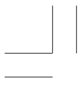
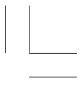
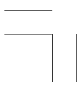
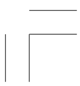
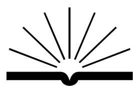
Democratizing Pension Funds

Ronald B. Davis

Democratizing Pension Funds
Corporate Governance and Accountability



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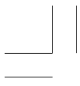
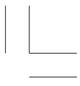
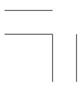
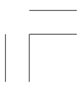

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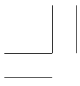
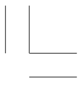
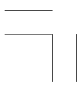
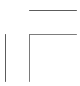

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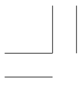
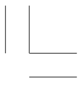

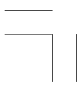
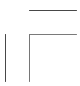

Introduction

Employee Ownership, Pension Funds, and Economic Power

The "Socialist Revolution"

In 1976, Peter Drucker proclaimed that the United States had become the first truly socialist country because the ownership of the means of production by the workers had been achieved.[1] He claimed that employees in the private sector beneficially owned at least 25 percent of American businesses' equity capital through their pension funds, while employees in public and non-profit institutions beneficially owned another 10 percent. Collectively, this was sufficient to provide them with control. In 1993, Mark Roe reported that pension funds owned $1.5 trillion dollars in equities, representing about one-third of the value of all equity stock, and that, in aggregate, they owned a control block in every major corporation in the United States.[2] The Employee Benefit Research Institute reported on the historical increase in equity holdings of employment-related retirement plans in the United States from 1950 to 1998. It reported that these plans held 0.8 percent of all equities in 1950, 4 percent in 1960, 9.4 percent in 1970, 18.6 percent in 1980, and 25.9 percent in 1990. By 1998, that figure had risen to 27.3 percent of all equities held in the United States, with a value of $3.5 trillion.[3] The total value of all assets of employment-related retirement plans in the United States in 2001 was $8.3 trillion.[4]

In Canada, at the beginning of 2002, the total value of all assets in all types of employment-related retirement plans was $1.2 trillion,[5] the value of assets in trusteed pension funds was $568 billion, and the value of equities held by these funds was $220 billion, or 38.7 percent of the total value of pension fund assets.[6] Trusteed pension funds directly owned equities representing about 10.4 percent of the value of the Canadian corporations on the Toronto Stock Exchange, and these stocks represented 12.9 percent of the value of the TSE 300 stock index in 2001.[7] Globally, Robert Monks reviewed various estimates of the equity holdings of funded pension plans in

North America and the United Kingdom in 2001 and concluded that collectively pension funds owned up to 77 percent of the equity in the largest 1,000 companies in the world.[8] Yet William Simon concluded that, despite the extent of this "ownership," a number of factors acted to restrict the "democratic and egalitarian" aspirations of pension fund socialism to merely a modest realization in the United States.[9]

Among these factors is the history of the courts' failure to recognize personal proprietary rights over assets held for the benefit of all plan participants in the plan.[10] Another factor, first identified by Adolph Berle and Gardiner Means in 1932, is the separation of "ownership" and control inherent in equity investments in the modern corporation.[11] There are also the intergenerational conflicts between employees and retirees, as well as those between younger employees on the one hand and older employees and retirees on the other.[12] Finally, because the control arising from pension fund share ownership can be exercised only by aggregating the holdings of a number of different pension plans, problems and costs related to collective action will be encountered. Despite these problems, however, the alternatives seem even less palatable. In the first alternative, the potential for control is not exercised. In the second alternative, it is exercised but the decisions about when, how, and for what purposes are left in the hands of individuals who are not accountable to the plan participants in any meaningful way for these decisions.

My contention is that there are both normative and prudential reasons why plan participants ought to exercise a greater degree of democratic control over the corporate governance decisions of funds held for their benefit, and why accountability for those decisions must flow from the funds' managers to the plan participants. By corporate governance decisions I mean decisions concerning the exercise of shareholder rights to try to increase the responsiveness of the management of investee corporations to shareholder concerns. Some of these concerns would include any changes in the financial or control structure, the independence of directors from management, accounting and auditing practices, and management of environmental, social, and ethical risks.[13] While it may be argued that this control should extend to determining the types of investments the plan purchases, I will argue that there is a limited scope for control of this feature of trustee responsibilities due to the nature of the decision making in that area. However, pension fund managers should be accountable to plan participants for active engagement in pressuring corporations in which the plan is invested to better manage environmental risks, such as global warming.

There are limits to this control and accountability generated by the dual-agency nature of plan participants' relationships to a fund's equity investments. "Dual agency" refers to the beneficiary–trustee agency problems in

the pension trust fund relationship and the stockholder–manager agency problems in the corporate equity investor relationship. Any agency relationship involves the attenuation of the principal's control merely from having to act through another human being's agency. The limits to control by and accountability to plan participants have not yet been tested to any real extent.

Instead, control over these decisions has been exercised primarily by large financial institutions without any formal or statutory obligations to account to the plan participants for their decisions. These institutions were granted this control by default, without any conscious or deliberate decision to do so, as a result of the uncertainty surrounding the proper locus of "ownership" early in the history of the Anglo-American pension system. In 1959, just a few years after the assets controlled by private pension plans funded through trusts began increasing dramatically, Paul Harbrecht wrote that control had been delegated to a few large financial institutions acting as financial trustees and investment managers.[14] He pointed to several factors that undercut plan participants' ability to exert any control over these trustees through court proceedings, including:

- employers' claims of ownership based on their discretion as to whether or not, and in what manner, to fund defined benefit pension promises
- the fact that employees' benefits typically did not "vest" until retirement or until after a lengthy period of service with the employer, if they vested at all
- employers' right to hire and terminate the trustees at will, and to amend and terminate the pension plan
- the courts' reluctance to grant employees standing to sue the trustee on a trust agreement between the employer and the trustee, or to recognize their property rights in the pension fund in the absence of vesting
- language in the pension plan and/or trust agreement that characterized the employees' pensions as gratuities granted by the employer.[15]

Many of these issues have been settled in the decades since Harbrecht wrote, either by legislation that imposed mandatory prefunding of pension promises and much earlier vesting of benefits or by court decisions recognizing the plan participants' legal and equitable interest in the assets of the pension fund.[16] It is also accepted today that the employers' contributions to pension plans are, in reality, deferred wages of the employees that are part of the total "package" of compensation paid for employees' services.[17] Yet, in his recent survey of decision making by Anglo-American pension fund investment managers, Gordon L. Clark notes that "[i]t is very rare for plan participants to have a voice in trustee investment decision making.[18]

Trustees and Investment Managers

A brief outline of the process followed in investing pension fund assets may provide some context with which to assess my proposal for beneficiary control. The description will be of a relatively large pension fund. Smaller pension funds may turn over all aspects of administration and investment to insurance companies, but the assets in such funds are relatively small compared with those in trusteed pension funds.[19]

Pension funds are usually held in a trust fund. A board of trustees appointed by the sponsoring employer administers the trust fund.[20] The trustees are typically mid-level managerial employees of the corporation. Pension funds receive contributions from the employer and invest them, either through asset managers employed by the fund or through investment management firms whose performance is assessed against investment return benchmarks, such as the average return earned on investments in a certain sector of the market. Failure to meet benchmarks may result in contract termination. Investment managers are typically given almost complete discretion to determine which corporate securities to purchase within the asset class(es) that they have been authorized to manage.[21] Earnings are returned to the trustees by the asset managers for either reinvestment or distribution to retired plan participants as regular pension payments.

Pension funds invest predominantly in corporate securities, both stocks and bonds, with the balance invested in fixed income government securities and real estate.[22] Among their purchases are stocks that carry voting rights on certain corporate governance decisions. When pension plans began to become major investors in voting stock, many pension fund trustees delegated the decision as to how to vote the fund's stock to the external investment managers, who initially were large commercial banks.[23] Although the use of the voting power of the pension fund's investments has become the topic of public discussion recently, the practice of delegating voting to investment managers continues to this day.[24] Thus, at best, the trustees retain some form of overall supervisory authority but have delegated to financial services industry experts the decision making about whether to invest in a particular project or security and how to exercise any voting rights that are included in an investment. Their decisions have an important impact on the economic, social, and political life of society.

