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THE FOURTH ABRAHAM L. POMERANTZ LECTURE

Tensions Between Institutional Owners and Corporate Managers: An International Perspective

INSTITUTIONAL OWNERS AND CORPORATE MANAGERS: A COMPARATIVE PERSPECTIVE

*Richard M. Buxbaum**

INTRODUCTION

The portfolio ownership of firms by institutional investors is not in itself a recent or recently noticed phenomenon. The “re-

* Professor of Law, University of California at Berkeley, School of Law (Boalt Hall).

This is an augmented version of a paper given as the Fourth Pomerantz Lecture at Brooklyn Law School in November of 1990, and retains the lecture style of that presentation. Material appearing since the end of 1990 has been only partially worked into the present article. I wish to thank the panelists and other participants at the lecture for their stimulating submissions, Professor Theodor Baums, Osnabrück (Visiting Scholar at Boalt Hall 1990-1991), for many helpful and critical review sessions, Professor Ronald Gilson, Stanford, for comments all the more helpful because of his disagreement with the premises for some of my proposals, and Dr. Christian Hammerl, LL.M. 1989, Michelle Thomas, LL.M. 1991, and Daniela Feldhausen, J.D. candidate, (all Boalt Hall) for their substantial research support. A grant to the Corporate Governance Project of the Earl Warren Legal Institute (Boalt Hall) from the California Public Employee Retirement System (CalPERS) underwrote much of the research for this paper.

markable" increase in institutional ownership of United States equities from 7.6 percent in 1900 to over 20 percent in 1950 was duly noted during the latter decade.¹ At that time, however, the concern, understandably, was with the concentration of ownership, and in particular of management of these assets, in banks and other traditional financial institutions.²

What has changed is the further transfer of ownership from these traditional intermediary structures directly to the beneficiaries or ultimate owners of these financial assets, or at least to other types of intermediaries whose relations with their portfolio firms are less symbiotic and less intimate than were these earlier relationships. This specifically new phenomenon, first brought to general public attention by Peter Drucker almost fifteen years ago, is a topic whose time has come, though the recognition of that fact is relatively recent. Half a decade passed after the publication of his book, *The Unseen Revolution*,³ with its announcement of the arrival of "pension plan socialism,"⁴ before Clark's even terser pronouncements on "the four stages of capitalism" appeared;⁵ and it took another five years for legal analysts to catch up with financial theorists in recognizing the normative significance of these phenomena.⁶

Now, however, the outpouring of legal commentary is in full flood;⁷ and if I add yet another comment to its waves, it is to

¹ See R. GOLDSMITH, *FINANCIAL INTERMEDIARIES IN THE AMERICAN ECONOMY SINCE 1900* (1958).

² See R. TILOVE, *PENSION FUNDS AND ECONOMIC FREEDOM: A REPORT TO THE FUND FOR THE REPUBLIC* 29, 39, 55 (1959).

³ P. DRUCKER, *THE UNSEEN REVOLUTION: HOW PENSION PLAN SOCIALISM CAME TO AMERICA* (1976).

⁴ Hardly the characterization a socialist would use, however; see particularly the massive study of R.L. DEATON, *THE POLITICAL ECONOMY OF PENSIONS* (1989), incorporating British, Canadian, and American experience; see also R. MINNS, *PENSION FUNDS AND BRITISH CAPITALISM: THE OWNERSHIP AND CONTROL OF SHAREHOLDINGS* (1980). For another (American) view of the phenomenon, see J. RIFKIN & R. BARBER, *THE NORTH WILL RISE AGAIN: PENSIONS, POLITICS AND POWER IN THE 1980s* (1978).

⁵ Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561 (1981).

⁶ The overview in R. IPPOLITO, *PENSIONS, ECONOMICS, AND PUBLIC POLICY* (1986) analyzes in economic terms a process analyzed in legal terms in B. KRIKORIAN, *FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT* (1989); see also Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117 (1988).

⁷ See especially the papers presented at the Salomon Brothers Center and Rutgers Center Conference on the Fiduciary Responsibility of Institutional Investors (June 14-15, 1990) [hereinafter *Salomon/Rutgers Conference*].

highlight the one element not yet acknowledged in these writings, namely, the transnational aspects attendant on the globalization of securities markets and the global reach of these American—and, to a lesser extent, Japanese and British—institutional investments outside their countries of origin, especially on the European continent.⁸

Because of the implications of these institutional investments for the merger and takeover movement of the 1980s, most of the discussion of the role of institutional ownership has focused on the relation of these holders to management—that is, to the “corporate governance” issue. The critical aspect of that general issue has been the role of these investors as voters, and their analogous role as passive or even as active participants in the market for corporate control—that is, in takeover, management-buyout, and defensive recapitalization transactions. The current ebb in that market’s volume of transactions, however, permits attention to be shifted to reflection on longer range, less transaction-specific trends and issues in this new setting of institutional ownership of equities.⁹ Specifically, it facilitates a look not only at chronic rather than acute corporate governance issues, but also at the “front end” issues that are related to the evolution and internal structures of these institutional investment vehicles themselves.¹⁰

The broadening of portfolio distribution that accompanies absolute growth in the size of these investment pools makes the comparative as well as the transnational aspect of this new investment situation a major issue in its own right.¹¹ The following

⁸ See also Buxbaum, *Institutional Ownership and the Restructuring of Corporations*, in Festschrift für Ernst Steindorff 7 (J. Baur, K. Hopt & P. Mailänder eds. 1990); Schneider, *Auf dem Weg in den Pensionskassenkorporatismus?*, 37 DIE AKTIENGESELLSCHAFT 317 (1990).

⁹ See also, from this general and not only takeover-driven perspective, Gilson & Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, originally presented at the Salomon/Rutgers Conference, supra note 7, now in 43 STAN. L. REV. 863 (1991). On the possibly temporary nature of the takeover lull, see *They Will Return*, ECONOMIST, Feb. 9, 1991, at 19.

¹⁰ This approach also recognizes that in most of Continental Europe the takeover phenomenon not only is less visible in practice, but cannot rely on the theoretical justification prevalent in the United States (the “market for control”) to nearly the same extent. See, e.g., von Thadden, *On the Efficiency of the Market for Corporate Control*, 43 KYKLOS 635 (1990).

¹¹ According to data derivable from the survey in 18 PENSIONS & INVESTMENTS, Jan. 22, 1990, at 14, the international (non-U.S.) equities dedicated to defined benefit plans

discussion focuses on these aspects of the institutional investment phenomenon. It is based on the outward-bound movement of American investment funds to foreign markets, and thus towards foreign firms, though some of its conclusions and proposals should bear with equal validity on foreign institutional investment in American markets and firms. It also looks at the channels of financial intermediation and their relation to this new form of savings and investment in comparative perspective.

I begin with a brief and unavoidably factual sketch of the reasons for and consequences of the different growth patterns of these investment pools in the United States and abroad. There follows a brief review of the related issue of the salient differences between the "receiving institutions" of the United States and of those abroad that intermediate and receive this flow of funds—the organized securities markets and the ultimate capital-seeking firms. That factual setting permits a comparative discussion of the legal and political issues raised by the growing globalization of institutional investment. In particular, it permits a discussion of the relation of financial intermediation—its agents, structures, and processes—to the corporate governance role of the new class of institutional investors.

The principal foreign setting chosen for this discussion is Germany. Its firms and intermediate financial institutions, as well as its laws, display important differences from their United States counterparts. On the other hand, its setting within a liberalizing European Community and its exposure, in substantial part via London, to mobile investment-seeking capital stemming from other European and other (including American) foreign savers invites reflections on possible changes in these institutions and laws over time.¹² It is this intermediary role of London, rather than an expectation that United Kingdom laws and institutions provide a basis for a *tertium comparationis*, that leads me to include some comments on the United Kingdom setting in this discussion.¹³ Nevertheless, the unique British

held by the top 200 American pension funds at the end of 1989 had a market value of almost \$27 billion.

¹² See Buxbaum, *supra* note 8, for a more detailed demonstration of these brief assertions.

¹³ For a discussion of the importance of pension funds and related institutional investors among owners of British firms, see R. MINNS, *supra* note 4, at 22 (1975 figures indicate that insurance firms and pension funds together hold almost one-third of the

history of a century-long, union-led, political battle for pensions, and the difficult fit of those pension funds' investment (and potential governance) activities within the City's financial world, in their own right yield insights into the still relatively open American and relatively closed German worlds of financial intermediaries.

The comparative focus of this study, thus, yields several conclusions:

(1) The dynamics of the phenomenon of institutional ownership—its reasons for developing, its future growth and proliferation problems, its potential limitations—still are not fully understood. Even a straightforward comparison of the past, present, and potential scope and characteristics of institutional savings growth and ownership patterns in otherwise similar economies can help make the individual national setting more comprehensible.

(2) The liberalization of capital movements and the transnational mobility of portfolio investment make the possible asymmetry of investment flows an important subject for investigation, given the impact of this capital mobility on the intermediation structures and processes of previously national financial markets.

(3) On the assumption that the rise in institutional investment disturbs preexisting factual and legal patterns of owner-manager relations within private firms, a comparative study of the different structural and functional aspects of these relations in otherwise similar economies can help in the formulation and analysis of policy proposals that aim to establish new owner-manager relations better suited than old ones to these new realities.

(4) Of specific importance are the structure, behavior, and performance of traditional financial intermediaries as these bear on the governance of firms. These attributes, indeed the actors themselves, likely will have to adapt to new forms of efficient intermediation made possible by the new institutional investors. It is therefore doubly important to understand these previous

equity shares of UK firms). NATIONAL ASSOCIATION OF PENSION FUNDS, LTD., SIXTEENTH ANNUAL SURVEY OF OCCUPATIONAL PENSION SCHEMES 1990, 53 (1991) indicates that these funds held approximately \$170 billion of UK and overseas equities as of 1990, 51% thereof in UK firms.

patterns and to evaluate their adaptability to the new institutions, which are in a position to recombine in one agent the previously separated roles of saver, intermediary, and owner.

(5) Finally, an initial comparative analysis of the underlying social, political, economic, and even cultural constraints on potential structural changes in the ownership and control of private firms in the modern liberal economy is independently useful. It may help remind us of the enduring validity of social theory in an era in which the discrediting of a major wing thereof—Marxist theory—leaves important social issues, in the West as well as in the East, unilluminated by self-reflection. This is a particularly important defect in a world that urgently needs to accommodate both ecological imperatives and economic orders, orders that neither in their socialist nor in their capitalist variants have yet learned to build those imperatives into their productive sectors' purposes and decision-making processes.

This is a large and ambitious program, and in this first look at the sketched situation little more than an agenda for ongoing inquiry can be achieved. I intend first to describe, and explain the reasons for, the growth of these institutional investment funds in their different national settings. I then describe their investment behavior, including their voluntary or regulated role as participants in the governance of the firms in their investment portfolios. From this follows a comparative review of the responses by the private firm sector as well as by government to this new phenomenon and its discontents. Particularly important here is the implication of these thrusts and counterthrusts at the transnational level.

On this basis, it is then possible to look at the structure and behavior of the financial intermediaries as these developed in their specific national historical setting, highlighting here the German *Hausbanken* and *Grossbanken*. The governance relationship between them and their portfolio firms is a particularly important issue, since it is one of the most appealing models suggested for the developing American relationship between pension funds and private firms. The analogous use of this model for the relation of institutional investors with firms in a "privatized" universe—as predicted or prescribed by some observers of the American scene—is discussed and rejected. A different aspect of that relationship, however, namely its role in le-

gitimating both the firms and the funds in their respective societal tasks, is more positively evaluated.

I. THE GROWTH OF INSTITUTIONAL INVESTMENT FUNDS IN COMPARATIVE PERSPECTIVE

A. *The Engines of Growth*¹⁴

Institutional investment vehicles generally are grouped in five categories: foundations and endowments, bank (non-pension) trusts, insurance companies, investment companies, and private and public pension funds.¹⁵ Motives for the investment of private households' surplus savings in corporate securities are not so cleanly categorizable, but making provision for retirement income is a large one. In the prevalent American as well as European terminology, retirement funding is based on three "pillars": a first pillar of social security or analogous income; a second pillar of employment-based, usually collectively bargained or granted "private pension" income; and a third pillar of privately and voluntarily initiated, individually purchased, retirement income. More succinctly, "[a]s originally conceived, Social Security was to be one of three sources of retirement income, the others being private pensions and savings."¹⁶

The first pillar is itself supported by government fiscal revenues and, despite the recent move towards the creation of social security reserves to safeguard payments for the coming several decades, still is predominantly a current account system.¹⁷ The second pillar, at least in the United States and United King-

¹⁴ For a general and widely comparative brief survey of many of the following issues of demographics, taxation, and fund structures, see Organisation for Economic Cooperation and Development (OECD), *Reforming Public Pensions* (Social Policy Studies No. 5) (1988).

¹⁵ Institutional Investor Project, Columbia University School of Law, *The Growth of Institutional Investors in U.S. Capital Markets* 6 (1988). The adequacy of the classification is questioned in Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 567 (1990).

¹⁶ Hurd, *Research on the Elderly: Economic Status, Retirement, and Consumption and Saving*, 28 J. ECON. LIT. 565, 590 (1990).

¹⁷ See H. AARON, B. BOSWORTH & G. BURTLESS, *CAN AMERICA AFFORD TO GROW OLD?* (1989). For the present, see simply the primary documentation, *Social Security Trust Funds: 1970 To 1988*, Table No. 587, in STATISTICAL ABSTRACT OF THE UNITED STATES 1990 (110th ed., 1989). On the related issue of the "last generation" and its inability to benefit from the bargain, see the microeconomic explanation of its limited relevance in H. VERBON, *THE EVOLUTION OF PUBLIC PENSION SCHEMES* (1988).

dom,¹⁸ is supported by the dedication of periodic premium payments to a trust fund that is in turn invested and in this augmented form is actuarially expected to yield the promised or required benefits. The third pillar, private assets, may in turn be occasionally or periodically transferred to a private version of such a trust fund, or may be more traditionally invested in the straightforward expectation that at the end of the day it will yield the desired retirement income. The five mentioned forms of institutional investment can be correlated, in roughly descending order of importance, to these three pillars of retirement income.¹⁹ A first comparatively critical question, therefore, concerns the proportion of total institutional investment found in these categories, and the trends in their absolute and relative growth rates.

In the United States the percentage of retirement income derived by all households from the second pillar, pensions, has remained fairly steady over the past decades, at roughly 15 percent of total income.²⁰ The percentage of income derived from the third source of support, private assets, however, has substantially increased over that time from 15 percent to over 25 percent.²¹ Thus the average household received approximately 40 percent of its retirement income from surplus savings that were either voluntarily or involuntarily invested, on the basis of voluntary or involuntary and periodic or irregular contributions, but overwhelmingly through intermediary institutional investors.

The percentage distribution of retirement-age households receiving various proportions of their total retirement income from these two sources reflects these aggregate data. Thus, while the percentage of households receiving over 50 percent of their total retirement income from pensions has barely increased in twenty years from 6 percent to 7 percent, the percentage of similar households receiving over 50 percent of their income from the mentioned privately held assets increased from 7 percent to

¹⁸ For a description of the British version of first and second pillar integration, see E. SHRAGGE, *PENSIONS POLICY IN BRITAIN: A SOCIALIST ANALYSIS* 146 (1984).

¹⁹ See Hurd, *supra* note 16.

²⁰ *Id.* See also G. FIELDS & O. MITCHELL, *RETIREMENT, PENSIONS, AND SOCIAL SECURITY* 13 (1984).

²¹ See Hurd, *supra* note 16.

