains to all the individuals in question.

The business judgment rule, then, works when other features of the economic landscape make it difficult for management types to turn a profit for themselves without doing so at the cost of somebody else. That rule is essential because nothing will drive able people from fiduciary positions faster than the sure knowledge that they will be required to compensate the firm for its losses when they cannot capture all the gains from successful transactions. Functionally, the compensation that is supplied to the shareholders comes from their ability to keep these gains, which are more likely to occur when able people, shielded by the business judgment rule, are at the helm. Where the risk of covert redistribution is low, the level of judicial oversight is necessarily reduced as well.

In sum, the full range of rules dealing with corporate responsibility do not supply the engine for advancement or the basis of innovation. But what these rules are able to accomplish is to remove some of the business risks that make individuals reluctant to commit their assets to a corporate or limited partnership venture in the first place. One can quarrel with disputes around the margin of this basic system, but there is nothing that undermines the system as a whole.

The last piece of the puzzle lies in the corporate (or partnership) opportunity doctrine, which provides that an individual officer or director of the corporation cannot divert to private use opportuni-
ties that were directed to that party in their corporate capacity. The point here is that the same fiduciary duty requires that party to respond to the duty of loyalty that is inherent in the office. But like all doctrines, corporate opportunity has its own fine points. There are many cases in which the officer or director has his or her own business, or in fact assumes these rules for multiple corporations. It is therefore not always clear to which entity the outside offer is directed. In principle, the outside party, as master of his own offer, can decide who receives that offer, but in some cases difficulties can arise when the role of the relevant party is not clearly specified in advance. But in these cases, the correct response is to get clarification of where the offer is intended to go, and to respond in time. In addition, the director or officer could enter into an explicit agreement with the relevant firms to decide how to proceed. What is most important in these areas is sensitivity to the relevant risks to which the corporate opportunity doctrine is directed.

II. CONDOMINIUMS AND COOPERATIVES

Let me now turn to a brief discussion of the risks of redistribution in connection with condominiums and cooperatives. The initial point here is that all of the risks of redistribution that arise when individuals are asked to contribute to entities in the corporate or partnership form are present in this context, so that institutional arrangements have to be set into motion to guard against risk of expropriation, including the use of both a fair value and business

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judgment rule for the association board members. Here it is more difficult to control these conflicts, for the simple reason that far more than financial interests are at stake when people have their apartments or homes, and their families and friends, wrapped up in these organizations. Now their concerns are not just with the protection of their cash and property, but also with the personal subjective value that they hope to derive from their homes. In these settings, differences in taste can easily lead to differences in how association members respond to collective initiatives. Rooting out conflicts of interest thus poses a real governance challenge. Fortunately, certain techniques are available to aid in their control.

The best place to start is with the potential conflicts that arise on the formation of these organizations. Unlike corporations, condominiums and cooperatives are almost never started by people who have separate holdings banding together under a common governance arrangement. Six people living on the same block may wish to form a condominium association, but they will find it heavy going because they have no way to measure the value of contributions or to put in place a sensible governance structure. It follows that these collective organizations emerge full born, as it were, from a single developer who figures out the layout and kind of units. The task is not easy, if only because variations in topography and views often make it difficult to achieve rough equality among all units. Developers have to create some units with good views of the water or mountains, some with poor views, and some with no views at all. They have to create some large, some small and some medium size units, all located on different portions of the site, each with its distinctive attributes. Given the built-in degrees of heterogeneity in any real estate project, the developer can rarely claim the advantages of a single class of stock that is open to public corporations. Instead, there are hard pricing questions, which often require a complex governance structure to help keep the potential conflicts of interest among the new home or apartment owners down to manageable levels once the entire operation is up and running.
Yet another set of difficulties arises when the various units are not sold at the same time. The common, and clever, way to deal with this risk is that the developer starts off by organizing a common plan which allows him to sell off the units sequentially, such that the rights of new buyers do not depend on the order in which the new units are sold. The key point is that the relationship of the units to the common plan is fixed in advance so that each new owner has the same relationship to all other owners and the association regardless of the relative order of the purchase. At this point no one need hasten or slow down a purchase in order to get some strategic advantage against other individuals. This does not mean that the timing of these purchases does not matter; for business purposes, it still does. A developer is often willing to make price concessions at the outset in order to attract tenants who other future buyers will find desirable. And that same developer will opt to raise prices when and if the units in question gain market acceptance. The use of these common plans thus eliminates a legal risk that no one wants to bear, without pricing freedom of the developer over the original sale cycle.

