

Common Ownership and The Decline of the American Worker

Law Working Paper N° 584/2021

May 2021

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ECGI Working Paper Series in Law

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For helpful comments we are grateful to Harshil Bansal, Danielle Chaim, Asaf Eckstein, Einer Elhauge, Luca Enriques, Merritt Fox, Michal Gal, Frank Giaoui, Ronald Gilson, Victor Goldberg, Jeffrey Gordon, Assaf Hamdani, Marcel Kahan, Michael Klausner, Bentley MacLeod, Curtis Milhaupt, Joshua Mitts, John Morley, Max Pearl, Menesh Patel, Katharina Pistor, Alex Raskolnikov, Edward Rock, Chuck Sabel, Richard Squire, Eric Talley, and participants at the following events: the Blue Sky Talk and the Faculty Workshop at Columbia Law School, the Business Law Workshop Series at the University of Oxford Faculty of Law, the Corporate Law Academic Workshop, the Law and Economics Seminars at the University of Tel Aviv Faculty of Law and the Hebrew University Faculty of Law. We also are grateful to Eitan Arom for his superb research and editing assistance.

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Abstract

The last forty years have seen two major economic trends: Wages have stalled despite rising productivity, and institutional investors have replaced retail shareholders as the predominant owners of the American equity markets. A few powerful institutional investors—dubbed common owners—now hold large stakes in most U.S. corporations. It is not a coincidence that at the same time American workers got a new set of bosses, their wages stopped growing, and shareholder returns went up. This Article reveals how common owners shift wealth from labor to capital, exacerbating income inequality.

Powerful institutional investors' policy of pushing public corporations to adopt strong corporate governance has an inherent, painful tradeoff. While strong governance can improve corporate efficiency—by reducing management agency costs—it can also reduce social welfare—by limiting investment and depressing the labor market. The shift to strong governance causes managers to limit investment and thus hiring, thereby depressing labor prices. Common owners act as a wage cartel, pushing labor prices below their competitive level. Importantly, common owners transfer wealth from workers to shareholders not by actively pursuing anticompetitive measures but rather by allocating more control to shareholders—control that can then be exercised by other shareholders, such as hostile raiders and activist hedge funds. If policymakers wish to restore the equilibrium that existed before common ownership dominated the market, they should break up institutional investors by limiting their size.

Keywords: Common ownership, institutional investors, corporate governance, labor monopsony, income inequality

JEL Classifications: J3, J42, K21, K22, K31, L4,

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COMMON OWNERSHIP
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ABSTRACT

The last forty years have seen two major economic trends: Wages have stalled despite rising productivity, and institutional investors have replaced retail shareholders as the predominant owners of the American equity markets. A few powerful institutional investors—dubbed common owners—now hold large stakes in most U.S. corporations. It is not a coincidence that at the same time American workers got a new set of bosses, their wages stopped growing, and shareholder returns went up. This Article reveals how common owners shift wealth from labor to capital, exacerbating income inequality.

Powerful institutional investors' policy of pushing public corporations to adopt strong corporate governance has an inherent, painful tradeoff. While strong governance can improve corporate efficiency—by reducing management agency costs—it can also reduce social welfare—by limiting investment and depressing the labor market. The shift to strong governance causes managers to limit investment and thus hiring, thereby depressing labor prices. Common owners act as a wage cartel, pushing labor prices below their competitive level. Importantly, common owners transfer wealth from workers to shareholders not by actively pursuing anticompetitive measures but rather by allocating more control to shareholders—control that can then be exercised by other shareholders, such as hostile raiders and activist hedge funds. If policymakers wish to restore the equilibrium that existed before common ownership dominated the market, they should break up institutional investors by limiting their size.

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INTRODUCTION

American workers are more productive than ever, but they take home the same pay they did forty years ago.¹ While firms have enjoyed blockbuster profits²—and the gross domestic product (GDP) has tripled³—most American households have not shared in this increasing prosperity. As wages have stagnated, income inequality has skyrocketed.⁴ Causes like de-unionization,⁵ globalization,⁶ immigration,⁷ labor market concentration,⁸ and technology⁹ have been blamed for these trends. But so far, an additional culprit has escaped detection: *common ownership*—a few powerful

¹ See, e.g., *Estimating the U.S. Labor Share* fig.1, U.S. BUREAU LABOR STATS. (Feb. 2017), <https://www.bls.gov/opub/mlr/2017/article/estimating-the-us-labor-share.htm>, (finding that the labor share of output has declined from 64% in 1982 to a low of 56% in 2011); JOSH BIVENS ET AL., ECON. POL'Y INST., *Raising America's Pay* 10 fig.a (2014), <https://www.epi.org/publication/raising-americas-pay/> (finding that while productivity and compensation grew in tandem from 1948 until 1979, thereafter between 1979 and 2013 productivity grew 64.9% while hourly compensation grew only 8.2%).

² See Robert Hughes, *Corporate Profits Hit a New Record as GDP Growth Is Revised Higher*, AIER (2018), <https://www.aier.org/article/corporate-profits-hit-a-new-record-as-gdp-growth-is-revised-higher/>; Nir Kaissar, *The Hard Part of Ending Inequality Is Paying for It*, BLOOMBERG OPINION (Sep. 2, 2019) (reporting that corporate profits as a percentage of GDP hit the highest on record in 2012 and remained elevated, according to the U.S. Bureau of Economic Analysis), <https://www.bloomberg.com/opinion/articles/2019-09-02/hard-part-of-ending-inequality-is-paying-for-it>; JAN DE LOECKER ET AL., *THE RISE OF MARKET POWER AND THE MACROECONOMIC IMPLICATIONS* 10 (2018), <http://www.janeeckhout.com/wp-content/uploads/RMP.pdf> (finding that in 2016, the average markup charged was 61% over marginal cost, compared to 21% in 1980).

³ *GDP (Constant 2010 US\$)—United States*, WORLD BANK, <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD?locations=US> (last visited Jan. 20, 2021).

⁴ Upper-income households now claim half of economic wealth, up from a third in 1980. Juliana Menasce Horowitz et al., *Trends in Income and Wealth Inequality*, PEW RSCH. CTR. (Jan. 9, 2020) <https://www.pewsocialtrends.org/2020/01/09/trends-in-income-and-wealth-inequality>.

⁵ See, e.g., Lawrence Mishel, *Unions, Inequality, and Faltering Middle-Class Wages*, ECON. POL'Y INST. (Aug. 29, 2012), <https://www.epi.org/publication/ib342-unions-inequality-faltering-middle-class>; see also Henry S. Farber et al., *Unions and Inequality over The Twentieth Century: New Evidence from Survey Data*, (Nat'l Bureau Econ. Rsch., NBER Working Paper 24587, 2018), <http://www.nber.org/papers/w24587>.

⁶ See, e.g., Guido Cozzi & Giammario Impullitti, *Globalization and Wage Polarization*, 98 REV. ECON & STAT. 984, 999 (2016).

⁷ See, e.g., Jason Anastasopoulos et al., *Job Vacancies and Immigration: Evidence from Pre- and Post-Mariel Miami 4* (Nat'l Bureau Econ. Rsch., Working Paper No. 24580, 2018), <https://economics.yale.edu/sites/default/files/w24580.pdf>.