12 percent.²² In short, almost one-fifth of American retirees live substantially off individually and collectively generated savings.

It also is important to note the specific increase in the role of government pensions (other than Social Security), because these pensions are funded and administered in ways directly relevant to our concern with the policy implications of institutional investment in and potential control of private firms.²³ The percentage of elderly households receiving more than 50 percent of their income from this source—essentially, state and local government employees—rose from 3 percent to 5 percent between 1971 and 1986. Perhaps more significantly, the percentage receiving some of their income (between 1 percent and 49 percent) from that source more than doubled from 3 percent to 8 percent.²⁴ One reason for the importance of this latter segment is the increasing incidence of so-called “integrated” retirement benefit plans, which both in the federal and state public employment sector base the second-pillar retirement benefit on the shortfall between Social Security benefits and some agreed-upon minimum pension benefit.²⁵ Since the Social Security component of that overall pension level, while growing, has steadily become a smaller proportion of the total package,²⁶ the federal public employment sector now has joined the state public employment sector to become a substantial player in the funding of the second pillar and in the investment of those funds in the corporate economy.

In this funding method lies one of the principal comparative points of reference for our topic, for it differs substantially from

²² *Id.*

²³ By 1987, approximately 7,300,000 elderly were receiving state or federal pension benefits. See Bixby, *Benefits and Beneficiaries Under Public Employee Retirement Systems, Fiscal Year 1987*, 53 Soc. Sec. BULL., June 1990, at 23.

²⁴ *Id.*

²⁵ While federal employees were under their own system for decades (the Civil Service Retirement System), since 1986, with the establishment of the Federal Employees Retirement System, even the federal government has moved to this integrated benefit system. See Bixby, *supra* note 23.

The British battle over this issue of integration, with its more ideological and class-conflict overlay, is well reviewed in L. HANNAH, *INVENTING RETIREMENT: THE DEVELOPMENT OF OCCUPATIONAL PENSIONS IN BRITAIN* (1986).

²⁶ Average annual benefits under the federal scheme were approximately \$13,500 by 1987; state benefits, because of the longer history of Social Security integration, were approximately \$7,500. See Bixby, *supra* note 23, at 25 (Table 3). Neither figure includes the Social Security component. See note 27 *infra*.

the funding method in Germany; I return to this immediately below. Remaining for a moment, however, with this look at the proportional roles of the pillars of retirement income, there is a second comparative point of reference in the relative importance of the first as against the second source of retirement income.²⁷ In the United States, the role of private pension funds has grown in importance because of the relatively less generous levels of retirement benefits paid under Social Security, the first pillar. For the working poor, be they poor during their working lives or during retirement, the low level of Social Security benefits (currently only \$975 per person per month and 150 percent thereof per couple at the practically unobtainable maximum)²⁸ is a fact of life. For the middle class it is an incentive both to save and, more to the point, to put pressure on employers to fund supplemental pension benefits. This pressure is expressed in the high growth rate of private (and, indirectly, even of public) sector pension plan funding.²⁹ Indeed, at one time it led to the consideration of plans to make private, supplemental pensions mandatory.³⁰ Great Britain also falls within this category, though for somewhat different reasons.³¹ In Germany, on the other hand, with state pension payments at a level much closer to average lifetime annual income,³² there is correspondingly less pressure on employers to make the funding of the second pillar a major priority.³³ This expresses itself in a demonstrably lower

²⁷ For a wide-ranging comparison of these eligibility and payment figures, see OECD Survey, *supra* note 14, at 114.

²⁸ 20 C.F.R. § 440 (1990). See the workout tables at I Unempl. Ins. Rep. (CCH) 168, 1056.

²⁹ Bodie, *Pensions as Retirement Income Insurance*, 28 J. ECON. LIT. 28 (1990), cites a governmental study indicating that 42 million American employees were covered by some sort of pension plan as of 1987. There is, however, a distinct break between the relative prevalence of employee pension plans of the large employer and the small one. See E. ANDREWS, *THE CHANGING PROFILE OF PENSIONS IN AMERICA* (1985) (82% of the employees of firms employing more than 500 persons were covered by a pension plan in 1983, against only 23% in the case of firms employing less than 100). See also the correlation with unionization reviewed in Bodie, *supra*, at 36.

³⁰ See M. HORLICK & A. SKOLNIK, *MANDATING PRIVATE PENSIONS: A STUDY OF EUROPEAN EXPERIENCE* (1978) (a study commissioned by the Social Security Administration).

³¹ See L. HANNAH, *supra* note 25.

³² The retirement income fluctuates around 65% of the average preretirement earnings. See *The Finances of the Statutory Pension Insurance Funds Between 1978 and 1981*, 34 DEUTSCHE BUNDESBANK MONTHLY REPORTS, Apr. 1982, at 14.

³³ See Guthardt, *Pensionskassen und Börse*, Federation of German Stock Exchanges, Symposium—Pensionskassen und Börse (June 7, 1989).

current level and lower growth rate for that sector.³⁴

The major point of comparative reference, however, lies in the way the pension obligations of both private and public sector employers are funded³⁵ and invested.³⁶ In the United States private employment sector, ERISA dictates what tax considerations also stimulate:³⁷ the current funding, through transfer payments from current revenues to a separate trust fund, of periodic payments sufficient, with their expected investment profit, to meet the defined benefit obligations typical of that sector.³⁸ In Great Britain, too, union and Labor Party strategy has

³⁴ See *Company Pension Schemes in the Federal Republic of Germany*, 36 DEUTSCHE BUNDESBANK MONTHLY REPORTS, Aug. 1984, at 30. In the case of the third pillar, private assets, the higher savings rate for German households, in comparison with American ones, of course militates against this differential. The overall difference, however, is not large enough to require a major qualification of the text statement. See *Saving Through Investment Companies on the Ascent*, 40 DEUTSCHE BUNDESBANK MONTHLY REPORTS, Oct. 1988, at 30; *Developments in Saving Through Investment Companies Since 1970*, 31 DEUTSCHE BUNDESBANK MONTHLY REPORTS, Aug. 1979, at 11.

The increasing longevity of both populations, and the increasing tendency towards earlier retirement than in previous periods, generates other pressures—especially pressure on the “intergenerational bargain” that today’s sacrifices by wage earners on behalf of current retirees will be matched tomorrow by another generation—but is not a point of difference between the two countries. For a comparative survey, see *REDEFINING THE PROCESS OF RETIREMENT—AN INTERNATIONAL PERSPECTIVE* (W. Schmühl ed. 1989).

³⁵ For an excellent comparative analysis of both the funding and the asset-and-liability valuation processes within the specific UK-German perspective, see S. PRODANO, *PENSION FUNDS: INVESTMENT AND PERFORMANCE* 118 (1987).

³⁶ The macroeconomic consequences of funded versus unfunded pension obligations is a major issue in itself, based on a “golden rule of accumulation” that examines the relationship between the economy’s rate of growth and the rate of interest. See Phelps, *The Golden Rule of Accumulation: A Fable for Growthmen*, 51 *AM. ECON. REV.* 628 (1961). For a recent discussion from the European perspective, see S. HOLMBURG, *THEORIE DER ALTERSSICHERUNG* (1988).

³⁷ At least for the larger corporations; the prevalence of pensions among smaller employers remains a matter of concern. See E. ANDREWS, *PENSION POLICY AND SMALL EMPLOYERS: AT WHAT PRICE COVERAGE?* (1989). See also note 29 and accompanying text *supra*.

³⁸ That this blithe statement skates over enormously complex questions of actuarial assumptions, funding practices, and multiple agent-principal monitoring issues among managers, employee-beneficiaries, shareholders, and creditors is self-evident. For a succinct introduction to most of these questions, see Bulow & Scholes, *Who Owns the Assets in a Defined-Benefit Pension Plan?* in *FINANCIAL ASPECTS OF THE UNITED STATES PENSION SYSTEM* 17 (Z. Bodie & J. Shoven eds. 1983); Friedman, *Pension Funding, Pension Asset Allocation, and Corporate Finance: Evidence from Individual Company Data* in *FINANCIAL ASPECTS OF THE UNITED STATES PENSION SYSTEM* 107, *supra*.

Whether a formally funded plan is appropriately funded depends on appropriate projections of liabilities at appropriate ratios (of projected to vested accrued liabilities) as well as the selected discount rates to present values. It is, therefore, difficult to make

consistently given the funding of pensions priority.³⁹ In Germany, on the other hand, tax law is only partly relevant and labor (and labor law) largely indifferent to this decision, with the result that the private firm's pension obligation to its employees is either totally off balance sheet or at most (since some recent legislative changes) treated as an unsecured obligation.⁴⁰ The practical result is that the "premium" represented by the annual on-the-book obligation is reinvested in the enterprise itself, not in financial assets issued by other firms in the economy.⁴¹ The *voluntary* single-employer ESOP—the Employee Stock Option Plan—is the closest American analogy,⁴² though it at least makes the benefit holder a current shareholder with an immediate residual claim against the employer-enterprise.⁴³

global statements about the projected "safety" of any, even a funded, plan. *See generally* L. KOTLIKOFF & D. SMITH, *PENSIONS IN THE AMERICAN ECONOMY* 13 (1983). The Pension Benefit Guaranty Corporation (PBGC) periodically releases lists of firms which by its measure have inadequately funded their pension plans (in the sense of assets available to pay out all claims if they were to close)—that is, the measure of insurer liability of the PBGC itself. *See, most recently, Shortfall in Pension Funds Cited*, N.Y. Times, May 9, 1990, at D4, col. 4.

³⁹ *See* L. HANNAH, *supra* note 25; R.L. DEATON, *supra* note 4, at 307.

⁴⁰ *See generally* Gesetz zur Verbesserung der betrieblichen Altersversorgung of 1974 [GVbetrAV], BUNDESGESETZBLATT, TEIL I [BGBl.] 3610 (1974); R. HÜFER & O. ABT, GVbetrAV: KOMMENTAR (1982); *Company Pension Schemes in the Federal Republic of Germany*, 36 DEUTSCHE BUNDESBANK MONTHLY REPORTS, Aug. 1984, at 30.

On the other hand, this unsecured obligation is secured by a more or less mandatory quasi-governmental reinsurance scheme funded by premia paid by each employer on a rigid scheme not tied to the safety of the particular firm's commitment. GVbetrAV, *supra*, § 10. For an English explanation, *see* Fürer, *Pension Plan Credit and Insolvency Insurance: The Foreign Experience*, in *PENSION PLAN TERMINATION INSURANCE: DOES THE FOREIGN EXPERIENCE HAVE RELEVANCE FOR THE UNITED STATES?* 31 (Kenneth Tolo ed. 1979).

For a discussion of the balance sheet as well as economic consequence of funded versus unfunded pension obligations, *see* Ryan, *Corporate Pension Fund Management: Measuring the Pension Liability*, 25 GA. L. REV. 117 (1990). On the separate but itself critical role of the U.S. guaranty schemes in encouraging opportunistic manipulation of pension funds by private firms, *see* Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1990 WIS. L. REV. 65; *but cf.* Pension Benefit Guaranty Corporation v. LTV Corp., 110 S. Ct. 2668 (1990).

⁴¹ As the equilibrium between future and current pension claims heaves into sight, pressures to anticipate this drain by beginning current funding of future claims also increase. It is an intriguing sidelight that in Germany today the main obstacle to this prefunding effort may be the competition for cash flow-generated funds created by investment needs in the enterprise sector of the former German Democratic Republic. *See* Price, *Unification Slows Pre-funding*, PENSIONS & INVESTMENTS, Oct. 15, 1990, at 1.

⁴² I.R.C. § 409A (1982).

⁴³ It also provides a direct voting right. *See* Note, *Employee Stock Ownership*

Such funds as are set aside are invested in different fashion in the two systems. For plans subject to its regulation, ERISA dictates prudent investment policy, which in turn dictates diversification among claim-issuing firms and among types of financial assets.⁴⁴ Critical to our discussion is the fact that in the United States this concept of prudence, recharacterized in recent years as a diversification imperative, implies a substantial proportional investment in corporate equities.⁴⁵ The figures confirm that point. Private (trusteed rather than insured) pension funds invest almost 50 percent of their assets in equities, and public pension funds are not far behind at 33 percent on the way to a higher equilibrium. Given the British practice of leaving these funds' investment decisions to the City and its typical practices, the proportion of equities to total financial assets of pension funds is even higher, and approaches two-thirds of total investments of those funds.⁴⁶

In Germany, by contrast, where the invested funds are subject to the regulation applicable to insurance companies, the applicable legal concept of prudence still is based on an asset conservation policy.⁴⁷ This means that neither private enterprises nor the private insurance companies typically used by those enterprises to guarantee (insure) pension benefits are permitted to invest more than 20 percent of their assets in corporate equities.⁴⁸ Even this figure is rarely reached, and the average figure

Plans, Voting Rights, and Plant Closings, 11 U. MICH. J.L. REFORM 162 (1977). In practice, according to Conard, *supra* note 6, at 149, this is typically passed through to the (employer-nominated) trustee, not on the model of U.S. proxy regulations but on the *Depotstimmrecht* model.

⁴⁴ Employee Retirement Income Security Act of 1974 [ERISA], Pub. L. No. 93-406, 88 Stat. 829 (codified at 29 U.S.C. §§ 1001-1461 (1974) and elsewhere). See generally J. LANGBEIN & B. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW* (1990). Decisions interpreting this imperative are as rare as they are inconclusive. See, e.g., *Brock v. Walton*, 794 F.2d 58 (11th Cir. 1986).

⁴⁵ See generally B. LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE* (1986).

⁴⁶ See Helowicz, *Pension Fund Investment*, in B. BENJAMIN, S. HABERMAN, G. HELOWICZ, G. KAYE & D. WILKIE, *PENSIONS* 83, 86 (1987).

⁴⁷ Section 54(a), *Versicherungsaufsichtsgesetz* [VAG] BGBI.I 2595 (1986). See generally E.R. PRÖLSS, R. SCHMIDT & P. FREY, *VERSICHERUNGSAUFSICHTSGESETZ-KOMMENTAR* § 54(a) (10th ed. 1989).

⁴⁸ The critical role of this issue to the health of the "three-pillar" structure of old-age support is evident, since the "pay-as-you-go" first pillar and a stable, capitalization-based second pillar buttress the stability of the system. See Heubeck, *Das Mischungsverhältnis Zwischen Umlage-und Kapitaldeckungsverfahren*, 78 Z. GESAMTE VER-

for analogous equity investment in Germany is roughly 10 per cent of total investment,⁴⁹ though recently the Office of Insurance Supervision has authorized somewhat more liberal equity investment practices that may in time raise this figure.⁵⁰ The consequence is that American and even British funds are a far larger and far more rapidly growing source of investment than are comparable German funds. Because of the global reach of these funds,⁵¹ this source of investment easily could match that of domestic sources. At present the only constraint on this result is the narrowness of organized securities markets in any particular country that is the destination of these investment flows.⁵²

SICHERUNGSWISSENSCHAFT 679 (1989).

⁴⁹ *Capital Formation and Investment Policy of Insurance Enterprises Since 1976*, 32 DEUTSCHE BUNDESBANK MONTHLY REPORTS, Apr. 1980, at 11, 15. See also the more recent statistics to the same effect in *Liquid Funds and Investments of Insurance Enterprises*, 42 DEUTSCHE BUNDESBANK MONTHLY REPORTS, Aug. 1990 (Part VI—Capital Market) (Table No. 7). The low domestic institutional (especially insurance) investment in domestic equities has been often noted and bemoaned. For a recent recapitulation, see Claussen, *25 Jahre Deutsches Aktiengesetz von 1965 (II)*, 36 DIE AKTIENGESellschaft 10 (1991).

