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Exercising the 'governance option': labour's new push to reshape financial capitalism

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New forms of stockholder activism call into question longstanding assumptions underpinning our system of corporate governance. Scholarship has largely failed to explain the basis for these new forms and, in particular, the differences among activists. Activists are not one undifferentiated mass. Both small activist hedge funds and large union-sponsored or -influenced pension funds use governance mechanisms to influence corporate behaviour. Pension funds, however, have a different set of incentives than hedge funds. The beneficiaries of these funds cannot easily switch between consumption and investment by buying or selling their holdings in firms. Thus, instead, institutional investors exercise an embedded 'governance option' found within shares of common stock to engage with firms. Organised labour, in particular, now uses its influence in pension funds to motivate progressive change by corporations. This form of activism has the potential to alter the balance of power between workers and capitalists in the era of financial capitalism.

Key words: Firm, Market, Financial capitalism, Corporate governance, Stockholder activism, Pension funds, Labour unions
JEL classifications: G33, K22, L2

1. Introduction

Over the last two decades, stockholder activism—the use by minority investors of the tools of corporate law and governance to influence firm behaviour—has taken on wider significance, predominantly in the USA but in Europe and Asia as well (Becht *et al.*, 2015; Partnoy, 2015).[1] The new phenomenon raises both an empirical and theoretical

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[1] The primary focus of the paper is on the USA, the centre of the so-called Anglo-American model of capitalism. That is for two reasons. One, at the risk of being viewed as culturally solipsistic, the USA still remains home to the largest and most liquid capital markets, which are the source of the problems this paper addresses. Two, the longstanding theoretical assumption has been that it is the USA that has avoided the

challenge. These two challenges are interrelated. Generally, the literature's empirical focus is on activism conducted by hedge funds aimed at achieving purely financial goals, such as increasing payouts to stockholders (Bebchuk *et al.*, 2015). Activism undertaken by large institutional investors such as pension funds is sometimes dismissed as irrelevant to the problems of corporate governance (Bainbridge, 2005). This preferential focus on hedge fund activism is, in turn, a result of the widespread acceptance of the long dominant theoretical framework used to analyze corporate structure and behaviour, the 'separation of ownership and control', first comprehensively examined by Berle and Means ([1932] 1991).

Institutional activism is, however, potentially far more significant than hedge fund activism. An important segment of institutional investors, led by union-sponsored and public sector pension plans, is now engaged in an effort to transform the modern capitalist firm, and thus capitalism as a whole, into a more accountable and socially responsible actor. This 'transformative' form of activism is not comparable to that undertaken by activists such as hedge funds.

Hedge fund activism can be considered 'traditional' as opposed to transformative. It is motivated, generally, to increase stockholder value as indicated by increases in share price or in payouts to stockholders. Hedge funds aim to generate above-market returns for their own investors by concentrating on a particular investment strategy. Activism has become one form of such concentration (Briggs, 2007). But that concentration is largely opportunistic, shifting in form and content depending on how each fund manager thinks he or she can use a particular situation to generate a (largely short-term) above-market return. Hedge funds, arguably, aim to reduce the costs associated with the agency relationship between inside managers and outside investors and thus generate positive abnormal returns. When they fail to earn those returns, a competitive market exercises discipline by forcing them out of business (Stevenson, 2015). Viewed in this light, hedge fund activism, contrary to the dominant view (Kahan and Rock, 2007), represents a relatively minor evolution in the traditional battle over agency problems between controlling and non-controlling investors.

The new 'transformative' institutional investor activism, on the other hand, aims to achieve a distinct social agenda that such activists view as consistent with their duties as 'responsible stewards of workers' capital' (AFL-CIO, 2018) generated by the 'deferred wages' of the beneficiaries of these funds. This wider agenda is missed or, at best, dismissed, by the existing literature (Romano, 1993; Schwab and Thomas, 1998; Kahan and Rock, 2007). Because that dismissal is grounded in the Berle and Means' perspective on the firm, that perspective must be reconsidered to accommodate the actual character and growing potential of the new 'transformative' activism.

The paper will begin, first, with that reconsideration of the theoretical explanation of the firm as an institution, then place that reconsideration in a larger political context linked to the legitimacy problem that capitalism must face and, finally, apply that reconsideration to the new forms of stockholder activism as a case study.

corporate governance problems associated with the complex centralised ownership structures found elsewhere (Hansmann and Kraakman, 2001). In fact, as the paper argues, the Anglo-American model has its own variant of problems like 'tunneling' (Johnson *et al.*, 2000) and 'pyramids' (Bertrand and Mullainathan, 2003) found in Europe, Asia and Latin America.

2. Re-thinking the nature of the firm

Understanding the modern corporation requires that one consider the question of power. As Coase (1937) famously noted, quoting Robertson (1923, p. 85), firms are 'islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk' (p. 388). Yet, underlying much of the orthodox literature on stockholder activism is an assumption, usually unstated, that corporate power should not be a concern, either from an economic or socio-political perspective. Arguably, in this view, there is no problematic concentration of power inside the firm because stockholders are widely dispersed, and managers are constrained by market forces, most notably that generated by the 'market for corporate control' (Manne, 1965). Of course, the original Berle and Means' conception of the tension between inside managers and outside stockholders did raise an alarm about the power that those managers had accumulated because of their controlling, and therefore potentially 'self-perpetuating', position in the firm (Berle and Means, [1932] 1991, p. 82). That concern with a possible 'new form of absolutism' certainly struck a chord in the New Deal era of the 1930s (p. 116).

But over time, the rise of 'agency theory' turned the Berle and Means' conception on its head (Jensen and Meckling, 1976). Managers were no longer seen to be economic 'princes' in charge of new 'economic empires' (Berle and Means, [1932] 1991, p. 116), but mere 'agents' subject to the authority of their principals, the stockholders. The potential for abuse by insiders could be minimised by a range of institutional reforms, including the mandatory disclosure of information to investors and the imposition of certain responsibilities on managers in the form of fiduciary duties. Viewed in this light, the firm is simply a legal fiction representing the 'nexus for contracting relationships' (Jensen and Meckling, 1976) or a 'contractual organization of inputs' (Alchian and Demsetz, 1972) that exists to solve problems related to transaction costs, that is, the costs of searching out the price of necessary inputs, negotiating the contracts necessary to secure rights to those inputs, monitoring the behaviour of the parties during the terms of the contract and resolving any disputes that may arise over the terms of the contracts (Williamson, 1975, 1985).

In a sense, the firm really does not exist except as a convenient legal fiction recognised in order to help establish and police these contractual relationships. Managers are simply those individuals particularly adept at negotiating and then monitoring the contracts required for inputs to the firm's production function. One could, within this framework, argue, as some have done, that 'workers' are simply people who prefer to work for someone else as opposed to independently—in other words, it makes no difference if we think of firms as environments where managers hire workers or where workers hire their boss (Samuelson, 1957, p. 894).[2] It is mere 'delusion' to conceive of firms as having any power or authority different from that

[2] One is tempted to argue that that such a world-view could only have resonance among tenured academics with years of experience with deans. But it is likely more difficult to gain acceptance for this view among assembly line workers in an auto parts plant in the *maquiladora* zone in northern Mexico or a free trade zone in coastal China. However, there are, in fact, increasing numbers of firms where this perspective has greater weight—particularly in professional services firms and in the high-tech world. It is widely known, for example, that lawyers are disinclined to engage in managerial and administrative tasks for their law firms and are willing to delegate such responsibility, even in the partnership form, to an executive committee or managing partner.

which is found in the surrounding market (Alchian and Demsetz, 1972, p. 777).[3] In this view, there is no concern about agent-managers having undue power relative to principal-stockholders. Managers are simply those appointed monitors of firm performance who are entitled to some extra level of remuneration consistent with the value of their efforts (aimed at, predominantly, minimising shirking of agents) on behalf of the entire firm.

