Do corporations increase inequality?

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Abstract

Do corporations increase inequality? Rising inequality of income and wealth has recently been linked to corporate governance, but closer analysis is still developing. This article proposes a leximetric grammar to understand the problem. Which 'significantly distributive rules' affect the income of executives and directors, employees, retirement savers and shareholding intermediaries the most? Evidence of legal change since 1900, compared with changes in the top 1% of income earners, shows remarkably common outcomes across three major 'varieties' of jurisdiction: the UK, Germany and the US. First, executive pay began rising, not just when shareholders generally lost a binding 'say on pay' in the 1970s, but when institutional shareholders in particular could monopolise pay decisions. Second, inequality was driven dramatically by the loss of voice at work for employees and their unions from 1980, but far more in the 'single channel' systems of labour-management relations. Third, over the late 20th century asset managers and banks came to appropriate shareholder voting rights with 'other people's money' (mostly from retirement savings). They were able to use those votes to make corporations buy their own financial products, subsidising financial intermediaries' share of GDP, and so inflating the income of the financial sector. This all means corporations are probably the most important 'pre-tax' cause of increasing inequality. However, with small but careful reforms, corporations could become institutions that promote economic and social justice.

Contents

1. Introduction

In *Capital in the Twenty-First Century*, Thomas Piketty elegantly argued that wealth concentrates, and economic divisions grow, because of a 'fundamental inequality', summed up as $r > g$. 'When the rate of *return* on capital significantly exceeds the *growth* rate of the economy,' wrote Piketty, 'it logically follows that inherited wealth grows faster than output and income.'[2] Return to capital (or labour) 'depends on the relative bargaining power of the various parties involved',[3] not just the supposed marginal utility added to production.[4] In practice, informational uncertainty is 'so large'

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[2] T Piketty, *Capital in the Twenty-First Century* (2014) ch 2, 25-26. Italics added. At 351, Piketty gives a simple mathematical example. If growth is 1% and return to capital is 5%, saving just one fifth of returns to capital ensures inherited grows more quickly than the economy (because the one fifth saved exceeds the 1% growth of everyone, including non-capital owners).

[3] Piketty (2014) ch 6, 212 (capital), and see also ch 9, 312 (labour) and 331 (executives)

[4] The 'marginal utility' of anything that can be sold is often said to be what prices in competitive markets are based upon: the buyer of a good or service will pay the amount that it adds in utility for the buyer's consumption or production. In essence, this suggests 'you get what you pay for' if you buy capital or labour, 'you get what it's worth' if you sell capital, and 'you get what you're worth' if you're working. See originally, WS Jevons, *The Theory of Political Economy* (1871) ch 1, 'Repeated reflection

that true marginal productivity is 'hard to define'. This leaves a market that 'is always embodied in specific institutions', with various 'hierarchical relationships'.[5] Why did inequality decrease following 'the shocks of 1914-1945'? The primary reason, said Piketty, was government 'taxing capital and its income at significant rates', plus high income tax at work, over the mid-20th century.[6] So, if you want to stop the 'stratospheric pay of supermanagers', the 'drift toward oligarchy', another 'age of inheritance', and a continuation of the 'crisis of globalized patrimonial capitalism',[7] then 'only dissuasive taxation of the sort applied in the United States and Britain before 1980 can do the job.'[8]

But do corporations increase inequality? If they do, tax can make corrections, but failing markets and institutions are unjustifiably driving inequality at the outset. The purpose of this article is to show the evidence that corporations are in fact the most significant 'pre-tax' cause of increasing inequality.[9] Piketty and many more economists writing recently are acutely aware of the corporation's significance (and the same could go for most business associations[10]) though they have explicitly not aimed to write an account of institutional change. Piketty emphasises that 'historical reality is more complex than the idea of a completely stable capital-labor split suggests', but wanted to 'indicate general principles' to analyse the 'objectively complex problem of governance of large organizations'.[11] Indeed, Piketty's *central* conclusion is that the 'concrete institutions in which democracy and capitalism are embodied need to be reinvented' based on informed participation in the governance of enterprise: the democratisation of the economy.[12]

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and inquiry have led me to the somewhat novel opinion, that value depends entirely upon utility.... To me it seems that our science must be mathematical, simply because it deals with quantities.... The ordinary laws of supply and demand treat entirely of quantities of commodity demanded or supplied, and express the manner in which the quantities vary in connection with the price.' Jevons, and anyone else who follows this view, neglects the qualitative aspects of laws underpinning markets and institutions. For a similarly flawed, but perhaps even more straight forward approach, see *In re Wragg Ltd* [1897] 1 Ch 796, 831, Lindley LJ, 'We must not allow ourselves to be misled by talking of value. The value paid to the company is measured by the price at which the company agrees to buy what it thinks it worth its while to acquire.'

5 Piketty (2014) ch 9, 331-334

6 Piketty (2014) ch 10, 373

7 Piketty (2014) ch 13, 417 and 512-514, 318, 473 respectively.

8 Piketty (2014) 512, here Piketty is referring specifically to executive pay, however it is clear that 'dissuasive taxation' is the primary solution that Piketty highlights for excessive returns to capital or other high incomes.

9 n.b. There is technically no such thing as a 'pre-tax' state because, something must pay for a system of courts that enforces property rights which are taxed. This fact is unwittingly, but accurately captured in the title of R Nozick, *Anarchy, State and Utopia* (1974) where Nozick posits that taxation is 'forced labour', and prefers a nightwatchman state that only enforces contracts, and gives actions in tort and unjust enrichment. He appeared unaware that T More, *Utopia* (1516) Book II, was ironic, that a perfect society was impossible, particularly given that the narrator was called Raphael Nonsenso, and utopia means 'no place'. See also JS Mill, *Principles of Political Economy* (1848) Book V, ch I, §2. The better view is that 'Taxes are what we pay for civilized society', per Holmes J, *Compania General De Tabacos De Filipinas v Collector of Internal Revenue*, 275 US 87, 100 (1927). Here 'pre-tax' refers to what happens in markets and institutions before taxation is applied on capital gains, corporate profits, employment income, sale of goods, and so on.

10 n.b. Partnerships, co-operatives and various types of trusts all present similar governance problems: though some may be better. The corporation is the focus because it is the most economically significant legal form of association. The focus, especially in part 2(3), on public companies is justified by their size - though privately held companies are no less important.

11 Piketty (2014) 311, 218 and 334. See also J Stiglitz, *The Price of Inequality* (2012) chs 3 and 4. See also, RG Wilkinson and K Pickett, *The Spirit Level: Why Equality is Better for Everyone* (2009) ch 16 (touching on corporate governance at 260-262).

12 Piketty (2014) ch 16, 570

The 'fundamental inequality' of $r > g$ is 'historical fact, not a logical necessity'.[13] It depends on 'shocks' to capital and 'public policies and institutions' to 'regulate the relationship between capital and labor.'[14] In other words, change the institutions, and you can have $r = g$, or maybe $r < g$.[15] Even more surprising (as part 2(3) will examine) if institutions change the distribution of capital, then when $r > g$, inequality could *decrease*. In summary, this article contends that although they increase inequality now, corporations can become institutions to promote social justice.

Part 2 develops a grammar, which can be utilised in 'leximetric' research,[16] to analyse the change in four sets of 'significantly distributive' rules,[17] those on (1) executive pay, (2) employee and union rights, and (3) shareholder and beneficiary rights. This approach will not impress those who believe capital, labour or other markets leave no margin where prices are swayed by the relative bargaining power of the parties.[18] It is footed on the 20th century legal consensus that bargaining power is structurally unequal between individuals and organisations.[19] This means corporate directors often have discretion to contract with shareholders, employees, retirement savers, creditors, and others, on terms they may choose to their advantage.[20] Those groups themselves can influence directors' discretionary power, depending on legal construction of markets and institutions, especially if they have legal rights to participate, through the vote, in corporate governance.

How can the impact of rules on long-run inequality be ascertained? Rule changes can be correlated with statistical changes in inequality, and compared across jurisdictions. Comparison is necessary because not every formal rule will have the same functional outcome in different legal

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13 Piketty (2014) ch 10, 353 and 358

14 Piketty (2014) ch 10, 358

15 Piketty (2014) 353, simply notes that this not, as an empirical matter, happened before. See also JS Mill, *Principles of Political Economy* (1848) Book II, ch 1, §1, 'Distribution of wealth... is a matter of human institution solely. The things once there, mankind, individually or collectively, can do with them as they like.'

16 The most sophisticated work in this field has been underway at the Centre for Business Research. The method is to attribute a higher or lower number to a selection of rules on shareholder, employee and creditor protection, and track cross-jurisdictional change over time. Devising a coding for 'significantly distributive rules' raises a number of further interesting questions. See generally, J Armour, S Deakin, P Lele and M Siems, 'How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection' (2009) 57(3) American Journal of Comparative Law 579

17 cf LA Bebchuk, 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law' (1992) 105(7) Harvard Law Review 1435, 1461, who refers to 'significantly redistributive issues' for norms where the 'distributive element is significant relative to the efficiency element'. By 'efficiency', Bebchuk has in mind a practice that produces wealth, for example, for shareholders while potentially allowing a transfer to a director. As discussed below, the terminology used here will be 'distributive' rather than 'redistributive' because there is no natural starting point for distribution one way or another.

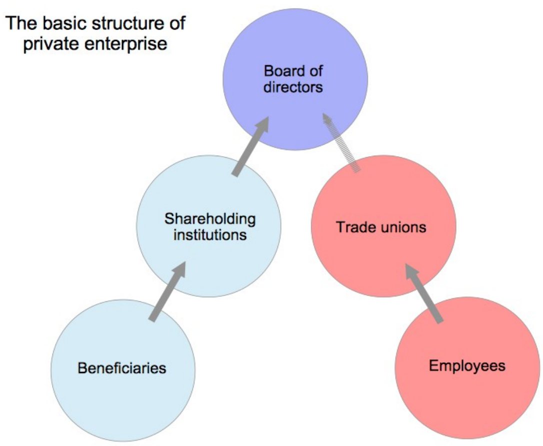
18 The view that there is no margin for bargaining power to operate seems to be connected with the standard supply and demand charts, depicting single lines, however this was originally intended only for commercial sales markets. See F Jenkin, *The graphic representation of the laws of supply and demand and other essays on political economy* (1887, 1996 edn Routledge) Part I, on commercial sales markets, first formulated the classic supply and demand graph later adopted by Alfred Marshall. Part II is about labour markets, where Jenkin thought the same principles and graphical representation were not applicable.

19 e.g. *Autoclenz Ltd v Belcher* [2011] UKSC 41, *Bürge* (19 October 1993) BVerfGE 89, 214, *NLRB v Hearst Publications, Inc*, 322 US 111 (1944) or Unfair Contract Terms Act 1977 Sch 2(a), Unfair Terms in Consumer Contracts Directive 93/13/EEC recital 16, and see generally F Kessler, 'Contracts of Adhesion – Some Thoughts About Freedom of Contract' (1943) 43(5) Columbia Law Review 629, 636.

20 M Moore, *Corporate Governance in the Shadow of the State* (2013) ch 1, names this 'discretionary administrative power'.

systems, where institutions differ. But when correlations are very close, and the theory is sound, a causal relation becomes persuasive. No doubt there will soon be a flood of interdisciplinary work precisely on this.[21] Regression analysis and controlling variables may achieve an increasingly accurate picture. But the difficulty is that quantitative tools are (by themselves) insensitive to the contextual quality of law: pulling the third bottom thread on two different spiders' webs can have very different results, depending on how the webs are built. So it is with law. This article offers a starter's guide to the web of legal history, with examples of the UK, Germany and the US.

The orthodox view, which this article follows, is that a corporation is a social institution,[22] where law mediates the rights of those who 'institute' the enterprise with their investments of capital and labour. As the simplified chart depicts below, capital today comes mainly from beneficiaries of shareholding institutions who save for retirement. An intermediary asset manager or bank has usually ended up with shareholder rights, instead of the person who actually contributes the capital investment.[23] On the labour side, employees can organise through trade unions who aim to collectively bargain for better terms at work, so the individual is not powerless against the corporate employer in getting a fair deal for their investment of labour.[24] The article does not deal with the additional problems in specific enterprises, in the public or regulated sectors, where markets systematically fail to protect the consumer or public interest.[25]



Does inequality matter for a productive economy? This important question will not be dealt with extensively in this article, except to say that it follows the majority view that unjustified inequality damages the economy in three main ways.[26] First, '[n]egligence and profusion', either among overpaid corporate directors, asset managers, or bankers in charge of 'other people's

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21 e.g. D Acemoglu and JA Robinson, 'The Rise and Fall of General Laws of Capitalism' (2015) 29(1) Journal of Economic Perspectives 3, discussing, in general terms, legal developments in South Africa and Sweden.

22 See E McGaughey, 'The codetermination bargains: the history of German corporate and labour law' (2015) LSE Working Papers 10/2015, part 2(3), 9, and AA Berle and GC Means, *The Modern Corporation and Private Property* (1932) 3 and 308.

23 See E McGaughey, *Participation in Corporate Governance* (2014) ch 1

24 cf R Goode, *Principles of Corporate Insolvency* (2005) 44, 'A third is the interest [in corporate insolvencies] of the workforce in preserving its investment of labour, expertise and loyalty to the enterprise'.

25 cf Piketty (2014) ch 16, 569 and generally JE Stiglitz, *Economics of the Public Sector* (3rd edn 2000)

26 cf JD Ostry, A Berg, and CG Tsangarides, 'Redistribution, Inequality, and Growth' (2014) IMF Staff Discussion Note SDN/14/02, finding inequality generally means lower growth, and modest redistributive tax may increase it. As its focus is tax, it does not deal with the effects from 'pre-tax' institutional framework, as will be tackled here.

money',[27] is an unjustified agency cost.[28] It causes those groups to work less productively, because they can 'serve their own pockets better by profiting at the expense of the company than by making profits for it.'[29] Second, underpaying employees damages economic productivity, as recognised through classical theory,[30] because if you are unfairly treated, you tend to be demotivated.[31] Third, at a macro-economic level, unequal income and wealth lowers effective aggregate demand because wealthier persons and entities have a higher propensity to save than consume.[32] This either removes that wealth from productive use altogether,[33] or increases transaction costs as savings go through investment chains.[34] Lower effective aggregate demand leads to a lower velocity of money circulating (e.g. less money paid to business, who hire fewer staff, who consume less), ultimately resulting in higher unemployment, perpetuating poverty and inequality once more. Accordingly the minority view that distribution may be segregated from efficiency will be disregarded.[35] This article proceeds on the foot that questions of equality and inequality matter both for a more moral and a more productive economy.

2. Significantly distributive rules

Which corporate rules are 'significantly distributive', so as to affect income and wealth the most? Generally speaking, a corporation's board of directors will conclude contracts on different terms with all contributors to the corporation. This is its primary distributive function. Logically, the ability of each contributor to vote for directors, or influence their actions, will affect the contracts' terms, the distributive balance, most. If you get to choose the people who pay you, it is likely they will pay you more. Relative influence can translate into the relative share of income that each group receives, particularly if the law enables people to act upon conflicts of interest.

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27 A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) Book V, ch 1, §107 and LD Brandeis, *Other People's Money and How the Bankers Use It* (1914)

28 cf SA Ross, 'The Economic Theory of Agency: The Principal's Problem (1973) 63 American Economic Review 134, 135, though note Ross focuses on information and did 'not treat the bargaining problem explicitly'.

29 AA Berle and GC Means, *The Modern Corporation and Private Property* (1932) 114, 'owners most emphatically will not be served by a profit-seeking controlling group. In the operation of the corporation the controlling group even if they own a large block of stock, can serve their own pockets better by profiting at the expense of the company than by making profits for it.'

30 e.g. A Marshall, *Principles of Economics* (3rd edn 1895) Book VI, ch 4, 649 and Smith (1776) Book I, ch 8, §§43 and 47

31 A Cohn, E Fehr, B Herrmann and F Schneider, 'Social Comparison in the Workplace: Evidence from a Field Experiment' (2014) 12(4) Journal of the European Economic Association 877. This may be an aspect of the fact that people work better when they are properly acknowledged, and less when their efforts are ignored or 'shredded'. Discussed further in E McGaughey, 'Behavioural economics and labour law' (2014) LSE Working Paper Series No. 20/2014.

32 JM Keynes, *The General Theory of Employment, Interest and Money* (1935) chs 19 and 24, and MS Eccles, *Beckoning Frontiers: Public and Personal Recollections* (1951) 76-77

33 e.g. E Platt, 'Top 50 US boardroom hoarders sit on $1tn in cash' (10 May 2015) Financial Times

34 Originally on transaction costs, see JR Commons, 'Institutional Economics' (1931) 21 American Economic Review 648

35 e.g. RH Coase, 'The Problem of Social Cost' (1960) 3 Journal of Law and Economics 1 at 5, 6, 8, 10 and 15 and L Kaplow and S Shavell, 'Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income' (1994) 23(2) Journal of Legal Studies 667. To avoid doubt, authors like these believed changes in distribution *per se* had no positive impact on productive efficiency, but maintained policies which serve a distributive function can only have a negative effect. This was always theoretically unsound, but now must be regarded as evidentially false: McGaughey (2014) LSE WP No 20/2014.

Of course, *every* legal rule has some distributive impact, no matter how small, or seemingly innocuous,[36] because the very function of legal rules is to mediate relative rights among people.[37] There is no 'neutral' starting point, or 'pre-regulatory' default,[38] because even in absence of specific regulation basic institutions like contract and property define the likely consequences for how rights and duties will be distributed.[39] In a world of unequal distribution, wealth and poverty, people with more resources and property can usually 'hold out' longer in any given contractual negotiation.[40] The law of tort, corporations and other associations affects how easily people can organise and take collective action.[41] And law always determines how much information is available or must be disclosed in markets before *any* contract is enforceable.[42]

Thus (1) relative wealth, (2) collective action capacity, and (3) information, are the basic building blocks of bargaining power.[43] At its most fundamental, with more wealth you get more bargaining power. With more bargaining power you can get more influence in the constitutions of corporations. And with more influence you can get more wealth. But the arbitrary, spiralling tendencies of unequal wealth and power need not affect markets and institutions if the standards for enforcing contracts are raised, the default position is that contributors to corporations have meaningful rights, and rights are taken seriously.

(1) EXECUTIVE PAY

Perhaps the simplest group of 'significantly distributive rules' (but undoubtedly those to have spilled the most theoretical ink) concern executive pay.[44] The over-rehearsed debate divides

[36] cf Aristotle, *Nicomachean Ethics* (ca 350 BC) Book V, who famously posited that 'corrective' and 'distributive' justice could be distinguished. This distinction, which is fundamental to our understanding of much of private law, does not mean problems of correction are non-distributive (as in remedies for breach of contract, tort, or unjust enrichment). On the contrary, correction is a sub-category of distribution: one of the most important methods of achieving distributive justice.

[37] R Hale, 'Coercion and Distribution in a Supposedly Non-Coercive State' (1923) 38 Political Science Quarterly 472 and R Hale, 'Bargaining, Duress and Economic Liberty' (1943) 43 Columbia Law Review 625

[38] e.g. C Sunstein, 'Switching the Default Rule' (2002) 77 New York University LR 106, 107-108, emphasising at 'common law, employers are typically given almost all of the initial entitlements' but 'there is nothing natural or inevitable about this state of affairs.' Note the common law differs between US states, and in the UK and Commonwealth has moved ahead: *Crofter Hand Woven Harris Tweed Co Ltd v Veitch* [1941] UKHL 2 (on the basic right to collective bargaining) and *Reda v Flag Ltd* [2002] UKPC 38, [45] (on the implied right to a just dismissal unless ousted by express terms or statute).

[39] E Warren, 'Bankruptcy Policy' (1987) 54 University of Chicago Law Review 775, 777. LA Bebchuk and JM Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105 Yale LJ 857, 881-890. H Collins, *Regulating Contracts* (2003) Part 4.

[40] Smith (1776) Book I, ch 8, §12. See also S Webb and B Webb, *Industrial Democracy* (1920) Part III, ch 2, 687-8.

[41] JS Mill, *Principles of Political Economy* (1848) Book V, ch XI, §§8-12. Contrast the perplexed and hostile little footnotes of M Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (1965) 68 and 102.

[42] The general requirement to enforce most day to day contracts is full disclosure of material terms, e.g. any securities contract, consumer contract or employment contract. In commercial contracts, the basic requirement is lower: that there should be no misrepresentation. The shift from common law's caveat *emptor* stance to basic information rights was a highly significant part of 20th century social evolution. In the UK, compare *Derry v Peek* (1889) LR 14 App Cas 337 and the Financial Services and Markets Act 2000. In the US see AA Berle and GC Means, *The Modern Corporation and Private Property* (1932) Book III.