⁵⁰ See Bering, *Erweiterte Anlagevorschriften für versicherungsunternehmen—Möglichkeiten und immanente Anwendungsgrenzen*, 5 BETRIEBLICHE ALTERSVERSORGUNG 144 (1987).

At the end of 1988, these "Pensionskassen" held only DM 76 billion in assets, of which only 2% was invested in corporate equities. See Bundesaufsichtsamt für Versicherungswesen, *Geschäftsbericht 1988*, at 88.

⁵¹ It may suffice to point out that the 1989 market value of the international (non-United States) equity portfolio of CalPERS, the California Public Employee Retirement System, was over \$430 million dollars. 1989 was the first year of substantial international transactions (\$493 million purchased, \$37 million sold), and the first in which the international portfolio was even separately broken out. See CalPERS, *Annual Investment Report* (1989).

⁵² Thus, to take one leading example, the market value of the German equities holdings of CalPERS (see note 51 *supra*) alone, at the end of 1989, was over \$23 million. Relatively speaking, this was a low investment, probably reflecting less a judgment on German firms than the inadequate investment opportunities on the German stock markets. The Australian equity holdings of CalPERS, to take an extreme case (small economy, active public stock market) were \$14 million; its UK holdings, \$60 million; its Hong Kong holdings, \$15 million; its Japanese holdings, \$224 million! *Id.* Perhaps, Taiwan is next. See WuDunn, *Taiwan Beckons Foreign Investors, but Its Stock Market Slips*, N.Y. Times, Nov. 9, 1990, at D10, col. 1. ("[W]ith stock prices depressed, securities officials say, now is an ideal time to raise the standards of the market and give it an international base by bringing in foreign institutional investors. . . . The Government [] . . . is about to review a proposal to allow foreign institutions . . . to invest an aggregate of \$2.5 billion in securities markets here.") In other words, the foreign institutional investment typically is still in the market as a wildly varying surrogate for the economy. With improved and deeper securities markets, a probability in post-1992 Europe, that situation will change.

Finally, one should not overlook the possibility of "on-shore" investment by American institutions in the equity securities of foreign issuers made possible by the recent promulgation of Rule 144A which permits qualified institutional investors to engage in secondary trading of foreign securities under certain qualifying conditions.⁵³ The "control-retention" requirements of ERISA had not seriously constrained the placement of pension investments abroad,⁵⁴ and this new relaxation may provide yet more impetus to investment in foreign securities. First reports on its use by foreign issuers suggest a strong focus on pension funds as the targets of initial placements of these securities.⁵⁵ As a result, this may become a major additional component of American institutional ownership of foreign firms. This form of investment undoubtedly will become a factor in the debate over the Jensen privatization thesis.⁵⁶ This thesis suggests that effi-

Aggregate United States holdings of foreign stocks—overwhelmingly institutional holdings—are of course correspondingly large. See the data recounted in note 51 *supra*. In 1989 alone net U.S. purchases of foreign stocks were roughly \$17.6 billion, though this was perhaps an unusual year because of the decline in the dollar and the sharp surge in several foreign stock markets. See Bach, *U.S. International Transactions, Fourth Quarter and Year 1989*, 70 SURV. CURRENT BUS. 33, 44 (Mar. 1990).

⁵³ Exchange Act Release No. 33-6862, 55 Fed. Reg. 17933 (Apr. 30, 1990). See generally Karol, *The Effects of Rule 144A*, 23 REV. SEC. & COMM. REG. 125 (1990).

⁵⁴ Section 1104(b) of ERISA prohibits a covered fiduciary from maintaining the "indicia of ownership" of plan assets outside the jurisdiction of the federal courts, except as authorized by the Secretary of Labor. 29 U.S.C. § 1104(b) (1974). A 1976 regulation, 29 C.F.R. § 2550.404b-1 (1977), permits foreign securities to be held overseas if controlled by a qualified financial institution. Although private sector plans are covered by this provision, public sector plans are not; neither, in any event, is constrained in its basic investment choices by this requirement. It does, however, encourage a tendency to leave the voting power over the stock, which itself is a plan asset, with these financial intermediaries, a consequence conflicting with the increasing concern of the Department of Labor—see note 55 and accompanying text *infra*—that this voting right be more rigorously monitored, free of potential conflicts of interests, and exercised for the exclusive benefit of the plan beneficiaries.

⁵⁵ See Hollie, *Foreign Deals Draw Investors' Interest*, PENSIONS & INVESTMENTS, June 25, 1990, at 3. There are, however, some unresolved issues about the eligibility of pension funds, specifically to invest in certain important categories of these foreign shares, issues too technical for this discussion. See Silverman & Braverman, *Regulation S and Other New Measures Affecting the International Capital Markets*, 23 REV. SEC. & COMM. REG. 179, 186 (1990).

⁵⁶ Jensen, *The Eclipse of the Public Corporation*, 67 HARV. BUS. REV., Sep.-Oct. 1989, at 61. For a succinct exploration of this relationship between privatization of the firm and private placement of financial assets with institutional investors, see Longstreth, *Takeovers, Corporate Governance, and Stock Ownership: Some Disquieting Trends*, 16 J. PORTFOLIO MGMT., Spring 1990, at 54.

ciency considerations related to the disaggregation of conglomerate firms and compensation of managers, to the transaction costs of remaining a public (listed) company, and to the possibility that institutional investments now are large enough to satisfy the capitalization needs of firms, combine to suggest that American firms will in the future "go private" on the LBO model. On balance, I consider this unlikely, for reasons further considered below. In any event, while Rule 144A placements are private placements, the restrictions on their use, restrictions necessary from the perspective of investor protection, indirectly keep the issuer in a public capital market.

B. *The Ownership Position of Institutional Investors*

The Institutional Investor Fact Book of 1991 of the New York Stock Exchange (NYSE) estimates that over 43 percent of all U.S. corporate equities were owned by institutional investors in 1989.⁵⁷ Brancato, extrapolating from partial data, raises that estimate to 45 percent for those equities on national exchanges.⁵⁸ It is by now commonly agreed that the proportion of institutional holdings of the equities of the largest United States firms is even higher—well over 50 percent for the top one hundred firms; and that, probably because of index and portfolio distribution strategies, the 45 percent figure holds even for the bottom quartile of the top thousand firms, a number almost equivalent to the bottom third of NYSE listings.⁵⁹

Newer data sets are generating other socially important measures and information. Thus, Brancato reports substantial

⁵⁷ NEW YORK STOCK EXCHANGE, INSTITUTIONAL INVESTOR FACT BOOK 1991 5 (Chart 2) (using the Federal Reserve Board's Flow of Funds data of Sept. 1990 and including in that proportion 6.7% held by foreign investors, not all of which, of course, are institutional investors; without that component, therefore, the figure would be 37%)[hereinafter FACT BOOK]. See also Black, *supra* note 15, at 570.

⁵⁸ *Institutional Investors and Corporate America: Conflicts and Resolutions*, Hearing on The Impact of Institutional Investors on Corporate Governance, Takeovers, and the Capital Market, Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 101st Cong., 1st Sess. 3, 15 n.11 (Brancato Report Oct. 3, 1990) [hereinafter Brancato Report]. See also Brancato, The Pivotal Role of Institutional Investors in Capital Markets 20, presented at the Salomon/Rutgers Conference, *supra* note 7.

⁵⁹ Brancato Report, *supra* note 58, at 22. The FACT BOOK reports that all US capital market equities were valued at \$3.8 trillion in 1989. FACT BOOK, *supra* note 57, at 2 (Chart 1).

concentration of overall investments within the largest institutional investors.⁶⁰ Since the largest investors are pension funds, especially (because of the size of the "work unit") public pension funds, the nature, structure, function, and processes of these pension funds have become an additional public issue of considerable importance.

In the United States, using 1988 data, three-fourths of the mentioned percentage of equity value held institutionally was held by institutions that can fairly be correlated with pension-related savings: the pension funds, the investment companies (mutual funds), and the life insurance sector of the insurance companies. Given the high absolute value of total institutional assets, over \$5 trillion in 1988 and approximately \$5.7 trillion by the end of 1989,⁶¹ this suggests that approximately \$4.5 trillion in total assets are held by institutions supporting the second and third pillars.⁶² Of these institutions, private and public sector pension funds alone were estimated to hold \$2.4 trillion in total assets, of which almost \$1 trillion was in the form of United States corporate equities, representing over 25 percent of the market value of this category of financial assets. And within this pension fund cohort, the public (state and local government) pension funds alone represent 30 percent.⁶³ Using the 1986 figure of 35 percent as the proportion of total institutional assets

⁶⁰ Brancato Report, *supra* note 58, at 23.

The same report also demonstrates the concentration of the management of these funds among the largest money-manager intermediaries. The top 20 accounted for over 43% of the top 200 funds, and overall controlled over 25% of all institutional investments (\$620 billion of \$2.4 trillion) by 1989. *Id.* It is this concentration among intermediaries, rather than among the funds themselves, that lends weight to the Jensen privatization thesis. See note 56 and accompanying text *supra*.

⁶¹ FACT BOOK, *supra* note 57, at 3 (Table 2) (including, however, over \$1.5 trillion of foreign-sector investment). This figure represents approximately 43% of all financial assets available through US capital markets, *id.* at 2 (Chart 1), and over 18% of all US financial assets, *id.* at 4 (Table 3).

⁶² The British figures are roughly comparable, which is not surprising given the similar structure and investment attributes—\$120 billion by 1984, growing at more than 10% annually. See L. HANNAH, *supra* note 25, at 139. See also Helowicz, *supra* note 46, at 85.

⁶³ State and local government pension plans cover a larger proportion of their sectors' employees than is the case in the private employment sector. Already a decade ago, the approximately 150 state plans, 300 large-city plans, and thousands of small plans together covered close to 12 million persons, while all private employer plans covered only approximately 30 million people. See L. KOTLIKOFF & D. SMITH, *supra* note 38, at 171, 352.

invested in United States corporate equities, it would follow that these public pension funds' equity holdings comprise over 7.5 percent of the market value of all listed and publicly traded stocks.⁶⁴

The growth rate of the entire pension-related institutional investment sector, especially for the private and public sector pension fund group, is as remarkable as these current aggregate figures.⁶⁵

C. *The National Capacity to Absorb Investment Flows*

The other side of the coin of this nationally differentiated flow of investments is the nationally differentiated absorptive capacity of the various stock markets, which in turn is a function of firm listings and of the depth of the public float of those listed stocks. Here the contrast between the United States and Germany is especially striking. Using the criteria of public ownership of securities and sufficient float to make their market value a reflection not only of day-to-day clearing prices but also of "intrinsic" value (that is, of the control premium), approximately eight thousand American firms are available candidates for institutional investments over public share exchanges as against, at the most, approximately eighty German firms.⁶⁶

The German private firm sector is more than one one-hundredth the size of the American one, of course, but even if private placement of equity securities were available as an investment alternative for foreign institutional investors, the U.S.-German firm ratio at best would be approximately 10:1, still well below the relative proportions of the private sectors of the two economies.⁶⁷ The reasons for this disparity lie in history and are briefly sketched later; for the present it is enough to take this as

⁶⁴ FACT BOOK, *supra* note 57, at 3, Table 2.

⁶⁵ *Id.* at 19 and Table 3. It is an article of faith among observers (especially participant-observers!) that particularly the premium-driven pension funds exist to buy, not to sell, financial assets. See, e.g., Henriques, *After Eight Years, the Bear is Back*, N.Y. Times, Sept. 28, 1990, at D1, col. 3 ("Most of the investment community is structured to buy stocks, not to sell them. . . . That's why pension funds exist and mutual funds exist and bank trust departments exist—to buy stocks."). Nor is this exclusively an American phenomenon. Price, *Australian Market Hobbled by Pension Funds*, 18 PENSIONS & INVESTMENTS, Oct. 1, 1990, at 3 ("Declining contributions to Australian defined benefit funds means fewer dollars available to invest in stocks.").

⁶⁶ See, e.g., Schneider, *supra* note 8, at 318.

⁶⁷ The story told in note 52, *supra*, amply confirms this observation.

a fact of life and to consider its consequences.

Using foreign rather than institutional investment as our measure, and fully recognizing the United States policy in favor of foreign, trade deficit-reducing, stock market investment as a major factor in increasing the foreign share, it still is striking that foreign investment currently accounts for roughly 10 percent of New York Stock Exchange market values,⁶⁸ and only 10 percent of London's, but 45 percent of Frankfurt's.⁶⁹ With a maximum of some six hundred listings on that exchange, over five hundred of which represent so small a percentage of their firms' stock issuance as to make investment in them an institutionally infeasible gamble,⁷⁰ there simply is no real absorptive capacity on such a mini-exchange.⁷¹

The consequences are twofold. For most stock corporations, the brute fact that bank and cross-corporate holdings render them inaccessible to a hostile change of control, and make ordinary bloc purchases less likely, ends the matter for the time being.⁷² For the larger segment of German business cast in the form of a *Gesellschaft mit beschränkter Haftung*, or membership corporation, the nontransferable and illiquid nature of their ownership interests accomplishes the same thing.⁷³ For that small number of firms genuinely accessible, on the other hand,

⁶⁸ Board of Governors, *United States International Transactions in 1989*, 76 Fed. Res. Bull. 267, 277 (May 1990); See also Board of Governors, *International Statistics*, 76 Fed. Res. Bull. A 67 (Table 3.4) (Sept. 1990).

⁶⁹ Report presented at Symposium, Pensionskassen und Börse, Federation of the German Stock Exchanges, Frankfurt (June 7, 1989). According to a survey of the situation at the end of 1989, foreign investors represented over 50% of all exchange transactions in domestic equity shares and over 30% of their value (including investment certificates). *AG-Report*, 35 DIE AKTIENGESELLSCHAFT R 382 (1990).

⁷⁰ This is a gamble, at least, from the traditional United States investment perspective, because the small public float means that these shares enjoy little of the "play" that the control-market component of the American stock market brings to national exchanges. Changes of control, and premium payments associated therewith, are less likely to target the minority of publicly held shares.

⁷¹ See also Kalfass, *The American Corporation and the Institutional Investor: Are There Lessons From Abroad?* — *The German Experience*, 1988 COLUM. BUS. L. REV. 775.

⁷² Hansen, *Das Höchststimmrecht und seine Probleme*, 35 AKTIENGESELLSCHAFT R 166 (1990), reports from his own investigations that only 6% of all Frankfurt-listing firms had more than 50% of their issued stock in public float; only 4% had 75% or more. Of course, among these were the largest—that is, there is a correlation between size of firm and wide distribution of ownership.

⁷³ See F. KÜBLER & R. SCHMIDT, *GESELLSCHAFTSRECHT UND KONZENTRATION* 71 (1988).

the literal "alienation" of their ownership is a probability over time unless blocked by even stronger defensive measures than those we have become used to in our takeover battles, measures, such as maximum-vote limitations, which the vulnerable German (and many other European) firms are busily implanting.⁷⁴

From a stock market and, even more important, from a public policy perspective, this disequilibrium embarrasses efforts to make the transition from the historically based German universal *Grossbank* dominance of corporate governance as well as of corporate ownership to the more open system envisaged and necessitated by "Europe 1992," a system most commentators believe also is inevitable.⁷⁵ Most of this transition embarrassment, of course, relates to the fear of hostile, especially foreign, takeovers. The tortuous path of the European Community's "Takeover Directive" from its official launching in January 1989 to its current foundering in the waters of hostility reflects these diffi-

⁷⁴ Hansen, *supra* note 72, found that, by the end of 1989, 23 of the 628 Frankfurt-listing firms, which, however, represented 28% of the original issue value of the listed shares, had adopted various restrictions of this category. An even more vivid picture, that of the lockup of an entire national corporate sector with the blessing of the country's major stock exchange, is provided for The Netherlands in R.P. VOOGD, *STATUAIRE BESCHERMINGSMIDDELEN BIJ BEURSVENNOOTSCHAPPEN* (1989). See especially his extensive, firm-by-firm tabulation of specific defenses. *Id.* at 449.