The Potential Impact of Participant Decision Making

There are several dimensions along which the importance of participant decision making can be measured, including the economic, political, and social. These dimensions are, of course, able to affect one another in judgments about the importance of a particular kind of decision. For example, one way one can measure the political importance of a particular decision is to look at its potential economic impact and vice versa. One important

factor in assessing the potential impact is the success that arguments in favour of what is often characterized as market-based regulation of corporate activity have enjoyed over the past few decades in North America. The arguments suggest that markets are better able than regulatory command and control to control harmful activity by corporations and/or their managers.[25] The successful promotion of "governance through markets" has thus increased the importance of participant decision making as one aspect of the use of markets to govern corporate activity. It represents one way in which a broader cross section of citizens can have a voice in market-based decision making, a voice that might otherwise be expected to be heard through the regulation of the corporation by governments in the name of the "public interest."

I am not suggesting that participant decision making is an acceptable or sufficient substitute for the "public interest" as expressed through the democratic process, but rather that it is the best that the market can provide, given the partial withdrawal of government from regulatory activity in favour of market efficiency. The biases and exclusion of important groups in our society that are inherent in the pension system's reliance on employment as the source of rights to participate have been discussed by other scholars and are not the focus of this book;[26] however, the representational weaknesses of pension plan participants as a decision-making body should be neither forgotten nor ignored.[27] Another indicator of relative importance is the relative size of pension fund assets in relation to other assets in the economy.

Size and Diminishing Role of the State

In 1976, Drucker predicted that pension funds would own at least 50 to 60 percent of US equity capital by 1985.[28] While the percentage of direct ownership of equity by pension funds has stayed relatively constant in the US market, pension funds' ownership of equity in the largest corporations has increased. As well, these percentages do not reflect their ever-increasing investments in global capital markets. For example, 1997 estimates of pension fund assets as a portion of annual gross domestic product (GDP) for the United Kingdom are 93 percent, while for the United States these assets represent 57 percent of its GDP.[29] By 2004, the UK pension fund assets were 125 percent of its GDP, with an estimated value of £1.63 trillion.[30] John Langbein calculated the value of US pension trust fund assets at $5.5 trillion in 1997.[31] By the fourth quarter of 2006, the Federal Reserve estimated that pension fund assets had grown to $9.75 trillion.[32] In Canada, the value of pension savings grew from $825 billion in 1993 to $1.33 trillion in 2003.[33]

The influence of pension funds is also connected to the distribution of their investments in various markets and how that distribution affects or can affect the operation of those markets. As they began to grow, pension funds tended to purchase the higher-priced equity issues of large established

companies, so that their ownership stakes in these firms were relatively larger than the percentage of equity ownership measured against the value of all stocks in the market.[34] While this pattern has persisted in large US pension plans, the increase in the absolute size of the funds has led to Clark's claims that these large funds and their service providers sustain the national and international financial services industries of New York, London, Toronto, Melbourne, and Sydney.[35]

This concentration of power has social and political implications, as well as economic consequences. One consequence of the growth in the size of pension funds relative to the total assets in a particular nation is that pension funds' investment decisions can have profound effects on the relative rates of investment in particular economic sectors and geographic regions of that state. The fiduciary relationships that govern the investment choices of trustees or their investment managers subject investment decisions to the constraints of those relationships and the underlying pension liability structure that must be funded from those investments. These constraints, together with those arising from the nature of the investment management business, drive investment or corporate governance decisions in ways that may be contrary to the state's economic policy and/or the interests of plan participants as citizens of that state, locality, or community.[36]

Thus, economic power is concentrated in the hands of pension fund trustees appointed by corporate management in a few large pension funds. Many of these trustees depend on the corporation for their livelihood or for continued employment once their term as trustee has expired. This power is further concentrated in the hands of investment managers who control the investment and corporate governance decisions for a number of these large pension plans.[37] These individuals and firms in turn may have their employment or their investment management service contracts terminated by the trustees. The grant of this power to agents by a widely dispersed group of plan participants raises issues of legitimacy and the legitimate use of the power.[38] It also raises the issue of the mechanisms by which legitimacy should be determined, and how the interests of the plan participants and of the society affected by decisions ostensibly made in their interests are defined and taken account of in the decision-making process. Implicit in my treatment of these factors as issues is a claim that the present system of decision making concerning pension fund assets does not adequately define these interests, take them into account, or provide appropriate mechanisms of accountability.

Structure

Chapter 1 will introduce some of the normative and prudential arguments in support of accountability to plan participants and a redefinition of their interests in pension fund investment and corporate governance decisions.

The redefinition situates them as members of a society in whose well-being and social fabric they have an interest, instead of as isolated rational wealth maximizers whose agents' only concern is maximum immediate financial gain in an efficient corporate securities market. The concepts introduced include the issue of fairness in the locus of decision making at levels far removed from the beneficiaries, the value of democratic decision making, the contested nature of shareholder wealth maximization as a primary norm for corporate governance, and the need to balance the process of "externalization" of costs onto plan participants and other members of society with increasing shareholder wealth.

In Chapter 2, I then set out an outline of the tax-supported retirement savings regime in Canada, including the defined benefit and defined contribution pension plans, the Registered Retirement Savings Plan, and the recent decision to invest contributions to the Canada Pension Plan in equities. This outline forms the basis for a discussion of the beneficial "ownership" of the funds' assets based on an analysis of the economic burden of contributions, the ultimate incidence of investment risk, and case law. The implications of the public interest in the private pension system arising from the tax deferrals granted, and the implications for the public pension system of failures in private pensions, are also discussed. Chapter 2 concludes that plan participants have a claim that the assets of the plan, including any corporate governance rights or influence arising from the plan's ownership of corporate securities, ought to be exercised to further their interests. In addition, there is a public interest in the exercise of these rights arising from the tax support and the reliance on the private pension system to generate adequate retirement incomes for a large portion of the working population.

Chapter 3 reviews the legal regimes of trust law and pension law in order to discover the doctrinal support for and impediments to accountability to plan participants in these regimes. In particular, the review of trust law concludes that there are two distinguishing factors in the application of the law of trusts to pension funds. First, the distinctive nature of a pension trust in which the employee is both settlor and beneficiary justifies an expansive interpretation of the trustees' fiduciary duties to include a requirement to account for corporate governance activity, as well as to accept a certain level of instruction from plan participants. Second, a more detailed scrutiny of the pension fund investment decision-making process and the roles of financial services industry professionals in that process leads one to conclude that participant involvement is a necessary antidote to the processes' agency problems. Court decisions that interpret the plan beneficiaries' interests as restricted solely to maximizing return on investments will be analyzed, as well as those that appear to have expanded the interests that can be recognized and acted on by pension fund trustees.

Pension law codifies much of common law trust law doctrine, while vindicating the public interest in adequate pension income by imposing minimum funding, vesting, and portability standards on private pension plans. These standards also support plan participants' claims to beneficial ownership of the funds. Further recognition of these claims is granted by requiring vesting of benefits after two years of service and permitting terminated employees to transfer an amount of the fund equal to the actuarially calculated value of these vested benefits to another retirement savings plan following their termination. Pension law has also codified investment standards that require diversification and impose standards of prudence that are consistent with a portfolio theory of investment, with its emphasis on acceptance of risk with appropriate compensation.

This standard can be contrasted with the traditional standard for assessing trustee investments, in which risk is to be avoided or minimized in order to preserve the trust's capital. This analysis of the effects of trust and pension law provides part of the context in which the claims for participant involvement in investment and corporate governance decision making can be evaluated. Further context is provided by the results of studies of the performance of pension fund investments, which indicate that the primary variable affecting return on assets appears to be the relative weighting of different classes of assets in the total investments of the fund. Thus, viewed in this context, the choice of investment and/or corporate governance decisions made by trustees is not so much a choice between investments/decisions that provide lower returns (but increased collateral benefits to participants) and those providing higher returns (but no benefits or collateral "costs" in the form of corporate "externalization"). Rather, they are choices among highly contested normative views of the role of corporate social responsibility, in which the effects of the choice on the long-term returns to the pension fund are also highly contested.

