A POWERFUL COALITION: WORKERS AND OWNERS VS MANAGERS

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John H. Biggs

I have had a long time personal and professional interest in two related subjects: pension plans and corporate governance. My talk tonight will be on some surprising ways they interact and what that interaction may mean for corporate governance in the years ahead.

Can any of you identify the following quote from a book by a well known business writer, published in 1976, just before the enactment of ERISA?

"If "socialism" is defined as "ownership" of the means of production by workers" – and this is both the orthodox and the only rigorous definition – then the United States is the first truly "socialist" country."

Peter Drucker was the author of The Unseen Revolution: How Pension Socialism Came to America.

This book was the culmination of Drucker's pension socialism thesis, starting with an article in *Harper's* in the 1950's and frequently addressed in later essays.

The book is a comprehensive attempt to describe the role of pension plans in the corporate governance of American public companies and has always appealed to me in its broad scope.

In 1976 Drucker estimated that 25% of common stock was held by company defined benefit pension plans and another 10% in public employee plans, giving workers roughly a 35% ownership share. Those numbers are significantly higher today. Surely, Drucker argued, a 35% block holding gave the workers de facto control of American companies.

In 1976 virtually all corporate pension plans were defined benefit in form – TIAA-CREF's defined contribution and Taft-Hartley plans were exceptions. Much of Drucker's analysis is driven and, in my view, flawed because he wrote before the era of defined contribution plans.

Remember that ERISA, enacted as his book was published, and other pension legislation in the late 1970's created the important pension institutions of 401(k) plans and IRA's, which together are now the largest asset base for America's pension accumulations. Keogh plans for the self-employed, which started a few years earlier, are another form of defined contribution plan.

Drucker contrasted the U.S. to European countries by calling our system "socialized" and theirs as "nationalized". An interesting distinction, particularly when we think of Russia. Also England had a comparable commitment to defined benefit plans, with similar investment strategies, but had gone a different route with nationalization of their largest companies.

Drucker reviewed the history of the post World War II pension development, focusing especially on the bellwhether General Motors plan. Charlie Wilson (famous for saying "whatever is good for GM is good for the country") started the creation of corporate pension plans in 1950 with strong opposition from the UAW. After court decisions made it clear that pensions were an appropriate subject for labor-management bargaining, there was a flood of new corporate defined benefit plans, over 8,000 new ones in one year.

What seemed radical in 1949, the adoption of Wilson's plan for GM, copied by others, involved a few key principles, articulated by Wilson:

(1) No investment in assets backing the plan should be in GM shares, or in GM debt. Instead invest in other companies' equity and debt.
(2) Corporate pension funds should be professionally invested as "investment funds". Incidentally, this policy spelled the end of traditional life insurance domination of pension management since not until ten years later did they develop methods for investing in common stocks.
(3) No investment in any company in excess of 5% of that company's stock. This is interesting as an example of America's populist opposition to block holding. At that time there was nothing to prevent ownership by a pension fund of major controlling blocks of another company's stock. Perhaps Wilson believed there would be a congressional reaction if GM's pension plan gained controlling interests in other companies.
(4) No investment should be made in excess of 10% of the pension funds assets, a sensible diversification.

A flaw in Wilson's bold but cautious plan, which we are now confronting, was not to see the long term financial risks exploding in defined benefit liabilities. There was some merit in the old fashioned life insurance company group annuity plans that compelled total immunization between assets and liabilities, and total shifting of risks to the insurer.

Several other interesting observations in Drucker's 1976 book: (1) he favored including municipal and state plans under ERISA, a sensible change not yet implemented in 2006 and (2) he had proposed compulsory government reinsurance of defined benefit plans in the 1950's – which he claims "startled no one." Obviously the PBGC was created under ERISA in 1976 as a kind of reinsurance.

Drucker has a lot of analysis of economic issues, particularly macro issues involving the formation of capital. He even made some comments on the demographic problems he saw then. He should be writing now!

