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Why Fissure?

The large corporation of days of yore came with distinctive borders around its perimeter, with most employment located inside firm walls. The large business of today looks more like a small solar system, with a lead firm at its center and smaller workplaces orbiting around it. Some of those orbiting bodies have their own small moons moving about them. But as they move farther away from the lead organization, the profit margins they can achieve diminish, with consequent impacts on their workforces.

It would seem that businesses would always have an incentive to shift out activities that were not core to their profitability to other firms if such activities could be done at lower cost externally. What changed that made this practice so much more pervasive? One of the unsatisfactory aspects of many analyses of contingent employment, precarious work, and the rise of workforce vulnerability generally is that they provide lists of usual suspects for the problems, but an incomplete account of why those factors together have led to the growing adoption of these practices. Although it is true, for example, that more industries are now exposed to international competition, simply asserting this fact does not mean that companies are in a better position to contract out work.

For an answer we must return to the business history described in Chapter 2: if the modern corporation that dominated the economic scene during of much of the twentieth century reflected adaptations to the market and technological forces acting on leading enterprises of the era, the decision to shed many of those activities to other business entities implies a change in both the forces acting on those companies and the technologies and organizational forms available to them to undertake business. In fact, that is exactly what happened.

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The fissured workplace reflects two interrelated changes that led companies to shed more and more employment as they faced intensifying pressure to focus on their core competencies. First, capital markets demanded it, reflective of changes in how those markets operate and the standards to which they held (and hold) businesses seeking financing. Berle's and Mean's concern that the separation of ownership from management insulated the modern corporation from scrutiny was replaced by a concern that the harsh stewardship of capital markets caused corporations to focus too strenuously on the short term. Changes in the financial sector created powerful incentives for lead firms to redraw the very boundaries of the corporation.

Second, technological changes created new ways of designing and monitoring the work of other parties, inside or outside the corporation. This enabled companies to shed activities while still ensuring that subordinate businesses adhered to detailed and explicit performance standards. Over the past three decades, it has become far less expensive to contract with other organizations—or create new organizational forms—to undertake activities that are part of producing goods or providing services. That alters the calculus of what should be done inside or outside enterprise boundaries. As a result, lead companies can simultaneously focus attention on a core set of activities (and direct employment relationships) as demanded by capital markets and shed more and more of the actual work done by the enterprise. We look at both changes in this chapter.

Demanding Capital

In chronicling the rise of the modern corporation, Adolph Berle and Gardiner Means in the early 1930s worried about the social consequences of the divorce of ownership and control. John Kenneth Galbraith thirty years later expected this schism to lead to managerial dominance of the economic landscape, as corporate leaders and their minions sought stability and persistence of their positions, leading to business and cultural malaise. Mainstream economists, at the same time, worried that the principal/agent problem inherent in the separation would lead businesses to become fat and lazy, unresponsive to the need to create value for their shareholders and not willing to make the changes necessary for the United States to compete with emerging countries, particularly Japan.

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These concerns look almost quaint now. Economists began to raise very different concerns a few years later, when they began emphasizing the disciplining effects of capital markets and the role of management in maximizing a business's value to shareholders, who are the residual claimants to what was produced by the firm.[1] The efficient market model of financial markets holds that the value of shares reflects the market's take on a company's underlying value and future prospects. Because capital markets are highly competitive, managers whose actions stray appreciably from those of owners—regardless of how diffuse those owners are—will quickly be reined in by the falling value of shares and the demand by shareholders to replace incompetent (or self-interested) managers with others more capable of obtaining full value from the business.[2] Major changes in financial markets have been the subject of many books, particularly in the wake of the Great Recession, and will not be recounted in detail here.[3] But a synopsis of the transformation of several critical pieces helps explain the growing demands placed on companies by public and private capital.

Institutional Investors

Sophisticated institutional investors who steer trillions of dollars into and out of private and public companies played a crucial role in disciplining the behavior of managers and keeping their attention focused on returns. One critical impetus arose from changes in the way households save for retirement. In 1980 about 58% of wage and salary workers with pensions had defined benefit pension plans, while less than 10% had defined contribution plans (with the remaining workers having a mix of both). By 2011 the balance had dramatically shifted, so that less than 10% of workers with pensions had defined benefit plans, while more than 60% had defined contribution plans.[4] The impact of this shift is significant: defined contribution plans require the recipients to invest money that has been contributed by the employer in stocks, bonds, and other assets that will one day fund (hopefully) their retirement.

The rise of defined contribution pensions—401(k) accounts—and the growth of IRAs (another replacement for traditional defined benefit plans) led to a huge infusion of household financial capital to be managed. In 1980, 3% of household financial assets in the United States were held in investment companies; by 2011 that share stood at 23%. A large portion of the capital held in 401(k)s and IRAs was managed through mutual funds, leading to an

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explosion in the assets held by those institutions.[5] In 1980 mutual funds were a backwater among investments, holding about $134 billion in financial assets. By 2011 mutual funds held $11.6 trillion in assets.[6]

Mutual funds are major investors in U.S.-issued stocks, holding 25% of outstanding stock at the end of 2011.[7] The management of assets in mutual funds is concentrated: in 2011 the largest five companies managed 40% of total net assets (versus 34% in 1990), the top ten managed 53%, and the top twenty-five managed 73%.[8] A small number of companies—BlackRock, Fidelity, Vanguard, T. Rowe Price—stand at the pinnacle of companies holding and moving capital assets. BlackRock, which managed $3.5 trillion in assets in 2011, owned at least 5% of the shares of more than 1,800 U.S. corporations. Similarly, Fidelity owned at least 5% of 677 companies and Vanguard owned 5% of 524. This made BlackRock the largest shareholder in one in five U.S. corporations, and Fidelity and Vanguard the largest owners in about one in ten U.S. corporations.[9]

The scale of assets managed by companies like BlackRock, Vanguard, and Fidelity, the fungibility of those assets, and the large number of alternative investments available to fund managers together breed little patience for low performance for stocks of a given risk level. Institutional investors increased the volatility in ownership of companies and the sensitivity of managers to changes in company valuations.[10] For example, mutual funds seldom buy and hold stocks, but rather buy and sell them frequently. In 2011 average weighted stock turnover in fund portfolios was 52% each year (a number somewhat below the almost forty-year average turnover rate of 58%).[11] Money flowing into publicly traded companies from mutual funds is therefore "impatient" and moves frequently in search of better returns for a given level of risk.[12] Other institutional investors, such as public pension systems like CALPERS, hedge funds, and insurance companies, utilize the growing range of instruments for investment and therefore play directly (through their clout in the market) and indirectly (through their daily trading activity) an equally aggressive role in the life of the companies held (or potentially held) by them.[13]

The Private Equity Model

The rise of private equity firms also played a growing role in forcing restructuring of leading businesses.[14] The number and value of deals from private

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equity firms expanded dramatically in the years before the 2008 recession. In 2001 there were only 20 deals, accounting for $335 billion of invested capital. By 2005 the number had grown to 171 deals, with a total of $1.077 trillion of capital invested, with the trend peaking in 2007 with 607 deals and $1.5 trillion in invested capital. Funds focused on buyouts make up about two-thirds of private equity capital, although given that private equity money is then heavily leveraged with capital borrowed by acquired companies (see below), the amount of money used in private equity buyout deals was probably well over $3 trillion in 2011.[15]

The methods employed by companies like BlackStone Group, KKR and Company, and Bain Capital involve not only the buying and selling of other companies, but a more direct role in the operations of those enterprises once acquired. In a typical deal, the private equity partners (who are designated "general partners") bring in investment capital from a set of limited partners, usually investors like pension funds, academic endowments, and wealthy individuals. The capital becomes the basis for a fund to acquire a portfolio of properties and companies. The general partners receive fees of usually 2% of the invested funds from the limited partners, as well as earning 20% of profits from the acquisitions once a hurdle rate for the limited partners has been achieved.