⁸ See, e.g., José Azar et al., *Labor Market Concentration* (Nat'l Bureau Econ. Rsch., Working Paper No. 24147, 2019) [hereinafter Azar et al., *Labor Market Concentration*], <https://www.nber.org/papers/w24147.pdf> (finding geographic concentration in labor markets throughout the U.S.).

⁹ See, e.g., Daron Acemoglu & Pascual Restrepo, *Robots and Jobs: Evidence from US Labor Markets*, 128 J. POL. ECON. 2188 (2020); Clemens Lankisch et al., *How Can Robots Affect Wage Inequality?*, 81 ECON. MODELLING 161 (2019).

institutional investors controlling large stakes in most U.S. corporations.¹⁰ As this Article explains, the shift to common ownership has been a significant cause of wage stagnation and income inequality.¹¹

Since the 1980s, control of the American stock markets has shifted from individual retail investors to an interlocking set of powerful financial institutions who own shares in practically all public corporations. Scholars have dubbed these institutions *common owners*.¹² Today, these highly diversified institutional investors own more than 70% of American publicly traded equity, up from less than 25% in the 1980s.¹³ The three largest asset managers—BlackRock, Vanguard, and State Street—collectively constitute the largest shareholder in nine out of ten S&P500 firms.¹⁴ The once-prevalent dispersed ownership structure¹⁵ has now been replaced by common ownership.¹⁶

Effectively, common owners have hung an “Under New Management” sign over publicly traded corporations. While these corporations employed 40% of the American workforce in 1980, after a steady decline, they only employed 29% in 2019.¹⁷ It would be an astounding coincidence that, at the same time American workers got a new set of bosses, the percentage of employees shrank, and their wages stopped growing. On the contrary, this

¹⁰ See Matthew Backus et al., *Common Ownership in America: 1980-2017* at 1, (Nat’l Bureau Econ Rsch., Working Paper No. 25454, 2019), <https://www.nber.org/papers/w25454> (documenting the increase in common ownership).

¹¹ This Article explains that the wage and inequality effects are driven by reduced investments caused by common ownership, see *infra* Section II, and a study has found that the aggregate-level investment gap is mostly explained by low competition and high common ownership, see Germán Gutiérrez & Thomas Philippon, *Investmentless Growth: An Empirical Investigation*, Papers on Econ. Activities, Fall 2017, 89, 120 <https://www.brookings.edu/wp-content/uploads/2018/02/gutierreztextfa17bpea.pdf> [hereinafter Gutiérrez & Philippon, *Investmentless Growth*].

¹² See, e.g., Edward B. Rock, *Institutional Investors in Corporate Governance* 4–5 (Univ. Penn. Carey L. Sch., Penn L.: Legal Scholarship Repository Paper 1458, 2015), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2459&context=faculty_scholarship (describing the “de-retailization of the capital markets” as a result of labor regulations and market forces).

¹³ See Jose Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1514 (2018) [hereinafter Azar et al., *Anticompetitive Effects*].

¹⁴ See Jan Fichtner et al., *Hidden Power of the Big Three?* 19 BUS. & POLS. 298, 313 (2017).

¹⁵ A dispersed ownership structure of a publicly traded corporation means that there is no individual shareholder with sufficient voting power and an incentive to exercise control over management. See, John C. Coffee Jr., *Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension between “Lumpers” and “Splitters”*, in THE OXFORD HANDBOOK OF CAPITALISM 463 (Dennis C. Mueller ed., 2012).

¹⁶ Backus et al., *supra* note 10, at 15 fig. 4 (showing the rise in share ownership by common owners).

¹⁷ See Frederik P. Schlingemann & René M. Stulz, *Has The Stock Market Become Less Representative of the Economy?* 2, (Nat’l Bureau of Econ. Rsch, Working Paper No. 27942, 2020), <http://www.nber.org/papers/w27942>.

Article argues that common owners are a driving force behind stalled wages and increasing income inequality.

Common owners move publicly traded firms *en masse* toward strong governance, which provides shareholders with greater control over managers. Managers who are more exposed to shareholder intervention are less likely to pursue bold, long-term, or transformative investments. Such investments are hard to evaluate and might be misperceived by shareholders as inefficient investments, thereby increasing managers' risk of being mistakenly fired. As investment falls, so too will hiring: Companies no longer require the labor force to operate new factories, staff new divisions, or open new offices and locations.¹⁸ This hiring shortfall will artificially depress wages, allowing firms to enjoy a wage discount and moving wealth from workers to shareholders. Because shareholders tend to be wealthier than wage-earners, this process not only causes wages to stagnate but also exacerbates income inequality.

This view runs counter to conventional wisdom in corporate law. Common owners are thought to bring savvy to the boardroom and draw praise for strengthening corporate governance in publicly traded corporations.¹⁹ Strong governance supposedly improves corporate efficiency by deterring disloyal managers from overinvesting and wasting resources on pet projects. In other words, *overinvestment* is a type of management agency cost that strong governance is believed to reduce.²⁰ More broadly, scholars have heralded institutional investors as guardians of shareholder rights whose ability to monitor corporations and hold disloyal managers accountable creates a net social benefit, a portion of which accrues to employees through their retirement plans.²¹

¹⁸ See Frederico Belo et al., *Labor Hiring, Investment, and Stock Return Predictability in the Cross Section*, 122 J. POL. ECON. 129, 131–32 (2014) (examining the relationship between hiring and investment).

¹⁹ See, e.g., Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2104 (2019) (documenting that the Big Three institutional investors “have been very active in supporting [shareholders] proposals advocating governance changes favored by their governance principles.”); Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507 (2020) (showing the benefits of common ownership in improving compliance).

²⁰ See, Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986) (introducing the problem of management overinvestment); Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989) (offering evidence in support of the empire-building hypothesis); Scott Richardson, *Over-Investment of Free Cash Flow*, 11 REV. ACC. STUDS. 159 (2006) (finding that strong governance reduces overinvestment); Micah S. Officer, *Overinvestment, Corporate Governance, and Dividend Initiations*, 17 J. CORP. FIN. 710 (2011) (finding that reductions in overinvestment at firms with poor investment opportunities are reflected in higher dividends).

²¹ See, e.g., Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1643–44 (2013) (arguing that “shareholder ability to intervene . . . provides long-term benefits to companies, shareholders, and the economy”); Bernard S.

However, this Article shows that in exchange for this marginal increase in the value of their pension's stock portfolio, employees of public corporations are resigning themselves to depressed hiring and stagnant wages, even as their productivity—and consequently their value to the corporations—surges to record levels.

Although strong governance improves corporate efficiency by deterring disloyal managers from overinvesting, it also deters *loyal* managers from investing in value-increasing projects.²² A loyal manager risks discipline and dismissal by investing in innovative, complex, or long-term investments that shareholders might misevaluate or misunderstand.²³ Therefore, both loyal and disloyal managers are likely to refrain from investing under a strong-governance regime. *Underinvestment* by loyal managers is an *inefficient* effect of strong governance. It is debatable whether, between these two opposing effects—decreasing management agency costs while discouraging value-creating investments—strong governance is, on average, socially beneficial.²⁴ But even assuming that strong governance decreases inefficient investments more than it discourages efficient investments, both effects decrease corporate investment—and thus, hiring.