Once this system is adopted, it is no longer necessary to try to put an organization together through a series of bilateral contracts among all potential unit owners, each concluded at different times on different terms. By interposing a central party, a condominium with 50 members need have only 50 contracts that run through the center, each binding each owner to all the others. But if bilateral agreements were required, each individual would have to have an (inefficient) contract with all other 49 owners, for a grand total \((50 \times 49)/2\), or 1225 contracts. Yet perfecting the legal framework for these arrangements did not come easy, for these restrictive covenants were hemmed in by requirements that the covenants run with the land, which meant that it was hard to find a landless middle-
man to organize the overall system. Indeed it was only by the late 1930s in Neponsit Property Owners Association v. Emigrant Industrial Savings Bank,\(^2\) that the problem was finally sorted out.

It still remains to determine how the initial single owner prepares for the creation of the new association. Typically, the first move in the conflict control business is to demarcate those elements that count as private and not subject to compromise by a collective decision. Individuals get the exclusive right to use their own property, thereby removing a very large fraction of total investment from collective control. On the financial front, the assessments imposed are usually predetermined at the original creation of the entity. At this point the individual buyers can adjust the price of the units to reflect the burdens of special assessments and the parallel benefits of joint control. The developer in general will do better if the assessments and control rights are proportionate to value, if only because it reduces the possibility of gamesmanship once governance over the association passes to the members.

One consequence of this demarcation is that it creates the necessity of devising rules once the units are sold, to decide which costs should be allocated to the owners of individual units and which to the condominium association. In the Narragansett condominium that my wife and I owned in Chicago between 1974 and 1980, the organization developed explicit rules to allocate the costs of leaks within the building. Essentially, and for ease of administration, liability turned strictly on the location of the leak. If the leak occurred within the confines of the unit, its owner was responsible for fixing it and paying for consequential damages. But if that leak arose in one of the common elements then we shared pro rata.

Or did we? One problem that arises is whether the common costs are borne by all owners, or whether those on the west wing,

\(^2\) 15 N.E.2d 793 (N.Y. 1938).
for example, are responsible for their costs, and those on the east wing are responsible for theirs. There are two ways to allocate these burdens—one of them is to say that each wing bears its own loss, so that all unit owners live and die by the luck of the draw. The second option is to hold that everybody is part of the common enterprise, so all insurance is against future common risks. If the losses happen all on the west wing, their owners win; if on the east, their owners win.

The only strong rule that binds under these circumstances is also the public rule with respect to special assessments. When choosing between these two kinds of coverage rule, consistency is essential. The owners on the west wing can’t be forced to bear their own costs while the east wing owners spread their costs over the entire commons. All owners have to elect the rule in advance, which the governance body then applies quickly and consistently. Let the agreement deviate from that consistency requirement, and there is a real risk of a taking that could allow for enjoining the operation of the rule. But note that corporations don’t have east and west wings, so they are not generally subject to this source of stress, at least until they enter into some imperfect joint venture.

Similar issues can arise with the allocation of the costs of repairs and improvements. As with liability issues, one possibility is to take them into account one at a time, at which point it becomes difficult to determine which units benefit from a particular change and which not. Part of that difficulty stems from the fact that certain repairs (say of a given walkway) are much more important to some unit owners than they are to others. The effort to prorate costs to net value, however, invites huge disputes on questions that do not admit any clear answer.

As with disputes over liability, one possibility is to avoid these squabbles by having all repairs paid for out of a common fund, in the hope that the errors will cancel out over time, which in turn will reduce overall administrative costs. Another approach is to fund these repairs through insurance that is paid collectively. That solution works if the actuarial values are correctly calculated. But it will
not work if the benefits are collected pro rata, when it is certain that
the actual expenditures will systematically deviate from those pro
rata contributions. One possible way to split the difference is to
avoid valuation exercises for high frequency, low value expendi-
tures, but to make them for low frequency, high value expenditures,
where the administrative costs make up a smaller fraction of the
overall expenses.

A similar division can be made with respect to big-ticket im-
provements that occur only infrequently. Yet here a further tension
is created with respect to the differences between objective and sub-
jective value. To see how this arises, assume that there are some
members who value their units and their environs far above the
market rate, and have no intention to sell. For these individuals the
only proper valuation is subjective, and it is possible that they will
object to many changes intended to enhance market value, since
market value is of no value to them. Put otherwise, the long-
termers may well rank subjective value higher than the cost of the
improvement, which they will then oppose, even if short-term resi-
dents think that the cost of improvement is less than the price in-
crement they can acquire when they put their unit on the market.