As to specifically corporate governance issues, he had several key predictions (none of which have yet surfaced.)

Drucker saw a fundamental conflict in the role of commercial banks in asset management. His prediction was that the two functions would be split apart with the traditional trust and asset management business spun off into separate companies.

He also predicted attempts by the government to expropriate pension assets, either by requiring pension plans to buy government bonds or by direct confiscation.

I remember reading The Unseen Revolution in the late 1970's and being puzzled by Drucker's thesis. Workers should somehow have asserted their control, but they had not in any significant way.

On rereading it in 2006, I continue to believe the revolution did not occur in the 60's and 70's. But I believe it has now started. We will date its beginning with the crash of the stock market in 2000, and it is steadily gaining force. The implication for corporate management in the next two decades will be profound. I will turn to those implications shortly.

I recommend to you a book just published in 2005 called Political Power and Corporate Control: The New Global Politics of Corporate Governance, by Peter Goureviteh and James Shinn. The authors explore fundamental issues on the interaction of politics and corporate governance. But most importantly it provides an analysis and ingenious empirical work on how pension plan ownership works through the political process. It argues that the large pension ownership in the U.S. has created an alliance of strange bed-fellows, workers and owners to challenge managements.

Let me briefly outline the thesis, how I believe it is currently being implemented and then hazard some predictions on the outcome of the thesis.

Goureviteh and Shinn address two key questions: first, why different countries have different corporate governance structures and second, what creates change in those structures. In their definition of "corporate governance", they focus on the prevalence of major block holding versus diffused shareholders, protection of minority shareholder rights, transparency to owners and the public of company operations, and the character of government regulation of public companies. Corporate governance is more than just what Boards of Directors do.

They argue that the fundamental conduit for change arises from political interests, expressed as the interests of three different but sometimes overlapping groups - owners, workers and managers.

With three groups, alliance can be created in six ways, i.e. pick one of the three possibles against two with either side winning out – hence 3 times 2. These days reading constantly about executive compensation, most Americans would characterize managers as dominating the coalition of workers and owners. In traditional Marxist analysis the owners always dominate the workers. Managers under the standard economic model treat both workers and managers as "factors of production". Furthermore in looking at corporate governance the recent focus, post Berle & Means, is primarily on the ongoing agency problems between owners and managers.

In many countries workers have the dominant role over managers and owners. To most Americans this probably describes the continental European economies.

Goureviteh and Shinn conclude that the U.S. has developed a workers and owners coalition that is beginning to show its domination over management. The result is that the American system displays three strong characteristics: (1) diffuse ownership (unlike, say, the Japanese, Korean and European block holding governance models), (2) strong minority shareholder protection and (3) transparency. They call our method the "transparency model".

This brief summary hardly does justice to the careful descriptive analysis of the authors.

What has led owners and workers to get together in America and also in the U.K. and certain small economies? The culprit turns out to be the much wider use of private pension plans (and we are including state and municipal employee plans under "private"). In most countries the national government provides substantial defined benefit guarantees and little is provided by employers or individual families.

For example, the total value of private pension assets in the U.S., UK, Canada, Netherlands, Denmark and Switzerland all exceed the value of one year's GDP – in fact over 100%. On the other hand in Italy the value comes to only 6% of GDP, in France and Germany only 16%.

In graphing the correlation between private assets as a percentage of GDP against a complex statistical measure of minority shareholder protections, the U.S., UK, and Canada are near the top; Italy, France and Germany near the bottom. The positive correlation is .56, surprisingly high for such a matching of unlikely pairs.

A further relationship is interesting. If a country relies heavily on government sponsored plans, with a larger reliance on future pay-as-you go government contributions, one might expect less political interest in protecting investors. This does turn out to be a negative correlation, minus .39, as suspected – i.e. protection of minority shareholders tends to be <u>less</u> in those countries that have high reliance on unfunded national pension systems.

Goureviteh and Shinn also explore some of the pension institutional differences that create a strong ownership interest in workers.