At first blush, it may seem that this approach is consistent with the view of Coase (1937) who suggested that firms emerge (as opposed to arms-length market relationships between sole proprietors) when at the margin the cost of producing a good is cheaper in a non-market hierarchy, that is, a firm, than it is to obtain through market relationships. In fact, Alchian and Demsetz attempted, with some difficulty, to argue that there was consistency between their approach and that of Coase. They acknowledge 'Coase's penetrating insight' about the need to recognise that markets have costs, too, but they dismiss what is, arguably, central to Coase's argument about why, in some cases, firms can undertake tasks more cheaply: because firm owners can exercise authority, power or 'fiat' and thus avoid the transaction costs one incurs in seeking out prices and negotiating terms in the arms-length transactions that take place in markets. More importantly, however, their approach, and those of their subsequent followers, seems, at best, oblivious to the historical and social context in which Coase's work appeared and must be understood.

Coase argued that while markets are places where 'free' exchange takes place, firms are hierarchies where orders are given and followed. His analysis followed field work he conducted inside major American auto companies like Ford and General Motors (GM) while in the USA from 1931 to 1932 (Coase, 1988). This was, of course, prior to the widespread unionisation of those firms. When GM wanted more workers in the paint department, it did not (absent a union) enter into negotiations with each worker that it wanted to transfer from the assembly line. Instead, it issued a directive and workers either followed that directive or were subject to discipline or dismissal. 'If a workman moves from department Y to department X, he does not go because of a change in relative prices, but because he is ordered to do so' (Coase, 1937, p. 387). One finds the very same conditions at work inside the Tesla assembly plant in Fremont, California, today, on the site, ironically, of a plant once owned by GM (Wong, 2017). Unless one recalls this authority-centred side of the original Coase argument, it is impossible to grasp the significance of Coase's insights.

Coase crystallised the ideas that underpinned 'The Nature of the Firm' while a student at the London School of Economics in the early 1930s. His work emerged in the middle of the rising fascist threat in Europe and the extant Stalinist system in Russia. Events in those countries had a significant influence on economic thinking in the USA and the UK. Coase later described himself as being a socialist at the time (although he might better be understood today as having been a social democrat or leftwing liberal). In part, his contacts while in America came through a referral from the British trade union leader Ernest Bevin (Coase, 1988). He was greatly interested then in the

[3] This approach was not as much at odds with earlier thinking as some might think. New Deal architect William O. Douglas (Douglas and Shanks, 1929), for example, argued that the modern corporation was a 'method' not a 'thing': 'When defined as a method the definition [of the corporation] varies. The definition for one purpose may be totally different from the definition for another' (p. 194).

'grand debate' about 'economic planning' that emerged in the wake of the triumph of Stalinism in the Soviet Union.[4]

It is striking that Coase's research leading to 'The Nature of the Firm' was also being conducted in wake of the publication of Berle and Means' widely received *The Modern Corporation and Private Property*. And Coase's work would be followed in just a few years by the appearance of *The Managerial Revolution*, the immensely popular dystopian study of fascism, Stalinism and the New Deal by James Burnham (1941). Burnham's book was part of an emerging debate triggered by the apparent economic successes of new authoritarian systems in Germany and Russia. Both books heavily influenced thinking then about the nature of modern capitalism and they continued to play havoc with theoretical frameworks for understanding capitalism for decades. Yet, they misstated the actual problem. They depended too heavily on the fear that a new opportunistic managerial class was emerging to take power, a fear likely heightened by Cold War tension between the west and the Soviet Union.

Liberals as well as many on the socialist left believed, understandably, that the challenge they needed to meet at the time was the apparently inevitable triumph of a command economy model over that of a market-based system of private ordering. These relatively new collectivised forms challenged pre-existing notions of Walrasian perfect competition (Cowling and Sugden, 1998; Palermo, 2007). The contemporary intellectual triumph of Keynes over Hayek was symptomatic of that larger struggle to defend the legitimacy of a new stage in capitalism. The young Coase can be seen as attempting, alongside Keynes, to contribute intellectually to an effort to help democratic societies evolve from an era where individual capitalists directly owned their firms to some new form of collectivised, yet still capitalist and presumably still democratic, era (Wapshott, 2011). The later triumph of the radical Hayekian view of the virtues of pure private ordering in the era of Thatcher and Reagan obscures our perspective today of this historical context for Coase's intellectual development.

The intellectual problem, then, was to make sense of the fact that some form of planning (inside the firm itself, not just via the state), and, thus, of at least some need to exercise authority over these organisations, must take place even in a capitalist society. Voluntary contractual relationships could not explain the emergence and success of Henry Ford's massive River Rouge complex. As Coase (1988) himself later put it, '…some [economists in the West were] maintaining that to run the economy as one big factory [as Russia was attempting to do] was an impossibility. And yet there were factories in England and America. How did one reconcile the impossibility of running Russia as one big factory with the existence of factories in the western world?' (p. 8). By exploring the inevitable tension between market and hierarchy in capitalism, Coase devised a framework that helped draw the appropriate borderline between the two forms. Coase, then, was part of a movement that aimed to save the new collectivising capitalism from the authoritarian ideologies emerging in the command societies of German, Italy and the USSR; and even from some of the more aggressive advocates within the New Deal itself.

[4] As Cowling and Sugden (1998) highlight, Coase contrasted 'economic planning' undertaken by and within the large corporation with the 'individual planning' that occurs in the market place through exchange. It is this concern with economic planning that connects Coase's work on the western capitalist firm with the experience of the new bureaucratic regime found in Russia.

A Coasean framework—that is, the firm as a potentially cost minimising institution—is very helpful at explaining the evolution of the firm into different forms in reaction to changes in external events like technology, labour processes or political factors. This approach, however, is ahistorical and does not explain the *emergence* or 'origins' of the capitalism firm as an historical fact (Palermo, 2007). Christos Pitelis (1987) suggests that it is more fruitful to argue that the firm is a form for 'exploiting' (the division of) labour through a mix of coercion and co-operation. Pitelis uses the concept of 'exploitation' in the dual sense of making better use of but, also, of appropriating labour power from workers that is not necessarily remunerated.

The 'Marxian' concept of exploitation has been perennially controversial. One possible resolution to the controversy is to note that while individual workers are, in a competitive market, appropriately rewarded for the sale of their *individual* labour power to the employer, they are not necessarily rewarded for what might be called the 'control premium' associated with the *cooperative* organisational dynamic that the employer puts in place and takes advantage of once workers are hired. This is analogous to the control premium said to be an asset of individual stockholders in a publicly traded firm. Stockholders, as discussed here, receive some protection against the expropriation of that premium in corporate law, but there is no such protection available to individual workers unless they engage in collective action to push wage rates above the market rate for their individual labour power. The effort of unions to use stockholder activism to increase the overall returns to pension plans may be an alternative, if partial and indirect, solution to this problem.

Following Pitelis, then, the firm emerged as an institution, as opposed to older forms of economic activity including the sole proprietorship and the putting out system, because it enabled entrepreneurs to organise the value creating production process more effectively, to 'exploit' cooperative labour more efficiently thus generating profits. Later work by Pitelis and Teece (2009) would extend this emphasis on value to the importance of using the firm to generate and capture the benefits of innovation, a key capitalist process. Notably, they would align themselves with the insight of Simon (1993) 'who mocked the assumption in transaction cost economics, that in the beginning there were markets' (p. 13). Firms come into being, in part, to create the markets needed to realise the value potential of firms. Capitalist firms are as constitutive of the market as much as they are a contingent reaction to market failure or an efficient alternative to market costs. This takes one beyond the ahistorical 'marginalism' of Coase and suggests that firms can be placed in a historical context, emerging with the transition to modern (and dynamically innovative) corporate capitalism in the late nineteenth century.