Using the investment funds, the private equity firms acquire a set of target companies that are viewed as undervalued by the market. Similar to leveraged buyouts in an earlier era, the private equity investors use only a portion of the investment funds to acquire the companies.[16] The remaining capital (far larger than the amount from the private equity investors) is borrowed through short-term (and high-interest) financing on the books of the acquired company from investment banks, other hedge funds, and other lenders.[17] At the end of the investment period for the fund, the value of the portfolio of companies is tallied and profits distributed to the fund's partners.

Profits for the group arise because the now heavily leveraged companies in the private equity portfolio face intense pressure to undertake radical restructuring, in part through the policies instituted by the new ownership group. Ownership conveys the right to take whatever steps—selling off of business units; restructuring those that are not sold; shedding particular activities—are deemed necessary to increase the value of the acquired companies so that they can eventually be sold at a profit. This creates a very high-powered and direct means of restructuring companies.[18]

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Executive Compensation and Firm Performance

The demands of investors on companies to improve performance were further sharpened by the growth of incentive-based pay systems for CEOs and other senior executives. Performance-based pay flows from the property rights perspective of incentive design. If the owners of companies really seek to increase their returns, they should fashion contracts with top managers to give the latter the incentives to do so (rather than allow them to pursue their own interests at the expense of investors as forecast by Berle and Means).[19]

Executive compensation for CEOs of the fifty largest firms in the United States was relatively modest, holding steady around the $1 million mark (in 2000 dollars), from the late 1930s all the way until the early 1970s. Beginning in the 1970s, however, the pay of top executives began to rise dramatically, crossing a particularly steep inflection point in the 1990s, when median pay for executives soared. Among the top fifty firms, median CEO compensation (in 2000 constant dollars) increased from $1.2 million in the 1970s to $1.8 million in the 1980s, and then jumped to $4.1 million in the 1990s. For the period 2000 to 2005 real median compensation among this group of CEOs hit $9.2 million.[20]

This rapid rise in compensation reflected the shift to performance-based pay linked to stock prices and options in major companies. Salary and bonuses represented 100% of compensation for CEOs in the largest fifty firms in the United States from 1936 to 1950. In the 1960s, salary and bonuses still accounted for 87% of all compensation. However, in the 1980s, compensation in the form of salary and bonuses fell to 74%, dropping further, to 53% of compensation, in the 1990s. By the time stocks, options, and compensation peaked in the period between 2000 and 2005, top CEOs earned only 40% of their compensation from salary and bonuses, while 23% came from stocks and long-term incentive plans (largely restricted stock) and 37% from options.[21]

As academic studies and news exposés revealed, while rewards did accompany upside results, executives also seemed to be well compensated even when stock prices went in the wrong direction (sometimes drastically so). One reason is that performance-based compensation policies (and the academic literature that justified them) generally assume an "arm's-length model of bargaining" between the CEO and top executives on one hand and the board of directors on the other in setting up incentive schemes. The reality, as re-

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searchers like Lucian Bebchuk and Jesse Fried demonstrated, is far different; there are a variety of reasons that the relationship between executives and directors is far more intertwined than suggested by the arm's-length model often assumed in corporate governance.[22]

As a result of both the intended performance effects and the hidden self-dealing built into many compensation systems, executive compensation dramatically increased the earning of top corporate leaders relative to others. The ratio between the pay received by the average CEO in total direct compensation and that of the average production worker went from 37.2:1 in 1979 to an astounding 277:1 in 2007. The effects of the recession knocked the ratio back to a "mere" 185:1 in 2009.[23]

Capital markets were not fazed by the trends in executive compensation. In fact, investors widely applauded the companies for adopting these pay schemes. But they did because of the policies CEOs and other business leaders instituted in pursuit of higher valuations.

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Today, one would be hard pressed to argue that the distance between ownership and control allows the creation of the "planned society" and the new industrial state forecasted by Galbraith. While there is still intense debate about whether the end result of capital markets remains efficient or myopic, few would disagree that management of corporate enterprises faced enormous pressure beginning in the mid-1970s as U.S. dominance in many core manufacturing industries faded and capital markets became more fluid.[24] In response, the lead companies subjected to this pressure began to change strategies significantly, putting in motion policies that would fissure employment.

The Pursuit of Core Competency and Its Consequences

A new and clear message emanated from public capital markets and private equity companies, reaching a crescendo by the late 1980s and early 1990s. It was echoed in articles and books by academics in business schools as well as by an army of consultants in new and established consulting companies. The message was simple: firms should focus their attention and their resources on a set of core competencies that represented distinctive capabilities and sources of comparative advantage in the markets in which they competed. Anything

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that did not directly support those core competencies would be carefully evaluated as to whether it should (1) remain part of the business at all; (2) be restructured to be done more efficiently internally; or (3) be outsourced to some other party that could provide the necessary activity externally at lower cost. In essence, the message was, Find your distinctive niche and stick to it. Then shed everything else.

The idea of core competency begs the question of what is "core" to a firm. Most proponents stressed that it was not about particular services, products, or functions by which companies gained current success, but about the underlying skills, knowledge sets, or business platforms that consistently produced those successful products or services. For a components provider in the automobile industry, core competency meant consistently developing and refining new products for transmissions rather than production excellence per se. For a hotel company, core competency reflected the ability to consistently provide a certain kind of customer experience for a type of business traveler, rather than owning and running a particular property in an important city. For a retailer, it meant the ability to manage inventory risk while offering customers a broader selection of products at its stores.[25] In an article often cited for its articulation of the concept, Prahalad and Hamel wrote: "During the 1980s, top executives were judged on their ability to restructure, declutter, and delayer their corporations. In the 1990s, they'll be judged on their ability to identify, cultivate, and exploit the core competencies that make growth possible—indeed, they'll have to rethink the concept of the corporation itself."[26]

The idea of core competency pushes executives to not define their business in terms of current products or strategic business units. Even firms in concentrated industries face competition: assuming that the profitability of a current set of products assures long-term success ignores these competitive pressures. In the popular conception of a core competency, a company needs to be able to recreate the reasons for its current success over time if it is to remain profitable (and in the good graces of its investors). That is what gives it long-term advantages over competitors, such as an ability to create and bring to market distinctive new products; to deliver consistent, high-quality services in multiple markets; or to consistently drive down the costs of making its products.

