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The Pension System and the Rise of Shareholder Primacy

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The Pension System and the Rise of Shareholder Primacy

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This article explores the influence of the pension system on corporate governance, which has so far received little attention in the corporate law literature. While the shareholder-centric view of corporate governance is strong today, this is a relatively recent development. "Managerial capitalism" began to give way to shareholder capitalism over the past three decades. I argue that changes in the pension system, specifically the shift from defined-benefit plans to defined-contribution plans that began in the 1970s, have been a major force pushing the corporate governance system toward shareholder primacy. While in traditional pension plans, workers depended primarily on their employer's ability to fund pensions, in today's system retirement benefits strongly depend on capital markets. Shareholder wealth thus became more important for larger segments of society, and pro-shareholder policies became more important relative to pro-labor policies strengthening employees' position vis-à-vis their employer. Consequently, shareholder primacy became the dominant factor in corporate governance debates. Managers today claim to focus on this objective and are less well positioned to take the interests of their firm's employees or other groups into account. The political economy of corporate governance underwent a seismic shift. While it is not clear whether shareholders truly benefit from most reforms, these have been largely supported by the center-left given their apparent beneficial effects for shareholders and consequently the middle class. For the same reason, unions have been among the most eager proponents of shareholder activism.

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1. Introduction

It is now widely accepted that the objective of corporate law and corporate governance should be to promote the wealth and welfare of shareholders. Business managers typically profess that they see themselves as primarily accountable to shareholders, as opposed to being subject to a responsibility to a wider community of interests, including employees, creditors, suppliers, customers and local communities.[1] Scholars of corporate law and financial economists tend to share this view. Shareholder primacy has not always enjoyed such widespread approval. It is true that since the time of the famous Berle-Dodd debate,[2] the discussion has always had two sides: Some argue for greater accountability on the part of managers to shareholders, while others favor a wider responsibility of managers to other "stakeholders" of the corporation, and even a corporate social responsibility to society as a whole.

Large, publicly-traded corporations in the middle of the 20th century were characterized by managerial capitalism: Managers had taken over as the bearers of the creative entrepreneurial spirit within the firm, and compared to their predecessors a generation or two earlier, they were hardly responsible to owners. Economists sometimes saw this as an advance over the previous period of economic development characterized by a focus on founders and founding families, given that the system seemed more rational and stable. However, around 1980, managerial capitalism began to give way to investor capitalism.[3] Hostile takeovers, and later equity-based executive compensation, began to emerge as the new forces creating incentives for managers to focus on share value.[4]

This article explores the reasons for this highly consequential change. It is often thought that shareholder primacy prevailed because it is more efficient, and managerialism therefore

[1] *See also* Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right,* 60 BUS. LAW. 1435, 1445 (2005) ("…until quite recently, the idea that directors might show concern for stakeholders has been associated mostly with sandals-wearing activists…").

[2] Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) (arguing that managers should be accountable to shareholders); Merrick Dodd, Jr., *For Whom Are Managers Trustees?* 45 HARV. L. REV. 1145 (1931) (arguing that managers should have a wider responsibility to society); A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV.1365 (1931) (rebutting).

[3] *E.g.* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 444 (2001).

[4] Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002) (suggesting that executive compensation creates incentives to abandon takeover defenses once the offer price has been bid up).

could no longer be maintained under modern economic circumstances. Relatedly, shareholder primacy is usually explored only as a phenomenon on the demand side of the capital market, i.e. of the corporate governance of firms. By contrast, I argue that one of the most important reasons, if not the main reason, is a fundamental change in the supply side of the capital market, in the consequence of which the interests of financial investors have become much more important in modern society. Specifically, I suggest that changes in the pension system helped to transform corporate governance into a system dominated by the shareholder interest and to edge out the managerial model. Up to the 1970s, the workers typically relied on payouts from a defined benefit (DB) plan for retirement. Employers bore the investment risk, and plans were designed to create incentives to stay with a particular employer. Workers' human capital and pension wealth were tied to the employer, thus creating a strong dependence on its continued ability to fund the plan. Since the 1970s, DB plans have been losing ground to defined contribution (DC) plans, including 401(k)s. These plans have the advantage of being more portable in the case of a job change, but employees bear the investment risk. Hence, a large part of the populace, at least the politically relevant middle class, became dependent on capital markets for retirement savings, and thus became, in the words of Chancellor Strine, "Forced Capitalists".[5]

These changes in the pension system had consequences on the structure of the US economy and the importance, nature, and content of corporate law that are hard to overestimate. First, pension wealth was no longer tied to the firm, but to the capital market. Second, workers' incentives to invest in firm-specific human capital seem to have decreased. In combination, these two shifts have not only been tied to higher labor mobility, but also an increasing importance of pro-shareholder policies to the middle class relative to pro-labor policies strengthening employees' position with a particular employer. Thus, the appeal of shareholder primacy and enhanced shareholder rights increased. Ultimately, this is likely the reason why shareholder primacy has such widespread support today, and shareholders are slowly, but steadily gaining power at the expense of boards of directors.

A number of reasons for the rise of shareholder primacy have previously been advanced. It is sometimes thought that developments in economics and finance, specifically agency theory,[6] contributed to an understanding that shareholder primacy was more efficient than managerial capitalism and delegitimized managers' technocratic expertise.[7] However, the relative success of the labor-centric corporate governance systems of West Germany and Japan in the 1980s rekindled US academics' interest in foreign corporate law and created doubts about the superiority of US practices.[8] Relatedly, it is often thought that shareholder primacy is inherently more efficient,

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[5] Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance,* 33 J. CORP. L. 1, 4 (2007).

[6] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[7] Hansmann & Kraakman, *supra* note 3, at 449 (citing the "force of logic" as a reason for the dominance of the shareholder model); Roberta Romano, *After the Revolution in Corporate Law,* 55 J. LEGAL EDUC. 342, 343-344 (2005) (discussing the impact of corporate finance on corporate law); PIERRE-YVES GOMEZ & HARRY KORINE, ENTREPRENEURS AND DEMOCRACY 146-147 (2008) (discussing managerial expertise being increasingly questioned due to more widespread business knowledge); Gerald F. Davis, *The Twilight of the Berle and Means Corporation,* 34 SEATTLE U. L. REV. 1121, 1127-1128 (2011) (discussing the rise of the shareholder primacy model); RAKESH KHURANA, FROM HIGHER AIMS TO HIRED HANDS 313-317 (2007) (discussing how agency theory undermined the legitimacy of the managerial model).

[8] *E.g.* Mark J. Roe, German "Populism" and the Large Public Corporation, 14 INT'L REV. L. & ECON. 187 (1994).

as shown e.g. by the failure of the conglomerate movement in the 1970s.[9] In this view, shareholder-oriented firms are inherently more competitive, which is why they eventually began to dominate markets.[10] It has therefore been suggested that the absence of strong shareholder primacy in the post-war decades was only possible because the US economy was growing and not subject to intense competition.[11]

I argue that the optimality of shareholder primacy is contingent on specific conditions: A more shareholder-oriented system is more desirable if pensions directly depend on investment success in the capital market rather than on a specific employer's or the government's ability and willingness to keep paying them. While this is at its core an argument of economic efficiency, I also explore changes to the politics of corporate governance. While it is clear that a number of factors affected actual corporate governance reforms through political and economic channels, I argue that the rise of shareholder primacy was in part an unintended consequence of regulatory changes in the pension sector. My argument complements other explanations that have focused on the growth of the financial industry and the availability of external debt finance, particularly for takeovers.[12]

Most shareholder primacists would typically argue that the US corporate governance system does not perfectly implement shareholder primacy, and often it is not clear if specific reforms actually help shareholders. While the politics of corporate governance are complicated, like political scientists such as Gourevitch and Shinn I suggest that these led to a stronger preference of pro-shareholder policies among workers.[13] Since pro-investor corporate law has become more important for the middle class, pro-shareholder policies have typically had the support of the center-left and of unions during the past two decades, which would previously have been hard to conceive. Admittedly, the strongest advocates of shareholder activism have in fact often been institutions managing DB plans such as unions and state public pension systems, who became active equity investors because of the elimination of regulatory restrictions on their portfolios. These regulatory changes were clearly another factor that contributed the spread of the idea of shareholder primacy. Both developments are two elements of a common trend toward equity. The increased dependence of retirees on equity investment across the board strengthened the role of institutional investors across the board and made pro-shareholder policies a more attractive. Drawing from the labor economics literature, I point out how these how firms used the possibility

[9] Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500,* 65 BUS. LAW. 1, 6-7 (2009) (discussing the inefficiency of conglomerates and mergers that destroyed shareholder value); KHURANA, *supra* note 7, at 297-305 (discussing economic distress in the 1970s as a reason for the shift in business culture).

[10] Hansmann & Kraakman, *supra* note 3, at 144 (arguing for the superiority of the shareholder model).

[11] *E.g.* GOMEZ & KORINE, *supra* note 7, at 137; William T. Allen, *Engaging corporate boards: the limits of liability rules in modern corporate governance,* in THE EMBEDDED FIRM 82, 90 (Cynthia A. Williams & Peer Zumbansen eds. 2011); *see also* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2064 (2001) (suggesting that shareholder primacy is more efficient in competitive markets).

[12] *E.g.* Sanford M. Jacoby, *Labor and Finance in the United States,* in THE EMBEDDED FIRM, *supra* note 11, at 277, 279; GERALD F. DAVIS, MANAGED BY THE MARKETS 81-85 (2009) (discussing the role of takeovers in ending managerialism); John W. Cioffi, *Fiduciaries, Federalization, and Finance Capitalism: Berle's Ambiguous Legacy and the Collapse of Countervailing Power,* 34 U. SEATTLE L. REV. 1081, 1106-1108 (discussing takeovers and the rising power of the financial industry in the 1980s).

[13] PETER ALEXIS GOUREVITCH & JAMES J. SHINN, POLITICAL POWER AND CORPORATE CONTROL 220-221 (2005) (suggesting a shift in the political preferences of workers toward minority shareholder protection); *see also* ALAN DIGNAM & MICHAEL GALANIS, THE GLOBALIZATION OF CORPORATE GOVERNANCE 222-230 (2009) (discussing retirement savings of workers as reason for the political importance of shareholders); Davis, *supra* note 7, at 1129.

created by these changes to shift how they interact with employees, and how this affected the creation of human capital. If firms have indeed become more competitive, one likely reason is these changes.

This article proceeds as follows. Section 2 provides a brief overview of the move from "managerial" to "shareholder" capitalism that has so fundamentally transformed the practice and theory of corporate law and discusses reasons that have been advanced in the literature. Section 3 describes the move from DB to DC plans in retirement savings and explores the reasons for the shift, which are grounded primarily in regulatory changes, but are also connected to structural changes in the US economy. In section 4, I connect the two issues and suggest that there is an institutional complementarity between the pension and corporate governance system; when many people effectively depend on capital markets for retirement savings, shareholder primacy in corporate law is relatively more desirable from the perspective of workers. Concurrently, with increased labor mobility and possibly less firm-specific human capital, the significance of policies protecting workers' position with a particular employer have decreased. While section 4 takes a public policy perspective, section 5 illustrates the effects for the political economy of corporate governance. Shareholder primacy has become a political cause for "the man on the street", and therefore the center-left. Unions adapted their strategies to this new situation and joined the ranks of shareholder activists pushing for stronger shareholder rights and shareholder wealth maximization. Section 6 suggests that an international comparison with other developed economies confirms the thesis: Continental Europe and Japan, whose corporate governance systems are known to be more mindful of the interests of employees and less shareholder-oriented than that of the US, also have very different pension systems where workers do not depend on the capital markets for retirement. Section 7 concludes.

2. From managerial to shareholder capitalism

The American corporate landscape today is very different from what it was 30 years ago. At least from the 1930s to the 1970s, corporate governance was characterized by what is often called "managerial capitalism." Large corporations were dominated by extensive managerial hierarchies that were to some extent self-replicating, and corporate boards effectively often perpetuated themselves without giving a strong weight to the interests of shareholders.[14] Corporations were truly "Berle-Means" firms in the vein of the seminal study by Adolph Berle and Gardiner Means, who identified the "separation of ownership and control" as the defining characteristic of large American firms in their 1933 book.[15] Some economists such as John Kenneth Galbraith[16] and management guru Peter Drucker[17] lent academic support to the proposition that this was an advancement compared to earlier stages of capitalism dominated by the owners of corporations.[18] In

[14] *See* DAVIS, *supra* note 12, at 72-77 (describing managerial dominance during this period); DAVID SKEEL, ICARUS IN THE BOARDROOM 108-11 (2005). For contemporary accounts of the "managerial revolution," see ALFRED DUPONT CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977); JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (4th ed. 1985).
[15] Adolf A. BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 69-118 (1933).
[16] GALBRAITH, *supra* note 14.
[17] PETER F. DRUCKER, THE NEW SOCIETY: THE ANATOMY OF INDUSTRIAL ORDER 340-343 (1950).
[18] *See also* Alan Dignam & Michael Galanis, *Corporate Governance and the Importance of Macroeconomic Context*, 28 OX. J. LEG. STUD. 201, 222 (2008) (explaining that the left saw managerialism as positive because it reduced the power of elite families, while the right welcomed it because society became more meritocratic).

the words of modern critics Hansmann and Kraakman, it was thought that "professional corporate managers could serve as disinterested technocratic fiduciaries who would guide business corporations to perform in ways that would serve the general public interest."[19] As Berle explained in a widely noted exchange with law-and-economics pioneer Henry Manne in 1962, the capital market was hardly an important constraint on managers in those days, given that contests for corporate control were unusual and firms rarely needed external equity finance.[20] While the discussion about the purpose of the corporation was still dominated by concerns about the role of powerful managers,[21] the idea of the "public interest" role of the corporation and corporate law remained stronger than today. Even just before 1980, "corporate governance structures gave the managers of large public corporations little reason to focus on shareholder concerns."[22]

Around 1980, corporations began to move toward a shareholder-centric model, which was brought about by two developments in the institutional structure of corporate governance.[23] First, hostile takeovers began to shake up corporate America.[24] Innovations in banking, such as the development of junk bonds and the proliferation of leveraged buyouts, played an important role.[25] As predicted by Henry Manne in 1965, the threat of being ousted by a hostile bidder created incentives for management to run the company efficiently instead of, say, engaging in empire building and creating unwieldy conglomerates that did not contribute to shareholder wealth creation.[26] On the academic level, agency theory, jump-started by Jensen and Meckling's famous 1976 article,[27] found its way into the academy and into the hearts and minds of economists and business and legal scholars. Hence, a changing paradigm in business education began to align the professed managerial objective with shareholder wealth maximization.[28] When the takeover market declined during the early 1990s, incentive-based executive compensation began to expand dramatically and to focus more on aligning incentives with share price. Thus, the professed alignment of managers' interests with shareholder interests remained in place.[29]

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[19] Hansmann & Kraakman, *supra* note 3, at 444.

[20] Adolf A. Berle, *Modern Functions of the Corporate System*, 62 COLUM. L. REV. 433, 438-447 (1962); *see also* GORDON DONALDSON, CORPORATE RESTRUCTURING 57-70 (1994) (explaining that up to the 1970s, large firms financed expansion projects through retained earnings rather than stock issues).

[21] Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light*, 7 NYU J. L. & BUS. 641, 671 (2011).

[22] Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 123 (2001).

[23] *See also* John C. Coffee, Jr., *The Folklore of Investor Capitalism*, 95 MICH. L. REV. 1970, 1973 (1997) ("No one doubts that managements are much more constrained today by investor preference …"); Davis, *supra* note 7, at 1127.

[24] *See* Holmstrom & Kaplan, *supra* note 22, at 124-126 (providing data about the prevalence of takeovers)

[25] *See* DAVIS, *supra* note 12, at 81-87; SKEEL, *supra* note 14, at 111-16; John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? – The Peculiar Divergence of US and UK Takeover Regulation*, 95 GEO. L.J. 1727, 1755 (2007); Kahan & Rock, *supra* note 4, at 873-74 (2002).

[26] Henry G. Manne, *Mergers and the Market for Corporate Control,* 73 J. POL. ECON. 110 (1965).

[27] Jensen & Meckling, *supra* note 6; *see* KHURANA, *supra* note 7, at 317-326; JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET 160-171 (2009).

[28] *See* KHURANA, *supra* note 7, at 305-23; *also see, e.g.*, DAVIS, *supra* note 12, at 87-93; KHURANA, *supra* note 7, at 297-305; Hansmann & Kraakman, *supra* note 3, at 440-41 (all arguing that a shareholder-based corporate governance system replaced a managerial system).

[29] Kahan & Rock, *supra* note 4, at 884 (suggesting that executive compensation creates an incentive to bargain for a high bid price). *But see* Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003); Lucian A. Bebchuk & Jesse M. Fried, *Pay without Performance: Overview of the Issues*, 30 J. CORP. L. 647 (2005) (arguing that executive compensation serves rent-seeking by management); *see also* Holmstrom & Kaplan, *supra* note 22, at 123 (pointing out that pay-for-performance plans before the 1980s were typically tied to accounting measures and not share price).

Shareholder primacy is of course not free of problems, which has led to criticism and sometimes outright rejection. First, the scandals of the beginning of the decade have led to the observation that the contemporary corporate governance system is inherently unstable due to the large disparity in power between management and diffuse investors.[30] The events leading up to the current "great recession" have further exacerbated concerns that at least some aspects of shareholder orientation may have detrimental consequences, particularly in the financial industry.[31] More fundamentally, it has often been argued that hostile takeovers and executive compensation (as currently implemented in most firms) do not actually serve the shareholder interest or that they direct the incentives of directors too strongly toward short-term share-value maximization. Some have argued that short-term pressures from capital markets in general have been a leading cause of the financial crisis.[32]

Second, the shift toward shareholder capitalism also had an impact on how firms interact with their employees. Labor power was at its peak during the 1950s through the 1970s, maybe in part because labor was a scarce resource.[33] Looking back in 1994, business scholar Gordon Donaldson argued that economic and social pressures forced management to serve the economic interests of all major constituencies of the firm, including employees, managers, and others.[34] While the pre-1980 structure favored the "career jobholder" interest in sustained corporate growth, the pendulum subsequently began to swing toward the financial interest of shareholders.[35] Modern economic theory provides us with an account of why, at least under certain circumstances, a "balancing board" of the pre-1980 type that is not only beholden to the shareholder interest may, at least under certain circumstances, be economically efficient. Not only shareholders, but also other corporate constituencies may be its residual claimants and should therefore be taken into account in the debate about the overarching goals of corporate governance. Employees, most of all, are often thought to be relevant as a matter of policy because of the specific human capital they sometimes contribute.[36] In Blair and Stout's team production model of corporate law, the board of directors is seen as a mediating hierarchy standing between shareholders and other corporate constituencies. Without a strong slant in favor of any particular group, directors are positioned to assign the rents produced by the corporation to all groups, thus permitting specific investment and allowing long-term business development.[37] Opportunistic "hold up" of other

[30] Mark J. Roe, *The Inevitable Instability of American Corporate Governance,* 1 CORP. GOV. L. REV. 1 (2006).
[31] *E.g.* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay,* 98 GEO. L. J. 247 (2010) (suggesting that executive pay packages resulted in excessive risk-taking in the financial industry).
[32] Kent Greenfield, *The Puzzle of Short-Termism,* 46 WAKE FOREST L. REV. 627, 629-630 (2011); Lynne L. Dallas, *Short-termism, the Financial Crisis and Corporate Governance,* 37 J. CORP. L. 266 (2012).
[33] *E.g.* DONALDSON, *supra* note 20, at 161; DIGNAM & GALANIS, *supra* note 13, at 222-223 (describing labor bargaining power at its peak).
[34] DONALDSON, *id.* at 19.
[35] DONALDSON, *id.* at 12, 17, 165-168.
[36] *See e.g.* KENT GREENFIELD, THE FAILURE OF CORPORATE LAW 55-59 (2006) (arguing that workers are residual claimants like shareholders because of pension benefits and their inability to diversify).
[37] Blair & Stout, *supra* note 39, at 288-89; *see also* Bruno Frey & Margit Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats,* 14 J. MGMT. INQUIRY 96, 99-101 (2005); Dignam & Galanis, *supra* note 18, at 221 ("dispersed ownership emerged … with a management unconstrained by shareholders and with a greater discretion to share resources with stakeholders"); Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance,* 50 HARV. INT'L L. J. 129, 136-143 (2009); Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm,* 113 Q. J. ECON. 387 (1998).

team members by shareholders with a short-term orientation is therefore made more difficult.[38] In this model, the attenuation of shareholder control over directors is seen as an advantage, since it facilitates specific investment by non-shareholder groups and the long-term development of the corporation.[39] As noted by Jeffrey Gordon, the Blair and Stout story seems to provide a good fit for the role played by the "managerial" board of the 1950s.[40] Firms were effectively run by top management, particularly CEOs, who had little reason to emphasize the interests of shareholders over those of other corporate "constituencies".