Take, for example, institutional investors' campaign against antitakeover protections such as staggered boards and poison pills.²⁵ The conventional wisdom is that removing antitakeover protections deters

Black, *Agents Watching Agents: The Promise of Institutional Voice*, 39 UCLA L. REV. 811, 815 (1992) ("The case for institutional oversight, broadly speaking, is that product, capital, labor, and corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available."); Audra L. Boone & Joshua T. White, *The Effect of Institutional Ownership on Firm Transparency and Information Production*, 117 J. FIN. ECON. 508 (2015) (finding that institutional investors facilitate information production, which enhances monitoring); Alan D. Crane et al., *The Effect of Institutional Ownership on Payout Policy: Evidence from Index Thresholds*, 29 REV. FIN. STUD. 1377 (2016) (finding that even non-activist institutions play an important role in monitoring firm behavior, leading to increased dividends).

²² See Zohar Goshen & Doron Levit, *Irrelevance of Governance Structure* at 7–8 (European Corp. Governance Inst., Finance Working Paper No. 606/2019, 2019), https://ssrn.com/abstract_id=3340912 (modelling the choice facing managers between whether to invest in pet projects or value-creating investment projects).

²³ Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017); Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016).

²⁴ The empirical findings are inconclusive. For a review of these studies, see Goshen and Squire, *supra* note 23, at 814–25.

²⁵ As early as 1999, corporate law scholars noted that "institutional investors had gone from expressing intense criticism of this device [the poison pill] to challenging particular aspects of its operation, in addition to seeking mandatory removal of it from the arsenal of corporate defenses." See John H. Matheson, *Corporate Governance at the Millennium: The Decline of the Poison Pill Antitakeover Defense*, 22 HAMLINE L. REV. 703, 704 (1999); see also Francis J. Aquila, *Adopting a Poison Pill in Response to Shareholder Activism*, PRACTICAL LAW: THE JOURNAL 22, 24–25 (Apr. 2016), https://www.sullcrom.com/files/upload/Apr16_InTheBoardroom.pdf.

inefficient investments by exposing underperforming managers to a hostile takeover threat.²⁶ But this conventional wisdom is only one side of the story. The fear of a takeover also deters loyal managers from making *efficient* investments.²⁷ Some visionary, hard-to-understand, or long-term investments are underpriced by the market, exposing talented, loyal managers to unjustified hostile takeovers.²⁸ Without antitakeover protections, loyal managers will likely distribute any free cash flow instead of making these beneficial investments.²⁹ Antitakeover protections are a

²⁶ See, e.g., Lucian A. Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 994 (2002) (arguing that “takeover threat provides managers with an important source of incentives to serve shareholders”). In today’s market, such a takeover would likely be dress-up as a “friendly” acquisition. See, e.g., Tingting Liua and J. Harold Mulherin, *How Has Takeover Competition Changed Over Time?*, 49 J. CORP. FIN. 104 (2018) (finding that “takeover competition across the entire auction process between deal initiation and completion has not declined. In effect, takeover competition via auctions has gone underground”).

²⁷ See, e.g., Mark Humphery-Jenner, *Takeover Defenses, Innovation, And Value Creation: Evidence from Acquisition Decisions*, 35 STRAT. MGMT. J. 668 (2014) (finding that hard-to-value firms that have antitakeover provisions make acquisitions that generate more shareholder wealth and are more likely to increase corporate innovation); Thomas J. Chemmanur & Xuan Tian, *Do Antitakeover Provisions Spur Corporate Innovation? A Regression Discontinuity Analysis*, 53 J. FIN. & QUANTITATIVE ANALYSIS 1163 (2018) (“antitakeover provisions help nurture innovation by insulating managers from short-term pressures arising from equity markets.”); Vivian Fang et al., *Does Stock Liquidity Enhance or Impede Firm Innovation?* 69 J. FIN. 2085 (2014) (finding that liquidity impedes innovation because of increased exposure to hostile takeovers and higher presence of institutional investors); Mark S. Johnson & Ramesh P. Rao, *The Impact of Antitakeover Amendments On Corporate Financial Performance*, 32 FIN. REV. 659 (1997) (finding that R&D expenditure increases with the adoption of antitakeover amendments because managers are less fearful of takeover attempts as a result of poor performance). A study that found the opposite result was criticized for using antitakeover laws as an exogenous event. See Julian Atanassov, *Do Hostile Takeovers Stifle Innovation? Evidence from Antitakeover Legislation and Corporate Patenting*, 68 J. FIN. 1097 (2013) (finding a decline in the number of patents and citations per patent for firms incorporated in states that pass antitakeover laws relative to firms incorporated in states that do not); Jonathan Karpoff & Michael Wittry, *Institutional and Legal Context in Natural Experiments: The Case of State Antitakeover Laws*, 73 J. FIN. 657 (2018) (criticizing studies using the legislation of state antitakeover laws as a relevant event); Emiliano M. Catan & Marcel Kahan, *The Law and Finance of Antitakeover Statutes*, 68 STAN. L. REV. 629 (2016) (providing additional analysis why studies using antitakeover laws are flawed).

²⁸ See, e.g., Jeremy Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988) (“If stockholders are imperfectly informed, temporarily low earnings may cause the stock to become undervalued, increasing the likelihood of a takeover at an unfavorable price; hence the managerial concern with current bottom line.”); Eitan Arom, *Hidden Value Injury*, 120 COLUM. L. REV. (forthcoming 2021) (manuscript at 14–16), https://papers.ssrn.com/abstract_id=3533411 (arguing that markets may fail to factor long-term value information into short-term prices).

²⁹ See Pornsit Jiraporn et al., *Dividend Payout and Corporate Governance Quality: An Empirical Investigation*, 46 FIN. REV. 251, 275 (2011) (showing that firms with “better governance quality” disproportionately distribute profits instead of reinvesting them).

double-edged sword: They provide cover for disloyal managers and loyal managers alike, encouraging both efficient and inefficient investments.³⁰

Common owners have more or less eliminated the use of antitakeover protections—including at most of the 500 largest American corporations—creating a chilling effect on investment levels.³¹ And removing antitakeover protections is only one of the strong-governance measures that common owners favor.³² Applying the whole arsenal of strong-governance measures across corporate America has generated a significant and systematic decrease in corporate investment.³³

Cutting investment is not harmless; rather, it causes corporations to cut back on hiring, depressing the demand for employees and keeping wages below their competitive rate. In other words, it creates a *monopsony*—a firm (or set of firms) with sufficient market power that it can and does cut back on its purchases of an input (here, labor) to reduce its price and enjoy a discount.³⁴ By switching firms *en masse* to strong governance, common

³⁰ The net social benefit of antitakeover protections remains inconclusive. See Miroslava Straska & H. Gregory Waller, *Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature*, 49 J. FIN. & QUANTITATIVE ANALYSIS 933, 950 (2014) (reviewing forty years of studies and concluding that “[d]espite the considerable amount of time and attention devoted to examining how antitakeover provisions affect shareholders, the net effects of these provisions on shareholder wealth remain uncertain”).

³¹ See *infra* section I.B.1.

³² See *infra* section I.B.