The business history of Apple Inc. is illustrative. The company's soaring profitability over the past decade arises not from its products per se but from

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its capacity to design, engineer, and market high-quality digital products at the cutting edge of its consumer base's tastes. Its decision to focus on product design, marketing, and retailing rather than on manufacturing goes back to the days of the Apple II (the company's earliest successful line of home computers, introduced in 1977). An estimated 70% of the manufacturing of the Apple II series was outsourced to other companies. In addition, Apple outsourced parts of marketing, printing, and even design aspects to other companies.[27]

Reliance on outsourcing remained a basic part of strategy spanning 1986–1997, the troubled period when Apple's founder, Steve Jobs, was ousted from the company. With Jobs's return as CEO in 1997, Apple struck out in new directions with the introduction of the iPod and the corresponding iTune stores (2001), iPhone (2007), and iPad (2010), digital products that came to eclipse its computer lines. Apple maintained its focus on design, new product development, and retailing (including through its own Apple stores). At the same time, it further expanded its outsourcing of manufacturing. When asked by President Barack Obama in February 2011 at a dinner meeting of Silicon Valley executives what it would take to make Apple products in the United States, Jobs crisply replied, "Those jobs aren't coming back." By 2012 the company directly employed 63,000 workers (primarily in its design and engineering staffs as well as in its retail operations), while relying on an estimated 750,000 workers worldwide outside the company to manufacture, assemble, and distribute its products.[28] Investors were delighted by the outcomes of the strategy that decoupled the tasks of creating new products from manufacturing them: Apple's stock price went from $7 in 2003 to over $600 in 2012.

The search for core competencies—and the demand to produce results for investors that demonstrated success in defining them and implementing changes reflecting them—has been ongoing ever since. While the results have been defined and play out in different ways over time, three broad phases of activity can be articulated. First, the search for core competency led to the dismantling of conglomerate corporations generally. But it also meant selling off business units in more narrowly focused companies, a particular focus of new private equity owners and buyout specialists.

Second, companies sought to shed activities necessary for ongoing operations but judged peripheral to core activities. This meant a set of headquarters functions at large companies that had often become extensive in prior periods

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of rapid growth, such as human resources, accounting and finance, and, more recently, information technology (IT). Likewise, it meant shedding many activities at the front lines of companies—whether in manufacturing plants, store outlets, or service delivery units—that were necessary to ongoing operations but not central to the core business, such as maintenance and janitorial services or security.

In more recent times, the demand for focus has led businesses to shed activities that are part of the core competency itself. Even the elements that make up a core competency are not immune from being shifted outward to other parties.

Goodbye, Conglomerates

Between 1962 and 1969, 22% of Fortune 500 companies were acquired in mergers. A group of huge conglomerate companies selling a wide and frequently incoherent range of products and brands emerged from this binge. Creating conglomerate companies was controversial even at the time of their growth. The Federal Trade Commission deemed conglomerate accounting that masked the profitability of individual product lines "a tool of deception."[29] The actual performance of many conglomerates undercut arguments about the economies of scale arising from centralized management of diverse business units ("good management is the same for any business") or superior access to capital that being part of the conglomerate conferred. Instead, unhappy shareholders of public companies and private equity investors began to question the results of broad acquisition strategies.[30]

Weakening macroeconomic conditions and declining stock prices created further pressure on conglomerate companies by the late 1960s to demonstrate to investors the value of the highly diversified enterprises. Corporate raiders attacked them as unwieldy and underperforming behemoths. By acquiring the companies through corporate takeover and selling off the loosely related (or unrelated) units, investors could extract value through the improved performance of units closer to the core business, and also benefit by selling the other units to external investors who could gain greater value from them. The dismantling of the conglomerate in this view would reveal that its pieces were worth more than the firm as a whole.[31]

The rise and demise of Beatrice Foods is instructive.[32] The company was founded as the Beatrice Creamery Company in Beatrice, Nebraska, in 1894,

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beginning as a grading operation for other dairy producers but quickly becoming a butter producer and creamery with its own label and product line. It grew by perfecting methods of packaging and distribution. By the early part of the 1900s, the company distributed products, and by 1930 it had moved its headquarters to what was then the hub of the U.S. food industry, Chicago, where the company produced 30 million gallons of milk and 10 million gallons of ice cream annually. It continued to grow in the next decades through acquisition of other creameries and expansion of its own production, responding to growing post–World War II demand for food. Beginning in the 1950s, Beatrice began to expand into related areas of food by acquiring other branded companies and changing its name to the more expansive Beatrice Foods, eventually acquiring well-known companies and food brands like Hunt's (catsup), Tropicana (orange juice), Wesson (cooking oil), La Choy (packaged Chinese food), and Orville Redenbacher's (popcorn). Acquisitions began to change shape in the 1970s when it purchased brands and companies like Jolly Rancher and Good & Plenty (candy), Culligan (water treatment), Avis (rental cars), Playtex (undergarments), Samsonite (luggage), and Airstream (trailers).[33]

Kohlberg Kravis and Roberts (later KKR), a major private equity company specializing in leveraged buyouts, understood what many in the public did not: that Beatrice had acquired well over a hundred major and valuable national brands. It purchased Beatrice for $8.7 billion in 1986 and began over the next four years to sell off the welter of brands and companies under its umbrella. The final units still operating under the Beatrice name were sold to ConAgra in 1990.

By the late 1980s, the flagship conglomerate companies of the 1960s had been dismantled through the actions of private equity companies like Kohlberg Kravis Roberts, corporate raiders like T. Boone Pickens, and leveraged buyout machers like Michael Milliken. But breaking apart conglomerated behemoths like Beatrice represented only the start of efforts to focus on core competencies. Along with and following divestment of peripheral business units, the insistent effort to shed turned inward.

Cutting the Corporate Periphery

Headquarters offices of companies and divisions blossomed in size and scope during much of the twentieth century. In time, the large range of support

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activities, spanning accounting, human resources, and information technology, came under increasing scrutiny as potential sources of cost reduction. These activities, it was argued, could be more efficiently undertaken by outside entities with greater experience and cost advantages in their provision.

Personnel, benefits, labor relations, and human resource departments had been fast-growing areas in corporate and divisional offices. The growth of unions in the middle part of the century led firms covered by collective bargaining agreements to create larger bureaucracies to deal with labor relations and compensation policies. Later, passage of laws on safety and health, discrimination, and fringe benefits required additional expertise. Over time, the offices gravitated away from a sole focus on compliance toward the broader function of human resource policies as a source of potential efficiency for the company, and in some cases as a source of strategic advantage.[34]

Yet because these departments were almost always cost centers rather than profit centers, they became an early target of outsourcing. Payroll represented the first function to be outsourced under the personnel / human resource umbrella, in part because of the potential efficiencies of undertaking these relatively standardized functions. Given the specific legal requirements of state and federal policies, the common platform of many payroll procedures, and the potential scale advantages of developing software systems to handle large payroll requirements, companies like Automatic Data Processing (ADP), Paychex Inc., and Ceridian Corporation grew quickly. These companies handle payroll and benefit functions.[35]

The scope of human resource activities being outsourced, however, soon broadened to include design, development, and implementation of benefit plans and workforce diversity programs. The complexity of some areas of legal compliance also led businesses to shift this work outward, particularly in rapidly changing areas of law. By the early years of the twenty-first century, the human resource outsourcing industry was estimated to have annual revenues of $21.7 billion, which accounted for more than 8% of all human resource spending. Contractors offered services in most areas of human resource policy, and major companies in a variety of sectors drew on their services. For example, in 1998 BP entered a seven-year deal to outsource compensation, benefits, payroll, organizational development, performance management, employee development, training, recruitment, and relocation to Exult, a small start-up company. As the outsourcing arrangement progressed over the period, an estimated 40% of BP's internal human resource staff was cut.[36]

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Exult and the series of companies that later acquired it signed similarly large deals with Bank of America, International Paper, Prudential Financial, and many others.[37]

Information technology activities in corporate offices became another common target for shifting outward. As with outsourcing payroll, companies seeking to trim overhead costs are attracted to the potential cost savings arising by bidding out IT activities to a competitive market with multiple vendors of similar services. An added impetus arises from the rapidly evolving nature of IT requirements and capacities: because of the pace of IT change, a company (even a large one) is challenged to keep abreast of software, hardware, and increasingly Internet-based innovations. For companies where IT is not central to the business model, contracting out provides access to the forefront of new services that may be applicable (at a comparable or lower cost than creating these capacities internally).