[43] See further E McGaughey, *Participation in Corporate Governance* (2014) ch 2(3)(a)

[44] The term 'executive pay' will be used rather than the more cumbersome 'director remuneration', because executive directors tend to be the greater concern. However, the law discussed here will cover directors as a whole. It excludes management employees, as they usually hold no special constitutional decision-making power, and are subject to directors' prerogative.

among two basic positions. First, there are those who contend executive pay reflects the marginal utility of the executives, rewarding them appropriately, like rewards for a sport star who wins a tournament.[45] The fact that a stable, equilibrium market price does not appear to have been reached is beside the point. Executive pay increased since the 1970s because of increasing size and globality of corporations,[46] which, it is said, required greater responsibility and skill.[47]

A second basic position is that super-inflationary executive pay is a market failure, and it fails because directors pay themselves.[48] Executive pay, this argument usually continues, is empirically unrelated to company performance.[49] But even if it were, the market-wide rises show it results from arbitrary power not productivity.[50] Other workers are not becoming comparatively stupid, less educated or talented than the 'superstar CEO'. The very functions of directors in large, existing corporations are more like those of skilled bureaucrats than superstars. However much we might fantasise about 'entrepreneurs' leading large companies,[51] those people will be starting new businesses, not ladder climbing in old ones. And when entrepreneurs *have* built their own companies, they are motivated by their work, not pay: 'performance pay' can even disrupt.[52] Most directors perform valuable but unremarkable functions, and just want to get on quietly – a sentiment acutely felt by the CEO of BP who, after Deepwater Horizon exploded, in the face of media crucifixion, said 'you know, I'd like my life back.'[53] Most executives, it might be said, would be very happy if the toxic social stigma (remarkably consistent across US and EU opinion[54]) were

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45 E Lazear and S Rosen, 'Rank-Order Tournaments as Optimum Labor Contracts' (1981) 89(5) Journal of Political Economy 841. It should be noted that there is no particular reason why sport stars *necessarily* are paid extravagant sums of money, as that development appears to coincide with (highly controversial) changes in ownership and regulation of sport clubs, television, licensing and advertising practices. Lazear and Rosen's argument eludes the possibility that sport enterprises are a classic example of where markets, and ordinary rules of competition law alone, systematically fail consumer (or member) interests.

46 HA Simon, 'On parsimonious explanations of production relations' (1979) 81 Journal of Economics 459, though this obviously precedes most of the main rises under discussion. It is not clear why firm size *per se* should justify more pay, although it seems plain that there will be more assets and labour under management from whom a cut may be taken.

47 cf RS Thomas, 'Explaining the International CEO Pay Gap: Board Capture or Market Driven?' (2003) Vanderbilt University Law School Law and Economics Working Paper No 03-05

48 e.g. L Bebchuk, JM Fried and DI Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation' (2002) 69 University of Chicago LR 751, and PL Davies, *Gower's Principles of Modern Company Law* (2008) 402

49 e.g. MJ Conyon, P Gregg and S Machin, 'Taking Care of Business: Executive Compensation in the UK' (1995) 105 Economic Journal 704

50 cf MC Jensen and WH Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) Journal of Financial Economics 305, 330, 'If my competitors all incur agency costs equal to or greater than mine I will not be eliminated from the market by their competition.'

51 cf MC Jensen and KJ Murphy, 'CEO Incentives? It's Not How Much You Pay, But How' (1990) 68(3) Harvard Business Review 138, argued 'corporate America pays its most important leaders like bureaucrats. Is it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?' The answer is that pay does not magically turn people into entrepreneurs, or attract them, because they usually build their own businesses. Hence, 'the most important financial innovation that I have seen the past 20 years is the automatic teller machine.' 'Paul Volcker: Think More Boldly' (14 December 2009) WSJ

52 See further M Moore, 'Corporate Governance, Pay Equity, and the Limitations of Agency Theory' (2015) University of Cambridge Faculty of Law Research Paper No. 8/2015, 30-36, on how variable performance pay distracts from the job.

53 Notably, after the Deepwater Horizon oil spill, plainly shaken by the media criticism, the CEO of BP Tony Hayward said, 'And we're… there's no one who wants this thing over more than I do, you know, I'd like my life back'. See E Crooks and A Edgecliff-Johnson, 'Cultural failings leave BP engulfed' (8 June 2010) Financial Times, and R Mason, 'BP faces revolt on £8m Tony Hayward pay' (29 May 2011) Daily Telegraph.

54 e.g. M Orton and K Rowlingson, 'Public attitudes to economic inequality' (2007) Joseph Rowntree, TNS Infratest

removed by bringing the cut-throat competition of exponential pay rises under control.

From these two positions, those who are content with rising pay tend to propose either nothing or transparency, while many opponents of rising pay (but by no means all) advocate greater shareholder control.[55] On this view, pay has risen because the possibility of conflict has run free, and shareholder voice can neutralise the conflicted directors' power. How do these over-rehearsed arguments square with the evidence in the UK, Germany and the US? Presumably, if the 'nothing or transparency' argument were sound, there should be no evidence of significant legal change as pay rose. If the 'conflicted director' argument were sound, legal change should be observable when executive pay – and perhaps inequality generally – began rising.

(a) United Kingdom

In the UK, the general position, since the Companies Act 1862, was that director remuneration 'shall be determined by the company in general meeting.'[56] That is company members, usually shareholders,[57] decided director pay, and they did so till around 1985. This was a model rule that would apply to all companies. So companies could change the default, and allocate power to another group.[58] This could be done when the company was formed, or through a 75 per cent member vote to amend the constitution.[59] Nevertheless, the model rules were clear that remuneration, by default, was not part of the ordinary 'business of the company [that] shall be managed by the directors'.[60]

The same basic legal framework remained in place through successive revisions in 1908,[61] 1929,[62] and 1948.[63] A provision was added in 1906 to say that directors could appoint a managing director from among themselves, on pay 'as they may think fit'. But this was subject to the

Politikforschung, *Ergebnisse einer repräsentativen Erhebung - Tabellarische Übersichten* (15 November 2007) a survey of 1000 people, 83% answered that €4.5m on average for the CEOs (*Vorstandsvorsitzenden*) of DAX30 companies was 'disproportionate' (*nicht angemessen*). MI Norton and D Ariely, 'Building a Better America—One Wealth Quintile at a Time' (2011) 6(1) Perspectives on Psychological Sciences 9

55 e.g. L Bebchuk and JM Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (2004)

56 Companies Act 1862, Table A, art 54. The Joint-Stock Companies Act 1856, Table B contained (after 45) no similar provision, though perhaps it was pointed out that the House of Lords in *Aberdeen Railway Co v Blaikie Brothers* (1854) 1 Macq 461, had emphasised the importance of avoid any possibility of a conflict of interest, Lord Cranworth LC saying, 'So strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.'

57 nb it is not necessarily the case that members are always shareholders. For example, employees could be enrolled as members if a company so chose, or indeed any other stakeholder. In companies limited by guarantee, the members are the guarantors.

58 It followed the general common law preference of democratic governance in corporations set by cases like *Attorney General v Davy* (1741) 26 ER 531 or *R v Richardson* (1758) 97 ER 426.

59 CA 1862 s 50 and see now CA 2006 s 21.

60 CA 1862, Table A, art 55. See now Companies (Model Articles) Regulations 2008 (SI 2008/3229) Sch 3, para 3

61 Companies Consolidation Act 1908, Table A art 69 (identical)

62 Companies Consolidation Act 1908, Sch 1, Table A, art 65 (amended by the Companies Act 1929, but identical)

63 CA 1948, Table A art 76, with some additions: 'The remuneration of the directors shall from time to time determined by the company in general meeting. Such remuneration shall be deemed to accrue from day to day. The directors may also be paid all travelling, hotel, and other expenses properly incurred by them in attending and returning from meetings of the directors or any committee of the directors or general meetings of the company or in connection with the business of the company.'

general meeting setting total director pay.[64] Executive pay was given some attention both in the Greene Committee of 1926 and the Cohen Report in 1945. After a scandal where a director had stolen around £1.2m without the other board members noticing,[65] Greene recommended that directors could not exempt themselves from liability for negligence. The committee also noted that a substantial body of shareholders 'should have the right to requisition a certified statement of the remuneration, etc., paid to directors, including managing directors.'[66] Reform concerned transparency more than amounts,[67] though it left 'the incomes of individual directors shrouded in darkness'.[68] The Cohen Report followed a major House of Lords case, where a managing director was found entitled to a large payout upon leaving office.[69] Cohen recommended limits on payments for loss of office, but took the view that 'the suggestion that managing directors are paid excessive sums is, as a rule, unfounded'.[70]

The decisive change was in 1985, when directors broke from *any* oversight from the general meeting. Before, it appears that most companies left their articles in the mould of Table A.[71] But then, the new Companies (Tables A to F) Regulations 1985 stated 'directors shall be entitled to such remuneration as the company *may* by ordinary resolution determine'.[72] The subtle syntactical difference was, unless companies changed their constitutions, the directors of companies following the model did not need to consult the general meeting *at all*. Directors 'may'

[64] Order of the Board of Trade, dated July 30 1906 substituting a new Table A for that contained in the first Schedule to the Companies Act 1862. SR&O 1906 No 596L.15, art 71. CCA 1908 Sch 1, Table A art 72. CCA 1908, Sch 1, Table A (amended by CA 1929) art 68. CA 1948 Sch 1, art 108.

[65] *Re City Equitable Fire Insurance Co* [1925] Ch 407. A director's duty of care became compulsory, but the company could buy insurance, and a court would have discretion to relieve the director, as under the Trustee Act 1925 ss 61-62. The operation of the rule now found in CA 2006 s 1157, from *Re D'Jan of London Ltd* [1994] 1 BCLC 561, shows directors of small companies are more likely to get relief than directors of large companies risking 'someone else's' money. The basic negligence standard under CA 2006 s 174, essentially reflects the famous decision in *Charitable Corp v Sutton* (1742) 26 ER 642.

[66] *Company Law Amendment Committee 1925-1926 Report* (1926) Cmd 2657, 19-22, para 50, 'disclosure of remuneration paid to, e.g., managing directors, might be harmful to the company, since cases not infrequently occur of attempts by competitors to induce a managing director to change his employment by offers of higher remuneration, and this practice would no doubt tend to increase if companies were compelled to disclose as a matter of course the remuneration which they pay.'

[67] Companies Act 1929 s 149 (contracts with the company must be disclosed), s 152 (exemptions of liability not permitted), s 182 (any loans to directors to be stated in accounts), s 273 (judicial relief from liability).

[68] O Kahn-Freund, 'Some Reflections on Company Law Reform' (1944) 7(1) MLR 54, 59, fn 25. CA 1929 s 148 allowed shareholders to request a statement of total (not individual) director remuneration, though the majority could veto.

[69] *Southern Foundries (1926), Ltd v Shirlaw* [1940] AC 701, 706, extracting, from its 1926 incorporation, the company's article 90, 'The directors may from time to time appoint any one or more of their body to be managing director or managing directors... generally upon such terms as to remuneration and otherwise as they may determine.' Then, the articles were changed in 1936, to say at art 68, 'The directors may from time to time appoint one or more of their body to the office of managing director or manager for such term and at such remuneration (whether by way of salary, or commission, or participation in profits, or partly in one way and partly in another) as they may think fit...' This followed Table A.

[70] *Report of the Committee on Company Law Amendment* (1945) Cmnd 6659, 45-49, para 89

[71] To give a *very* small and crude sample, a search at UK Companies House for FT30 companies (the forerunner of the FTSE100) for the period before 1947 showed the following: Fine Spinners and Doublers (reg no. 00236624) art 94 (pay fixed at £750 pa for the chair £500 pa for others, except managing director, or general meeting decided), Harrods (reg no. 00030209) art 63 (£1200 pa or more from general meeting), Imperial Chemical Industries (reg no. 237667) art 83 (£2000 pa, plus 1.5% profits or more fixed by general meeting) Rolls-Royce (reg no. 00087989) art 89 (£150 pa, or more from general meeting) Vickers-Armstrongs (reg. no 00227013) art 82 (general meeting decides annually), and F. W. Woolworth & Co (reg no. 00104206) appears only to have provision for managing directors. Identifying constitutions on any given date at Companies House, among multiple, similarly named entities in a group, is hard. Please email me for further information.

[72] SI 1985/80, Table A, art 82.

have done, but this was a decisive change from saying remuneration '*shall* be determined by the company in general meeting.' Companies took precisely this opportunity, and soon directors were regularly found paying themselves multi-million figures with little regard for procedure.[73]

As pay grew and attracted public criticism, the Cadbury Report supported the novel suggestion that a committee of 'independent' directors could play a legitimising role.[74] The curious theory, which went into the UK Corporate Governance Code, was that a comply-or-explain Code could define 'independence' of directors. It was possible to be 'independent' when you had depended on the people you were paying to get your job. The Greenbury Report, overseen by the chairman of Marks & Spencer, issued a further Code of Best Practice, which ultimately went into the Listing Rules and the Code.[75] Other suggestions included requiring that pay was 'performance related'. This goal that was said to be achievable by giving directors share options, ambitiously entitled 'long-term incentive plans'.[76]

These measures did not halt rising pay rates. So then it was said that shareholders should become more active in casting their votes at meetings.[77] In 2002 new Regulations required companies to give shareholders a 'say on pay', as if this was something new. But, in contrast to the pre-1985 position, these 'says' had no binding effect.[78] By then, the drafters of the upcoming Companies Act 2006 seem to have decided new model articles should reflect what was happening. So, quite remarkably, they were written to say, 'Directors are entitled to such remuneration as the directors determine'.[79] As pay rose more, in 2013 section 439A was inserted in the Companies Act 2006, so shareholders can have a binding say on the pay *policy* of directors, but not the actual figure. Other provisions put important limits on the length of service contracts, restrict loans to directors, and payments for loss of office.[80] But pay continues to rise.

Plotting these rule changes against the share of income received by the top 1% of earners, and the (not so) available information on pay ratios (the CEO's pay as a multiple of the

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73 e.g. *Guinness plc v Saunders* [1990] 2 AC 663, in breach of what is now CA 2006 s 171, a director was paid £5.2m by a committee for a takeover without any basis in the constitution for 'special remuneration'. The House of Lords held the payment was void.

74 Cadbury Committee, *Report of the Committee on the Financial Aspects of Corporate Governance* (1 December 1992). This partly followed the model set by the US. The calls for more 'independent' directors appear to have a history as a diversionary tactic against reform to require responsibility to employees and other stakeholders, both in the US and UK.

75 Study Group on Directors' Remuneration, *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (1995). See also Company Accounts (Disclosure of Directors' Emoluments) Regulations 1997 (SI 1997/570)

76 cf JC Coffee, 'Shareholders Versus Managers: The Strain in the Corporate Web' (1986) 85 Michigan LR 1, arguing that such 'incentive pay' compounds agency costs as managerial income become undiversified, and they will be more risk averse, unwilling to make innovative changes that are out of the ordinary.

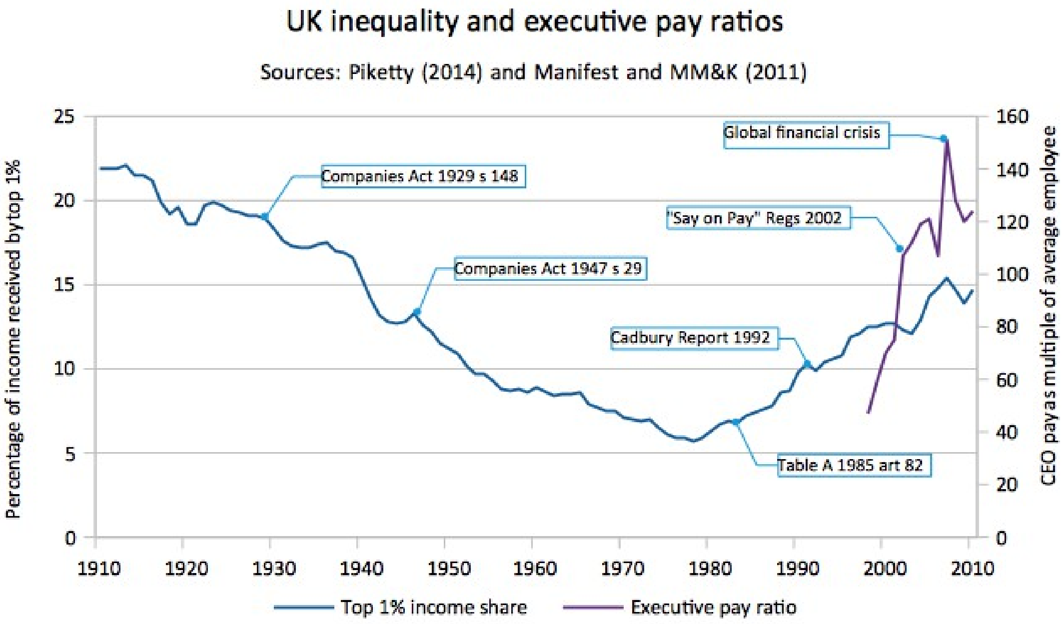
77 Hampel Committee, *Committee on Corporate Governance: Final Report* (1998)

78 Directors' Remuneration Report Regulations 2002 (SI 2002/1986). A similar EU-wide change was initially rejected by the EU High Level Group of Company Law Experts, *Final Report* (2002) 65

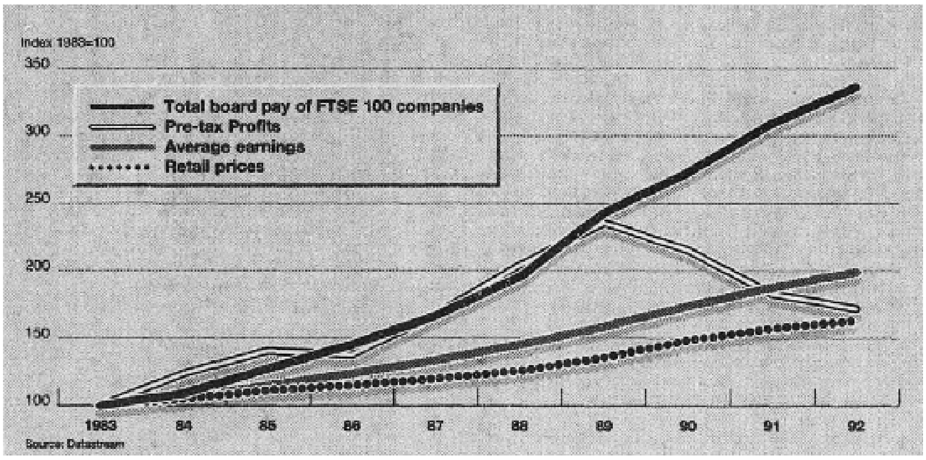
79 Companies (Model Articles) Regulations 2008 (SI 2008/3229) Sch 3, para 23

80 CA 2006 ss 188-196

average employee), the following picture is revealed.[81]



Plainly, executive pay is only *one* potential causal contributors to changes in income or wealth inequality. But, as far as available statistics on pay ratios go, there is a consistent fit with rising share of income of the top 1 per cent of earners, and rising executive pay. Using a different measure, for the period 1983 to 1993, the Financial Times had recorded that the increase in 'total board pay of FTSE 100 companies' was close to 350 per cent in 10 years, starting in 1983.[82]



From this, the conclusion could well be drawn that putting the law back to the traditional position, where the general meeting sets pay (the actual figure, not just the policy), will reverse the seemingly arbitrary upward trend.

81 Piketty (2014) Technical Appendices, Table S9.2 and Manifest and MM&K, *The Executive Director Total Remuneration Survey 2011* (March 2011) 78.

82 P Martin, 'More Than Their Job's Worth' (15 May 1993) Financial Times, 8. Datastream's source is unclear. A Kransdorff, 'Shifting trends in directors' pay' (27 October 1982) Financial Times, 12, describes an IoD commissioned 'Directors' Rewards survey' and advice to use US remuneration committees to deflect accusations that directors are 'deciding their own pay'.

However, UK company law has since 1947 given a simple majority of members the power to dismiss any director, with 28 days' notice and a fair hearing, for any reason determined by the members.[83] Members can also give specific instructions to the board, albeit that this typically requires a 75 per cent resolution.[84] For instance, a resolution could tie pay packages to a multiple of earnings of other staff members.[85] At any time, shareholders could have nullified the 1985 rule change. But why did pay already seem to be rising (if not so fast) and why had shareholders in no FTSE100 company coupled resolutions to dismiss boards to executive pay?

The answer is, shareholders – particularly UK asset managers who have come to monopolise shareholder rights – deliberately chose to support executive pay rises. For instance, asset managers surveyed in 1999 'indicated that they supported bigger salary increases for UK executives'.[86] If the goal were pay reduction, removing pay decisions completely from conflicted directors might be necessary, but giving binding votes to shareholding intermediaries would not be sufficient. It might even be said to be harmful, if asset managers were the source of the widely perceived 'feline obesity' epidemic.[87] Piketty's view was that 'only dissuasive taxation' would do the job, as it affects the 'social norms' regarding pay.[88] This may be persuasive, but as part 2(3) will explore below, the regulatory framework that enables conflicted asset managers and banks to vote with 'other people's money', helped create those social norms *and* act upon them.

(b) Germany

If the UK picture becomes ambiguous upon closer inspection, Germany's case is even less clear. German law on director pay has not fundamentally changed since 1937. Under the Public Companies Act 1965 (*Aktiengesetz 1965*), pay for directors on the executive board (*Vorstand*) is set by directors on the supervisory board (*Aufsichtsrat*), who under §87 should ensure it 'bears a reasonable relationship to the duties of such member and the condition of the company.'[89] For the most part, this has always been the case.[90] In turn, the pay of supervisory board directors is

83 CA 1947 s 29 re-enacted in CA 1948 s 184 CA 1985 s 303 and CA 2006 s 168. This effectively codified the common law standard found in *R v Richardson* (1758) 97 ER 426, and *Attorney General v Davy* (1741) 26 ER 531.

84 Companies (Model Articles) Regulations 2008 (SI 2008/3229) Sch 3, para 4

85 n.b. behavioural evidence suggests that comparative pay affects productivity, and significant productivity gains can be made by delegating pay distribution decisions to staff members as a whole. See A Cohn, E Fehr, B Herrmann and F Schneider, 'Social Comparison in the Workplace: Evidence from a Field Experiment' (2014) 12(4) Journal of the European Economic Association 877 and G Charness, R Cobo-Reyes, N Jimenez, JA Lacomba and F Lagos, 'The Hidden Advantage of Delegation: Pareto-improvements in a Gift-exchange Game' (2012) 102(5) American Economic Review 2358

86 R Gribben, 'Investors Champion Boardroom Pay Rises' (19 July 1999) The Daily Telegraph, 27, referred to in B Cheffins, 'The Metamorphosis of "Germany Inc.": The Case of Executive Pay' (2001) 49(3) American Journal of Comparative Law 497, 510.