Corporate law still reflects the managerialist world;[41] a prominent example is the board's wide discretion to defend against hostile takeovers,[42] which has often been criticized by shareholder primacists.[43] To this day, direct shareholder influence on managerial decision-making is lower in the US than in European corporate governance systems.[44] While it would be obviously wrong to equate shareholder primacy with shareholder power, there are reasons to believe that pro-shareholder mechanisms such as "modern" executive compensation are often cosmetic and do not actually benefit shareholders all that much. But clearly, a lot has changed since 1980. As Gordon points out, the role of the board of directors has shifted from a managerial board to the contemporary monitoring board, whose professed objective is to monitor management on behalf of shareholders.[45] Moreover, the (temporary) prevalence of hostile takeovers and the rise of equity-based executive compensation must have shifted the balance toward shareholders at least to some extent, since these instruments set incentives closer to shareholder interests than to those of employees. But even if all of these changes were without effect, shareholder primacy has won as

[38] Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 795-797 (2007). Institutional investors specifically are often criticized as having short-term objectives. *See e.g.* Jacoby, *supra* note 12, at 285.

[39] *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); *see also* Kent Greenfield, *The Impact of "Going Private" on Corporate Stakeholders*, 3 BROOK. J. CORP. FIN. & COM. L. 75, 86 (2008) ("If management is more autonomous, it is possible for managers to use their autonomy to allocate more of the corporate surplus to employees and other stakeholders."). *See also* LYNN STOUT, THE SHAREHOLDER VALUE MYTH 52-54, 91 (2012) (suggesting a new line of criticism called "Tragedy of the Investment Commons", according to which shareholder primacy policies may also be harmful because corporations focusing on shareholder wealth will be more successful in the short run, while huritng the economy overall by reducing the value of other investments and depleting long-run development potential).

[40] Jeffrey N. Gordon, *The Rise of Independent Directors in the United States 1950-2005: Of Shareholder Value and Stock Market Prices* 1465, 1513 (2007).

[41] *E.g.* Christopher M. Bruner, *Power and Purpose of the "Anglo-American" Corporation,* 50 VA. J. INT'L L. 579, 593-603 (2010) (describing how Delaware law remains at least partly committed to managerial governance); Dalia Tsuk Mitchell, *Legitimating power: the changing status of the board of directors*, in THE EMBEDDED FIRM, *supra* note 11, at 60, 76-77.

[42] Moran v. Household Int'l Inc., 500 A.2d 1346 (Del. 1985) (declaring that the board has the power to issue a poison pill); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (takeover defense must be "reasonable to the threat posed"): Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387 (Del. 1995) (defense must be coercive or preclusive to fail the Unocal test). *See e.g.* William T. Allen, Jack B. Jacobs & Leo E. Strine, *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1086 (2002) ("*Moran* … and *Unocal* … upheld the primacy of directorial power").

[43] *E.g.* Ronald J. Gilson, *Unocal Fifteen Years Later (and what we can do about it),* 26 DEL. J. CORP. L. 491, 512 (2001).

[44] Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697, 736-750 (2005); Gelter, *supra* note 37, at 148-151, 156-161.

[45] Gordon, *supra* note 40, at 1514 n.187.

an idea explaining how large corporations ought to be governed.[46] All reform proposals have to be justified in the language of shareholder primacy.

3. From defined benefit to defined contribution plans

A second, maybe even more consequential shift occurred during the same period, beginning in the 1970s, namely one in the private pension system. In section 3.1, I describe the change and provide data for the transformation of the pension system, and in section 3.2, I explore its reasons.

3.1. The empirical facts

In the period approximately between 1920 and the 1970s, large employers provided a comprehensive set of benefits to workers.[47] Specifically, coverage with employer-sponsored pension plans increased during the post-war decades, primarily because of the growth of big business.[48]

Large employers typically introduced pension plans because they were favored by unions and employees. Unions pushed for employer-provided pension plans because Social Security benefits were considered grossly inadequate.[49] Social Security, having been created during the New Deal, eroded quickly in the 1940s due to inflation.[50] The predominant form of private pension was the defined benefit (DB) plan, under which an employee receives a pension of a specified amount upon retirement. Employers hoped that they would help to attract talented workers. Unions were equally interested, because they typically negotiated the plans and were often able to control their administration when they took the form of a "Taft-Hartley" arrangement.[51] Generous pension plans were thought to secure union support of labor peace.[52]

An advantage of a DB plan for employees is that they are funded by the employer,[53] who bears the investment risk: When the plan becomes underfunded, the employer has to fill the gap

[46] *E.g.* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 717 (1996) ("[…] the shareholder wealth maximization norm […] has been fully internalized by American managers").

[47] David Charny, *The Employee Welfare State in Transition*, 74 TEX. L. REV. 1601 (1996).

[48] Steven Sass, *The Development of Employer Retirement Income Plans: From the Nineteenth Century to 1980*, in OXFORD HANDBOOK ON PENSIONS AND RETIREMENT INCOME [hereinafter: OXFORD HANDBOOK] 76, 83-84 (Gordon L. Clark & Alicia H. Munnell eds. 2007) (noting a "dramatic" expansion of coverage from 15% in 1940 to approaching 50% in 1980); Munnell, *supra* note 50, at 363.

[49] ALICIA H. MUNNELL & ANNIKA SUNDÉN, COMING UP SHORT. THE CHALLENGE OF 401(K) PLANS 6 (2004).

[50] STEVEN A. SASS, THE PROMISE OF PRIVATE PENSIONS 120 (1997); *see* Alicia H. Munnell, *Employer-Sponsored Plans: The Shift from Defined Benefit to Defined Contribution*, in OXFORD HANDBOOK, *supra* note 48, at 359, 359 ("*voluntary* employer-sponsored pensions play a major role in supplementing relatively modest pay-as-you-go public pensions")

[51] *See* Teresa Ghilarducci, *Organized Labor and Pensions*, in OXFORD HANDBOOK, *supra* note 48, at 380, 391-393; SASS, *supra* note 50, at 124-142 (discussing the role of organized labor in the establishment of company pension plans); JAMES A. WOOTEN, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974. A POLITICAL HISTORY 34-39 (2004). Regarding Taft-Hartley plans, *see infra* section 5.3.

[52] Sass, *supra* note 48, at 86.

[53] *E.g.* Barry L. Friedman, *Individual accounts and the continuing debate over social security reform in the United States*, in RETHINKING THE WELFARE STATE 205, 220 (Martin Rein & Winfried Schmähl eds. 2004); Leora Friedberg & Michael T. Owyang, *Not Your Father's Pension Plan: The Rise of 401(k) and Other Defined Contribution Plans*, FED. RES. BANK ST. LOUIS REV., Jan.-Feb. 2002, at 23, 23.

to allow it to fulfill specified pension obligations. Employees bear risk when the plan is underfunded, uninsured, and the employer is financially unable to support it.[54]

Traditional DB plans were designed to create an incentive for employees to stay in the same firm until retirement:[55] Benefits were frequently defined in terms of a percentage of the income in the highest-paid years of employment, multiplied by a factor increasing with years of service.[56] The strong weight on the last years in the career, typically the highest earning ones, resulted in an incentive to stay in the same company.[57] An employee changing his job mid-career risked losing substantial benefits. For example, when leaving the firm at age 45 with a claim to a monthly pension of $100 upon retirement, the employee would not lose that claim, but it would be put on hold until retirement 20 or 30 years later, without any adjustment to the time value of money.[58]

All of this changed in the late 1970s, when employers gradually began to phase out DB plans and to replace them with DC plans such as the now ubiquitous 401(k)s.[59] These differ from DB plans in that the employer does not promise a pension payment based on a specific formula, but solely to make contributions to the employee's retirement account. Employees typically have some options regarding how to direct their investment, and consequently bear the investment risk.[60] The employer has no subsequent funding obligation if the plan has no investment success.

While defined contribution plans dominated among pension plans with fewer than 100 participants even in the 1970s, DC plans completely eclipsed DB plans subsequently among larger plans.[61] There were 20,035 DB plans and 8,587 DC plans with more than 100 participants in 1975, but only 11,368 DB plans and 70,125 DC plans with more than 100 participants in 2006. Figure 1 illustrates how DC plans eclipsed DB plans among large employers in the mid-1980s:[62]

[54] *E.g.* Friedman, *supra* note 53, at 220 (noting the risk of employer bankruptcy in a DB plan); *See also* Sass, *supra* note 48, at 87 ("If the employer went bust, so would the benefits of current and future pensioners").

[55] *See generally* RICHARD A. IPPOLITO, PENSION PLANS AND EMPLOYEE PERFORMANCE 10-29 (1997) (discussing how DB plans were used to create an implicit contract between employers and employees that resulted in low turnover).

[56] In other cases, benefits were computed on the basis of a fixed dollar amount for each year of service *E.g.* Munnell, *supra* note 50, at 365 (giving the example of 1.5% of final three-year average pay for each year of service, which adds up to 30% of income for an employee with a 20-year employment history with the firm); Edward A. Zelinsky, *The Cash Balance Controversy*,19 VA. TAX REV. 683, 687 (2000); EDWARD A. ZELINSKY, THE ORIGINS OF THE OWNERSHIP SOCIETY. HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA 1 (2007).

[57] Munnell, *supra* note 50, at 365; Sass, *supra* note 48, at 87 (describing that typically pension claims only vested after 10 years with the same employer); MUNNELL & SUNDÉN, *supra* note 49, at 2.

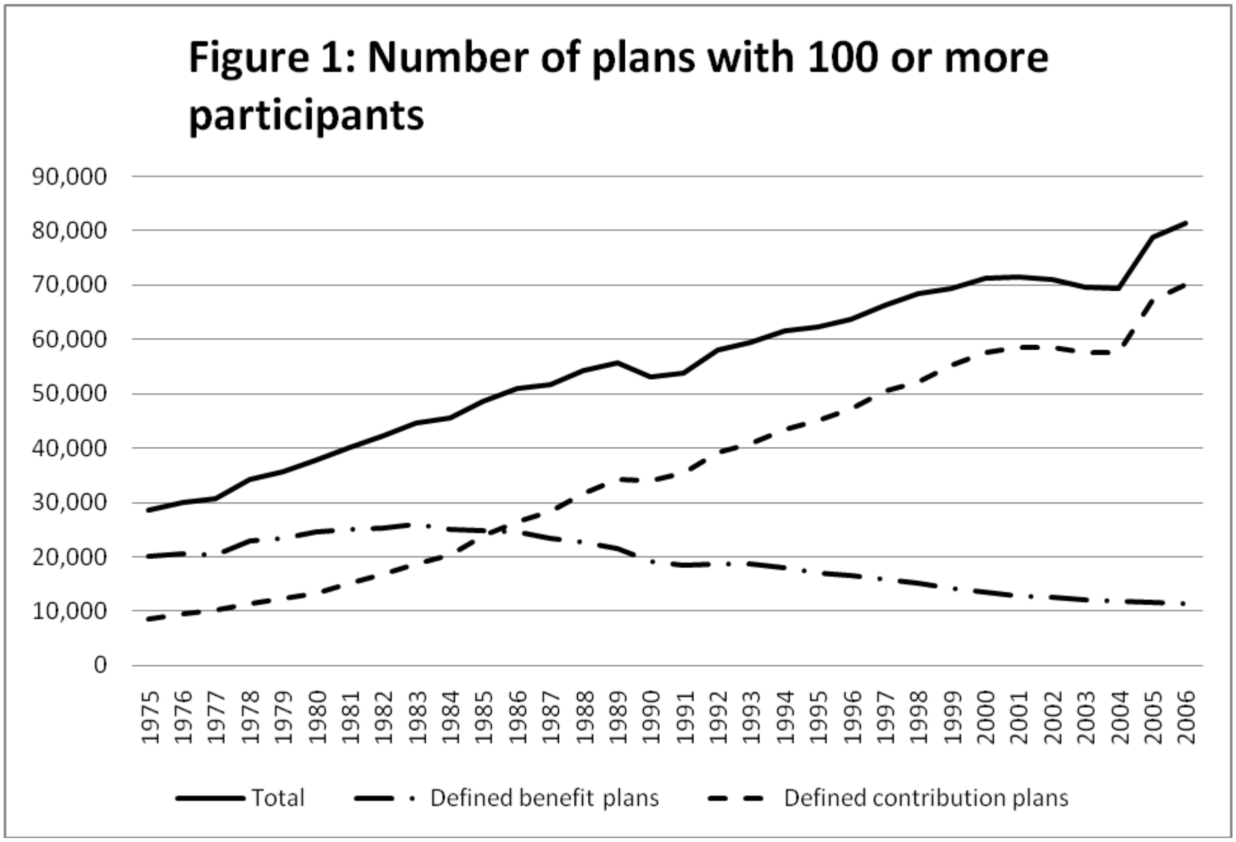
[58] ZELINSKY, *supra* note 56, at 39-40. The administrative hassle resulting from switching may have further increased the incentive to stay with a particular firm, given that claims were not portable and employees needed to deal with all prior employers when retiring.

[59] *E.g.* WOOTEN, *supra* note 51, at 278 ("As late as 1978, more than 80 percent of individuals […] were in a defined-benefit plan.). *See also* Barry L. Friedman, *Individual Accounts and the continuing debate over social security reform in the United States*, in RETHINKING THE WELFARE STATE. THE POLITICAL ECONOMY OF PENSION REFORM 205, 220 (Martin Rein & Wilfried Schmähl eds. 2004).

[60] *E.g.* Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L. J. 451, 458-461 (2004).

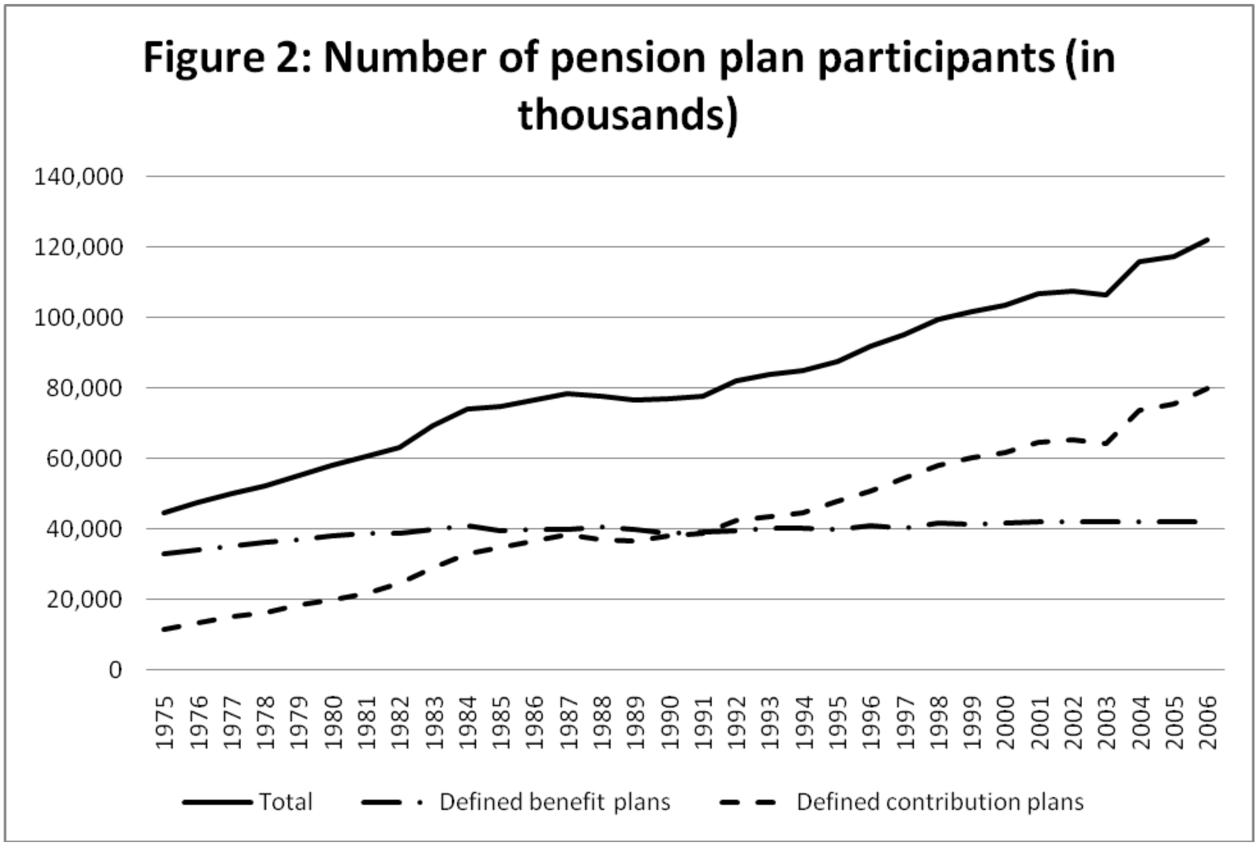
[61] *See generally* MUNNELL & SUNDÉN, *supra* note 49, at 16.

[62] Source of data: US DEPARTMENT OF LABOR EMPLOYEE BENEFITS SECURITY ADMINISTRATION, PRIVATE PENSION PLAN BULLETIN HISTORICAL GRAPHS AND TABLES 4 (2009), available at http://www.dol.gov/ebsa/pdf/1975-2006historicaltables.pdf (accessed December 11, 2010). The surge in 2004 is the result of changes in reporting requirements and the Department of Labor's counting method. *See* US DEPARTMENT OF LABOR EMPLOYEE BENEFITS SECURITY ADMINISTRATION, *id.* at 31.



The total number of pension plan participants is maybe even more illustrative. As shown in Figure 2, the number of pension plan participants has strongly increased.[63]

[63] Source of data: US DEPARTMENT OF LABOR EMPLOYEE BENEFITS SECURITY ADMINISTRATION, *id.* at 5. The data also include workers participating both in a DB and a DC plan.