Chapters 4 and 5 review the impediments and incentives arising from corporate and securities law. Corporate law brings another set of agency relationships into the picture, that between the shareholders and the managers of the corporation. As has been pointed out by scholars, however, this is not a classic agent/principal relationship because the purported principals, the stockholders, are not able to give directions to the agent as to the agent's conduct. Of course, this lack of control can be offered as one justification for limiting to the amount invested in the firm the stockholder's liability for any damages that result from corporate activity.[39] Thus the corporate governance activities of pension funds are necessarily limited to the influence the pension funds can exert on management through persuasion, backed by the threat of exit from the pension funds' investment, and those matters on which shareholder votes are binding on corporate management, including the election of the board of directors. A single pension fund's

investments in a corporation are unlikely to be large enough to win a vote, or even to persuade a reluctant management to change its practices; thus, it may require the coordination of a number of pension plans' votes or influence to accomplish a particular change.

Such coordination may impinge upon the arena of securities law, which governs the offer for sale of corporate securities and certain types of communication about the corporation and its securities. Securities law also regulates the conduct of votes among shareholders through its proxy voting rules. In addition, forming alliances among shareholders may be considered a change of control activity that is also subject to regulation under securities legislation.

Chapter 6 will summarize the present state of the rights and norms concerning the participation of plan participants in corporate governance decision making by trustees or their agents using corporate assets held for the benefit of those participants. Various initiatives to increase active corporate governance by pension plans in Canada, the United States, and the United Kingdom will be reviewed. While these initiatives are making progress, their voluntary nature and the conflicts inherent in the ability of plan sponsors to unilaterally control the nomination and terms of trustees and investment managers necessarily limits the potential scope of success for the initiatives. Several potential regulatory and administrative changes in the pension regulation and corporate and securities law regimes are then reviewed. With respect to pension regulation, these changes may include: setting a minimum standard of joint trusteeship; independent chairpersons of boards of trustees; enforcement activity requiring the exercise of proxy votes and accounting to plan participants; and prohibition on continued registration of plans that do not require socially responsible corporate governance guidelines to be followed by investment managers.

In the corporate and securities law field, the proposed changes include: changes to voting rules; easier nomination of directors; cumulative voting; mandatory outside directors; and express recognition of social responsibility as part of the directors' mandate. In the securities law field, the expansion of mandatory disclosure to include corporate policy and activity with reference to certain standards in the employment, human rights, environmental, and social fields is discussed as being justified as disclosure of material facts affecting long-term value.

Chapter 6 will also discuss the issues that arise in determining the manner in which plan participants will provide direction to the trustees regarding corporate governance activity. It will provide a framework for resolving the issues of representative democracy versus direct participation through referenda. A tentative conclusion is offered that a combination of direct policy setting together with representatives serving on the board of trustees may best serve to maximize the democratic potential while allowing for effective

decision making. It will also be necessary, however, for the government to retain some limits on the scope of decision making in order to vindicate the public interest when it is threatened by majoritarian self-interest.

The Conclusion affirms that the normative basis for the proposal for beneficiary control is the challenge of providing meaningful participation in decisions that affect the economic direction of our society without utilizing the somewhat discredited electoral machinery of the state. It is based on a vision of the citizen as a member of a community, not as an atomistic self-regarding utility maximizer whose bonds with the community are those that serve to maximize utility and no more. Rather, the bonds themselves and the process by which they are defined and agreed upon have a moral value in the concept of reciprocity and a social contract that is based on a long-term relationship. While "ownership" has often been identified with neoliberal individualism, the collectivization of property in the pension fund may provide an avenue for plan participants to utilize their "ownership" to enhance reciprocal relationships in a social contract. It also provides a means by which this social contract can touch those who often seem most removed from its concerns – the management of large corporations, whose decisions affect whole communities and nations. These managers often appear to be responding to the imperatives of abstract shareholders, unconnected to any specific community, abstractions that apparently demand immediate wealth maximization. Involvement of pension plan participants in corporate governance activity will provide an opportunity for these managers to hear the views of actual shareholders situated in communities and their social contracts, rather than always responding to an abstract version of these shareholders. In sum, hopefully it will permit a further realization of the democratic and egalitarian aspirations of "pension fund socialism."[40]

1
Corporate Investment by Employee Pension Funds: A Deal with the Devil?

A Normative Theory for Beneficiary Control

A Summary of the Background: Limited Liability and Corporate Social Responsibility

There often appears to be a conflict between corporations and the public over the issue of corporate "social responsibility." This is interesting because for individual members of a social grouping, the issue does not arise in the same manner. That is, even though we are inundated by stories about numerous individuals who act in ways that we find socially irresponsible, there are few basic questions about whether or not individuals ought to be "responsible" for their actions.[1] In contrast, all dimensions of the concept of corporate "social responsibility" are deeply contested among scholars who have written on the issue, yet a blue ribbon commission issued a report outlining the concern among members of the public over a perceived lack of social responsibility being exhibited by corporations.[2] The concern stems from the lack of accountability through democratic institutions of corporations, whose scale of economic activity often surpasses that of many governments.[3] Instead, the individuals who manage the corporations are often said to be accountable only to the corporation's shareholders, and only to the extent they fail to maximize shareholder wealth.[4]

Yet the shareholders are not personally accountable for any legal wrongs arising from the decisions of the corporation in the same manner that an individual might be accountable. Their potential liability to those who may legally claim compensation for the consequences of those corporate decisions is limited to the extent of their financial investments in the corporation. The corporation's managers have a duty to promote the shareholders' interests and thus are not accountable to any other constituency affected by the corporation's decisions. Thus, the corporation, even though it has been granted the status of a legal person under the law, is not accountable to anyone other than the shareholders.[5] This apparent lack of accountability

on the part of corporate management may not be a problem, however, since they are bound to advance the interests of shareholders. Shareholders are members of society and, as such, will be adversely affected by socially irresponsible corporate decisions along with other members of that society. Some of the concerns about the negative effects on society might be assuaged if shareholders could require management to act in socially responsible ways.[6] However, the duty of corporate managers to advance shareholder interests does not extend to their actual interests as members of society, but rather only to the interests imputed to shareholders through legal doctrines and the operations of securities markets.

Corporate Accountability: Answering the Demands of the Legally Constructed Shareholder

On closer examination, the accountability of management to the actual individuals who own the shares, or for whose benefit they are held, is rather fictional. Instead, the shareholders to whom the directors are accountable are artificially constructed by the perceived requirement that managers must maximize share prices and by the operation of securities markets as immortal beings whose only desire is that the value of their shares be maximized. These artificially constructed shareholders desire share value maximization irrespective of any interests, desires, or needs of the actual "shareholders," and, where necessary, in opposition to the shareholders' actual desires.[7] The securities markets provide the immortality for the fictional shareholder because an individual shareholder's death does not destroy the fictional shareholder's status, but merely changes the identity from the individual to the individual's estate or beneficiary. This change of identity makes no difference to the fictional shareholder's relevant characteristics. This situation leaves us with powerful economic organizations whose primary accountability is not to a human being or even a group of humans, but rather to the one-dimensional construct of the wealth-maximizing shareholder. Scholars have recognized the dangers to society and its well-being from the inexorable demands of share price maximization, and have proposed that corporate management be released from strict compliance with the logic of share price maximization. Some have proposed that managers be required to exercise their human judgment through a broader recognition of a duty to consider the interests affected by the corporation.[8]

Thus, the exclusion of all of the attributes, needs, and desires of human beings, except one, from the motivating force for corporate activity is certainly an important source of the concern about corporate social responsibility. Daniel Greenwood has expressed this concern as follows:

> Specifically, I contend that the fictional shareholder is fundamentally different from the human beings who ultimately stand behind the fiction.