The 'owner' of the modern firm, then, has command over social(ised) labour. Firms, in this view, are centres of *power* exercised by private individuals (though, in the post-Coasean world, generally no longer single individuals as sole proprietors) over other human beings and over accumulated social resources. Pitelis goes further and notes that that power is maintained by capitalists who *both own (shares) and control* their firms even in the era of the modern publicly traded corporation (see also Pitelis and Sugden, 1986). That is, there is no Berle–Means' 'separation of ownership and control'. This critical conclusion is, in fact, consistent with a more robust view of Coase's original insights into the firm and it provides us with the key to understand the rise of today's 'transformative' stockholder activism.

3. The legitimacy problem

Once one understands that firms are centres of power over other individuals and social resources, another problem emerges that Coase did not confront. This is the risk of a conflict between, on the one hand, what those in control of the firm do with those people and resources and, on the other, broader social goals. This highlights the potential problem of the 'legitimacy' of corporate behaviour. Thus, while Justice Douglas may have agreed that the firm is only a 'method', he also recognised the existence of a larger 'public good' that corporations must serve. He and Berle and other New Dealers wrote of the need to exercise 'social control' over finance (Clark, 1939).[5]

Orthodox theory in law and economics does not ignore this potential problem. On the contrary, it articulates an argument precisely aimed at justifying the private ordering of social resources in the face of a potential conflict with the wider world. It borrows the concept of a 'separation of ownership and control' from Berle and Means, among others,[6] and posits the existence of the 'agency' problem introduced above between those who nominally 'own' firms in the form of shares, on the one hand, and those who are in 'control' of firms, on the other. If there is a separation, then there is a problem of 'costs' associated with this so-called 'agency' problem. These costs are very similar to the transaction costs that Coase discussed. But they also include the risk that 'managers' will behave opportunistically with 'other people's money' (Brandeis, [1914] 1933).

Thus, agency theorists argue, principals (stockholders) have to monitor their agents (managers) lest the latter loot the corporate entity. There is a need, therefore, for structural and/or market innovations to help reduce these agency-induced costs. A variety of these exist, including boards of directors, securities laws, state corporate law, etc. But, by far the most important, in the eyes of law and economics, and probably the most desirable, is the 'market for corporate control'. If the shares of a company can be easily sold, then 'owners' (i.e. stockholders) can put disciplinary pressure on 'managers' when they attempt to behave opportunistically with owners' money. In Hirschman's (1970) phrase, they have an 'exit', as opposed to merely a 'voice' option.

Technically, a simple decision rule should thereby control corporate insider behaviour: assuming an all equity firm, stockholders want firm managers to accept all projects that have a positive net present value. Positive net present value means that the firm can deploy stockholders' assets more profitably than those stockholders could if they invested in the available external, that is, non-firm, opportunities. (Notice that in an idealised competitive environment, it is, by definition, very difficult to *find* positive net present value projects.) This approach is broadly consistent with the Coasean analysis of the firm—recall that Coase argues organising activity inside a firm makes sense when the entrepreneur can carry out that activity at lower transaction costs than those she would have to pay in the market. If, however, the firm's managers are not able to find any positive net present value projects, then they should, assuming away any other factors like a tax regime disadvantageous to distributions, return the firm's cash to the

[5] By 'finance', they meant capitalists. They did not have the same view of the separation of ownership and control that is common today.

[6] Veblen, Brandeis, Marx and Smith all wrote about the same problem in various ways, though perhaps at somewhat less pregnant moments than Berle and Means.

equity owners. *In extremis* this might mean shutting down the firm and distributing its remaining assets to creditors and stockholders.

And indeed, *if* certain assumptions are met, then there would appear to be some validity to this idea. Since shares are, arguably, now widely held by the adult population, there is even a strong case to be made by private ordering advocates that the capital markets (in which shares trade and, thus, where one finds the market for corporate control emerging) can generate politically legitimate outcomes. Thus, it is not coincidental that, parallel to the emergence of the Coasean view of the firm, was the development of public choice theory, which argues that interest groups (or, as Mancur Olson (1982) called them, rent-seeking 'distributional coalitions') distort outcomes in the world of 'democratic' politics. Thus, there is an argument that the world of firms and capital markets is better at generating legitimate outcomes than traditional political institutions.

But there is a problem. If firms *are* a centre of power, then the individuals on the receiving end of the power will inevitably and understandably want to say something about whether or not markets, in fact, generate legitimate outcomes. There may even be differences of opinion between those who exercise power in corporations and those who are subjects of that power about the substantive content of what is legitimate or not. In a kind of partial accommodation of this potential class conflict, some law and economics proponents actually make room for the emergence of unions as appropriate bargaining agents in certain instances (Williamson, 1985; Stone, 1988). But with widespread share ownership through pension funds and other institutional investors, there has also emerged a view that workers' (or 'consumers') preferences can be expressed through the capital markets thus obviating the need for alternative centres of power such as unions or political parties. If workers, now seen really as consumers who simply transact in shares the same way they buy food or widgets, do not like the way a company is behaving, they can sell their shares in that company.

Does this really work? If so, how does one explain the growing discontent with corporate behaviour in the form of the anti-globalisation movement, the emerging effort to make companies liable for a variety of human rights violations and other efforts to express discontent with the firm/market Coasean world through political action? More fundamentally, how does one explain the apparently 'inefficient' outcomes in the bubble period of the late 1990s and its aftermath in the Enron/Worldcom-induced 'crisis of corporate governance'? Not to mention, of course, the massive credit bubble that grew up shortly thereafter only to burst in a global financial crisis as serious as the Great Depression. The market for corporate control was in place prior to these developments—there was strong evidence for it in the LBO takeover boom of the 1980s, and earlier, if one accepts the arguments of the theory's founding figure, Henry Manne—and yet the possibility for exercising 'exit' did not forestall the governance crises that emerged.

In fact, leading orthodox figures shook their heads in awe at this paradox. Richard Posner (2009) wrote, 'The movement to deregulate the financial industry went too far by exaggerating the resilience – the self-healing powers – of laissez-faire capitalism' (p. xii). Alan Greenspan (2008) testified to the US House of Representatives: '[T]hose of us who have looked to the self-interest of lending institutions to protect stockholder's equity (myself especially) are in a state of shocked disbelief' (p. 2). This possible 'rift in the lute' of law and economics has wider implications. The Coasean approach has been at the heart of policy efforts to spread capitalism to the so-called 'emerging market countries' of the developing world, to the new nations that have emerged out of the former Soviet Union, and to post-Maoist China (Coase and Wang, 2012). If we find that there are fundamental problems with the model, then we may learn more about why the transition process in these countries has been so problematic.

The starting point for an alternative argument is to recognise the severe limits of the Coasean/Berle–Means model. Pitelis (1987) identifies a critical assumption at the heart of this model: that of 'perfect substitutability' between investment in shares (or, 'corporate saving') and consumption ('personal saving'). In fact, he argues, there are potentially significant imperfections in this relationship, and therefore the market for corporate control which serves to police corporate behavior cannot always function effectively. This, Pitelis writes, 'removes from non-controlling shareholders [primarily workers] their ultimate means of putting pressure on corporate controllers: their ability to sell and/or not to add further to their shareholding' (p. 5). The orthodox model, however, relies on the assumption that workers/consumers who own shares can easily and straightforwardly decide when to sell their shares in order to use cash now (or invest elsewhere in more promising companies). This assumption is crucial to the efficiency of the model because, in Pitelis' view, insiders at the firm have an interest in retaining corporate profits for future capital accumulation. Such an interest is only heightened if, in fact, as Pitelis and Teece (2009) maintain after Penrose (1959), the firm must marshal significant resources in order find ways to generate profitability, indeed, to create the very markets, it needs to be viable. If, in fact, outsiders who own shares cannot freely and easily decide to sell, then their ability to put pressure on insiders to behave in an optimal manner is undermined. The price signals that the capital market is supposed to generate for managers will go dark.