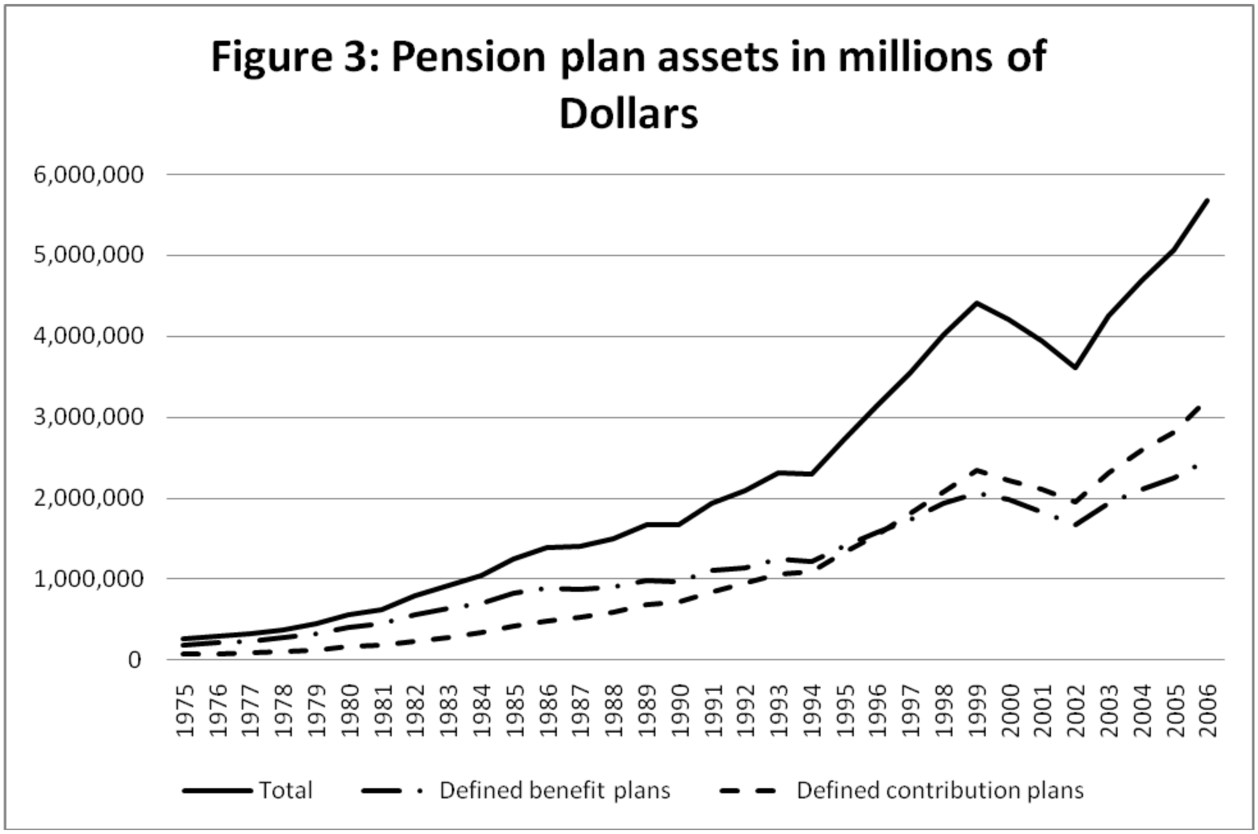


About 33 million American workers participated in DB plans in 1975. Their number rose only modestly to about 42 million. By contrast, the number of DC plan participants rose from a meager 11.5 million to almost 80 million. In relative terms, the roles of DB and DC plans reversed: While in 1981, 60% of pension beneficiaries relied solely on DB plans, in 2001 about 60% only had a DC plan.[64]

The increase in pension plan assets is not less impressive, as shown by Figure 3. Interestingly, the value of assets owned by DB plans remained larger than those of DC plans up to the mid-1990s.[65]

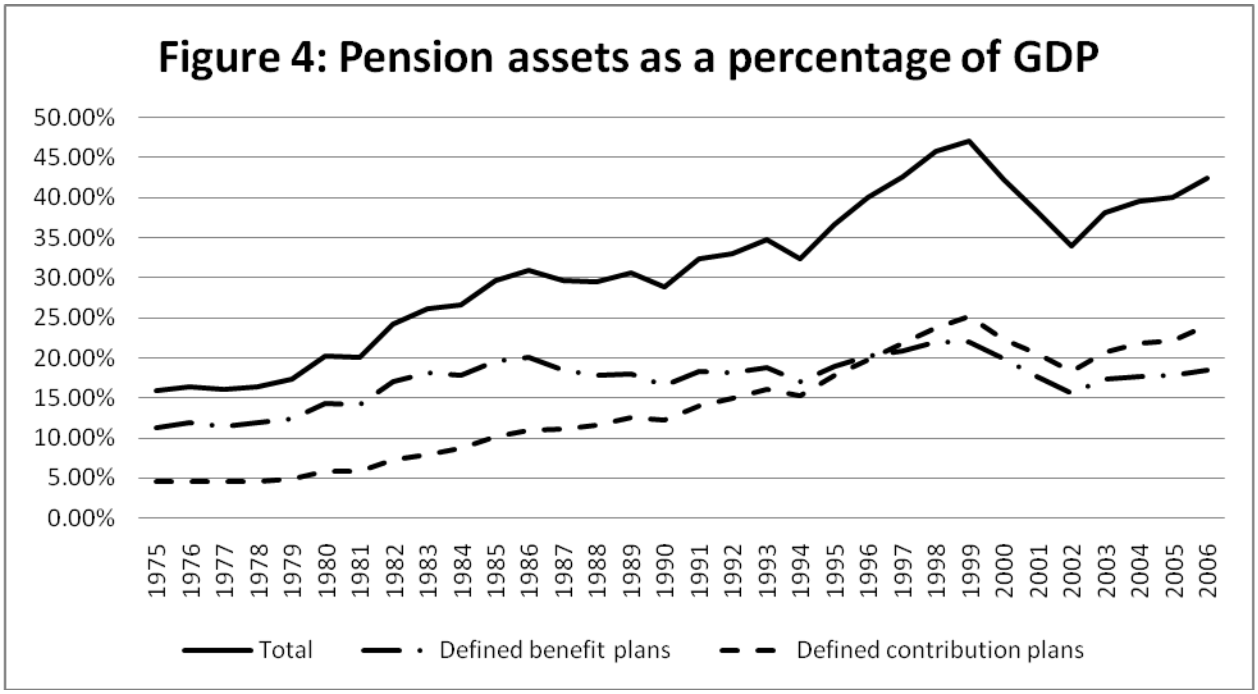
[64] Munnell, *supra* note 50, at 365-366.

[65] A possible reason could be that the last generation of workers relying primarily on DB began to retire at that time.



The development of pension assets is maybe the most interesting because it shows the significance of retirement savings as a branch of the financial industry that has grown in importance. Consider Figure 4, which shows the same data as a percentage of the gross domestic product of the United States.[66]

[66] GDP Data from http://www.usgovernmentspending.com/us_gdp_history (accessed December 11, 2010).



As a percentage of GDP, pension assets increased from less than 16% in 1975 to 42.42% in 2006, with a peak at more than 47% in 1999. The increase in the late 1990s and the subsequent sharp downturn are obviously explained by the dot.com bubble and the stock market decline when it burst.

Concurrently, the financial dependence of senior citizens on private pension plans compared to other sources of income increased from the 1970s to the 1990s; while the share of income from Social Security payments stayed more or less the same at about 30%, the share of capital increased from about 30% to 40% from the 1970s to the 1990s.[67] Thus, only comparing private pensions and Social Security, the relative importance of the latter decreased.[68] Needless to say, for a vast number of Americans in the lower income brackets, it remains the main source of income after retirement.[69] However, for the middle and upper brackets, private pensions clearly increased in significance. For the top 40% income earners among retirees, private pensions are a very important source of income.[70]

401(k) and related pension savings vehicles such as IRAs allow their beneficiaries to choose and to allocate their pension wealth according to their personal risk preferences. This pro-

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[67] Sass, *supra* note 48, at 90; *see also* Munnell, *supra* note 50, at 364 (noting that Social Security typically provides workers with about 30% of pre-retirement income).

[68] Jacob S. Hacker, *Policy Drift: The Hidden Politics of US Welfare State Retrenchment*, in BEYOND CONTINUITY. INSTITUTIONAL CHANGE IN ADVANCED POLITICAL ECONOMIES 40, 69 (Wolfgang Streeck & Kathleen Thelen eds. 2005) (showing a decrease of the significance of Social Security as a share of combined pension benefits from about 50% in 1970 to less than 40% in 2001).

[69] Hacker, *id.* at 64 ("The likelihood that a worker's employer will offer a pension decreases dramatically with income"). *See* Atsuhiro Yamada, *The Evolving Retirement Package*, OECD LABOUR MARKET AND SOCIAL POLICY OCCASIONAL PAPER NO. 63, 48 (2002), at http://dx.doi.org/doi:10.1787/767702557126; Sass, *supra* note 48, at 91 (both noting that the large bulk of capital earnings accrue to high- and middle income earners, while low income earners tend to rely on social security to a higher degree).

[70] *See e.g.* GAO, RETIREMENT INCOME. IMPLICATIONS OF DEMOGRAPHIC TRENDS FOR SOCIAL SECURITY AND PENSION REFORM 25-26 (1997), at http://www.gao.gov/archive/1997/he97081.pdf (providing data for 1994).

vides future retirees with the impression of being in control over their financial well-being[71] and may have contributed to the popularity of such plans.[72] As shown in Table 1, reporting the 2001 data, a large proportion of these assets are invested in equity:[73]

Financial instrument	Defined benefit plans	Defined contribution plans[74]
Equities	47.4%	44.8%
Mutual funds	5.9%	22.8%
Bonds	27.7%	9.3%
Cash	7.6%	5.1%
Guaranteed investment contracts	4.8%	11.9%
Other	6.5%	6.2%

Table 1: Distribution of Private Pension Assets in 2001

Mutual funds, which constitute a considerable proportion of DC plan investments, invest a large proportion of their assets in equity instruments, as shown in Table 2:[75]

Type of asset	Defined contribution plans	IRAs
Domestic equity	68%	60%
Foreign equity	7%	8%
Hybrid	9%	8%
Bond	7%	10%
Money market	8%	14%

Table 2: Distribution of Mutual Fund Assets in 2001

Potential retirees are therefore to a large extent dependent on the development of the stock market, and to a lesser extent, of the bond market. The reason for the dominance of equity, however, is that it is the only type of investment that yields profits that are high enough "to make retirement income programs work."[76] Employee stock option plans (ESOPs) are a special case; firms may have good reasons to encourage employees to invest their retirement assets with them, e.g. to create greater identification with the firm and incentives to maximize shareholder wealth.[77] Just

[71] MUNNELL & SUNDÉN, *supra* note 49, at 71.
[72] ZELINSKY, *supra* note 56, at 29-30 ("[T]he defined contribution paradigm reflects …a conception which carries tremendous appeal in a culture which … places a high value on private property, individual autonomy, and self-sufficiency.").
[73] Source: MUNNELL & SUNDÉN, *supra* note 49, at 74. Different data (with the same general thrust) are provided by E. PHILIP DAVIS, PENSION FUNDS 138 (1995).
[74] These figures include both 401(k)s and IRAs.
[75] Source: MUNNELL & SUNDÉN, *supra* note 49, at 75
[76] SASS, *supra* note 50, at 249.
[77] *But see* Shlomo Benartzi, Richard H. Thaler, Stephen P. Utkus & Cass R. Sunstein, *The Law and Economics of Company Stock in 401(k) Plans*, 50 J. L. & ECON. 45 (2007) (providing evidence that employees systematically underestimate the risk of holding company stock, while employers overestimate the benefits of ESOPs); *see also* Joshua D. Rauh, *Own company stock in defined contribution pension plans: A takeover defense?* 81 J. FIN. ECON. 379 (2006)

before the market downturn in 2001, in a number of large firms such as Proctor & Gamble, Coca Cola and General Electric, more than 75% of 401(k) assets consisted of company stock.[78] As a consequence of scandals such as Enron and WorldCom, where many employees lost most of their pensions, investment in company stock has decreased from 19% of all 401(k) assets in 1999 to 9% in 2009.[79]

3.2. Reasons for the shift

No single explanation has emerged for the shift from DB to DC plans, but a number of factors that seem to have played a role have been identified. The most important one is regulatory requirements intended to protect retirees, which made DB plans unattractive and costly for employers. Several regulatory choices seem to be jointly responsible.

3.2.1. ERISA

Congress adopted the Employee Retirement Income Security Act (ERISA) in 1974. ERISA immediately resulted in the termination of many private benefit plans that became too costly for employers to maintain.[80] It had a number of consequences that led the US down the path toward a "defined contribution society."[81]

ERISA imposed more severe regulatory burdens on DB plans than on DC plans. A number of bankruptcies that left employees without pensions had raised public awareness that employees required better protection against underfunding.[82] The most frequently cited example is the closing of the Studebaker automobile plant in South Bend, Indiana, in 1964, which left 8,500 employees with no or significantly reduced retirement benefits.[83] Critics argued that the computation of funding for promised future retirement benefits were actuarially complex. Management was therefore in the position to use the resulting uncertainty about pension benefits to attract workers by sending the signal that the firm was offering high pensions, while in reality it was uncertain whether their successors several decades down the road would honor this promise.[84]

Congress stepped in with a complicated statute to make sure employees actually got what they were promised. First, DB plans were subjected to minimum funding rules, given that DB plans had previously often been woefully underfunded.[85] Second, ERISA introduced mandatory

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(suggesting that the company stock ownership is, among other reasons, encouraged by firms because it lowers the chance of success for hostile takeovers).

[78] David Millon, *Enron and the Dark Side of Worker Ownership*, 1 SEATTLE J. SOC. JUST.113, 118 (2002);118; MUNNELL & SUNDÉN, *supra* note 49, at 101.

[79] EMPLOYEE BENEFIT RESEARCH INSTITUTE ISSUE BRIEF, No. 350, November 2010, at 23; MUNNELL & SUNDÉN, *supra* note 49, at 113 (providing data stock losses for employees in 12 companies in 2001/2002).

[80] BRUNO STEIN, SOCIAL SECURITY AND PENSIONS IN TRANSITION 84-85 (1980) (discussing and giving data about plan terminations after ERISA).

[81] ZELINSKY, *supra* note 56, at 38; *see also* Sylvester J. Schieber, Richard Dunn & David L. Wray, *The Future of the Defined Contribution Revolution*, in LIVING WITH DEFINED CONTRIBUTION PENSIONS 273 (Olivia S. Mitchell & Sylvester J. Schieber eds. 1998).

[82] SASS, *supra* note 50, at 202-213 (discussing the legislative process that led to the enactment of ERISA).

[83] *See* SASS, *supra* note 50, at 183-186; MUNNELL & SUNDÉN, *supra* note 49, at 8; WOOTEN, *supra* note 51, at 51-79.

[84] Munnell, *supra* note 50, at 367; ZELINSKY, *supra* note 56, at 43.

[85] *See e.g.* DAVIS, *supra* note 73, at 99; SASS, *supra* note 50 (reporting that union-bargained DB plans only had an average funding ratio of 60%). Obviously, DC plans are not subject to the funding requirement, given that employers do not promise a particular benefit that could be funded. ERISA § 301(a)(8), 29 U.S.C. § 1081(a)(8) (exempting "individual account plans", i.e. DC plans, from the funding requirement). *See also* PETER J. WIEDENBECK, ERISA.

vesting standards, under which employees have non-forfeitable rights to a specified percentage of benefits depending on the number of years of service.[86] Third, firms not only had to comply with administrative and accounting requirements, but also contribute to the Pension Benefit Guaranty Corporation (PBCG) to insure pension benefits.[87] Fourth, ERISA imposes a fiduciary duty on trustees managing the plan assets,[88] which exposes employers to a liability risk. With this heavy burden on DB plans, DC plans became relatively more attractive.[89]

Employers also began to see the potential of selling their stock to employees in the form of ESOPs in order to align the incentives of employees and shareholders.[90] These are easier to set up in the form of a DC plan, since ERISA established a 10% limit on the acquisition of the employer's own stock that applies only to DB plans.[91]

3.2.2. § 401(k) of the Internal Revenue Code

The second important legislative development was § 401(k) of the Internal Revenue Code, which was adopted by Congress in 1978. Like ERISA, it was not a conscious regulatory choice intended to make DC plans more attractive, but was rather intended to solve the controversy of whether deferred salaries that are paid into a pension plan should be taxed in the year when work is performed and the plan is funded, or when the employee receives the actual payment.[92]

Two aspects further made 401(k) plans more attractive to employers. First, it also allowed matching contributions by the employer to be deductible before taxes.[93] Companies proceeded by making matching contributions contingent on employees investing them in the employer's stock.[94] Second, these plans typically allow employees to control the funds in their own accounts and to direct them to investment vehicles in line with their personal preferences.[95] ERISA encouraged the creation of "participant-directed" DC plans because the employer or other persons designated as or deemed to be fiduciaries are not liable for investment losses that result from the

PRINCIPLES OF EMPLOYEE BENEFIT LAW 13 (2010) (describing additional requirements for DB plans and legislative motives for the differentiation).

86 29 U.S.C: § 1053. *See e.g.* STEIN, *supra* note 80, at 78-79.

87 ERISA Subchapter III, Subtitle A, 28 USC §§ 1301-1311, *see* Munnell, *supra* note 50, at 367; ZELINSKY, *supra* note 56, at 44. The PBGC guarantees pension payments only up to a specific amount that also depends on the age at retirement (with lower guarantee for early retirees). *See* http://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html.

88 ERISA § 404, 28 USC § 1104.

89 *See* MUNNELL & SUNDÉN, *supra* note 49, at 9; ZELINSKY, *supra* note 56, at 46.

90 ZELINSKY, *supra* note 56, at 47.

91 ERISA § 407(a)(2), 29 U.S.C. 1107(a)(2), § 407(b)(1), 29 U.S.C. 1107(b)(1).

92 While the IRS argued for "constructive receipt" of deferred pay arrangements, and hence taxation in the year when the plan is funded, the contrary view held that benefits should be taxed when they are received, i.e. during retirement, when the employee is typically in a lower tax bracket. MUNNELL & SUNDÉN, *supra* note 49, at 5; ZELINSKY, *supra* note 56, at 49-50. § 401(k) was passed as a compromise between the two positions by permitting a favorable tax treatment only when the employer implemented certain social policy goals such as non-discrimination between workers of different income levels for deferred compensation arrangement. *See* INTERNAL REVENUE CODE § 401(k)(3), (11). While it was not initially clear whether the new statute could apply to pension plans, the IRS clarified the issue in a 1981 regulation. MICHAEL J. CLOWES, THE MONEY FLOOD. HOW PENSION FUNDS REVOLUTIONIZED INVESTING 188-190 (2000) (discussing the history of the regulation); MUNNELL & SUNDÉN, *id*.

93 Richard A. Ippolito, *Toward Explaining The Growth of Defined Contribution Plans*, 34 INDUS. REL. 1, 13-14 (1995); *see* Internal Revenue Code § 401(m).