> The law and the legally created structure of corporation and market filter out all the complexity of conflicted, committed, particularly situated, deeply embedded and multi-faceted human beings, leaving only simple, one-sided monomaniacs. Human beings have short lives, spent in particular places with particular relationships to other human beings; they constantly confront the problems of finitude and commitment. Shareholders, in contrast, are in significant senses immortal, uncommitted and universal: They are indifferent as to time and place, language and religion. They are indifferent between projects and personalities. They are understood to care deeply about one important and vital human aim – profit maximization – but not at all about numerous others. While the ultimate owners of the shares are specific, situated, conflicted and committed human beings, shareholders in most instances may be thought of more appropriately as a "large, fluid, changeable and changing market."[9]

Lawrence Mitchell noted the dehumanizing effects of the shareholder profit maximization duty on the directing minds of the modern corporation, and the dangers of permitting corporations to enjoy all of the rights and powers of a natural person in liberal society:

> But the limiting condition of the corporation is that while the directors, officers and employees might well look and sound like the natural people of liberalism's ideal, the reality is otherwise. Instead of animating the corporation, the corporation animates them ...
>
> Outside of the boardroom or the office they may be regular people, church-going, good parents, members of the country club, and respectable people in their community who balance their various roles and obligations in life against one another in ways they find both fulfilling and consistent with their systems of values. But once they act under color of their offices ... they take on a single function, a single form: to cause the corporation to maximize its profits ... And as such they forgo the capacity of people so prized by liberalism – the capacity for self-determination.
>
> This might not be such a bad thing if we treated the corporation as the artificial legal construct that it is, if we understood it to exist for a narrow purpose and that the consequence of that limitation was that we carefully watched and regulated what the corporation did, that we carefully watched and regulated the way their directors, officers and employees behaved.[10]

Others have expressed concerns about the unlimited licence granted to corporations because of the separation of the power to exercise that licence from the responsibility of any individual human for the consequences of that exercise.[11] This concern about the exercise of unaccountable power is not confined to academics and commentators. A recent survey of Canadians

found that 72 percent of those surveyed wanted corporate executives to take social responsibility issues into account in corporate decision making.[12]

The Dual Nature of Plan Participants: Stockholders or Externalities?

The issue of the social responsibility of corporations is not new and has been the subject of earlier debates over the ability and desirability of corporations' "externalizing" the costs of their activities. Some scholars have advocated expanding the scope of directors' duties to include consideration of the interests of stakeholders, such as employees, creditors, suppliers, consumers, and the communities in which the corporations conduct their activities, in order to determine the appropriate level of externalization. Much of the early debate centred on the devastating effects on employees who lost their jobs during the takeover boom in the 1980s and the subsequent era of firm failure and restructuring resulting from excessive leveraging.

Gordon L. Clark explored this issue in his detailed examination of the restructuring activities of three large US corporations that centred on their efforts to shed large, unfunded pension liabilities to long-service employees as part of the restructuring strategy.[13] He described the issue as determining the appropriate boundaries between the economic interests and social obligations of corporations, and documented what he described as a crisis of regulation in the American political economy, illustrated by the inability of the regulatory regime to adequately protect workers' pension benefits.[14]

In two of the cases, the corporations were involved in secret keeping and deception in its relations with the employees, their unions, and federal pension regulators in order to gain their cooperation in and/or acquiescence to some of the steps in the strategy. In one case, the corporation provided altered documents and resisted disclosure in subsequent litigation. One scheme involved the corporation management's targeting of certain plants, production lines within plants, and individual employees for either permanent layoff or retention. The decision between these options was based on whether they would be eligible for plant-closing pensions in the near future (layoff) or were already eligible (retain). The strategy meant that employees who lost their jobs and would otherwise have been eligible for plant-closing pensions were both out of a job and denied any pension rights until they reached age sixty-five. The second corporation engaged in a sham transaction in which it ostensibly "sold" its steel-making division to a near-insolvent corporation with no experience in the industry, while retaining control of the valuable assets through security on the loan used to finance the sale. After the inevitable bankruptcy of the steel-making division, the second corporation disclaimed all responsibility for the pension liabilities of the employees because the purchaser had assumed the liabilities. This strategy meant that employees who qualified for pensions or were in receipt of pensions received only the (much lower) maximum pension benefits guar-

anteed by the US federal Pension Benefit Guarantee Corporation.[15] In both cases, the strategies were found to be unlawful many years after the events took place, due to the concealment of the strategy and the length of the litigation. As a result, Clark concludes that in these cases the public welfare in protecting private pension schemes was not advanced because by the time judgment was rendered, both the workers and executives involved had long departed. In addition, the penalties were either unenforceable, because the corporation's assets were highly leveraged, or less than the benefits that accrued from the shedding of the pension liabilities.[16]

Clark's concern about both the corporate strategy and the outcomes of regulatory efforts is that they were the result of and reinforced a mode of corporate behaviour that treated compliance with public regulation as just one more factor to be considered in the cost/benefit analysis of corporate strategy. He suggests that such corporate behaviour can lose its claim to legitimacy only when it is evaluated on the basis of moral sentiments rather than prices. He offers Fried's view that the dependence of contractual relations on social norms of trust and honesty makes contractual relations a social institution that "provides the basis for a procedurally just society" as one example of regulation based on the maintenance of social institutions rather than individuals' assessment of costs and benefits.[17]

Clark's prescription for the crisis of regulation envisioned a renewed regulatory regime explicitly claiming legitimacy for the moral foundations of public regulation of economic imperatives. He saw the average citizens' abhorrence of certain aspects of economic life as providing the force for such regulation. The renewed regime would emphasize individual responsibility of corporate management through increased use of criminal sanctions instead of corporate fines, and through the shaming of executives in the criminal courts, in a manner similar to the treatment of professionals who are disbarred or have their licences to practise their profession revoked.[18] In evaluating this suggestion and some of the regulatory initiatives following Enron, one must clearly consider and balance the effects on plan participants from both the dangers of deterring profitable corporate activity, as discussed by Ronald Daniels,[19] and the incredibly devastating consequences of market corrections following events such as the failure of Enron.[20] Further detail on the Enron failure is provided later in this chapter, in the section entitled "The Enron Pension Story: The Triumph of Perverse Incentives."

Thus, in Clark's view, corporate management will not serve as the source of meaningful implementation of considerations of justice and fairness in the corporation's dealings with its stakeholders or society. Only an outside force grounded in the moral claims of society on the one hand, and with sufficient legitimacy to intrude on the "private" sphere of managerial decision making on the other, may be able to set appropriate boundaries to the economic imperatives of corporate management. While Clark views this as

a legitimate role of government, he notes that the US Congress has shown no willingness to assume such a role.

This book grew out of a realization that pension plan participants straddle both sides of the social responsibility debate, as they are both stakeholders (as workers, retirees, and community members) and stockholders (as the beneficial owners of the equity investments of their pension funds). The insight at the book's foundation is that in this dual aspect of the plan participant stakeholder may lie the answer to two related problems in corporate governance, namely, social responsibility and the need for an alternative to share price maximization as the measure of corporate performance.

In order to address these problems, however, the artificially schizophrenic existence of the plan participant stakeholder/shareholder must be broken down. That is, the plan participants' actual needs, desires, and preferences must be reflected in the corporations' decision making, rather than only the share price maximization preferences imputed to the artificially constructed shareholder. Janis Sarra provides a compelling argument that even where employees are not both stockholders and stakeholders, their investments in the firm give rise to residual claims on the value of the corporation's assets, and thus are such that directors should be required to take employees' interests into account in corporate decision making.[21] Where the stakeholder/shareholder preferences diverge with respect to the "externalization" of some costs of corporate activity, consent, an important normative value in a liberal, democratic society, becomes engaged in the decision about which set of preferences will govern. Thus, when employees' jobs, benefits, and pensions are being eliminated by the corporations' managers, it is often said that these losses are inflicted because it is in the best interests of the corporations' shareholders (or, to put it another way, the law has given the shareholders the right to terminate the employees' jobs with relatively little compensation). Yet, these decisions are made without reference to the actual preferences of the shareholders, other than the imputed preference that shareholders consent to any action that increases the price of their shares.

I should be clear at this early stage that, in the paragraphs above, I am not referring to the situation in which the employees of the corporation own a significant proportion of the corporation's voting stock. Most applicable pension legislation restricts the percentage of the plan's assets that can be invested in a single corporation's securities to 10 percent, and prudence would ordinarily require investment at a much lower percentage than the maximum. I am therefore referring instead to a situation in which corporate managers are eliminating employees' jobs, benefits, and pensions in a manner similar to that described by Clark, *supra* note 13. In such circumstances, the actual preferences of the stockholders (a significant proportion of whom may be pension funds) ought to govern. If they find the proposed

method of elimination socially irresponsible and repugnant because, for example, it destroys the trust implicit in the promise of pension benefits, they may reject such a course of action, either prospectively or retrospectively through a change of management.