Even small improvements can generate major controversies, es-
pecially when tenants are from different age groups or have differ-
ent levels of wealth. Here is my second Narragansett story from the
1970s, which helped persuade my wife and me that it was time to
consider home ownership. At one acrimonious annual meeting, a
huge debate erupted on the question of what kinds of phones and
guard service should be placed in the lobby for sums of about $200
per month. Indeed, there was a thirty-minute debate as to whether
the phones in the lobby would be two-way communication devices
or one-way communication devices. On the one side were individ-
uals with greater wealth and children, who wanted higher services,
and on the other were retirees, presumably with lesser wealth and
no children at home, who wanted fewer services with the attendant
cost savings. The bipolar distribution of sentiment guaranteed a
long debate in which the losers (and I cannot remember who they
were) felt dutifully aggrieved. However (to my knowledge), nobody moved out solely on account of this conflict. In this case, the exit right is far more costly to exercise than it is with the sale of corporate shares. Indeed, with corporations, a diversified portfolio is a good way to hedge risk. But in a condominium, it becomes absolutely critical to make the right judgments because these specific assets are not diversifiable. No person can sensibly buy a 1% interest in 100 condominiums, and choose not to live in any of them. In these contexts subjective value matters across the board, so each owner would like to have the veto right over others.

If it turns out that heterogeneity is a real problem, it should come as no surprise that developers, anticipating their customers’ preferences, have strong incentives to impose multiple restrictions on all future association members. These restrictions are intended to reduce the level of variance by keeping out individuals along certain well-defined dimensions, some of which include wealth, age, pets, family members and amenities. These preferences matter in exercising control over public areas which are limited public goods to which each association members has a right to access, but which must be shared with others. Any distribution conflicts that arise ex post will be embedded in the price that a future condominium or cooperative owner will pay for the unit, both at the time of original sale and thereafter. The feedback mechanism means that the initial developer has to capitalize (negatively) the costs of a bad governance design. The point applies with equal force to such sensitive issues as race and religion, where powerful public “human rights laws” impose strict antidiscrimination norms on these operations, a position that is likely to prove contentious and counterproductive, given that no government knows enough to make judgments as to who should be a member of what collectivity and why. Any relaxation of exclusion rules, whether coercive or voluntary, will always increase governance costs thereafter. The difference is that trade-offs are made more accurately by private developers than by government regulators who never bear the costs of their own decisional errors. This is not to say that members of these associations prize
homogeneity on all dimensions. Diversity on racial and ethnic lines is a key value for many homeowners, and that value is in turn reflected in the way in which some voluntary organizations constitute themselves. The argument for private ordering in these cases is that on balance the total number of associations will rise as government impediments to voluntary organization are reduced.

The last issue that faces a condominium or cooperative concerns the alienation of units. In one sense that problem is always more complicated than the routine sale of stock in a public corporation. Recall that shares and shareholders are usually fungible, so that it is only with some kind of takeover transaction that sales of shares by individual shareholders becomes tricky, as each shareholder has to take into account the responses of other shareholders in deciding whether to hold, sell or tender their shares. Otherwise, these transactions are built for speed in order to create a highly liquid market that permits accurate valuations. In contrast, the sale of a condominium or cooperative unit bears a far closer relationship to the sale of a share in a closed corporation or family business, because the identities of the parties matter. Not only does partial control depend on who moves in or out, but the choice of tenants could influence the quality of life inside the organization. The transfer of houses and apartments is not built for speed, given both the values involved in the transaction and the importance of making sure that all the deeds and papers are accurately drawn.