94 Millon, *supra* note 78, at 115; MUNNELL & SUNDÉN, *supra* note 49, at 101.

95 ZELINSKY, *supra* note 56, at 51.

beneficiaries' choices.[96] Consequently, participant direction has become very common. Between 1988 and 2005, the share of participant-directed plans (among DC plans) increased from 10 to 67 percent, with these plans now accounting for 86% instead of 15% of participants.[97]

3.2.3. The changing industrial structure of the economy

The regulatory changes discussed so far followed, accompanied, or accelerated changes in the structure of the economy and how firms interacted with employees. Labor economists have plausibly interpreted traditional DB plans and their peculiar design as a way of managing the workforce. First, private pensions were initially introduced to set incentives for employees to retire at the age preferred by the firm.[98] Second, as pointed out above, DB plans helped to tie workers to their employer by inhibiting job changes.[99] Third, the underfunding of DB plans very likely prevented unions from "holding up" the employer:[100] Underfunding creates a strong deterrent for unions against driving a hard very bargain vis-à-vis the employer. A large outflow of assets to current workers would likely endanger the firm's future ability to supplement the funding gap, and thus make it less likely that retirement benefits can be fully paid. On the other side of the bargaining table, unions tended to favor DB plans because of the cohesive effects they had on the workforce and put them into the central position of negotiating the DB formula with the employer.[101] Obviously, ERISA's funding and vesting requirements made this balance more difficult to sustain;[102] furthermore, the inflation of the 1970s destroyed the amount of the "bond" (i.e. the underfunded amount).[103] These factors in combination undermined the rationale for DB plans.

Initially, business leaders and unions were skeptical of many regulatory elements proposed for pension reform.[104] ERISA was largely the product of eager reformers in Congress who

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[96] ERISA § 404(c)(1), 28 USC § 1104(c)(1). It suffices if participants have the choice between three investment options. *See e.g.* WIEDENBECK, *supra* note 85, at 136-138; ZELINSKY, *supra* note 56, at 51; Michael E. Murphy, *Pension Plans and the Prospects of Corporate Self-Regulation,* 5 DEPAUL BUS. & COM. L. J. 503, 549 (2007) ("section 404(c) effectively relieves the corporate sponsor of fiduciary responsibility for the plan").

[97] William E. Even & David A. MacPherson, *Growth of Participant Direction in Defined Contribution Plans,* 49 INDUS. REL. 190, 196 (2010). *See also* Schieber et al., *supra* note 81, at 275; Even & MacPherson, *id.* at 194, 206 (suggesting that the possibility to escape 404(c) fiduciary liability has played a role, albeit not the only one).

[98] WOOTEN, *supra* note 51, at 20-21.

[99] *Supra* section 3.1.

[100] Richard A. Ippolito, *The Economic Function of Underfunded Pension Plans,* 28 J. L. & ECON. 611, 615-616 (1985); In economic parlance, hold-up reference to a situation where two actors are in a long-term relationship, in which at least one of them has made a specific investment on which it expects to receive a return. The other party can threaten to exit the relationship in order to expropriate the quasi-rent on the investment. In an employment relationship there may be hold-up opportunities for both parties.

[101] ZELINSKY, *supra* note 56, at 33-34

[102] SASS, *supra* note 50, at 210 (explaining that workers would still get the pension if union demands bankrupted the employer).

[103] Ippolito, *supra* note 100, at 629.

[104] SASS, *supra* note 50, at 200, 202; WOOTEN, *supra* note 51, at 100-101 (both explaining resistance by business and union leaders in an advisory committee rejecting proposals made by the Kennedy administration in 1963). *But see* SASS, *id.* at 215 (explaining that by the early 1970s, the CIO had become "the only powerful interest group that supported reform"). Unions were e.g. split on the issue of vesting, was seen as desirable by those in industry dominated by single-employer plans, but as detrimental by unions controlling multiemployer plans. *See* WOOTEN, *supra* note 51, at 142-143.

put aside interest group politics and responded to public opinion, which increasingly had become concerned about workers left without pensions after bankruptcies.[105]

The significance of unions and of industries where the pension bargain of the above type was struck has decreased significantly since the 1970s. Union membership in the American workforce plummeted from 35% in 1953 to 9% in 2003.[106] Econometric studies found that about half of the shift between 1979 and 1989 can be explained by "a reduction in the employment share in firms and industries that had relatively strong preference for defined benefit plans."[107] Losses for DB plans occurred mainly among non-unionized workers.[108] Thus, DC plans also began to be used for personnel management purposes: § 401(k) allows firms to match the additional contributions of workers,[109] which enables them to reward those with a high propensity to save. This may allow firms to identify better workers, the theory being that these are more often able to defer gratification to the future.[110]

3.2.4. Redistributive pension plan terminations

The final explanation is the least benign one: During the 1980s, it became financially attractive for firms to terminate DB pension plans in a move called "termination for reversion." Many DB plans had become overfunded, i.e. the trust held a larger amount of assets than was needed to cover expected pension payments.[111] Firms used the opportunity to terminate DB plans and create DC plans instead, while taking the excess value of the plan assets (over the net present value of the pension payments) into corporate profits.[112] Legally, plan terminations were made possible by a 1983 ruling by the IRS (encouraged by the Department of Labor), which clarified that plan terminations were not only permissible in narrow cases of "business necessity", but generally as long as the employer bought an annuity for the existing benefits from an insurance company.[113]

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[105] SASS, *id.* at 218-219; *see also* WOOTEN, *supra* note 51, at 177-178 (describing efforts to obtain union support for ERISA).

[106] Ghilarducci, *supra* note 51, at 384; *see also* SASS, *supra* note 50, at 229, 239; Michael L. Wachter, *Labor Unions: A Corporatist Institution in a Competitive World,* 155 U. PA. L. REV. 581, 613, 634 (2007).

[107] Ippolito, *supra* note 93, at 18; *see also* Alan L. Gustman & Thomas L. Steinmeier, *The Stampede Toward Defined Contribution Pension Plans: Fact or Fiction?* 31 INDUS. REL. 361 (1992) (explaining about half of the shift with changes in employment in different industries); ZELINSKY, *supra* note 56, at 33; SASS, *supra* note 50, at 229.

[108] Ippolito, *supra* note 93, at 9.

[109] *E.g.* a 401(k) plan might have a base contribution of 5% made by the employee and an additional 5% by the employer. If the employee decided to save another percent, the firm can then decide to match that contribution by paying another (tax-deductible) percent into the plan.

[110] Ippolito, *supra* note 93, at 14; IPPOLITO, *supra* note 55, at 85; Richard A. Ippolito, *Stayers as "Workers" and "Savers",* 37 J. HUMAN RES. 275 (2002).

[111] One major reason were high interest rates that depressed the discounted value of pensions. Mitchell A. Petersen, *Pension Reversions and Worker-Stockholder Wealth Transfers,* 107 Q. J. ECON. 1033, 1035 (1992); Margaret M. Blair, *The Great Pension Grab: Comments on Richard Ippolito, Bankruptcy and Workers: Risks, Compensation and Pension Contracts,* 82 WASH. U. L. Q. 1305, 1307 (2004). In the 1990s, a soaring stock market continued to make DB plans look overfunded in spite of lower interest rates.

[112] Richard A. Ippolito, *Tenuous Property Rights: The unraveling of defined benefit contracts in the US,* in PENSION POLICY IN AN INTEGRATING EUROPE 175, 176 (Onorato Castellino & Elsa Fornero eds. 2003).
see also Norman P. Stein, *Reversions from Pension Plans: History, Policies, and Prospects,* 44 TAX L. REV. 259, 277-279 (1989) (surveying legal methods of pension plan terminations under the tax code).

[113] Up to 1983, the Internal Revenue Code had prohibited payouts to employers to situations until all employee claims were satisfied. IRC § 401(a)(2). Funds remaining in the plan could only be captured by the employer in cases of actuarial error. 25 C.F.R. § 1.401-2(b)(1). A termination was permissible only in narrowly defined situations of

In the words of the labor economist Richard Ippolito, the "ruling dramatically altered the defined benefit pension contract", since it allowed employers to terminate plans outside of financial distress in order to create profits.[114] For workers, a termination meant that future payouts no longer depended on the salary at the end of their career, but rather at the time of the plan termination.[115] Furthermore, the funding risk for future pension contributions was shifted from shareholders to employees (and the PBGC).[116]

Terminations often happened after an LBO (leveraged buyout),[117] an acquisition that burdens the target firm with debt taken out to finance the purchase. Not only do LBOs often create strong pressures to cut costs at the expense of employees, but reversions in particular were seen as permitting raiders to violate implicit contracts with workers by taking the profit instead of using it to enhance pension benefits.[118] In many cases, reversions seem to have resulted in considerable redistribution from workers to shareholders, since employees seemingly were not compensated for the higher risk of default.[119] There were about 585 terminations between 1980 and 1985, and more than 1500 in 1986 alone.[120] Between 1980 and 1989, 1635 plans were terminated, yielding an aggregate of $ 18 billion dollars (corresponding to 45% of these plans' assets) to employers.[121] Admittedly, most DB plans were shut down in the context of factory closures, but about one third were pure asset reversions that seem to support a redistributive theory.[122]

From 1986 onwards, Congress attempted to protect plans from terminations by imposing a reversion tax.[123] However, the long-term effect was to make DB plans even more unattractive to employers,[124] who reacted by reducing the target funding ratios and ultimately by converting DB plans into cash balance plans, which allowed them to avoid the tax penalty.[125]

"business necessity" (i.e. financial distress). Rev. Rul. 71-152, 1971-1 C.B. 126 (1971); Richard A. Ippolito, *Bankruptcy and Workers: Risks, Compensation and Pension Contracts,* 82 WASH. U. L. Q. 1251, 1287 (2004); *see also* Stein, *supra* note 112, at 261, 293 (discussing the historical context of the ruling). The IRS' 1983 ruling made it clear that plan terminations purely made for the purpose of capturing a reversion were permissible if the employer bought an annuity for the existing benefits from an insurance company. Rev. Rul. 83-52, 1983-1 C.B. 87 (1983). *See* Ippolito, *id.*; WIEDENBECK, *supra* note 85, at 279; Stein, *id.* at 261-262, 282. It also allowed firms to use less conservative assumptions when computing a plan's amount of liabilities. *See* Stein, *id.*, at 305-306.

[114] Ippolito, *supra* note 113, at 1287; *see also* Charny, *supra* note 47, at 1613, 1629 (suggesting that employers reneged on implicit deals with workers by cutting benefits after LBOs); Stein, *supra* note 112, at 262 (explaining that the 1983 ruling reflected a new understanding of the tax code that protected only employee benefits accrued at the time of termination, but did not protect expectations under an implicit contract relating to future wage increases and adjustment to inflation).

[115] Richard A. Ippolito & William H. James, *LBO, Reversions, and Implicit Contracts,* 47 J. FIN. 139, 142 (1992); Stein, *supra* note 112, at 276.

[116] Blair, *supra* note 111, at 1306-1307.

[117] Ippolito & James, *supra* note 115; *see also* CLOWES, *supra* note 92, at 187-188 (discussing individual cases of LBO-financed plan reversions).

[118] Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order,* 97 COLUM. L. REV. 1519, 1543 (1997).

[119] *See* Blair, *supra* note 111, at 1308-1309 (discussing the relative costs of risk-bearing incurred by shareholders and employees).

[120] Ippolito, *supra* note 112, at 177.

[121] Stein, *supra* note 112, at 259-260.

[122] Ippolito, *supra* note 112, at 182; *see also* Petersen, *supra* note 111, at 1052 (firms where the pension bond is the largest are most likely to be affected by a reversion, which lends support to the transfer theory).

[123] Richard A. Ippolito, *Reversion Taxes, Contingent Benefits, and the Decline in Pension Funding,* 44 J. L. & ECON. 199, 200 (2001). The tax was originally 10%, but subsequently increased to 15% in 1988 and to 50% in 1990. Ippolito, *supra* note 113, at 1288; Stein, *supra* note 112, at 262-63, 320.

[124] Ippolito, *id.*, at 203-204 (explaining that the reversion tax discourages excess funding of DB plans because it makes it expensive remove excess assets). Ippolito also points out that Congress in 1986 passed legislation that disal-

4. Effects on employees' human capital and pension wealth

The transformation of the American pension system came about not through deliberate planning, but largely as an unintended consequence of regulation primarily intended to protect workers.[126] This section proceeds by explaining why this had important consequences for both workers and corporate governance. I proceed by describing the tradeoff between the two assets employees have in an employment relationship, namely human capital and pension wealth (section 4.1), and explain to what risks they are exposed under different pension systems (sections 4.2 and 4.3). I subsequently retrace the changes in the tradeoff resulting from the shift from DB to DC plans and suggest that this fundamentally changed the impact pro-investor corporate governance policies have on workers (sections 4.4 and 4.5).

4.1. The tradeoff

Consider the situation of a middle-class employee. Very broadly speaking, most of us cover our living expenses from two sources. First, we typically rely on a constant income stream to make a living, most of which comes from employed labor. We therefore care not only about our current job, but also about our education, skills, and abilities, in other words, the potential to earn a living in the future. The expected value from this can be referred to as our human capital in a broad sense, and we should deeply care about policies affecting our earnings potential. Second, we rely on savings to cover our expenses when we fall on hard times, such as a period of unemployment, or when we are no longer able or willing to work. Retirement savings are the most important component. We therefore care about policies that affect our pension plans, which is why it is valuable to explore both human and financial capital more deeply. The tradeoff between these two is of crucial importance to the shareholder primacy debate. Employees' human capital interest (resulting from rent-seeking or returns on specific human capital investment) is generally less secure when managers in a corporation are strongly focused on maximizing shareholder wealth. However, because of the rise of DC plans, pro-shareholder policies have gained in relative importance compared to pro-employee policies that protect their position with a particular employer.

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lowed overfunding a plan by more than 150% (without losing the associated tax benefits), although the effect of the limit is small compared to the tax. Ippolito, *id.* at 204, 218-219. Internal Revenue Code § 412(c)(7) and ERISA § 302(c)(7), 29 USC § 1082(c)(7), as amended by P.L. 100-203, December 22, 1987, 101 Stat 1330.

[125] Ippolito, *supra* note 113, at 1288-1289. While cash balance plans are formally DB plans where the employer guarantees a specified amount, each employee is assigned a fictitious account with a monetary value corresponding to his pension claim, thus making the plan look much like a DC plan. *E.g.* Friedman, *supra* note 53, at 221; GEORGE A. (SANDY) MACKENZIE, THE DECLINE OF THE TRADITIONAL PENSION 55 (2010). A conversion is therefore not considered a termination, but an amendment to the plan. Ippolito, *supra* note 113, at 1289 n.41.

[126] Once the idea was established, investment vehicles functioning on the same principle were created and began to spread widely. Individual retirement accounts (IRAs), which are endowed with tax advantages provide similar tax advantages for individuals not covered by pension plans, became available as an investment vehicle to anyone in 1981. Economic Recovery Tax Act,, P.L. 97-34. Even though their tax advantages were again limited to low-income earners in 1986 (Tax Reform Act of 1986, P.L. 99-514), but they continued to proliferate. ZELINSKY, *supra* note 56, at 52-58. Other examples include health savings accounts, which allow those that have high-deductible health insurance to save for medical expenses, and Educational Savings Accounts. *See* Medicare Prescription Drug, Improvement, and Modernization Act of 2003, P.L. 108-173 (superseding the older Medical Savings Accounts); I.R.C. § 529 (educational savings accounts). *See* ZELINSKY, *supra* note 56, at 60-70, 83-84 (discussing various types of investment vehicles). In each case, the investment risk is borne by the individual.

4.2. Human capital and pension plans

Employees typically prefer to stay at their current job unless another offers clear advantages. There are basically two possible reasons for this. First, employees may be able to extract rents from their employers. It is often costly for employers to hire and train new employees. Incumbents may therefore have some bargaining power to obtain wages and benefits above their marginal product. Unions and legal institutions that enhance employees' power may allow employees to organize and to extract rents from employers collectively.[127] In a corporation, these rents reduce profits for shareholders.

Second, employees may have a human capital investment in their current job in the form of skills and training. According to economic theory, human capital, can be general, i.e. useful in a wide range of occupations. It can be industry-specific, meaning that the acquired skills are applicable across a range of similar or equivalent jobs in different firms. It can also be firm-specific, meaning that it is useful with a particular employer.[128] Firm-specific investment is beneficial when workers are able to do their jobs more quickly and efficiently, make fewer mistakes, and create higher-quality products, thus rendering the firm more competitive.[129] Firm-specific human capital obviously includes skills to perform a particular job, e.g. to use a particular machine. It has also been suggested that, while few skills actually are specifically useful within one employment relationship only, idiosyncratic combinations of skills may be.[130] In this case, particular subsets of skills may be transferable, but not the whole package, given that no other job requires the same combination. In other cases, the employee's specific skill may be of an organizational nature. In the context of pension contracts, Richard Ippolito gives the example of a worker who "has worked with the same people for a long time, and really knows how to create teams that work together for different kinds of jobs."[131] In other words, employees may also need to learn to work within a different corporate culture or organizational structure and how to navigate it to be as effective as possible.[132]

The role of pension plans in the employer-employee relationship depends on who pays for the creation of human capital. If the employer pays for the employees' training, he will want to make sure that the employee stays at least until the employer has recovered his investment. Individual employees can threaten to leave in order to extract higher wages or other advantages from

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[127] Much of the corporate law literature seems to favor this interpretation. *E.g.* Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence and Corporate Ownership and Governance,* 52 STAN. L. REV. 127, 150 (1999) (suggesting that German codetermination allows unions to extract rents from shareholders).

[128] GARY S. BECKER, HUMAN CAPITAL 11-36 (1964); *See also* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 26 (1996); James M. Malcomson, *Individual Employment Contracts,* in 3 HANDBOOK OF LABOR ECONOMICS 2291, 2311-2337 (Orley Aschenfelter & David Card eds. 1999) (reviewing the literature on contractual protection of specific investment); David Neumark, *Productivity, Compensation, and Retirement,* in OXFORD HANDBOOK, *supra* note 48, at 721, 722, Larry Fauver & Michael E. Fuerst, *Does good corporate governance include employee representation? Evidence from German corporate boards,* 82 J. FIN. ECON. 673, 679 (2006).

[129] *See e.g.* Lawrence E. Mitchell, *Toward a New Law and Economics,* GEO. WASH. LEGAL STUD. RES. PAPER NO. 495 (2010), at http://ssrn.com/abstract=1557730, at 51 (suggesting that firms financed by venture capitalists thrive when they have substantial human capital).

[130] EDWARD P. LAZEAR, INSIDE THE FIRM 342 (2011) (giving the example of work in a tax software company requiring knowledge of computer programming, economics, and tax law).

[131] Ippolito, *supra* note 113, at 1254; *see also* Egon Franck, Stephan Nüesch & Jan Pieper, *Specific Human Capital as a Source of Superior Team Performance,* 63 SCHMALENBACH BUS. REV. 376, 377-381 (2011) (discussing team-specific capital).