Even though outsourcing IT began only in the 1990s, by 1998, 38% of surveyed companies had shed some of their IT activities to outside vendors.[38] As was the case with human resources, the first IT activities to be shed were routine functions that were fairly standardized across companies or new services with which the organization had little prior experience. These included data center operations, application maintenance, and network management.[39] Because of the idiosyncratic nature of other IT work, the scope of outsourcing widened more slowly to IT functions serving more core activities such as marketing (through web design and maintenance), user support, and application development. But recent surveys indicate that expansion to these more customized areas is proceeding, facilitated by companies providing high-security cloud-based servers.[40]

Cutting the Workplace Periphery

In the past, major employers hired landscaping crews, janitors and maintenance staffs, and security providers to keep facilities clean, well maintained, and looking presentable to employees, customers, and the public. But just as departments like payroll, publications, human resources, and information technology showed up as cost centers rather than profit centers, these activities were not directly related to making products or delivering services. Given the rising pressure to focus on core competencies, janitorial and maintenance services were some of the early activities to be pushed out of large businesses.

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The logic was clear: Why should a major company pay its own employees to mop floors, clean bathrooms, vacuum rugs, and mow lawns when a myriad of outside companies were willing to offer those services? The incentives at some companies were further sharpened by the fact that some of these activities were unionized (particularly facility security services) even in workplaces where other employees were not covered by collective bargaining.

These activities were also relatively self-contained, lowering the costs of shifting them out to other service providers once the decision to shed them had been made. And as more of these activities moved outward, new competitive markets for service provision grew. The competition in the new markets to provide janitorial and security services intensified, lowering prevailing prices and further benefiting lead companies.[41]

In some cases, lead companies hired other big companies for those services, for example ABM Industries, a $3.5 billion maintenance, security, and janitorial company. Those large companies often hired and trained their own employees to provide cleaning services. This was particularly true if maintenance services included specialized activities requiring a trained workforce, such as when cleaning required particular techniques or capabilities.

In other cases, companies hired third parties to coordinate maintenance for them, such as cleaning of company headquarters or landscaping of the grounds. In turn, those companies, acting much like general contractors in the construction industry, hired other, smaller businesses to undertake pieces of the contract. In some cases, different floors of the same company might be cleaned by separate cleaning contractors. Work and employment could be split even more as contractors further subcontracted the work.[42]

Franchising also began to expand in the outsourced cleaning industry. Janitorial service providers usually do their work after hours with no direct supervision from the customer. Assuring customers that cleaners will both meet quality standards and be trustworthy custodians of facilities after hours creates opportunities for branding janitorial services. A new industry formed for providing branded services to medium and large business users via franchised janitorial services.

Whether to specialty maintenance companies, to subcontracting networks, or to franchised enterprises, the shifting out of peripheral activities is significant. By 2000 an estimated 45% of janitors worked under contracting arrangements, and more than 70% of guards were employed as contractors.[43]

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Cutting Deeper

As the pressure to focus continued, business units within many corporations sought further ways to shed activities and reduce costs while protecting the parts of the business central to profitability. Management scholars and consultants promoted the idea of streamlining business processes that had, over time, become encumbered, slow, and wasteful. Companies had allowed many operations to become flabby, in this view, and were weighed down by internal processes that were often redundant, inefficient, quality-plagued, and unproductive. To compete more effectively, companies needed to strip their business practices to the core, analyze what the critical features of them should be, and rebuild them accordingly.

"Reengineering" was an influential approach in this area first articulated by Hammer and Champy and then taken up by other business scholars and by management consultants; it involved taking apart the components of processes by which businesses made products or provided services. Through a rigorous examination of these pieces, the production process could be reengineered in order to reduce waste, increase throughput, speed up delivery processes, and improve productivity. In so doing, companies would be able to better provide their products at lower cost.[44]

One example of the ever-deepening effort to shed activities from the core of companies occurred in logistics and distribution. Moving intermediate products between different stages of production or out to retailers or customers is an intrinsic part of production. Changes in retailing discussed below have made logistics even more important. Auto parts suppliers providing components to car companies operating under lean production principles often must be ready to deliver parts in relatively short time spans requiring efficient logistic operations. Modern lean retailers similarly demand rapid replenishment of products and sophisticated logistic operations.

Nonetheless, manufacturers, agricultural companies, and retailers began to shift distribution operations outward. In the 1980s this began by having trucking companies take over more of the basic transportation activities formerly done by their own in-house transportation fleets. In the 1990s companies like DHL began to offer expanded services for clients in packaging, sorting, and labeling for internal and external operations. By the early years of the twenty-first century, integration of information technology with distribution activities allowed providers like UPS and Schneider Logistics to manage

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particular transportation operations such as product returns. Most recently, logistic operations have come to entail taking on the responsibility for the entire logistic activities of major companies.[45]

As in other cases, the first stage of shedding activities was fairly straightforward and standardized. Logistics providers can achieve lower costs by higher-capacity utilization of distribution facilities, by allocating those distribution facilities more efficiently, by more efficient transportation routing, and by other economies arising from providing services to multiple customers at once. They can also more effectively smooth the ups and downs of logistic needs across companies facing different demand patterns. As a result, transportation and distribution activities moved outward fairly quickly as the market for such services developed and the financial benefits of using them became apparent to many companies.[46]

If such economies arose in logistics, why not move up the production process to manufacturing or procurement? If an outside business could provide janitorial and landscaping services to hotels, why not find other providers to clean rooms, or to run the kitchens of chain restaurants? The logic of shedding activities could potentially be applied deeper and deeper into the core operations of businesses—as long as the crown jewels of core competency were not compromised.

Dangers of Shifting Too Much

The benefits and costs of shedding corporate, divisional, and facility-level activities to other companies become more complex as the activities go deeper into the core competency of the lead company. Businesses face significant risks if outsourced functions interact with decisions central to core competency or require nuanced understandings of customers, markets, or other external factors. For example, companies have found that shifting away major human resource and IT functions can backfire if it impinges upon the development of key staff positions in the case of personnel or undermines building strategic data systems or services in regard to IT. The problem is intensified if business functions are hard to bring back in-house once outsourced.

Shifting out core production activities came to the manufacturing sector in the late 1980s. In a detailed study of the use of temporary employment agencies at an automotive supply company, Erickcek, Houseman, and Kalleberg found that four of the five auto supply plants they studied used temporary

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agencies, with two of the plants relying on them for more than 20% of their production employment.[47] In a period of rapid growth, the company chose to rely on lower-paid temporary workers alongside a relatively high-paid non-union workforce.