³³ *Id.*

³⁴ COUNCIL ECON. ADVISORS, LABOR MARKET MONOPSONY: TRENDS, CONSEQUENCES, AND POLICY RESPONSES 2 (2016), https://obamawhitehouse.archives.gov/sites/default/files/page/files/20161025_monopsony_1_abor_mrkt_cea.pdf (“[A] firm with monopsony power has the ability to pay lower prices for its inputs.”). While monopolies use market power to increase the price of goods they sell to consumers, *monopsonies* use market power to decrease the price of goods they *purchase* from suppliers. See *id.* Although common owners own *multiple-firms* that collectively should be termed an *oligopsony*, this Article elects to use the somewhat more palatable *single-firm* term *monopsony* as a matter of style. See *Oligopsony*, Merriam-Webster.com, <https://www.merriam-webster.com/dictionary/oligopsony> (last visited Apr. 28, 2020) (defining “oligopsony” as “a market situation in which each of a few buyers exerts a disproportionate influence on the market”).

owners create a labor market monopsony without resorting to collusion,³⁵ and indeed, likely without intending to create one.³⁶

Notably, and contrary to standard economic usage, this monopsony is based on concentration of shareholder ownership of many firms rather than concentration of firm control over supply or demand. Generally, monopoly denotes a single supplier, or a few suppliers in collusion, setting prices they will accept for a given output; while monopsony denotes a single buyer, or a few buyers in collusion, setting prices they will pay for a given input. Thus, in standard labor economics, a labor monopsony is driven by *firms'* market power, through concentration or collusion, over *employees*, enabling the firms to set the price for labor rather than taking the market equilibrium price. This Article suggests that this labor monopsony, by contrast, is driven by concentration of *shareholders'* market power over *management* of numerous entities, each separately pursuing its own economic interest. This concentration of ownership results in lower demand, and consequently a lower equilibrium price, for labor, causing wages to stagnate rather than rise with productivity increases.³⁷

While it has been empirically proven that two-thirds of the decrease in investment and hiring is attributable to common ownership and governance, this Article presents a novel economic model that exposes the *mechanism* by which common ownership and governance structure leads to stagnant wages.³⁸ In a competitive market, shareholders will respond to abnormally low wages by switching to weak governance so that managers will be free to invest and take advantage of discounted labor prices.³⁹ As more firms switch to weak governance and increase their investments, increased hiring will push wages up, making investments less profitable. A symmetric process of firms switching to strong governance kicks in to discourage investments when wages are abnormally high. Wages and governance structure thus form a feedback loop, resulting in a competitive

³⁵ While this Article's thesis—that common owners create a monopsony—applies to *all* inputs, such as materials and equipment, we focus on labor for two reasons. First, when the inputs in question are goods and services rather than labor, common owners benefit less from monopsony pricing. Because they likely also own stakes in the suppliers, their gains via the buyer firms are offset by losses in the seller firms. However, when the resource in question is labor, common owners capture economic value that otherwise would be reflected in wages and salaries, in which they have no stake. Second, workers tend to have less discretion to withhold their services from the market, as they need to earn a living. Thus, workers wield less bargaining power than providers of goods and services. Orley C. Ashenfelter et al., *A Shred of Credible Evidence on the Long Run Elasticity of Labor Supply* (Nat'l Bureau Econ. Rsch, Working Paper No. 15746, 2010), <https://www.nber.org/papers/w15746.pdf> (noting the “relatively broad consensus that the long run elasticity of labor supply is not likely to be large”).

³⁶ As explained *infra* in Section III.D., pushing firms toward stronger governance manifests itself in higher profits, making common owners believe they are reducing agency costs. Unfortunately, the true effect of high profitability is driven by the depressed wages.

³⁷ See *infra* Section III.E.1.

³⁸ See *infra* Section III.B.

³⁹ See *infra* Section III.B.

equilibrium where a certain number of strong- and weak-governance corporations coexist and are equally profitable—and, importantly, where wages are determined competitively.⁴⁰

Common ownership breaks this feedback loop. Unlike in the competitive equilibrium, common owners push firms toward strong governance *regardless of prevailing labor prices*. Fewer firms with weak governance leads to lower investment, reduced demand for labor, and decreased wages.⁴¹ Those firms that continue to invest (the remaining weak-governance firms) see increased profits due to the labor discount. And because common owners hold the entire portfolio of strong- and weak-governance firms, their portfolio values go up. By preventing firms from switching to weak governance, common owners disable the market mechanism—choice of governance structure—that normally drives wages back up when they are below their competitive rate. As a result, under common ownership, the model predicts wages will be persistently low without the need for collusion among firms.⁴² And because the labor monopsony means greater profits for (typically wealthier) shareholders and lower wages for (typically less wealthy) employees, it exacerbates income inequality.⁴³

Importantly, this Article shows that common owners exert labor-monopsony power not by *exercising* control in a certain way (as existing literature argues⁴⁴) but rather by *allocating* control to shareholders (pushing toward strong governance⁴⁵), which can then be exercised by other shareholders such as activist hedge funds⁴⁶ or hostile acquirers.⁴⁷ That is, institutional investors do not need to engage in any illegal anticompetitive conspiracy—such as coordinating production cutbacks across firms⁴⁸—to enjoy a labor discount. Rather, they only need to strive to

⁴⁰ See *infra* Section III.C.

⁴¹ See *infra* section III.D.

⁴² In our model, common owners increase shareholder profits at the expense of other stakeholders not through illegal coordination in the pricing of products (output) as suggested by other theories, but rather through strong governance resulting in monopsony pricing of labor (input). For discussion of the other theories, see *infra* Section III.E.

⁴³ See, e.g., Joshua Gans et al., *Inequality and Market Concentration, When Shareholding Is More Skewed Than Consumption*, 35 OXFORD REV. ECON. POL. 550 (2019).

⁴⁴ For description and analysis of these studies, see generally C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L.J. 1392 (2020).

⁴⁵ See, *infra* Section I.B.

⁴⁶ See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Cost of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013).

⁴⁷ See *infra* Section I.B.1.

⁴⁸ When organizing a cartel, each corporation affects the other corporations, requiring the cartel to allocate quotas and monitor against defections. See Joseph E. Harrington & Andrzej Skrzypacz, *Private Monitoring and Communication in Cartels: Explaining Recent Collusive Practices*, 101 AM. ECON. REV. 2425 (2011).

maximize the value of their shares in each corporation. Thus, the common ownership monopsony theory does not share the same drawbacks as other theories alleging anticompetitive effects of common ownership.⁴⁹

Acknowledging the inherent tradeoff of strong governance—reducing management agency costs while creating a labor monopsony—presents a difficult dilemma for policymakers. Should they side with employees or shareholders? If shareholders' interests are the sole concern, nothing should be done. The power of common owners will continue to grow, and with it, the effects of strong governance.⁵⁰ If the interests of employees are the concern, however, then policymakers should act. To return markets to their previous competitive equilibrium, where labor and capital efficiently and equitably shared corporate value, they must eliminate common owners' monopsony effect.

To achieve this goal in the absence of collusive activity that can be directly policed, this Article suggests breaking up the large institutional investors by limiting their size, thus removing their structural impacts on governance. Several institutional investors have assets under management (AUM) in the trillions of dollars. Limiting institutional investors to holding no more than a half-trillion dollars in AUM would increase the number of institutional investors, encourage competition in the market, and readjust the balance of power between managers and shareholders. These shifts would reignite corporate managers' incentives to increase corporate investment and labor demand, restoring the labor markets' competitive equilibrium and leading to higher wages and greater income equality.