[132] John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 MICH. L. REV. 1, 74 (1986).

the employer.[133] If a trained group of employees is hard to replace, unions are in a good position to engage in rent-seeking. DB pension plans tie employees to the employer and make it more difficult for them to "hold up" the firm; before ERISA, DB plans penalized individual employees who switched jobs.[134] On the collective level, pervasive underfunding of DB plans made it harder for unions to drive a hard bargain.[135] Thus, pension arrangements in effect turned industry-specific skills into firm-specific, and thus reduced employees' potential to extract rents from the firm. ERISA made this kind of arrangement impossible.[136]

If the cost of the creation of firm-specific human capital is borne by employees, the situation is different. Employees will only be willing to invest if there is a return, such as higher future wages, expanded benefits after a period of continuous employment and a high likelihood of advancing in the corporate hierarchy.[137] They may have an expectation to make a certain income within the firm, enjoy particular working conditions and benefits, and have certain career prospects if they do a good job. From the perspective of human capital theory, all these expectations are considered (quasi-)rents on an investment made early in the employment relationship. A related, but not entirely identical issue is that employees may need to move to obtain a particular job. Employers often cover relocation expenses to attract employees, since being in a particular location may also turn industry-specific skills into firm-specific ones.[138] Some of the costs may not be recoverable, such as those of reorganizing one's social life.[139] Thus, while employees are in principle free to switch jobs, they may be de facto "locked in" with the current employer. Moving to a job in another region where the same skill set is required may be deterred by the cost of moving.

The question is then how employees can obtain reasonable assurance that employers will not renege on worker expectations and engage in what is known as "holdup" in economic terminology. As explained above, the team production model of corporate law sees this as an important purpose of the board of directors that is in the position to balance the interests of various constituencies of the firm; by shutting out shareholders (who may have an ex post interest to engage in holdup) from decision-making, employees may have some degree of protection.[140]

In the labor economics literature, DB pension plans add another angle to the analysis, namely as part of a long-term, partly implicit contract that rewards loyalty with wages that in-

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133 *See* Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance,* 99 COLUM. L. REV. 508, 509-516 (1999) (suggesting that Japanese firms are able invest in employee training because these have no outside career options).

134 *Supra* notes 55-58 and accompanying text.

135 *Supra* notes 100-101 and accompanying text.

136 Furthermore, firms may prefer to confer benefits only to long-term, high-skill employees. ERISA's non-discrimination requirement prevents firms from targeting specific types of employees. Charny, *supra* note 47, at 1622-1623.

137 *See e.g.* Andrei Shleifer & Lawrence Summers, *Breach of Trust in Hostile Takeovers,* in CORPORATE TAKEOVERS. CAUSES AND CONSEQUENCES 33, 37 (ALAN J. AUERBACH ed. 1988) (discussing implicit contracts between firms and employees); Charny, *supra* note 47, at 1613 (discussing the use of pension to encourage investment in employer-specific skills by employees).

138 *See* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128, 35 (1994) (quoting an engineer comparing the difficulty of getting another job in the same industry in Texas and in Silicon Valley).

139 In this context, economists speak of regionally immobile "social capital" that reduces worker mobility. *See* Michael Bräuninger & Andreia Tolciu, *Should I Stay or Should I Go? Regional Mobility and Social Capital,* 167 J. INST. & THEOR. ECON. 434 (2011).

140 *Supra* notes 35-40 and accompanying text.

crease with seniority.[141] DB plans create an incentive for (at least) promotion-achieving performance and firm-specific investment, given that they reward a long tenure in the firm and because pension payments depend on late-career salary (typically resulting from promotion within the firm).[142] This is plausible when pension plans cannot be terminated because of legal hurdles, when they are entrenched because of deals with powerful unions, and when a managerialist board has no incentive to cut labor cost in order to create shareholder wealth.

For the descriptive point about shareholder primacy, it is relatively unimportant whether the rent-seeking explanation or the human capital explanation is empirically more important.[143] It suffices to realize that employment constitutes an asset. This asset's value is the net present value of expected income streams (from future wages, benefits, and vacation time) in the current job minus the equivalent ones in the next best one.[144] Margaret Blair estimates that the value of a job is considerable for employees, given that employees who are laid off in the course of a plant closing typically earn 10-15% less in their subsequent job.[145] This figure should realistically vary between jobs, and it should be greater for employees with either better rent-seeking opportunities at the firm, or greater specific investment and therefore expectations to receive quasi-rents from continued employment.[146] The bottom line for the analysis of the politics of corporate governance is that employees have a desire to keep their jobs, and to support policies that foster and protect returns on their human capital.

4.3. The exposure of pension wealth to risk

While policies relating to their employment position are clearly important to workers, expected retirement benefits are their other major asset. There are clear differences between DB and DC plans that matter for employee preferences with respect to policies relating to pension wealth.

In a DB plan, the employer bears the plan's funding risk. The major issue for employees is plan underfunding combined with the risk of the employer's default. ERISA addressed the issue with the requirement to set up a trust to hold pension assets.[147] While firms had begun to set up trusts for tax reasons decades earlier,[148] they were often underfunded. Previously, employees had to hope that the firm stayed in business and continued to fund the plan; in other words, one of the main risks for employees was whether the firm would continue to honor its commitment and

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[141] Edward P. Lazear, *Why is There Mandatory Retirement?* 87 J. POL. ECON. 1261 (1979); Edward P. Lazear, *The Future of Personnel Economics*, 110 ECON. J. F611, F617-F619 (2000); Friedberg & Owyang, *supra* note 53, at 27; Neumark, *supra* note 128, at 723-724.

[142] *See e.g.* Neumark, *supra* note 128, at 724-725 (discussing the incentive set by DB plans for specific human capital investment); MACKENZIE, *supra* note 125, at 48-49 ("Final-salary pension plans … create a powerful incentive for strong (or at least promotion achieving) performance on the job and loyalty to the firm, and reward the build-up of know-how that is specific to the firm.").

[143] *See* Neumark, *supra* note 128, at 725-726 (surveying the evidence for

[144] Ippolito, *supra* note 113, at 1253. Rationally, an employee would only switch jobs if the value of another job minus the cost of switching exceeds the value of the current one. Ippolito, *id.* at 1254.

[145] Blair, *supra* note 111, at 1310.

[146] Unionization can also be a possible consequence or reason for firm-specific investment, since unions protect employees' rents and quasi-rents. Unionization rates tend to be higher in manufacturing, where implicit deals with workers and specific investment are sometimes thought to be more common. *E.g.* Charny, *supra* note 47, at 1625-1626.

[147] § 403 ERISA, 29 U.S.C. § 1103.

[148] Langbein, 107 YALE L. J. 169 (1997). By contrast, in some European countries such as Germany, Spain, Italy, Sweden and Austria, firms often commit to paying retirement benefits directly, and thus need to fund provisions for future payments in their balance sheets. GORDON L. CLARK, PENSION FUND CAPITALISM 59-60 (2000) (discussing "book reserve" plans in Germany).

avoid going into bankruptcy.[149] Even with the insurance provided by the PBGC today, beneficiaries of a DB plan run the risk of losing the uninsured portion of the plan when the firm is not financially solvent and the plan becomes underfunded (e.g. because of a capital market downturn):[150] If firms are unable to fill the funding gap at that time, employees may lose a portion of their pension.[151]

Risks for employees are different in today's DC world. On the one hand, 401(k) plans are individual accounts that are controlled by the beneficiary, who can transfer them to a new employer's plan or shift the assets into an IRA. This reduces switching costs and the degree to which employees are tied to a particular employer. On the other hand, with a DC plan, potential retirees bear the investment risk because the employer does not have to jump in if the plan assets do not suffice to meet pension obligations.

The amount of funds available for retirement depends on investment success.[152] DC plans such as 401(k)s and IRAs (often consisting of 401(k) assets rolled over after a job change[153]) are invested in publicly-traded securities. The share of investment in stocks strongly increased at least between 1989 and 2001, when more than half of 401(k) plans reported to invest "mostly in stock."[154] Consequently, it is important for future retirees that capital (in particular equity) markets are doing well. In the bull markets of the 80s and 90s, and even in the years after the 2002 financial scandals, many employees did quite well and accumulated a significant retirement bonus. The financial crisis that started in 2008 showed the downside of the defined contribution society: Pension assets were flattened, which made it difficult for many to retire as planned.[155] Thus, in theory, a DC plan should eliminate the employee's risk-bearing with respect to the bankruptcy of the employer since it is not involved in pension payments, other than in a DB plan. That, however, assumes that retirement accounts are properly diversified. During the boom years, many firms encouraged employees to invest in the firms' own shares, often in the form of ESOPs. But even normal retirement accounts were often weighed heavily in favor of the employer, partly because employers often only matched employee contributions if they were invested in their own stock. Obviously, putting retirement assets into ESOPs makes employees bear the risk of the development of their employers' stock. Excessive investment in company stock has led to disaster for some employees in cases such as Enron, where many lost much of their retirement savings.[156] Of course, stock market downturns also affect DB plans; DB plans become less liquid and it may become harder to make pension payments due to liquidity constraints; in severe cases, the spon-

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[149] *E.g.* Friedman, *supra* note 53, at 220 (noting the risk of employer bankruptcy in a defined benefit plan); *see also* Sass, *supra* note 48, at 87 ("If the employer went bust, so would the benefits of current and future pensioners"); MACKENZIE, *supra* note 125, at 53.

[150] *Supra* note 87 and accompanying text.

[151] Friedman, *supra* note 53, at 220.

[152] *E.g.* MUNNELL & SUNDÉN, *supra* note 49, at 68.

[153] MUNNELL & SUNDÉN, *supra* note 49, at 69.

[154] Andrew A. Samwick & Jonathan Skinner, *How Will 401(k) Pension Plans Affect Retirement Income?* 94 AM. ECON. REV. 329, 333 (2004) (reporting an increase of investment "mostly in stocks" from 23.69% to 54.54% between 1989 and 2001, and a decrease of investment "mostly in bonds" from 39.52% to 10.01%).

[155] *See e.g.* Edward Whitehouse, Anna D'Addio & Andrew Reilly, *Investment Risk and Pensions: Impact on Individual Retirement Incomes and Government Budgets,* OECD SOCIAL, EMPLOYMENT AND MIGRATION WORKING PAPERS No. 87, 47 (2009) ("Pension funds lost 23% of their value in OECD countries in 2008").

[156] *See* Millon, *supra* note 78, at 119; MUNNELL & SUNDÉN, *supra* note 49, at 113 (providing statistics about cases where significant amounts of retirement assets where lost, and discussing Enron in more detail); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections,* 69 U. CHI. L. REV. 1233, 1248-1249 (2002) (describing the retirement problem of Enron employees).

soring firm may have to pitch in to close the funding gap.[157] The financial crisis of 2008/09 has hit the remaining DB plans hard, forcing firms to reduce shareholder's equity by putting funding liabilities on their balance sheets.[158]

Thus, the core difference in the employee's financial position is that in a DC plan, an employee is a shareholder, namely either a diversified investor in the capital market or in his own employer through an ESOP. In the case of well-diversified investment, employees should no longer have a strong interest in the employer's financial well-being except to the extent that it protects their human capital.[159] If the pension plan is heavily invested in the employer, the employee becomes a long-term shareholder strongly dependent on the firm's long-term development.

By contrast, in a DB plan, the position of the employee compares to that of a bondholder of the employer (specifically a secured bondholder to the extent of the guarantee by the PBGC and that of an unsecured bondholder for additional amounts);[160] the employee depends on the employer to meet his obligations and to continue to fund plans, and is subject to the risk of opportunistic benefit cuts.[161] Like a bondholder, employees do not participate in a general upswing in the economy that elevates values above the promised amount[162] and are also subject to the risk of inflation.[163]

4.4. Shifting employee interests

Even assuming a constant level of human capital investment during the past thirty years, the shift from DB to DC plans must have had consequences for what policies are in the interest of employees, particularly when shareholder interests and employee interests conflict.[164] Employees depend less on their employer for their financial capital, and more strongly on the capital market. For many families, their 401(k) plans represent the bulk of the available financial assets and thus determines financial security in retirement.[165] Capital markets have therefore become very important for the middle class.

The classic shareholder-labor controversy of this type is whether managers should be allowed to defend against hostile takeovers. Both managers and workers would by default prefer a "quiet life", meaning an absence of hostile takeovers disrupting their routine and putting their

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[157] *See* OECD, PRIVATE PENSIONS OUTLOOK 2008, 18-19 (2009).

[158] James J. Hanks, Jr., *Legal Capital and the Model Business Corporation Act: An Essay for Bayless Manning,* 74 L. & CONT. PROBS. 211, 229-230 (2011).

[159] The overall well-being of the respective industry should still matter to the individual industry as long as he has industry-specific human capital, and to unions hoping to maintain membership.

[160] Ippolito, *supra* note 113, at 1258-1259; Shigeto Kashiwazaki & Hiroharu Fukazawa, *Current Situation and Issues of Retirement Benefits (Corporate Pension) in Japan,* 7 JAPAN LAB. REV. 66, 73 (2010) (making the analogous argument for Japan). Empirical evidence shows that the tab is effectively picked up by shareholders, and that corporate equity risk reflects the riskiness of the assets held by a firm's pension plan. *See* Li Jin, Robert C. Merton & Zvi Bodie, *Do a firm's equity returns reflect the risk of its pension plan?* 81 J. FIN. ECON. 1 (2006).

[161] Kashiwazaki & Fukazawa, *supra* note 160, at 73-74. Note that the employees is not diversified resulting from pension plan underfunding is not diversified at all. *See* Ippolito, *supra* note 100, at 611; Ippolito, *supra* note 113, at 1259 (arguing that the underfunding of pension plans discourages unions from engaging in holdup to the detriment of shareholders).

[162] PETER F. DRUCKER, THE UNSEEN REVOLUTION 94-95 (1976).

[163] DRUCKER, *id.* at 96-97; Markus Roth, *German Private Pension Law,* in IMAGINING THE IDEAL PENSION SYSTEM 131, 143 (Dana M. Muir & John A. Turner eds. 2011).

[164] Arthur R. Pinto, *The United States,* in PUBLIC COMPANIES AND THE ROLE OF SHAREHOLDERS 13, 22-23 (Sabrina Bruno & Eugenio Ruggiero eds. 2011).

[165] MUNNELL & SUNDÉN, *supra* note 49, at 68-69.

jobs at risk.[166] A takeover puts employees at risk since it often results in significant restructuring of the enterprise, which often leads to changes to corporate objectives, product lines, factories, and thus conditions of work and maybe the downsizing of the workforce. Labor therefore typically prefers strong takeover defenses. Shareholders may want managers to defend against hostile takeovers to the extent that this drives up the price paid by the bidder,[167] but they will want a takeover to go forward once managers have bargained for a good price with the bidder.[168]

The shift in the private pension system has thus affected the effects of different policies on employees. An employee saving for retirement in a DB plan firm needs to care little about how corporate law policies affect share values in general, and the value of her employer specifically. Her two objectives – protecting her human capital and her pension wealth – can be achieved by largely the same means, namely by staying in the firm and hoping for a favorable working environment and workplace conditions, promotion opportunities within the firm, and that the firm continues to operate the pension plan. The capital market is only important when employer loses his ability to fund the plan. Even if employees have no firm-specific human capital investment, in a traditional DB plan, they have specific financial capital as de facto bondholders of their firm and are thus subject to a possible holdup threat. Pro-shareholder policies that create pressure to cut costs and downsize may not only threaten their human capital, but also their financial capital if the end result is a reduction of pension benefits, or even the ultimate termination of a DB plan following an LBO.[169] Pension wealth, therefore, will generate little, if any worker preferences for pro-shareholder policies at the expense of labor in DB plans.[170] Workers will strongly prefer policies that result in a stable labor environment and will disfavor pro-shareholder policies that are antagonistic to that result.

In a DC plan, pro-shareholder policies will have a direct impact on employee wealth that may change whether a particular policy is beneficial or detrimental to employees. For example, a proposed policy that facilitates hostile takeovers may reduce the value of human capital, while at the same time increasing the value of pension wealth. That does not imply that workers no longer need to care about their job. Even if there is no specific human capital, workers bear a switching cost and often have to accept less well-paying jobs. However, on the margin the closer connection between share value and pension wealth in DC plans implies that the benefits of pro-

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[166] *E.g.* Marianne Bertrand & Sendhil Mullianathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043, 1066-1067 (2003) (suggesting that managers prefer a "quiet life" not involving confrontation with labor).

[167] In the debates about Delaware takeover law, managers at least claim that bidders offer an inadequate price because the stock market does not fully reflect the value and the potential of the firm, and that shareholders are likely to be duped into a accepting an inadequate offer. *See e.g.* Allen et al, *supra* note 42, at 1091 ("The first argument is that stockholders with diversified portfolios will be better served if informed directors are permitted to block business combinations that they believe in good faith are ill-advised").

[168] This is the rationale for so-called Revlon duties, according to which the board of directors is required to maximize price once a sale of the company has become inevitable. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (1986).

[169] See the discussion of opportunistic terminations in section 3.2.4

[170] Peter Drucker coined the term "pension fund socialism" in a 1976 book and argued that employees already owned American business through DB plans. However, he acknowledged that psychologically employees neither knew that they were owners nor perceived or experienced ownership. DRUCKER, *supra* note 162, at 97. The reason is that employees in DB plans are better characterized as creditors than as owners. *See also* Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 567-568 (1981) (predicting a growing influence of pension fund administrators).

shareholder corporate policies are greater than in DB plans, thus making these relatively more advantageous compared to pro-labor policies.[171]

4.5. Shareholder primacy and social welfare

Weighing the pro-shareholder and pro-labor policy objectives against each other, an overall social welfare analysis will most likely come to a different conclusion in the corporate DB world of the 1970s and the DC world of today. In a hypothetical society where 9 out of 10 employees are subject to a DB plan and 1 is subject to a DC plan, the larger number of workers is more likely to benefit from pro-labor policies that generally protect human capital as opposed to pro-shareholder policies that benefit DC pension wealth (and have little impact on DB pension wealth). If the numbers are reversed, a redistributive policy change that benefits shareholders at the expense of employees may hurt human capital to some extent, but for many employees, this will be outweighed by benefits to DC pension wealth (while the impact on DB pension wealth will be smaller).

A well-meaning social planner would therefore very likely favor a different corporate law policy. Leaving other possible effects of the change aside, the optimal point in a shareholder-labor scale will shift closer to full shareholder primacy in a world where DC plans dominate. The shift to greater shareholder primacy since the 1970s may reflect the fact that the effects of pro-shareholder policies on employees have become relatively more beneficial.[172]

The analysis so far has assumed that the extent of human capital investment has remained constant and that it is also unchanged in its degree of specificity, the conclusion being that it is desirable for the balance to shift to some extent in favor of investor interest. However, to optimize policy choices, one would need to determine the relative significance of firm-specific human capital and pension wealth. Margaret Blair estimates that the value of specific human capital is typically several times as large as pension wealth.[173]

Apart from that, the transformation of pension wealth may have affected incentives to invest in specific human capital. The growth of DC plans coincided and maybe was partly the consequence of the decline of "large hierarchic firms and unionized industries", while it "was growing in high-tech firms and small, non-unionized companies".[174] Relatedly, labor mobility began to increase in the late 1960s:[175] Thus, firm-specific human capital has likely become less important in the United States economy during the past decades.

The increase in labor mobility, which was influenced by a variety of economic, social and technological factors, started earlier than the change in the pension system. Industries preferring DB plans likely declined for other reasons, while others prospered.[176] However, traditional DB

[171] While an ESOP would seem to make workers prefer less risky corporate decisions given their non-diversified portfolio, a generous takeover premium might sometimes help to overcome worker resistance.

[172] Changes in the pension system may have contributed to the popularity of shareholder primacy in academia. As a business school professor put it at a conference on shareholder primacy: "The closer I get to retirement, the more I like shareholder wealth maximization." This tongue-in-cheek remark reflects that with increasing age, human capital (understood as net present value of future earnings) decreases, while pension wealth (net present value of pensions) increases.