However, the strategy was not without its problems. The extensive use of temporary workers impacted the quality of the supplier's products. As the share of workers from temporary agencies increased beyond one-quarter of the workforce, this problem became particularly acute. The human resource director described the tension between plant managers concerned about quality and executives concerned about lowering costs:

> And . . . quality is starting to have problems . . . and now it's like, "We've got to get this temporary ratio back down." We'll start edging back down to 20, and . . . then the goal becomes 15 percent . . . and now there's always this discussion, "Well, it's more cost-effective to have the temporaries." So it doesn't seem to be an initiative with the executives to get that ratio down. So even though they talk about it, we are never going to get this high rate down.[48]

In the end, the human resources director notes that the cost advantage concerns raised by senior executives prevailed and that the plant settled at operating "within 20 to 25 percent . . . But we are in this constant state of denial, yet that number still stays up there and . . . the vice president of human resources is . . . [saying], "We've got to get it down."

The auto supplier story reveals a tension created by fissuring, relating to what is called a principal/agent dilemma. Because the interests and objectives of subordinate providers of fissured activities are different than those of the lead business, the incentives of the business doing the work of the lead company may undermine some of the latter's objectives. In pursuit of its own profits, an independent provider of a service may choose to compromise quality, use lower-skilled employees, or be more likely to violate workplace laws than the lead company. The more misaligned the incentives of the secondary provider are relative to those of the lead company, the bigger the problem.

Shedding activities to other organizations creates a second problem. By shifting employment to another party and paying for services provided, the lead employer is less able to monitor performance, since those doing the work are now potentially hidden within another organization. Once again, this problem can be addressed in part by how the lead company carves up the work

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to be done, ensuring that the performance is as observable as possible. If so, the lead company will be able to detect if it is getting the performance it needs, and the market forces created by secondary businesses jockeying to be providers of the service will push toward pricing linked to performance (which is the point). However, if performance is not easily observed, other mechanisms must be devised to provide better information if the strategy is to succeed.

A third problem arises when shifting out activities to others creates the threat of "holdups." Engaging outside parties to undertake important activities for the lead company risks allowing those outsiders to use their potential leverage to withhold those activities to capture some of the benefits that arise from fissuring. This problem becomes particularly vexing if the subordinate unit has significant ability to advance its internal agenda over that of the primary organization, such as through the control of skill.

A central task for successful fissuring is to strategically shift out work so that the lead firm remains in what Red Barber, the famed announcer for the Brooklyn Dodgers, called "the cat- bird's seat." That is, make sure the subordinate players have limited power to stray from the central objectives of the lead company. For example, one way to limit the potential for holdup is to have many potential businesses available to provide the fissured activity. The more competitive the market for those services, the less able any one company will be to demand to share more of the benefits from fissuring.[49]

The fissured workplace therefore does not reflect an either/or strategy, but rather a careful balancing act. On one hand, the lead organization wants to protect and enhance the core competencies driving its profit model. On the other, it wants to shift work to other parties to the extent possible. But here is where balance is crucial. Shifting too much work out or selecting the wrong party to do that work can undermine the crown jewels arising from the core competencies of central concern to customers and investors. One needs a glue to hold the two pieces together.

New Technology and the Falling Cost of Coordination

The corporation of the twentieth century had a set of organizational arrangements to solve the boundary problems of firms and markets, built on the

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communication technologies, monitoring and coordination mechanisms, and systems of contracts of that era. The revolution in computing power (and the impact of Moore's Law, which says that the number of transistors on integrated circuits doubles every eighteen to twenty-four months) has lowered the costs of acquiring information in regard to selection and monitoring.[50] The expansion and ubiquity of communication provided by the Internet and digital communication systems similarly lower the cost of acquiring and sharing information relevant to these purposes.

The development of complementary technologies that allow low-cost collection and instantaneous transmission of data—everything from bar codes and scanners (2-D and now 3-D), small, even microscopic, wireless sensor technologies of all varieties including motes, and geo-coded transponders—creates unparalleled (a.k.a. scary) capabilities to track detailed information at minute levels of time and geographic specificity. Together, these technologies enable new relationships in all aspects of how businesses, markets, and their boundaries are configured.

A final form of cost reduction developed alongside the above-mentioned high-tech forms is more low-tech in nature. A variety of new organizational methods of contracting came into their own in the 1980s going forward that lowered the costs of shifting work out. The most striking of these was franchising. Although traditional franchising arose much earlier as a unique business form to enable distribution in a small number of industries, its application to fast food and later to other sectors (what is called business-format franchising) transformed it into a malleable way of structuring business relationships. The development of new forms of contracting and the establishment of law and experience around it lowered the cost of applying the fissured idea to new industries and relationships.[51]

Fissured workplaces could not have spread absent the falling cost of gathering information and undertaking monitoring in light of developments in the digital world. Two examples illustrate the implications of information and communication technologies in this way.

Falling Information Costs in Trucking

Running a trucking business inherently raises the problem of costly information. The work requires hiring individuals to transport valuable goods from one place to another, unmonitored for much of the time between when they

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are loaded on and taken out of the vehicle. Not only is the cargo valuable, but so is the vehicle used to move it. Along with the security of the goods, delivering them on time is also a key outcome for the end customer and the trucking business. So the trucking company faces the problem of both selecting good drivers and monitoring them as they drive and deliver the goods.

Falling information and communication technologies gave rise to a solution: onboard computing (OBC). OBC allows truckers to find the best routes for travel and to avoid potential delays. More importantly (from the perspective of companies), it allows trucking firms to know where drivers are at any time. The arrival of OBC and the falling costs of information associated with it should therefore lead trucking companies to realign their relationships with truckers. Baker and Hubbard, in a series of papers on the impacts of OBC on organizational structure and outcomes, point out that OBC can affect trucking companies in two ways. On one hand, it lowers the direct costs of monitoring truckers, allowing the company to watch drivers more closely. This might induce companies to keep truckers as direct employees, because they can use ongoing information to keep truckers on schedule and prevent unauthorized detours or stops (and also to detect costly behavior like speeding on highways or even falling asleep at the wheel).[52]

However, OBC also reduces the cost of coordinating drivers, since it provides real-time information on location. With lower costs of coordination, if a company could assure that its packages would move from point A to point B on time but could secure those services more inexpensively through, say, treating the truck driver as an independent operator outside of the pay structure of the large firm, so much the better. This increases the lead company's ability and interest in contracting out trucking activities rather than doing them on an in-house basis.[53] The OBC example also points out that fissuring, as enabled by falling information costs, is not simply a yes/no decision but still involves a balancing of the first two elements of the recipe, albeit with a greater tip toward shifting that work outward given the lower costs.

Falling Information Costs in Retailing

As in trucking, the technologies that allowed for the lean retailing revolution require a rebalancing of the benefits and costs of contracting. In this case, the key technologies are bar codes, scanners, and electronic data interchange (EDI), along with the falling costs of computers, allowing use of abundant

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real-time sales data. On one hand, these technologies lower the cost of monitoring the performance of suppliers and could push toward greater backward integration by retail firms. In this sense, digital information systems helped solve Ford's problems of overly ambitious backward integration in the 1930s by improving the lead company's ability to watch key suppliers.

On the other hand, as with trucking, the digital technologies allow better coordination of suppliers. This means that the retailer, as the coordinator with the principal economies of scale in distribution, can take greater advantage of its logistics competency, while leaving the provision of goods to manufacturers who have scale advantages in production. So the retailer coordinates the system (increasingly not with its own trucks, but using subcontracted trucks under close scrutiny) but keeps the production activity safely ensconced with the supplier. Enhanced monitoring allows it to carefully scrutinize performance. Along with the availability of multiple suppliers in increasingly global supply chains, the advantage remains on the side of the lead retailer, lowering holdup and associated dangers.