This Article proceeds as follows. Part I describes the rise of common ownership and the shift toward strong governance. Part II presents the empirical evidence that the shift to strong governance has decreased investment and caused wages to stagnate. Part III sets out an economic model that explains the link between governance structure and wages and shows how common owners break the governance equilibrium by altering the balance of strong- and weak-governance companies. Part IV outlines the policy implications of the monopsony effect. Finally, the Conclusion will summarize.

I. THE RISE OF COMMON OWNERSHIP

The move from dispersed ownership to common ownership dramatically changed how corporations are owned and run. Retail shareholders—everyday folks holding stock in pensions or investment

⁴⁹ See *infra* section III.B.1.

⁵⁰ Mergers in the asset-management industry are expected to increase concentration. See, e.g., Leslie P. Norton, *Triam's Nelson Peltz Wants Invesco and Janus Henderson to Merge*, BARRON'S (Oct. 2, 2020), <https://www.barrons.com/articles/triams-nelson-peltz-wants-invesco-and-janus-henderson-to-merge-51601681008>.

accounts—could not meaningfully monitor corporate conduct.⁵¹ By contrast, large asset managers like BlackRock and State Street have the power and sophistication to influence their portfolio companies.⁵² Common owners have used this newfound influence to usher in a new era of strong governance, pushing for measures that empower shareholders over managers.⁵³ As this Article will show, the shift from weak to strong governance, precipitated by the rise of common ownership, has had far-ranging consequences.

Section I.A describes how common owners unseated retail investors as the dominant force in the American equity markets. Section I.B. shows how common owners have used this influence to institute strong-governance measures that make directors and officers responsive to shareholders' desires.

A. From Dispersed to Common Ownership

Sixty years ago, the equity markets were dominated by dispersed shareholders and managers who ran corporations more or less exactly how they saw fit.⁵⁴ The three largest institutional investors—BlackRock, State Street, and Vanguard, the so-called “Big Three”—did not yet exist.⁵⁵ Today, their collective AUM exceeds the GDP of China.⁵⁶ This sea change in the American equity markets precipitated the monopsony effect that is the subject of this Article.

⁵¹ See Barbara Black, *Are Retail Investors Better Off Today*, 2 BROOK. J. CORP. FIN & COM. L. 303 (2008) (defining retail investors as “individual investors who, compared to institutional investors or wealthy individual investors, have modest portfolios, a lesser degree of investment acumen and less individualized attention from professional advisors”).

⁵² See *supra* note 21 and accompanying text.

⁵³ See *infra* section I.B.

⁵⁴ See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (10th ed. Transaction Publishers, 2009) (describing the then-modern corporation as one owned by “a large body of security holders . . . who exercise virtually no control over the wealth which they or their predecessors in interest have contributed to the enterprise”). See generally Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) (coining the term “Berle-Means corporation” and defining it as one with “fragmented shareholders buying and selling on the stock exchange”).

⁵⁵ See *A Remarkable History*, VANGUARD, <https://about.vanguard.com/who-we-are/a-remarkable-history/> (last visited April 6, 2020) (noting that Vanguard was founded in 1975); *History*, BLACKROCK, <https://www.blackrock.com/corporate/about-us/blackrock-history> (last visited Apr. 6, 2020) (noting that Blackrock was founded in 1988); *Our History*, STATE STREET GLOBAL ADVISORS, <https://www.ssga.com/us/en/individual/etfs/about-us/our-history> (last visited Apr. 6, 2020) (noting that State Street Global Advisors, the asset management arm of State Street, was founded in 1978).

⁵⁶ Blackrock, State Street, and Vanguard have a combined AUM of more than \$16 trillion. See *infra* note 62. The gross domestic product of China as of 2018 was \$13.6 trillion. GDP (Current US\$), THE WORLD BANK, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?most_recent_value_desc=true (last visited Apr. 28, 2020).

A few figures regarding institutional investors—mutual funds, pension funds, and insurance companies—help put the magnitude of this change into perspective. In 1965, institutional investors held a relatively small fraction of the stock market—about 14%.⁵⁷ Then, as Professors Ronald Gilson and Jeffrey Gordon described,⁵⁸ shifts in employee retirement-savings regulation created a huge source of funds under institutional investors' control.⁵⁹ Consequently, by 1980, institutional investors controlled about 25% of the stock market, with pension funds alone holding 17.4%.⁶⁰ And by 2016, institutional investors collectively held over 50% of the market.⁶¹

Importantly, this shift created a concentrated class of shareholders that are highly diversified and dominant. First, institutional investors are *concentrated*: Among them, a few firms wield especially significant influence.⁶² Overall, the largest twenty-five institutional investors hold

⁵⁷ See BD. GOVERNORS FED. RESRV. SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 1965–1974 at 95 tbl.L.213 (2014), <http://www.federalreserve.gov/releases/z1/20140306/annuals/a1965-1974.pdf> (showing that the entire equity market of all U.S. public shares was worth less than \$750 billion at the time). Shares of U.S. corporations not held by institutional investors were held directly by the public or by large shareholders, including controlling shareholders. See John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 848 (1999) (discussing ownership patterns of U.S. corporations and noting the presence of controlling shareholders in an appreciable segment of the economy).

⁵⁸ See Gilson & Gordon, *supra* note 46, at 878.

⁵⁹ Specifically, three regulatory choices were the main cause: the reliance on privately funded pensions (instead of Social Security), the enactment of Employee Retirement Income and Security Act of 1974 (ERISA), and later, the shift from defined-benefit to defined-contribution pension plans by employers. First, substantial tax incentives encouraged workers and employers to look to private plans rather than Social Security. See *id.* at 878–79. Next, ERISA mandated that companies must hold pension funds in fully-funded special entities with fiduciary duties to the employees; public pension funds followed suit, and pension-fund assets increased more than threefold to \$3 trillion between 1980 and 1990. See *id.* at 879–80. Finally, the shift to defined contribution (specified contributions to retirement accounts in the employee's control) accelerated demands for the services of institutional investors. See *id.*

⁶⁰ James M. Poterba & Andrew A. Samwick, *Stock Ownership Patterns, Stock Market Fluctuations, and Consumption*, in 2 BROOKINGS PAPERS ON ECON. ACTIVITY 295, 313 tbl.5 (William C. Brainard & George L. Perry eds., 1995) (describing the changing pattern of stock ownership during the previous three decades, and the association between share price movements and consumption).

⁶¹ See BD. GOVERNORS FED. RESRV. SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 2005–2015 at 123 tbl.L.223 (2016), <https://www.federalreserve.gov/releases/z1/current/annuals/a2005-2015.pdf>.