In dealing with this question, there is an important difference between condominiums and cooperatives: only with the cooperative does the Board have a veto position on sale. In effect, these organizations are dominated by long-termers who are not concerned with market values, but with the particular living environment and the high subjective values it generates. In a cooperative, the debt paper is often on the building as a whole, in which each of the unit owners technically own shares. The common debt means that the board has to make sure that the new owner can pick up his or her share of the common debt; thus, all potential buyers are screened by the board or its delegate before the transaction can go through. In a
condominium, the debt is parceled out to unit owners, each of whom has a lien only on his or her separate property. Accordingly, the Board typically can block a transaction under the condominium bylaws only if it is prepared to buy the property at the stated price. Most new projects take the condominium form, so it seems clear that the imposition of extra barriers on moving is far from becoming the dominant solution. Yet from a distance, the full set of rules running from acquisition through management to disposition are consistent with the hypothesis that the initial single owner developed a set of rules that maximized its return by providing subsequent takers with the best available institutional structure, given what was known at the time. Relative to public corporations, the differences are exactly what we should expect from businesses that start out with one owner, whose covenants and restrictions can optimize the value of the common resources even after they pass by contract into private hands. The same cannot be said of unions, which start, as will become clear, from very different premises.

III. UNIONS

The most instructive way to attack the union question is to look at the form that unions take when they are governed only by the common law rules of property, contract and tort. In this situation, membership in a union is only obtained by voluntary acceptance, where the worker hopes to use union representation to gain bargaining leverage against employers that more than not offsets his loss of autonomous choice in accepting or turning down job offers. As with corporations and condominiums, the union has to organize its internal operation to assure each member that the costs of joining are kept lower than benefits acquired through collective action.

In an unregulated environment that objective is difficult to achieve. The first challenge is that unions have no right to force their labor on reluctant employers who refuse to do business with them. Given that labor markets offer a large range of employees, the employer can usually look elsewhere. If any union tries to block by
force the employer from hiring other workers, that union is guilty of the tort of interference with prospective advantage. If the union tries to induce workers to break their contracts while in the employ of the firm, it will be guilty of the tort of inducement of breach of contract. If the union tries to lure a firm's business partners away, it could be guilty of a collective refusal to deal under the antitrust law. Faced with all these obstacles, it is difficult to organize a firm without the backing of force, given the lengths to which most firms will go to avoid unionization. The purely voluntary model does not work very well.

It is precisely for this reason that unions have always sought exemptions from the application of general common law rules. That movement first bore fruit in Great Britain with the passage of the Trade Disputes Act of 1906, which had three major provisions. By the first, it held that union contracts were not subject to private rights of action. By the second, the tort of inducement of breach of contract was barred with respect to union activities. By the third, the antitrust (or conspiracy) risk was neutralized by a provision that actions done legally by one person did not become illegal if done by the members of a labor organization, which effectively nullified the antitrust risk. The ominous words were: "An act done in pursuance of an agreement or combination by two or more persons shall, if done in contemplation or furtherance of a trade dispute, not be actionable unless the act, if done without any such agreement or combination, would be actionable."

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4 Trade Disputes Act of 1906, 6 Edw. 7, ch. 47.
The common law in the United States often flirted with the position taken in the 1906 Act. Then Judge Holmes in *Vagalahn v. Gunter* wrote "[t]here is a notion, which latterly has been insisted on a good deal, that a combination of persons to do what any one of them lawfully might do by himself will make the otherwise lawful conduct unlawful. It would be rash to say that some as yet unformulated truth may not be hidden under this proposition."\(^5\) In typical Holmes fashion, he never answers the question he raises. But there is no doubt that his views were influential in securing passage in 1914 of the Clayton Act,\(^6\) under which Section 6 exempted unions from the antitrust laws in an obvious imitation of the 1906 Trade Disputes Act.\(^7\) But by the same token, even this protection of the union position did not force management to bargain with unions and left them free to hire other workers more to their liking. It was therefore only with the National Labor Relations Act of 1935\(^8\) that unions were able to achieve a position of real strength, acting as the exclusive bargaining representative of the workers, and chosen typically by an election of workers within an appropriate unit, with whom the employer had a duty to bargain in good faith. The union was protected against the antitrust risk. It could disrupt preexisting contracts with impunity.\(^9\) It could force the employer to the bargaining table. There is no question that this structure provoked in the short run a substantial increase in the number of union workers.\(^10\) The great social development that occurred with the pas-
sage of the NLRA was the rise of the Congress of Industrial Organizations, which offered plant-wide approaches to collective bargaining that stood in sharp contrast to the craft union bargaining favored by the American Federation of Labor.  