In contrast to the Berle and Means framework, as noted above, Pitelis dismisses the notion that there is an actual separation of ownership and control in the firm. There was, as he explains, no managerial revolution. Instead, capitalism evolved through two major stages. In the first, which we can suggest extended from the origins of modern capitalism in the eighteenth century until the late nineteenth century, capitalists both owned and controlled their firms, but, as firms' capital needs expanded, in the second stage, they give up partial ownership to outside investors. This largely corresponds with the era of finance capitalism (Hilferding, [1910] 1981). Ownership was, in fact, not so much at that point 'separated' as destroyed as Herman Cahn described the process in his long overlooked but important contemporary study, *Capital To-day: A Study of Recent Economic Development* (1918). The firms owned by individual entrepreneur-owners were consolidated into large entities organised by investment bankers such as Morgan, in exchange for a share of massively capitalised new entities. Alternatively, a Carnegie or Rockefeller was able to stay on top of their rapidly expanding organisations for many years while selling out stakes to large numbers of outside investors. But actual capitalist owners, now in collective organisations, not bureaucratic managers, retained, and still today retain, overall control of 'strategic' decisions (Pitelis and Sugden, 1986; Pitelis, 1987; Holderness, 2003).

Capitalist owners are thus able to exploit the nominal owners of shares, the beneficiaries of the large institutional investors, who cannot, because of the disabling structure of pension funds, effectively exercise their 'exit' option. These beneficiaries are, then, the *non-controlling* stockholders and, in a sense, involuntary investors in the shares of capitalist firms. They are hostages to the decisions over what to do with corporate profits taken by controlling (often minority owner) capitalists. As Pitelis (1987) concluded:

An important reason why non-controlling stockholders may fail fully to offset the effect of corporate saving policies on their consumption/saving is the 'pension funds revolution'. This has resulted in a sizeable proportion of corporate shares being owned by people, usually wage earners, who have no control over or even knowledge of their ownership claims on shares bought by 'their' funds. This makes it unlikely that these indirect stockholders will react, e.g. to increases in corporate retentions by reducing their saving, or by borrowing and/or trying to 'declare their dividends', i.e. to sell 'their' shares. In this sense, the 'pension funds revolution' helps to maintain and perhaps enhance the aggregate level of shareholding, and removes from the non-controlling stockholders their ultimate means of putting pressure on corporate controllers; their ability to sell and/or not to add further to their shareholding. (p. 5)

At the core of Pitelis' view of the problem of exit are the classic collective action and information asymmetry problems. Widely dispersed and numerous small investors are at a significant disadvantage relative to insider capitalists who both own and control. These impediments in the capital markets to perfect substitutability undermine the assumptions of the dominant market-based theories of corporate governance. There is no 'democratic' price signal being sent to managers that helps them allocate corporate resources in a socio-politically legitimate manner.

Pitelis notes that there are two views that explain the current dominance of large publicly traded corporations, neo-classical and managerial.[7] In the firm idealised by the former school—and it must be idealised as there is much less substantive historical work on the origins of the corporate firm done by the neo-classical school—there is no such thing as a minority controlling stockholder group. Instead, all stockholders—large and small, individual or institutional—can presumptively exit or maintain their share position in a firm. They can do this easily and cheaply and are, thus, constantly sending signals to a firm's managers (who are not quite the same as Berle's self-serving and opportunistic managers) about key decisions, such as the level of cash retentions versus dividends. The managerial view, on the other hand, contends, as already indicated above in the brief introduction to the work of Berle and Burnham, that somehow a new dominant class of bureaucratic planners took hold of the modern firm from within its own ranks, and somehow the former owning-controlling founding stockholders departed. Both schools, then, depend centrally on the idea of heavily diluted ownership of the firm. But as Pitelis (1987) notes, if one assumes that 'capitalists are rational, utility-maximizing individuals in the neoclassical/managerialist sense, it follows that, in expanding their firms, capitalists will wish to retain control' (p. 3).

If, in fact, capitalists retain control through smaller share positions,[8] one is left with the potential for a legitimation crisis since firms inevitably impact social outcomes but

[7] To his credit, Pitelis discusses what he calls a third 'Marxist' view of the firm as well. See, for example, Marglin (1974) and Baran and Sweezy (1967). The so-called 'Marxist' literature in this area, however, is highly problematic (with some exceptions). In most cases, as Pitelis notes, the Marxist view simply collapses into an acceptance of the 'managerial revolution'.

[8] The Delaware Court of Chancery, the leading corporate law judicial body in the USA, has gone so far as to suggest that a stockholder can 'control' a corporation with only a 22% position in the company. Legal scholars Bebchuk and Kastiel (forthcoming) argue that control is possible with 'with a below-5% stake' (p. 2). There is a substantial literature that explores the governance problems that emerge when cash flow rights are not aligned with ownership interests. See Johnson *et al.* (2000) and Bertrand and Mullainathan (2003). Much of this literature focuses on developing countries and other non-US settings where, it is assumed, that controlling stockholder dominate as opposed to the USA where, presumably, there is a 'simple' corporate structure with controlling managers and dispersed owning shareholders. Applying Pitelis' distinction between controlling and non-controlling stockholders, however, allows one to see that the problems that are allegedly only those of the non-Anglo-American world, in fact, also afflict Anglo-American capitalism. (Corporate) history has not come to an end here or there, despite the ambitious claims of some advocates of the Anglo-American model (Hansmann and Kraakman, 2001).

are now doing so on an ever-narrower social basis without accountability or the checks and balances of any countervailing power. Zingales (2017) notes 'that the interaction of concentrated corporate power and politics is a threat to the functioning of the free market economy and to the economic prosperity it can generate, and a threat to democracy as well' (p. 114). Similarly, work by Branston, Cowling, Pitelis, Sugden and Tomlinson among others—informally known as part of the 'Warwick School' (due to their affiliation with that University)—suggests that how one approaches the 'nature of the firm' can lead to different perspectives on questions of the public interest. As noted above, these authors see the modern public corporation as a 'centre' or 'locus' of 'strategic decision making' (Branston *et al.*, 2006 (borrowing, in part, from Zeitlin, 1974 and following Cowling and Sugden, 1987, 1998)) thereby making 'corporate governance a central policy issue' and conclude that there may be 'a failure to govern in the public interest' because of a lack of representation in the firm by all those whose interests are impacted by its decisions.[9]

This growing power imbalance is reinforced by the weakening of labour law and of unionisation in the advanced economies. Industrial relations law was thought to have had a legitimating effect on economic decision making through the *process* by which firms generated outcomes (Stone, 1981; Diamond, 2003). Collective bargaining, grievance systems, union elections and labour participation in the political arena together comprised the 'industrial relations' system or ideology, once thought crucial to generating a sense of the fairness of those outcomes. Now, increasingly, the firm is once again, as it was in the early part of the twentieth century, viewed as a source of the arbitrary, or unchecked, exercise of power. Corporate law, in this sense, is now labour law because it enables this arbitrary exercise of power by helping controlling owners of firms implement Coasean hierarchies that successfully direct labour without any input from labour. Because the surrounding market for corporate control cannot performs its function, even that theoretical check on self-serving insider decision making is not a source of countervailing power to these hierarchies.