87 cf K Wedderburn, *The Future of Company Law: Fat Cats, Corporate Governance and Workers* (IER 2004) ch 6

88 Piketty (2014) 512. For another view, see C Frydman and R Molloy, 'Pay Cuts for the Boss: Executive Compensation in the 1940s' (2011) NBER Working Paper 17303, 24-26

89 Aktiengesetz 1965 §87

90 Allgemeine Deutsches Handelsgesetzbuch 1869 §192 (for Kommanditgesellschaften, supervisory board member pay set by

set either in the constitution or by the general meeting.[91] Today, the supervisory board in companies with over 2000 staff is elected half by employees, half by shareholders, but shareholders hold a casting vote.[92] In practice, shareholder votes are monopolised by banks.[93]

Despite continuity in the basic rules, executive pay has risen dramatically in Germany since 1993.[94] Two focal points are often mentioned. The first is usually said to be the takeover by Daimler-Benz AG of the Chrysler Corporation in 1998. This apparently 'drew attention to the fact that Chrysler's No. 2 executive made more in 1997 from salary, bonus and share options than the top 10 Daimler-Benz executives combined.'[95] Second, there was a scandal in 2000 when the telecommunications company Mannesmann AG was taken over by the British Vodafone Airtouch plc. The *Vorstand* CEO Klaus Esser was given DM57m, including a DM32m 'appreciation award', while the *Aufsichtsrat* chair Josef Ackermann (gainfully employed at Deutsche Bank by the time of his trial) and other directors were also given a total of €60m. This led to an unsuccessful criminal prosecution of the directors for bad faith (*Untreu*),[96] but also a successful civil law action for 'wasting corporate assets' under §87.[97] Reasoning somewhere between US and UK courts,[98] the Federal Court of Appeal held that, because it was not part of their ordinary salary, the directors' 'appreciation award' was *per se* unlawful. Happily, the court found they did not need to figure out what 'reasonable' pay under §87 might actually mean.[99]

general meeting) §227 (executives can be removed at any time, without prejudice to contractual pay claims). Revised in 1884 without change. Handelsgesetzbuch 1897 §231 (executives can be removed at any time, without prejudice to contractual pay claims) §245 (requirements for pay for supervisory board members as a percentage of profits; pay can only follow a general meeting resolution). Aktiengesetz 1937 §78 (supervisory board to ensure executive pay is reasonable) §98 (supervisory board members paid according to the constitution, which can only be changed by general meeting resolution).

91 Aktiengesetz 1965 §113

92 Aktiengesetz 1965 §101 and Mitbestimmungsgesetz 1976 §§8-9 and 27

93 Aktiengesetz 1965 §135. See further, below at 2(3). The last collected statistics, before their mysterious abolition in 2004, showed that banks had consistently exercised around 60 per cent of shareholder voting rights. The use of the word 'monopolised' is not, therefore, intended to be emotive, rather than technical. In EU monopoly regulation, a 'dominant position' can be achieved with even with a market share under 30%. See generally *AKZO Chemie BV v Commission* (1993) Case C62/86, [1993] 5 CMLR 215.

94 e.g. A Barker and C Bryant, 'Germany overtakes UK corporate executive pay stakes' (5 January 2015) Financial Times

95 B Cheffins, 'The Metamorphosis of "Germany Inc.": The Case of Executive Pay' (2001) 49(3) American Journal of Comparative Law 497, 508-9.

96 Strafgesetzbuch 1871 §266, 'Whosoever abuses the right accorded him by law, official instruction or legal transaction to manage the property of a third party, or violates the duty entrusted him by law, official instruction or legal transaction to safeguard the property of a third party and thereby disadvantages whomsoever's property interests had been entrusted to him, shall be imprisoned for up to five years or fined. In especially serious cases, the punishment is anything from six months to 10 years in prison.'

97 Aktiengesetz 1965 §87. Bundesgerichtshof (21 December 2005) BGHZ 50, 331, NJW 2006, 522.

98 See *Rogers v Hill*, 289 US 582 (1933)

99 This timorous (though hardly uncommon) judicial attitude may be contrasted with rather more open reasoning of *Heller v Boylan*, 29 NYS 2d 653, 679 (1941) per Collins J, 'Assuming, *arguendo*, that the compensation should be revised, what yardstick is to be employed? ... Yes, the Court possesses the power to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific.... To act out of whimsy or caprice or arbitrariness would be more than inexact – it would be the precise antithesis of justice; it would be a farce.... If comparisons are to be made, with whose compensation are they to be made- executives? Those connected with the motion picture industry? Radio artists? Justices of the Supreme Court of the United States? The President of the United States? Manifestly, the material at hand is not of adequate plasticity for fashioning into a pattern or standard.' Ultimately the suggestion appears to be that ultimately the stakeholders who contribute to the corporation are better placed than a court to decide.

After the financial crisis, the Reasonableness of Executive Compensation Act 2009 inserted the right of shareholders to have a say on executive pay (though non-binding, as the supervisory board still decides).[100] Data on changes in the executive pay ratio to average employees appear to be unavailable before 2006. However the general trend can be seen in available data on the multiple of *all* directors (not just the 'CEO': the following graph is intended to refer to all executive directors on the *Vorstand*, or executive board) with a detectable upward drift beginning in 1986, and decisively so in 1993.[101] This is not easy to relate to any legal change, nor (as the graph below at part 2(2)(b) will show) changes in the top 1 per cent of income earners.

Two more legal changes are often highlighted. First is the Control and Transparency in Enterprise Act 1998. This contained a provision allowing directors to get share options via new issues or repurchases,[102] previously banned, meaning executive pay could expand further. Share options typically fix minimum prices regardless of market rates, and involve no downside for the executive in line with firm fortunes. However, it is chronologically plain that, if this measure was significant, it merely compounded, rather than triggered, the inflationary trend.

Second, the top rate of income tax was cut from 51 per cent to 42 per cent between 2000 and 2005, but then increased again to 45 per cent in 2007. Tax cuts are thought to lead to rising pay because perhaps under a more liberal tax regime directors know they can keep more of what they award each other.[103] The frustrating difficulty is that tax incentive arguments can cut both ways. You could equally argue, for example, "if directors are subject to a higher marginal rate of tax, they will want to increase their pay further to compensate for what tax is taking away." Empirical evidence does not clearly falsify or substantiate either assertion. In any event, the tax

100 Gesetz zur Angemessenheit der Vorstandsvergutung 2009, inserting Aktiengesetz 1965 §120(4).
101 F Fabbri and D Marin, 'What Explains the Rise in CEO Pay in Germany? A Panel Data Analysis for 1977-2009' (2012) IZA DP No. 6420, 10, Figure 3, 'Earnings Gap, 1977-2008: Ratio of per-Capita Board Compensation to Average Earnings'. The data source for executive pay is consulting firm Kienbaum (which had data since 1976) and for average employee wages it is the German Quarterly Earnings Survey.
102 Gesetz zur Kontrolle und Transparenz im Unternehmensbereich 1998 §§71(8) and 192(2)
103 e.g. Cheffins (2001) 49(3) American Journal of Comparative Law 497, 519.

changes came some time after the initial rises in pay. So, if German executive pay appears less related to rules on the board/shareholder power balance (i.e. the rules did not change but top incomes did) which other factors mattered?

The essential point seems to be that shareholder rights were dominated by banks from about 1923.[104] Back then, banks gradually assumed the function of holding shares, and casting votes on their clients' behalf through no better reason than their dominant market position, and a quirk of property law that required shares to be certificated. This practice was codified in the Aktiengesetz 1937,[105] and was never reversed after the fall of the fascist dictatorship, despite continued proposals.[106] So, an answer to why German executive salaries took off from 1993 necessarily involves the psychology of bankers after reunification, as addressed below.

It is worth noting briefly that in Switzerland, a similar legal framework had developed, until a vote was held in 2013, literally called the 'People's Initiative against Rip-off Salaries'.[107] The campaign targeted rising executive pay. Its method was to ban banker intermediary voting, require the board compensation committee be elected by shareholders, and require pension funds (whose structure is regulated so that beneficiaries have a democratic voice) to be active in casting votes. It resulted in the second highest ever vote in a Swiss referendum,[108] and immediately attracted the derision of a number of eminent German corporate lawyers.[109] The novel approach is to remove power, and the conflict of interest, both from the board *and* financial intermediaries.

(c) United States

In the US similar changes to the UK took place, but earlier. Nineteenth century corporation law treatises, like Victor Morawetz in 1886, thought it 'would be contrary to established principles to allow the directors or other agents of a corporation to fix their own compensation'.[110] Similar to German regulation, compensation should be fixed by a corporation's charter, or the by-laws adopted by a majority of members.[111] The second option appears to have been widely exercised.

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104 RG Urteil (19 June 1923) RGZ 107, 67, 70. RG Urteil (20 November 1925) RGZ 112, 273, 279. G Opitz and H Schultz (15 May 1925) 24 Bankarchiv, Special Issue, Nr 16. E Micheler, 'English and German securities law: a thesis in doctrinal path dependence' (2007) 122 LQR 251, 272-277. E McGaughey, *Participation in Corporate Governance* (2014) ch 6(2)(c)-(d), 154-156.

105 Centralverband des deutschen Bank- und Bankiergewerbes (1930) BankA 1930-31, 116 and Aktiengesetz 1937 §114

106 Aktiengesetz 1965 §135 and Geßler Commission, Bundesministerium der Finanzen, Grundsatzfragen der Kreditwirtschaft - Bericht der Studienkommission (1979) 287

107 In German, Eidgenössische Volksinitiative «gegen die Abzockerei» or in French, Initiative populaire «contre les rémunérations abusives» (2013).

108 In Switzerland, a 'referendum' is a vote for or against legislation, while an 'initiative' may create new constitutional laws.

109 e.g. KJ Hopt, 'Conflict of Interest, Secrecy and Insider Information of Directors, A Comparative Analysis' (2013) 2 ECFR 167, 181

110 V Morawetz, *A Treatise on the Law of Private Corporations* (2nd edn Little, Brown and Co 1886) vol I, §508

111 Morawetz refers to the following cases ***: *Loan Ass v Stonemetz*, 29 Pa St 534, *Citizens' Nat Bank v Elliot*, 55 Iowa 104, *Holder v Lafayette &c Ry Co*, 71 Ill 106 (1873), *Maux Ferry Gravel Ry Co v Branegan*, 40 Ind 361, *Illinois Linen Co v Hough*, 91 Ill 63 (1878)

Toward the end of the century executive salaries were thought to be growing to enormous levels.[112] Every state could have different regulation, but corporations would usually have basic flexibility to change their rules. Over the 1920s, more executive bonus plans evolved,[113] and companies changed their constitutions to eliminate the need for stockholder involvement. By 1929 it was clear that a basic shift had taken place and executive pay was routinely being determined by boards.[114]

After the Wall Street Crash, a flood stockholders launched litigation to challenge high pay. A first type argued that loose practices for executive pay did not follow a corporation's own rules, or state law.[115] A second, and potentially more intriguing type, argued that high pay could in itself be unlawful, for being beyond the implicit expectations of stockholders – a 'waste' of corporate assets.[116] On top of these challenges, the Securities and Exchange Commission was created in 1933,[117] and was empowered under the Securities Act of 1933 §26(14) to require disclosure of any executive pay above $25,000 upon a new securities issue. Theoretically, the combination of disclosure and a new judicial standard of waste might have led to court control of high pay. However, this did not happen in practice, not least because of judges' incredulity about what standards were meant to be followed in limiting pay.[118] Courts felt inherently more capable in enforcing rules on the procedure for pay, but not substituting their judgment for the judgment of corporate stakeholders. In 1942, taxation was introduced which in functional terms created something like a 'maximum wage'.[119] The Treasury created a 'Salary Stabilization Unit' which processed 750,000 requests a year, and whose approval was necessary to increase wages for those earning above $5,000.[120] However, this remarkable experiment ended shortly after the War.

Why did top incomes continue to compress post-war, but begin to rise in the early 1970s? Among the 50 different corporate laws in the US, Delaware had emerged as a clear 'winner' of the race to become the most desired state of incorporation. Delaware's statute was originally silent on the question of the general meeting's control over executive pay. But in 1922 the

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112 *Beers v. New York Life Ins. Co.*, 20 N.Y. Supp. 788 (1892) ***

113 'Legal problems of corporate executive bonus plans' (1931) 41 Yale Law Journal 109

114 e.g. *Church v. Harnit*, 35 F. (2d) 499, 502 (C.C.A. 6th, 1929) certiorari denied 281 US 732 (1930) where an Ohio company stockholder challenged payment of bonuses and deferred compensation to five directors, who voted their own pay. The company's Code of Regulations said officers 'shall be paid such compensation as may be determined by such board.' Hickenlooper J held, while noting that no unfairness of the consideration was alleged, that the payments were valid.

115 *Rogers v Guaranty Trust Company*, 288 US 123 (1933)

116 *Rogers v Hill*, 289 US 582 (1933)

117 Emergency Price Control Act 1942. See EE Witte, 'American Experience with Wage Stabilization' [1952] Wisconsin Law Review 398

118 e.g. *Heller v Boylan*, 29 NYS 2d 653, 679 (1941) per Collins J, and *Winkelman v General Motors Corp*, 44 F Supp 960, 969-70 (SDNY 1942)

119 Public Law 729, "An Act to Amend the Emergency Price Control Act of 1942, to Aid in Preventing Inflation, and for Other Purposes."

120 C Frydman and R Molloy, 'Pay Cuts for the Boss: Executive Compensation in the 1940s' (2011) NBER Working Paper No. 17303, 11

Delaware Supreme Court had affirmed (like the UK's Table A) that directors were not entitled to set their own pay unless there had been a shareholder resolution, or alternatively there was an explicit provision in the corporation's articles providing for directors setting their own pay.[121] In 1959, it was held that directors were entitled to use their own business judgment in how and how much employees were paid, including management staff,[122] though this was very different to condoning directors setting *their own* pay. The same position remained until a somewhat unnoticed amendment in 1969.[123] From then, the presumption was reversed. 'Unless otherwise restricted by the certificate of incorporation or bylaws,' said the new Delaware General Corporation Law §141(h), 'the board of directors shall have the authority to fix the compensation of directors.'[124] And so it was since.

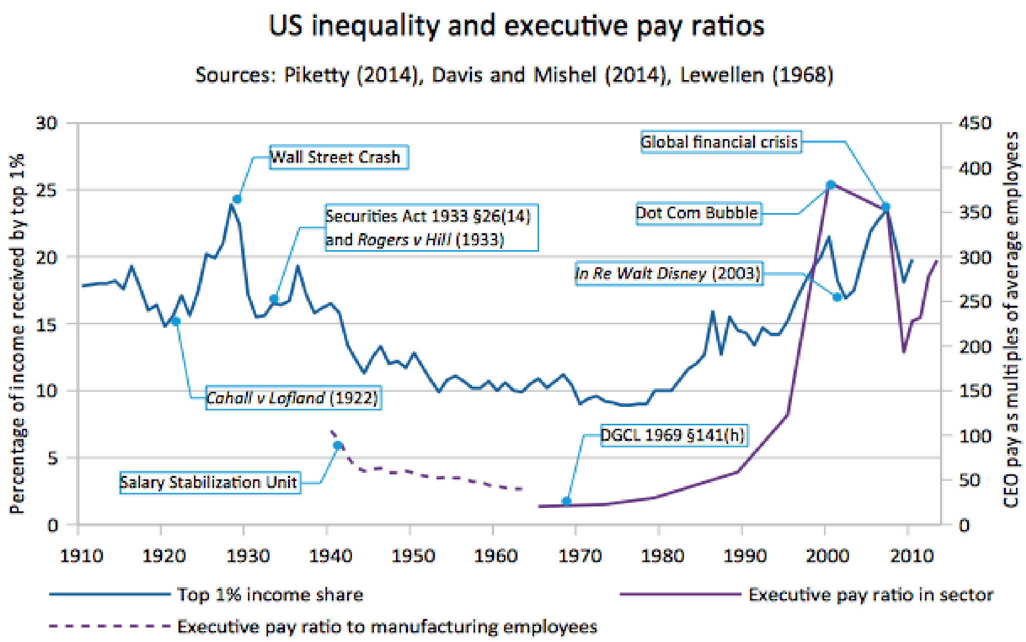
How many corporations changed their bylaws to stop directors setting their own pay? Not many, it seems, because by 1980, Detlev Vagts' said that 'the board has clear responsibility for setting managerial salaries', including it seemed, its own.[125] Case law became preoccupied, instead, with challenges to exotic bonus and stock plan payments, usually alleging a procedural defect. Vagts noted that having 'independent' directors had appeared to ease the courts, and there was 'a general movement in state statutes and decisional law to drop all constraints on self-dealing except for judicial determination of unfairness.'[126] Over the 1990s, executive pay of Fortune 500 CEOs rose 481 per cent.[127] The same period saw high economic growth, but a disproportionate amount was captured by the richest section of society,[128] leaving the majority of people with a stagnant and precarious standard of living for the last four decades.[129]

Nevertheless, the Delaware courts felt this was the ideal time to lower the pay regulation standards further still, even questioning the most basic procedural safeguards. The chair of Walt Disney, Michael Eisner, had agreed a pay package with Michael Ovitz without discussing an executive compensation report (which astutely noted the pay was excessive) with the board. Ovitz walked away with $140 million after one year. In a first judgment, Chief Justice Veasey said that the corporate waste standard was 'confined to unconscionable cases where directors irrationally

[121] *Cahall v Lofland*, 12 Del Ch 299, 114 A 224 (Ch 1921), affirmed, 13 Del Ch 384, 118A1 (1922)
[122] *Lieberman v Becker*, 38 Del Ch 540, 155 A 2d 596 (Super Ct 1959)
[123] S Arsht and WK Stapleton, 'Delaware General Corporation Law: 1969' (1969) 25 Business Lawyer 287
[124] This is the same since revisions in 1974, 1980, and up to today.
[125] DF Vagts, 'Challenges to Executive Compensation: for the Markets or the Courts?' (1983) 8 Journal of Corporation Law 231, 268
[126] Vagts (1983) 8 Journal of Corporation Law 231, 269
[127] M Diebel, 'Stock Options are Making a Lot of Fat Cats Fatter' (2 November 1999) Treasure Coast Business Journal (Vero Beach, Florida) at A9). See also BJ Hall and LB Liebman, 'Are CEOs Really Paid Like Bureaucrats?' (1998) 113 Quarterly Journal of Economics 655, 661-67 and T Perry and M Zenner, 'CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?' (2000) 35 Wake Forest LR 123, 123-24, 145.
[128] US Census Bureau, *Historical Income Tables: Households* (2013) Table H-3. Mean Household Income Received by Each Fifth and Top 5 Percent, All Races: 1967 to 2013.
[129] e.g. TA Sullivan, E Warren and JL Westbrook, *The Fragile Middle Class: Americans in Debt* (2000)

squander or give away corporate assets.'[130] In a second judgment, Chancellor Chandler held board members could not be liable unless they showed 'reckless indifference to or a deliberate disregard of the whole body of stockholders', taking actions which are 'without the bounds of reason'.[131]

Faced with this legal position, the response of shareholding institutions who were democratically accountable to their contributors (i.e. most state public pension and trade union pension funds, not asset managers) was to push for the retraction of pay decisions from directors' hands. In Delaware, charter amendments can only be instigated on the initiative of directors – not members (an exceptional practice, from a comparative viewpoint). Shareholders can, however, make proposals which put heavy pressure on the board if there is a majority outcome. Perhaps in order to garner more support, the first step taken was to propose amendments for non-binding 'say on pay' votes, though in 2007 the average support was 41.7 per cent.[132] The Dodd-Frank Act 2010 sped this up, introducing a requirement for corporations to hold non-binding votes on pay.[133] However, the levels of pay continued to grow.[134]



Like in the UK (but with more historical data) a clear consistency is evident between the top

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[130] *Brehm v Eisner*, 746 A2d 244, 263 (2000). This gradually built on previous Delaware case law, but seems unrelated to the original concept envisaged by the US Supreme Court, which appears best understood as an application of *laesio enormis*.

[131] *In re Walt Disney Derivative Litigation*, 825 A 2d 275 (2003). The same fact pattern would have constituted a clear breach of the duty of care under the prevailing common law approach. See *Charitable Corp v Sutton* (1742) 26 ER 642 and more recently *Re Barings plc (No 5)* [2000] 1 BCLC 523 where the directors also failed to pay regard to a report (which audited the Singapore office's risk systems in this case) and were found to be 'unfit' (i.e. negligent) to continue as directors.

[132] Riskmetrics Group, *Postseason Report* (2007) 6

[133] Dodd-Frank Act 2010 §951

[134] Piketty (2014) Technical Appendices, Table S9.2, A Davis and L Mishel, 'CEO Pay Continues to Rise as Typical Workers Are Paid Less' (12 June 2014) Economic Policy Institute, and WG Lewellen, *Executive Compensation in Large Industrial Corporations* (1968) ch 8, 123, Table 1, and ch 9, 177, Table 13.

percentage of incomes and pay ratios. The pay ratio measures from 1940 to 1963 differ to those from 1965 to 2013,[135] but still capture the basic change. Delaware's 1969 law, empowering directors to pay themselves, was at the start of the exponential curve. But change took time. Why was the 'take-off' delayed, just as a change was not to happen in Germany until 1993? Across all jurisdictions, shareholder votes are appropriated by financial institutions. So to understand executive pay, the identity and attitudes of shareholding institutions – asset managers and banks – is fundamental. We return to this in part 2(3). But for now, the picture does not square with the argument that absence of exclusive shareholder voice was the *only* cause of the rise.