Nonetheless, the feature of the current union arrangement of greatest relevance here is a necessary consequence of the union elections that were legitimated by the NLRA. The union is rarely, if ever, formed with the unanimous consent of its members. Unions are, as it were, born in sin. Indeed, even if there are clear majorities at the time of recognition, the membership could split on specific issues that arise down the road. That brute fact of divided sentiments makes unions more difficult organizations to operate than either corporations or condominiums. The inevitable presence of dissenting workers and the ongoing need to maintain majority support and create opportunities for the redistribution of wealth among workers through union power are far greater than the similar incentives in our first two cases. Indeed much of the decline of unionization is attributable to the difficulty of maintaining this wobbly institutional structure in the face of determined employer opposition, which is often intent on splitting the loose and imperfect union coalition at every possible opportunity.

Thus from the outset it is clear that the unions do not operate with complete contingent state contracts that will identify specific protections (we won’t condemn your unit), to optimal sharing arrangements. Given governance by majority rule, the heterogeneity problem with union membership turns out to be extremely persistent because it is only with difficulty that unions can overcome free-rider and expropriation risks. There is at every juncture the risk that

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some initiative that gains the support of the majority union membership will work a negative harm to some identifiable minority. The larger overall union pie may offer a smaller slice to those minority shareholders. Just this prospect is one reason why workers with foresight are often leery of casting their lot with a union, which means that the outcomes of these elections, especially today, are far from certain. Thus skilled workers who are in a distinct minority in many plants often fear the leveling effect that will arise because the union will tend to favor in its negotiations the more numerous unskilled workers. There is a wonderful passage from Justice Holmes from Vegelahn v. Gunter,12 which explains the appeal that unions had to many intellectuals at the height of the labor movement around the turn of the last century:

One of the eternal conflicts out of which life is made up is that between the effort of every man to get the most he can for his services and that of society disguised under the name of capital to get his services for the least possible return. Combination on the one side [meaning capital] is patent and powerful. Combination on the other side is the necessary and desirable counterpart if the battle is to be carried on in a fair and equal way.13

But this passage is deeply flawed in its analysis of the overall position. It is of course the case that it is easier for “capital” to band together than it is for unions to organize a workplace. Holmes’s analysis overlooks that the collectivization of wealth in the capital markets need not, and typically does not, create monopoly structures, but efficient competitive firms. Shareholders will commit to these ventures even if there are no monopoly rents to secure, be-

13 Id.
cause the corporate form allows them to engage in scale ventures that they could not do in acting in their individual capacity, and they do so under arrangements that guard against the risk of expropriation. But workers cannot organize in this efficient fashion, and instead do so in order to act like a cartel with power against the individual firm.

At this point the union faces two problems, each of which has negative implications for overall social welfare. The first is that all collective bargaining arrangements in the labor context raise the serious issues that accompany bilateral monopoly situations, in which, when the workers come together under an exclusive representative, they change market structure in a way which doesn’t happen when the firm organizes its shareholders. The market is no longer competitive, which means that there is no unique wage schedule that could come out of collective bargaining. There are no longer small continuous price adjustments. In their place come larger movements that can easily result in lockouts by the employer or strikes by workers, neither of which have any role to play in competitive markets, which make these dramatic gestures futile, as other firms will expand capacity to fill up the gap.

That basic point about overall market instability interacts with a second, which is that once the aggregate compensation figure is set, there is no unique allocation of those supracompetitive wages among various unit members. Their distribution is subject to some degree of discretion within the union even after peace is made with the employer. Hence political infighting within the union over salaries and the other conditions of employment remain persistent, even if they do not give rise to open warfare on the matter. At this point, conferring monopoly power on a union allows it to claim rents, whose destabilizing effect on internal governance systems
makes them less effective than they would otherwise be. The dangers of these cartels are enduring and widespread.14

In common discussion, little attention is often paid to the distinction between monopolization and cartelization because both are per se illegal under the antitrust laws, even though unions are now exempt from those laws under Section 6 of the Clayton Act. But, antitrust laws to one side, the key point is that cartels are always less efficient in operation than one-party monopolists when insulated from all liability. To see why this is the case, it is best not to start with the labor situation, but to look at an industrial cartel like OPEC.15