⁶² See Stephen Choi et al., *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 55 (2013) (stating that three specific mutual funds dominate other mutual funds in terms of the size of assets under management). For example, in the commercial sector, BlackRock Funds holds approximately \$7.81 trillion in AUM, Vanguard Group holds \$6.2 trillion, Fidelity Investments holds \$3.46 trillion, and State Street holds \$3.15 trillion. *About BlackRock*, BLACKROCK, <https://www.blackrock.com/sg/en/about-us> (as of 9/30/2020); *Fast Facts About Vanguard*, VANGUARD, <https://about.vanguard.com/who-we-are/fast-facts/> (as of 1/31/2020); *Fidelity by the Numbers: Asset Management*, FIDELITY, <https://www.fidelity.com/about-fidelity/our-company/asset-management> (as of 9/30/2020).

more than 30% of all U.S. corporate shares,⁶³ and the largest ten hold the vast majority of those assets.⁶⁴ Second, institutional investors are *diversified*: Their holdings essentially span the global equity markets.⁶⁵ The largest asset managers have between 80% and 97% of their equity invested in index funds,⁶⁶ encompassing mid- and small-cap companies as well as large ones. For instance, BlackRock has a 5% or greater stake in more than 2,000 of the 3,900 publicly traded American corporations.⁶⁷ Third, common owners are *dominant*: They hold large stakes in *most* publicly traded corporations.⁶⁸ Institutional shareholders own, on average, over 70% of the stock in the 1000 biggest firms.⁶⁹ The Big Three, when considered together, are the “single” largest shareholder in almost half of all publicly listed U.S. companies (1,662 out of approximately 3,900 firms) and most of the S&P 500 (438 out of 500 firms).⁷⁰

The dominance of horizontal shareholders has resulted in increasing overlap in the ownership of all major American corporations. For instance, in 1999, the odds that two public companies in the same industries shared a 5% owner were one in five. By 2014, that figure was nine out of ten—that is, 90% of public companies shared an owner that held at least 5% of each company.⁷¹ The portfolios of common owners encompass entire industries;

Who We Are, STATE ST. GLOBAL ADVISORS, <https://www.ssga.com/na/us/institutional-investor/en/home.html> (as of 9/30/2020).

L., L. & Econ. Rsch. Paper Series, Working Paper No. 17-08, 2017), <https://ssrn.com/abstract=2928883>.

⁶⁴ As of December 2017, *Structure of Large Institutional Investors 1* (Nat’l Bureau Econ. Rsch, Working Paper No. 22247, 2017), <http://www.nber.org/papers/w22247.pdf>.

⁶⁵ See Gilson & Gordon, *supra* note 46 at p. 884; see also Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016) (describing “horizontal shareholding,” where large financial institutions hold significant shares in competing corporations, as pervasive) [hereinafter Elhauge, *Horizontal Shareholding*].

⁶⁶ See Fichtner et al., *supra* note 14, at 304. For example, funds that track the S&P 500 hold 500 of largest publicly traded American corporations representing some 80% of available market capitalization. See S&P 500, S&P DOW JONES INDICES, <https://us.spindices.com/indices/equity/sp-500> (last visited Apr. 28, 2020).

⁶⁷ Giovanni Stampelli, *Are Passive Index Funds Active Owners?*, 55 SAN DIEGO L. REV. 803, 811 (2018).

⁶⁸ See *id.*; Luis A. Aguilar, Commissioner, Sec. & Exch. Comm’n, Institutional Investors: Powers and Responsibilities, Speech at the Center for the Economic Analysis of Risk Workshop (Apr. 19 2013) (transcript available at <https://www.sec.gov/news/speech/2013-spch041913laahtm>) (“Simply stated, institutional investors are dominant market players ...”).

⁶⁹ See Matteo Tonello & Stephan Rabimov, THE CONF. BD., THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 27 (2010), http://shareholderforum.com/e-mtg/Library/20101111_ConferenceBoard.pdf (showing that in 2009, ownership concentration of institutional investors in the top 1000 U.S. corporations by market value was 70%).

⁷⁰ Fichtner et al., *supra* note 14 at 311–13.

⁷¹ See José Azar, *Portfolio Diversification, Market Power, and the Theory of the Firm 2* (Univ. Navarro Bus. Sch., Working Paper No. 1170-E, Mar. 2017),

for example, horizontal shareholding is prevalent in the airline, banking, technology, and retail sectors.⁷²

Importantly, although the terms “horizontal shareholders”⁷³ and “common ownership” are relatively new, the phenomenon dates back to the advent of institutional ownership: Any highly diversified shareholder is technically a common owner.⁷⁴ But only when institutional investors grew in power was the term “common owners” coined by scholars concerned with their anticompetitive consequences on product markets.⁷⁵ This Article thus uses the term common owners and institutional investors interchangeably.

B. The Push for Strong Governance

While corporate law scholars have sometimes described institutional investors as “rationally reticent” to take an active approach to govern their portfolio companies,⁷⁶ common owners themselves sing a different tune. For example, William McNabb, Vanguard’s chief executive, commented in a letter to Vanguard’s portfolio corporations, “[S]ome have mistakenly assumed that our predominantly passive management style suggests a passive attitude with respect to corporate governance. Nothing could be further from the truth . . . We have no interest in telling companies how to run their businesses, but we have valuable governance insights to share with the board of directors.”⁷⁷ McNabb’s letter illustrates how, over the past four decades, common owners have reshaped the corporate-governance paradigm by pushing for strong-governance measures that give shareholders substantial control over corporate managers.⁷⁸

<https://media.iese.edu/research/pdfs/WP-1170-E.pdf>. One study found that the level of overlap in stock ownership grew by more than fifteen times between 1980 and 2012. See Erik P. Gilje et al., *The Rise of Common Ownership* 19 (Apr. 19, 2018) (unpublished manuscript), http://cgsc.global/wp-content/uploads/2018/05/6.-Levit_The_Rise_of_Common_Ownership_June_6_2017P-1.pdf.

⁷² See, Elhauge, *Horizontal Shareholding*, *supra* note 65.

⁷³ *Id.*

⁷⁴ See Gilson & Gordon, *supra* note 46 at 884 (describing diversification as institutional investors’ dominant investment strategy).

⁷⁵ See, e.g. Azar et al., *Anticompetitive Effects*, *supra* note 13.

⁷⁶ See Gilson & Gordon, *supra* note 46, at 895.

⁷⁷ Letter from F. William McNabb III, Chairman & CEO, Vanguard, to Bds. Dirs. Vanguard Portfolio Cos. 1 (2015), https://pcg.law.harvard.edu/wp-content/uploads/2016/09/7-CEO_Letter_03_02_ext.pdf.

⁷⁸ See Zohar Goshen & Sharon Hanes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263, 277–82 (2019) (explaining how institutional investors have pushed for strong governance and shareholder empowerment, obviating to a large degree the need for courts to protect shareholders’ rights); Barry Burr, *Money Managers Increasing Activism on Governance—But Quietly*, PENSIONS & INVESTMENTS (March 19, 2012), <https://www.pionline.com/article/20120319/PRINT/303199980/money-managers-increasing-activism-on-governance-but-quietly>.

Even the most “passive” of investors—index funds that mimic market portfolios such as the S&P 500—actively agitate for strong governance. Of course, index funds cannot express dissent by selling, as they are constrained to maintain a market portfolio. However, they can—and do—vote, disproportionately in favor of measures that empower shareholders⁷⁹ and mostly as part of one-size-fits-all voting policies.⁸⁰ On the other hand, active funds, unconstrained in their trading, use the threat of exit—that is, selling—to influence corporate governance.⁸¹ Additionally, asset managers engage both formally and informally with their portfolio companies by discussing strategy and governance with management.⁸²

The most prominent outcome of these activities has been the push for strong governance.⁸³ While the particular policies promoted by institutional investors have changed over the decades, they share the goal of increasing shareholders’ influence over their portfolio companies.