What the Glue Must Do

For fissuring to be successful, the lead company must design and deploy mechanisms that assure that the businesses in orbit around it operate in a way compatible with its core strategies.[54] Importantly, the chosen organizational mechanisms must ensure that the secondary players do not undermine the basis of the lead company's core competency (for example, brand image, product quality, coordination economies).[55] Easier said than done.

The principal/agent problem—that is, the difficulty faced by one party (the principal) of using another party (the agent) to undertake work on its behalf—arises because information is costly. First, it is costly for the principal to gather information about the agents in selecting across them: some agents may have qualities that might undermine the objectives of the principal. If the characteristics of the agent are particularly hard (costly) to see, the agents who approach the principal first might be the ones who in fact the principal wants to avoid. This issue, called *adverse selection,* can be alleviated the more the principal can make informed decisions about the agents it chooses.[56]

The second problem arises from the cost of observing the agent once hired. Many of the activities that the principal wants the agent to undertake are

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hard to observe directly (our discussion of employment picked up this problem in regard to setting wages). The harder (or, once again, more costly) it is to observe and monitor the agent, the more its actions may diverge from what the principal wants.[57]

To play its crucial role as glue to assure that subsidiary businesses undertake the activities shed by the lead organization without undermining outcomes central to its core competencies, the lead company must promulgate and communicate standards and see that they are followed. This requires significant investment by the lead organization beyond simply listing what it wants its subordinates to do. Specifically, standards and accompanying policies must accomplish three things:

1. Provide clear and explicit guidance on what is expected. This is the nub of standards promulgated by many lead organizations in different forms.
2. Provide a system of monitoring and auditing to ensure that those standards are followed.
3. Provide for significant penalties in the face of failure to meet goals.

Of course, the problem of incomplete contracts remains even given explicit standards: there will never be sufficient pages in a manual or enough lawyers to craft them to cover every exigency that might arise to assure that the core values of a company are protected while shifting work to others. But the contract systems that have emerged, and the organizational forms that have grown around them, clearly try to do so to the extent possible and significantly curtail the principal/agent problems that may arise. Examining the three elements of standards reveals how serious companies are about keeping the core elements of fissuring from undermining one another.

Explicit Standards: What We Expect

The glue for fissured employment rests on explicit and detailed standards crafted by lead businesses and followed by all subsidiary organizations. The competitive importance of standards, as well as their detailed content, has been overlooked in much of the literature dealing with incomplete contracting.[58] One reason is that standards reflect core competencies and reveal

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strategic—and proprietary—aspects of the lead business. They are therefore jealously guarded and difficult to obtain. I present many different examples of standards in reviewing "fissured forms" in Part II. But several examples illustrate their general nature.

The information technologies and related systems underlying lean retailers dramatically reduce the amount of time between purchase of goods and provision to customers. But this technology platform also alters the relationship between retailers and their complex network of suppliers, in particular by specifying in great detail the logistical arrangements required for delivering and replenishing products.

Saks Fifth Avenue, a publicly held department store catering to upper-end customers, has adopted lean retailing principles as part of its core competency. It depends on its vendors to comply with rigorous delivery standards and provides them with a standards manual with clear guidelines on their interaction. The manual covers issues ranging from methods of payment and order shipment protocols to the consequences of failing to meet standards. The preamble to the manual makes the importance of standards to Saks's core competency very clear:

> Saks Fifth Avenue is committed to supporting the Universal Product Code (UPC), Electronic Data Interchange (EDI), and the GS1 US standards. We believe that by implementing these technologies and guidelines, we can expedite our merchandise flow to the selling floor, manage our inventories better, increase sales, and enhance customer service. This in turn allows us to continue to build a more successful and mutually profitable partnership with our vendors.[59]

The Saks Fifth Avenue vendor standards manual makes the importance of vendor adoption of these standards very clear in its opening pages. For example, it provides explicit instructions on the preparation of cartons, orders, labeling, and packing for all products shipped to it in order to "utilize available technology to implement efficiencies and improved management within the supply chain while expediting our merchandise to the selling floor and enhancing our service to our customer." To achieve this objective, the standards specify that the vendor's shipments must be accurate and received 100% "floor ready," without any merchandise preparation required by the retailer.

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This in turn entails adoption of a complex set of requirements around using the correct hangers and other display materials (ten pages on such matters, including detailed pictures) and labels (eight pages on these matters).

Subcontracted work for lead businesses in technical fields requires similar attention to detail. These businesses require not only specific terms about when and how the particular subcontracted work is to be conducted, but exacting terms about the quality, pace, and technical standards to be achieved. AT&T, for example, provides a detailed task matrix for subcontractors that undertake maintenance activities on the company's cell towers, specifying not only the particular work expected of the contractor, but also the role of AT&T and subordinate organizations in monitoring that work.

With branding as their defining core competency, fast-food restaurants insist that franchisees adhere rigidly to standards regarding products, service, and physical facilities. The preliminary documents prospective franchisees receive make the centrality of standards in the operation of the business explicit. The Dunkin' Donuts standard franchise agreement is typical (and blunt) in its statement of this principle: "All Dunkin' Donuts Stores must be developed and operated to our specifications and standards. Uniformity of products sold in Dunkin' Donuts Stores is important, and you have no discretion in the products you sell."[60] Taco Bell's franchise agreement similarly states that the franchisee

> shall faithfully, completely, and continuously perform, fulfill, observe and follow all instructions, requirements, standards, specifications, systems and procedures contained therein [the company's franchise operations manual]; including those dealing with the selection, purchase, storage, preparation, packaging, service and sale (including menu content and presentation) of all food and beverage products, and the maintenance and report of Restaurant buildings, grounds, furnishings, fixtures, and equipment, as well as those relating to employee uniforms and dress, accounting, bookkeeping, record retention and other business systems, procedures and operations.[61]

All fast-food franchises provide detailed standards setting out the terms for prospective franchisees and an even more detailed operating manual once franchisees have joined the chain.[62] Table 3.1 gives excerpts from several fast-food franchise agreements, illustrating the detailed standards incorporated in them as well as the requirement that franchisees adhere closely to them.

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Table 3.1 Franchise agreement statements regarding compliance with brand standards: Fast-food industry, selected examples

Eating/drinking brand	Excerpt from franchise agreement
Dairy Queen	Your operating agreement is a contract between you, ADQ and us. You are a part of the national and international franchise system of DQ Grill & Chill and Dairy Queen franchisees and sub-licensees, and you must adhere to various system standards of quality and uniformity that ADQ establishes and modifies periodically, as well as standards and requirements that we establish and modify periodically. You will use ADQ's nationally recognized trademarks and service marks that are approved for your concept; have access to the distinctive operational and management attributes of the DQ system; participate in ADQ's national and regional sales promotion programs; and receive the benefits of association with a nationally recognized franchise system, including various forms of training, opening and operational assistance (see Item 11).[1]
Dunkin' Donuts	If you sign a franchise agreement, you will operate a franchised *Dunkin' Donuts* Store. Under our franchise agreement, we grant our franchisees the right (and they accept the obligation) to operate a *Dunkin' Donuts* Store, selling doughnuts, coffee, bagels, muffins, compatible bakery products, croissants, pizzas, snacks and other sandwiches and beverages that we approve. We may periodically make changes to the systems, menu, standards, and facility, signage, equipment and fixture requirements. You may have to make additional investments in the franchised business periodically during the term of the franchise if those kinds of changes are made or if your store's equipment or facilities wear out or become obsolete, or for other reasons (for example, as may be needed to comply with a change in the system standards or code changes). All *Dunkin' Donuts* Stores must be developed and operated to our specifications and standards. Uniformity of products sold in *Dunkin' Donuts* Stores is important, and you have no discretion in the products you sell. The franchise agreement is limited to a single, specific location and we have the right to operate or franchise or license others who may compete with you for the same customers . . . The distinguishing characteristics of the *Dunkin' Donuts* System include, for example, distinctive exterior and interior design, decor, color and identification schemes and furnishings; special menu items; standards, specifications and procedures for operations, manufacturing, distribution and delivery; quality of products and services offered; management programs; training and assistance; and marketing, advertising and promotional programs, all of which we may change, supplement, and further develop.[2]