An early example of preference for the imputed rather than actual preference is found in a 1973 debate between Milton Friedman, the economist of profit-not-social-responsibility fame, and Eli Goldston, chairman of the board of Eastern Gas and Fuel Associates.[22] In response to Friedman's claim that a truly competitive enterprise had to choose between social goals and profit to survive, or else be able to exercise monopoly market power, Goldston responded with three claims. First, he stated that Eastern Gas had polled its shareholders and received 87 percent support for its practice of donating 1 percent of pre-tax income to charitable contributions. Second, he said that the path to maximizing profits was a difficult one to chart and that in the real business world, "you're lucky if you have a plus or minus 10 percent fix on things." Finally, he claimed that corporations were made up of people who "are not detached from society" and that society expected corporations to do more than maximize profit. Friedman's response emphasized that the only efficient role for corporations in achieving social progress was in engaging in competition to eliminate monopolistic profits and in paying the unsubsidized price for resources used and charging these costs to consumers in the prices of the goods they distribute. When Goldston objected that overemphasizing the maximization of profit let the lowest common denominator, "the cheapest louse in every operation," determine what was good for the country, Friedman responded with his view that it was wrong of corporate executives to make such decisions with other people's money; they could only legitimately do so using their own money.[23] What neither Friedman nor Goldston dealt with any further were the implications of Goldston's corporation's having the support of an overwhelming majority of the stockholders for at least some of the social goals that stockholders' money was utilized to support.

Pension Fund Corporate Governance: Why It Must Be Exercised in the Interests of Plan Participants

Is There a Conflict between Shareholder and Stakeholder Interests?

My claim is that the corporate governance rights attached to the equity investments of pension funds must be exercised in the best interests of the pension plan's participants and those spouses and dependents who are also beneficiaries of those funds. In particular, they ought to be exercised to protect and enhance participants' interests as employees, retirees, members of communities, and parents of children where these interests are at risk in corporate decision making, and where doing so does not clearly conflict

with the goal of providing adequate retirement income for the participants. The seeming conflict between the goals of protecting the interests of plan participants as workers, retirees, or community members and providing an adequate retirement income is more apparent than real. There is no direct trade-off between these goals once the unique characteristics of pension fund investments with respect to timelines and liquidity are taken into account. In fact, corporate strategies that maximize share prices in the short term may actually harm the investments by pension funds over the medium and long term. Serious questions have been raised about the nature of the connection between stock prices and the value of the corporate investment. Thus, the exercise of corporate governance rights is required, not merely permitted, by the fiduciary duty to act in the best interest of the beneficiaries imposed by the common law and by pension statutes on those who hold the equity investments in trust for the employee-beneficiaries.

In addition to the benefits that may flow directly to the employee-beneficiaries from this exercise of corporate governance rights, both the employee-beneficiaries and civil society may receive indirect benefits in the form of increased democratic participation and accountability. The need for pension fund fiduciaries to consult with plan participants about their interests as employees, community members, and parents and the potential conflicts with the adequate retirement income goals of a pension fund (adequate investment income flows) may lead to democratization of important aspects of civil society. David Sciulli has emphasized the potential for corporate boards of directors to be sites of forms of decision making that support democratic societies by preventing abusive exercise of positional power within the corporation.[24] Amartya Sen argues that decisions about what human capabilities are to be privileged over others can be legitimized only by public discussion and democratic acceptance.[25] Attempts to use the corporate governance rights of the employee-beneficiaries to raise the protection of their interests as both stakeholders and stockholders can put the issues of corporate social responsibility and the appropriate measure of corporate performance on the agenda of corporate boards. The employee-beneficiaries' dual aspects of stakeholder and shareholder situate these debates over corporate social responsibility and measurement of corporate performance in a broader context, more conducive to the types of discussion envisioned by Sciulli and Sen, than the discussions of directors bound to promote the maximization of share price.

Objections to the Introduction of Shareholders' Actual Desires into the "Pure" Shareholder Construct

Undoubtedly, a major objection to this proposal will be that implementation of this conceptual framework will lead to undue interference in the "market" for the corporation's securities by introducing concepts and values

that are irrelevant to the present value of the future stream of income discounted for the risk involved (the "price" of the security), which is the only reliable measure of corporate performance. Cynthia Williams analyzes this claim of interference in the context of her proposal that the US Securities and Exchange Commission (SEC) require expanded disclosure of social factors in corporate operations, and rejects it because expanded disclosure would support the free and knowledgeable exercise of consumer preferences in the market.[26] In the context of using shareholder proxy votes to try to change management's policies, however, the justification must necessarily extend beyond consumerism as the source of legitimacy for shareholders' influence over management's policy making. Nevertheless, it is important to keep in mind that decisions on social policy issues are continually being made by corporate management. Therefore, the contest for legitimacy between corporate management and shareholders is over who should decide social policy, not whether or not a social policy decision must be made. As well, the objection will be that incorporating stakeholder preferences into directors' decision making merely dilutes the directors' loyalty to shareholders and thereby increases agency costs by substituting an inherently incoherent duty for a coherent one.[27] Another possible objection is that the issues of social responsibility and the protection of stakeholder interests are really issues of market failure that are more properly dealt with through the political process, rather than through the use of private law rights.[28] The economic efficiency of share price maximization has come under increasing scrutiny, however, because the use of fiduciary duty as a means of filling "gaps" in the incomplete contracts that are the hallmark of the corporate form does not inexorably require the duty to be to maximize share prices. Rational investors would prefer a rule to maximize the value of all of the financial claims against the corporation rather than just the share prices, because as rational investors, their investments are diversified across all classes of available corporate investments.[29]

The coherence of the shareholder wealth maximization standard has also come under question. Scholars have raised questions about the coherence of the concept with respect to the timing of shareholdings; that is, is it a duty to today's shareholders or to tomorrow's?[30] Other commonly used measurements of pecuniary benefit to shareholders – corporate earnings and share prices – have come under scrutiny due to the potential for destruction of shareholder wealth that can also occur using these measures. Henry Hu points out that the traditional measure of shareholder benefit – earnings or earnings per share – can increase while shareholder wealth is actually reduced.[31] He then points out that an increasingly accepted alternative, share price maximization, also suffers from the inability of corporate management to control the influence of irrational factors on stock prices, and the discounting effects on stock prices of information asymmetry

between managers and market participants. The effect of these factors is that actions that may increase the stock price may be harmful to the intrinsic value of the investment, and even if corporate management could control these factors, we would not want them to do so. Hu explains as follows: "Managers would be encouraged – indeed required – to take whatever actions are legally permissible to drive the trading price up, even if it were to destroy the true, intrinsic value of the shares. The cart is put before the horse; the ability to manipulate share prices within the bounds of the securities laws becomes the test of management rather than the ability to produce widgets."[32]

Scholars have also noted that the shareholders of any corporation consist of those that are diversified and those that are undiversified. These two groups of shareholders have quite different and conflicting interests with respect to management's risk assumption strategies: the former is indifferent to the risk of bankruptcy, while the latter is risk-averse with respect to bankruptcy. Many scholars have measured the duty to maximize shareholder wealth with reference to the risk preferences of diversified shareholders. Richard Booth argues that adopting the risk preferences of diversified shareholders is not a self-evident choice for management because diversified shareholders would prefer that corporate management's risk preferences were the same as undiversified shareholders because: (1) management must guess at the preferences of diversified shareholders, given the different forms of diversified investing they utilize; (2) shareholders can diversify away from company-specific risk more cheaply than management can through conglomeration; and (3) diversified shareholders are more likely to be bondholders as well, and therefore oppose diversion of wealth from other asset classes.[33]