[173] Blair, *supra* note 111, at 1310.

[174] Munnell, *supra* note 50, at 367; Gustman & Steinmeier, *supra* note 107.

[175] *E.g.* Gueorgui Kambourov & Iourii Manovskii, *Rising Occupational and Industry Mobility in the United States: 1968-1997*, 49 INT'L ECON. REV 41 (2008) (describing an increase in mobility both between jobs and between different industries).

[176] Different levels of investment of human capital may be optimal in different industries, and it may even be possible to organize work in ways that require different levels of firm-specific human capital within a specific industry. *See*

plans were suited to industries with a stable workforce and not those where workers tend to switch jobs frequently in the course of their career.[177] Since ERISA made it more difficult to inhibit mobility, it may have made the former industries relatively less competitive. Thus, it probably accelerated the trend toward more mobility, less firm-specific human capital, and possibly more general or industry-specific human capital.[178] The regulatory changes of the 1970s thus further helped the transformation of the American economy.

Note that the point on social welfare is one of relative efficiency of shareholder orientation given specific circumstances. The overall effects of the change are more complex and probably indeterminate: On the one hand, the reduction of firm-specific investment may have hurt the American economy, and DC plans may harm workers by burdening them with investment risk they are not well suited to bear. One the other hand, the shift to DC plans may also have reduced employee resistance against innovation and changes in the work environment. Larger financial markets may have encouraged economic growth.

5. The changing political economy of shareholder primacy

In this section, I explore the consequences for the interest group politics of corporate governance. Sections 5.1 and 5.2 look at the general political environment and suggest that changes in the pension system helped to align the interests of workers with those of shareholders, thus leading to the rise of the "transparency coalition" identified by political scientists. Sections 5.3, 5.4 and 5.5 provide an illustration of this seismic shift in the politics of corporate governance by looking at the rise of shareholder activism during the same period. A significant contribution to shareholder activism came from unions, which embraced the newly found "capitalist" interest of workers as equity investors, and thus began to promote shareholder wealth maximization as one of their policy objectives. The shift from DB to DC plans was very likely not the only factor; in fact, some of the most important shareholder activists are public pension plans operating under a DB system, who also became more strongly involved in equity markets due to regulatory changes. The objective is to show that the implementation of pro-shareholder reforms is partly the unintended consequence of changes in the pension sector that made the proposition of shareholder primacy more attractive.

5.1. Shareholders and the center-left

The increased importance of pension wealth for the welfare and well-being of individuals also had an impact on the politics of corporate governance. With the middle class increasingly depending on pension savings, shareholders as such have become an important political constituency.[179] Consequently, the political center-left has championed the cause of shareholders, since an anti-management agenda resonates with members of the middle class, who are often both shareholders and employees.[180] Pro-shareholder reforms of the past 20 years tended to be endorsed by

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e.g. MARGARET M. BLAIR, OWNERSHIP AND CONTROL 263-266 (1995) (discussing differences in worker mobility and wage premia for incumbents between industries).

177 Munnell, *supra* note 50, at 367.

178 *See* Jacoby, *supra* note 12, at 286 (suggesting that firms no longer invest in long-term projects such as employee training due to the short-term horizon of institutional investors).

179 Davis, *supra* note 7, at 1129 (suggesting the increasing political importance of shareholder value due to the increase of the number of households invested in the stock market from 20% in 1983 to 50% in 2001).

180 Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 338 (2011).

the Democratic Party and opposed by the Republicans, who were often in favor of reforms that sought to cabin allegedly excessive litigation.[181] This is most clear in the context of the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010, which reacted to corporate governance crises of Enron and the Great Recession respectively:[182] Democrats supported reforms that provided stronger securities regulation, "Say on Pay" and "Proxy Access", whereas Republicans, alongside lobbyists such as the Business Roundtable and the Chamber of Commerce, generally aligned themselves with critics who argued that overregulation was liable to stifling the economy. Some of the initiatives that led to the most recent reforms, such as the 2009 proposal for a Shareholder Bill of Rights Act, clearly established a connection between corporate governance failures and "losses that have been borne by millions of Americans who are shareholders through their pension plans, 401(k) plans, and direct investment."[183] One of the most telling examples where the pro-shareholders forces were not successful is the Private Securities Litigation Reform Act of 1995, which was intended to curtail securities litigation and was enacted by a Republican Congress over President Clinton's veto.[184]

5.2. The "transparency coalition" and its effects

The major corporate governance reforms of the last two decades have primarily affected securities law, and have sought to make management more transparent and more accountable to the investing public. The dividing line on these policy issues tended to run between management and all other groups in corporate governance. In situations like this, it is comparatively easy for what Gourevitch and Shinn have christened the "transparency coalition" to dominate corporate law policymaking. In such a situation, managers have to yield to the demands of investors and workers on the political level, both of which benefit from transparency.[185]

However, not all corporate governance issues lend themselves to a shareholder-worker coalition. In contrast to the shared interest in transparency, employees may be more skeptical about increasing the actual decision-making power of shareholders, particularly in decisions with redistributive effects between capital and labor. Some hostile takeovers likely entailed such conflicts. In Delaware, where takeover law took shape in the case law in the 1980s and early 1990s, managers retained their preeminence as the leading interest group to shape the law on takeover defenses, without having to enter into coalitions. In most cases, managers of companies threatened by hostile takeovers were the prime sponsors of most anti-takeover statutes,[186] but they of-

181 *See* John W. Cioffi & Martin Höpner, *The Political Paradox of Finance Capitalism: Interests, Preferences, and Center-Left Party Politics in Corporate Governance Reform,* 34 POL. & SOC'Y 463, 480-484 (2006).

182 JOHN W. CIOFFI, PUBLIC LAW AND PRIVATE POWER 108-136 (2010).

183 Shareholder Bill of Rights Act of 2009, S.1074, 111th Cong. (2009), at 2. Bruner, *supra* note 180, at 337-338 (citing from the bill and describing the Obama administration's agenda to help the middle class).

184 CIOFFI, *supra* note 182, at 105-107. It is certainly not a new development for the Democratic Party to side with investors against managers. As Cioffi & Höpner (*supra* note 181, at 484) point out, "the New Deal of the 1930s created modern securities regulation." Adolf Berle advocated shareholder primacy and was an advisor to President Roosevelt. William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the* Modern Corporation, 34 J. CORP. L. 99, 114-118 (2008). Bratton and Wachter document that Berle's erstwhile opponent Merrick Dodd associated himself with representatives of managers who saw planning by the managerial elite as the way out of the incipient Great Depression. Bratton & Wachter, *id.*, at 123-124.

185 GOUREVITCH & SHINN, *supra* note 13, at 210-211.

186 *See* William J. Carney, *The Production of Corporate Law,* 71 S. CAL. L. REV. 715, 749-751 (1998) (listing corporate sponsors of statutes).

ten received passive or active support from unions.[187] In some cases, legislation supported solely by managers would have been unlikely to pass without the endorsement of a traditional Democratic constituency such as labor.[188]

Takeovers, however, are no longer politically as salient as they were in the 1980s. During that period, DB plans had only begun to be supplanted by DC plans; thus, political decisions on state takeover law might actually come out differently in today's environment.[189] The corporate governance reforms of the past two decades – or reform projects – were intended to make managers *more* accountable to shareholders. Putting independent directors in charge of the board's audit committee[190], strengthening auditor independence,[191] strengthening shareholder voice in director appointments[192], and "say on pay"[193] would at first glance not seem to have colorable detrimental consequences for employees.

However, it is sometimes thought that in the managerial model of the 1950s employees tacitly or explicitly formed coalitions with management to the detriment of outside shareholders;[194] in this view, management agreed to generous deals regarding wages and benefits for employees, while unions would not object to "sweet deals" or private benefits of control for top management. Obviously, reforms increasing transparency and strengthening shareholder voice may be making this kind of deal more difficult. Conceivably, in a stakeholder model of corporate governance, corporate opacity might make it easier to engage in long-run deals with labor that would be assessed very critically under the short-term pressures emanating from the capital markets.[195] In a less transparent corporate world where managers are less exposed to pressures from

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[187] John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups,* 1988 WIS. L. REV. 435, 438 n.8; Mark J. Roe, *A Political Theory of American Corporate Finance,* 91 COLUM. L. REV. 10, 63-64 (1991); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes,* 61 GEO. WASH. L. REV. 14, 24-25 (1992); Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears,* 1999 ANN. SURV. AM. L. 85, 96 (1999).

[188] Kenneth B. Davis, *Epilogue: The Role of the Hostile Takeover and the Role of the States,* 1988 WIS. L. REV. 491, 496-497.

[189] As seen in section 3.2.4, through the terminations for reversion after an LBO takeovers may actually have contributed to the replacement of DB plans with DC plans.

[190] Sarbanes-Oxley Act § 301.

[191] *See* Sarbanes-Oxley Act, Title II.

[192] The SEC has repeatedly issued proposals to amend its rules in order to expand "shareholder access", which would permit larger shareholders to place nominees for a limited number of seats on the company's proxy statement. The initial proposal was made in 2003 (Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,785 (proposed Oct. 23, 2003). § 971 of the Dodd-Frank Act of 2009 explicitly gave the SEC authority to pass such a rule, which it did in the form of Rule 14a-11. This highly controversial rule was struck down by the the Court of Appeals for the DC Circuit. Business Roundtable and Chamber of Commerce of America v. SEC, No. 10-1305, July 22 (DC Circ. 2011). The SEC subsequently decided not to appeal. *See* http://www.sec.gov/news/press/2011/2011-179.htm.

[193] Dodd-Frank Act § 951 (introducing a new Securities Exchange Act § 14A, which requires shareholder votes on executive compensation. On the preceding discussion s*ee*, Jeffrey N. Gordon, "*Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-in*, 46 HARV. J. ON LEGIS. 323 (2008).

[194] *E.g.* Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure,* 22 COMP. LAB. L. & POL'Y J. 97, 101 (2000); GOUREVITCH & SHINN, *supra* note 13, at 237-238; GOMEZ & KORINE, *supra* note 7, at 99-135.

[195] Institutional investors in general and pension funds in particular are often criticized for their short-term orientation. *E.g.* Jacoby, *supra* note 12, at 285. Relatedly, the argument that hostile takeovers maximize shareholder wealth rests on the assumption that market values reflect long-term firm value with reasonable accuracy. *See* Michael L. Wachter, *Takeover Defenses when Financial Markets are (only) relatively efficient,* 151 U. PA. L. REV. 787, 819-823 (2003); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy,* 31 J. CORP. L. 637,

the capital markets, it may be easier to implement pension plans, whose conceivable benefits for human capital[196] are hard to assess for the financial market.[197] The bottom line is that changes in corporate governance that result in increased transparency could be a factor associated both with the shift toward DC plans and the increasing dominance of shareholder over labor interests.

5.3. The rise of institutional investors

The changes in the private pension landscape have also had the effect of channeling the political power of shareholder value through the pension system,[198] thus increasing the significance of the financial industry, both on the level of individual firms where pension wealth is invested, and on the political level. Due to institutional constraints, the effects on the politics are more nuanced than one might expect.

There are several models of how pension wealth is managed. Their structure is determined by the Taft-Hartley Act, which allows employer-provided pension plans to have at most 50% union representatives on their board of trustees.[199] Thus, pension plans are either controlled by corporate managers or under shared control by employers and unions. Employer-pension plans obviously do not appear as separate actors in corporate governance.[200] Plans under shared management (so-called Taft-Hartley plans) are usually multiemployer plans and therefore dominated by unions, which are independent corporate governance players. 401(k) assets, by contrast, are typically invested in mutual funds.

Consider the Conference Board's data on equity ownership in the United States.[201]

674 (2007) ("academic endorsement of … short-term stock price …may reinforce inappropriate managerial decisions).

[196] *See* sections 3.2.3, 4.2, and 4.3 above.

[197] Furthermore, with the rise of the DC paradigm, DB pension plans are becoming less familiar to shareholders, to whom they may appear as an unjustified privilege of unionized workers. *Compare* the debate about pension benefits of public employees. *Move Public Employees Into 401(k)s? Room For Debate*, N.Y. TIMES, February 27, 2011.

[198] Tom Hadden, *Corporate Governance by Institutional Investors? Some Problems from the International Perspective*, in INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 89, 94 (Theodor Baums, Richard M. Buxbaum & Klaus J. Hopt eds. 1994) (pension fund managers are only interested in shareholder wealth).

[199] The Taft-Hartley Act of 1947 prohibits employers from making payments to unions, including union-run pension funds, except plans with equal representation of employees and employers (i.e. unions and managers) on the board. Labor Management Relations Act of 1947, ch. 120, § 302(c)(5), 29 U.S.C. § 186(c)(5). The act was part of the backlash to the New Deal, when managers feared increased union influence and induced Congress to pass the Act prohibiting payments to plans that were fully controlled by unions, which unions might have used to fund strikes or activity directing against employers. *See* Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 76, 84-85 (1993) (discussing interest groups in the legislative process); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1075-1077 (1998) (describing the origin, structure, and prevalence of Taft-Hartley Plans); Murphy, *supra* note 96, at 531-532. ERISA applies both to corporate pension plans and Taft-Hartley plans, which are often multiemployer plans and are typically dominated by unions. *See* Marleen O'Connor, *Organized Labor as Shareholder Activist: Building Coalitions to Promote Worker Welfare*, 31 U. RICH. L. REV .1345, 1357 (1997). Pension plans directly controlled by employers do not engage in shareholder activism. Roe, *id.* at 109.

[200] Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 596-598 (1990); Roe, *supra* note 199, at 109 ("ERISA rules and pension structure help protect managers form intrusive shareholders"); Murphy, *supra* note 96, at 525-529.

[201] THE CONFERENCE BOARD, THE 2010 INSTITUTIONAL INVESTMENT REPORT 25-26 (2010), available at http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=1872.

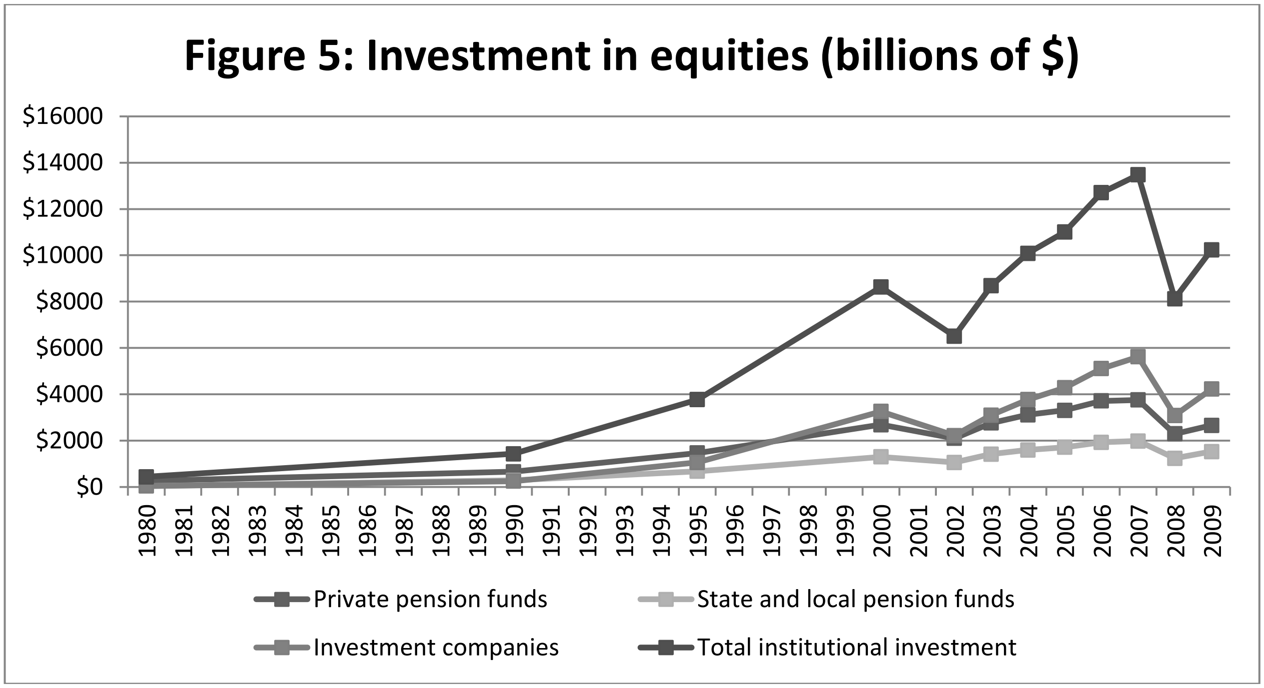

Figure 5: Investment in equities (billions of $)

Figure 5 illustrates the growth of institutional investment from 1980 through 2009. Total institutional investment increased from $436.2 billion in 1980 to $13,473 billion in 2007, just before the financial crisis. These figures of course do not only include vehicles for pension wealth,[202] and not all investment company assets are pension assets (although a large part is). The increase was also not only the consequence of growing stock market prices.

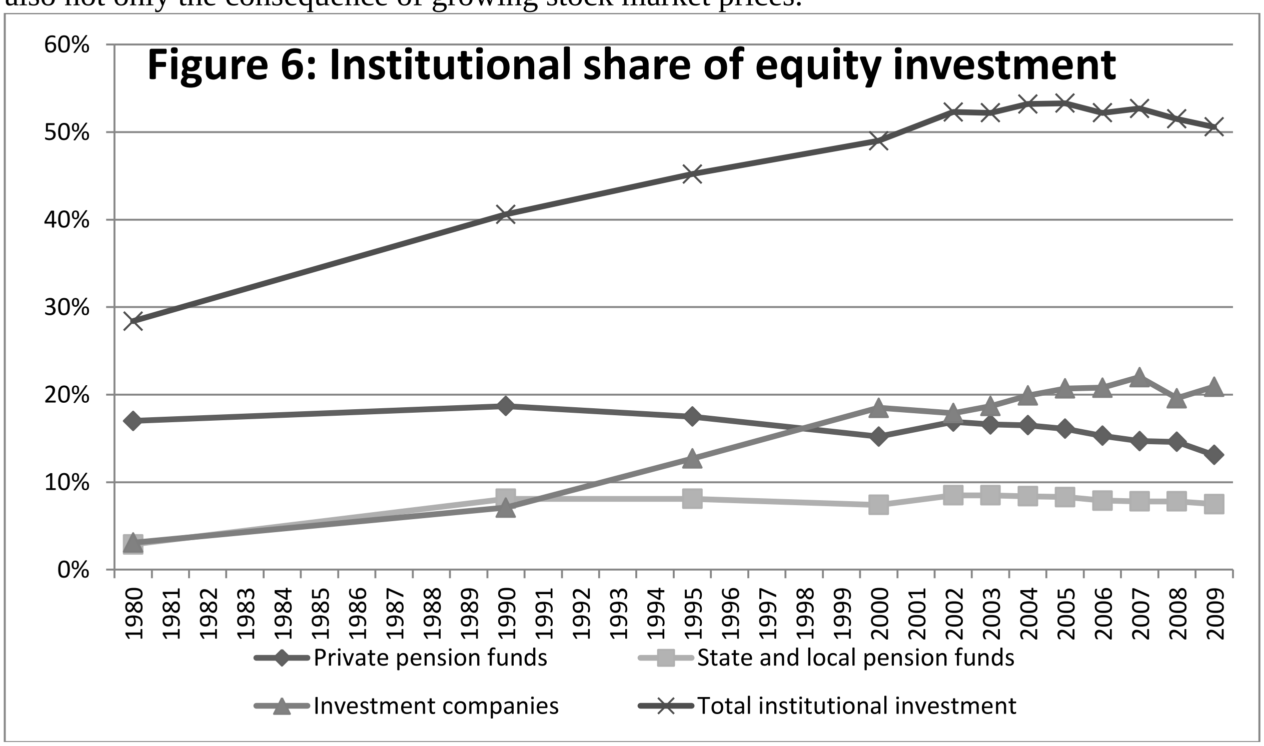

Figure 6: Institutional share of equity investment

[202] Insurance companies, savings institutions and foundations were left out in figures 5 and 6.