(*continued*)

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Table 3.1 (continued)

Eating/drinking brand	Excerpt from franchise agreement
Einstein Bros. Bagels	Restaurants are characterized by our system (the "System"). Some of the features of our System are a specially-designed building or facility, with specially developed equipment, equipment layouts, signage, distinctive interior and exterior design and accessories, products, procedures for operations; quality and uniformity of products and services offered; procedures for management and inventory control; training and assistance; and advertising and promotional programs. We may periodically change and improve parts of the System . . . You must operate your Restaurant in accordance with our standards and procedures, as set out in our Confidential Operating Manual (the "Manual"). We will lend you a copy of the Manual for the duration of the Franchise Agreement. In addition, we will grant you the right to use our marks, including the mark "Einstein Bros." and any other trade names and marks that we designate in writing for use with the System (the "Proprietary Marks").[3]
KFC	KFC outlets must be built to specifications approved by KFCC. The KFC Operating Standards Library (the "Standards Library") explains the required standards for preparing products to be sold at the KFC outlet and operating the outlet (see Standards Library—Table of Contents attached as Exhibit I). The KFC outlets are characterized by a unique system which includes special recipes and menu items; distinctive design, décor, color scheme and furnishings; standards, specifications and procedures for operations; procedures for quality control; training and assistance; and advertising and promotional programs (the "System").[4]
Long John Silver's	LJS Restaurants offer a limited menu featuring fish, seafood, chicken and related items. The Restaurants are designed to serve food promptly and offer dine-in, take-out and in a significant number of Restaurants, drive-thru service. Your Restaurant must be built to LSJ's specifications and operated in accordance with LJS's standards.[5]
Pizza Hut	A broad spectrum of the general public patronizes Restaurants as a source of high-quality pizza and related products and services. A unique system characterizes Restaurants that consists of special recipes, seasonings, and menu items; distinctive design, décor, color scheme, and furnishings; standards, specifications, and procedures for operations; procedures for quality control; training and assistance programs; and advertising and promotional programs (the "System"). A variety of trademarks, service marks, slogans, logos, and emblems that PHI designates for use in connection with the System (the "Pizza Hut Marks") identify the System. PHI has operated Pizza Hut "Red Roof" restaurants since 1958, when PHI opened its first restaurant.

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Table 3.1 (continued)

Eating/drinking brand	Excerpt from franchise agreement
	PHI has granted franchises for Pizza Hut "Red Roof" restaurants since 1959. PHI has operated Pizza Hut "Delivery" restaurants and PHI has allowed its franchisees to engage in delivery of pizzas since 1984. PHI has operated Pizza Hut "Express" restaurants (a concept not offered under this disclosure document) since 1987.[6]
Taco Bell	You must operate your facilities according to methods, standards, and procedures (the "System") that Taco Bell provides in minute detail. The System is Taco Bell's sole property and is embodied in the Franchise Operations Manual, commonly referred to as the Answer System (the "Manual"). Taco Bell will furnish you with Books 1, 2, 3 and 5 of the Answer System at no cost and you may order, at your option and expense, Books 4 and 6, all of which are also currently available in cd format. The Manual is incorporated by reference into and is part of the Franchise Agreement, and has the same force and effect as other provisions of the Agreement. Taco Bell may choose to provide the Manual to you via electronic access to a confidential website, in which case Taco Bell will notify you that all or part of the Manual is posted on the website. You agree that it is your responsibility to provide access to the website to those of your employees (but no other persons) for whom the website is intended by Taco Bell. Your failure to follow the System as described in the Manual is a breach of the Franchise Agreement.[7]

1. American Dairy Queen Corporation: Dairy Queen Franchise Disclosure Document, April 17, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

2. Dunkin' Donuts Franchising LLC: Dunkin' Donuts Franchise Disclosure Document, March 28, 2008. Accessed through BlueMauMau.org, http://www.bluemaumau.org/ufocs_free_and_without_a_salesman_attached.

3. Einstein and Noah Corporation: Einstein Bros. Restaurant Franchise Disclosure Document, December 20, 2005. Accessed through FREEFranchiseDocs.com, http://www.freefranchisedocs.com/einstein-and-noah-corporation-UFOC.html.

4. KFC Corporation: KFC Franchise Disclosure Document, March 24, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

5. Long John Silver's Inc.: Long John Silver's Franchise Disclosure Document, March 24, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

6. Pizza Hut Inc.: Pizza Hut Franchise Disclosure Document, March 25, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

7. Taco Bell Corporation: Taco Bell Franchise Disclosure Document, March 24, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

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Monitoring and Auditing: Do What We Ask

In order to ascertain if the businesses undertaking the work are doing what the lead organization intends, the contracts, standards manuals, and franchise agreements provide for explicit forms of ongoing monitoring. These are usually a combination of self-audits and audits (sometimes surprise inspections or, in the case of franchising, customer visits by undercover staff of the franchisor) undertaken by the lead organization or on their behalf by third parties.

Saks Fifth Avenue conducts accuracy and financial audits on vendor shipments as they arrive at distribution centers. This allows the company to validate shipment accuracy "by comparing and verifying the electronic information transmitted in your ASN [advanced ship notice] in conjunction with the associated GS1-128 label (at store, style, color, size, size, quantity level) or on your invoice against the physical units of the contents of your cartons." It also uses a random audit process to create for each vendor a performance index gauging its accuracy level; vendors are ranked in tiers, from "platinum" (best) to "targeted level" (worst).

Subcontracted relationships in many of the agreements reviewed in Part II usually include an escalating level of audits, based on the degree of quality, deadlines, or other compliance issues. Typical is a contract between a major telecommunications carrier (Cingular) and its subcontractors used to undertake ongoing maintenance work; it includes an escalating system of audits, increasing as the number of quality problems increases. Under the audit system, Cingular

> will audit 15% of all Sites awarded in a market at Vendor's expense . . . If greater than 1% of the initial 15% of individual Sites audited per market have Major Defects, then Cingular may request an additional 5% of Sites be audited in that market at Vendor's sole expense.[63]

Franchising agreements similarly provide for the usually unrestricted right of the franchisor to conduct inspections. The Taco Bell agreement, for example, states:

> The Company shall have the right at any time and from time to time without notice to have its representatives enter the Restaurant premises for the

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> purpose of inspecting the condition thereof and the operation of the Restaurant for compliance with the standards, specifications, requirements and instructions contained in this Agreement and in the Manual, and for any other reasonable purpose connected with the operation of the Restaurant.[64]

In addition to surprise inspections of facilities, chains in the eating and drinking industry also use "secret shoppers" to gauge adherence with service standards.