For a discussion of these defensive measures under current German law, especially of this *Höchststimmrecht* cap on the exercise of voting power by a single shareholder, see Baums, *Höchststimmrechte*, 35 *DIE AKTIENGESELLSCHAFT* 221 (1990), and Schneider, *Gesetzliches Verbot für Stimmrechtsbeschränkungen bei der Aktiengesellschaft?*, 35 *DIE AKTIENGESELLSCHAFT* 56 (1990). Following a commissioned study, the EC Commission is separately considering a ban on this particular defensive measure. See *EG-Kommission plant Verbot des Höchststimmrechts*, 36 *DIE AKTIENGESELLSCHAFT* R 55 (1991).

For a wider-ranging discussion, see W. WERNER, *PROBLEME "FEINDLICHER" ÜBERNAHMEANGEBOTE IM AKTIENRECHT* (1989); and compare the polemic between the more control market-based argument of Adams, *Was spricht gegen eine unbehinderte Übertragbarkeit der in Unternehmen gebundenen Ressourcen durch ihre Eigentümer?*, 35 *DIE AKTIENGESELLSCHAFT* 243 (1990) and the more corporatist argument of Zöllner & Noack, *One share - one vote?*, 36 *DIE AKTIENGESELLSCHAFT* 117 (1991).

⁷⁵ It is in this context that the comparison with the United Kingdom has some significance. The British pension funds were early able to invest in a wider and more liquid range of financial assets, especially corporate equities, both because of their availability in the more open UK system and because of the early arrival of competition among financial intermediaries. See L. HANNAH, *supra* note 25, at 76. Thus both the funds and the intermediaries are, within the European Community, a significant engine for modernization or liberalization of this combined firm and intermediation structure.

The UK also offers a historical test of the argument that foreign players in time influence both the structure and the behavior of preexisting domestic intermediaries. See, e.g., D. MEERSCHWAM, *BREAKING FINANCIAL BOUNDARIES* 162 (1991).

culties,⁷⁶ as does its vacillating reaction to Member State efforts to insulate national firms from a European version of the market for corporate control. But the story has implications beyond the takeover arena, and beyond the German scene, and these implications form the basis for much of what follows. Our domestic experience with the governance role of the institutional investors may inform the pending European experience even as it may be reciprocally shaped by Europe.⁷⁷

D. *The Relationship of Institutional Investors and Firms*

The "alienation" of private sector ownership into foreign hands has at bottom a financial and economic significance. But its significance is in the first instance also a straightforward issue of corporate governance. A totally passive portfolio investor, whose unhappiness is expressed only in the time-honored way of voting with one's feet, may be easier to accept than an active one. As United States funds begin to flow into European stock markets in significant amounts, the American corporate governance situation, and especially the institutional sector's evolution towards an active role in corporate governance, will begin to have significance in the European setting.⁷⁸ At the same time,

⁷⁶ *Obstacles to Hostile Bids are Target of New EC Plans*, 2 External Impact of Eur. Unif. (BNA) 6 (May 18, 1990). On the earlier draft, see Note, *The European Community's Proposed Directive on Takeover Bids and Its Impact on Shareholders' Rights*, 16 BROOKLYN J. INT'L L. 561 (1990); see also Baums, *Übernahmeregeln in der Europäischen Gemeinschaft*, 5 ZEITSCHRIFT F. INTERNAT'L PRIVATRECHT 21 (1989).

⁷⁷ European-wide concern with these issues is reflected in DEFENSIVE MEASURES AGAINST HOSTILE TAKEOVERS IN THE COMMON MARKET (J. Maeijer & K. Geens eds. 1990); see also IBA Section on Business Law, Report, *Constraints on Cross Border Takeovers and Mergers*, 19 INT'L BUS. LAW. 51 (1991).

⁷⁸ The situation already has spawned a mini-industry of specialized intermediaries exploring the "barriers" to U.S.-style participation in the corporate governance element of foreign portfolio holdings and offering both informational and implementing services. See, e.g., INTERNATIONAL CORPORATE GOVERNANCE (J. Lufkin & D. Gallagher eds. 1990); INVESTOR RESPONSIBILITY RESEARCH CENTER, SHAREHOLDER RIGHTS ABROAD (1990); Investor Responsibility Research Center, *How to Vote Non-U.S. Proxies*, in GLOBAL SHAREHOLDER (1990).

At the same time, the relatively passive traditional attitude of foreign institutional investors, especially the British superannuation funds is giving way to U.S.-style assertive behavior. See Buxbaum, *supra* note 8, at 30; ASSOCIATION OF BRITISH INSURERS, THE ROLE AND DUTIES OF DIRECTORS — A STATEMENT OF BEST PRACTICE (1991); ASSOCIATION OF BRITISH INSURERS, RESPONSIBILITIES OF INSTITUTIONAL INVESTORS (1991), as well as the recent formation of interest groups such as the Institutional Shareholders' Committee and the Pension Investment Research Consultants. Generally to this shift of UK institu-

the different factual and legal structures within which European corporate governance relations are embedded not only dictate a different pattern of assimilation for this new type of shareholder, but hold their own lessons for the future evolution of investor-manager relations on the American scene.

The past decade has witnessed the emergence of a conscious and active institutional investor.⁷⁹ A major spur to the development of this attitude was the institutional sector's reaction to the increasingly effective effort of management, with shareholder approval, to claim for itself the right or, without that express approval, the power to forestall or defeat hostile takeover efforts. At first, the institutional drive to preserve for investors, not managers, the ultimate tender or recapitalization decision was partly blunted by the way in which financial sector intermediaries exercised much of the portfolio voting power for these institutions, along with the investment decisions themselves. The large, especially public sector institutions, however, began to draw that power in-house. The private sector institutions were willingly or unwillingly brought to the same conclusion by force of federal guidelines that come close to treating the portfolio voting power like the discretionary investment power, namely, as a plan asset.⁸⁰ This subsumption under a general duty of prudence had special bite in the area of shareholder participation in decisions to emplace antitakeover devices, but recent Department of Labor suggestions, as well as the practice of important institutional agents, such as Wells Fargo Investment

tions' behavior, see Taylor, *Can Big Owners Make a Big Difference?* 68 HARV. BUS. REV., Sep.-Oct. 1990, at 70, 78; Sherman, *Governance Lessons from Abroad*, 15 DIRECTORS & BOARDS 24 (1991). As to the German scene, and the arrival there of a respectable shareholder interest association, the Deutsche Schutzvereinigung für Wertpapierbesitzer, see *West Germany's New Investor Activism*, IRRG GLOBAL SHAREHOLDER, Aug. 1990, at 5.

⁷⁹ In lieu of direct and detailed citations to the following, see the citations in Buxbaum, *supra* note 8, at 17-25, and the recent overview in Sommer, *Corporate Governance in the Nineties: Managers vs. Institutions*, 59 U. CIN. L. REV. 357 (1990).

⁸⁰ For a discussion of this development, following on the so-called "Avon Letter" of the Department of Labor, see Buxbaum, *supra* note 8, at 25. A rare case actually focusing on the duty to vote as an element of prudence in the ERISA context is *Schoenholtz v. Doniger*, 628 F. Supp. 1420 (S.D.N.Y. 1986).

While these imperatives still are limited to the domestic field, some pressure to extend them to the voting of shares of foreign issuers is beginning to be felt, and certainly nothing in the philosophy leading to the subsumption of voting within the general duty of prudence would exclude the foreign situation. See *U.S. Labor Department Favors Global Proxy Voting*, IRRG GLOBAL SHAREHOLDER, Aug. 1990, at 2.

Advisors,⁸¹ and large mutual fund family sponsors, such as Fidelity Investments,⁸² have taken the issue beyond that specific set of problems to general shareholder activism. The upshot is that at least the large and especially the public sector fund today is an increasingly active participant in and initiator of a wide range of active corporate governance behavior patterns.

This activity has come so far along as to bump up against some significant constraints created by traditional securities regulation. These constraints may have been originally enacted to prevent financial manipulation, but now they stand in the way of new efforts to augment this institutional power.⁸³

I do not intend to recapitulate the excellent recent analyses of the technical problems that at least in the United States prevent these new owners from enjoying rights that the formal legal regime purports to grant to all owners but which are as much a snare and delusion as they are an entitlement.⁸⁴ Nevertheless, a brief sketch of these technical problems is a necessary introduction to a broader, more policy-oriented comparative review of these important efforts to implement the traditional vision of shareholder primacy in the modern setting.

The dysfunctional impact of an otherwise commendable regime of United States securities regulation on the role of institutional investors has begun to be criticized in the economic and legal literature, and need not be reviewed in detail here. Immediate reform proposals focus on the proxy system, especially on its unavailability for a modern, institutional investor-driven form of director nomination and to a lesser extent on its potential threat to communication between these shareholders.⁸⁵ The

⁸¹ See Buxbaum, *supra* note 8, at 19.

⁸² See Investor Responsibility Research Center, 6 CORP. GOV. BULL., Nov.-Dec. 1989, at 153. This particular development of more aggressive postures in hitherto quiescent segments of the institutional investor sector also is noted by Gilson & Kraakman, *supra* note 9, at 9 n.11.

⁸³ Fiduciary rules from sources other than securities regulation (e.g., from ERISA or common-law sources) also may constrain active governance behavior, especially at the boardroom level, by institutional investors. See Roe, *Institutional Investors in the Boardroom*, in *INSTITUTIONAL INVESTORS: CHALLENGES AND RESPONSIBILITIES* (A. Samsetz & J. Bickler eds. forthcoming 1991)

⁸⁴ These are particularly well set forth in Conard, *supra* note 6, and much of what follows in the text is taken from that source.

⁸⁵ Black, *supra* note 15, at 536, details yet other problems for institutional investors under the current proxy regulation regime.

major initiative of CalPERS to put reconsideration of these issues on the SEC's agenda,⁸⁶ and the clear if muted resistance of the corporate establishment to that reconsideration, are evidence of the importance of this problem. They also demonstrate the new role of the old legal regime to insulate management's control of the director nomination process, and more generally of the overall process of setting the agenda for shareholder voting, against intrusion by the new ownership.

A second reform effort, proposed by Conard⁸⁷ but not yet finding resonance elsewhere,⁸⁸ is directed to the inappropriate application of the problematic "controlling person" concept of traditional securities regulation to this new group of institutional investors, if they take collective or consciously parallel actions that trigger the concept and its many civil and administrative consequences. In his view, the underlying original purpose of creating this vague but potent "controlling person" concept, namely, to prevent intrusion on corporate decision-making processes by financial institutions not acting through the board of directors, is inapplicable to the benign purposes for which institutional investors form coalitions (primarily, to nominate and elect directors). Whether it is so easy to separate the investment banker goat from the institutional investor sheep, however, is not obvious at first glance. The issue has deeper and more ambivalent implications involving the appropriateness of bringing institutional investors into the kind of private intermediation network proposed by the Jensen privatization thesis and found under rather different circumstances in the traditional German intermediation structure.⁸⁹

A third constraint lies in the antitrust laws. The Hart-Scott-Rodino Antitrust Improvements Act of 1976 requires the filing of information about the acquisition of certain percentages of a firm's shares with the Department of Justice to permit consideration of antitrust issues. This has been reported to be a significant deterrent to concerted if not individual institutional

⁸⁶ See the widely circulated formal request from CalPERS to the Division of Corporate Finance, S.E.C. (Nov. 3, 1989), *reprinted in* INSTITUTIONAL INVESTORS: PASSIVE FIDUCIARIES TO ACTIVIST OWNERS 454 (1990).

⁸⁷ See Conard, *supra* note 6.

⁸⁸ See especially the critique of Gilson & Kraakman, *supra* note 9, at 56.

⁸⁹ See text accompanying note 56 *supra*.

purchases.⁹⁰ An even more significant constraint may be in the offing, now that aggressive private defensive efforts to take a firm "out of play" are being buttressed by an increasing number of statutes that not only support specific defenses (such as control-share acquisition constraints)⁹¹ but authorize management to consider the interests of other constituencies in general.⁹² In response, equally aggressive countermoves by some institutional investors also have developed.⁹³ There is a potential if slight risk that these can cross the line of antitrust law. For example, this might be the case with a call for a collective boycott of institutional investment in a firm taking advantage of Pennsylvania's recent and deservedly notorious antitakeover and antiproxy contest statute.⁹⁴ In short, a number of public law regimes, and not only the law of securities regulation, inadvertently if not legitimately stand in the way of at least some proposed means to the achievement of a more assertive role for institutional investors in their capacity as shareholders and voters.⁹⁵

⁹⁰ 15 U.S.C.A. §§ 1311-1312 (West Supp. 1991). See Conard, *supra* note 6.

⁹¹ See, e.g., the various classes of "control share" and "business combination" statutes analyzed in Sroufe & Gelband, *Business Combination Statutes: A 'Meaningful Opportunity' for Success?* 45 BUS. LAW. 891 (1990).

⁹² See the notorious Pennsylvania antitakeover and antiproxy contest statute, 15 PA. CONS. STAT. ANN. § 2571 (Purdon Supp. 1991). Another bellwether of this new retrograde approach is the 1990 Massachusetts statute reported by Gilson & Kraakman, *supra* note 9, at 15 n.25. The more generally phrased "stakeholder consideration" statutes are cited and briefly reviewed by Lipton & Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 214 (1991), who count 29 such statutes by the date of publication.

A separately fascinating and dubious approach, redolent of German social theory of the Rathenau era, is a 1989 addition to the Michigan Business Corporation Act, 1989 Mich. Pub. Acts 121, which would allow an appropriately qualified "independent director" to represent "the corporation" rather than shareholders, and carry out that representative function in an institutionalized form reminiscent of an ombudsman. See thereto Moscow, Lesser & Schulman, *Michigan's Independent Director*, 46 BUS. LAW. 57 (1990).

⁹³ For a recent survey, though at a slightly hyperbolic level, see Fromson, *The Big Owners Roar*, FORTUNE, July 30, 1990, at 66. See also Paré, *Two Cheers for Pushy Investors*, FORTUNE, July 30, 1990, at 95.

⁹⁴ See note 92 *supra*. Not in confirmation of the legal evaluation of this behavior, but in confirmation of its sensitivity, see the remark of Walter Wriston, former CEO of Citibank, N.A., that when "big pension funds (even public pension funds) get together and decide on what they think, they run the risk of triggering anti-trust laws," in *CEOs Speak Out On Directors*, MGMT. REV., Oct. 1990, at 15.

⁹⁵ A good picture of the efforts to institutionalize institutional investors' ability to pool information and to coordinate action can be gleaned from *Hearing on The Impact of Institutional Investors on Corporate Governance, Takeovers, and the Capital Mar-*

This tension can only be understood and resolved within the context of the various levels of markets—for firms and for shares—within which these actors engage and contend.