(2) Employee and union rights

If the regulation of executive pay appears linked, but not decisively, to changes in inequality, what about the pay of everyone else who invests their labour in the corporation? Directors delegate management and work through a chain of employees, who typically represent the corporation to the outside world.[136] Invariably there are two basic terms implicit in employment contracts. First, the corporation may direct its employees within the scope of contractual duties.[137] This residual power effectively enables the employer to unilaterally vary the *quid pro quo* of the bargain, for instance by requiring staff work harder. Second, as the employer, the corporation appropriates the benefits of the employees' labour.[138] So, for example, corporations can (without an express clause) take the gains of growth in production. But if losses result, employees are frequently the first to bear the brunt through dismissals – a systemically undiversifiable job risk.[139]

In short, the default rules of employment allow corporations to take everything, give less back, and call the difference profit. But if those rules are altered through agreement or law, the assumption that returns to capital exceed growth could change: in Piketty's terminology, perhaps to make $r = g$ or $r < g$. This could be true before relying on the state for redistributive taxation and spending. Corporate directors are typically empowered to determine staff pay policies as part of their managerial function.[140] This means anything which touches the director's discretion will have very significant distributive consequences. So, to what extent can employees participate in,

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135 As the statistics from Lewellen (1968) involve manufacturing workers only, the rates appear to be naturally higher than those from Davis and Mishel (2004).

136 e.g. *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480, Handelsgesetzbuch §54, and *South Sacramento Drayage Co v Campbell Soup Co*, 220 Cal App2d 851, (3d Dist 1963)

137 e.g. *Lawrie-Blum v Land Baden-Württemberg* (1986) Case 66/85, [1986] ECR 2121 at [17] and cf Restatement of the Law (Second) of Agency (1958) §220

138 See *Stevenson, Jordan & Harrison v MacDonald & Evans* [1952] 1 TLR 101, BGB §950 and generally for the US, O Lobel, 'Intellectual property and restrictive covenants' in KG Dau-Schmidt et al, *Labor and Employment Law and Economics* (Elgar 2009) vol 2, ch 18. Of course, intellectual property being appropriated by employers is just one example of this fundamental, but little noticed standard term of employment.

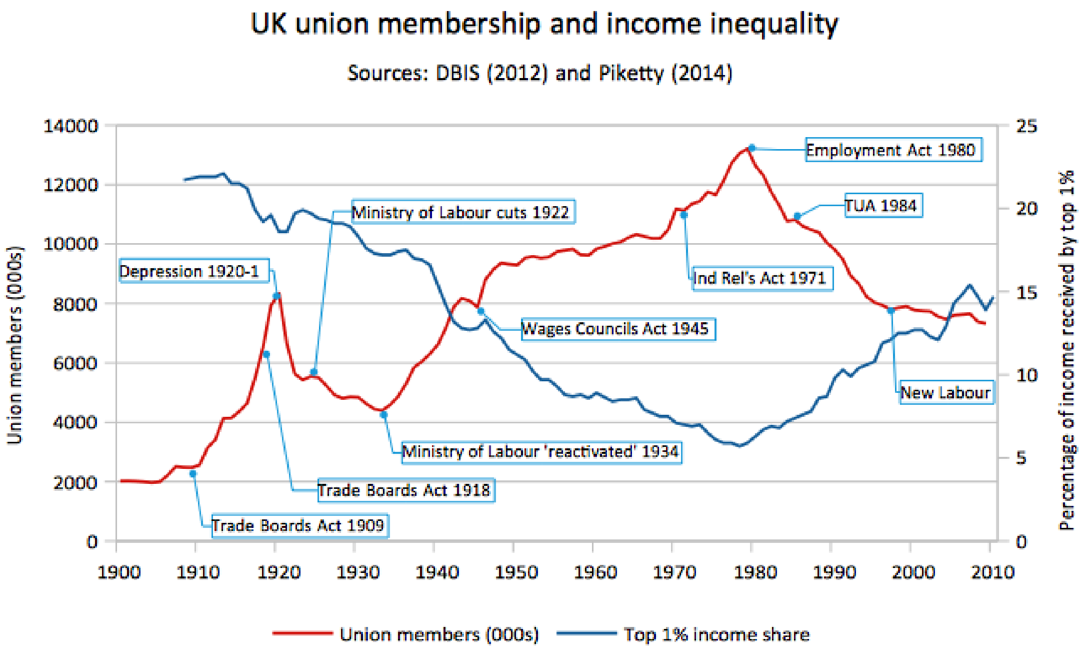
139 e.g. E Warren, 'Bankruptcy Policy' (1987) 54 University of Chicago Law Review 775, 790

140 Companies (Model Articles) Regulations 2008 (SI 2008/3229) Sch 3, para 3, Aktiengesetz 1965 §87 and DGCL §141(a)

or otherwise influence, the board of directors' discretion in setting workplace pay?

(a) United Kingdom

The UK is well known for following a 'single channel' model of workplace participation.[141] There is a rich history of direct participation rights,[142] which today play an essential (but often forgotten) part of university workplace, or pension governance.[143] Otherwise, collective bargaining is typically the only option for a British voice at work. Independent trade unions, democratically organised by members, seek collective agreements to regulate everyone's terms at work. If employers refuse to bargain, unions may take collective action 'in contemplation or furtherance of a trade dispute'.[144] This basic rule has existed in the UK since 1875.[145] But without a union, individual workers, by default, will have no realistic voice in large corporations. The result, when union membership is plotted against income inequality changes, is remarkable.[146]



Correlation does not necessarily mean causation,[147] but the UK's case is clear: collective bargaining changed income inequality. The more difficult question is, what changed union

141 e.g. PL Davies and C Kilpatrick, 'UK Worker Representation After Single Channel' (2004) 33(2) ILJ 121
142 See E McGaughey, 'British codetermination and the Churchillian Circle' (2014) UCL LRI Working Paper 2/2014
143 e.g. *Memorandum and Articles of Association of the London School of Economics and Political Science* art 10.5, and the Pensions Act 2004 ss 241-243.
144 TULRCA 1992 ss 219
145 Conspiracy and Protection of Property Act 1875 s 3
146 The sources are N Brownlie, *Trade Union Membership 2011* (DBIS 2012) 22-23 and T Piketty, *Capital in the Twenty-First Century* (2014) Technical Appendices, Table S9.2
147 For example, it could be said that a more equal society fostered the growth of trade union membership, or that the two are unconnected. This seems counterintuitive, since one of the primary functions of trade unions has always been to reduce inequality through collective bargaining, see S Webb and B Webb, *Industrial Democracy* (1920) Part II, ch 2.

membership? Before any question of law (shown in the chart's labels) people's collective will to organise innovatively in their workplaces is key. Union representatives who innovate (despite the temptations of familiar, conservative strategies of protest) usually succeed.[148] But for law itself (in the UK historically), three main groups of rules appear most relevant.

First, rules can empower government to promote union membership. The Trade Boards Act 1909 empowered the Board of Trade to set minimum wages in the 'sweated industries'.[149] This encouraged the first, and unprecedented, rise in union organising, because unions could actively campaign for the state to improve conditions. A Ministry of Labour was created in 1916, and after the Trade Boards Act 1918,[150] the Minister could fix wage scales in an industry if employers did not reach a voluntary solution by recognising and collectively bargaining with union representatives.[151] 'Joint Industrial Councils' in most major industries resulted. The significant drop in union membership from 1920 (and accompanying rise in inequality) resulted from a post-war depression,[152] and from 1922 a new coalition cut the Ministry of Labour's functions.[153] However, the Ministry of Labour picked up its organisational work once more after 1934, with new legislation being passed to underpin the bargaining process in sectors like cotton and road haulage.[154] The Wage Councils Act 1945 revived the policy of enforcing minimum wages in all sectors of industry, again spurring union growth by welcoming their participation.[155] Overall, active encouragement by government departments played a decisive, historic role in boosting unions, and compressing inequality in the UK.

Second, unions could be empowered (to varying degrees) to collectively agree with employers that all staff would be enrolled in a trade union. The strongest form of this was the

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[148] See further VL Allen, *Power in trade unions: a study of their organisation in Great Britain* (1954) 295-6 and LS Penrose, 'The Elementary Statistics of Majority Voting' (1946) 91 Journal of the Royal Statistical Society 56

[149] cf Winston Churchill MP, Trade Boards Bill, Second Reading, Hansard HC Debs (28 April 1909) vol 4, col 388, 'It is a serious national evil that any class of His Majesty's subjects should receive less than a living wage in return for their utmost exertions.... where you have what we call sweated trades, you have no organisation, no parity of bargaining, the good employer is undercut by the bad, and the bad employer is undercut by the worst... where those conditions prevail you have not a condition of progress, but a condition of progressive degeneration.'

[150] See Reconstruction Committee, *Sub-Committee on Relations between Employers and Employed: Interim report on joint standing industrial councils* (1917) Cd 8606

[151] KD Ewing, 'The State and Industrial Relations: 'Collective Laissez-Faire' Revisited' (1998) 5 Historical Studies in Industrial Relations 1, 17-20

[152] S Webb, 'The British Labour Movement and the Industrial Depression' (1923) 7 International Labour Review 209

[153] Cave Committee, *Report to the Ministry of Labour of the Committee Appointed to Enquire into the Working and Effects of the Trade Board Acts* (1922) Cmd 1645. It survived outright abolition in the Conservative and Liberal coalition's proposed programme of cuts: see the Geddes Report, *Committee on National Expenditure. First interim report of Committee on National Expenditure* (1922) Cmd 1581, at 141 ff.

[154] Ewing (1998) 5 Historical Studies in Industrial Relations 1, 26-30, noting at 26 'bureaucratic intervention by the process of 'administrative regulation' in the direction of encouraging the development of JICs through the medium of the Ministry of Labour... is clear from the annual reports of the Ministry of Labour from 1934 onwards where we find a greater readiness to acknowledge what would now be referred to as the 'proactive' work of the department.' See the Cotton Manufacturing Industry (Temporary Provisions) Act 1934 and Road Haulage Wages Act 1938. The Ministers for Labour in this period were the Conservative MP Sir Oliver Stanley, the Liberal MP Ernest Brown, and the Labour MP Ernest Bevan.

[155] See O Kahn-Freund, 'The Wages Councils Bill' (1945) 8(1) Modern Law Review 68

'closed shop'. This meant employees could not be hired, or had to be dismissed, if they were not union members: they could not 'opt out'. This was basically lawful since the Trade Union Act 1871,[156] despite continual attempts by a hostile judiciary to prevent unions enforcing it.[157] A considerable body of case law developed regarding the reasonableness and procedure for excluding employees when they did not belong to the union.[158] The Industrial Relations Act 1971 attempted to mandate a right to not belong to a union, and only allow unions to charge fees if confirmed by a ballot. Unions refused to comply with the Act, and it was reversed in 1974.[159] But then, the Employment Act 1980 ended the closed shop by requiring there to be ballot support of 80 per cent.[160] The following year, the European Convention on Human Rights held (relevant for all Europe) that ECHR article 11 was incompatible with a complete closed shop.[161] This was eventually held to mean freedom 'from' association with a trade union.[162] The Employment Act 1990 made a complete prohibition on any closed shop, and it remains today.[163]

It remains questionable whether unions are still able to make 'fair share' agreements, so that non-union members make reasonable contributions for the benefits of being in a workplace with collective bargaining.[164] However, unions are fully entitled to reach collective agreements where staff members are automatically enrolled in the union when they start work, if they are free to opt out. Behavioural economics, which underpinned the policy of automatic enrollment in the Pensions Act 2008, suggests that people would mostly *not opt out* if auto-enrolled in a union. However, people do not *opt into* union membership (despite the obvious benefits, like any insurance policy) simply because of human inertia, known as the 'status quo bias'.[165] Unions have not tried auto-enrolment yet. With an opt-out, it would be entirely lawful. Arguably, this simple psychological fact, the 'status quo bias', combined with the demise of the closed shop, is the

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156 The minority report before the Trade Union Act 1871 recommended this: *Eleventh and Final Report of the Royal Commissioners appointed to Inquire into the Organization and Rules of Trades Unions and Other Associations* (1868-1869) Parliamentary Papers vol xxxi, pages xxix-xxx

157 e.g. *Quinn v Leathem* [1901] AC 495, *Conway v Wade* [1909] AC 506, *Reynolds v Shipping Federation* [1924] 1 Ch 28, *Rookes v Bernard* [1964] AC 1129.

158 e.g. *Amalgamated Society of Carpenters v Braithwaite* [1922] 2 AC 440, *Lee v Showmen's Guild of Great Britain* [1952] 2 QB 359, *Nagle v Feilden* [1966] 2 QB 633

159 Trade Union and Labour Relations Act 1974

160 EA 1980 s 7, inserting Employment Protection (Consolidation) Act 1978 s 58A

161 *Young, James and Webster v United Kingdom* (1981) 4 EHRR 38, [55]

162 *Sørensen and Rasmussen v Denmark* [2006] ECHR 24, cf *Lavigne v Ontario Public Service Employees Union* (1991) 2 SCR 211

163 Trade Union and Labour Relations (Consolidation) Act 1992 s 137

164 *Confederation of Swedish Enterprise v Sweden* (1996) 22 EHRR 409 Social Rights Committee of the Council of Europe, thought wage monitoring could legitimately require the payment of a fee, depending on the real use of the fee for things other than wage monitoring. However in *Samuel v London Bus Services Ltd* (2008) ET Case No 3202466/2008, a Tribunal came to the view that a fair share agreement breached the TULRCA 1992 s 146(3) 'right not to be subjected to any detriment as an individual by any act, or any deliberate failure to act, by his employer.... for the sole or main purpose of enforcing a requirement... that... he must make one or more payments.' The Tribunal did not, however, apply the appropriate test of whether a reasonable person would believe they were subject to detriment, and such an interpretation of s 146(3) may not comply with art 11.

165 See further E McGaughey, 'Behavioural economics and labour law' (2014) LSE Law, Society and Economy Working Papers 20/2014, 29-30

primary cause for the attrition of union membership in Europe since 1981.

Third, there are rules empowering or restraining collective action, including the right to strike.[166] Logically, the capacity of organised employees to take collective action influences what they can gain. The foreseeable gains will influence the desirability of effort to organise.[167] Against whom can unions take collective action? For what reasons? And what are the procedures for a strike to be lawful? In some form, there has been a right to strike since the Trade Disputes Act 1906.[168] However, restrictions have fluctuated. So called 'secondary' action is where a union seeks to take action against an employer, or another party, who asserts they have no employment relationship with the striking employees. For example, employees may be given contracts stating their 'employer' is a subsidiary company, although the parent company is in ultimate control of the corporate group policy. After the General Strike of 1926 failed, the Trade Disputes and Trade Unions Act 1927 banned action against anyone but the party who an employment contract designated as the employer.[169] This ban was lifted by the Trade Disputes and Trade Unions Act 1946, but was reinstated by the Employment Act 1990.[170] In judge made law, UK unions were also restricted (on questionable grounds) from taking collective action against privatisations and outsourcing in 1984 and 1999,[171] on the ground that there was ostensibly no 'trade dispute'.[172]

Another way of changing the cost/benefit equation of collective action, and maybe discouraging union membership, is procedural requirements before collective action becomes lawful.[173] The Trade Union Act 1984 installed various incompetently drafted rules requiring (in summary) unions to conduct ballots before collective action, with every employee included and

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166 This right is a fundamental human right in international law, and fundamental to every democratic society, because it is necessarily suppressed by every authoritarian regime, which must suppress plural sources of organisational power and dissent. See further B Gernigon, A Odero and H Guido, 'ILO Principles Concerning the Right to Strike' (1998) 137 International Labour Review 441.

167 This has a psychological explanation in the phenomenon of 'loss-aversion'. A Tversky and D Kahneman, 'Loss Aversion and Riskless Choice: A Reference Dependent Model' (1991) 106(4) Quarterly Journal of Economics 1039. For a discussion of political theory on the likelihood of collective action, see JC Coffee, 'The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated' (2012) 97 Cornell LR 1019

168 See *Morgan v Fry* [1968] 2 QB 710, Lord Denning MR, 725, 'It has been held for over 60 years that workmen have a right to strike (including therein a right to say that they will not work with non-unionists) provided that they give sufficient notice beforehand: and a notice is sufficient if it is at least as long as the notice required to terminate the contract.'

169 Trade Disputes and Trade Unions Act 1927 s 2. See also *National Sailors' and Firemen's Union v Reed* [1926] Ch 536, Astbury J, in blissful disregard for political reality declared that secondary action, and the General Strike as a whole, was unlawful.

170 Now codified in TULRCA 1992 s 224. This provision is, however, contingent on the legal definition of the 'employer'. In turn, this concept is defined by the courts. See J Prassl, *The Concept of the Employer* (2015) 216 ff

171 See *Mercury Communications Ltd v Scott-Garner* [1984] ICR 74 and *University College London Hospitals NHS Trust v Unison* [1999] ICR 204

172 The definition of a 'trade dispute' under TULRCA 1992 s 219 should be interpreted according to the statute's purpose, which appears to be closely related to the statement of principle by JS Mill, *On Liberty* (1859) ch 5, §4, 'Trade is a social act.' See further, Hansard HC Debs (10 March 1905) vol 142, col 1063

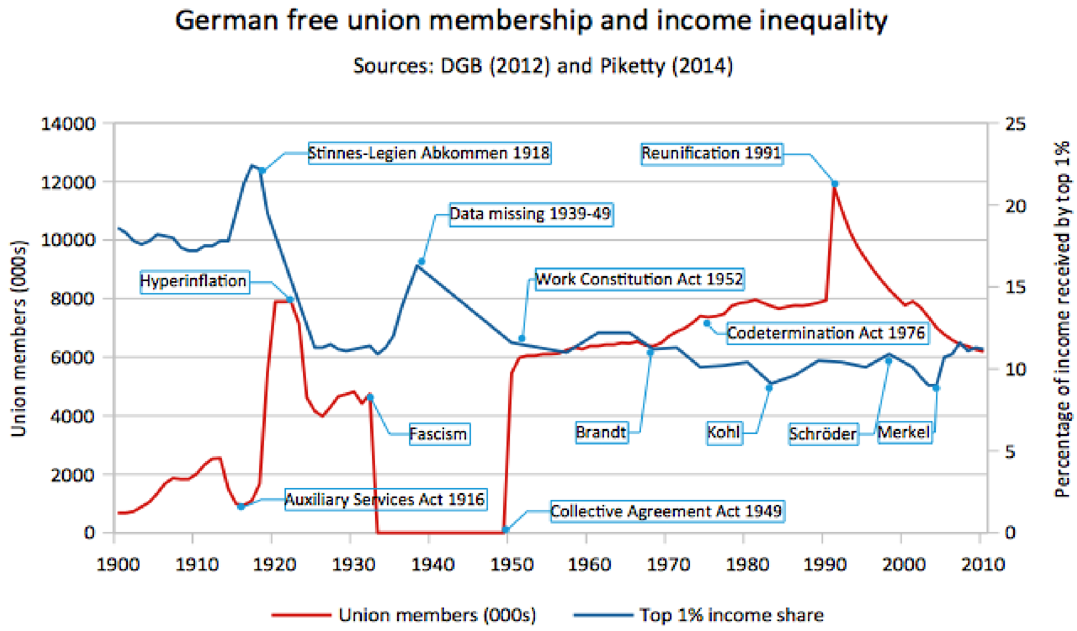
173 cf Lord Donovan, *Royal Commission on Trade Unions and Employers' Associations* (1968) Cmnd 3623, 426-430, rejected ballots. Secretary of State for Employment and Productivity, *In Place of Strife: A Policy for Industrial Relations* (1969) Cmnd 3888, proposed discretion for the Secretary of State to hold ballots, if there was 'a serious threat to the economy or public interest'.

none excluded, to warn employers, notify them of the results.[174] After subsequent revisions,[175] and halting case law,[176] a draconian interpretation of the rules was applied from the financial crisis to the start of the 2010 government's austerity programme. Hostile first instance judges granted injunctions against strikes, until appellate courts finally put the legal uncertainty to rest.[177] However, the obvious frustrating effect upon the right to strike encourages the view that "Thatcher's anti-trade union laws" are responsible for the decline in union membership,[178] and consequent rise in inequality. Indeed, in the UK it is chronologically difficult to separate suppression of collective action from changes to government promotion, and union member enrolment practice. This makes comparison all the more useful.

(b) Germany

German freedom of association, and the right to take collective action, has remained roughly constant since it was enshrined in the post-war constitution, the Grundgesetz 1949 article 9(3).[179] Because of Germany's bitter experience with the compulsory, nationalised Nazi union (*Deutsche Arbeitsfront*) from 1933, after 1945 unions did not pursue a 'closed shop' strategy, where employees could not opt out.[180] The Federal Labour Court (*Bundesarbeitsgericht*) holds collective action, including a strike, is lawful if it is for the purpose of achieving a collective agreement.[181] Collective action must also be proportionate, with an emphasis on attempting negotiation.[182] 'Secondary' action (or solidarity striking) is lawful when it fulfils the same requirements.[183] Ballots, and giving express warning employers, are not a statutory requirement for a strike, but trade union rulebooks invariably require that ballots will take place.[184] Keeping this in mind for the post-1949 period, the comparison of trade union numbers and inequality shows the following.