4. The case study: 'transformative' activism

4.1 The scale of the activism

A possible solution to this accountability problem, however, has begun to emerge in the financial markets and in the courtroom. New efforts are underway to make corporations responsive to the wider 'public good' through new forms of institutional activism led by unions and the pension funds they jointly manage with their employers. Pension funds have, of course, long placed a small portion of their assets in hedge funds that engage in what has been described here as 'traditional' activism aimed at improving returns by policing the presumed agency costs of the Berle–Means firm. Of the more than 80% of the assets of multiemployer 'defined benefit' (DB) funds invested directly

[9] This emphasis on 'strategic decision making' moves the analysis beyond the formal boundaries of the firm and, thereby, in contrast with either the 'nexus' of contracts argument or the older Coasean market v. firm approach, offers an arguably more robust understanding of the socio-political implications of corporate power. Additional relevant work can be found in Cowling and Sugden (1994), Cowling and Tomlinson (2005) and Pitelis and Tomlinson (2017). An interesting critique of the Warwick School from a 'legally-grounded' perspective can be found in Hodgson (2002).

in equities and fixed income, however, only a small single-digit percentage is allocated to hedge funds and, therefore, a very much smaller percentage in the subcategory of activist hedge funds (DeFrehn and Shapiro, 2011).[10] Increasingly, pension funds and other large institutional investors now also carry on their own distinct and direct forms of activism. And while increasing commitments to their own activism, institutional funds have begun reducing their commitments to traditional hedge funds in response criticism by union groups (Parisian and Bhati, 2015; Steyer, 2016).

This new direct activism is built around a distinct social agenda that is consistent with the underlying source of capital placed in these funds, but it represents a significant breach in the longstanding ability of controlling stockholders to depend on labour's capital to be passive capital. Structurally, that capital is a form of deferred wages, often the result of collective bargaining between management and organised labour. Labour unions have a significant, although not always exercised, potential influence over the management of these funds. This is true in both the large public sector funds such as the California Public Employees Retirement System (CalPERS) or the New York City Employees Retirement System (NYCERS) as well as in private sector 'Taft-Hartley' funds.

CalPERS, for example, is a public agency that manages the public employee retirement system for the state of California. It is led by a Board of Administration that includes 13 members, six of whom are elected by active employees and/or retirees and, 'in practice, come from public employee unions' (Walsh, 2002). A seventh seat, filled by the state legislature, is currently held by an experienced union leader. Four seats are filled *ex officio* by state government officials, while the remaining two are named by the Governor of the state. It is the largest and, arguably, most influential public DB pension plan in the USA, and one of the largest institutional investors in the world. It manages more than $300 billion in assets and invests in more than 10,000 companies globally for its more than 1.8 million retirement system members and more than 1.4 million health program system members and their families (CalPERS, 2016a). It states, for example, that one of its core investment beliefs is that 'a long time investment horizon is a responsibility and an advantage' and that 'CalPERS may engage investee companies and external [fund] managers on their governance and sustainability issues….' (CalPERS, 2015). NYCERS manages more than $50 billion in assets and has long professed similar investment beliefs (Murphy, 2009).

'Taft-Hartley plans' are named after the legislation that imposed regulations on them in 1947 as part of the emerging Cold War era social contract between labour unions and employers. They are, by contrast to plans such as CalPERS, private sector-based multiemployer DB funds managed by a joint labour-management board of trustees pursuant to collective bargaining agreements. While jointly managed with employers, the union trustees can and often do come from a single union while those trustees

[10] DB funds pool regular payments from employers, manage the investment of the pooled assets and then pay out a predetermined or 'defined' benefit amount to retired employees. The funds can either be in-house funds owned and managed by a corporation or funds set up via collective bargaining as trusts that are managed by a board of trustees appointed by firms and their unions. 'Defined contribution' (or 'DC') plans, on the other hand, pool payments from employers and employees ('defined contributions') but these are invested in the stock of the employer's firm or into a mutual fund(s) selected by the employee from an available menu. The amount available to the employee in retirement from a DC plan is unpredictable. DC plans thus shift significant risk to individual employees but offer some greater flexibility in investment choices as well as greater portability (Bodie *et al.*, 1988). It is unlikely that much more than a negligible portion of DC assets are invested in activist hedge funds or in any form of activism at all.

representing management come from competing individual businesses. This can give the unions the opportunity to speak on such boards with a single, and influential, voice. There are approximately 1,400 multiemployer DB plans in the USA covering 10 million workers (Pension Benefit Guaranty Corporation, 2018). These plans manage approximately $500 billion in assets, compared to $3.7 trillion in DC plans, $2.1 trillion in single employer DB plans and $3.1 trillion in state and local (i.e. public sector) DB plans. In total, this represents close to $10 trillion pooled in retirement plans, representing about half the value of the entire capitalisation of the stocks listed on the New York Stock Exchange. Traditional activist hedge funds, on the other hand, are much smaller, with assets under management (AUM) of $112 billion in the first half of 2016 (Sullivan & Cromwell, LLP, 2016).

As a form of deferred compensation, the 'capital' deployed by these funds is fundamentally a form of *social capital*, the result of collectively generated and allocated value. Thus, while pension funds often employ a professional managerial team, whose members may look indistinguishable on paper from their colleagues at hedge funds, they answer to a very different beneficiary. Their strategies towards, and impact on, corporate managers can differ accordingly. While the professionals at an independent hedge fund are engaged in a primarily financial exercise on behalf of investors seeking a strictly financial return, those operating inside, or engaged on behalf of, a pension fund are part of a larger political culture, whether they recognise it or not. The new era of stockholder activism has contributed to a growing consciousness of the potential impact of this political culture. Historically, the pension fund managers have viewed themselves as part of the coalition of forces that control the corporation and thus are predominantly supportive of that controlling coalition. This is consistent with the argument of Pitelis (1987; see also Pitelis and Sugden, 1986 and Hilferding, [1910] 1981) that founding capitalists of a firm may fund growth through the creation of pension funds as a means of retaining control, but certainly not with the intent of sacrificing it, either to the funds themselves or to some new layer of managers. The emergence of a new form of activism thus represents a shift away from what might be called the 'default' position long taken by those professional fund managers.

The current wave of 'transformative' activism began in the early 2000s. In the wake of a post-dotcom crash bear market and corporate crises at major public corporations such as Enron, WorldCom, Global Crossing and Tyco, a response from stockholders was probably inevitable. Dozens of lawsuits were filed in an effort to recover the value of collapsed shares and other financial instruments, but these would (eventually) yield only pennies on the dollar: fictitious gains that led to fictitious losses generated largely fictitious recoveries, except perhaps for fees paid to plaintiffs' lawyers.[11] At the same time, however, outside the courthouse, in dozens of annual meetings across corporate America, an unusual player entered the scene. The American labour movement initiated an attempt to change the way corporate America was behaving. Labour unions and their affiliated pension plans introduced between 300 and 400 stockholder resolutions in 2003, nearly twice as many as in 2002 (Deutsch, 2003). The resolutions covered a range of leading corporate governance issues including concerns about

[11] The litigation that followed the collapse of Worldcom, for example, led to payments (largely out of insurance policies) of 42 cents on the dollar for bondholders, while stockholders received only 56 cents per share on stock that had once traded at 60 dollars. Lawyers for investors received $195 million in fees (Bloomberg News, 2005).

excessive CEO pay, the expensing of stock options, auditor independence, offshore tax havens, and the separation of CEO and Board chair positions (McGee, 2003). While many of these resolutions were advisory in nature, a large number received an unprecedented number of votes, which led many corporate managers to promise change even where management secured a majority vote against labour-backed reforms. In addition, the number of resolutions put forward likely underestimates the scale of stockholder activism because, at numerous companies, management negotiated a resolution of stockholder demands in exchange for not having the matter brought out publicly at an annual stockholders meeting (Deutsch, 2003).