In addition, the functional coherence of shareholder wealth maximization has been questioned as a result of the invention of new financial products that "unbundle" rights traditionally attached to shares into separately owned voting rights, rights to receive dividends, and rights to the residual value of corporate assets. This raises the question of which set of rights management ought to maximize.[34] Finally, the participation of corporations in the political process may make illusory the idea of the political process as the proper forum for correcting market failures. Corporate directors are duty-bound by the shareholder wealth maximization norm to utilize the corporation's considerable resources to oppose any attempt to use the political process to impose the cost of externalities on them.[35]

Consistency with Norms of Justice and Democratic Decision Making

Thus, the "deal with the devil" aspect of pension fund equity investments has hopefully become clearer. The nature of the share price maximization norm is such that the corporation imposes as many costs of corporate activ-

ity as legally possible on the plan participants as citizens (externalizing all possible costs), while utilizing their money to vigorously oppose any attempts to regulate this externalization in the political forum, and proclaiming that the directors are doing so in the plan participants' interests as share price-maximizing shareholders. This subordination of the shareholders' actual interests need not be so, however, and it is both just and consistent with democratic values that pension funds engage their beneficiaries in a dialogue about the appropriate limits to the actions of the corporations that they "own." Justice is implicated in such a dialogue first through justice's consistency with notions about the illegitimacy of alienating another's property without their consent. Where the use of (or failure to make use of) that property can result in both benefits and costs to the beneficial owners and/or their social or economic environment, then it is just that the owner be consulted about the appropriate trade-off in the circumstances, rather than have their consent implied from membership in the pension plan.

Pension plans are not merely the beneficent acts of grateful employers toward their faithful servants. Rather, on the one hand, they represent a form of mutual commitment between the employer and employees to contribute to and maintain a fund to provide pension benefits. On the other hand, pension plans also involve mutal commitment between employees to share the investment risks of the pension fund, as well as pooling the risks of funding benefits based on the life expectancies of the plan members. The use of the trust as a funding tool is an important part of this commitment as it involves mutual sharing of the benefits and risks of the fund's investments. Merely offering money to buy shares would deprive the employer of one of the most important benefits a defined benefit pension plan provides – loyalty energized by the increased benefits that typically accrue near the end of an employee's career. There are certain characteristics of pension funds that impart more of a collective or social character to their ownership than individualized private ownership. These characteristics will be discussed in greater detail in the section "Implications of the Public Origins of Today's Pension Schemes" in Chapter 2. As one example, by combining their assets in defined benefit plans, employees can obtain more pension benefits per dollar in the fund because monies that are not used to provide benefits to shorter-lived retirees can be used for the longer-lived, unlike the case in more individualized schemes. In a individualized defined contribution plan, those funds that are not used to provide pension benefits for the individual and spouse become part of the estate on their death and are no longer earmarked for pension benefits.[36] This social character of ownership does not justify the appropriation of those rights without consultation or consent.

Second, a dialogue between pension funds and their beneficiaries about the appropriate limits to the actions of the corporations that they "own" is

consistent with democratic values. Democracy is consistent with the understanding that human development is a process that requires debates about the choices to be made in a particular society and that the participation of those affected is a source of legitimacy and authority for the resulting decisions.[37] The legal construction of the corporation as the economic organization whose sole goal is that of shareholder wealth maximization has, to a large degree, insulated it from such debates by practically excluding all other considerations as legitimate sources of justification for corporate actions.[38] Third, the dialogue between pension funds and their beneficiaries can function as a countervailing force to the allocative effects of markets on the distribution of resources and opportunities in society. It will thus counter the injustice of the markets' pricing mechanisms' effect of redistributing resources to those who enter the markets with the greatest entitlements.[39] Fourth, this dialogue counters, to some extent, the relations of subordination (to the corporation as the employer) that otherwise dominate the constellation of economic relations within the corporation, and, in doing so, furthers norms of equality among economic actors.[40]

This is not to say that pension funds should take over the day-to-day operation of the corporations in which they invest, but they can and should raise, as matters of general policy, human resource, ecological, political, and human rights issues on behalf of their beneficiaries. This does not mean that the pension funds must forgo investment income in the name of protecting other interests of their beneficiaries. It does mean, however, that where corporate management is faced with choices between these goals, it may no longer be able to automatically choose share price maximization as the only legitimate alternative, invoking their fiduciary duty to shareholders, because many of those shareholders may object vociferously.

Prudential Reasons for Employees to Oppose Share Price Maximization as a Corporate Norm

Diversification and Externalities

There are also a number of prudential reasons why maximization of share prices should not be supported by beneficiaries of pension funds and retirement savings plans as the norm for corporate management. They include the effects of diversification of investments and the fragility of a finance-based economic system. Diversification of investment among different asset classes in order to reduce the portion of the risk that arises from the specific attributes of a particular asset or class of assets is a well-established investment strategy for pension funds.[41] Thus, a fully diversified pension fund investment strategy would involve investment in both equities and corporate bonds or other forms of non-equity securities. As a result, to the

extent that maximizing share prices is achieved at the expense of the value of other claims to corporate assets, such as bonds, commentators have suggested that utilizing share prices as a measure of the economic efficiency of certain corporate transactions is not suitable. The increase in share prices may be a result of a transfer from other claimants to the shareholders.[42] Clearly, for a pension fund that is invested in a diversified manner, it is not efficient for the increase in the value of one investment to come at the cost of the value of another.

Robert Monks has utilized a similar reasoning with respect to global investment by pension fiduciaries. In his view, fully diversified pension funds (Global Investors) cannot encourage corporate managers to engage in the process of externalization of costs. He comments:

> The Global Investor is likely to make good decisions for the long-term of society, because it can afford in most cases to take a long-term view, and a diversified view. An ordinary domestic investor may choose to invest in a corporation that externalizes the brunt of the harm that it is doing. But importantly, *nothing is external to a global shareowner.* Institutions having investments in all countries have virtually no incentive to permit environmental and hiring practices in the poorest countries that can only have the impact of competing with their own investments elsewhere.[43]

If one accepts Monks' reasoning, then it could also apply to investments within national markets by such investors.[44] Ronald Gilson and Reinier Kraakman suggest that the only rational expenditure for all indexed portfolios is to design corporate governance strategies that enhance the value of the entire portfolio rather than the value of individual firms in the portfolio.[45] Of course, it may be an overstatement to say that nothing is external to a global shareowner, given the much deeper problems of informational asymmetry, thin capital markets, and opaque legal systems that are part of a global investor's realities. These factors may mean that some costs from corporate activities may not be reflected in the overall pricing of investments in the affected market. Perhaps the claim could be rephrased as one that global shareowners have to be alive to the adverse effects on their portfolios of investing in exploitation. This is especially so in the case of pension funds, as their investments have tended to be concentrated in the higher-value stocks in the market.

Share Price Maximization Creates Perverse Incentives for Managers

Another concern that has been expressed is that the installation of share price maximization as the norm of corporate governance has created perverse incentives for corporate management through the divergence between

capital market expectations and the actual earnings that can be delivered in competitive product markets.[46] These incentives have been exacerbated by compensation practices that generate extreme rewards for managers who increase these prices over the short term.[47] Henry Hu recognized the moral hazard created by these practices and described it as follows:

> Although not widely noted in the academic literature, managerial compensation can have the opposite effect as well, as may occur when compensation is highly sensitive to perceived performance, and true, risk-adjusted performance is difficult to measure. The moral hazard is obvious when such a monitoring problem exists. If the individual's superior were not cognizant of the full extent of the risks being assumed, the superior might overestimate performance of the individual and thereby overpay the individual. In an environment involving both this sort of informational asymmetry and highly variable compensation, the individual will be sorely tempted to take large, unrecognized risks. A corresponding argument can be made for the moral hazards facing an entire management team relative to its stock market superior when the stock market does not recognize the full extent of the risks a corporation's management team has elected to have the corporation assume.[48]

Management has also adopted a number of strategies aimed at the balance sheets, such as cost cutting, labour shedding, divestment and acquisition of product lines, and increasing of leverage in order to increase the return on equity above that provided in the products and services markets.[49] Commentators have pointed to two trends that have contributed to the ability to sustain an apparently endless asset-price appreciation in financial markets despite the divergence between earnings and market expectations. First, a high degree of leverage has enabled corporate management to distribute cash flow to shareholders instead of reinvestment.[50] The value of highly leveraged equity can be eroded quickly, however, if the liquidity of the stock is threatened or the flow of earnings that support its value suffers a shock.[51] The second trend is that the increase in the amount of retirement savings available to be invested in a shrinking pool of equities has bid up the price of those shares.[52] This development, however, may result in a financial bubble in which stock prices are overinflated.[53]