174 TUA 1984 ss 10-11
175 See now TULRCA 1992 ss 226-232B, as amended by TURECA 1993 and the Employment Relations Act 1999.
176 See *Inter-City West Coast Ltd v RMT* [1996] IRLR 583 and *RMT v Midland Mainline Ltd* [2001] IRLR 813
177 See *Milford Haven Ports Authority v Unite the Union* [2010] EWCA Civ 400, *British Airways Plc v Unite the Union (No 2)* [2010] EWCA Civ 669 and *RMT v Serco; ASLEF v London & Birmingham Railway* [2011] EWCA Civ 226.
178 n.b. the opposite could equally be true: suppression of workers' rights is met by increased determination to organise.
179 See also Tarifvertragsgesetz 1949, the Collective Agreement Act 1949, which regulates the capacity of unions who may enter collective agreements, their legal effect, and the duties of disclosure and publicity owed by the parties.
180 CG Hanson, S Jackson, D Miller, *The Closed Shop: A Comparative Study in Public Policy and Trade Union Security in Britain, the USA, and West Germany* (1982) ch 13, 201. Whether the Grundgesetz art 9(3) contains a 'freedom from association' (negatives Koalitionsfreiheit) was controversial since the Weimar Constitution art 159. Alfred Hueck (who was 'de-Nazified' in 1949) and Hans Carl Nipperdey (co-author of a pro-Nazi labour law text, but Federal Labour Court judge post war) supported this view: *Lehrbuch des Arbeitrechts* (1932) II 501. Hugo Sinzheimer, who wrote those provisions of the constitution, and was later put in a concentration camp, thought there was no such thing: *Grundzüge des Arbeitsrechts* (1927) 81 ff. The Bundesverfassungsgericht has repeated on many occasions that there might be a 'freedom from association', e.g. BVerfGE 1, 264, 274 (30 April 1952) and BVerfGE 50, 290, 367 (1 March 1979), but laden with ambiguity or in *obiter dicta*. F Gamillscheg, *Kollektives Arbeitsrecht* (2008) Bd II, 64, notes in the parliamentary debate history, such a right was expressly voted down: 'Ein Zwang zum Betritt darf nicht ausgeübt werden'. He says the right is 'a pure product of fantasy' (ein reines Phantasieprodukt).
181 BAG (28 January 1955) GS 1/54
182 BAG, *Verhältnismässigkeitprinzip* (21 April 1971) GS 1/68 and BAG (17 December 1976) 1 AZR 605/75; [1977] NJW 1079.
183 BAG (21 June 1988) 1 AZR 651/86 and BAG, *Publishing House case* (19 June 2007) 1 AZR 396/06.
184 See generally, M Weiss and M Schmidt, *Labour Law and Industrial Relations in Germany* (4th edn Kluwer 2008)



It is immediately apparent that, like in the UK, a 'mirror image' is there, but the mirror is cracked by the traumas of German history. First, the wild volatility from 1914 tracks the collapse of the Imperial Monarchy in 1918, the pandemonium of Weimar hyperinflation, and the catastrophe of fascism from 1933. Second, the peak in union membership in 1990 (interestingly, well below the UK's 1979 peak) is the effect of East German members joining the German Trade Union Federation (*Deutsche Gewerkschaftsbund*) upon reunification. But the subsequent sharp decline until 2000 suggests that many of those four million unionists were 'artificial': all Soviet bloc unions were dominated by the military dictatorship.[185] Yet reunification should not conceal, from the DGB's perspective, the calamity of the overall drop. Third, from 1949 generally, the inverse correlations of union members and inequality are not nearly so pronounced as in the UK. This points to the fact that German labour relations developed a critical 'second channel' for workplace participation, in codetermination: the right of workers to have votes in work councils on a list of workplace issues, and for the boards of large companies.

What affected union membership in German labour law before 1949? And how did codetermination develop throughout? Before 1949, the most important shifts in collective labour law touched the very legality of the right to organise, to collectively bargain and take collective action. In 1890, Bismarck's Socialist Act 1878 had expired,[186] so union organisation and strike

[185] e.g. CE Shaw, 'Management-Labor Committees' (1950) 3(2) Industrial and Labor Relations Review 229, citing Brigadier General Smirnow in 1947, proclaiming 'the manager's right to exercise undivided control over the plant' and 'freedom from petty tutelage by works councils'.

[186] Sozialistengesetz (19 October 1878) RGBl 34, 351-358. Long title: 'Law Against the Efforts of Social Democracy to Endanger Society.'

action became basically lawful. This triggered the start of the rise that continued through 1900. Unions were democratically organised,[187] in stark contrast to the Prussian dominated state. In 1903 the Empire Court (*Reichsgericht*) held that agreements were not legally binding.[188] This was reversed in 1918, so local collective agreements could be declared binding regionally and nationally across an industry by the Minister, and from 1923 by an arbitration panel.[189] Gradually, however, over the 1920s decisions by the Empire Labour Court (*Reichsarbeitsgericht*) whittled away the freedom of trade unions to organise and take action, announcing that representatives owed duties to 'the company' that they worked for.[190] These changes in themselves probably had less direct effect on union numbers than the economic violence of hyperinflation. But in any case, when the Nazis took over the state, their first act following May Day was to storm union offices, shut them down, and imprison the leaders.[191] Figures for the top 1 percentage share of income are missing from 1920-1925 and 1937-1949 (in the chart, this misleadingly straightens the line). However the sharp recorded rises in inequality, from 1916 to 1918 and 1933 to 1937,[192] match what were in effect forced labour laws imposed on German workers.

The first critical change was the Auxiliary Service Act 1916 (*Hilfsdienstgesetz 1916*) which, as the Reich's war economy became increasingly desperate, imposed a duty to work in §1 on the whole adult male population. By itself, this removed the basic contractual freedom of a German worker, and so effectively broke his bargaining power. This Act, however, has also been called 'the end of the unilateral right to manage',[193] as Social Democrats in the Reichstag insisted upon elected work councils in workplaces with over 50 people, with the right of staff to take matters to arbitration.[194] Those work councils were shams because the arbitration system behind them was rigged by employers. *But* they were a forum for the organisation of trade unions. They were the focal point for the exponential rise in union numbers as the revolution forced an end to the horrors of perpetual war. The peak in 1920 enabled a general strike to win against the Kapp-Putsch, and defeat the reincarnation of military government.

Second, the free system of codetermination came from collective agreements, beginning

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187 B Schildbach, *Verfassung und Verwaltung der Freien Gewerkschaften in Deutschland* (1910). H Peters, 'Rechtliche Stellung und innerer Aufbau der Arbeitnehmerberufsvereine' in W Kaskel, *Koalitionen und Koalitionskampfmittel* (1925)

188 Reichsgericht (30 April 1903) RGSt Bd. 36, S. 236-240.

189 Tarifvertragsverordnung 1918 (allowed the Minister to make collective agreements binding regionally and nationally). Schlichtungswesen Verordnung 1923 (compulsory arbitration, after which collective agreements could be declared binding).

190 O Kahn-Freund, 'The Social Ideal of the Reich Labour Court - A Critical Examination of the Practice of the Reich Labour Court' (1931) translated in R Lewis and J Clark, *Labour Law and Politics in the Weimar Republic* (1981)

191 See E McGaughey, 'The codetermination bargains: the history of German corporate and labour law' (2015) LSE Law, Society and Economy Working Papers 10/2015, 26-32

192 n.b. Although statistics are absent after 1939, inequality probably continued to surge until the Nazi state was bankrupt: usually thought to be when Hitler launched WW2. See generally K Robert (a pseudonym), *Hitler's Counterfeit Reich* (1941) chs 9 and 10

193 HJ Teuteberg, *Geschichte der Industriellen Mitbestimmung* (1961) 508 ff

194 Hilfsdienstgesetz 1916 §13

with the post-WWI Stinnes-Legien Abkommen of 1918.[195] Unions and business collectively agreed for 'common resolution of all economic and social questions in German industry and trade'. This collective bargain was then codified into law.[196] Codetermination was abolished, like all labour rights and freedoms, by the fascist dictatorship in 1933. However, from 1946 as they revived, unions collectively bargained for work councils (which exercised a binding voice on workplace issues, including dismissals) and the right to vote corporate board members. Again, those 'codetermination bargains' were subsequently codified into law. In coal and steel, staff could elect half the supervisory board, while in other industries staff could elect one-third.[197] In 1972, the work councils and one-third laws were recast, and in 1976 in companies with over 2000 staff, workers could elect one half of the supervisory board, although the chair with a casting vote remained a shareholder representative.[198]

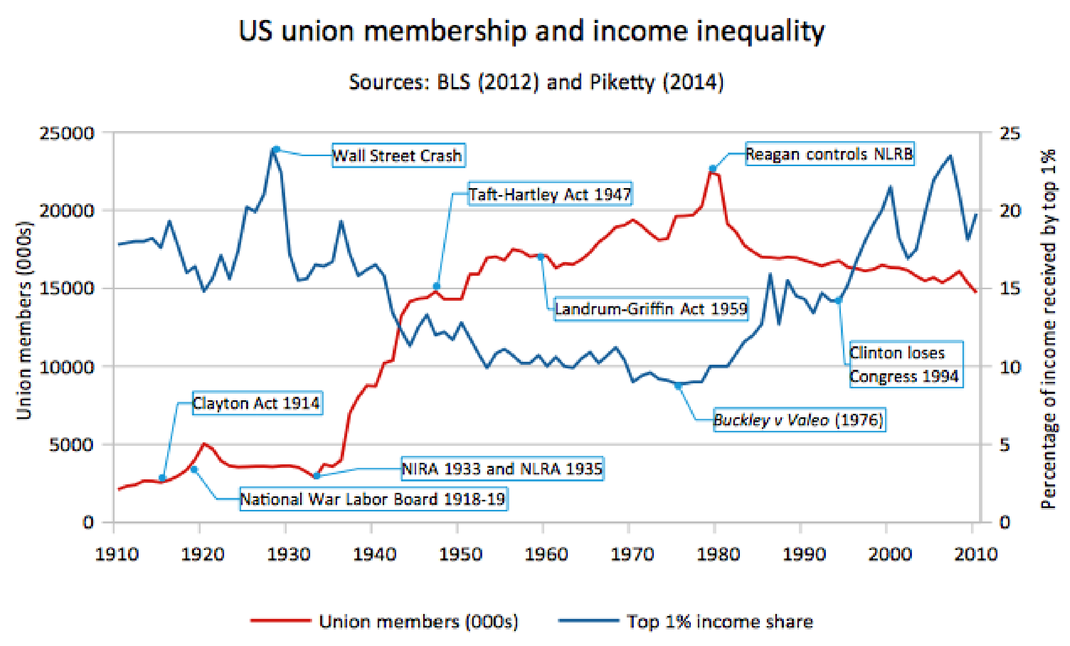
These rule changes have an ambiguous relation with union membership rises. The most obvious cause of inequality changes appear simply to be the governments (and presumably all policies, including promotion of labour rights) of Willy Brandt and Helmut Schmidt (1969-1982), a reversal under Helmut Kohl (1982-1998), improvement under Gerhard Schröder (1998-2005), and deterioration under Angela Merkel (from 2005).[199] Union membership *is* connected, but why not strictly so? It is plausible to think that codetermination had a dual impact: (1) an organisation effect, reducing fluctuation in union membership, and ultimately allowing *fewer* union members to have more influence, because there were embedded workplace participation institutions, and (2) a stabilisation effect, so that fluctuations in union membership caused *narrower* swings in inequality. In short, it is harder to unravel workplace participation when people have got legal rights to vote, and harder to drive social division, than in a single channel system.

(c) United States

Like the UK, the US operates a single channel of workplace representation, if anything at all. The 'ossification of American labor law' is a theory that emphasises no significant legislative reform occurred since 1959 (or perhaps 1974[200]), freezing collective labour relations in time, with

[195] McGaughey (2015) LSE Law, Society and Economy Working Papers 10/2015, part 3(2)
[196] McGaughey (2015) LSE Law, Society and Economy Working Papers 10/2015, part 3(3) and (4). See the Weimar Verfassung art 165 (a right to participate in the 'entire field of economic development', including 'legal representation in factory workers councils'), Betriebsrätegesetz 1920 §66, 84-87 (binding rights on workplace issues, such as breaks or pension administration, and dismissals taken to arbitration) and the Aufsichtsratgesetz 1922 §§1-4 (allowing two members of the supervisory board to be elected by employees).
[197] Montanmitbestimmungsgesetz 1951 and Betriebsverfassungsgesetz 1952
[198] Betriebsverfassungsgesetz 1972 and Mitbestimmungsgesetz 1976. Now also, see the Drittelbeteiligungsgesetz 2004.
[199] There appears to be an obvious role here (and an interesting contrast to Tony Blair's tenure from 1997 to 2007) for the efficacy of social welfare, tax and fiscal stimulus policies, particularly in East Germany. The impact on the statistics of the rapid improvements in Eastern Germany cannot be overestimated.
[200] The Employee Retirement Income Security Act 1974, arguably, is a very important labour law, discussed below at part 2(3)(c).

deadlock in judicial precedent and political 'shutdown'.[201] There is a real threat, a despondent tale might continue, to the survival of American labour rights. In the public sector, state governors press to require referendums for any collective agreement.[202] In the private sector, plans are made to privatise trade unions through employer dominated 'teams'.[203] But despite stereotypes, the US happens to have the world's oldest law enabling codetermination,[204] it led experiments with staff representation on boards,[205] and after political parties unions remain the largest democratic organisations in society. Moreover, *national* union statistics do not represent the 'geopolitical' complexity of union membership in states: very low in southern and mid-west states, but at west European levels in west coast and north-eastern states.[206] Since 1935, US workers have a right to organise and take action, and employers must collectively bargain in good faith if the union wins majority support in the workplace.[207] The resulting impact on inequality is clear.[208]



Two preliminary points should be made. First, the volatility in the income of the top 1 per cent is

[201] C Estlund, 'The Ossification of American Labor Law' (2002) 102(6) Columbia Law Review 1527
[202] See M Peters and C Porter, 'Wisconsin Court Upholds Law Curbing Unions' Rights' (31 July 2014) Wall St Journal, Governor of Wisconsin, Scott Walker, was able to do this because the National Labor Relations Act 1935 does not cover the public sector of state governments.
[203] The Teamwork for Employees and Managers Act of 1995 would have repealed NLRA 1935 §8(a)(2) prohibition of 'company unions' that are in any way dominated by or accountable to the employer, rather than the workforce. It was vetoed by Bill Clinton, but still has supporters among a certain group of US employment lawyers. cf US Department of Labor and US Department of Commerce, *Commission on the Future of Worker-Management Relations: Final Report* (1994) II. Employee Involvement, which recommended clarification of the law on how non-dominated workplace participation can function. For an obvious, American drafted example of a work council law, that presents no problem to §8(a)(2) or *Electromation Inc*, 309 NLRB No 163, 142 LRRM 1001 (1992) see *Control Council Law No 22 Works Councils* (10 April 1946) in *Official Gazette of the Control Council for Germany* (1945-1946) 43(R498). Unions can bargain for this now if they choose.
[204] Massachusetts Laws, General Laws, Part I, Title XII, ch 156 Business Corporations, §23
[205] LW Hunter, 'Can Strategic Participation be Institutionalized? Union Representation on American Corporate Boards' (1998) 51(4) Industrial and Labor Relations Review 557. E McGaughey, 'Democracy in America at Work', Forthcoming.
[206] e.g. Bureau of Labor Statistics, 'Union Members – 2012' (23 January 2013) Chart 1
[207] National Labor Relations Act 1935 §7 (29 USC §157)
[208] Bureau of Labor Statistics *** Series D 940-945 and Piketty (2014) Technical Appendices, Table S9.2

far higher than the UK, suggesting that the highest American earners are far more exposed to the propensity of the American economy for repeated financial crisis.[209] Second, the US population has grown far more substantially than the UK's or Germany's over the period covered.[210] So, although all charts show 'raw' union membership numbers (not density[211]) the *relative* fall in union membership after 1980 is greater: adjusted for population, the mirror effect would be even more striking.[212] In the private sector, union membership density was already in decline from 1954.[213] Otherwise, we see a peak in union members 1921, the start of the New Deal's economic bill of rights in 1933, and a final climb from 1976 to 1980, before the fall up till today – in each case matching inverse fluctuations of inequality. What drove the change?

First, the steady expansion of union membership until 1921 met, but overcame, staunch opposition as basic rights to organise and take collective action were forged. Progress was temporarily suppressed in 1908,[214] when a majority on the Supreme Court felt emboldened to use the Sherman Antitrust Act 1890 to make union activity unlawful, as if it were a cartel in restraint of trade.[215] This judicial policy was reversed by the Clayton Act 1914,[216] affirming that 'labor is not a commodity'.[217] From 1918 to August 1919, the National War Labor Board organised union bargaining with employers.[218] After the 1921 election, the Supreme Court found that secondary

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209 On which see generally, JC Coffee, 'The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated' (2012) 97 Cornell LR 1019

210 In 1900, the US population was around 76m, in 1950 151m, in 2010 309m. In the UK, in 1900 38m, 1950 50m, 2010 63m. In Germany, in 1900 54m, 1950 68m, and 2010 81m. Thus, the US population more than doubled from 1950-2010, whereas it is rose by roughly 25% in the UK and Germany in the same time.

211 For recent density statistics, see OECD, *Trade Union Density* (1999-2013), methodology explained here. US density was 10.8%, while the UK was 25.4%, and Germany 17.7%. Union density differs again from collective bargaining coverage, and so is not a simple guide to union bargaining power.

212 The reason this article used charts based on raw numbers (and the choice was by no means 'right'), was that the density statistics are historically less complete, and method changes with the statistical office's definition of the labour market size: in turn it depends on methodology for calculating unemployed people (e.g. surveys and estimates? Benefit claimant count?).

213 On private sector numbers, see WT Dickens and JS Leonard, 'Accounting for the Decline in Union Membership, 1950-1980' (1985) 38(3) Industrial and Labor Relations Review 323. The authors attribute the decline to economic change, but as shown below, the abolition of the closed shop, and reticence of government promotion in the private sector, appears the more plausible primary cause.

214 The Supreme Court had the opportunity before, after *United States v Debs*, 64 Fed 724 (CC Ill 1894) when the Attorney General invoked the Sherman Act against Eugene V. Debs leading the strike against a wage cut at the Pullman Company. *In re Debs*, 158 US 564 (1895) affirmed the judgment without reference to the Sherman Act.

215 *Loewe v Lawlor*, 208 US 274 (1908)

216 Clayton Act 1914 §6 (15 USC §17)

217 This reflects the idea that labour markets are not like any other market because the 'commodity' being traded (the person) is capable of negotiating its own price, reflecting on its evaluation of self-worth, and being motivated positively or negatively to work with others. When corn or capital is bought and sold, at any price, it does not really notice. It follows that collective to regulate the price of labour may be essential to promote trade: unequal bargaining power is the true restraint.

218 National War Labor Board, 'Principles and Rules of Procedure' (1919) and RB Gregg, 'The National War Labor Board' (1919) 33(1) Harvard Law Review 39, and LL Jaffe, 'Post-War Labor Relations: The Contributions of the War Labor Board' (1943-1944) 29 Iowa LR 276, 'Not more than three years later the Steel Industry had smashed the Unions and underwritten the Open Shop Era of the Twenties. It is, of course, true that the Board worked out in considerable detail the meaning of the right to collective bargaining: it forbade individual contracts, discharge for union activity, etc. It thus gave concreteness to an idea which only a decade later bore fruit. It insisted on the 'living' or 'minimum' wage and one observer believed (in 1919) that it had established the principle as an 'actuality'; yet as we know it failed to educate the Supreme Court in this respect and certainly much of Industry remained unconverted.'

action was an 'unlawful conspiracy'.[219] Closed shops were essentially lawful,[220] but until 1932 employers were allowed to demand that workers did not belong to a union as a condition of employment.[221]

Second, the New Deal from 1933 caused a spectacular rise in union membership through express protection of the right to collectively bargain and take action. The federal government actively promoted organisation through the National Industrial Recovery Administration before 1935,[222] and the National Labor Relations Board after.[223] The role of the Board was to organise an expansion in people's voice at work. It did so through overseeing democratic elections in workplaces, and policing 'unfair labor practices' by employers, designed to suppress unions.[224] Just like in the UK, government support for collective bargaining was instrumental to union organisation and the policy goal of reducing inequality.

Why did union membership stall post-war? First, the Taft-Hartley Act 1947 brought three significant changes. Perhaps benign in itself, it introduced new 'unfair labor practices' of unions that during campaigns for collective bargaining. Far more substantially, it abolished secondary action. Most critically it outlawed the closed shop,[225] and expressly empowered states to enact legislation banning 'union security agreements': where unions could collect fees through the employer from non-union members in return for the benefits from collective bargaining.[226] A number of states had already passed laws against the closed shop, but the measure was far more long-term: over time there would be a growing number of what proponents called 'right-to-work' states.[227]

Second, the Landrum-Griffin Act 1959 required complex standards for union elections, and information or voting rights for members. In itself, this need not have led to a reduction in union membership. Many of its supporters believed they were strengthening the union movement in the long run. However, a significant cultural attack accompanied the idea of 'democratising the unions', causing a temporary fall in numbers. No significant labour law change accompanied the drop from 1971, or the quick rise from 1975. This matches the Nixon/Ford administration, and then Carter administration's promotion of public sector union membership.