In retrospect, that reaction to the crisis in corporate governance was not simply a knee jerk response signalling a short-lived reaction. It marked a new era in the exercise of stockholder power as both the AFL-CIO as well as the new Change to Win labour federation (which broke away from the AFL-CIO in 2005) and several of their large affiliate unions such as the Teamsters and the Service Employees International Union pushed for hundreds of similar proposals over the next 15 years.[12] This broad-based effort followed earlier limited, though occasionally successful, forays in the capital markets by labour unions and other activist groups. One prominent example was the PetroChina Campaign against the initial public offering of a large state-owned Chinese oil company in the spring of 2000 (Diamond, 2003). This effort, led by the AFL-CIO, was supported by CalPERS and numerous other institutional investors and triggered the near collapse of the multibillion dollar offering organised by investment bank Goldman Sachs. It served as a model for the much wider effort that then followed. As with PetroChina, unions have been joined in their subsequent campaigns by public sector retirement systems where labour union representatives sit on their boards of trustees, as well as by a range of smaller 'social justice'- and 'corporate social responsibility'-focused investor groups. As one indicator of the significance of the new activism, a search of the SSRN data base reveals 96 scholarly papers with 'pension fund activism' mentioned. A large majority of those were posted in 2003 or thereafter (84 out of 96). The same search run on Google Scholar generates 1,900 results overall, with 1,500 of those dated 2003 and after.[13]

Building on their new-found audience in the wider stockholding community, the AFL-CIO began pressing the Securities and Exchange Commission (SEC) for changes to proxy rules that would make it easier for independent candidates to conduct future election campaigns for corporate board seats (Trumka, 2003). The US Congress required the SEC to implement some form of so-called 'proxy access' in the Dodd Frank financial reform act passed in 2010 in the wake of the latest round of corporate scandals associated with the collapse of the real estate market.[14] The SEC passed a rule as

[12] The AFL-CIO is an umbrella entity that encompasses 55 unions with approximately 12.5 million members. Change to Win has approximately 5.5 million members and is made up of the Teamsters, the Service Employees, the United Farm Workers of America and the Communications Workers of America.

[13] A similar query by Frank Partnoy (2015) on 'hedge fund activism' in 2015 paralleled my result with the phrase 'hedge fund activism' having, in his words, 'grown from virtually non-existent to mainstream' over the last decade (p. 99).

[14] '"Proxy access" is shorthand for the ability of a long-term shareowner (or a group of long-term shareowners) to place a limited number of alternative board candidates on the company's proxy card (ballot) for the company's annual shareowner meeting. Proxy access also allows the nominating shareowner to provide a brief description of each alternative candidate in the proxy card's accompanying document, known as the proxy statement' (Council of Institutional Investors, 2018).

required that same year, only to have it vacated after a legal challenge in federal court (*Business Roundtable* v. *SEC*, 2011). In response, unions and friendly institutional investors turned to direct stockholder resolutions requesting bylaw changes at corporations to enable access by stockholders, under certain conditions, to a firm's proxy solicitation. A majority of the firms included in the S&P 500 have agreed to allow proxy access to long-term stockholders with, typically, a 3% or more ownership position in the company (Council of Institutional Investors, 2018). While no labour-led campaign has put forward candidates for board seats, some funds are now more aggressive in opposing board nominees put forward by incumbent managers. CalPERS, for example, voted in the 2017–18 proxy season against 483 directors at 141 companies because of those companies' failure to increase minority and women representation on their boards (Jacobius, 2018). CalPERS and the California State Teachers' Retirement System ('CalSTRS'), which manages $228 billion in assets, have created a database of potential women and minority candidates qualified for corporate board seats.

4.2 The scope of the activism

The array of topics that has emerged since that turning point add up to a virtual constitutional agenda that could alter permanently the direction and impact of the modern public corporation. In 2016, human rights-related stockholder proposals were introduced at, among other leading publicly traded companies, Chevron, Coca-Cola, Kroger, McDonald's, Netflix, PepsiCo, UPS, Wendy's and Yum Brands. Resolutions regarding fair labour practices were put forward at Alphabet (formerly Google), Amazon, CVS, Best Buy, Marathon Petroleum, Panera and Staples. Dozens of other resolutions were introduced regarding climate change, fracking, greenhouse gas reduction goals and other sustainability issues at oil, food chain and social media entities (Welsh and Passoff, 2016).

In the 2019, 'proxy season',[15] according to one environmental activist group, 'more than 400 stockholder resolutions [were] filed on a wide range of social, environmental, and corporate governance issues' covering topics such as climate change, renewable energy, fair labour standards, human rights, and corporate lobbying (Green America, 2019). The AFL-CIO's list of 'key' annual meeting votes at a select group of 32 companies in 2016 included resolutions related to corporate governance issues, human rights violations, proxy access, board diversity, government service golden parachutes and sustainability reporting. Among the targeted companies were Altria, Anthem, Blackrock, Dow Chemical, Exxon, Facebook, Goldman Sachs, JPMorgan, Salesforce.com, Verizon, Wal-Mart and Xerox (AFL-CIO, 2016).

Again, these numbers are only an indication of the impact of the new activism. Many resolutions lead to negotiations with companies and a voluntary withdrawal of a stockholder proposal. Further, as certain initially controversial issues—one example is commitments by corporations against LBGT discrimination—become widely accepted social norms, stockholder proposals around that issue decline in number. CalPERS, for example, announced that its climate risk proposals at two oil companies were withdrawn in 2016 'prior to a proxy vote because the companies agreed to implementation during

[15] Publicly traded corporations in the USA generally convene annual meetings of stockholders in the late spring of each calendar year.

engagement discussions' (CalPERS, 2016b). This is further evidence, of course, for the hypothesis stated here that the new activism is impacting corporate behaviour.

Both the AFL-CIO and Change to Win have now established in-house groups that initiate, lead and coordinate the campaigns behind these resolutions as well as other political or legal strategies. Formally, these entities provide advice to affiliate unions or directly to union trustees who are sitting on the boards of jointly managed private sector pension plans. Those plans, in turn, introduce the stockholder resolutions directly and/or instruct their financial intermediaries (typically investment advisors and brokers at major investment banks) to support particular resolutions. In addition, several larger unions affiliated with the two federations have built up their own internal teams by hiring experienced legal and financial professionals to press a similar agenda. These efforts are only intermittently connected directly to, or constrained by, union organising efforts or traditional collective bargaining goals. Instead, the labour effort stems from a robust and progressive view of the fiduciary obligation labour unions believe their trustees must uphold.

In parallel, public sector pension funds—some of whom have labour union representatives on their boards or, in the case of single trustee funds, depend heavily on unionised workforces for financial and political backing—have initiated their own corporate social responsibility campaigns. The two most ambitious and widely followed are efforts by CalPERS and NYCERS. These campaigns have led to important changes in the way that many funds allocate their assets and select and oversee their fund managers. A recent example at CalPERS is their adoption of a five-year strategic plan of engagement on 'Environmental, Social, and Governance' (ESG) issues. 'The strategic plan serves as the framework by which CalPERS executes its shareowner proxy voting responsibilities; engages public companies to achieve long-term, sustainable risk-adjusted returns; and works with internal and external investment managers to ensure their practices align with CalPERS' Investment Beliefs' (CalPERS, 2016a; on joint efforts of CalPERS and the AFL-CIO, see Webber, 2018). CalPERS' efforts are global in impact. Its investment staff recently announced it was reviewing the fund's holdings in 13 companies, including Finland's Nokia and the Scandinavian based Nordea Bank, because of these firm's possible activities in Sudan and Iran (Diamond, 2018b).

These efforts are not without controversy inside the pension plans. A long-time CalPERS Board member who was also serving as Board President in 2018 was defeated for re-election to the Board by a representative of a small police officers' union (Diamond, 2018a). The police officers oppose the pro-ESG principles of CalPERS as well as a plan by the California State Treasurer, an ex-officio member of the CalPERS Board, to sell the fund's holdings in gun manufacturers. The election appears to be an outlier with only one other Board member on the 13-member Board known to be a critic of the fund's ESG principles. The fact that these issues are being contested through an open democratic political process underlines the innovative nature of this new challenge to traditional market-based principles being made by union representatives managing funds like CalPERS.