E. *Public and Private Markets in Comparative Perspective*

Most of the discussion of institutional investor participation in corporate governance proceeds from a liberal, market-oriented economic premise. This premise requires the active participation of this new actor in the standard American capital market, a market that allegedly monitors firm performance through two subparts—its clearing market and its corporate control market.⁹⁶ Corporate management's well-documented efforts to escape from the consequences of the latter and its arguable encouragement of a dysfunctional "short-termism,"⁹⁷ while they have been reasonably successful at state judicial and now even legislative levels,⁹⁸ suffer from an eventually unbrookable contradiction. These firms wish to remain in the public market yet avoid one of its still inescapable attributes, namely, its corporate control monitoring.⁹⁹ Only the privatization of these firms, in Jensen's terms,¹⁰⁰ would be consistent with that wish; but in a products and services market like that of the United States, that solution simply is not available for at least the top thousand and perhaps the top five thousand firms.

Here, too, the experience of Germany in its version of that privatized structure is instructive and, to some critics of American "short-termism," seductive. Faced with the liberalization of the European capital markets that is an essential concomitant of the creation of an "American-sized" single and internal market

ket, *Before the Subcom. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 101st Cong., 1st Sess. 123-212 & passim (Oct. 3, 1989).

⁹⁶ Fama, *Agency Problems and the Theory of the Firm*, 88 J. POLIT. ECON. 288 (1980).

⁹⁷ See, e.g., Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987).

⁹⁸ See the statutes cited by Lipton & Rosenblum, *supra* note 92.

⁹⁹ From this perspective, at least, the argument of G. ROTH, *DAS TREUHANDMODELL DES INVESTMENTRECHTS; EINE ALTERNATIVE ZUR AKTIENGESELLSCHAFT?* (1972), in favor of converting the shareholder into a passive trust beneficiary was consistent in formulating a powerful redemption right for otherwise disenfranchised shareholders. In this way, an indirect market test and market reference remains to control management behavior and results.

¹⁰⁰ See Jensen, *supra* note 56.

for goods and services, German policy makers public and private agree, whether enthusiastically or reluctantly, that the opening of its financial market structures is unavoidable.¹⁰¹ The German economy's current transition out of its traditional privatized, off-market firm structure strongly suggests that a privatization structure for an economy and polity above a certain minimum size is not feasible.

In any event, at least on the American scene and within the American historical and political context, the Business Roundtable's preferred solution of a joint managerial-financial-institutional corporatism is an unstable one. It would be untempered even by that indirect mediating/monitoring superstructure available in the tight and disciplined interlock with financial intermediaries still, if decreasingly, found in Germany and Japan but clearly unavailable in the United States with its large number of competitive financial intermediary institutions.¹⁰² The simple mention of the recent collapse of Drexel Burnham Lambert and of much of the savings and loan industry—and perhaps the relationship between these phenomena¹⁰³—should suffice to remind us of this difference.

Even more to the point, this managerial solution would need a level of ideological legitimation that simply cannot be

¹⁰¹ The unusual public hearing conducted by the Economic Committee of the German Bundestag in May of 1990 on the topic, "The Power of Banks" [*Bankenmacht*], in response to the parliamentary questions submitted by the Social Democratic Party and the Greens, was to a considerable extent motivated by this changing European scene. See Protokoll No. 74, 11th Wahlperiode, Deutscher Bundestag, Ausschuss für Wirtschaft, Az. 742-2401, May 16, 1990, Stenographisches Protokoll [Stenographic Transcript of the 74th Session of the above committee]. Question No. 1 to the assembled experts read:

How do you judge the competition of the banks among themselves, as well as that between banks and other financial enterprises (e.g., insurance firms) in the Federal Republic of Germany? How will the EC common market affect the national and international competitive position of the German banks? What role will the trend to all-purpose financial institutions play here?

Id. at 5 [Author's translation].

¹⁰² This is the principal reason for questioning the import of current *institutional* mechanisms by means of which the German and Japanese banking systems provide the kind of "audit management" that comes closest to the kind of oversight a large bloc holder which cannot sell its holdings exercises over the firms in the portfolio. See the eloquent plea for this approach in Drucker, *Reckoning with the Pension Fund Revolution*, 69 HARV. BUS. REV., Mar.-Apr. 1991, at 113.

¹⁰³ See Stevenson, S. & L. *Tries Recasting Self as Victim*, N.Y. Times, Nov. 19, 1990, at D1, col. 6.

found in its current adversarially formulated presentations.¹⁰⁴ The old legitimating ideology—the myth of shareholder supremacy—had to be abandoned once institutional shareholdership threatened to make it real,¹⁰⁵ but giving that new ownership a pejorative connotation is at best a defensive tactic, but hardly a legitimating ideology. That can only be found through cooperation with these new institutions that, after all, represent all of us in our capacity as salary and wage earners.

In addition—and not in contradiction—the liberal economic premise on which this managerialist version of corporatism would function faces a severe test once ecological imperatives are expected to be operationally satisfied within its framework. If the ecology, along with the atom bomb, loomed large enough to render irrelevant the Marxist-Leninist belief in the inevitability of the collapse of capitalism, it behooves us to take seriously the possibility that it will also put that system under significant pressure. This, more than concern with the negative consequences of exposing corporate decision-making to the short-term mentality of stock and control markets, is what dictates a new respect for a different, longer term vision of corporate behavior.¹⁰⁶ And this vision, unlike the adversarial vision of institutional investors as short-term profligates that underlies the narrow view of short-term versus long-term decision-making immanent in the liberal economy, needs the cooperation of institutional ownership with corporate management to be realized. Further, that cooperative venture now has a unique opportunity to be realized. It can find in the wage-based origin of much of that institutional ownership a unique and perhaps the only en-

¹⁰⁴ See, e.g., THE PUBLIC POLICY INSTITUTE OF NEW YORK STATE, THE \$600 BILLION BURDEN (1988); Lipton, *supra* note 97.

¹⁰⁵ See Buxbaum, *Juridification and Legitimation Problems in American Enterprise Law*, in JURIDIFICATION OF SOCIAL SPHERES 241 (G. Teubner ed. 1987).

¹⁰⁶ This is more than simply a broader version of what already has occurred in the specific context of "socially sound" investing by institutional shareholders. See B. LONGSTRETH, CORPORATE SOCIAL RESPONSIBILITY AND THE INSTITUTIONAL INVESTOR (1973); J. SIMON, C. POWERS & J. GUNNEMAN, THE ETHICAL INVESTOR: UNIVERSITIES AND CORPORATE RESPONSIBILITY (1972). It involves the incorporation or subsumption of previously "external" values within the profit-maximization paradigm. For the macroeconomic version of this argument, see Passell, *Rebel Economists Add Ecological Cost to Price of Progress*, N.Y. Times, Nov. 27, 1990, at C1, col. 5 (reviewing the activities and expectations of the International Society of Ecological Economists).

during legitimation for embarking on the voyage to integrate ecological and efficiency concerns in a new statement of corporate missions and processes.

III. A NEW RELATIONSHIP — AMERICAN AND EUROPEAN PERSPECTIVES

This is a plea pitched at a high level of generality. Therefore, a few comments on the validity of the diagnosis and the operational possibilities of any prescription are appropriate.

A. *The Goals of Management and of Institutional Owners*

First, the diagnosis. In my opinion, it is not the fear of the corporate stock and corporate control markets that leads a Fortune 100 company to resist the internalization of the social costs inherent in an appropriately long-range view of production and distribution policies that are sound from environmental and social perspectives. It is simply the normal, understandable, and to a degree societally legitimated drive for profit maximization that has long been thought to be the essential condition for the production of goods and services at low prices. That, alone, would not distinguish the American setting from others. This drive, however, takes place, at least in the United States, within a cultural frame of reference that sees labor and capital as antagonistic competitors, and in a setting untempered by the mediating institutions found in other liberal economies at both the governmental and the societal (especially the firm) level.

It is not, again, fear of these monitoring markets that turns all but a very few firms away from seeking ways to join public sector producers in filling the critical need for social goods ranging from transportation and communication infrastructure, to shelter and education, to the absorption of an increasingly dysfunctional and racially specific surplus labor population. It is, simply, the traditional focus on the production of privately purchasable and priceable goods and services. And we could extend the litany. In short, whatever our individual value judgments about the appropriate role of private sector firms may be, it should be clear that the "long range" versus "short range" arguments and prescriptions abounding within the traditional liberal economic framework are an inadequate substitute for the combined ecologic-economic frame of reference that is beginning

to be perceived as vital for the survival of a liberal economy—as it would have been for a socialist one.¹⁰⁷

Second, the prescriptions. A universe of small shareholders, whatever their individual value orientations towards these considerations, cannot bring these values to bear on the private sector the way firms and markets presently are organized. Indeed, to sharpen the paradox, even if they could do so with their voluntary savings, perhaps through ecologically “sound” firms and mutual funds, they could not do so with the increasingly large proportion of their wealth that is involuntarily or at least collectively saved and invested.¹⁰⁸ Only large institutional intermediary shareholders can act in this fashion.

To do so, they need two things. First, they need mechanisms to express their values to their portfolio firms more directly than is feasible by means of voting or acting in the capital and, especially, the control market (though they need those, too). In the second place, they need mechanisms to formulate these postulated values within their own boundaries before transmitting them to those firms, in order to legitimate their own behavior and decisions.

B. *Behavioral Versus Structural Implementation*

It is on the first issue that most recent commentary has focused, beginning with current legal rules governing the exercise of institutional investors’ rights, as briefly reviewed above, and moving on to proposals or critiques of alternative mechanisms and processes by means of which these voters might influence corporate management. And within this first issue, most atten-

¹⁰⁷ See Heilbroner, *Economics as Ideology*, in *ECONOMICS AS DISCOURSE* 101 (W. Samuels ed. 1990); *Reflections (After Communism)*, *THE NEW YORKER*, Sept. 10, 1990, at 91, 91, 99; and, from a perspective slightly more critical of the ability of labor and management together to take strong ecologically responsible decisions, see Hoss, *Runder Tisch für die Umwelt*, *Die Zeit*, Nov. 9, 1990, at 13 (Hoss was parliamentary speaker for the Greens in the Bundestag).

A first step in this direction is the effort of institutional investors to bring environmental issues before shareholders via the shareholder proposal route (e.g., the “Valdez Principles” issue). See Minow & Deal, *Corporations, Shareholders, and the Environmental Agenda*, 12 *CARDOZO L. REV.* 1359 (1991); Pink, *The Valdez Principles: Is What’s Good for America Good for General Motors?*, 8 *YALE L. & POL’Y REV.* 180 (1990).

¹⁰⁸ This is already clearly recognized in K. HOPT, *DER KAPITALANLEGERSCHUTZ IM RECHT DER BANKEN* 207 (1975) who following upon this recognition examines earlier efforts to insinuate such shareholder representation into traditional board structures.

tion has been paid not to the structures within which and the procedures by means of which these investors' agents would play out their governance functions, but to the actors themselves, their attributes and means of selection.

This, I believe, is starting at the wrong end, the personalized end, of the problem. It should be neither surprising nor distressing that the pool from which the new recruits are to be chosen is the same pool from which today's recruits come. If Caesar and Spartacus mark the extremes of the conceivable range of governors of that modern version of the state called the large-enterprise sector, and if Samuel and Jeremiah mark the extreme of the conceivable range of the formers' monitors, then the range between the background of the CEO and the background of the new professional independent director recruited from the ranks of senior partners of large accounting, law, and investment banking firms appears as little more than a point on the former spectrum.¹⁰⁹

At this cosmic level, of course, the differences between national business cultures that do exist even among states of similar economic organization tend to disappear, and our exercise tends to lose specific comparative salience. It therefore is preferable, if anticlimactic, to return to the second-order set of differences existing among those nations, differences expressed in variant forms of savings and investment patterns, of owner and manager relations, and of general neo-mercantilistic and liberal accommodation.

Two features are worth examining at that second-order but for that reason genuinely comparative level: the real structure and function of enterprise monitoring, and the real structure and function of intermediation between saver-beneficiaries and institutional investors. It is my argument that the latter is more basic than, and determines, the former. I begin, nonetheless, with the former and, in particular, with a look at the often pos-

¹⁰⁹ A salutary lesson as to whether there is adequate personal behavioral differentiation between the two types of representatives may be gleaned from the analogous role of independent counsel representing the independent directors' litigation committee in the typical derivative suit. I will not extend this discussion by delving into this experience, but will rest on the assertion that the results obtained by means of this process do not suggest that the independent nature and well-paid status of this professional version of decision making gives us reason to hope for the sea change expected by Gilson & Krankman, *supra* note 9.

tulated difference between managerial and professional cultures. Berle and Dodd introduced that dimension of professionalism in their deservedly famous Depression-era debate two generations ago,¹¹⁰ and it underlies even the assumptions, not to mention the solutions, found in the current business, professional, and academic literature briefly presented above.

An appropriate starting point for this part of our inquiry is the excellent recent critique and proposal of Gilson and Kraakman.¹¹¹ In order to demonstrate the validity of their preferred solution to the governance problem, namely, the paid professional director hired by and responding to an institutional investor and representing the latter on a number of boards sufficient to generate an appropriate professional income for this representative, they first consider and dismiss two alternatives.¹¹² The first is the shareholders' advisory committee, to which I return below. The second is a contrasting pair of governance figures they label the LBO and the German/Japanese governance model respectively.

According to Gilson and Kraakman, the newly privatized corporation, hailed by Jensen as the wave of the future, whose managers and sponsors are effective monitors for their passive institutional investor-partners because they themselves hold substantial equity positions, is an inadequate model because it resolves the governance dilemma "largely by eliminating it through the wholesale substitution of debt for equity and the introduction of overwhelming financial incentives. The LBO recipe not only prescribes withdrawal from the public market; it also requires a massive reassignment of equity to insiders."¹¹³

This model Gilson and Kraakman contrast with a "radical alternative," the German/Japanese "bankers model," while noting their underlying similarity: the unification of ownership and control in the person of a professional intermediary which has a direct equity involvement in the monitored firm. This alternative is deemed as inappropriate to the American scene as is its

¹¹⁰ Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

¹¹¹ See note 9 *supra*.

¹¹² See also Adams, *Zur Behandlung von Irrtümern und Offenbarungspflichten im Vertragsrecht*, 108 ARCHIV FÜR CIVILRECHT 453 (1986).

¹¹³ Gilson & Kraakman, *supra* note 9, at 877.

homegrown "LBO" counterpart, because, they assume, the American institutional investor is fated to remain rooted in a legal and political culture that dictates institutional ignorance and institutional passivity. The preferred solution, then, is the professional director who will bridge the gap between the governance and the ownership of public companies.¹¹⁴

As I have already suggested, however,¹¹⁵ the operational difference between the old director proposed by management to fill the monitoring position, and the new director, proposed by owner to manager to play that role, lies primarily in the recruitment channel and the pay scale. The old director is a current or retired CEO of a noncompeting firm; the new director is an accountant, investment banker, or attorney, typically a member of a firm whose principal function is to give legal or management consulting advice to the management of the companies to be monitored. At a time when the entire production sector of the former German Democratic Republic is in the hands of a reorganization trustee (the *Treuhandanstalt*), staffed by a baffling—and baffled—mix of these old and new types,¹¹⁶ it is particularly beguiling to contemplate the role of these proposed monitors.¹¹⁷ The comparison may be challenged, but I believe that the few analogous experiences we have available, particularly the mentioned role of independent directors and independent counsel in disposing of derivative litigation, do not suggest unbridled optimism about the role of the proposed professional directors.

¹¹⁴ They overlook, and I leave as a subject for another day, the problem well articulated in C. STONE, *WHERE THE LAW ENDS* 184-98 (1975). Stone argues that the most important involvement of external (including owner) actors is below the level of a board of directors. Recent European commentary, however, already has begun to reexamine this issue from the specific perspective of institutional investment. See, e.g., Rehinder, *Andere Organe der Unternehmensverfassung*, 18 *ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT* 305 (1989). For a first American look at this kind of institutional solution, see Futter, *An Answer to the Public Perception of Corporations: A Corporate Ombudsperson?*, 46 *BUS. LAW.* 29 (1990).