Here is the key difference. In a standard monopoly situation, a single firm owns all the particular assets. It has efficient shareholders, so whenever it maximizes the value for one shareholder, it maximizes it the value for all shareholders, given their single class of common stock, which offers a huge operational advantage. Thus if a single company owns all the relevant production of oil, what it will always do is shut down the wells that produce high cost oil in order to take advantage of its low cost oil. In so doing, it both maximizes its own profits and, ironically, does better for the public than it would if it produced the higher priced oil. Under OPEC, however, no country has ownership of all the oil brought under cartel governance. Therefore the only way in which to keep the high cost producers in the cartel if their production is idled is to make them a side payment that leaves them better off than if they decided to resume production, and thus force down prices. Yet deciding just how to price those side payments is a serious business that admits

to no unique solution. To avoid the valuation problem, the cartel switches to a system of output quotas whereby all firms are allowed to produce certain amounts of oil in ways that constict supplies to raise overall price levels. These maneuvers usually keep prices high enough so that the inefficient producers like Venezuela can remain in the market, even if Saudi oil costs less to extract and is of better quality. The more external pressures on the oil market from noncartel oil or from natural gas, the more costly these inefficiencies to the overall success of the cartel. The upshot is that each firm gets a quota for which it is free to charge whatever it wants, so that the market equilibrium is based on the total amount of usable oil produced. In effect, the cartel is always less efficient than the monopolist.

Union workers necessarily form cartels. Even within given trades, their skill levels are uneven. Across trades, the gaps are still broader. Like a cartel, the union has the political need to keep a majority of its members happy, so that the upshot is that it is forced to adopt union work rules that are necessary for internal solidarity, just like OPEC must make room for the Venezuelan crude. A union must be able to keep the majority support of its workers. If in fact it decides that it would like to deploy only the smallest and most efficient possible workforce, garnering therefore high overall wages, it would have to find a way to compensate those employees who are cast off to one side, without having any idea on how to set those compensation levels. Of necessity therefore unions organize themselves in cartel-like fashion through work rules to make sure that inefficient producers stay within the workforce as the price for their political allegiance. In extreme cases this involves “featherbedding,” whereby coal tender operators continue to work on diesel trains or
redundant GM factory workers receive compensation for showing up to work when their jobs become redundant.16

Putting all the pieces together shows why even the best of unions—and many are far from best—labor under a built-in handicap with respect to their non-union competitors. This is a handicap that no amount of legal ingenuity can prevent. Combined with the bilateral monopoly, the cartel rules are subject to further stress when wages are sharply cut during any lockout or strike. In contrast, any firm that organizes itself along competitive markets has two corresponding advantages—it doesn't have to worry about mispricing individual jobs in order to forge the optimal workforce, and it doesn't have to worry about substituting capital expenditures for inefficient labor expenditures.

This set of advantages explains why the so-called "yellow-dog" contract, i.e. in union argot, a contract that only a yellow-dog would sign—has such power when it is not banned by legislation, as it has been since the passage in 1932 of the Norris-LaGuardia Act.17 The contract, which tells workers that they cannot join a union while in the firm's employ, slows down the formation of unions and thereby the adoption of inefficient work rules. These contracts were rightly upheld in the much disputed 1917 case of Hitchman Coal v. Mitchell, in the interest of the workers who sign them in order to spare themselves the risk of disruption by strike and gain the benefit of the higher wages that always follow in the wake of more efficient production.18 These contracts would have remained the dominant form of industrial contract, if they were not banned on supposed grounds of public policy by the labor statutes of the 1930s, which perversely

16 For a description and critique of historic featherbedding practices, see generally Benjamin Aaron, Government Restraints on Featherbedding, 5 STAN. L. REV. 680 (1953).
18 245 U.S. 229 (1917).
did what they could to strengthen union monopoly power at the expense of more efficient market arrangements.\textsuperscript{19}

But even when yellow-dog contracts are banned, conflict among union members appears in countless different ways, all of which sap union strength. It is therefore no surprise that the term “scab” was used to describe those workers who during a strike were willing to cross picket lines to work for the employer. The strike only works if all workers are willing to abide by the collective judgment to sacrifice short term gains for long term benefits. But individual workers have different risk preferences, different time horizons, and different wage levels. It could easily make sense for many workers that have much to lose to cross a picket line set up by other workers who prefer to take the high-risk, high-return strategy. The stakes are enormous, and tempers get heated during the vote. It is often the case that unions will resort to physical force to prevent their own members (“scabs”) from crossing picket lines. Even before a strike takes place, a strike vote often features exactly these tensions among workers and on some occasions between workers who want to settle and a militant leader that does not.