Traditional employer sponsored <u>defined benefit</u> plans, in the GM model, kept the fundamental investment risk with the employer, except in extreme bankruptcy conditions. For example, when Enron failed, the workers in another company's defined benefit plan were not hurt directly.

Under a 401(k) plan, or 403(b) – or an IRA or Keogh – the hurt was direct – given that such plans lodge the investment risk firmly on the worker or family.

It is worth pausing briefly to recall how significant the worker or family owned plans have spread since Drucker wrote <u>The Unseen Revolution</u>. I will rely on a recent release by EBRI, based on a study from the Federal Reserve's survey of consumer finances. EBRI reports that 74% of American families had some member of the family in a 401(k) type plan in 2004 up from just 32% in 1992 and from virtually zero in pre-ERISA era when Drucker wrote his book. Furthermore 29% owned an IRA or Keogh plan. Defined benefit plan participation was down to 24% in 2004 compared to 40% in 1992.

And these plans were important to American families. For those with defined contribution plans, or, IRA's or Keogh's, the assets in those plans comprised, at the median, <u>63% of their total financial assets</u>.

Consider the political response in 2003 when Sarbanes-Oxley passed congress on an expedited basis, driven ironically by one of the most anti-regulatory administrations in our government's history. I can assure you that

Mike Oxley, a deeply conservative republican from a red district in a red state, did not want his name on a bill creating a huge new federal regulatory agency (the PCAOB) and a tough regulatory regime over one of America's largest professions, the auditors.

Surely, Karl Rove was fully aware of the political issue involved with a high percentage of American families affected by WorldCom's demise so soon after Enron's.

Through the political process, workers' socialism is coming to America – but in a very peculiar form in an unexpected alliance between workers as owners and investors as owners. This is an alliance which is demanding protection of investors, honest financial reporting, better internal financial controls, and much greater penalties for those in management not delivering the demanded results.

It is interesting to see other current symptoms of <u>The Unseen Revolution.</u>

Institutional investors have been largely passive over the last several decades. It took strong enforcement by the Department of Labor, with aggressive audits, to persuade asset management groups that they should at least <u>vote</u> their proxies according to some set of credible standards. The Wall Street rule was widely passive, if you disagree with management just sell the stock. The ERISA initiative and the passivity of asset managers have led to the extraordinary rise to power of the proxy advisory firms. In effect, asset management firms have <u>outsourced</u> their responsibility as owners. Developing an independent, thoughtful view on the wide variety of complex corporate governance issues is a costly matter. Very few asset managers do anything of the sort. Certainly, none of the top talent in any such organization would wish to devote time to the subject.

Perhaps the requirement that mutual fund companies disclose their votes will induce some principled review of how proxies are voted. I doubt it. It is hard work, not interesting to most investment analysts and ultimately too costly.

The cost is in two parts: (1) a small cost, the cost of the people devoted to governance issues and (2) a very large cost, that of offending important clients of the asset management firm. The SEC has noted the latter conflict. Gourevitech and Shinn have a nice and very accurate quote of Bob Monks, the maverick Republican who has campaigned for decades for better corporate governance activism by institutions: "the trustees of private pension plans are appointed by the plans' sponsoring companies, which are anxious to avoid a reputation for <u>activism</u> – as are the money managers to whom the trustees often delegate their buying decisions. In extreme cases, activism invites reprisal; in more moderate circumstances, it would tend to make them "unclubbable" in a world where lucrative management contracts are available only to those who "go along to get along".

For a simple illustration, there is a key question to ask. Why haven't any of the firms, investment management responsible for hundreds of billions in ERISA assets, ever filed a proxy resolution that was opposed by management? There are other similar questions one might ask.

But the tide is shifting. Clearly retirees in the 21st century will have to develop investment balances to finance an ever rising percentage of their retirement income. The statistics EBRI reported will become more dramatic in the several decades ahead. Asset managers will be forced to respond.