¹¹⁵ See note 109 and accompanying text *supra*.

¹¹⁶ Compare *Die Wollen gar Keine Hilfe*, *DER SPIEGEL*, Sept. 1990, at 40 and *Aufgabe Nicht Verstanden*, *WIRTSCHAFTSWOCH*, Aug. 24, 1990, at 14 with the moderate analysis of Christ, *Wunder dauern etwas länger*, *Die Zeit*, Nov. 16, 1990, at 7.

¹¹⁷ See the discussion of the role of independent counsel for independent directors' litigation committees, at note 109 *supra*.

C. *The Comparative Contribution to the Governance Debate*

We now have intimated that there are two arguments supporting a closer look at a more intimate, less "external" and adversary corporate governance relationship between the institutional investor and the firm. One derives from the privatization hypothesis, the other from the all too briefly sketched "economic" hypothesis. Both rest on a politically shaped view of economic institutions and are not too concerned with the analytical version of economic analysis of firms and markets that dominated recent discussions until real actors in real institutions confounded both its proponents and its critics.¹¹⁸ Further, they have this in common: they would make the issue of corporate governance, whether of the Lipton & Rosenblum or the Gilson & Kraakman variety, dependent on the financial and economic role of institutional investors, rather than making corporate governance the primary issue.

In this situation, a closer look at the relation between financial intermediation and corporate governance is more important than, or at least logically precedes, a closer look at whether the shareholder-paid professional director is a better director than the president of a university, the retiring CEO of a neighboring company, or the investment banker.

I believe it can be demonstrated that the LBO model is not a variant of the German/Japanese banker model, but an essential definitional component of the latter. The banker model is the expression of the historically contingent rise of finance capitalism to its current position of influence; the LBO model, in turn, is a minor operational description of that banker model. The "massive reassignment of equity to management," which to Gilson & Kraakman is so critical a component of the American model and of its distinguishability from the German/Japanese model is, in economic terms at least, an accidental feature.¹¹⁹ It

¹¹⁸ See Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CALIF. L. REV. 1671 (1985).

¹¹⁹ In historical/cultural terms, however, it may be more than an accidental feature; indeed, it may be yet another indicator of some basic structural and behavioral differences between the European and American business and financial scenes. These differences may have more to say about appropriate structures of regulatory/self-regulatory, prospective/retrospective, administrative/civil, and—generally—private/public societal interaction with these sectors than differences explained in (more easily explainable) economic terms.

occurs at the time of transition from public company status to private company status. It is neither a necessary nor a stable element of the future operation of the LBO company, but simply a transfer payment to old management by the financial intermediary/sponsor of the transition, which in turn allows the latter to make—and profit from—the changeover. The market failure implicit in the opportunity of management to exact this transfer toll probably can be traced to the background of the old director type as much as to the conflict of interests inherent in the financial intermediary structure, but that is another story.¹²⁰

If this characterization is descriptively valid in rough terms, then the far more critical inquiry is to compare the traditional American corporate governance structure with the traditional German one, and to identify the underlying features of financial intermediation that explain the differences this comparison reveals.¹²¹ By historical accident, the German *Grossbank* gained its double foothold on the German corporate directorate first through its role as veto-holding guest owner during the period of hyperinflation,¹²² then through its role as proxy-holder of publicly held shares, and finally through its ability to carry past World War II its universal banking role of equity as well as credit supplier to German firms.¹²³

An essential condition of this progression was and is the tightly oligopolistic structure of the German major-bank sector, which has its own quite contingent historical explanation. A second condition is the predominance in Germany of firms smaller and less conglomerate than many American, British, and Japa-

¹²⁰ See Crystal, *Cracking the Tax Whip of C.E.O.s*, N.Y. Times, Sept. 3, 1990 (Business World Supp. Magazine), at 48, 54; cf. Denis, *Defensive Changes in Corporate Pay-out Policy: Share Repurchases and Special Dividends*, 45 J. FIN. 1433, 1453 (1990); see also the sources cited in Instit'l Shareholder Services, Inc., *Executive Pay — Up, Up, and Away*, 6 ISSUE ALERT, May 1991, at 1.

¹²¹ For the fairly analogous Japanese situation, see especially Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LITERATURE 1 (1990) and Sheard, *The Main Bank System in Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAV. & ORGANIZATION 399 (1989), also discussed in Gilson & Kraakman, *supra* note 9, at 27. For a thorough general discussion, see THE JAPANESE FINANCIAL SYSTEM (Y. Suzuki ed. 1987). For a recent US-Japan comparison, see MEERSCHWAM, note 75 *supra*.

¹²² See K. NÖRR, *ZWISCHEN DEN MÜHLSTEINEN* (1988).

¹²³ The recent analysis in Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991), fruitfully contrasts with the German situation the facts and reasons for the fragmented role of banking and insurance institutions as corporate equity owners.

nese multinationals, firms that make their global mark more through niche exploitation than through the broad-ranging product line coverage typical of those other multinationals. That institutional difference permits these firms to fit more readily into the tightly organized universal *Grossbanken* structure than would, say, a General Motors with its need to use public capital markets even for commercial paper placement let alone for equity support. And a third reason may lie in the influence of the German financial authorities, especially the *Bundesbank*, which for policy reasons until recently wanted no expansion or institutional restructuring of money markets—and, by implication, of capital markets—outside the framework of the *Grossbanken*.¹²⁴ Whatever its provenance or reasons for enduring, the German version of the institutional investor is the universal bank, which by law may hold 25 percent of the common stock of any non-banking firm,¹²⁵ and which through the tight proxy mechanism known as the *Depotstimmrecht* (*Depot*) may control up to an actual majority of the firm's voting stock.¹²⁶ This institutional investor, which as a financial intermediary moves savings to the

¹²⁴ See Schaeede, *Liberalization of Money Markets: A Comparison of Japan and West Germany*, 1989 J. INT'L ECON. STUDIES 25 (1989). On the actually developing role of the mark and the yen in international capital markets, see, respectively, Tavlas, *On the International Use of Currencies: The Case of the Deutsche Mark* (IMF Working Paper, unpublished, Jan. 1990), and Tavlas & Ozeki, *The Japanese Yen as an International Currency* (IMF Working Paper, unpublished Jan. 1991).

¹²⁵ The most frequently cited study is a governmentally commissioned one. See Bericht der Studienkommission (Gessler Kommission), *Grundsatzfragen der Kreditwirtschaft*, 28 SCHRIFTENREIHE DES BUNDESMINISTERIUMS DER FINANZEN (1979). See also the journalistic account in 1979 DER SPIEGEL, at 81.

For an earlier survey of actual bank participation in the stock ownership of German firms, see G. PUTTNER, *DAS DEPOSTIMMRECHT DER BANKEN* (1963), which also, as the title implies, surveys the agency control available through the transfer of voting rights to these banks by other shareholders. On the latter phenomenon and its legal as well as factual basis, see W. VALLENTIN, *DIE STIMMRECHTSVERTRETUNG DURCH BANKEN NACH DEM AKTIENGESETZ VON* (1965).

The recent (1989) debate centering around a proposal to reduce the maximum percentage of firm ownership by one bank to 5% is reviewed in *Die Macht der Banken*, 43 Z. GES. KREDITWESEN 1 (1990). For a brief English-language discussion, see Kallfass, *supra* note 71.

¹²⁶ See the recent and detailed review of holdings and of voting power in Gottschalk, *Der Stimmrechtseinfluss der Banken in den Aktionärsversammlungen von Grossunternehmen*, 1988 WSI-MITTEILUNGEN 294. As of the end of 1989, the three *Grossbanken* held custody of over 44% of all domestic shares held by all financial institutions in *Depot* form, comprising a market value of approximately DM 300 billion. See AG-Report, 35 DIE AKTIENGESELLSCHAFT R 378 (1990).

German firm through both its equity and its debt channels, plays a particularly important role in that firm, in part because of the two-tier board structure that is a feature of the German legal system.¹²⁷ It typically occupies one position and has at least a crisis-activated influence on the occupancy of the other positions on the firm's supervisory council, the *Aufsichtsrat*. In other words, this investor can influence the filling of those positions (one-half the total) that the law does not assign to employees and thus leaves to shareholders to fill.¹²⁸ It thus can strongly influence, at least by veto if not by full power of initiative, the choice of the CEO, and thereby, indirectly, the composition of the second-tier managing board, the *Vorstand*. What managerial strategies and decisions it does not formally control through these ownership-related rights and powers it can influence through its intimate and, as the "*Hausbank*," preferred if not exclusive credit-extender position vis-à-vis the firm.¹²⁹

This powerful symbiosis was made possible by the availability of a stable, low-cost domestic deposit base unchallenged by competitive investment opportunities. It has not gone unnoticed or unchallenged in Germany¹³⁰ and in neighboring states, and

¹²⁷ See the recent comprehensive factual review in K. Fischer, *Hausbankbeziehungen als Instrument der Bindung zwischen Banken und Unternehmen* (Diss., Bonn 1990) and the overview and evaluation in Baums, Banks and Corporate Control Program in Law and Economics, University of California at Berkeley (Working Paper No. 91-1) (unpublished 1991) (both on file at Boalt Hall Law Library).

¹²⁸ The explanation by Werner, *Aufsichtsratsstätigkeit von Bankenvertretern*, 145 Z. GES. HANDELSRECHT 252, 253 (1981) emphasizes the minority role of "the" bank representative largely by pointing to the parity of labor members arising from the codetermination feature of German law. In fact, however, it is not the normal power of the executive management to propose candidates but the ability to monitor this power that is at issue.

¹²⁹ To this should be added the important role of cross-holdings of equity shares among the large industrial firms themselves, which supports and is supported by this banking sector interlock. For a recent critique specifically of this phenomenon, see Monopolkommission, *Gesellschaftsrecht und Konzentration*, HAUPTGUTACHTEN 1986/1987, 281 (1987). Cf., however, the review of more recent studies in Baums, *supra* note 74, concluding that the larger the client firm, the less significant any single bank, although also confirming that the "Big Three" collectively retain significant influence of the type described in the text.

¹³⁰ Indeed, it is a favorite and enduring topic of debate in both its factual and normative implications. Of the postwar literature alone, see, e.g., E.J. MESTMÄCKER, *VERWALTUNG, KONZERNGEWALT UND RECHTE DER AKTIONÄRE* (1958); R. WIETHÖLTER, *INTERESSEN UND ORGANISATION DER AKTIENGESELLSCHAFT IM AMERIKANISCHEN UND DEUTSCHEN RECHT* (1961); G. ROTH, *supra* note 99, at 184; U. IMMENGA, *AKTIENGESELLSCHAFT, AKTIONÄRS-INTERESSEN UND INSTITUTIONELLE ANLEGER* (1971); E. SCHWARK, *ANLEGERSCHUTZ DURCH WIRTSCHAFTSRECHT* (1979).

may yet be subject to erosion as a consequence of the liberalization of European capital markets and financial intermediation systems attendant on "Europe 1992."¹³¹ One powerful legitimization of its existence and endurance, however paradoxical this may seem at first glance, is the development of the parity concept of codetermination—*Mitbestimmung*—and the participation by employees, in substantial part through their organized labor representatives, in the governance structure of the German firm. Winter's argument, more than a quarter-century ago, that only an oligopolistically organized industrial sector could deal with an oligopolistically organized labor sector (and vice versa) in reciprocally satisfactory ways and with mutually acceptable results,¹³² finds strong confirmation in the German firm governance structure of today.

Earlier I sketched the primary consequences of this system for the organized capital market of Germany and its limited absorptive capacity for foreign institutional investment, as well as the secondary consequence that this saturation danger is beginning to express itself in the behavior of German firms vis-à-vis the new, foreign institutions that would enter their ownership universe via that market. Now, however, it is the more positive role of labor participation in the guidance of, and thus in the social legitimization of, the private-sector firm that I wish to explore for the comparative insights this labor participation may shed on the relationship of the new institutional investor to the governance of corporations.

D. *The Relation Between Financial Structure and Corporate Governance*

This employee participation mechanism not only is embedded in the just described specific organizational relationship between the German finance and productive sectors, but in all probability could not have been introduced and could not function except within the context of that specific relationship,

¹³¹ On the other hand, it also has been recommended as the appropriate European, if not even American, form. See, e.g., Steinhjerr & Huveneers, *Universal Banks: The Prototype of Successful Banks in the Integrated European Market? A View Inspired by German Experience*, (1990).

¹³² Winter, *Collective Bargaining and Competition: The Application of Antitrust Standards to Union Activities*, 73 *YALE L.J.* 14, 19 (1963).

which itself of course is an expression of nationally specific older and deeper economic, political, and social structures. One way to examine its potential utility on the American scene, therefore, is to examine the possible convergence between the underlying financial-economic organizations in the United States and Germany.

If Jensen's privatization hypothesis is to be proved in practice, it will require the presence of strong private investors, able and motivated to take "private-placement" positions next to their investment banker counterparts. While the long-expected and equally long-delayed arrival of universal banking in the United States might be seen as one way to encourage the local adaptation of the German structure, that overlooks the significant structural difference, in terms of number of competitive units, between the two countries. It would take more consolidation of the American banking sector than anyone foresees before that sector could begin to function with the minimum degree of oligopolistic discipline that is the hallmark of the German scene.¹³³

Nonetheless, the institutional investors, especially the large pension funds, are in a position to fulfill at least a large part of that private placement mission.¹³⁴ Indeed they had been enthusiastically trying to do so during the LBO, MBO, and defensive recapitalization movements of the recent past.¹³⁵ On balance, the

¹³³ On the reasons for these different patterns of firm organization and their relation to the roles of banks in primary capital formation and in secondary capital market development, see Tilly, *Banking Institutions in Historical and Comparative Perspective: Germany, Great Britain and the United States in the Nineteenth and Early Twentieth Century*, 145 Z. GES. STAATSW. 189 (1989).

For an interesting review of the relatively high proportion of friendly as against hostile takeovers even in the UK economy, and the reasons therefore, see Franks & Mayer, *Capital Markets and Corporate Control: A Study of France, Germany and the UK*, 10 ECON. POL'Y 192 (1990).

¹³⁴ Parker & Star, *Partnerships Seek to Raise \$8.6 Billion*, PENSIONS & INVESTMENTS, Oct. 17, 1990, at 3, reviewing institutional investors' recent interest in this private route, makes the additionally interesting point that new decision making or at least participation structures may evolve specifically through this form of intermediation: "Moreover, the partnerships are evolving into true joint business ventures between the general partners and their institutional partners. Some partnerships have set up . . . advisory boards whose members include institutional partners. A few have begun inviting institutional partners to meetings with the top executives of the portfolio companies." See also Roe, *supra* note 123, at 55, on the monitoring possibilities of more structured forms of direct institutional investment.

¹³⁵ The current outcome of this suggests a salutary lesson about the desirability of

Jensen scenario may still be deemed a highly questionable one within the framework of the highly competitive financial intermediation sector that marks the American scene, and would hardly yield the field to these new intermediaries without a fight. Nevertheless, to the extent that the privatization scenario has even a partly viable future, it would demonstrate some convergence with the German model, primarily because of the major direct role institutional investors seem to be prepared and able to play in that scenario.