A similar problem arises when the union is forced to engage in concession bargaining with the employer because its packages of wages and benefits are unsustainable in the face of competitive market pressures. In these cases, seniority rules often matter, so that some workers get to stay at high wages while others are let go. Alternatively, current workers get to keep most of their benefits by agreeing that future members will be required to accept far lower and more competitive wages. The conflicts of interest that arise whenever these two-tier structures are imposed are evident. It is

\textsuperscript{19} See, e.g., The Anti-Injunction Bill (Norris LaGuardia Act) of March 23, 1932 (Ch. 90, 47 Stat. 70), codified at 29 U.S.C. ch. 6.
equally the case that employers would love to remove the top tier and do business with the latter, so that workplace arrangements are always made more stressful by internal cleavages that affect both how workers relate to each other and to management.

More explosively, the conflict of interest inside unions could easily take place along racial lines. That indeed was the case when black and white unions on the Louisville & Nashville line were forced to merge under the Railway Labor Act of 1926, at which point the white workers took over control of the union and promptly allocated all the plumb jobs to their own members. The Court was powerless to undo the statute, but in Steele v. Louisville & National R.R., it did impose a fiduciary duty, called the duty of fair representation, that required the union to give equal treatment to members of both races. This duty is better than nothing, but it did little in the short run to control matters because the minority workers always had the hopeless task of going to the NLRB or the courts to enforce their rights. Two separate unions organized along racial lines would have been a far more efficient outcome, because it would have done better to guard minority workers against factional intrigue.

At that point, if the two unions do merge, it will not be by a hostile takeover, but by a contract in which the black workers could have insisted on explicit contractual protects instead of having to wait years for the announcement of a weak fiduciary duty which let all the hostile union leaders retain their power. Today these racial tensions have thankfully softened, but there is no doubt

22 323 U.S. 192 (1944).
23 See id. at 202.
that racial and ethnic alignments within a union can make it more difficult to run the plant if management is not able to deal directly with its disaffected workers.

In all these cases, the union has to be on constant guard against the return to a competitive labor market in which its services are minimized. Terms like scab and yellow-dog are part of the sustained effort of unions to resist members who try to return to a competitive equilibrium. Nonetheless, in the long run no union structure is going to prove sustainable against nonunion firms that operate by contract, unless propped up from the outside. Thus the most dramatic feature of unionization is that as workplace heterogeneity increases, so too will these conflicts of interest. Historically it was no accident that the original burst of union power took place in large industrial plants where heterogeneity was not the dominant issue, even at the time that the conflict between craft and plant bargaining units often raged. Union power, measured as a fraction of unionized workers, peaks when the AFL and CIO merge in 1954. From then on, it is a straight decline of union representation in the workforce, so that the inefficiency of the union structure essentially drives unionization levels in the private sector from about 35 percent in the market as of 1954 to about 6.7 percent today. Virtually none of this decline is due to a change in substantive labor law after 1954, until in the last year or two, which saw the addition of "Right to Work" movements in Michigan, Indiana and Wisconsin.

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25 Mayer, supra note 10, at 11 fig. 1.
26 Id. at 12.
IV. POLITICAL IMPLICATIONS

In closing, it is worth noting the implications for general political theory from this discussion. The initial point is that unanimous consent is never the starting point for political unions whose power is tied not to people but to territories in which dissenting individuals will always live. Only in totalitarian societies do election outcomes show a level of near-unanimity, and that outcome is well-nigh conclusive evidence of the overall corruption of the system. But in ordinary democratic societies, closely contested elections are often the norm. Yet, just as in union settings, these conflicts threaten to undermine the overall efficiency of the polity, and do so in settings where perfect market competition cannot be obtained.

The lesson from this analysis for classical liberals like myself, who work within the broad Lockean tradition, is to find ways to reduce the stresses that heterogeneous populations put on collective decision-making. One clear implication of this theory is that small homogenous nations are likely to tolerate larger governments with proportionally more collective expenditures, as the risk of massive redistribution is lowered given the relatively cohesive society and complex distribution. But within the context of a larger society, like the United States, these constraints count for far less. In large or noncohesive societies, the lesson from the failed experiment of union democracy is that strenuous steps should be taken to reduce the opportunities of political struggle in order to increase the ability of government to focus effectively on those functions—the control of violence, the creation of infrastructure—that cannot be organized by private parties.