4.3 Activism in Silicon Valley

Two specific examples from Silicon Valley demonstrate the potential of the new activism. Tesla, Inc., the startup electric car manufacturer, is tightly controlled by a small group of inside owners centred around Elon Musk, who wrested control of the firm from its founders several years ago (Baer, 2014). Despite being publicly traded, Musk dominates the board of directors of Tesla. Numerous institutional investors began raising concerns about Musk's control over the last few years. Led by the CtW Investment Group, an investment advisory group housed at the labour federation Change to Win, investors began an activist campaign to reform corporate governance at Tesla. This included calls to restructure the company's board of directors away from its tight dependence on Musk. When Tesla proposed in 2016 to acquire another company also dominated by Musk, SolarCity, CtW, joined by CalSTRS, the giant UK investment manager Hermes, and entities managing large public sector funds for the state of Connecticut and the City of New York, again raised concerns about conflicts on the Tesla board (Garland *et al.*, 2017). These five funds managed financial assets exceeding $700 billion and thus their input carried weight.

While the acquisition was approved, soon thereafter Tesla announced that it was adding two new independent directors to the Tesla board. While Tesla did not expressly acknowledge the CtW campaign, *The Wall Street Journal* reported that the change in the board's composition was a response 'to pressure' and 'criticism' from the labour-led shareholders (Higgins, 2017). Tesla's CEO Elon Musk had, at first, dismissed the pension funds' demand but soon conceded via his Twitter account that 'yeah', two more independent board members would, indeed, be appointed.[16]

More recently, the SEC intervened at Tesla to require that the company include two more independent directors on its board as well as separate the role of Board Chair and that of Chief Executive Officer, a longstanding demand of pension fund activists across corporate America (SEC, 2018).[17] CtW followed this with an additional letter co-signed by several major public sector pension funds calling for additional improvements in corporate governance at the company (DiNapoli *et al.*, 2018). CtW welcomed the appointment of a new Board Chair who was, Tesla announced, to serve in that role on a full time basis, an unusual step indicating the oversight role the Chair was expected to undertake (Higgins and Stewart, 2018; Tesla Inc., 2018). In April 2019 Tesla announced three board members who are close members of CEO Elon Musk's inner circle would leave the board in the near future, a move which Tesla said was 'in connection with certain stockholder-friendly corporate governance initiatives' (Tesla, 2019). This serves as a concrete example of an ongoing effort by non-controlling stockholders for influence at a firm with a dominant controlling stockholder.

In a second effort, the Amalgamated Bank, a New York-based and union-controlled commercial bank and manager of $40 billion in pension fund assets, joined with

[16] The mercurial and provocative CEO of Tesla, Elon Musk, may have felt that by appointing as one of the new board members James Murdoch, the son of the notoriously anti-union Rupert Murdoch, he was poking a finger in the eye of the labour activists targeting his firm. Whether or not the younger Murdoch shares his father's hostility to unions is not clear, but the addition of two directors from outside Musk's inner circle has changed the dynamics on the board. When controversy erupted at the company because of a misleading and false tweet by Musk regarding a possible buyout of the firm, the independent directors went so far as to hire their own outside legal counsel to advise them (Sorkin *et al.*, 2018). This is highly unusual.

[17] At the end of 2018, Tesla announced the appointment of Larry Ellison, billionaire founder of software giant Oracle, and Kathleen Wilson-Thompson, an executive with Walgreens Boots-Alliance, to its board of directors. Ellison, as a large investor in Tesla who views himself as a kind of mentor to the younger Musk, will be viewed as part of the control group around Musk. Wilson-Thompson, however, as the second African-American woman appointed to the board, may help coalesce a more independent faction at the firm. Her expertise is in human resources and she is viewed as someone who will be sensitive to the concerns raised about labour conditions at Tesla. She also sits on the boards of two other industrial manufacturing companies (Peterson, 2018).

several Taft-Hartley pension plans as well AP7, the Swedish state pension fund, to file suit against Facebook, its founder Mark Zuckerberg and its entire board of directors for breach of their fiduciary duty to stockholders in connection with a proposal to issue a new third class of common stock with no voting rights (Katz, 2017). The Class C shares that Facebook planned to issue would have further consolidated the control already possessed by the company's founder Mark Zuckerberg even as Zuckerberg sold off some of his holdings in Facebook shares to fund private philanthropic efforts. On the eve of trial, Zuckerberg withdrew the proposed stock issuance and the case was settled, a victory for the labour-led institutional investor plaintiffs and a clear signal to Silicon Valley companies that insider control of those companies would be met with scepticism if not outright opposition.

5. The 'governance option'

Inevitably, union and public sector pension fund activism has been criticised by contractarian and agency school scholars (Romano, 2001; Anabtawi, 2006; Bainbridge, 2007). They generally dismiss union intervention in the capital markets as self-serving, if not outright self-dealing. But these opponents ignore the fact that the beneficiaries of large institutional funds possess the right to an embedded 'governance option' as part of their ownership of financial assets.[18] Stock can be viewed as made up of a 'bundle' of rights. The primary focus of hedge fund activists is to maximise the value of the right to payouts via dividends or stock buybacks. But shares of stock also contain certain 'governance' rights, such as the right to vote on key corporate decisions, the right to access certain private corporate information, the right to attend, speak and vote at annual meetings, and the right to pursue derivative claims against directors and officers on behalf of the corporation as a whole.

The exercise of these rights is purely optional. Typically, pension funds delegate management of their assets to fund managers who are closely tied to large financial institutions. These same financial institutions have a vested interest in establishing a close relationship with those in actual control of firms, the partial owners who maintain strategic power in the corporation. Thus, fund managers typically ignore the potential to exercise any aspect of the embedded governance rights independently and instead vote consistently with management. Thus, the potential value of the embedded governance option declines much like an unexercised option to buy or sell of financial instrument that is no longer 'in the money'.[19]

To borrow an approach from the world of international security, long-term non-use of a weapon undermines its credibility and only the credible threat of the use of power gives that power reality. The labour movement, therefore, is now beginning, instead, to exercise what remains still a largely unexercised embedded 'governance option'. This has the potential to generate a genuine countervailing force to the private centre of

[18] 'Embedded options' are features of financial instruments that sometimes go unrecognised and therefore mispriced and unexercised. Examples include call and put options on bonds.

[19] A 'put' option refers to an option to sell an asset to another party. To 'put' a financial instrument means to exercise that option and thus triggering the obligation of the other party to buy the instrument. The option to buy an asset is a 'call' option. One exercises such an option by 'calling' it, mandating the counter-party to sell the instrument to the holder of the option. On the continuing importance of 'controlling' stockholders despite the Berle–Means separation thesis, see Pitelis (1987) and discussion above.

power resident in the (Coasean) corporation and possibly help re-establish the social legitimacy of modern economic decision making.

More specifically, the exercise of this option overcomes the problem of imperfect substitutability introduced by Pitelis. As Pitelis (1987) described the heart of the problem, the 'pension funds revolution':

> has resulted in a sizeable proportion of corporate shares being owned by people, usually wage earners, who have no control over or even knowledge of their ownership claims on shares bought by 'their' funds. This makes it unlikely that these indirect stockholders will react, e.g., to increases in corporate retentions by reducing their saving, or by borrowing and/or trying to 'declare their dividends', i.e. to sell their shares. (p. 5)

In other words, absent an effort to exercise the embedded governance option, pension savings are rendered (or, to continue the analogy with traditional options, 'put') back to the capitalist class as a form of capitalist savings. Pitelis (2016) more recently has noted that 'the huge surpluses engendered through occupational pension funds could/should be seen as capitalist savings' (p. 7). That means they become fuel for the fire of capitalist accumulation not to be used (or, if so, only accidentally used) in workers' (consciously self-determined) interests.