Figure 6[203] shows that the share of institutional investors in equity investment also increased relatively, namely from less than 30% to around 50%. Private and public pension funds initially grew (relatively speaking) from a share of about 17% and 3% respectively. After 1990, private funds began to lose market share, while public finds largely maintained theirs, with private funds showing up with 14.7% in 2007 and public ones with 7.8% in the same year. Meanwhile, investment companies' share increased from only 3.1% in 1980 to 22% in 2007. Overall, the total share of these three types of investment vehicles grew from 23% to 42.5% of the equities market.

5.4. Unions as corporate governance activists

The newfound significance of capital markets for workers was of course not lost on unions, which began to use their power to the benefit of their constituents. Unions no longer only engage in classical industrial action, but have become some of the most visible shareholder activists[204], both through Taft-Hartley pension plans and through their own holdings.[205] Some unions, such as AFL-CIO and the Teamsters, were parties in notable corporate law cases relating to shareholder voting, some of which ostensible had nothing to do with labor issues.[206] Furthermore, in the early 1990s, unions switched alliances with respect to takeovers: Instead of siding with managers to oppose them,[207] they began to join forces with other shareholders to obtain the highest return on their investment.[208] Unions have supported corporate governance legislation intended to hold managers more accountable to shareholders, including Sarbanes-Oxley[209] and shareholder proxy access.[210] They generally support pro-shareholder institutions such as the Council of Institutional Investors and the International Corporate Governance Network.[211]

Part of this may be owed to highly contextualized decisions to engage in shareholder activism and the fragmented character of the American labor movement: Unions have little reason to care about workers in other firms who are not their members. A single national union might

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[203] Data from THE CONFERENCE BOARD, *supra* note 201 (obvious mathematical error corrected by the author).

[204] *E.g.* Marleen O'Connor, *Labor's role in the shareholder revolution,* in WORKING CAPITAL: THE POWER OF LABOR'S PENSIONS 67, 67 (Archon Fung, Tessa Hebb & Joel Rogers eds. 2001). Shareholder activism is often part of a so-called "comprehensive campaign", in the course of which unions employ all available tactics against a firm, including public relations and legislative initiatives. *See e.g.* James J. Brudney, *Collateral Conflict: Employer claims of RICO extortion against union comprehensive campaigns,* 83 S. CAL. L. REV. 731, 738 (2010).

[205] *See* Schwab & Thomas, *supra* note 199, at 1081 (pointing out that unions are not subject to ERISA fiduciary duties with their own holdings).

[206] *E.g.* AFL-CIO v. Wal-Mart, 1992 WL 111285 (Del. Ch. 1992) (seeking a stock list to inform shareholders about the use of prison labor); Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores, Inc., 821 F. Supp. 877 (S.D.N.Y. 1993); Int'l Brotherhood of Teamsters General Fund v. Fleming Companies, Inc., 975 P.2d 907 (Okla. 1999) (finding that shareholders may propose and adopt a bylaw requiring the redemption of a poison pill); *see also* CA Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008) (public-sector union seeking a bylaw amendment requiring the reimbursement of shareholders for expenses relating to contested director elections); AFSCME v. AIG, 462 F.3d 121 (2nd Cir. 2006) (public sector union seeking bylaw amendment to allow shareholder proxy access).

[207] *E.g.* Randall S. Thomas & Kenneth J. Martin, *Should labor be allowed to make shareholder proposals,* 73 WASH. L. REV. 47 (1998).

[208] O'Connor, *supra* note 194, at 101, 109-110; *see* Thomas & Martin, *supra* note 207, at 48-51 (describing the historical development of union activism).

[209] *See* Sanford M. Jacoby, *Finance and Labor: Perspectives on Risk, Inequality, and Democracy,* 30 COMP. LAB. L. & POL'Y J. 17, 51-52 (2008). (describing the AFL-CIO's support for Sarbanes-Oxley).

[210] *See* Jacoby, *id.* at 55-56 (discussing union support for shareholder proxy access); Sanford M. Jacoby, *The Future of Labor and Finance,* 30 COMP LAB. L. & POL'Y J. 111, 116 (2008).

[211] Brishen Rogers, *The Complexities of Shareholder Primacy: A Response to Sanford Jacoby,* 30 COMP. LAB. L. & POL'Y J. 95, 98-99 (2008).

have reacted differently. Nevertheless, it seems paradoxical for unions, whose purpose is to represent employees, to support hostile takeovers and other business measures that may entail downsizing and job cuts.[212] However, their changed focus looks justified when one realizes that unions have been operating under very different circumstances in recent decades: Membership decreased dramatically during the 1980s.[213] While unions certainly continued to have an interest in preserving jobs in order to maintain their membership, because of aging cohorts of workers retiring, a larger percentage of their constituents were pensioners. Consequently, obtaining a good return on their investments for aging members became relatively more important.[214] In addition, ERISA may also have played a role in instigating union shareholder activism, given that the pension plan's board members were subject to the statute's fiduciary duty.[215]

The view of unions as true shareholder activists has of course been challenged. In the popular press, it has sometimes been suggested that unions use their influence as shareholders to advance a general political agenda.[216] In the more nuanced academic discussion, critics such as Reinier Kraakman suggested that unions are likely to prioritize workers' interests over shareholder wealth, given that the former are tied up in a specific firm. Thus, labor can capture rents in the guise of wages; by contrast, the pension investment in shares is spread out over a diversified portfolio and thus hard to influence through activism.[217] However, an empirical study by Schwab and Thomas' found that union activism more often than not works in favor of shareholder wealth.[218] While the anecdotal and empirical picture is certainly ambiguous, both public and private sector unions have initiated and supported measures that are generally thought to be in the interest of shareholders. These include pro-takeover initiatives such as pill-redemption bylaws, staggered

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[212] Simon Deakin, *The rise of finance: What is it, what is driving it, what might stop it?,* 30 COMP. LAB. L. & POL'Y J. 67, 71 (2008); *see also* Teresa Ghilarducci, *Solving the Paradox of Workers as Shareholders: A Comment on Sanford Jacoby,* 30 COMP. LAB. L. & POL'Y 85. 88 (2008) (ironically suggesting that unions are funding their "class enemies").

[213] O'Connor, *supra* note 194, at 101; O'Connor, *supra* note 199, at 1379. Wachter, *supra* note 106, at 582, 634 (plotting the percentage of union workers 1930-2005); Murphy, *supra* note 96, at 532 (describing a decline in union membership from 30% to 9% between the 1950s and 2000). Takeovers in which unionized employees were laid off seem to have been one of the reasons. Thomas & Martin, *supra* note 207, at 41, 47-48.

[214] *See* Thomas & Martin, *id.* at 49 (describing the new-found union opposition to takeover defenses); Teresa Ghilarducci, James Hawley & Andrew William, *Labour's Paradoxical Interest and the Evolution of Corporate Governance,* 24 J. L. & SOC'Y 26, 34 (1997). The success of "comprehensive campaigns" by unions that include shareholder activism has apparently also contributed to growth in union membership since 2005, particularly in the services industries. Brudney, *supra* note 204, at 742.

[215] Schwab & Thomas, *supra* note 199, at 1077-1078; O'Connor, *supra* note 194, at 129-130; *see also* Rogers, *supra* note 211, at 107 (suggesting that the ERISA trustee duty would weigh against union use of shareholder activism for other ends than wealth maximization).

[216] *E.g. Pension Fund Blackmail,* WALL ST. J., *March 31, 2005,* at A10 (accusing the AFL-CIO of influencing managers to oppose private social security accounts).

[217] Reinier Kraakman, *The Mystery of Union Shareholder Activism: Commentary on Schwab and Thomas,* in EMPLOYEE REPRESENTATION IN THE EMERGING WORKPLACE: ALTERNATIVES/SUPPLEMENTS TO COLLECTIVE BARGAINING 431, 433-434 (Samuel Estreicher ed. 1998). To protect workers from excessive risk, diversification is mandated by § 404 of ERISA (29 U.S.C. § 1104(a)(1)(C)), which may inhibit private pension fund activism. *See* Murphy, *supra* note 96, at 506-507.

[218] Schwab & Thomas, *supra* note 199, at 1090 (summarizing their finding that unions have become "sophisticated players in corporate-governance battles", where the "battles emphasize efficiency and firm value."); *see also* GOUREVITCH & SHINN, *supra* note 13, at 251 (identifying "an emerging tendency for workers to make common cause with shareholders"); see also Murphy, *supra* note 96, at 539.

boards,[219] and bylaw amendments relating to shareholder voting, such as the contested issue of majority voting instead of plurality voting in elections for directors.[220] There were also some widely publicized cases where unions pushed "corporate social responsibility" proposals or labor issues.[221] Still, even without a full empirical assessment, it seems fair to say that union activism has to a large degree helped the cause of shareholder primacy. As early as 1994, other shareholders trusted unions enough for the evidence to show that union proposals received more votes than others.[222] This is a significant change compared to union activities a few decades earlier.

5.5. Activism by other institutional investors

One might object that union-sponsored plans have traditionally been DB plans. However, even they are increasingly becoming DC plans, which may have made it further likely for unions to support shareholder-wealth-oriented proposals, given that the influence of share value on pension wealth has increased.[223] Generally, however, public pension funds have been much more active shareholders, most notably the biggest in the country, CalPERS.[224] While government employees typically enjoy DB plans, the fiduciary requirement and the increased difficulty in securing state money to cover funding gaps may have incited them to promote shareholder wealth. Before 1980, very little public pension money was invested in equities because state pension systems were typically not permitted to invest a large proportion of their portfolio in shares.[225] Until a 1984

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[219] *E.g*. UNITE v. May Dept. Stores Co., 26 F.Supp.2d 577 (S.D.N.Y. 1997); Int'l Brotherhood of Teamsters General Fund v. Fleming Companies, Inc., 975 P.2d 907 (Okla. 1999). *See* Schwab & Thomas, *supra* note 199, at 1045 ("The most frequent proposals in the 1995 and 1996 proxy seasons were those to redeem or vote on poison pills and to repeal classified boards").

[220] *See e.g.* SEC No-action letter to Penn Nat'l Gaming, Inc. March 30, 2011, http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2011/unitehere033011-14a8.pdf (addressing UNITE's 14a-8 majority voting proposal); SEC No-action letter to NRG Energy, Incl., January 28, 2009, at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/liuna012809-14a8.pdf (discussing LIUNA's majority vote proposal); SEC No-action letter to Suntrust Banks, January 13, 2010, at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2010/unitedbrotherhood011510-14a-8.pdf (addressing the United Brotherhood of Carpenters's 14a-8 proposal); WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ASSOCIATIONS 214-217 (3[rd]. ed. 2009) (example of pension fund using 14a- to introduce majority voting); SEC No-action letter to Verizon Communications, February 2, 2009, http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/ibew020209-14a8.pdf (discussing private sector union proposal to introduce cumulative voting).

[221] Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores, Inc., 54 F.3d 69 (N.Y. Ct. App. 1995) (14a-8 proposal relating to Wal-Mart's allgedly discriminatory policies); *see also* United Paperworkers Intern. Union v. International Paper Co., 1992, 801 F. Supp. 1134 (S.D.N.Y. 1992) (union activism relating to environmental policies); O'Connor, *supra* note 199, at 1363-1366 (describing the controversy about alleged employment discrimination at Cracker Barrel); *see* O'Connor, *supra* note 204, at 71-73; O'Connor, *supra* note 194, at 113-115 (surveying union use of shareholder proposals in the context of labor disputes or negotiations). *See also* Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 590 (2006) (describing United Food Worker's Union use of pension holdings to increase their bargaining power vis-à-vis Safeway).

[222] Thomas & Martin, *supra* note 207, at 67-68; Schwab & Thomas, *supra* note 199, at 1052.

[223] Schwab & Thomas, *supra* note 199, at 1040.

[224] *E.g.* Sanford M. Jacoby, *Convergence by Design: The Case of CalPERS in Japan*, 55 AM. J. COMP. L. 239, 243-254 (2007) (describing the history of shareholder activism by CalPERS); Stephen J. Choi & Jill E. Fish, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 315 (2008); Aaron Lucchetti & Joann S. Lublin, *Corporate Governance: Calpers Targets Directors Who Neglect Holders*, WALL ST. J., April 16, 2004, at C1 (describing CalPERS' renewed efforts at shareholder activism); *see also* City of Westlaw Police & Fire Retirement System v. Axcelis Technologies Inc. (Del. 2009) (public sector pension plan seeking to put a majority voting bylaw amendment on the target company's proxy statement).

[225] Jacoby, *supra* note 209, at 46.

amendment to the California constitution, CalPERS could only invest up to 25% of its portfolio in stocks.[226] For similar regulatory reasons, many pension funds had few or no equities in their portfolios until the mid-1990s.[227] The proponents of the Californian amendment argued that prudent equity investment would create a higher yield and thus save taxpayers money.[228] With regulation receding and equities being increasingly seen as the highest-yield class of investment, pension funds across the country shifted into equities.[229] In other words, the equity-based model penetrated the public sector because private pension funds displayed better performance.[230] Ultimately, the success of the private DC model may therefore have contributed to changing practices in the public sector.

Nevertheless, it is not surprising that state and local government pension funds are among the most active institutional investors. One reason may be that some of them are unusually large, and another that they comprise about 40% of the pension sector.[231] Having to accommodate demographic challenges and funding gaps, public pension funds largely embraced the idea of shareholder primacy.[232] Large pension funds are likely to be more active because they have more predictable inflows and outflows, and because their portfolios inevitably mirror the economy as a whole, thus eliminating the exit option.[233] Like unions, they also have other controversial political and social goals, given that they have to appeal to their political constituents.[234] Generally, however, they look to the shareholder wealth bottom line when acting as shareholder activists.[235] Taking into account that the public sector clients of public pension plans never worked in the companies in which their retirement savings are invested, it has apparently been easy for public pension plans to favor shareholder over labor interests; public pension fund activism has often let to layoffs and divestitures.[236]

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[226] CAL. CONST. ART. 16, § 17 (1984 version); CALIFORNIA BALLOT PAMPHLET, Primary Election, June 5, 1984, Proposition 21 (proposition to amend the California constitution to allow state pension plans to eliminate the 25% ceiling in order to allow higher investment returns). CalPERS had been required to invest only in long-term bonds that matched its payment obligations, but was permitted to invest 25% of its portfolio in stocks in 1967. *See* Bruce E. Aronson, *A Japanese CalPERS or a new model for institutional investor activism? Japan's pension fund association and the emergence of shareholder activism in Japan, 7* N.Y.U. J. L. & BUS. 571, 593 n55 (2011). The ceiling was eliminated in 1984.

[227] David Hess, *Protecting and Politicizing Public Pension Assets: Empirical Evidence on the Effects of Governance Structures and Practices,* 39 U.C. DAVIS L. REV. 187, 194 (2005). In Minnesota and New York, public pension plans were permitted to invest in equities in 1995 and 1996 respectively. 1994 MINN. SESS. LAW SERV. CH. 604 (S.F. 2316); c*ompare* MINN. STAT. ANN. § 356A.06, subd. 7(f), (k)(2) (permitting investment into equities of up to 85% of plan funds) *with* 1989 MINN. SESS. LAW SERV. 319, § 6, subd. 6(B). 1996 SESS. LAW NEWS OF N.Y. CH. 712 (A. 11226). *Compare* NY RETIREMENT & SOCIAL SECURITY LAW (1996) § 177(2) (permitting at most 2% of fund assets being invested in equities) *with* NY RETIREMENT & SOCIAL SECURITY LAW (1997) § 177(2) (permitting 60%).

[228] CALIFORNIA BALLOT PAMPHLET, *supra* note 226, at 26, 27.

[229] CLARK, *supra* note 148, at 65 (explaining that equities became attractive in bull markets).

[230] Hess, *supra* note 227, at 194.

[231] Black, *supra* note 200, at 598-599; Anabtawi, *supra* note 221, at 588.

[232] Jacoby, *supra* note 209, at 46.

[233] BLAIR, *supra* note 176, at 167-168.

[234] Black, *supra* note 200, at 599-600 (pointing out that some public pension fund managers have to face elections); *see* Mark J. Roe, *Delaware's Politics,* 118 HARV. L. REV. 2491, 2524-2525 (2005) (giving an account of CalPERS' tendency to get involved in labor disputes and CSR issues); Hess, *supra* note 227, at 206 (discussing criticism of CalPERS' activism).

[235] *See* Ghilarducci et al, *supra* note 214, at 30 (reporting that CalPERS targeted firms because of poor performance).

[236] Jacoby, *supra* note 209, at 47 (quoting a CalPERS official commenting that some may firms need to lay off more employees); *see* O'Connor, *supra* note 194, at 110 (describing criticism that pension fund managers are driving downsizing).

The spread of 401(k) plans contributed to the enormous expansion of the mutual funds industry, where much of these savings are invested.[237] Interestingly, mutual funds have embraced shareholder activism comparatively late and have been described as "relatively docile shareholders" because they rarely engage in activism.[238] They have often been described as "voting with their feet" by selling if they are discontent with management.[239] While the resulting effect on the stock price can of course have an effect on management, the picture seems to be quite complicated. Some observers have criticized possible conflicts of interest of mutual fund managers. Arguably they are sometimes inclined to please corporate managers, who are in the position to direct employees' 401(k) wealth to investment companies that do not object to the firm's corporate governance practices.[240] There is some evidence that business ties make mutual funds vote in a more manager-friendly way, but it is not unambiguous.[241] Counterintuitively, Cremers and Romano found that even a 2003 SEC rule requiring disclosure of voting decisions has not led to more pro-shareholder votes by mutual funds, but rather to an increased support of executive compensation plans proposed by management.[242]

Another host of reasons has been advanced to explain why 401(k) plans do not lead to an optimal amount of shareholder activism from an investor perspective: Mutual funds make money through the fees they charge investors,[243] and they tend to be strongly diversified, which is why any benefits from shareholder activism on the firm level would be captured by other shareholders.[244] They also tend to focus on short-term investments, which is typically not compatible with

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[237] Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders' Rights,* 34 J. CORP. L. 843, 848, 858 (2009); Murphy, *supra* note 96, at 544-545; *see* David J. Carter, *Mutual Fund Boards and Shareholder Action,* 3 VILL. J. L. & INV. MGMT. 6, 19, 22 (2001) (summarizing data about 401(k) investment in mutual funds); Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why not disclose?* 23 CARDOZO L. REV. 1419, 1426, 1428 (2002) (providing data about the growth of the mutual fund industry).

[238] Leo E. Strine, *The Delaware Way: How we do Corporate Law and some of the New Challenges we (and Europe) face,* 30 DEL. J. CORP. L. 673, 687 (2005); *see also* Palmiter, *supra* note 238, at 1430-1431; Jacoby, *supra* note 209, at 55.