That large mission statement in turn has two strong implications. The first is that it is critical to control the forms of taxation so as to reduce the risk that various factions will find ways to shift the
costs of public order onto someone else. Virtually all classical thinkers from Aristotle to Locke, to Hayek were in favor of some form of flat tax on either income or consumption as the only way to avoid factional conflicts, which can arise in two ways.\textsuperscript{28} The first is fights over the level of progressivity within the tax system. The second is the proliferation of special taxes on given trades or activities that can precipitate a political free-for-all. No tax is distortion-free. But among the class of coerced exactions, this basic tax structure represents the most efficient form with the fewest distortions. Spreading around the cost of general improvements across all asset holders limits their willingness to make expenditures that produce private gains at the cost of social losses. In effect, this taxation is a partial antidote in the political context to the same redistribution problem that arises with unionization. Indeed on the formation of the federal government in 1787, the founders used the corporate model by insisting that expenditures had to be limited to classic public goods—the payment of the public debt, the provision of the common defense, and the “general welfare of the United States” and not just for the benefit of this or that faction.\textsuperscript{29} They put in this power of tax-ation to counteract the fundamental weakness of the Articles of Confederation, which forced the national government to beg for contributions from the states to discharge its functions. But the Framers were well aware that while the power was necessary, it also had to be accompanied by limits on net transfers across states to combat the risks of disunion. Essentially these are anti-redistribution schemes, and they were necessary to allay concerns that rich states would be beggared by poor states. It could be the case, perhaps, that generalized flood relief or common improve-
ments were permissible, but transfer payments to particular individuals based on need was not done for the benefit of the United States as a whole. Of course, adherence to this doctrine today would put the kibosh at the national level on such programs as federal unemployment benefits, Social Security, Medicare, and Medicaid—all of which cost a lot more than flood abatement.

The second way to contain the risk at the federal level was to limit Congress to a narrow set of enumerated powers. The correct design here is to have Congress regulate to remove state blockades to interstate commerce, but otherwise leave the regulation of manufacture and agriculture to the states, where the exit right creates an imperfect but useful counterweight to state national power. But again, the desire to impose cartels in manufacture, labor and agriculture drove the New Deal to the opposite position, so that federal power was expanded to allow for these activities.\(^3\)

The third major safeguard against redistribution comes from the protection of individual rights, most notably through a strong takings clause that applies to all forms of taxation and regulation at the federal and state level. Essentially this was designed to face head on the question, “Does the state ever force redistribution by taking property from A, not paying for it, and then giving it to B?” The fair value rule associated with corporate governance carries over to control misconduct by public officials through the just compensation formula. Yet when the Supreme Court decided that taxes were not takings and that mere regulations of land use were not takings, its implicit good-government frame of mind opened up politics to redistribution on a grand scale, with the predictable negative long term consequences.\(^3\)

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\(^3\) See, e.g., Brushaber v. Union Pacific R.R. Co., 240 U.S. 1, 24 (1915).
The third source of the difficulty relates to one of the major structural flaws in the original Constitution that did not have any "Givings Clause" intended to protect against government giveaways. In 1987, I "amended" the Constitution in a law review article I wrote for the Cato Institute. My shadow Givings Clause provides, "Nor shall public property be given for private use without just compensation." This norm essentially displaces the lax business judgment that can come into play when there is a conflict between the government and its citizens. My proposal has not (yet) been systematically incorporated into the Constitution, so the government now has yet a third degree of unneeded freedom.

My somewhat pessimistic assessment of the long-term position in the United States is that three big holes below the water line is quite a lot to cope with. We do not have any of the anti-transfer mechanisms that make corporations a success. We don’t even give it the good college try that we have in the condo or co-op situation. What we’ve done instead is to take the union model and apply it aggressively in the political domain where it does no good. The object lesson is that the dangers of faction and redistribution require the resolute response that are found in corporate and condominium settings. Instead, the law follows the failed union model, to the long-term disadvantage of the nation.

It is, moreover, no coincidence that the 1936 October term of the Supreme Court was the watershed moment in both the private and public sphere. It was during that term that naïve visions of good government led a divided Supreme Court to first uphold the special protection for unions in the private sector and then to sanction the massive expansion of federal and state power over the economy. The consequences are predictable. Today the transfer budgets dom-

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inate all the public goods budgets by a very substantial amount. Defense shrinks, transfer payments start to increase, and growth stalls. These are high prices to pay for failure to understand the major challenges that lie in the path of collective enterprises, whether they be corporations and partnerships, condominiums and cooperatives, or labor unions and indeed government writ large. It is only through a conscious return to earlier principles that it will be possible to dampen, and perhaps reverse, this modern trend. Let us hope that the time is not too late.