These trends pose dangers to both the ability of the pension system to deliver the promised benefits and the ability of the corporate sector to continue its participation in the productive sector of the economy. The seeming failure to invest for the future while maximizing cash flow to shareholders has raised concerns that the core function of the corporation – to bring together assets and labour to produce goods and services efficiently – is

being ignored and that the economy will suffer for it. Teresa Ghilarducci summarizes the problems of short-term investment for pension plans as arising from market failures on the one hand (particularly the gaps in market coverage) and the regulatory regime, which fails to distinguish the interest of pension funds in continuing employment and contributions from the interests of ordinary income trusts.[54] One shorthand term for this phenomenon is "short-termism." Robert Monks and Allen Sykes have suggested that the short-term stock price maximization pressure actually forces management to act in ways that are harmful to the value of the corporation over the long term, and therefore to investors with longer-term investment horizons.[55] A recent review of institutional investors in the United Kingdom noted that pension fund investment managers perceived that their performance was being judged over very short periods, and expressed concerns about the potential distortion from such managers' failure to invest in long-term wealth creation.[56] Michel Aglieta has pointed out that pension funds cannot accept the nominal financial returns generated through asset-price appreciation and must seek long-run economic return that increases labour productivity in order to have an increase in real wages that will support the present mixed public/private pension system with the much smaller workforce in place following the retirement of the baby boom generation.[57] If capital markets are consistently outperforming the growth rate of the economy, then there is a transfer of the benefits of that growth from labour to capital, in the form of reduced wages and employment.[58] However attractive this may seem over the short term, the long-term effects of such a transfer in conditions of low rates of economic growth may be harmful to pension plan beneficiaries. Someone must be willing to pay prices for future retirees' financial assets at a level that will provide an adequate retirement income, and without economic growth the next generation may not be able to pay those prices.[59]

Recently, a number of authors have reviewed attempts by labour unions in the United States to mobilize the corporate governance activities of those pension funds where union members have trustees and to extend worker representation into other funds.[60] The unions' aim is to align the decisions about the allocation of workers' savings and the strategic directions of the firms where they invest and work with what is defined as "long-term value."[61] Long-term value is achieved through the cooperative efforts of various corporate stakeholders, and is contrasted with short-term value, extracted through capital market pricing that encourages a strategy of value stripping and zero-sum approaches by management.[62] As the some of the authors acknowledge, the union movement faces significant hurdles, particularly with respect to 401(k) plans,[63] and will require regulatory initiatives to allow participants to gain access to the governance levers of such plans.[64]

The potentially infinite lifespan of pension funds (as long as employees continue to work for the corporation) together with their relatively long-term liquidity requirements can potentially combine to overcome the pressures generated by the use of the short-term share price as the primary measure of the economic value of the investments.[65] The hollow nature of the promise of share price maximization as a measure of corporate performance could not be clearer than in the Enron saga. One firm, even one that, at one point, had the seventh largest capitalization in the US, may not be the basis for conclusions about share price maximization, but there are also instances of the very same kind of earnings management aimed at supporting the short-term stock price at Sunbeam, WorldCom, Qwest, and Global Crossing.[66] Enron's management were motivated by options and bonuses that provided incentives to increase short-term stock prices, leading them to disregard everything else, including the corporation's survival and the retirement benefits of its employees.

The Enron Pension Story: The Triumph of Perverse Incentives

Enron sponsored a "defined contribution" 401(k) plan for its employees, to which they could contribute up to 15 percent of their salary, subject to a maximum yearly contribution.[67] Enron contributed one-half of the amount donated by the employee in the form of its own stock. The employee was allowed to choose how his or her contributions were invested among various investment options, including the purchase of more Enron stock. The stock contributed by Enron had to be held in the individual employee's account until the employee was fifty years old.

By the end of 2000, 62 percent of the Enron 401(k) plan's assets were invested in Enron's common stock.[68] Of that amount, 89 percent was stock purchased voluntarily by employees.[69] Employees at other large corporations in the United States are even more committed to employer stock in their 401(k) retirement savings plans. In her statement to the Senate Governmental Affairs Committee, Susan Stabile pointed out that approximately 20 percent of 401(k) plans had invested at least 50 percent of their assets in employer stock, with Procter & Gamble (94.7 percent), Sherwin-Williams (91.6 percent), Abbot Laboratories (90.2 percent), and Pfizer (85.5 percent) being among the large corporations in the lead.[70] When Enron entered bankruptcy protection, the stock ceased to be available for public trading. In testimony before the Senate Committee on Health, Education, Labor and Pensions, Enron employees related how their 401(k) accounts went from six figures to a few hundred dollars while they received assurances that the company's prospects were good. In addition, they were unable to sell the portion of stock purchased with their contributions during the crucial phase of Enron's collapse, due to a hold on trading activity because the Enron plan was changing administrators.[71]

For many employees at Enron, the 401(k) plan was not the only source of potential retirement income; they also had benefits available from a defined benefit pension plan. The latter, however, had also been eroded over the years through a combination of factors, including the use of Enron stock in its employee stock ownership plan (ESOP) to offset a significant portion of the defined benefits.

Up to 1 January 1987, employees at Enron and its predecessor companies participated in a traditional defined benefit pension plan that provided retirement benefits based upon the final average salary of employees and their years of service.[72] Effective 1 January 1987, the pension plan was amended to provide a "floor-offset" benefit, in which the benefit provided from the pension plan's assets was "offset" by the amount of that benefit that could be generated from Enron's ESOP program. That is, if an employee was entitled to $600 per month on retirement under the benefit formula, and his or her ESOP account would generate $400 per month, then the employee would receive only $200 of the monthly benefit from pension fund assets. The remainder of the $600 benefit was paid from the ESOP account's assets.[73]

While this type of pension fund arrangement was not unusual, the steps that Enron took when it ended the "floor-offset" benefit in 1994 appear to be unique in that they effectively transferred the future investment risk of the ESOP portion of the benefit to the individual non-retired employees.[74] Once the "floor-offset" benefit was discontinued, Enron began to "release" the stock in the ESOP to the participants at the rate of 20 percent per year, and in doing so used the current market value of the stock that was released to fix the offset of their benefits earned for the 1987-94 period. This fixed offset was used in calculating the benefits owed from the defined benefit plan, irrespective of the future performance of the stock.[75] According to one news article, an unidentified former employee claimed that this employee's pension benefit summary issued in June 2001 indicated that no benefits were payable for the 1987-94 period as they were all offset by the market value of the ESOP's Enron stock, which the statement indicated was worth $385,000.[76] While the $385,000 amount may seem small, it represents the value of five of a potential total of thirty years of benefits (approximately 17 percent of the total benefits that could be earned by the employee). In a defined benefit pension plan, the current value of those five years of benefits would gradually increase until an employee became eligible for early retirement benefits under the plan, at which point the current value would increase dramatically until the mandatory retirement age. The offset of the 1987-94 pension benefit was computed at the prices for Enron stock in effect from 1996 to 2000 (when the ESOP stock for the offset was being "released" to the participants and the offset was "fixed"). Thus, if the method of "fixing" the employees' offset holds up to legal scrutiny, then

this employee and many others will receive no pension benefits from the Enron defined benefit pension plan for their service from 1987 to 1994, as a result of the Enron stock price crash.[77]

The Enron story provides one illustration of how the interests of employers and pension plan participants conflict with respect to the design and administration of the pension plan.[78] There are also conflicts of interest, however, with respect to corporate governance activity by the pension fund's fiduciaries.