[239] *E.g.* Daniel Gross, *Some Mutual Funds Are Joining the Activist Bandwagon,* N.Y. TIMES, January 15, 2006 (quoting an investment analyst).

[240] Palmiter, *supra* note 238, at 1432; Jacoby, *supra* note 209, at 55; Murphy, *supra* note 96, at *560*; *see* Black, *supra* note 200, at 602 ("(i) mutual funds often invest 401(k) and defined contribution pension plan funds for corporations, and thus face some of the same pressures as other corporate pension fund managers"); Roger W. Ferguson, *Riding Herd on Company Management,* WALL ST. J., April 27, 2010, at A15 (President of TIAA-CREF pointing out mutual funds managers' possible conflicts of interest).

[241] Gerald F. Davis & E. Han Kim, *Business ties and proxy voting by mutual funds,* 85 J. FIN. ECON. 552 (2007) (finding no relationship between business ties and voting patterns on the firm level, but an aggregate propensity of mutual fund families with more business ties to vote in favor of management); Taub, *supra* note 237, at 875-876 (finding that mutual funds were less likely to vote in favor of shareholder proposals when the same mutual fund family also managed the company's 401(k) plan); for data on mutual fund proxy voting, *see also* Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance,* 1 J. BUS. & TECH. L. 157 (2006).

[242] K.J. Martijn Cremers & Roberta Romano, *Institutional Investors and Proxy Voting on Compensation Plans: The Impact of the 2003 Mutual Fund Voting Disclosure Rules*, 13 AM. L. & ECON. REV. 220 (2011); *see* Proxy Voting by Investment Companies, Securities Act Release, No. 8188, Fed. Sec. L. Rep. (CCH), ¶ 86826, at 87,142 (Jan 31, 2003), 68 Fed. Reg. 6564-85 (requiring disclosure); Murphy, *supra* note 96, at 546; *see* Aaron Lucchetti, *Monthly Mutual Funds Review – Labor Puts Pressure on Funds – AFL-CIO's Trumka Discusses Why Unions Push for More Disclosure,* WALL ST. J., March 3, 2003, at R1 (discussing union support for disclosure of union votes); Jacoby, *supra* note 209, at 55; Taub, *supra* note 237, at 864 (describing conflicts of interest at Deutsche Bank resulting from its investment bank advising a takeover), and 868-869 (discussing Fidelity's vote at Intel in light of it managing Intel's 401(k) plan).

[243] Strine, *supra* note 238, at 687.

[244] Strine, *id.* at 687.

shareholder activism.[245] Nevertheless, at least some mutual funds have become more active in recent years, pushing for shareholder wealth alongside other institutional investors.[246] Mutual funds have also generally supported proposals to strengthen the role of shareholders in corporate governance such as proxy access.[247]

This is not the place to tell the complete story of shareholder activism and proxy voting by institutional investors that seek to bring managers more in line with shareholder concerns. Overall, of course, there are considerable limitations to shareholder activism by any of the three types of institutions, such as diversification and the lack of staff to take a deeply engaged role in systematic corporate governance research.[248] The enthusiasm about institutional investor activism expressed by shareholder primacists certainly faded in the late 1990s and 2000s.[249] In recent years, other factors have pushed firms more strongly to cater to the interests of shareholders, including activism by hedge funds taking larger stakes in firms[250] and the influence of proxy advisors, particularly ISS, on the voting decisions of financial institutions.[251] Nevertheless, pension savings and the increase in the institutional character of share ownership have certainly encouraged shareholder activism and the implementation of reforms in line with the shareholder primacy vision.

6. Pensions and shareholder primacy abroad

A quick look at other developed economies, particularly Continental European countries and Japan, confirms the thesis that the shift from DB to DC plans is linked to the move from managerial to shareholder capitalism in the US. Both in terms of their corporate governance and pension systems, these countries look more (but not entirely) like the US did before the changes described in this article.

With respect to corporate governance, it is often claimed that in countries outside the common law world, shareholders are not very well-protected, share ownership is concentrated, and capital markets are comparatively small.[252] More importantly for this article, Continental Europe and Japan are usually thought to be characterized by models that give precedence to other

[245] Palmiter, *supra* note 237, at 1431.

[246] Palmiter, *id.* at 1435-1440; Gross, *supra* note 239; Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1001 (2010); *see also* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1276 (2008) (discussing mutual fund activism by Fidelity and Vanguard); *see* Black, *supra* note 200, at 602 (describing Fidelity's transient opposition to an antitakeover statute in 1990); Gretchen Morgenson, *Belated Apologies in Proxy Land*, N.Y. TIMES, August 20, 2006 (describing Putnam Funds attempt to influence firms).

[247] *E.g.* Barbara Krumsiek, Calvert Comment Letter: Upholding Shareholder Democracy through the Proxy Process, July 23, 2007, at http://www.sec.gov/comments/4-537/4537-79.pdf (supporting SEC proposal on proxy access)

[248] *E.g.* Coffee, *supra* note 23, at 1975 (pointing out the limitations of even CalPERS' possibilities).

[249] Coffee, *id.* at 1981-1983 (discussing possible reasons).

[250] Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

[251] James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1 (2010).

[252] The reasons are highly disputed. Based on cross-sectional empirical studies, it is often argued that the civil law tradition is less amenable to investor protection than the common law. Rafeal La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 J. ECON. LIT. 285 (2008). According to the contrary view, left-wing politics inhibited the development of pro-shareholder institutions in Continental Europe. Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460, 502-516 (2006).

constituencies over shareholders.[253] Germany (alongside a number of other Central and Northern European countries) stands out by giving employees representation on the board of directors, and thus at least some influence on corporate matters.[254] Japanese firms have long been known for strong pro-worker orientation, in particular a "lifetime employment" relationship with employees.[255] In combination with strong cross-ownership structures within the so-called "keiretsu", Japanese firms can probably even be called labor-dominated. But even in jurisdictions with little or no employee participation in boardroom decision-making such as France and Italy, the extensive powers of controlling shareholders are balanced by strong labor laws that are considerably more strongly weighed in favor of employees than in the US.[256]

While there are of course many differences among the various Continental European pension systems and between them and the Japanese one, there are two comparative patterns. First, government-funded Pay-As-You-Go (PAYGO) pensions systems play a greater role for retirees at least in Continental Europe than Social Security does in the US. While data from different countries are often directly comparable, the OECD figures on the sources of retirement income of those over 65 are probably most illustrative (Table 3).[257]

	Public transfers	**Work**	**Capital**
France	85.44%	6.50%	8.07%
Germany	73.07%	12.09%	14.84%
Italy	72.20%	23.80%	4.00%
Japan	48.34%	44.29%	7.37%
United Kingdom	49.36%	12.09%	38.55%
United States	36.13%	34.20%	29.67%

Table 4: Sources of Income for those 65 and older

In the Continental European jurisdictions, public transfers (i.e. public pensions) dominate. The UK resembles the US more closely, except that less income is derived from work above that age. Japan similarly stands out because of its high percentage of income derived from work, but the low significance of income based on capital is striking. Only looking at the ratio between public transfer and capital in each country would show that the relative importance of public and private pensions is similar to Continental Europe.

Like Social Security, PAYGO systems abroad take the form of a DB plan underwritten by the government: Employees and employers pay contributions to a government entity, which uses

[253] *E.g.*, Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 500–01 (2001); Hansmann & Kraakman, *supra* note 3, at 443–449; Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 733 (2004); Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 INT'L REV. L. & ECON. 203, 208–09 (1994).

[254] *See, e.g.*, Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in EMPLOYEES AND CORPORATE GOVERNANCE 163, 168 (Margaret M. Blair & Mark J. Roe eds., 1999); Luca Enriques, Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, in THE ANATOMY OF CORPORATE LAW 89, 100-101 (2nd ed., Reinier Kraakman et al. 2009).

[255] *E.g.* Caslav Pejovic, *Japanese Corporate Governance: Behind Legal Norms*, 29 PENN. ST. INT'L L. REV. 483, 492-495 (2011).

[256] *See e.g.* Gelter, *supra* note 37, at 171-173 (discussing employment law in Continental Europe).

[257] OECD, PENSIONS AT A GLANCE 60 (2009). The data (for a larger set of countries) are available at http://dx.doi.org/10.1787/635426478286. Similar data for a small set of countries are also available for 1978-1980 at OECD, REFORMING PUBLIC PENSIONS, OECD SOCIAL POLICY STUDIES NO. 5, 55 (1988).

these funds to pay current retirees. The amount of the pension normally depends on the number of years worked, contributions made, and the age of retirement.[258]

Second, private pensions in Continental Europe and Japan tend to be of the DB variety more often than in the US (or the UK),[259] with domestic pension funds long remaining limited in significance.[260] Both German and Japanese company pensions are traditionally "book reserve" plans, where the firm commits to paying a specified pension in the future without setting up a trust fund.[261] In 1996, about 56% of German employment-related pension claims took this form.[262] In France, employers' organizations and labor unions jointly set up a national DB pension plan in the years after World War II.[263]

The UK is an exception to the European pattern. Its corporate governance system has long been characterized by shareholder-centrism and differed both from the managerialism in the US and the labor models of Continental Europe and Japan.[264] Like the US pension system, the UK one is characterized by a low level of state pensions and a high level of private pensions.[265] As in the US, pension reforms during the early 1980s, encouraged British firms to shift from traditional DB plans to DC plans.[266] Since the mid-1990s, the vast majority of new employer-sponsored plans were DC plans, and more than half of existing DB plans has been phased out.[267]

This brief comparison reveals a pattern: Countries where workers rely more strongly on government pensions and DB plans than those in the United States also exhibit less developed

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[258] Lothar Schruff, *Pensions and Post-Retirement Benefits by Employers in Germany*, 64 BROOK. L. REV. 795. 795 (1998); Bert Rürup, *The German Pension System. Status Quo and Reform Options*, in SOCIAL SECURITY PENSION REFORM IN EUROPE 137, 139-143 (MARTIN FELDSTEIN & HORST SIEBERT EDS. 2002); Kathryn L. Moore, *Lessons from the French Funding Debate*, 65 OHIO ST. L. J. 5, 9, 13 (2004) (describing the DB formula for French public pensions); Charles Yuji Horioka, *Japan's Public Pension System in the Twenty-First Century*, in JAPAN'S NEW ECONOMY 99, 99-101 (Magnus Blomström, Byron Gangnes & Sumner La Croix eds. 2001) (Japan); *see also* Friedrich K. Kübler, *Institutional Owners and Corporate Managers: A German Dilemma*, 57 BROOK. L. REV. 97, 100 (1991) (reporting that in 1991, a German pension of a typical retiree corresponded to 70% of the last salary).

[259] *E.g.* Gordon L. Clark, *Pension systems: a comparative perspective* 7 (2000), *at* http://ssrn.com/abstract=228948.

[260] *E.g.* Kübler, *supra* note 258, at 99 ("Pension funds so far have had very little importance.").

[261] Charny, *supra* note 47, at 1641; Stefan Prigge, *A Survey of German Corporate Governance*, in CORPORATE GOVERNANCE – THE STATE OF THE ART AND EMERGING RESEARCH 943, 1019 (Klaus J. Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch & Stefan Prigge eds. 1998); MACKENZIE, *supra* note 125, at 228 (all discussing Germany); David Rajnes, *The Evolution of Japanese Employer-Sponsored Retirement Plans*, 67 SOC. SEC. BUL. 89, 91, 93 (2007) (discussing Japan); Robert L. Clark, *Japanese Pension Plans in Transition*, BENEFITS Q., First Quarter 1995, at 59 (discussing DB payouts to retirees in Japan).

[262] Schruff, *supra* note 258, at 804; *see also* Ahrend, *supra* note 261, at 86 (providing the 1991 data).

[263] Lucy apRoberts, *Comments*, in SECURING EMPLOYER-BASED PENSIONS 105, 109-110 (Zvi Bodie, Olivia S. Mitchell & John A. Turner eds. 1996).

[264] *E.g.* BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL 30 (2008) (pointing out that in UK companies, shareholders can recall the board); Bruner, *supra* note 41, at 593-611; Dignam & Galanis, *supra* note 18, at 221-222 (both comparing the UK and the US). The most known example is maybe the "City Code on Takeovers and Mergers", which provides a self-regulatory framework for takeovers favoring shareholder choice.

[265] The Basic State Pension (BSP) is comparatively low for European standards and provides an average replacement ratio of only about 15%.Carl Emmerson & Paul Johnson, *Pension Provision in the United Kingdom*, in PENSION SYSTEMS AND RETIREMENT INCOMES ACROSS OECD COUNTRIES 296, 299, 301 (Richard Disney & Paul Johnson eds. 2001). *See also* David Blake, *The United Kingdom. Examining the Switch from Low Public Pensions to High-Cost Private Pensions*, in SOCIAL SECURITY PENSION REFORM IN EUROPE, *id.*, at 317, 317 (noting that public finances are thus less affected by demographic change). The "State Second Pension" (S2P), which replaced a similar plan known as SERPS in 2002, allows an opt-out into a private plan. Emmerson & Johnson, *supra* note 265, at 303.

[266] Munnell, *supra* note 50, at 371-374; MACKENZIE, *supra* note 125, at 245 (all discussing changes in the British private pension system).

[267] Munnell, *supra* note 50, at 375.

pro-shareholder institutions in their corporate laws. In the case of a stock market downturn, the modern American worker is immediately affected by the loss of value of his or her retirement account. With stock markets being much smaller relative to GDP[268] and individual household savings more often being held in savings accounts, movements in the stock market typically do not matter very much for the middle class in these countries.[269] From the perspective of the Continental European or Japanese middle-class, it is "rich folks on Wall Street" who lose money in a stock market downturn. Retirement benefits primarily depend on the government's ability and willingness to fund the public pension system and in some cases the employers' ability to pay pensions.

While it would be beyond the scope of this article to fully explore the complex relationships among pension systems, corporate ownership structures, and possible international convergence toward shareholder primacy, some authors have identified demographic problems of public PAYGO pension systems both in Europe and Japan and an increasing international trend toward DC pension plans as a driver for this form of international convergence in corporate governance.[270] In Continental Europe and Japan, a connection with the political movement to push national pension systems into the direction of the DC paradigm since the early 1990s seems very likely. Conspicuously, scholars identified some degree of convergence in corporate governance and a trend toward the shareholder model during the same period.[271]

7. Conclusion

I have argued that the place of shareholder primacy in the corporate governance system of the US has shifted, at least partly due to the change from DB plans to DC plans. When DC plans predominate, the advantages of shareholder primacy over a more expansive view of the objective of corporate law weigh more strongly than they did in the heyday of managerial capitalism. The implication is that policies that give more weight to shareholders over labor have become relatively more desirable. The shift from DB to DC plans has made Americans more directly dependent on capital markets and has thus helped to make shareholder primacy and shareholder wealth maximization a more attractive intellectual position.

The impact on the actual politics of corporate governance is more ambiguous. While a clear causal link is difficult to establish, it is clear that causality at least in part runs from the pension system to corporate governance. Regulatory changes such as ERISA were intended to protect workers and not the consequence of changes in the financial system. The greater dependence of workers' pension wealth on the capital market instead of the employer possibly resulted in a reduction of firm-specific human capital, and thus strengthened political support for shareholder primacy. Many shareholder primacists would probably agree that pro-shareholder reforms often

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[268] *E.g.* Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance,* 52 J. FIN. 1131 (1998).

[269] Marcel Tyrell & Reinhard H. Schmidt, *Pension Systems and Financial Systems in Europe: A Comparison from the Point of View of Complementarity,* 47 IFO-STUDIEN 469, 488-489 (2001) (suggesting that German firms with "book reserve" pensions rely less on capital markets compared to their UK equivalents).

[270] GOUREVITCH & SHINN, *supra* note 13, at 215-217; MATHIAS M. SIEMS, CONVERGENCE IN SHAREHOLDER LAW 289 (2008).

[271] *See* Hansmann & Kraakman, *supra* note 3; Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function,* 49 AM. J. COMP. L. 329 (2001) (both discussing convergence of corporate governance practices); Bebchuk & Roe, *supra* note 127 (suggesting that path dependence impedes convergence).

remain cosmetic. Nevertheless, unions, who were once the opponents of both management and shareholders in securing better conditions for workers, were co-opted into shareholder capitalism through the pension system. The seeds for the development may have been sowed through the Taft-Hartley Act's system of pension plans run jointly by employers and unions, but it came to full fruition only when shareholder value started to become of profound importance for unions and their aging constituents. Shareholder activism partly originated from institutions largely operating within the DB paradigm, such as union and public pension funds, which were also driven toward more equity investment due to regulatory changes from the early 1980s onwards. As far as private pension funds are concerned, ERISA's fiduciary and funding requirements – which also helped to drive investment into DC plans – contributed to the spread of shareholder activism. With union pension power declining because of the shift to 401(k) plans, unions are aware that they need to seek alliances with managers of these plans to maintain their activist agenda.[272]

History is sometimes said to repeat. The end of the economic crisis that began in 2008 is still not in sight, and comparisons to the Great Depression of the 1930s are frequently drawn in the popular press. When the Great Depression devastated private investment in the stock markets and pension savings, the political response was the introduction of Social Security.[273] Today, the reaction seems to be the opposite. During the past three decades, the ubiquitous 401(k) plan has become the default expectation for retirement benefits in the US. The woman and man on the street have become aware of corporate governance issues and how they affect their retirement prospects. DC plans are even considered for public employees,[274] and the Bush administration proposed to convert Social Security into a contribution-based system with individual accounts as well.[275]

Thus, in spite of criticism, it seems that the shareholder movement will continue and even gain more strength. With employees often having the choice between different mutual fund families for their pension contributions and of course completely free choices for IRAs and other investment vehicles, pressure on institutional investors to exert their corporate governance role more actively is bound to increase. Detractors of shareholder primacy often oppose pro-shareholder reforms on the level of corporations, and sometimes bring forward reform proposals that are opposed to the shareholder-oriented model. This type of discussion tends to emphasize the corporate governance of firms, i.e. the demand side of the capital market. This article has shown that changes in the pension system have unleashed powerful forces on the supply side of the capital market that keep pushing corporate governance ever more strongly toward shareholder primacy. Skeptics of shareholder primacy need to rethink their agenda and address our dependence on equity investment. Otherwise, attempts to challenge the dominant model will be futile. Shareholder primacy, with its positive and negative implications, will be here to stay.

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[272] Jacoby, *supra* note 209, at 56; *see also* Coffee, *supra* note 23, at 1987-1988 (speculating about a possible decline of pension fund activism during the rise of 401(k) plans). *See e.g.* Gina Chon, *Share-Buying Plan Opposed – Investor Group Resists Proposed SEC Rule to Shorten 13(D) Filing Time Frame,* WALL ST. J., August 20, 2011, at B2 (discussing alliances between mutual funds and pension funds to oppose changes to SEC's rules that may make coordination between shareholder activists more difficult).

[273] Maria O'Brian Hylton, *Evaluating the Case for Social Security Reform: Elderly Poverty, Paternalism, and Private Pensions,* 64 BROOK. L. REV. 749, 751-754 (1998); CLARK, *supra* note 148, at 50; CLOWES, *supra* note 92, at 21; Munnell, *supra* note 50, at 362.

[274] *See Move Public Employees Into 401(k)s?, supra* note 197.

[275] *E.g.* ZELINSKY, *supra* note 56, at 93.