1. *The 1980s: The Age of Hostile Takeovers*

Before 1980, managers of public corporations were loyal to the corporation, not the shareholder.⁸⁴ Governance mechanisms were hardly used.⁸⁵ Hostile takeovers were relatively few, and proxy fights were uncommon, with little chance of success. Boards were mainly composed of insiders supporting management. Long-term performance plans were expansively employed and referenced accounting measures instead of stock market prices, tying managerial incentives only indirectly to shareholder value. Accordingly, management ownership of equity was modest; in 1980,

⁷⁹ Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 113–14 (2016).

⁸⁰ See, e.g., *Proxy Voting Guidelines for U.S. Securities*, BLACKROCK (Jan. 2019), <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>; *Vanguard Funds Proxy Voting Guidelines for U.S. Portfolio Companies*, VANGUARD (April 1, 2019), https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf; Rick Lacaille & Rakhi Kumar, *2019 Proxy Voting and Engagement Guidelines: North America*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 27, 2019), <https://corpgov.law.harvard.edu/2019/03/27/2019-proxy-voting-and-engagement-guidelines-north-america>.

⁸¹ See, e.g., Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2912 (2016) (documenting institutional investors use of exit, the threat of exit, and “behind the scenes” discussions with boards and management to achieve governance goals).

⁸² See *id.* (finding “widespread use of private discussions [with portfolio firms] support[ing] the view that investors try to engage firms behind the scenes through direct negotiations”).

⁸³ See Edward S. Adams, *Bridging the Gap Between Ownership and Control*, 34 J. CORP. L. 409, 425 (2009) (“[I]nstitutional investors tend to acquire a significant portion of stock in a corporation to gain a measure of control in the corporation.”).

⁸⁴ See Bengt Holmstrom & Steven Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSPS. 121 (2001) [hereinafter Holmstrom & Kaplan, *Merger Activity*].

⁸⁵ *Id.* at 123.

only 20% of chief executive officers' (CEOs) compensation was tied to stock market performance.⁸⁶

By 1980, institutional investors crossed the 25% ownership mark,⁸⁷ reaching a size that allowed them to end the era of managerial freedom by unleashing a wave of hostile takeovers.⁸⁸ Notably, hostile takeovers are a powerful external strong-governance mechanism that can hold inefficient managers accountable.⁸⁹ The takeover activity that started to accelerate in the early 1980s and boomed throughout much of the decade⁹⁰ was fueled by the rise of institutional investors in two ways. First, because institutional investors were more interested in extracting high returns and less loyal to incumbent management than individual investors, they were the main sellers of large blocks of shares in takeovers.⁹¹ Second, institutional investors were also the takeovers' main financiers, investing large amounts in buyout funds and the market for high-yield bonds.⁹² Indeed, Professors Bengt Holmstrom and Steven Kaplan believe that without a large increase in institutional investors' funds, it is unlikely that there would have been a willingness and ability to support multi-billion dollar takeovers.⁹³

Unleashing takeovers was just the beginning. More importantly, the rise of institutional investors shifted the power from stakeholders to shareholders, giving rise to what is known as *shareholder primacy*.⁹⁴ This shift became the norm in corporate America—even after the takeover wave subsided in the 1990s⁹⁵—leading to increased shareholder power and stronger governance.

⁸⁶ Brian Hall & Jeffrey Liebman, *Are CEOs Really Paid Like Bureaucrats?* 113 QUAR. J. ECON. 653 (1998) (“[B]oth the level of CEO compensation and the sensitivity of compensation to firm performance have risen dramatically since 1980, largely because of increases in stock option grants”).

⁸⁷ Paul Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q.J. ECON. 229, 233 (2001) (finding that institutional investors controlled 26.8% of the market value of all publicly traded stocks in 1980).

⁸⁸ See Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, 15 J. APPLIED CORP. FIN. 8, 11 (2003) (“It was the potential for improved corporate performance, combined with the increased ownership of institutional investors, that gave birth to the takeovers, junk bonds, and LBOs of the 1980s.”).

⁸⁹ See, Henry G. Manne, *Cash Tender Offers for Shares—A Reply to Chairman Cohen*, 1967 DUKE L.J. 231, 236–37 (1967) (arguing that the threat of raiders encourages managers to manage their companies as efficiently as possible).

⁹⁰ See Holmstrom & Kaplan, *supra* note 84 at 123.

⁹¹ *Id.* at p. 132.

⁹² Most of the financing for takeovers came in the form of high-risk high-yield bonds, also known as “junk bonds,” most famously issued by Michael Milken through the investment bank Drexel Burnham Lambert. See Elijah Brewer & William E. Jackson, *Requiem for a Market Maker: The Case of Drexel Burnham Lambert and Junk Bonds*, 17 J. FIN. SERVS. RSCH. 209 (2000).

⁹³ See Holmstrom & Kaplan, *Merger Activity*, *supra* note 84, at 132.

⁹⁴ See, Reinier Kraakman & Henry Hansmann, *The End of History for Corporate Law*, 89 GEO. L.J. 440 (2001).

⁹⁵ See Holmstrom & Kaplan, *Merger Activity*, *supra* note 84, at 132.

2. The 1990s: The Age of Independent Boards

Institutional investors kept growing in power, crossing the 40% ownership mark in 1990 and surpassing the 50% majority ownership mark by the end of the decade.⁹⁶ While in the 1980s, institutional investors activated an external governance mechanism—hostile takeovers—in the 1990s, they cemented the shift to shareholder primacy through internal governance mechanisms—-independent boards⁹⁷ and equity compensation.⁹⁸ Both mechanisms were aimed at aligning management incentives with shareholders' interests and stock market prices.

As thoroughly detailed by Professor Jeffrey Gordon, in the 1990s, public companies' boards became markedly more independent and active monitors than in the past.⁹⁹ While in 1980 independent directors comprised on average 31% of boards, in 1990 they became the majority, holding 60% of the seats, and 69% in 2000.¹⁰⁰ This trend continued, eventually reaching a supermajority of independent directors. In 2016, for instance, in *most* corporations on the S&P500, independent directors held more than 70% of the seats.¹⁰¹ Independent directors are more inclined to hold managers accountable to shareholders.¹⁰² This shift directly affected CEO turnover, exhibiting a marked increase in turnovers and hiring of new CEOs from outside the company.¹⁰³ In the largest 500 U.S. firms, internal turnovers went up from an annual rate of 11.74% in 1992 to 18.78% in 2000, shortening the average tenure from about 8 years to about 5 years.¹⁰⁴ And around half of all CEO turnovers were performance-induced.¹⁰⁵ Similarly,

⁹⁶ Gompers & Mertick, *supra* note 87, at 237 fig.I.

⁹⁷ Jeffrey Gordon, *The Rise of Independent Directors in The United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1526 (2007) (detailing the rise of independent boards).

⁹⁸ Brian Hall & Jeffrey Liebman, *The Taxation of Executive Compensation*, 14 TAX POL'Y & ECON. 1 (2000) [hereinafter Hall & Liebman, *Taxation*] (finding that the dramatic explosion in stock options involves changes in the fraction of shares held by large institutional investors, corporate governance, and the market for corporate control, rather than tax considerations).