Penalties and Other Consequences

A system of standards is ultimately only as strong as the potential costs they impose on those who are required to follow them. Though they take different forms and escalate with varying tolerance for noncompliance and quality infractions, the standards underlying fissured employment all include significant consequences for failing to live up to them. These take two principal forms. First are fees or penalties related to specific failure to meet standards, which may begin with warnings and proceed to fees related to the costs (to the lead organization) imposed by the infraction, a fee deemed a form of liquidated damages, or a penalty simply intended to impose a cost (but not directly related to the quality or service infraction).

For example, the Saks Fifth Avenue vendor agreement grants Saks the right to

> refuse and/or return all goods which do not meet our purchase order specifications of style, size, color, quantity and/or quality (including unauthorized substitutions); or which are shipped before the ship date, or after the cancel date, or without valid purchase order numbers or without valid department numbers . . . To cancel a purchase order, in whole or in part, in the event the goods are not shipped in accordance with the terms and conditions hereof . . . To cancel a purchase order, in whole or in part, in the event the goods are shipped after the cancel date, time being of the essence.[65]

The manual presents an extensive list of "offset charges and codes" that indicates the "expense offset" that will be charged to the company for being out of compliance with standards specified in the manual. For example, if a ven-

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dor includes more than one purchase order in a carton, it will be charged $5 per carton or $150 per shipment, whichever is greater. Ticketing a product with the wrong retail price is assessed at $25 per shipment plus $.05 per unit with the wrong price. A late advanced ship notice costs $5 per carton (with no stated upper limit). Saks reserves the right to either deduct total charges from its payment to the vendor for the products or "demand direct payment of expense offset fees . . . specified in the Vendor Standards Manual." These offsets can become quite costly, as can those associated with having the order returned for failure to hit the delivery window.

The telecommunications contract frames penalties (in the form of liquidated damages) specifically around the importance of time: "SUPPLIER recognizes the importance of meeting Delivery Dates and agrees to the following liquidated damage provisions and procedures." If a contractor fails to meet a deadline after the parties have attempted to resolve a delay, the carrier is given the right to cancel the order and to recover liquidated damages specified in the contract. The damages are "the greater of either (a) 15% of the price of Delayed Materials and/or Services or (b) a specified $ amount for each day of delay."

The second type of penalty, which is even more costly, is the loss of the contract, supply relationship, or franchise. The right to revoke the agreement is usually explicit and places a great deal of power in the hands of the lead organization. In the telecommunications case, Cingular (the carrier) states in its terms with subcontractors that "CINGULAR may Terminate the Agreement, or any Order in whole or in any part, at any time, for its own convenience and without cause, without any charge, liability or obligation whatsoever upon written notice to SUPPLIER."[66]

In franchising, agreements usually require the franchisee to correct any failure to meet standards found in the course of inspections. If the franchisee fails to correct the problem, the franchisor retains the right to fix the deficiency itself and charge the franchisee for the cost of doing so. Pizza Hut's franchise agreement includes the right to close an outlet where a failure to meet standards potentially threatens the health and safety of either employees or customers.[67] The ultimate penalty for failing to live up to standards is loss of the franchise itself and the associated investments of the franchisee. Given the size of these investments, they are an area of significant tension and litigation. But as I explore in Chapter 6, the franchisor retains significant authority to terminate franchisees.[68]

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Coming Full Circle: Capital Market Responses to Shedding Employment

Financial markets increasingly drive companies under their exacting scrutiny to focus on shareholder value. This leads them to shed business units and products no longer viewed as core and to prune away remaining activities even in the core that might be viewed as peripheral. Several recent studies provide evidence underscoring the connection between capital market pressure and employment restructuring.

Employment Impacts of Private Equity Activity

Based on a study of 3,200 firms that were targeted by private equity firms between 1980 and 2005 and the 150,000 establishments connected to them, Steven Davis et al. estimate the impact of private equity buyouts on employment growth and destruction relative to a control sample of similar firms and establishments that were not acquired. The study finds that establishments controlled by the targets of private equity had employment declines of 3% over the two years following the buyout and 6% over five years relative to the control sample. The authors note that "these results say that pre-existing employment positions are at greater risk of loss in the wake of private equity buyouts." The employment declines are particularly large in cases where publicly held companies are acquired and taken private by the private equity firms.[69]

However, the study also finds employment increases at new establishments of the target firm opened after acquisition. When those increases are included, overall net relative job losses at target firms are less than 1%. Nonetheless, the net employment impacts at targeted firms in public-to-private buyouts remain high: over 10% net loss two years following the transaction.[70]

A companion study by the same research team examined productivity effects in manufacturing firms targeted by private equity.[71] They found higher labor productivity growth in establishments targeted by private equity than in a control set of firms, attributable to shrinking or closing less productive establishments in the targeted firms. This is consistent with the shedding process described in this chapter. The study does not provide direct evidence on the types of jobs that are being eliminated in the period following acquisitions or on the types of new jobs created later. However, the aggregate net employment

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changes and productivity effects found in the studies are consistent with a story where targeted firms eliminate jobs in business units, product areas, or functions no longer judged as core by the private equity owners, and expand, later on, in only those job areas directly related to their core activities.[72]

Stock Market Effects of Downsizing

In June 2012 Dan Akerson, the CEO of General Motors, announced a series of new policies to cut employment at its European and Canadian operations while streamlining its global product development functions "as key priorities to boost the automaker's lackluster stock price."[73] GM's share price increased in the days after the announcement was made.

If financial markets increasingly push companies to pare activities and focus on core competencies, one would expect to find evidence of a relationship between such employment reductions and increases in the share prices of publicly held companies. In the middle part of the past century, when large companies directly employed large and diverse workforces, a layoff would be perceived by investors as a sign of retrenchment by that company in light of an anticipated downturn in demand and therefore a need for employment reductions. Reduced employment spelled trouble for a company and its investors, and stock prices would fall in the wake of that news.

But the reaction of stock markets to employment reduction announcements began to change in the 1990s, as reflected in research by Hank Farber and Kevin Hallock.[74] They show that the stated reason for major layoffs has changed over time. As one would expect, companies cite factors directly related to slumps in demand following business cycle trends, although those reasons were cited less frequently during recessions in the early 1990s and 2000 than in the 1970s and 1980s. Reorganizations were more commonly cited as reasons for layoffs in recent years, particularly in the 1990s and during the recession in the early years of the twenty-first century. Cost control issues were also cited more frequently as causes for layoffs, being invoked in about 6.5% of all job announcements in the 1970s, 10% in the 1980s, and 17% in the 1990s.

But the most striking findings concern the effects of job loss press releases on changes in stock prices before and after the announcement.[75] Share prices responded negatively following job loss announcements in the 1970s and 1980s. However, stock prices actually rose on average following job loss announce-

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ments in the 1990s and were not significantly affected by layoff announcements in the first decade of the twenty-first century. The fact that capital markets responded less negatively, and in some of Hallock's and Farber's estimates positively, to announcements of layoffs implies that mass layoffs in recent decades are viewed very differently than they were in the era of large employers. Rather than seeing them as signs of weakening positions, investors seem to view layoffs at worst as routine corporate activities and even positively as a signal that executives have decided to redraw the lines of what will and will not be done by the company going forward.

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