Reasons to Increase Accountability: Conflicts of Interest with Respect to Corporate Governance

It is important to remember that for many private sector pension funds, the employers' management, not the employee-beneficiaries, appoints the trustees. Those managers have little or no interest in encouraging the practice of active intervention by pension fund trustees in corporate governance. Mark Roe points out that private sector managerial control of the bulk of the pension funds involved in equity investments is a core structural problem for any program of active corporate intervention by institutional investors. He states: "Those calling for greater institutional involvement in corporate governance must face the complicating fact that the institutions, primarily controlled by corporate managers, are being asked to monitor corporate managers. Such a circle of control makes monitoring difficult, perhaps impossible."[79]

The potential for conflicts of interest is present in managerial control over pension funds, and recent history with respect to conflicts arising when financial markets analysts are employees of investment banking firms has shown that pressure will be exerted despite analysts' ostensible independence. These conflicts have been the subject of a number of newspaper stories.[80] Roe reviews the reports of similar pressure being exerted by managers on pension fund fiduciaries to vote with management in proxy fights, as well as the attempts by investment management firms to keep from having to cast proxy votes in order to avoid giving offence to potential clients.[81] In Canada, Jeffrey MacIntosh has described these counter-incentives as arising from the pressure on fund managers from corporate management to maintain or obtain the pension fund's investment business, the distribution of which is controlled by management.[82] For an illustration of these conflicts, see Chapter 3 for the story of the change in its vote on the Hewlett-Packard/Compaq merger by Deutsche Bank's proxy voting division after the investment banking division arranged a meeting with the management of Hewlett-Packard.[83]

These conflicts have led scholars to call for changes in the manner in which pension fund trustees are appointed. Following their review of a number of studies of the state of corporate governance activity in Canada,[84]

Ronald Daniels and Randall Morck suggested that the beneficiaries of pension funds should elect senior managers of corporate and public pension funds. The suggestion was made in order to deal with concerns about the managers' commitment to the beneficiaries' interests arising from their employment by fund sponsors. They also recommended that any breach of their fiduciary duty to the beneficiaries should make them liable to class action lawsuits by the beneficiaries.[85] Recently, another author from the US has suggested that an appropriate response to problems of corporate governance following the Enron and WorldCom revelations would be to combine Gilson and Kraakman's concept of independent directors recruited by associations of institutional investors with the notion that instructions on choice of directors would be provided directly by plan participants.[86]

Beyond Conflicts: Public Sector Pension Plans and the Struggle for Legitimacy

Public sector pension plans are in the forefront of corporate governance activity among institutional investors. Many of these plans are also in the vanguard of new global initiatives by institutional investors to enhance the use of environmental, social, and governance factors in their fund's investment activities pursuant to United Nations Principles for Responsible Investment or to encourage disclosure of climate change risks by the large corporations in which they are invested, through the Carbon Disclosure Project. These initiatives are discussed in more detail in Chapter 5.[87] The pension funds involved in these initiatives are predominantly from the public sector.[88] Indeed, when the United Nations Environment Programme Finance Initiative and the United Kingdom Social Investment Forum decided to publish a study of how pension funds are taking environmental, social, and governance issues into consideration in their investment process, only public sector pension funds were used as case studies.[89]

The case studies reveal the struggle that even pension funds willing to consider environmental, social, and governance issues are having in describing their actions in a way that indicates the impact they are having on the companies in which they invest and on the return on their investments. The following quote from the case study of ABP, the pension fund for the Dutch government and education employees that is the second largest pension fund in the world, illustrates the dilemma:

> ABP believes that companies with strategies that encompass both financial and environmental, social and governance issues will deliver better long-term performance. As a result, the pension fund considers the integration of ESG information throughout its mainstream investment analysis to be essential and promotes the integration of material issues into its investment decision-making by both internal and external fund managers. Ultimately,

> ABP believes capital markets will appropriately value and reflect environmental, social, governance risks and opportunities in stock prices. However, while progress is being made, good quality data and research on extra-financial ESG issues is broadly lacking.

This concern is reflected in a survey of UK pension trustees in 2006, in which they reported that the barriers to the integration of social, environmental, and ethical factors into investment practices clustered around cost versus benefit and the ability to evaluate the financial impact on investee companies.[90] It will clearly take some time and the investment of considerable resources to develop tools that evaluate both the impact of ESG factors on investee companies and the impact of various ESG strategies by pension funds on the companies and the funds' returns.[91]

Given the lack of immediately quantifiable data, trustees recognize that any measurable impact will probably occur over the long term.[92] This leaves the decision to incorporate ESG factors into pension funds' investment strategies vulnerable to challenge, and this possibility may inhibit trustees from commencing or continuing with a responsible investment strategy. Seeking members' support for this initiative would assist in sustaining and legitimizing public sector pension funds' expenditure of resources on responsible investment strategies.

The Potential of Democracy and Accountability

The benefits for pension plan participants of implementing accountability for corporate governance activity are the ability to effect change in the behaviour of the corporation that will improve the social and physical environment in which they live, and the ability to control potential abuses of corporate power by management that may adversely affect the financial returns of their pension funds. The potential economic and social devastation of global warming has been extensively analyzed in the report by Sir Nicholas Stern to the Prime Minister of the United Kingdom, *The Economics of Climate Change*.[93] Stern reports that the benefits of present expenditures to reduce greenhouse gas emissions outweigh the long-term costs of not doing so by a margin of at least 5 to 1.

Pension plans, as major sources of capital for industries that are major emitters of greenhouse gases, can play a role in encouraging the investment in technology and processes that reduce emissions in their investee companies. As outlined above, public sector pension plans are active in initiatives to define the scope of the problem and the risks in particular industries and corporations, refusing to wait until some governments finally decide to act. Yet, where are the major private sector pension plans? In its 2006 Key Proxy Vote Survey of thirty-four Canadian investment management firms that

collectively manage $371.6 billion in pension assets, of which $88.5 billion are invested in Canadian equities, the Shareholder Association for Research and Education found that 73 percent of the firms participating in the survey indicated that their pension plan clients had given them *complete* discretion to vote the proxies for more than 85 percent of the pension fund assets they manage.[94] Clearly, these plans have not yet taken seriously their fiduciary responsibility to exercise their corporate governance rights.

In a recent speech to the Conference Board of Canada conference on corporate social responsibility, a senior official of the Canada Pension Plan Investment Board made it clear that one of the considerations in the allocation of capital by the Board is the assessment as to whether or not a particular corporation is likely to be a loser in the market shift in response to climate change.[95] If plan members were members of the board of trustees of private sector pension plans, it would be possible to for them to challenge the plan's inactivity on this major risk to the long-term financial return of the plan and to the future well-being of its members.

Plan members can also benefit from accountability for their pension funds' corporate governance activity by being able to galvanize the fund to engage corporations' directors concerning matters such as management compensation arrangements that are unconnected to performance. The problems of corporate executives' compensation have been well documented.[96] In response, institutional investors have sponsored resolutions to amend the bylaws to give shareholders a non-binding vote on executive compensation packages. These resolutions have recently begun receiving enough votes to pass at the annual shareholder meetings of some publicly traded companies in the US.[97]

These are two examples of corporate governance activities that pension funds might pursue if plan governance activities were a matter for which the trustees were accountable to the plan members. It should be clear, however, that the determination of what environmental, social, and governance matters, if any, the pension plan ought to pursue will and ought to be in the hands of the plan members. They will determine the agenda following a discussion of the issues. I set out a more detailed proposal for this process of accountability in Chapter 6.

Pension Plan Corporate Governance Is a Matter of Public Policy

Enron is not just a story about out-of-control managers and the devastating effect on employees and retirees. Many would argue that the choices of employers and employees about their pension savings are private and should not be the concern of policy makers. There are two arguments that counter this position. First, private pension plans receive tax subsidies in order to support a public policy that employees who retire should have an adequate

income. Second, any failures of the system are borne by the general public, who will have to provide substitute income for inadequate pensions generated through tax-subsidized private employers. Lastly, the choices that undermine the publicly funded policy of providing adequate retirement income through a combination of public and private pension schemes appear to benefit employers only. The hundreds of millions of dollars of Enron stock in these retirement savings and pension plans represented an immense tax subsidy to the corporation for its employee benefit plan.

The following chapter discusses the tax-supported scheme for retirement savings and pension plans in Canada, together with the law concerning the beneficial ownership of the funds, including their investments in corporate securities. It concludes that the law supports the view that fiduciaries who control these funds are under an obligation to exercise the funds' corporate governance rights in the interests of the employee-beneficiaries.