[219] *Duplex Printing Press Co v Deering*, 254 US 443 (1921)
[220] See HT Lewis, 'The Economic Basis of the Fight for the Closed Shop' (1912) 20(9) Journal of Political Economy 928
[221] *Coppage v Kansas*, 236 US 1 (1915) Holmes J, Day J and Hughes J dissented. Reversed by the Anti-Injunction Act 1932. Railroad workers were already protected under the Erdman Act 1898 §10.
[222] *Schechter Poultry Corp v United States*, 295 US 495 (1935) struck down the National Industrial Recovery Act 1933.
[223] NLRA 1935 §9 (15 USC §159)
[224] NLRA 1935 §8 (15 USC §158)
[225] NLRA §8(a)(3)
[226] NLRA 1935 §14(b) and *Lincoln Federal Labor Union 19129 v Northwestern Iron & Metal Co*, 335 US 525 (1949).
[227] See A Cox, DC Bok, RA Gorman and MW Finkin, *Labor Law: Cases and Materials* (14th edn 2006) 1193, noting 12 states between 1944 and 1947, 21 by 2006, and now 25.

Critically, in 1976, the US Supreme Court held in *Buckley v Valeo*, that people could spend unlimited amounts of money on their own political campaigns,[228] the trigger that explains many things in US politics since.

Why did union membership sharply drop, and go into long term decline from 1980? When Ronald Reagan became President, two members of the National Labor Relations Board immediately resigned, and Reagan publicly attacked air-traffic control workers when they took collective action. As the Presidency controlled appointments to the NLRB, and its funding, ultimately like with any government department or regulator, it was in a position to end its functions.[229] Without the NLRB's support, and practically bound to the need for a juridified ballot procedure, where employers' lawyers could at every stage raise objections, US unions were in an even weaker position than their UK counterparts (who if needed were accustomed to strike to get a collective agreement, once they had enough members). The NLRB quickly ran up a backlog of unfair labor practice allegations, effectively cancelling a large number of future collective agreements. In 1983, Reagan appointed an attorney who worked for a 'right-to-work' lobby group as the new NLRB chair. This brought trade union membership down to density levels of the 1930s.[230] A temporary rise in the first two years of a Clinton government was ended quickly with the advent of a Republican Congress in 1994, and the attrition continued since.

While the US and and the UK are both seen as single channel systems, the greater reliance of the US union movement on government bureaucracy allowed hostile governments from 1980 to dramatically decrease union membership without positive legal enactment. In the UK, the Employment Relations Act 1999 created a similar regime for unions to get statutory recognition, overseen by the Conciliation and Arbitration Committee, which may plausibly be expected to have a similar 'dependency' effect in the longer term.[231] In German workers are less vulnerable: organisation capacity is embedded in work councils and board codetermination.

Whatever the system, changes in union membership are shaped by law. Many social science studies on union membership focus on extra-legal changes (e.g. changes in labour force

[228] *Buckley v Valeo*, 424 US 1 (1976). White J's decision is to be preferred. Out of this came *Citizens United v Federal Election Commission*, 558 US 310 (2010). *Citizens United* also entitles unions to contribute unlimited money to political campaigns, but gives no voice to workers in the corporation: it amplifies the voice of '[W]hoever controls the corporation'. Scalia J in oral argument of *Burwell v Hobby Lobby Stores, Inc.*, 573 US _ (2014) at page 53 of the transcript. All other developed democracies limit absolute spending during election time (by constituency, etc), the very thing that *Buckley* disastrously forbid.

[229] HS Farber and B Western, 'Ronald Reagan and the Politics of Declining Union Organization' (2002) 40(3) British Journal of Industrial Relations 385, usefully recount much of the story, but argue that union membership decline preceded Reagan's control of the NLRB by a few months, and so could not have caused the decline. This view is mistaken: Presidential control of NLRB action was immediate through implicit threats, no matter when the Presidency formally appointed its own candidates. See NLRA 1935 §153(a).

[230] Department of Labor, *Labor Force, Chapter D, Earnings, Hours and Working Conditions* (Series D 683-1036) D 946-951, showing a 15.8% density in 1939, up from 6.7% in 1935.

[231] cf A Bogg, *The Democratic Aspects of Trade Union Recognition* (2009) ch 5

composition, technology, or globalisation and increased competition from workers in developing countries) to explain decline.[232] This work tends (and rightly so) to be carefully indeterminate and qualified in its conclusions, because many countries have not experienced such a decline and are subject to the same pressures. The evidence shows, not merely that the law is a more significant factor among those socio-economic factors: the law determines the relevance of all factors absolutely. This stands to reason, because if you consciously aimed to reduce or increase union membership, and inequality, legal reform is a logical way to begin.[233]

(3) Shareholder and beneficiary rights

The channels of worker participation in corporate governance shape inequality.[234] Rights do pay. But beyond getting a 'fair day's wage for a fair day's work', eventually people should be able to retire with dignity. Over the 20th century, more and more pay was saved, deferred in use, for old age. Savings needed to be invested. Mass investment was dispersing capital ownership,[235] and it was 'inventing retirement'.[236] This ushered a quiet reformation of capital markets because today the greatest source of money for shares and securities comes from employees saving: through pension, life insurance and mutual funds.[237] The division between capital and labour has grown less distinct.[238] 'Labour's share of income' compared to 'capital' could no longer describe a simple picture of one 'rentier class' exploiting another, because much of that capital is returning to employees saving for retirement. In practice, modern investment chains came usually to look like this:

employee/individual → pension fund/life insurance co/mutual fund/corporation →

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232 e.g. J Visser, 'Why Fewer Workers Join Unions in Europe: A Social Custom Explanation of Membership Trends' (2003) 40(3) BJIR 403 (usefully depicting at 405 how Belgian or Swedish membership was robust or increasing), C Schnabel and J Wagner, 'Determinants of trade union membership in West Germany: evidence from micro data, 1980-2000' (2005) 3 Socio-Economic Review 1, and C Schnabel, 'Union membership and density: Some (not so) stylized facts and challenges' (2013) 19(3) EJIR 255 (pointing to 'social values and employee attitudes').

233 K Renner, *The Institutions of Private Law and their Social Functions* (1948) ch III, however, gives some reasons to not be over-optimistic about law's capacity to achieve social change or, at the most extreme, create an 'idolatry of the decree'.

234 cf R Hale, 'Bargaining, Duress and Economic Liberty' (1943) 43 Columbia Law Review 603, 625, 'The market value of a property or of a service is merely a measure of the strength of the bargaining power of the person who owns the one or renders the other, under the particular legal rights with which the law endows him, and the legal restrictions which it places on others.' Also J Pen, *Income Distribution* (1971) 361, 'I claim that if power remains concentrated at the top, the distribution of the firm's income among senior and junior employees will be a reflection of this command structure.'

235 n.b. Piketty (2014) ch 1 defines 'capital' to be the same as property. In contrast, the law usually defines capital as the sum of valuable assets invested in a company, which it may use for production. For this end, AA Berle, 'Property, Production and Revolution' (1965) 65 Columbia Law Review 1, draws a useful distinction between 'productive' property that is used for the purpose of production (whose use is differently regulated or taxed), and 'passive' property which is consumed by individuals. The most important capital regulation is that 'legal capital' (the sum initially invested by members) could traditionally not be to pay dividends unless (depending on the legal system) shareholders approved it, or directors certified a company's solvency. There had to be a surplus 'profit' beyond this sum.

236 The title of the excellent book, RL Hannah, *Inventing Retirement: The development of occupational pensions in Britain* (1986)

237 For a landmark in this revolution, see AA Berle, 'Property, Production and Revolution' (1965) 65 Columbia Law Review 1

238 H Hansmann and R Kraakman, 'The End of History for Corporate Law' (2000) 89 Georgetown Law Journal 439, 452

asset manager/bank/broker → custodian/nominee → company director

Traditionally, individual shareholders used to exercise their own voting rights. But in this historic shift, asset managers and banks (who carried out share trading) came to appropriate shareholder votes. The real contributors to equity (usually employees saving), the ones who are the ultimate beneficiaries of investment, became separated from economic voice. The stark reality is that 'shareholder value' became, not a problematic, but an utterly meaningless measure of economic success a long time ago: the 'value' could be going to an intermediary playing with other people's money, rather than the ultimate investor.[239] Ownership had never necessarily meant control, and contribution no longer meant participation in modern corporate governance.[240]

Before and since the financial crisis, shareholder rights have been seen as solutions by some for particular problems, like rising executive pay.[241] But more generally shareholder rights became the focus of powerful criticism,[242] as much as in the late 19th and early 20th century.[243] This poses a puzzle. While shareholder protection in all countries has tended to increase,[244] there has been no fundamental change in 'significantly distributive' shareholder rights. In particular, there has been no enhancement of shareholder rights to elect or remove directors in the UK since 1947, or in Germany since 1937, and in Delaware those rights were weakened in the 1960s.[245] What *did* change is the composition of shareholders. Financial institutions separated the ultimate contributor to equity from the right to participate, and the economic consequences were profound.

How could changes in shareholder *and beneficiary* rights affect inequality? The answer lies with financial intermediaries (asset managers, bankers, traders, hedge fund owners) who appear to

239 Usually forgotten, this was the point made in the second part of the title of AA Berle and GC Means, *The Modern Corporation and Private Property* (1932). The logic of private property is dismantled when the person who contributes to production does not get the reward, because the incentives for efficient use of property (by directors or financial intermediaries) dissolve. The intermediaries can make money from their position, not by working hard: what today is often called 'rent-seeking'.

240 E McGaughey, *Participation in Corporate Governance* (2014) ch 2 (on whether the discourse of the 'separation of ownership and control' is still appropriate) and ch 6 (the evolution of voice for contributors to equity behind shareholding institutions).

241 e.g. L Bebchuk and J Fried, *Pay Without Performance* (2004) 198-199, making the powerful argument that pay decisions should be removed from the hands of directors, but apparently concluding (quite unnecessarily) that it should go to shareholders, who in any case only decide the pay policy, not the actual figure. This seems to have been the idea behind CA 2006 s 437A.

242 e.g. S Deakin, 'Against Shareholder Empowerment' in J Williamson, C Driver and P Kenway (eds), *Beyond Shareholder Value* (2014), D Ferreira, D Kershaw, T Kirchmaier and E Schuster, 'Shareholder Empowerment and Bank Bailouts' (2012) ECGI - Finance Working Paper No. 345/2013, and LE Strine, 'Can we do better by ordinary investors? A pragmatic reaction to duelling ideological mythologists of corporate law' (2014) 114 Columbia LR 449

243 e.g. JS Mill, *Principles of Political Economy* (7th edn 1909) Book V, ch IX, §11. S Webb and B Webb, *Industrial Democracy* (1920) Book II, ch 3. W Rathenau, *Vom Aktienwesen: eine geschäftlich Betrachtung* (1917). LD Brandeis, *Business – A Profession* (1914) ch 2, referring to an existing 'tyranny of capital'.

244 M Siems, 'Shareholder Protection Around the World: "Leximetric II"' (2008) 33 Delaware JCL 111

245 E McGaughey, *Participation in Corporate Governance* (2014) ch 4. This is not for a moment to suggest that election rights are the only ones that matter. The right to call meetings, give instructions, pre-empt share issues, or sue for breach of duty plainly have an effect.

have enjoyed super-inflationary pay rises just like corporate executives.[246] It must be said explicitly at the outset that a sound financial sector is fundamental for socio-economic development, and minimisation of systemic economic risk. Soundness means financial experts who manage investments like a prudent person who feels morally bound to provide for others,[247] and display the 'punctilio of the honor the most sensitive... at a level higher than that trodden by the crowd'.[248] But what incentives do financial intermediaries have if they appropriate the shareholder rights from other people's money?

First (and most obviously) asset managers and bankers will support rising executive pay if they themselves are highly paid. They will not wish to vote down super-inflationary executive pay, lest the spotlight reflects back on them: on the contrary, they will be supportive, if in return corporate boards can support them.[249] How might that work? Second, asset managers are typically in the business of selling retirement and investment products. Logically they would want to push (maybe centre stage,[250] maybe 'behind the scenes'[251]) for corporate boards to use pension schemes that utilise their services. They would make money if multi-employer, defined benefit schemes that do their own asset management broke down (maybe on the pretext of 'pension risk') into individual defined contribution accounts that command higher fees. Third, if banks appropriate shareholder rights, they might want to influence companies to buy banking services from them. If banks' shareholders are integrated with insurers or asset managers, they would also want those businesses to have more customers. Fourth, intermediaries might want to encourage the purchase of "complex" financial products, which are marketed as diversifying risk,[252] but inevitably increase fees and margins for more hedging, and swapping, and churning.

More fundamentally, financial institutions that appropriate shareholder rights have incentives to restrict the supply and distribution of capital to maintain their place. To Piketty, it forced the equation that inequality increases when returns to capital exceed growth (when $r > g$) because fewer people have capital to earn income, than those who earn income from labour. But of course, this need not be true. After twenty years of intense debate on the causes of different

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246 This point should not be overstated: Piketty (2014) ch 8, 303, notes financial professions' income account for 20 per cent of top incomes, far less than 'skyrocketing pay packages of top managers'. Financial intermediaries' significance is in power over corporate governance generally, cooperating with those executives.

247 See *Belchier v Parsons* (1754) 96 ER 908, per Lord Hardwicke LC and *Learoyd v Whiteley* (1886) LR 33 Ch D 347, per Lindley LJ

248 *Meinhard v Salmon*, 164 N.E. 545 (NY 1928) per Cardozo J

249 Hence the point above at part 2(1)(a), on fund managers surveyed in 1999 supporting executive pay rises: R Gribben, 'Investors Champion Boardroom Pay Rises' (19 July 1999) The Daily Telegraph, 27.

250 e.g. J Wasserman, 'CA: Governor ousts CalSTRS appointees who oppose his pension plan' (11 February 2005) Free Republic

251 cf BS Black and JC Coffee, 'Hail Britannia?: Institutional Investor Behavior under Limited Regulation' (1994) 92(7) Michigan Law Review 1997, on shareholder activism of unknown quantity or quality 'behind the scenes'.

252 Standard corporate finance theory holds that investment in just 20 companies equals 95% of the value of investing in a full stock market index listing, and investment in 100 companies realises 99% of the value of full index diversification: RA Brealey and SC Myers, *Principles of Corporate Finance* (3rd edn 1988) 156.

shareholder ownership structures (dispersed or blockholding),[253] it was noticed that 'the pension system is of crucial importance to the development of capital markets.'[254] For instance, the evidence shows that the size of stock markets increase with the quantity of money people saved for retirement.[255] Probably, this was the trigger for the extreme 'separation of ownership and control', in the sense originally identified by Gardiner Means in the US from 1916.[256]

To be precise, the relationship between pensions and share ownership is this: if a country has a large income-indexed (rather than a minimum floor type) state pension system (the 'first pillar'), people's need to for retirement through occupational pensions ('second pillar'), and private pensions ('third pillar') is less urgent. Occupational and private retirement savings are largely invested in share and securities markets. So, a minimum-floor state pension will tend to cause dispersed shareholdings because (assuming a basic level of economic development) the markets are flooded with retirement money. An income-linked state pension system will tend not lead to a flooded share market, which may leave blockholding shareholders in place (though this is by no means inevitable[257]). This explanation is strongly supported by stock market dispersion statistics, compared to public spending on pensions as a percentage of gross domestic product, in 26 OECD countries at the start of the 21st century.[258]

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253 e.g. MJ Barclay and CG Holderness, 'Private Benefits of Control in Public Corporations' (1989) 25 Journal of Financial Economics 371 (arguing blockholders can exploit minority shareholders), R La Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny, 'Law and Finance' (1998) 106 Journal of Political Economy 1113 (arguing blockholding comes from legal origin) and MJ Roe, *Political Determinants of Corporate Governance* (2003) (arguing blockholding is a reaction to social democratic power, apparently expressed in job security and unions). The literature is vast. The reason it did not identify the answer (that retirement savings determine dispersed or blockholder share systems) is presumably that corporate lawyers and financial economists were not accustomed to looking beyond their field of expertise (i.e. behind the recorded shareholder). This is an illuminating example of 'path dependency' in academic thought.

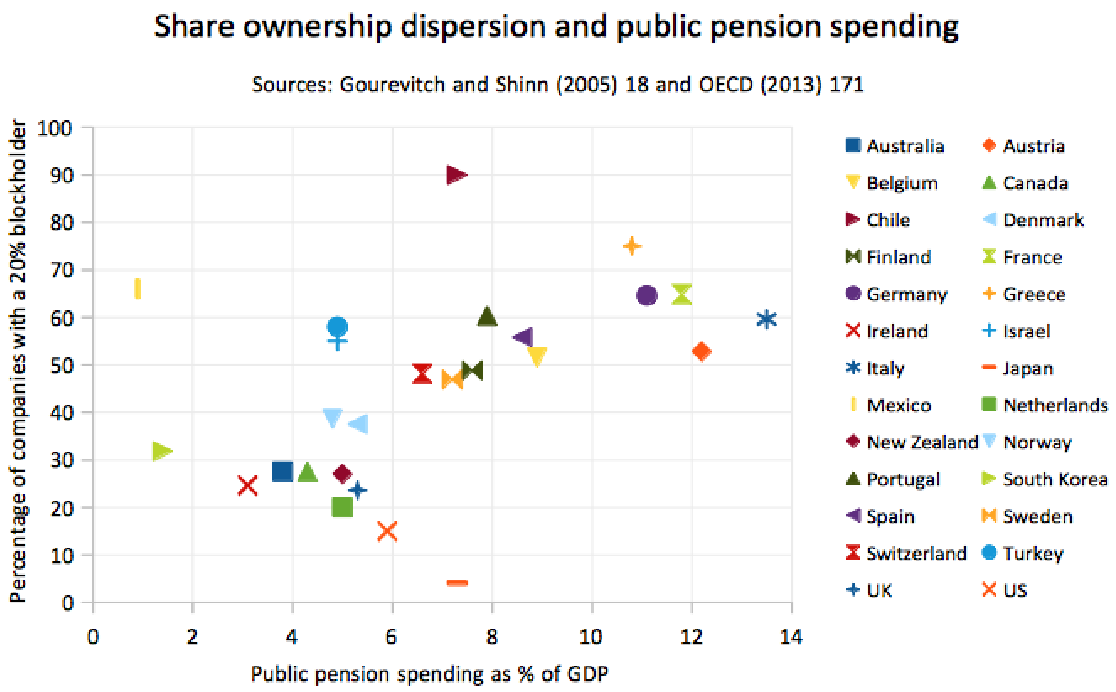
254 M Roth, 'Employee Participation, Corporate Governance and the Firm: A Transatlantic View Focused on Occupational Pensions and Co-Determination' (2010) 11 European Business Organization Law Review 51, 56-58

255 e.g. M Hauck, 'The Equity Market in Germany and its Dependency on the System of Old Age Provisions' in T Baums et al (eds), *Institutional investors and corporate governance* (1994) ch 19, 555, 556, observing new equity issues correlate with increases in pension reserves.

256 GC Means, 'The Separation of Ownership and Control in American Industry' (1931) 46(1) Quarterly Journal of Economics 68. See also L Hannah, 'The 'Divorce' of ownership from control from 1900 onwards: Re-calibrating imagined global trends' (2007) 49(4) Business History 404 (arguing a strong separation in the UK was established in 1900). cf BR Cheffins, *Corporate Ownership and Control: British Business Transformed* (2008) chs 9 and 10 (arguing that *really* strong dispersion took place post-WW2 as income and estate tax rises encouraged blockholders to sell more, and more institutional investors – from the retirement based 'wall of money' – were there to buy). Both Hannah and Cheffins appear right – there was significant dispersion of ownership in the UK up to 1900 (reflecting an affluent class) but a further acceleration of dispersion post-WW2.

257 As we will see in the case of Germany, the concentration of capital among corporate blockholders is subsidised by a rule (essentially indefensible) that allows corporations to self-invest their employees' pensions, ostensibly without giving employees a voice in the use of their capital.

258 See P Gourevitch and J Shinn, *Political Power and Corporate Governance* (2005) 18, who use as sources studies from 1998-2003, and OECD, *Pensions at a Glance: OECD and G20 Indicators* (2013) 171, taking the data column for 2000, to be consistent with Gourevitch and Shinn's time period. The other OECD countries, for which dispersion data was not available are Czech Republic, Estonia, Hungary, Iceland, Luxembourg, Poland, Slovakia, and Slovenia. A moving bubble graph could be constructed if dispersion data was less limited.



Two points are noteworthy. First, there are outliers (Mexico, Chile, Japan) whose particular historical contexts explain their deviation from the essential trend:[259] more retirement money disperses share ownership. Second, public pension spending admittedly is a rough proxy for income linked state pensions, but it is justified on country-by-country inspection. Countries with higher pension spending do indeed have more strictly income linked state pensions (e.g. Greece, Germany), countries with the most dispersed shareholding have minimum safety-net state pensions (e.g. UK, US), and the centre cluster have mixed systems: state pensions are income linked but with low caps (e.g. Switzerland, Sweden).[260] This is a logical, and evidentially sound explanation, compared to the problematic suggestions that dispersion or blockholding might relate to legal origin, degrees of social democracy, or other amorphous factors.[261]

What follows, in the most general sense, is that there is nothing inevitable about the current distribution of capital. It can be more or less widely dispersed. Left to themselves, existing corporations and financial institutions will have a private incentive to limit the supply of capital, whatever the social costs, because (at present) it can be used to retain economic power. Only collective bargaining and positive state policy, including tax, has spread the ownership of

[259] In brief, Mexico and Chile are at lower stages of development compared to other OECD countries shown here. Japan's very high dispersion, compared to high public pension spending, is artificial because of its well known *keiretsu* practices of cross-holding. See Gourevitch and Shinn (2005) 5 and 18-19, 'Japan and China are therefore correctly classified according to shareholding concentration, but their cases show a limit to the accuracy of this indicator in fully revealing the character of control in governance mechanisms.'