Nonetheless, if the underlying social, political, and bureaucratic infrastructure for this kind of a role diverges as widely between Germany and the United States as I have briefly suggested, and if the German version is itself as subject to structural change in its new liberal European context as I believe, a skeptical attitude towards the "European" role proposed for the American pension fund, and towards the governance patterns growing out of that role, remains appropriate. Instead, other aspects of the German experience, aspects relating more directly to the legitimacy of the German intermediation-and-governance structure, may turn out to be more interesting analogies in our search for the appropriate governance structure in the American context. It is to these aspects that I would like to devote the balance of this discussion.

This more attractive convergence hypothesis rests directly on the growing congruence of the American public pension fund segment of institutional investors and the German cohort of labor members of corporate boards—not in their role as capital providers, which they do not share, but as participants in corporate governance. The German employee (*Arbeitnehmer*) enjoys parity of representation on the first-tier supervisory council, the *Aufsichtsrat*, subject only to the tie-breaking right of the representatives of shareholders. The employee participates in this version of corporate governance on the basis of a social compact that, however disputed its original emplacement may have been, is supported today by a broad spectrum of political and economic forces.¹³⁶ It may not be directly capable of insinuation

moving these pension funds into the private intermediation role envisaged, or at least necessitated, by the privatization hypothesis.

¹³⁶ See Kübler, Book Review, 153 Z. GES. HANDELSRECHT 496 (1988)(reviewing D. REUTER, *DIE MITBESTIMMUNG ALS BESTANDTEIL DES NORMATIVSYSTEMS FÜR DIE JURISTIS-*

into American economic institutions because of the different underlying conditions that have already been mentioned,¹³⁷ but for reasons specific to the American scene an American analogue thereof is both attractive and feasible.

First of all, this employee participation is already a fact of life. The current legal regime, not easily displaced, gives the pension fund and other institutions the vote and thus the influence on management that its ownership share carries. While pleas for "responsible" voting, for taking a "balanced time horizon" perspective, and similar calls may¹³⁸ have some effect in specific situations such as the tender of shares into a control bid, they have little operational salience in the steady-state relationship of a bloc holder to its portfolio firms' management. Direct political efforts simply to disenfranchise institutional investors as somehow improper voteholders have been floated but have little chance for success. Inside the velvet glove of jawboning lurks a paper tiger, not an iron fist. The voting power of the institutional investor, however encumbered by the constraints on group activism that already have been enumerated, is clear and present.

There is a more positive analogy in the experience of the German system that labor-management cooperation need not be a zero-sum game. While the large, particularly pension-related institutional investor, because of portfolio distribution and index strategy considerations, is locked into a permanent investment in any given enterprise, this need not be seen only as a defect of institutional investment. The employment-related mission of the permanently invested pension fund also can have a positive ef-

CHEN PERSONEN DES HANDELSRECHTS (1987)).

¹³⁷ In technical, legal terms of adaptability, see especially Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. & SEC. REG. 155 (1982). In legal-policy terms, see particularly the skeptical evaluation of Vagts, *Reforming the 'Modern' Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 36 (1966); cf. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1485 (1984). In more social-theoretical terms, compare Teubner, *Industrial Democracy Through Law?*, in CONTRACT AND ORGANIZATION: LEGAL ANALYSIS IN THE LIGHT OF ECONOMIC AND SOCIAL THEORY 261 (T. Daintith & G. Teubner eds. 1986) with Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 U. CHI. L. REV. 73, 161 (1988).

¹³⁸ See the panoply of these calls reviewed in Buxbaum, *supra* note 8, at 24.

fect on the enterprise mission and the enterprise management,¹³⁹ and, beyond that, on the public or societal interest.

This is the place to complete the earlier discussion of the social need for new time frames as well as new priorities if overriding questions of ecological survival are to be better answered within the liberal economic framework of modern free enterprise systems than they were in the socialist framework of state enterprise systems. As I indicated, this paradigmatic shift in the frame of reference for private firm behavior needs an ideological legitimation, and I believe that the German codetermination system provides at least a starting point for that search.

American analogues to codetermination should begin not with their substance but with the evolution of organizational forms within which the new substantive proposals might take root. The beginning, of course, is in the shift from insider boards to outsider boards, from the old Standard Oil model of nine senior executives and one investment banker to Harold Williams's ideal of nine pillars of the professions, the business community, and the society, tempered only by the Chief Executive Officer of the firm. This is where the representatives of substantial institutional investors can find their first place.

But it is only one place, and they as owners are only one representative among others, even if more insistent and capable of achieving and holding that place than are those other guest monitors invited and subject to replacement (except in times of crisis) by their host, the CEO. It is here, incidentally, that the professional representative directors proposed by Gilson & Kraakman¹⁴⁰ find their place. It is here, too, that an American version of the European Community's proposed Fifth Company Law Directive,¹⁴¹ creating an internal functional split between inside managing and outside monitoring directors sitting on the same board, might be considered.¹⁴²

The second step in the organizational evolution begins to

¹³⁹ This view to some degree also underlies European discussions of efforts to provide employee-owners participation rights in enterprises outside the traditional board structures. See, e.g., Loritz, *Arbeitnehmerbeteiligungen und Verbandssouveränität*, 15 Z. UNTERNEHMENS- U. GESELLSCHAFTSRECHT 310 (1986).

¹⁴⁰ See *supra* note 9.

¹⁴¹ Commission of the European Communities, *Amended Proposal for a Fifth Directive*, 26 O.J. EUR. COMM. No. C 240, art. 3 (Aug. 19, 1983).

¹⁴² See Conard, *supra* note 6, at 139.

look more like the two-tiered board model familiar in Germany. One version, a managerialist one, recently was floated by Lipton and Rosenblum: a board comprised principally of outside directors, all elected for a five-year term of office, all nominated, not only ratified, by the shareholders, and all campaigning on the basis of a strategic plan for the corporation that could include, and that would be the exclusive channel for, a takeover bid or other auction or recapitalization proposal.¹⁴³ Putting aside its admitted origin as a management-insulation device (for reasons that some call good and some call bad), it is interesting in the present context in that it hints at a two-tier system. This is a board of shareholder representatives, inevitably dominated by institutional investors in control of the proxy solicitation mechanism. It implies the structured appointment of, and a structured relation with, a management that probably would evolve to be similar to a *Vorstand*, if only because of the inherently strict separation of this shareholder council from the management function. This separation is predictable, since the focus on basic corporate strategy as the core of the quinquennial election process presumably dictates the use of fund managers and financial advisors as board nominees. Financial sector specialists rather than neighboring CEOs would be the typical candidates. The continuity of shareholder representatives as directors would be compromised if investment (and disinvestment) turnover rates were too high; most larger institutional investors, however, not only the public pension ones, have moved towards a passive investment portfolio strategy to the point that they have the requisite continuity of investment for this purpose.¹⁴⁴

A second version, an institutional one, is the shareholders' advisory council, propounded by representatives of institutional investors.¹⁴⁵ This would leave the existing board of directors in place, but also transmute it over time into an analogue of the German second-tier board, the *Vorstand*, for reasons not so dissimilar to the first. The "upper" council's substantive functions might well remain more limited and more hortatory than in the

¹⁴³ Lipton & Rosenblum, *supra* note 92, at 224.

¹⁴⁴ See Brancato Report, *supra* note 58, especially Exhibit 16 (Turnover of Institutional Holdings in Top 50 Corporations) and Exhibit 17 (Annual Percent Turnover of Equity Holdings) at 69.

¹⁴⁵ For a review of these variants, see Taylor, *Can Big Owners Make a Big Difference?*, *supra* note 78.

managerial version; and if unduly limited they might well justify the Gilson & Kraakman criticism of advisory councils per se as paper tigers.¹⁴⁶ Its inevitable and legitimate control of the proxy process for the election of directors, however, would move it towards institutionalizing itself, in time leading to a separation of governance functions between that council and the now subordinate board of directors,¹⁴⁷ and to a more explicit and stable equilibrium between the increasingly divergent calls for shareholder wealth maximization and "corporate" wealth maximization.¹⁴⁸

In any event, whichever variant were taken, this new structured separation of supervisory and managerial functions would provide the basis for operationalizing a somewhat more public or socially oriented version of long-range decision making within the traditional liberal economic framework of corporate governance. While I have styled one managerial and one institutional in provenance and motivation, the only hard difference between them is the five-year insulation of management built into the former. So far as their susceptibility or amenability to institutional investor control is concerned, there would seem to be little difference between them. Each escapes the limitations of present-day unitary boards, which combine the worst of both worlds in being neither close enough to operational management to control it effectively nor detached enough to offer a different perspective.¹⁴⁹ These structural variants, therefore, should permit more effective monitoring than would a "professional direc-

¹⁴⁶ See note 9 *supra*, at 871.

¹⁴⁷ An interesting insight into this evolution is provided by Windbichler, *Zur Trennung von Geschäftsführung und Kontrolle bei amerikanischen Grossgesellschaften*, 14 Z. UNTERNEHMENS- U. GESELLSCHAFTSRECHT 50 (1985), who sees a de facto turn towards split-board systems in the trend towards board committees and their specialization in control as well as in information development.

¹⁴⁸ See especially Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 368 (1990), proposing an owners' "Intrinsic Value Committee" for this purpose.

¹⁴⁹ Indeed, one inherent rebuttal of the Gilson & Kraakman argument lies in their implicitly ignoring what by common consensus is understood to be the inherent inability of any board of directors to be more than distant monitors of the self-set goals of executive management. See M. EISENBERG, *THE STRUCTURE OF THE MODERN CORPORATION* 162 (1976). I realize Eisenberg at that time also rejected the adaptability of the German "two-tier" model to the American scene, *id.* at 177, but fifteen years ago his argument could not take into account the institutional ownership considerations that lead me to resume the discussion.

tor" plan with its minimal professional intrusion into a board otherwise left with its present structure, functions, and processes intact.¹⁵⁰

E. *The Mutual Legitimation of Management and Ownership*

The second part of the prescription is more difficult to render operational, but in the long run perhaps more important both to the postulated new mission of corporate management and to the continuing legitimacy of the American form of pension funding itself. If the new pension fund intermediaries are to lend legitimacy to new public and private law versions of effective enterprise functioning, indeed if they are themselves to remain insulated from the inevitable erosion of their funding support as legislators discover the possibilities of cheating on the contribution or payout obligations at the margin, they themselves need to be legitimate.¹⁵¹ That need implies participation by their beneficiaries in the formation of the policies that in turn are to be transmitted to and imposed upon firms.

On both counts—the operational realities of new firm governance with new representatives and new or more complex missions, and the operational realities of bringing the voice of beneficiaries to bear on the decisions of the funds—European, especially German, law turns out to have surprisingly detailed relevance. While it is not possible at the conclusion of this long discussion to provide proof of this in detail, I have singled out two regimes or systems that bear particularly close examination, one at the corporate and one at the fund level.

¹⁵⁰ The reader, of course, always should be aware of the "grass is greener" phenomenon. This may be the place to note the interest in the American unitary board system expressed by some German writers concerned with defects in the supervision, especially at times of crisis, available through the German two-tier system. (They do not, however, focus on the institutional investor.). See K. BLEICHER, D. LEBERL & H. PAUL, *UNTERNEHMUNGSVERFASSUNG UND SPITZENORGANISATION: FÜHRUNG UND ÜBERWACHUNG VON AKTIENGESELLSCHAFTEN IM INTERNATIONALEN VERGLEICH* (1989); cf. Theisen, *Das Board-Modell: Lösungsansatz zur Überwindung der "Überwachungs-lücke" in deutschen Aktiengesellschaften?*, 34 *DIE AKTIENGESELLSCHAFT* 161 (1989).

¹⁵¹ Indeed, one political response to the claims of institutional investors, especially public pension funds, is to question their legitimacy exactly on this point of beneficiary participation in decision making. See, e.g., Lochner, *The Current Debate Concerning Proxy Reform*, Remarks to the Tenth Annual Ray Garrett Jr. Corporate and Securities Law Institute, Stamford, Conn., SEC News Release (May 24, 1990) ("But if democracy is such a good thing for a corporation . . . shouldn't institutional shareholders be required to pass proxy voting rights through to the real beneficial owners of the shares?").

The first is the already mentioned regime of labor codetermination at the board level with which the German legal and political system, otherwise in a liberal economic mold reasonably close to the American one, has had considerable practical experience. The salience of that experience to the issue of the institutional investors' legitimacy is the light it casts on what we still believe to be the formal conflict of interests between labor and capital, each a factor supplier whose short-run benefit necessarily entails a short-run detriment to the other. The German experience in working out this conflict at the operational board of directors level demonstrates that the operative issue is not this "conflict of interests" but the value added by persons with somewhat different views of the world to the board's decisions. In one sense, this suggests that the entire cohort of labor representatives is little different from the spectrum of persons ranging from public figures of various persuasions to reasonably reflective lawyers, accountants, and bankers, surrounding the cohort of CEOs on the typical American board of directors.

The German experience also is salient in demonstrating that the structural or organizational stretching-out of the decision-making hierarchy over two tiers provides the important tempering effect of time horizons to the decisional output. I highlight both points, however, for a different reason: legitimation is a two-way street. The responsible behavior of the labor representatives legitimates them and the entire institution of codetermination just as their involvement in the firm's decisions legitimates the management of the firm to its constituents and its society. The issue is not conflict versus harmony, but mutual adaptation of values and strategies to mitigate the burden of inevitable conflict.

F. The Decision-Making Structure of the Institutional Investor

The second comparative aspect of legitimating the institutional investor, especially the pension fund, to fulfill its role as genuine participant in corporate governance, lies in the appropriate organization of its own decision-making structure and processes. We have already reviewed and, I trust, discarded the option of disenfranchising these portfolios entirely, though this is an option that has tantalized some participants in the current

debate¹⁵² and, indeed, has a surprisingly long history in the American discussion.¹⁵³

We also can put aside the question of the pass-through of portfolio voting power to investors in mutual funds and other voluntary investment vehicles. The listed or other publicly traded investment company legitimates the exercise of its voting power in two ways: by the monitoring effect of the price for its shares, and by the existence of market choice for investment vehicles of varying investment philosophies. While neither is ideal as a legitimating vehicle for the exercise of the franchise, these two market exits go some way towards alleviating the "bureaucratic power-exercise" legitimacy problem. They go even further when coupled with improved disclosure of voting philosophy and of actual votes¹⁵⁴ and with improved control of the conflict of interests inherent in the transfer of the voting power to the investment adviser or fund manager with myriad other relationships with the firms in the portfolio.

The interesting legitimization question involves the collective pension funds and their governance by means of beneficiary participation including, but by no means limited to, portfolio voting power pass-through procedures. Internal analogues to the market choice provided by investment companies are not available. The collective nature of the savings decision is not, conceptually speaking, a categorical obstacle (note the increasing flexibility and variety of investment choices nowadays available at least to participants in supplemental pension plans), but it is an obstacle. The difficulty is compounded when market valuation issues are added, since these funds are not intended to be available for

¹⁵² See, e.g., *THE \$600 BILLION BURDEN*, *supra* note 104.

¹⁵³ See, e.g., R. TILLOVE, *supra* note 2, at 82.

¹⁵⁴ See, for example, the recently enacted CAL. CORP. CODE § 711 (West 1990), requiring such trustees to keep records of their voting decisions and to make them available to beneficiaries and their representatives.