Ironically, the orthodox 'perfect substitutability' argument in the era of the publicly traded corporation has its roots in the world-view of socialist reformism initially established by Edward Bernstein of the German social democracy. Bernstein ([1899] 1993) viewed the new 'joint-stock company' (as the publicly traded corporation was known at the time) as a kind of democratisation of capitalism from within. This fit well with the already established idea within the socialist movement of 'socialisation' of the means of production as an ongoing trend (a phenomenon that clearly intrigued the young socialist Ronald Coase). The missing question was what kind of political developments were needed in order to push the capitalist system over the top, so to speak, into socialism. For Bernstein, there was an 'evolutionary' process underway that was, in part at least, being driven by this new democratic form of corporate governance. The emerging separation of ownership and control was not a problem to Bernstein because of the alleged democratic effect of widespread share ownership. A more dominant (and darker) view would take hold, however, influenced by figures like Edward Bellamy, Berle and, later, Burnham—that the separation thesis necessarily implied managerial dominance (Lipow, 1982).

Nonetheless, the concept of the socialisation of the means of production was real enough. In fact, as Pitelis (1987) notes, it heightens the level of class tension in modern capitalism:

> The emergence of the joint-stock company and its associated tendency towards SOMP [socialization of the means of production] mark a new era in the development of capitalism. Previously, capitalism was characterized by an important antithesis; the coexistence of *social production*, the participation of the vast majority of people in the production process, and *private appropriation*, i.e. the appropriation of (a disproportionate part of) the social product by a minority of people who owned and controlled the means of production. The tendency towards SOMP, I suggest, raises the above antithesis to its highest level; as it results in a coexistence of *social ownership*, with *social production* on the one hand, and *private appropriation* on the other. A small minority of people is now appropriating the social product by virtue their control over the means of production, the largest part of which is owned collectively by others. (p. 2)

It should be apparent now why both mainstream theorists and reformist socialists like Bernstein were so willing to think of diffuse share ownership as so significant. It is the only way around the implication of concentrated power in the firm, that capitalism has within its walls a fundamental pathology.

But the concept of a 'governance option' takes us one step beyond this pathology. It helps us recognise the social effect outside the firm of this contradiction between private appropriation of a socially generated collective product. If capitalism is pushing outwards on the boundary of the firm because of the impact of the socialisation of the means of production, the surrounding society is pushing inwards against that boundary as a constituent part of what Engels ([1880] 1918) called the 'invading socialist society':

> In the trusts, freedom of competition changes into its very opposite - into monopoly; and the production without any definite plan of capitalistic society capitulates to the production upon a definite plan of the invading socialistic society. Certainly this is so far still to the benefit and advantage of the capitalists. But in this case the exploitation is so palpable here that it must break down. No nation will put up with production conducted by trusts, with so barefaced an exploitation of the community by a small band of dividend-mongers. (p. 120–21)

The contemporaneous feel of this argument is palpable. Thus, today it seems eminently sensible to recognise a 'governance option' which empowers workers to respond to the volatility, uncertainty, irrationality and, fundamentally, the structural inadequacy of financial capitalism.

6. Conclusion

The emergence of a new era of labour union activism by way of the trillions of dollars of financial capital that trade unions either influence or control has been—depending on your political persuasion—predicted, promised or feared for decades. Perhaps, the most famous of these assessments came from the management guru, Peter Drucker, who claimed that the USA had moved into a new economic era called 'pension fund socialism' (Drucker, 1976). 'If socialism', Drucker argued, 'is defined as "ownership of the means of production by the workers"—and this is both the orthodox and the only rigorous definition—then the United States is the first truly "Socialist" country' (p. 1). Somewhat less ambitious analysts have suggested that union-influenced pension funds are really no different than other active stockholders—these funds act as a responsible counterweight to the sometimes less than responsible behaviour by corporate insiders (Schwab and Thomas, 1998). This viewpoint might even be seen as comforting to some, if not always to corporate insiders, because it is consistent with the dominant paradigm of the so-called Anglo-American model of capitalism and the widely accepted concern about the 'separation of ownership and control'.

While the Drucker view was clearly an overstatement, it did serve a useful purpose. It established a kind of benchmark, a useful heuristic device, that one could use to measure the actual impact of the rise of a new kind of force in American post-war capitalism. And there was certainly, at the time Drucker worked on this issue, growing anecdotal evidence of the phenomenon he thought so important. The rise of pension fund and institutional investor power was part of a significant structural shift in the American economy as capital markets grew significantly at the expense of traditional commercial banks over the last decades of the prior century (Edwards, 1996). Hawley and Williams (2002) report a dramatic shift from retail to institutional ownership in the late twentieth century:

Beginning in the 1970's and accelerating through the remainders of the century a reconcentration of ownership took place as fiduciary institutions - mutual funds, insurance companies and, most importantly, public and private pension funds - came to own a larger and larger fraction of corporate equity. As recently as the 1970's the household sector owned about 80% of U.S. corporate equity. However, by the end of the 1990's their holdings had fallen below 45% while institutional holding [*sic*] had risen to almost 50%. A similar trend occurred in the United Kingdom where institutional ownership peaked at about 60% in 1994. (p. 285)

In other words, a substantial portion of corporate America is, indeed, controlled by large financial intermediaries arguably acting on behalf of individual American workers.

But precisely because of the problems identified by the law and economics paradigm that dominates corporate law theory today, this 'revolution', if you will, has not brought about anything like a socialist society.[20] Recognising this, one might be tempted to suggest that the alternative that the agency school points towards, what might be called a variation on the liberal pluralist model that rests so much on the idea of competing power centers as a sustaining force in American life, has now emerged. The unprecedented level of stockholder activity, along with a few well-publicised prosecutions of major Wall Street insiders, can be seen as confirmation that, at the end of the day, the system works. There are checks and balances that emerge to temper bad behaviour; there are competing interest groups that make sure no one goes too far; and, of course, there is a legal fraternity—judges, scholars and practitioners alike—that works to strike the proper balance between government regulation and private ordering.

This paper strikes a cautionary note. There is a deeper problem afoot, a problem that does not give rise to easy answers. Now there is the distinct possibility that this time the pendulum may not swing back, that a new balance may not be struck, that the collapse of Enron, WorldCom, Lehman Brothers and Bear Stearns cannot be dismissed, as they were by some law and economics figures, as 'failed business models'. Instead, the ongoing corporate and financial debacle of the last 15 years could be viewed, like the miner's canary, as a warning of a breakdown in the framework that has long been thought to generate social and political legitimacy in Anglo-American capitalism. At the same time, these events present an opportunity to confront the current situation and perhaps lead to a different institutional arrangement that resolves this legitimacy problem.

Specifically, it can be argued that large institutional investors, particularly those influenced by, or jointly managed by, labour union representatives, are now exercising a 'governance option' embedded in the financial assets they own. This governance option is traditionally 'put' back to management via the fund management structure that currently controls or heavily shapes the direction of fund assets. Instead of exercising any of the bundle of rights that make up this option, the beneficiaries of these funds simply have allowed it to simply lapse unused or allowed fund managers—Wall Street insiders—to exercise it (or not) on their behalf.

[20] Of course, Peter Drucker's concept of 'socialism' should not be taken at face value. At the point he was writing, 'socialism' was thought to mean some form of collective ownership of corporate assets, presumably by the government. Drucker was one of several major corporate theorists who were exploring non-statist forms of collectivism. Berle, too, thought the rise of pension funds could mark a new era in capitalism. These figures were attempting to avoid what they thought of as a worse outcome—Stalinism, which during the long Cold War was always a concern to them.

But now that option is being exercised through increased labour-led stockholder activism instead of being allowed to lapse and that is helping to reshape the nature of corporate governance. In fact, these new activists have no choice but to wield the rights they possess but have long left fallow. The legitimacy problem the firm generates for capitalism mandates a response.

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