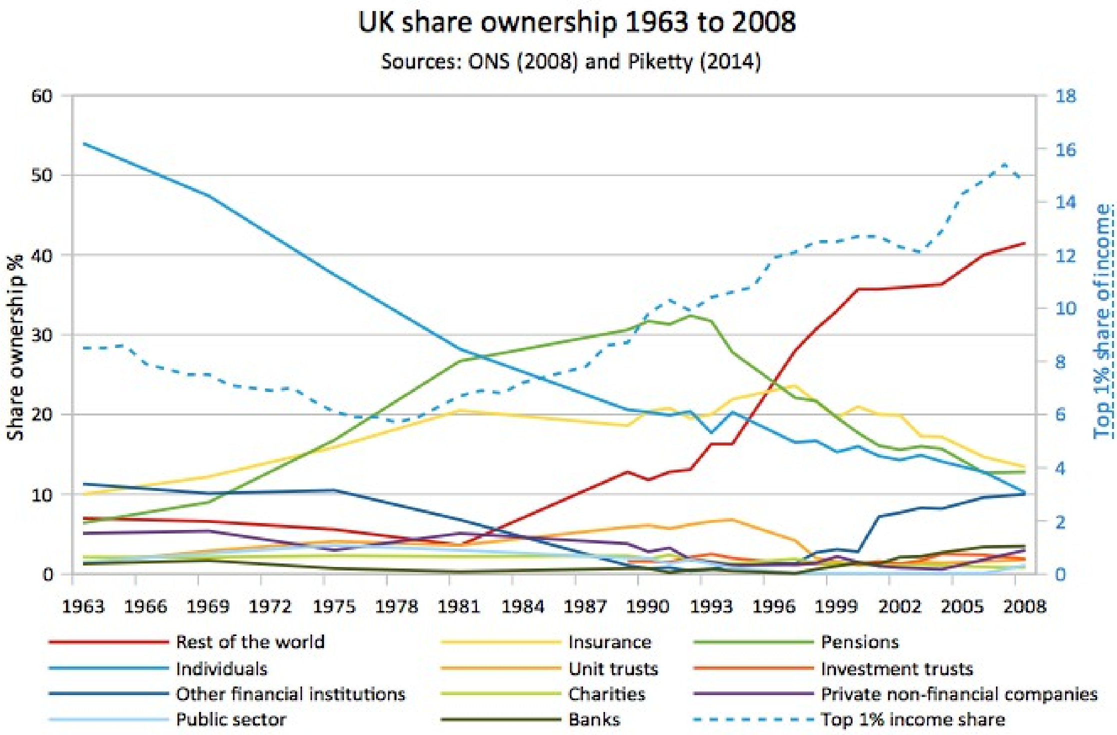
[260] See E Whitehouse, *Pensions Panorama: Retirement-Income Systems in 53 Countries* (2007)

[261] La Porta, et al (1998) 106 Journal of Political Economy 1113 and Roe (2003) respectively.

capital. But then, it is easy to imagine the continuation of capital dispersion, so that everyone shares more equally in economic prosperity. If it were desired, not only could inequality decrease when $r > g$,[262] the corporation 'could become a vehicle for rationalized wealth distribution' that serves our 'ideal of a just civilization.'[263]

(a) United Kingdom

In UK institutional shareholding, the pattern of 'significantly distributive rules' is more revealing in what it does not show. The UK's capital ownership pattern became very dispersed (if not equally so[264]) after 1945. Critically, economic change outpaced change in the law, and enabled the concentration of power in asset managers hands, largely without legal enactment, as individual shareholding declined. Official statistics from the later 20th century are the best place to start.[265]



Four main points are noteworthy. First, there was an ongoing collectivisation of capital in the post-war period. Institutional shareholding became more efficient than individual shareholding in an economy of mass investment. The critical 'tipping point', when large City firms would have

262 n.b. it does not follow that changing capital distribution to ensure $r > g$ decreases inequality would be (if at all) the desirable method to reduce inequality. The only point is that it could be done: economic laws are only as unchangeable as real laws. To give a simple example, suppose 90% of the population hold an equal share of capital, but are poorer than the richer 10% who hold no capital and earn money solely from highly paid labour. In such a state, increasing return to capital would logically decrease inequality, because it would increase the income and wealth of the poorest.

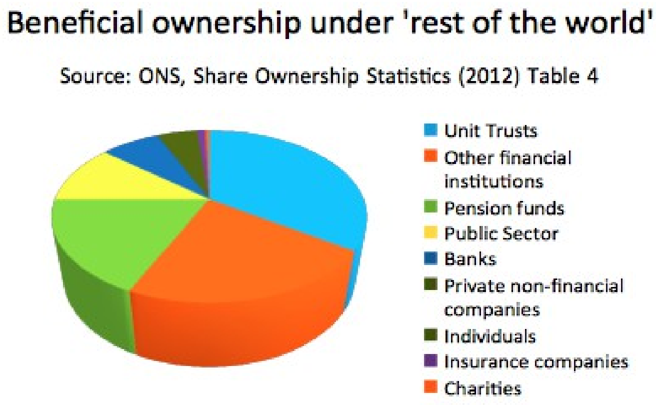
263 As put by AA Berle, 'Property, Production and Revolution' (1965) 65 Columbia Law Review 1, 17

264 See P Ireland, 'Shareholder primacy and the distribution of wealth' (2005) 68(1) Modern Law Review 49

265 Office for National Statistics, *Share Ownership Survey* (2008) Table A and Piketty (2014) Technical Appendices, Table S9.2

gained collective dominance in shareholder voting rights, appears to be somewhere in the 1970s. By then individual shareholding had fallen enough, and pension, insurance, unit trusts and mutuals had risen to a workable majority – *if* asset managers could appropriate voting rights.

Second, the rise and drop in collective bargaining (with a logical time lag) accounts for the rise and decline of pensions (green),[266] and also the growing affluence, but then stagnation, of people who bought life insurance (yellow).[267] Third, the proportion of shares held by the 'rest of the world' (red) was investigated for the first time in 2012, and is shown in the pie chart.[268] Fourth, the UK's increase in percentage of 'other financial institutions' (dark blue) includes open ended investment companies, which largely replaced unit trusts (orange), but also hedge funds, and funds of funds, into which pensions or insurers themselves increasingly bought. Multi-layered beneficial relationships are not adequately computed by the Office for National Statistics, and this deteriorated in 2010 with a method alteration, which (with very inadequate reasoning[269]) ostensibly cut pensions and insurance numbers in half.[270]



Which significantly distributive rules determine who gets the votes in the economy? First, there are rules on the voice of the ultimate contributor to equity in a collective fund. At least since the post-WW1 years, the preferred UK model of organising collective retirement schemes has been to empower beneficiary voice in a trust fund, rooted in the principles of democratic work councils.[271] Collective agreements in the 1930s successfully held back the substitution of contract or insurance based schemes,[272] where property in the fund was thought to be legally abstracted from the contributors.[273] Particularly in the post-WW2 period as occupational pension

266 In addition, the Trustee Investment Act 1961 empowered pension trusts to invest more in stocks.

267 Compare the chart above at part 2(2)(a). Life insurance is, of course, a functional equivalent to a pension, as such policies generally mature upon retirement. It is also unique among insurance types, because the insured events (in life and death) are certain to occur. See further J Lowry, P Rawlings and R Merkin, *Insurance Law: Doctrines and Principles* (2011)

268 ONS, *Ownership of UK Quoted Shares, 2012* (25 September 2013) 18, Table 3, shows 48.3% from the US and Canada, 25.8% from Europe, 10.1% Asia, 7.2% Africa, 4.1% Middle East, 2.5% Latin America, 1.7% Oceania, 0.1% 'Offshore UK'.

269 See the justifications in ONS, *Ownership of UK Quoted Shares, 2012* (25 September 2013) 1. The 'analysis' was carried out by two companies, Equiniti and Orient Capital, whose apparent conclusion was that shares 'are increasingly held in multiple-ownership pooled accounts, where the beneficial owner is unknown.' Logically, beneficial ownership should be recorded for the ultimate owners that are elected by beneficiaries, not intermediaries. Otherwise custodians would 'own' all the shares!

270 Discussed by PL Davies, 'Shareholders in the United Kingdom' in R Thomas and J Hill (eds) *Research Handbook on Shareholder Power* (2015)

271 e.g. Bournville Works, *A Works Council in Being* (1922) LSE Archives, HD5/118

272 L Hannah, *Inventing Retirement* (CUP 1986) ch 3, 'The insurance challenge (1927-1956)', on Ernest Bevin's role in particular.

273 Such reasoning is now to be regarded as flawed. The same obligations of stewardship exist, regardless of the legal form of a retirement scheme, e.g. Stewardship Code 2012, Principle 1, 'The policy should disclose how the institutional investor applies

savings really grew, a standard collective agreement would envisage employee elected, or union nominated pension trustees, jointly managing with representatives of the employer. Proposals to codify these practices in law during the 1970s did not pass.[274] Yet occupational pension funds continued to spread on this participatory, codetermination model through the 1980s.[275]

While UK collective bargaining was still strong, the relative quantity of pension savings rose, but peaked in 1992.[276] The minimum standard model of beneficiary voice was finally codified in the Pensions Act 1995.[277] Now, the Pensions Act 2004 requires a minimum of one-third member nominated trustees,[278] though larger collectively bargained schemes set the standard at one-half. Nevertheless, pension funds did not directly invest in shares and exercise voting rights. The Pensions Act 1995 section 34(4) gave trustees a strong regulatory incentive to delegate investment functions to asset managers, because then trustees became immune from liability for breaches of the duty of care. This provision was mainly intended to cover issues of selecting investments,[279] but an unintended consequence was that voting on shares was delegated too.

Second, if investment functions were delegated what power did trustees (at least those who are accountable to their beneficiaries' votes) have against asset managers in the investment chain? General trust and fiduciary principles have always subjected any asset manager, or indeed bank, to exercise voting rights (as with all powers) they held in the best interests of beneficiaries.[280] This includes the duty to follow specific instructions on votes held on trust.[281] This is the 'irreducible minimum core' of fiduciary obligation.[282] This was the consensus in the City, accepted as obvious by the Hampel Committee in 1998: asset managers have a duty to follow clients' instructions, and the duty arises whatever the formal legal relation to the client.[283] Fiduciary obligations of the asset manager are owed to clients in pooled funds over the aliquot

stewardship with the
aim of enhancing and protecting the value for the ultimate beneficiary or client.'

274 Occupational Pensions Board, *Solvency, Disclosure of Information and Member Participation in Occupational Pension Schemes* (BPP24 1974-5) Cmnd 5904 and White Paper, *Occupation Pension Schemes: The Role of Members in the Running of Schemes* (1976) Cmnd 6514

275 T Schuller and J Hyman, 'Pensions: The Voluntary Growth of Participation' (1983) 14(1) Industrial Relations Journal 70, 73

276 cf Wilson Report, *Committee to Review the Functioning of Financial Institutions* (1980) Cmnd 7937, 535, chart 5.2, predicting (fancifully in retrospect) that pension money would continue on the same trajectory. It did not because unions were broken.

277 Pensions Act 1995 ss 16-21, following the Goode Report, *Pension Law Reform* (1993) Cm 2342, para 4.5.24

278 Pensions Act 2004 ss 251-253

279 See discussion in the Goode Report, *Pension Law Reform* (1993) Cm 2342, 353, para 4.9.28-29

280 e.g. *Keech v Sandford* [1726] EWHC Ch J76, *Boardman v Phipps* [1967] 2 AC 46. It should be emphasised, it is fundamentally wrong in principle to limit the concept of 'best interests' to 'financial interests', as reflected in CA 2006 ss 170 and 172.

281 *Kirby v Wilkins* [1929] 2 Ch 444, Romer J holding a bare trustee has a duty to follow instructions from an absolutely entitled beneficiary, or vote in their best interests. Also, in *Butt v Kelson* [1952] Ch 197, Romer LJ held that beneficiaries can compel one to vote, and the court could exercise a power if beneficiaries were among themselves in disagreement. These cases refer to votes held on 'bare trust', though presumably the situation is the same when there is a complex trust, but the document is silent on voting: then, that particular 'stick' in the bundle of ownership rights is to be regarded as 'bare'.

282 *Armitage v Nurse* [1997] EWCA Civ 1279

283 Hampel Committee, *Final Report* (1998) para 5.7

share that is invested,[284] a matter of clerical simplicity as invested funds are fungible.[285] It is doubtful that those basic rights can be limited by contract,[286] because the possibility of conflict of interest is too overt. Only in 2015 did the UK's first Association of Member Nominated Trustees begin instructing asset managers how to vote on environmental, social and governance issues.[287]

Before 2015, at least by the late 1970s, UK asset managers had acquired a dominant position over shareholder votes and have held it up to today. This came from the fact of the ongoing collectivisation of capital, concentrated simply because of administrative efficiency into institutional shareholding. From the Financial Services Act 1986, an array of new financial products could be sold in the securities markets,[288] which were sufficiently complex to require more expert advice and fees. In mutual funds, beneficiaries have a basic right to direct their asset managers.[289] There is no barrier for policyholders of life insurance companies doing the same: a fact reflected in the requirement to fulfil the client's 'reasonable expectations'.[290] Even more, accountholders of high street banks have a right to instruct the bank.[291] But the difference in those forms of investment is that individual actors (without a representative voting system) face significant obstacles to take collective action and to make their preferences clear.[292] And on social and governance issues, particularly inequality, asset managers' preferences differ starkly.

(b) Germany

The legal changes in German institutional shareholding are even less revealing than those in the UK. The statistical data on German share ownership is also limited. But up until 2004 it contained a critical figure: that over 60 per cent of shareholder votes are controlled by banks.

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284 See *Barlow Clowes International Ltd v Vaughan* [1992] 4 All ER 22, per Dillon LJ, recounting the case worked on the presumption that 'the assets and moneys in question are trust moneys held on trust for all or some of the would-be investors... who paid moneys to BCI or associated bodies for investment, and are not general assets of BCI.'

285 e.g. *Lehman Brothers International (Europe) v CRC Credit Fund Ltd* [2010] EWCA Civ 917, [171]

286 An argument could theoretically be made that asset managers' 'freedom of contract' allowed them to impose their preferred terms (to do nothing while at the same time taking votes other people's money) on their clients. However, the likely legal position is that those contracts are subject, like any, to the Unfair Contract Terms Act 1977, and limitations may well be unreasonable as Schedule 2(a) requires the parties' bargaining power to be taken into account. Naturally, this would in no way impede the freedom of sophisticated commercial parties. A third option, based in orthodox equity rather than contract, is that the right is part of the irreducible minimum of fiduciary obligation. The result is that the duty to follow instructions cannot be abridged, and it is well described today as a basic economic right. See, originally, *Vernon v Bethell* (1762) 28 ER 838.

287 See AMNT, *The Red Lines: Proposed voting instructions* (June 2015)

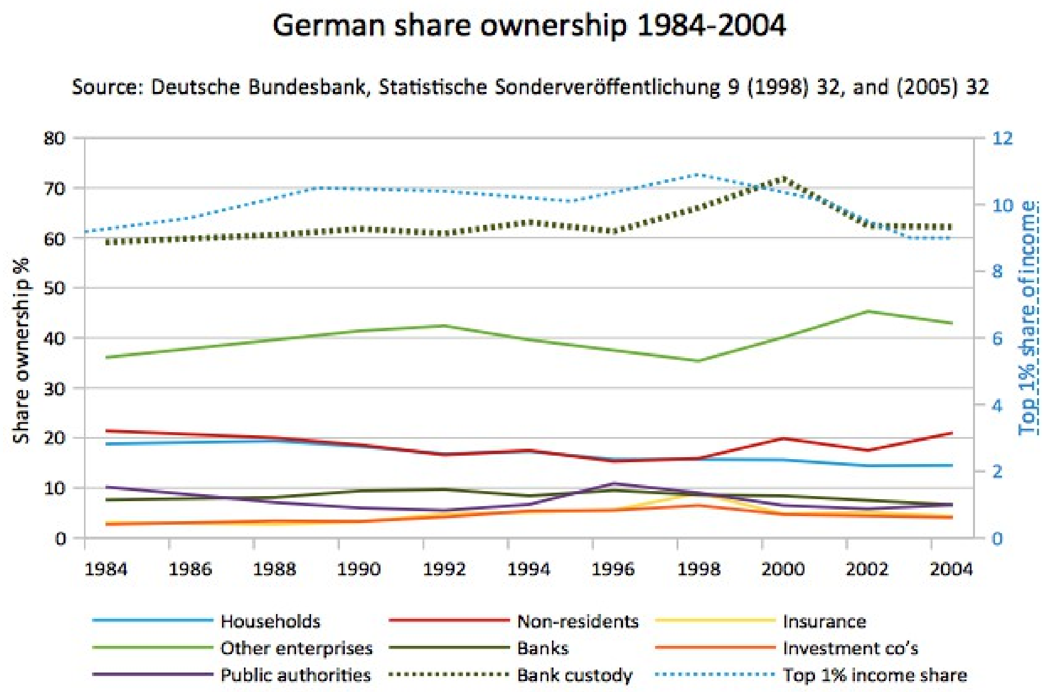
288 FSA 1986 s 63, now in FSMA 2000 s 412. This disapplied the Gaming Act 1845 to contracts used 'by way of business'.

289 Open-Ended Investment Company Regulations 2001/1228 (amended by SI 2005/923) r 34A

290 *Equitable Life Assurance Society v Hyman* [2000] UKHL 39, on the need to fulfil the clients' reasonable expectations.

291 e.g. Barclays Wealth Management and Investment, *Barclays Terms: Your Agreement With Us* (July 2012) Section B, Part 5, 7.15 and Part 7, 5.2.

292 n.b. various arguments can be made that asset managers should retain votes (1) that asset managers are experts, (2) that engagement should not be separated from voting, (3) that transparency avoids conflict. The replies are that asset managers' expertise lies in trading, not voting or engaging (hence the perceived need for the Stewardship Code 2012, against inactivism). What little engagement there is, is conflicted. Transparency is welcome, but cannot eliminate those risks.



German statistics show greater stability in share ownership. The state pension is income linked, meaning fewer people need occupational or private pensions, and a relatively smaller capital market. Occupational retirement money falls under the 'other enterprise' and 'insurance' figures.

The concentration of power is inordinate for two main reasons.[293] First, among occupational pensions, German courts allowed employers to take their workers' money and either self-invest this sum, or choose to provide a pension form (particularly insurance) in which staff had no voice.[294] This view of the law was rejected by the leading commentary during the 1920s,[295] but after the war it prevailed in the Federal Labour Court, where judges quoted their own alternative 1930s commentaries.[296] German trade unions, however, have not yet collectively bargained to change the form of their members' pensions sufficiently, nor litigated the position of the courts that denies their members a voice in their funds. Why the absence of contest? Occupational pensions have hitherto been smaller (financially and politically) compared to the state pension, and so not as salient among union objectives. The quantity of shares owned by 'other enterprises' includes companies that have appropriated, and self-invested their workers'

[293] Explored in detail in E McGaughey, *Participation in Corporate Governance* (2014) ch 6(2)

[294] Betriebsrentengesetz 1974 §1 contains the five different pension forms (direct-promise, insurance, a support scheme, pension scheme, and pension fund). But this says nothing about whether the workforce has a codetermination right: that depends on case law. See further, McGaughey (2014) ch 6(2)(b) 149-150

[295] G Flatow and O Kahn-Freund, *Betriebsrätegesetz* (1931) 348, 'Das Gesetz will bei allen Wohlfahrtseinrichtungen "das einseitige und deshalb der Gefahr der Willkür ausgesetzte Verfügungs- und Verwaltungsrecht des Arbeitgebers durch Einräumung von Mitverwaltungsbefugnissen an die Arbeitnehmer beschränken" (vgl. RAG v. 21.6.30, Bensh. Samml. Bd 9, 331).'

[296] BAG AP Nr 5 zu §56 BetrVG [Bl2R,3]; AP Nr3 ... BAG 15, 136 [139] = A{Nr6.... BAG 17, 316 [318-319] and BAGE 27, 194 (12 June 1975) 3 ABR 13/74, DB 1975, 1559 = AP Nr 1 zu §87, unsurprisingly endorsing the unreasoned views in A Hueck and HC Nipperdey, *Lehrbuch des Arbeitsrechts* (2nd edn 1930) Bd II, §66 Nr 9.

money, boosting their capacity to cross-invest in other firms. Insurance firms' share of the market is lower because of traditional regulation restricting their possible investments.