But let me conclude with some ideas about how this coalition of workers and owners may force management to change.

First I think we will continue to have deep political support for tough regulation of public companies, and eventually even further regulation of institutional investors. We see this political effect vividly now in the problem of hostile juries. Huge settlements have been reached rather than risking a jury trial on complex financial transactions. American business is simply not trusted – reputations of companies and CEOs are at a dangerously low level. Too many people on juries see their 401(k) retirement plans affected by alleged corporate misdeeds.

Secondly, executive compensation is going to be an extremely contentious battleground. We may end up moving to the British model where shareholders have a much stronger role in limiting executive compensation – and the British institutions have been effective. I suspect this issue ultimately will be resolved in congress.

Thirdly, there will be significant changes on how directors are elected. The majority rule will doubtless replace plurality voting, whether adopted voluntarily or through changes in Delaware law or even exchange listing requirements. But there will be follow on changes.

Fourth, transparency to investors will go to extremes – to levels that will appear absurd to many of us. Some think the long overdue SEC proposed disclosure requirements on executive compensation go too far. But consider another example, will workers and owners continue to let corporate philanthropy continue at all or will the disclosure requirements make every gift subject to exhaustive conflict of interest disclosures? Will all potential lobbying expenses require disclosure?

Obviously owners and workers will care deeply about financial reporting – at least integrity if not clarity.

Fifth and finally, I think we will see a change in the kind of institutions that are included under the name of “corporate activists”, a somewhat <u>disreputable</u> name. We will still have to deal with four groups who give corporate activists a bad name: (1) special interest groups; (2) certain crank types, whom all of you can name, who make a farce out of annual meetings; (3) state and city pension plan activists with poorly concealed political motivations; and (4) union harassment representatives without serious understanding of corporate governance.

But the new owner-worker coalition will introduce <u>serious</u> labor resolutions. The quality of the legal staffing of the major national union groups has improved substantially, and the quality of the resolutions improved – with many garnering substantial, and sometimes majority support from institutional investors.

And institutional investors are changing significantly. Hedge fund managers and private equity firms bring sophisticated, economically oriented advocacy into the camp of activists. And surely the pressures will mount on asset managers to take a more effective role – with substantial commitment of resources. If they do not do so one can predict some form of reaction from the <u>owner & worker coalition</u> – either through political force or direct pressure on firms. Perhaps Peter Drucker’s prediction of fifty years ago will finally come true – that the asset management function will have the same kind of independence standards for example, as currently applied to auditors. Will firms administering 401(k) plans have to be separated from the investment management functions? Drucker’s prediction was limited to bank trust departments – the concept is the same in 2006 but the relevant institutional set up is dramatically different.

There are also some issues on which workers and owners will not agree. Investor owners will never be persuaded to support unionization of workforces, or support of open ended benefit commitments such as the original GM plan.

At a more subtle level, workers will oppose efforts to open up the market for corporate control, something which is in the interest of investors. – <u>that</u> market can endanger jobs, in attrition or elimination of business units. Obviously non-worker owners would support a flourishing market. But on this issue it appears that managers have dominated since their focused efforts on individual states have not been effectively blocked by more nationally oriented investors. Poison pills are clearly here to stay along with local protective provisions for state domiciled companies.

There are other consequences one might suggest. And I am sure when I reread this five or ten years from now there will be lots of surprises.

In conclusion, Peter Drucker's predictions were made a bit early. And institutional changes that he did not foresee, especially the dramatic shift to defined contribution plans, have created an American socialism that seems pretty benign compared to the fears that the word socialism raises. Our private sector remains dominant but a new coalition of owners and workers will assert much more control over how public companies are managed.

Maybe once again American capitalism has found a balanced and acceptable solution. But the days of imperial CEO's are numbered. The days of managed earnings are certainly gone. Stock option plans have seen their heyday. Those who manage money will be held to much higher standards. It is hard to be against those values of this worker-owner coalition.