The Department of Labor recently proposed legislation to mandate disclosure of the proxy voting policy by plans subject to ERISA, thus moving towards the California approach. See Dep't of Labor, Proposed Section 104(b)(4) Submission to Congress (Oct. 26, 1990) ("The Administrator shall furnish: . . . (B) For plan years beginning on or after January 1, 1991, upon written request of any participant or beneficiary, a copy of the voting policy of any person responsible for exercising any voting rights of securities held by the plan or directing the exercise of any such voting rights.") See also Statement of David George Ball, Assistant Secretary for Pension and Welfare Benefits, U.S. Dep't of Labor, Before the Subcomm. on Labor of the Senate Comm. on Labor and Labor and Human Resources (July 24, 1990).

removal via a market but only for lump-sum or periodic payout in the retirement context. In any event, as is the case with voluntary investment, market choices and valuations are an awkward surrogate for the political aspect of the problem, namely, the legitimation of the exercise of an enormous voting franchise by the appointed agent of two principals, the settlor and the beneficiary.

Voice or governance mechanisms are the question, and the special but central case of the pass-through of the franchise is the arena within which it can be posed. The direct pass-through on the analogy of the street name or *Depotstimmrecht* holder or, in the pension context, on the analogy of the famous Sears Roebuck Company employee stock holdings,¹⁵⁵ is not an easy solution. One obstacle is the lack of direct correspondence between the legal title of the trustee to specific stocks and the beneficial interest of the employee to a fungible portion of the *res*. On the other hand, the more stable the portfolio, the more feasible it should become to provide the beneficiary with a pro-rata vote on the ESOP model, which then, as to each issuer's stock in the portfolio, is transmuted into a set number of votes per beneficiary.

This, however, while itself a heroic assumption, does not resolve two problems specific to pension funds. Even if the portfolio remains stable, the beneficiary's share (which in any event is contingent on the future event of retirement or at least of vesting) does not; rather, it varies with time in service and with the shifting size of the beneficiary universe. Of course, it is not essential that the pass-through be exact; surrogates for weighted voting such as past contributions or years of service would at least provide an approximate fair share of the franchise.

The difficult problem, rather, is that the pooled investment is dedicated to periodic retirement income or lump-sum annuity purchase payments, a purpose incompatible with the split voting outcome created by ordinary pass-through mechanisms.¹⁵⁶ Split voting by a sole agent for different beneficiaries is common in traditional nominee situations, but leads simply to the aggregation of an ultimate majority-decided firm decision.¹⁵⁷ Dissidents

¹⁵⁵ For a brief description of this episode, see R. TILOVE, *supra* note 2, at 60.

¹⁵⁶ See Buxbaum, *supra* note 8, at 27.

¹⁵⁷ *Id.* See, however, Smith, *Voting in Contested Elections*, 5 PRENTICE HALL L. &

are comforted not only by exit opportunities through a market but, above all, by the fact that their original investment is voluntary. If these beneficiaries' participation in the development of the intermediary's portfolio governance (as well as investment) strategy is to be treated as a matter of right and not of privilege, however, the difference in the two investment situations needs to be respected. In other words, the deference to majority rule implied by a voluntary investment cannot without more be transposed to the collective savings/investment situation implied in the pension situation.

Two approaches then commend themselves. One is to require these beneficiaries to draw the consequences of their individual decisions on these matters, much as the employee-participant in a voluntary pension scheme today can choose investment vehicles but then must live with that choice. In the long run, that implies the development of separate pension-investment pools if, as is likely, some of these decisions (such as takeover defenses or environmental constraints on product lines) have investment consequences.¹⁵⁸ Apart from the political problem assumed (too readily) to arise from the abandonment of paternalistic concern with private choices, however, the complex, attenuated, and dubious correlation of the slow cumulation of vote choices over time with ultimate market value designations for pensions renders this approach both cumbersome and more confusing than supportive of the legitimation purpose of the exercise.¹⁵⁹

A second, time-honored approach,¹⁶⁰ therefore, would be the interposition of intermediate employee institutions specifically

BUS. INSIGHTS 25 (1991) (describing the pitfalls of split voting).

¹⁵⁸ An analogous flexibility already exists for the voluntary supplemental benefit plan, for which the computer makes the provision of a number of specific investment rationales, and even of personal, directly managed plans, feasible.

¹⁵⁹ For a brief discussion of "directed voting rights," including the radical notion of a special auction, see U.S. Dep't of Labor, Office of Pension and Welfare Benefit Programs, Public Hearing on Corporate Governance 155, 159 (Jan. 10, 1985).

¹⁶⁰ "Time-honored" not only by reference to collective bargaining, but specifically by reference to detailed proposals of an earlier day concerned with the development and transferability of vested firm-level pensions for an increasingly mobile American workforce. One complex proposal was to transfer the voting rights inhering in the investment portfolio to the public agency that was to be responsible for guaranteeing the pension payments (i.e., to a precursor of the Pension Benefit Guaranty Corporation!). See M. BERNSTEIN, *THE FUTURE OF PRIVATE PENSIONS* 293 (1964).

designed to elicit and transmit employee views on these matters to the portfolio-voting intermediaries. The elected business agent of the union, in those sectors which still boast of unions, is the obvious model for this institution. Here, too, the German experience with employee intermediaries and with their selection would be instructive.

The present American situation is not satisfactory from this perspective. In the private employer sector, the monitoring provided by ERISA and its concern with the exercise of the franchise attached to an investment portfolio may be a warrant, albeit an indirect warrant, against flagrant agent abuses,¹⁶¹ but it does little for the underlying legitimation of the role of these large funds in the first place. In the public sector, the lack of a relationship between the public employment setting of the beneficiaries and the private employment setting of the portfolio firms further attenuates the sense of involvement that is the beginning of a sense of legitimation.¹⁶² The rest is done by the sheer size and distance from the workplace of most of these institutions. This makes them more susceptible to the legitimate but conflict-ridden intrusion of legislative and administrative political interests—the “settlors”—than amenable to the participation of the beneficiaries.¹⁶³

New York's recent experience, both with the legislative deferral of premium payments through actuarial juggling¹⁶⁴ and with the executive's attempted use of the *Task Force Report* to justify pension investment in social infrastructure,¹⁶⁵ should suf-

¹⁶¹ See, e.g., PROXY VOTING OF PENSION PLAN EQUITY SECURITIES (Dan McGill ed. 1989); Buxbaum, *supra* note 8, at 20.

¹⁶² See generally R. TILOVE, PUBLIC EMPLOYEE PENSION FUNDS (1976).

¹⁶³ See the discussion of these conflicts more than a decade ago in PENSION TASK FORCE, SUBCOMMITTEE ON LABOR STANDARDS, HOUSE COMM. ON EDUC. AND LABOR, 94TH CONG., 2D SESS., INTERIM REPORT ON ACTIVITIES (Comm. Print 1976); more generally, see L. KOHLMEIER, CONFLICTS OF INTEREST: STATE AND LOCAL PENSION FUND ASSET MANAGEMENT (1976).

¹⁶⁴ See Barbanel, *Pension Shift for Teachers is Questioned*, N.Y. Times, Oct. 11, 1990, at B1, col. 5.

¹⁶⁵ GOVERNOR'S TASK FORCE ON PENSION FUND INVESTMENT (N.Y.), OUR MONEY'S WORTH: THE REPORT OF THE GOVERNOR'S TASK FORCE ON PENSION FUND INVESTMENT (1989). New York was not alone in floating this approach, though it was the first major one to use it, when the New York City Teachers' Retirement Fund bailed New York City out of bankruptcy. See Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 1006 (1977). During Governor Edmund (Pat) Brown's administration, California organized a Governor's Public Investment Task Force, later converted into the

fice as a cautionary reference against unreflective continuation of the present situation.¹⁶⁶ Some protection against these inroads exists in the constitutional prohibition against the impairment of contracts,¹⁶⁷ but this is a crude control, too uncertain in its potential application.¹⁶⁸ Paradoxically, it is often too harsh when applied, especially because of the difficulty of distinguishing an actual reduction of benefits from reductions caused by variations in the prefunding formulae¹⁶⁹ at times when strong funded positions collide with weak current account positions of the public fisc.¹⁷⁰

Pension Investment Unit, which identified the pension plan investment patterns of various governmental units, and proposed a large-scale use of their investments for social purposes. See CALIFORNIA GOVERNOR'S PUBLIC INVESTMENT TASK FORCE, FINAL REPORT (1981); STATE OF CALIFORNIA, OFFICE OF PLANNING AND RESEARCH, TARGETING INVESTMENT FOR ECONOMIC DEVELOPMENT: PENSION INVESTMENT UNIT ANNUAL REPORT (1982); See also Savage, *Brown's Push for Risk in Pension-Fund Investments*, CALIF. J., July 1981, at 258. Other states, including Massachusetts, Minnesota, and Wisconsin also looked at these issues a decade ago. See R. MESSINGER, REVITALIZING NEW YORK CITY'S ECONOMY 17 (1980).

For a current overview of this situation in the United States, see INSTITUTE FOR FIDUCIARY EDUCATION, ECONOMICALLY TARGETED INVESTMENTS (1989). See also the critique and case studies in SOCIAL INVESTING (D. McGill ed. 1984).

¹⁶⁶ See particularly Black, *supra* note 15, at 598.

¹⁶⁷ See generally Taylor, *supra* note 78.

¹⁶⁸ Compare *Dombrowski v. City of Philadelphia*, 431 Pa. 199, 245 A.2d 238 (1969) with *Kosa v. Treasurer of State of Michigan*, 408 Mich. 356, 292 N.W.2d 452 (1980) and *AFSCME Councils 6, 14, 65 and 96, AFL-CIO v. Sundquist*, 338 N.W.2d 560 (Minn. 1983) — and the last, in turn, with *Christensen v. Minneapolis Mun. Employees Retirement Bd.*, 331 N.W.2d 740 (Minn. 1983).

Especially instructive is *Knight v. Board of Admin.*, 223 Cal. App. 3d 527, 273 Cal. Rptr. 120 (1990), in which the clear repudiation by the legislature of an unconscionable windfall benefit inadvertently created by prior legislation is correctly but almost incoherently upheld against an impairment-of-contract challenge.

¹⁶⁹ See, e.g., *Birnbaum v. New York State Teachers Retirement Sys.*, 5 N.Y.2d 1, 152 N.E.2d 241, 176 N.Y.S.2d 984 (1958). On this problem of actuarial assumptions, including their accounting conventions, see Friedman, *supra* note 38.

¹⁷⁰ See *California State Teachers' Ass'n v. Cory*, 155 Cal. 3d 494, 202 Cal. Rptr. 611 (1984); *Valdes v. Cory*, 139 Cal. 3d 773, 189 Cal. Rptr. 212 (1983); *Dadisman v. Moore*, 384 S.E.2d 816 (W. Va. 1989). See generally the criticism of *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234 (1978) (state intrusion on employers' obligation under private pension arrangement) and its reading of *United States Trust Co. of New York v. New Jersey*, 431 U.S. 1 (1977), in L. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 622 (2d ed. 1988).

The larger issue, of course, is that of intergenerational equity, given the free ride of the first generation of pension plan beneficiaries (at least under governmental plans) and the risk of slower population growth over time. For recent discussions of this aspect of the "continuing funding" problem, see Feldstein, *Should Private Pensions Be Indexed?*, in *FINANCIAL ASPECTS OF THE UNITED STATES PENSION SYSTEM*, *supra* note 38, at 211-27; Merton, *On Consumption Indexed Public Pension Plans*, in same, at 259; and the vivid

It is therefore critical to foster beneficiary-guided or at least beneficiary-influenced fund management structures, and to learn from the experience of those public funds that are structured to provide this guidance from elected representatives. If the interposition of intermediate employee-beneficiary institutions can help avoid the temptation of excessive settlor involvement with the creation and especially the use of these funds, this alone would justify the effort to devise appropriate forms of that intermediation. If in addition these structures can help funds avoid the charge of illegitimacy in their interaction with their portfolio firms, the case for support of fund advisory or managing boards substantially elected by their beneficiaries would seem clear.¹⁷¹

The foregoing discussion has been limited to the legitimization of pension investments as active owners within the framework of traditional liberal economic terms of reference. The direct use of pension assets for "non-pension" distributions to the beneficiaries, however, also is a matter of public concern, though it is not the subject of this paper. It implicates similar issues of participation in decision-making. While it is as tempting as it is financially problematical, the alternative of using (at least private sector employer) pension funds for direct investment in social assets specific to the workforce, such as employee housing or even own-firm takeovers,¹⁷² cannot even be seriously discussed in the absence of legitimization of such decisions through partici-

review in Samuelson, Comment (on Merton), in same, at 276.

¹⁷¹ See, e.g., California Public Employees' Retirement System Law, CAL GOV'T CODE § 20100 (West Supp. 1991), creating a Board of Administration of 13 members, six elected by the active and retired members of the system and its affiliate systems, all serving four-year terms, *id.* § 20101, in whom the management and control of the system is vested, *id.* § 20103.

The current tendency of British systems to recede from membership-elected board structures in the private sector is marked and criticized in L. HANNAH, *supra* note 25, at 140. It is interesting, however, that conservative policy analysts have been making a concerted effort to shift most schemes to defined contribution form on the explicit ground that this passes through to the *individual* employee-beneficiary the property interest, including the voting right, in this component of the wage/pension package. *Id.* at 141. On the recent changes, see Creedy & Disney, *The New Pension Scheme in Britain*, in *THE ECONOMICS OF SOCIAL SECURITY* 224 (A. Dilnot & I. Walker eds. 1989); Creedy & Disney, *The 'Twin-Pillar' Approach to Social Insurance in the UK*, 36 *SCOTTISH J. POL. ECON.* 113 (1989).

¹⁷² See, e.g., the discussion in M. WEISS, *PENSION FUND INVESTMENTS: THE ISSUE OF CONTROL* (1978), reprinted in 5 *CENTER FOR ECONOMIC STUDIES, STUDIES IN PENSION FUND INVESTMENTS* (1981).

pation in their making by the pension beneficiaries.¹⁷³

There is a larger issue at stake here, namely, the secular change of the American labor-firm relationship from one characterized by unionization and collective adversarial behavior to a more involuted and reciprocally entangled one. If corporate domination of that situation is not to freeze into a temporarily attractive but eventually destabilizing form of political corporatism, nonpaternalistic structures of employee-employer relations, especially in this area of post-retirement support, will have to evolve.¹⁷⁴ In our own search for that path the European experience is not necessarily a model to emulate, but it is a setting to reflect on, a setting whose positive as well as negative lessons may provide some illumination for that search.

¹⁷³ In the case of public sector pension funds, a mild version of this variation, e.g., lending fund assets to fund members for residential home purchases, is both politically interesting and, because of direct legislative participation, politically legitimate. *See, e.g.,* California Public Employees' Retirement System Law, CAL. GOV'T CODE § 20215 (West Supp. 1991). The same may be said of politically (legislatively) mandated divestment of shares of firms doing business in South Africa. Broader mandates and prohibitions, of course, become more problematical.

It is interesting that one English critic separately identified public pension funds, with their direct (and therefore legitimate) political base within an elected local authority, as the only type of entity that might risk innovative investment in local enterprise development; however, because of the general statutory duty of public pension funds to take expert advice on their investment policy, it would be "important to invite sympathetic experts on to the panel.[!]" R. MINNS, *supra* note 4, at 160-62.

¹⁷⁴ And this despite Drucker's fears that:

[F]or labor . . . to try to use pension fund socialism as a means to expand union power by becoming the representative of the employees in their role as principal owners . . . [is] fraught with grave risk for the American trade union . . . [because it] can only aggravate the already existing threat to the cohesion of the union: the tug of war between the younger workers and the older members.

P. DRUCKER, *supra* note 3, at 142. Compare the view of the "paraproprietary society" of pension-owning workers (and their relation to their firms) in P. HARBRECHT, *PENSION FUNDS AND ECONOMIC POWER* 285 (1959).