Second, banks control most shareholder voting rights because German shares were thought to require certification, and be deposited somewhere for safe keeping and speedy transfer. Banks provided deposit services. From the 1920s, they used standard form contracts – enabled by their dominant market position – to take and exercise voting rights. This development was defended on the ground that, if banks did not control votes, nobody would hold company directors to account.[297] Furthermore, it was thought that the average person, who was a shareholder, was reckless.[298] The banks' monopoly on voting rights were entrenched in the Aktiengesetz 1937.[299] This fascist law was not reversed in the 1965 reforms,[300] and most of it remains today despite ongoing investigations,[301] and proposals.[302] Neither was the issue resolved by the Control and Transparency Act 1998.[303] German corporate law still uses other people's votes to subsidise immense power for a cartel of bankers at the heart of Europe.[304]

Because the law has essentially remained the same since 1937, and statistics are scant, it is impossible to identify the precise relationship between bank or shareholder power and income inequality. Moreover, statistics on top incomes, compiled by Piketty, are collected through tax receipts.[305] There has been widespread, long-term tax evasion in Germany (regrettably not unique), particularly among executives and bankers who refuse to pay their debts, while advising others on how to do the same.[306] This makes it likely that the inequality statistics underestimate the scale of German income disparity. What changed in 1993, when executive pay started its dramatic rise? Given that banker power was always exercised over shareholder votes, the answer

297 FA Mann, 'The New German Company Law and Its Background' (1937) 19 Journal of Comparative Legislation and International Law 220, 236-237

298 JCD Zahn, *Wirtschaftsfuhrertum und Vertragsethik im Neuen Aktienrecht or Economic Leadership and Contractual Ethics in the New Corporate Law* (1934) 93, 'Die Demokratie des Kapitals wird ebenso verschwinden wie die politische.' Helpfully reviewed by F Kessler (1935) 83 University of Pennsylvania Law Review 393

299 AktG 1937 §114

300 AktG 1965 §135

301 Geßler Commission, Bundesministerium der Finanzen, *Grundsatzfragen der Kreditwirtschaft - Bericht der Studienkommission* (1979) 287. Ernst Geßler happened to have worked on the Aktiengesetz 1937.

302 e.g. Die Grünen, *Demokratisierung der Wirtschaft: Beschränkung der Bankenmacht* (18 October 1989) Bundestag Drucksache 11/5401, 3 and SPD Fraktion, *Handelsblatt* (16 June 1992) 6.

303 HD Assmann, 'Zur Reform des Vollmachtsstimmrechts der Banken nach dem Referentenentwurf eines Gesetzes zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG-E)' (1997) 42 Aktiengesetz. Sonderheft 100, 108

304 The word 'cartel' is used here in the technical, legal sense. In particular, Aktiengesetz 1965 §135 is liable to be found contrary to the Treaty on the Functioning of the European Union art 107(1). Banks collude before most company elections, contrary to TFEU art 101. See F Kübler, 'Comment: On Mark Roe, German Codetermination and German Securities Markets' (1998-1999) 5 Columbia Journal European Law 213, 'Most shareholders give their proxy to a limited number of nationally operating banks. For the election of shareholders' representatives to the supervisory board of the public corporation, management prepares a list of candidates which, although open to discussion with the banks, are almost certain to be accepted.'

305 cf Piketty (2014) 281-2

306 e.g. 'Steuerhinterziehung: Commerzbank zählt Rekordsumme' (24 March 2003) Der Spiegel. 'Zumwinkel Verdict: Ex-CEO of Deutsche Post Avoids Jail in Tax Evasion Case' (26 January 2009) Der Spiegel. J Schotter, 'Commerzbank in tax probe over unit in Luxembourg' (24 February 2015) Financial Times.

may lie with the psychology of reunification: a time for rewards to begin.

(c) United States

Had Germany followed the US approach, banks would no longer be an issue. According to the orthodox view, if American bankers had 'tried to imitate the German bankers, [they] would have had to run their banks from jail.'[307] In particular, during the New Deal, brokers (who were usually banks or in the same position) were prohibited from voting for customers on whose behalf corporate stocks were purchased.[308] The ban, however, was not complete. In the years up to the global financial crisis, brokers had again begun to use other people's votes, including setting the executive pay of Walt Disney's Michael Ovitz.[309] The Dodd-Frank Act 2010 completed the ban, so that no intermediary bank can cast votes on its customers' behalf unless instructions are given.[310] Thus, German style banker dominance of shareholder votes was strangled at birth in the US, and is now as dead and buried as it is in Switzerland.

Instead, the plot for dominance of US shareholding intermediaries resembled the UK's but (as is the American way) its script was even more of a 'blockbuster'. The dispersion of US shareholding, the great separation of ownership and control first documented by Gardiner Means,[311] took place as Americans prospered with the strides in collective bargaining and economic growth toward the end of WW1. Without a state pension, either income linked as in Germany, or with a minimum safety net as in the UK, American savers turned to other options: life insurance in part,[312] but even more notably in stocks. Before the enforcement of basic disclosure duties, millions individual savers could be missold 'subprime' stocks. And indeed, Wall Street crashed in 1929 precisely because stock promoters took advantage of so many people.[313] When the Social Security Act 1935 created the minimum state pension, and the National Labor Relations Act 1935 empowered unions to collectively bargain for fair pensions, the number and size of occupational pensions set the long run change of US share ownership in motion.

[307] MJ Roe, 'Some Differences in Corporate Structure in Germany, Japan, and the United States' (1993) 102(8) Yale Law Journal 1927, 1951. But again, as explained above, German bankers' power is probably contrary to EU law.

[308] Securities and Exchange Act 1934 §14b, empowering the SEC to make the New York Stock Exchange introduce Rule 452. See R Maidman, 'Voting Rights of After-Record-Date Shareholders: A Skeleton in a Wall Street Closet' (1962) 71(7) Yale Law Journal 1205, 1215 and DF Vagts, 'Reforming the "Modern" Corporation: Perspectives from the German' (1966) 80 Harvard Law Review 23, 57.

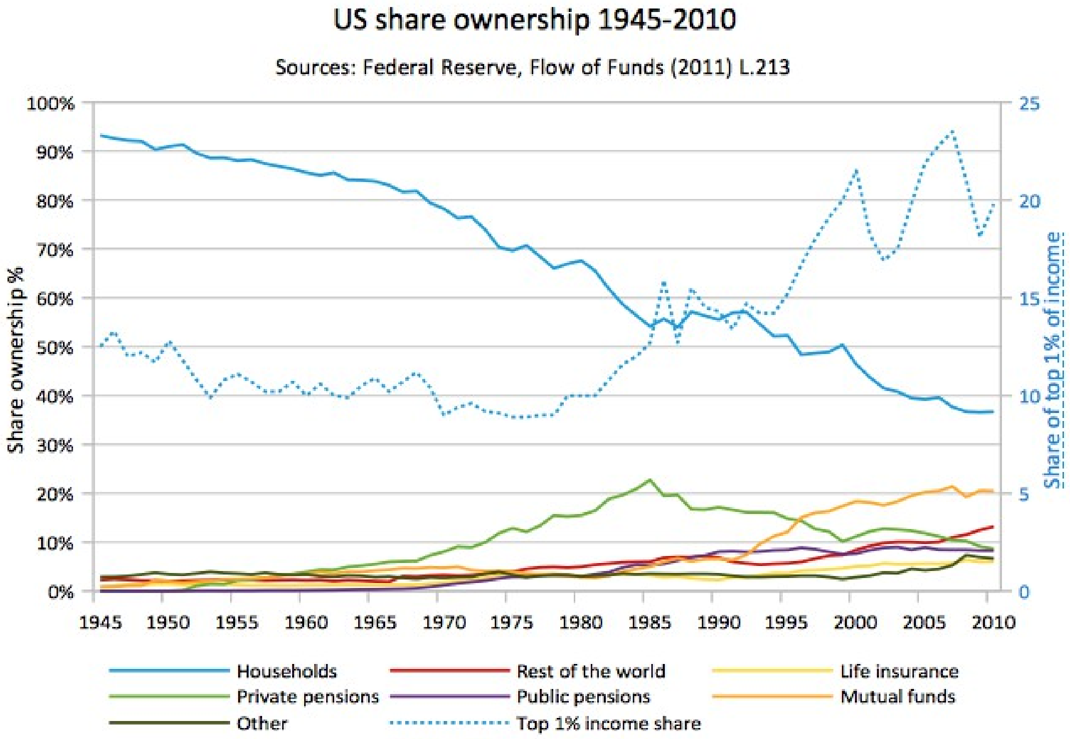
[309] *Report and Recommendations of the Proxy Working Group to the New York Stock Exchange* (5 June 2006) 9

[310] Dodd-Frank Act 2010 §957 and Securities and Exchange Act 1934 §6(b)(10)

[311] GC Means, 'The Separation of Ownership and Control in American Industry' (1931) 46(1) The Quarterly Journal of Economics 68

[312] See LD Brandeis, *Life Insurance: The Abuses and the Remedies. Address Delivered before the Commercial Club of Boston* (1905)

[313] Other narratives have emphasised speculation, or the monetary supply, but are wrong to the extent they claim they have found the *only* cause. These arguments neglect the views, and reforms, of people who were there at the time and who wrote the new securities laws: see AA Berle and GC Means, *The Modern Corporation and Private Property* (1932) Book III.



Like in the UK, individual 'household' share ownership (blue) was in terminal decline since the war. Most notably, the rise of private pensions (green) really began in the early 1950s, while other collective share vehicles rose as alternatives from the 1980s. What voice did US retirement savers have in the use of their money? The US had led the world in formulating the codetermined retirement savings model, after Andrew Carnegie happened to appear before the Commission on Industrial Relations 1915, and became persuaded that participatory pensions were part of the solution for economic conflict.[314] The experience led him to set up the Teachers Insurance and Annuity Association for university staff, now TIAA-CREF.[315] In the 1930s, when trade unions began bargaining for occupational pensions beyond the social security minimum, they sought pension trusts controlled by the union. After a campaign by employers to regain control, the Taft-Hartley Act 1947 §302(c)(5)(B) required that boards of all pension funds that the employer paid into were to have equal representation of unions and employers.[316] These were collectively bargained, multi-employer schemes. They covered 3.3m workers in 1960, and 9.7m in 1988.[317]

In addition, individual private employers could have their own pension schemes, but there could scarcely be any worker voice in individual accounts. The first of these began in with the

[314] Commission on Industrial Relations, *Final Report and Testimony* (1915) vol 1, and (1916) vol 9, 8288
[315] WC Greenough, *It's My Retirement Money - Take Good Care of It: The TIAA-CREF Story* (Irwin 1990) 33-37
[316] Labor Management Relations Act 1947 §302(c)(5)(B) (29 USC §186)
[317] HR Bartell Jr and ET Simpson, P*ension Funds of Multiemployer Industrial Groups, Unions, and Nonprofit Organizations*, occasional paper 105 (National Bureau of Economic Research, 1968) and Rep. Peter Visclosky, 135 Congressional Record H5984–05, H6233 (1989) citing a study by the ME Segal consulting firm.

Self-Employed Individuals Tax Retirement Act 1962.[318] Then, in the Internal Revenue Code in 1978, §401(k) introduced a new individual account saving with deferred taxation that employees and employers could pay into. Individual pensioners had little bargaining power to get better terms on how their plans were managed. The Tax Reform Act 1986 placed caps on other forms of retirement plans, encouraging more people to switch into 401(k) plans still. Some state government pensions had employee representation. But the employer (i.e. the state governor, and appointees) dominated most. This changed with the Uniform Management of Public Employee Retirement Systems Act 1997 §17(c)(3), by requiring transparency of state pension rules: more employees quickly got a democratic vote in their retirement funds' management.[319]

Who actually got the votes on all this money? By the 1970s and 1980s, collective pension schemes with representatives elected by beneficiaries (primarily Taft-Hartley plans, state pension plans, and TIAA-CREF) were in a position to take their own corporate governance in house. Some began to try, but in Delaware and under federal law, found a hostile response to expression of any wishes to do with social or environmental matters.[320] Furthermore, smaller schemes delegated investment issues to asset managers, who took up the votes. The huge growth in 401(k) plans from 1979, and their further surge in 1986 (counted under the orange, mutual fund statistics) meant asset manager control. The Employee Retirement Income Security Act 1974 had stipulated that if investment functions were delegated to asset managers, the trustees of a scheme would become immune from breach of duty.[321] Financial deregulation allowed asset managers to trade ever more complex products for pension funds, while at the same time influencing an increasing number of votes in corporations who would buy those same products.

Could US beneficiaries instruct their investment advisers on how they wishes their votes to be cast? The basic answer appears to be 'yes'. The Investment Company Act 1940 and Investment Advisers Act 1940 are silent on the issue, so standard equitable principles apply.[322] There is no explicit regulation on asset managers yet, as for brokers, though the Securities and Exchange Commission could issue clarifying rules. Has this regulation affected inequality? As in the UK, asset manager control coincides with the rise of executive pay: the 'take-off' point again appears in the 1970s: particularly with ERISA 1974. The evidence suggests this was the change that caused growth in US financial services: subsidised by a grand pattern of self-dealing.

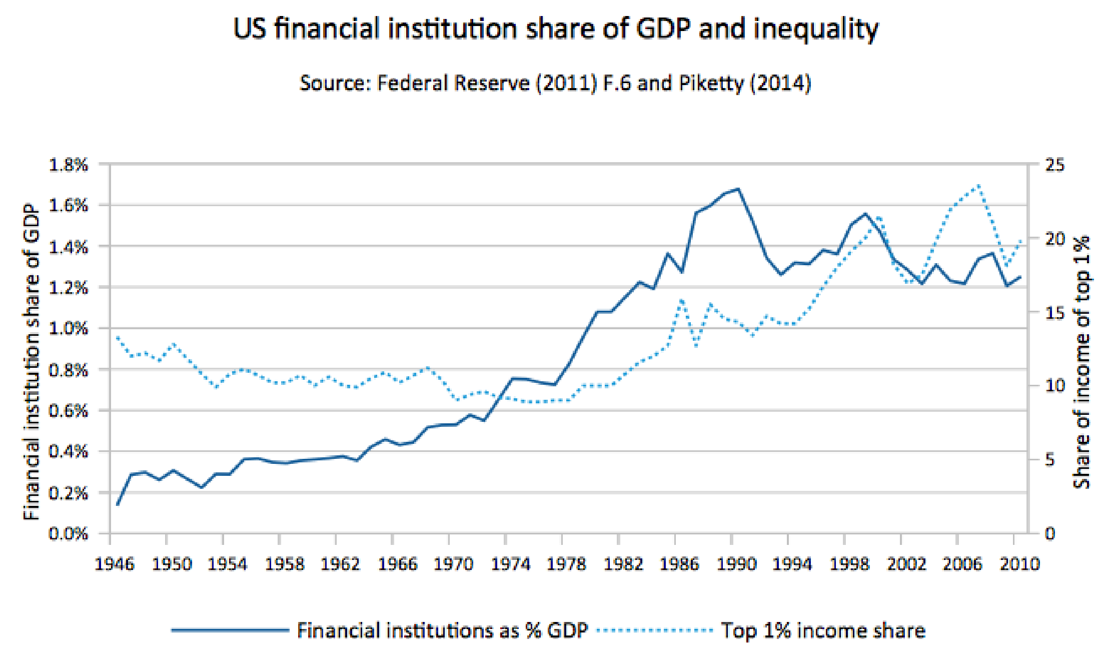
318 ERISA 1974 extended tax deferment on individual accounts.

319 D Hess, 'Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices' (2005-2006) 39 UC Davis LR 187, 195, recording by 1998, out of 2670 public retirement systems there was an average of 36 per cent elected trustees, 15 per cent *ex officio* trustees and 44 per cent appointed trustees.

320 The position still remains unclear. See generally, *Lovenheim v Iroquois Brands*, 618 F Supp 554 (1985) and PR Stanton, 'SEC Reverses Cracker Barrel No-Action Letter' (1999) 77(3) Washington University LR 979

321 ERISA 1974 §408(c)(3), 402(d)(1) and 404(c)(1)

322 e.g. Massachusetts Uniform Trust Code 2009 §§105(b)(2), 802 and 808 (Mass General Laws, Pt II, Title II, ch 203E)



Financial service growth matches growing inequality, and it began from the very time that people's retirement savings were growing, and were increasingly put into individual accounts. This suggests a very strong case that asset managers, who could exploit corporate power for their own ends, have been a significant causal contributor to overall growth in inequality.

3. Conclusion

This article has shown the evidence that corporations increase inequality in the UK, Germany and the US in three main ways. First, directors and institutional shareholders have been enabled set ever higher rates of executive pay. Second, inequality grew when people were deprived of a meaningful voice at work, even while corporate employers could appropriate the benefits of their employees' labour. Third, asset managers and banks have been enabled to take shareholder votes from other people's money, particularly retirement savings. Those votes made corporations over-invest in financial services, over-inflating the City of London, Frankfurt and Wall Street at the expense of economic stability. These changes in legal rights, to participate in corporate governance, are the greatest 'pre-tax' cause of rising inequality. By understanding legal and social change, it becomes clear that with careful, prudent reforms the modern corporation could become – not a threat to economic stability – but an institution that promotes social justice.

Ultimately questions of inequality and social justice are not just economic, but political and moral. Justice, at its most basic, means people getting what they are due.[323] But while ancient

[323] Justinian, *Institutes* (ca 540) Book I, Title I

notions of justice subordinated individual freedom completely to the 'public good',[324] post-enlightenment philosophy has consistently held the most important goal to be the improvement of the content our 'character' while lending each other a 'helping hand',[325] to bring forward everyone's 'capacity',[326] the 'utmost possible development of faculty in the individual human being',[327] and to ensure that 'the opportunity to develop individuality becomes fully actualized.'[328] If these arguments are persuasive, and we conceive that we should owe to one another a duty to fulfil these goals, 'social justice' means the creation of institutions for continual human development:[329] it is 'the first value of social institutions'.[330] Inequality holds back economic growth and development.[331] But its causes are not merely supply and demand, changing marginal utilities, technological advance, or globalisation. It happens through political choice. At the heart of change explained in part 2 were decisions of courts or legislatures to constrain economic voice, or to give people freedom so that everyone could participate in the economy.

Of course, it could be argued that the real 21st century danger is that an increasingly unvaried monopoly capitalism will threaten to remove democracy in politics, just as it is being removed in the economy.[332] US government 'shutdown' in 2013 was an extreme example. EU 'austerity' and 'structural adjustment' are milder forms of the same phenomenon. Bank cartels and corporate monopolists, it might be said, will fund strategists, lobbyists and think-tanks who blame the public sector for ongoing economic crises. They will weaken welfare, and cut government, while pushing for trade deals to sign away the next government's powers to realise the will of its people. It will not matter, this argument would continue, what evidence there is about inequality, and its causes. Evidence will not matter once political decisions have been made

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[324] Plato, *The Republic* (ca 380BC) D Lee (1955, 2nd edn 2007) 137-8, Book IV, Part IV, Justice in State and Individual.
[325] B Spinoza, *On the Improvement of the Understanding* (1677) §§13-14
[326] T Paine, *The Rights of Man* (1792) Part II, ch 3
[327] S Webb and B Webb, *Industrial Democracy* (9th edn 1926) Part IV, ch 4, 847-849
[328] AA Berle, 'Property, Production and Revolution' (1965) 65(1) Columbia Law Review 1, 17.
[329] A Sen, *The Idea of Justice* (2010) 228-230 and J Stiglitz, 'Employment, social justice and societal well-being' (2002) 141 International Labour Review 9, and on an essentially similar understanding of 'utility', see JS Mill, *Principles of Political Economy* (1848) Book V, ch XI, §6 and JS Mill, *Utilitarianism* (1863) ch 5.
[330] J Rawls, *A Theory of Justice* (1971) ch 1
[331] See United Nations Development Programme, *Human Development Report 2010, 20th Anniversary Edition. The Real Wealth of Nations: Pathways to Human Development* (2010) refining human development's definition. See also, RF Kennedy, *Remarks at the University of Kansas* (18 March 1968) '... that Gross National Product counts air pollution and cigarette advertising, and ambulances to clear our highways of carnage. It counts special locks for our doors and the jails for the people who break them. It counts the destruction of the redwood and the loss of our natural wonder in chaotic sprawl. It counts napalm and counts nuclear warheads and armored cars for the police to fight the riots in our cities. It counts Whitman's rifle and Speck's knife, and the television programs which glorify violence in order to sell toys to our children. Yet the gross national product does not allow for the health of our children, the quality of their education or the joy of their play. It does not include the beauty of our poetry or the strength of our marriages, the intelligence of our public debate or the integrity of our public officials. It measures neither our wit nor our courage, neither our wisdom nor our learning, neither our compassion nor our devotion to our country, it measures everything in short, except that which makes life worthwhile.'
[332] cf JCD Zahn, *Wirtschaftsfuhrertum und Vertragsethik im Neuen Aktienrecht* or *Economic Leadership and Contractual Ethics in the New Corporate Law* (1934) 93, 'Die Demokratie des Kapitals wird ebenso verschwinden wie die politische.' 'Democracy of capital will disappear just as it did in politics.' Zahn was the primary author of the Aktiengesetz 1937 (Public Companies Act 1937).

in principle. The only alternative, we could be told to conclude, is to renew the force of government, to break financiers and oligarchs through tax and state power.

If a choice had to be made between monopoly capitalism and reviving strong democratic government, there is no question that government is infinitely preferable: democracy will not destroy markets, but monopolists threaten democracy. Yet this binary choice between 'private or public' vanishes once it is seen that all institutions, political and economic, have a governance structure, where people have rights, within rules that society is competent to make. In a world of mass corporations, mass democracies, and mass education, the state itself – though it remains a critical expression of democratic preference – becomes ever less unique. States lose the legitimacy of their old monopoly on violence. People will not be governed by threats and force, but only by consent and by law. Rule-making is delegated to new political bodies both transnational and local. As this deliberative process continues, so does the expansion of economic voice. A now-forgotten enemy of democracy possibly put it best. 'When you get a democratic basis for your institutions,' said the man who wrote the UK's first modern company law, 'you impose on yourselves the task of re-modelling the whole of your institutions, in reference to the principles that you have set up'.[333] Those are principles that reject increasing inequality. They embrace the socially just corporation.

[333] Mr Robert Lowe, HC Hansard Debs, *Representation of the People Bill, Third Reading* (15 July 1867) vol 188, col 1543.