⁹⁹ Gordon, *supra* note 97, at 1473.

¹⁰⁰ *Id.* at 1565 Appendix Table 1.

¹⁰¹ Renee Lightner & Theo Francis, *Inside America's Boardrooms*, WALL ST. J., <http://graphics.wsj.com/boards-of-directors-at-SP-500-companies>.

¹⁰² That attitude was bolstered by reducing the influence of management on directors' appointments, Gordon, *supra* note 97, at 1496, and by increasing the amount of directors' equity-based compensation, Holmstrom & Kaplan, *Merger Activity*, *supra* note 84, at 133.

¹⁰³ Gordon, *supra* note 97, at 1531.

¹⁰⁴ Steven Kaplan & Bernadette Minton, *How Has CEO Turnover Changed?*, 12 INTER. REV. FIN. 57, 61-62 (2012) ("In the earlier period from 1992 to 1996, total CEO turnover using definition 1 is 12.62% per year implying an average tenure of 7.9 years. In the period from 1997 to 2002, total turnover increases to 19.15% per year, implying an average tenure of just 5.2 years").

¹⁰⁵ Alex Edmans, et al., *Executive Compensation: A Survey of Theory and Evidence*, 1 HANDBOOK ECON. CORP. GOVERNANCE 383, 421 (2017).

external hires as a percentage of all new CEO appointments increased from 15% in the 1970s to 27% during the 1990s and 32% during the 2000s.

Increased monitoring increases CEOs' dismissal risk, and as expected,¹⁰⁶ CEOs' compensation went up to compensate for the turnover risk.¹⁰⁷ For example, an S&P 500 CEO's average total compensation increased from about \$2 million in 1980 to more than \$4 million in 1990, peaking above \$18 million in 2000.¹⁰⁸ And while in 1980 equity-based compensation was 20% of total CEO compensation,¹⁰⁹ in 1993 it surpassed 50%, and in 2000 it peaked at 78%.¹¹⁰ These changes resulted in an increase of CEO pay-to-performance sensitivities by a factor of ten times from 1980 to 1998.¹¹¹ Importantly, maximizing shareholder value became a powerful guide to managerial behavior.

These changes of the 1990s were fueled by the growing ownership of institutional investors and their activism. These investors used shareholder value to measure performance, publicly targeted underperforming firms, strongly backed equity-based compensation for CEOs, and organized "just vote no" campaigns in director elections to protest continued poor performance.¹¹² The next decades have shown a further increase in shareholder power and strong governance.

3. The 2000s: The Age of Hedge-Fund Activism

The increase in power of institutional investors continued in the 2000s. In parallel to strengthening internal governance mechanisms,¹¹³ a new powerful external governance mechanism—hedge-fund activism—has emerged. Activist hedge funds, which have gained dominance in the market

¹⁰⁶ Benjamin Hermalin, *Trends in Corporate Governance*, 60 J. FIN. 2351 (2005).

¹⁰⁷ Edmans, et al., *supra* note 105, at 433.

¹⁰⁸ Kevin Murphy, *Executive Compensation: Where We Are, and How We Got There*, 2 Handbook Econ. Fin. 211, 225 (2013).

¹⁰⁹ Edmans, et al., *supra* note 105, at 400.

¹¹⁰ Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, (2005).

¹¹¹ Hall & Liebman, *Taxation*, *supra* note 98.

¹¹² Gordon, *supra* note 97, at 1528–29.

¹¹³ For example, "[a]nnual director elections, majority vote rules for director elections, shareholder approval for poison pills, and proxy access bylaws are some of the critical governance practices that have become common practice thanks to investor support," as one booster put it. See Kosmas Papadopoulos, *The Long View: The Role of Shareholder Proposals in Shaping U.S. Corporate Governance (2000-2018)*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 6, 2019). A more skeptical observer described how activists have capitalized on the "rhetorical high ground" of director accountability to push for special meetings power, the ability to act through majority consents, the elimination of supermajority requirements, and more. Latham & Watkins LLP, *Future of Institutional Share Voting: Three Paradigms*, CORP. GOVERNANCE COMMENT. (July 2010), https://www.lw.com/upload/pubcontent/_pdf/pub3617_1.pdf3. The larger point is that institutional investors support a diverse and rapidly evolving group of strong-governance measures including those mentioned here, the effect of which is to put the fate of directors more and more into the hands of their shareholders.

over the last two decades,¹¹⁴ have carved out a market niche by acquiring stakes in underperforming firms and implementing measures to boost performance.¹¹⁵ While common owners do not normally agitate for operational change at their portfolio firms, activist owners do—and common owners tend to support them, especially when the proposed changes align with their governance agenda.¹¹⁶ The presence of common owners makes it more likely that an activist hedge fund will (successfully) try to replace a company’s managers.¹¹⁷ Support for hedge fund activists is, therefore, a strong governance mechanism in its own right as it puts managers at the mercy of their shareholders.

Additionally, hedge-fund activism—and its support among common owners—has a more direct impact on governance. Hedge funds often use weak governance as an excuse to mount activist campaigns against corporate management.¹¹⁸ Activist campaigns are more likely to succeed when they advocate for board efficiency and independence and against takeover defenses.¹¹⁹ In other words, hedge funds do the work of fighting for stronger shareholder rights, with passive owners supporting them from the sidelines.

During the 2000s, common owners, with the help of these activists, kept pushing firms towards increased shareholder power, in particular advocating for governance mechanisms that allow shareholders to remove and discipline managers. The following measures are by no means exhaustive but illustrate the broad governance changes pushed on portfolio corporations by common owners and hedge-fund activists.

i. Poison Pills—Poison pills restrict shareholders’ right to sell to a hostile buyer, preventing potential raiders from taking over a company

¹¹⁴ Activist hedge funds grew from less than three billion dollars in AUM in 2000 to almost \$200 billion in 2015. See AIMA & SIMMONS & SIMMONS, UNLOCKING VALUE: THE ROLE OF ACTIVIST ALTERNATIVE INVESTMENT MANAGERS 12, <http://www.sewkis.com/wp-content/uploads/9386e594-838e-46c0-a842-3d914714aee3.pdf> (last visited Jan. 18, 2021); Paula Loop et al., *The Changing Face of Shareholder Activism*, HARV. L. SCH. F. ON CORPORATE GOVERNANCE (Feb. 1, 2018), <https://corpgov.law.harvard.edu/2018/02/01/the-changing-face-of-shareholder-activism>. Meanwhile, activist events increased from less than fifty in 1999 to almost 500 in 2007. J.P. MORGAN, SHAREHOLDER ACTIVISM AND THE IMPLICATIONS FOR INVESTORS 1 (2014), <https://www.jpmorgan.com/jpmpdf/1320668288894.pdf>.

¹¹⁵ See generally Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008) [hereinafter Brav et al., *Hedge Fund Activism*] (using a novel data set to chronicle the acquisition and proxy behavior of activist hedge funds).

¹¹⁶ See Ian R. Appel et al., *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, 32 REV. FIN. STUDS. 2720, 2752 (2019) (“[W]e only find . . . increased activists’ successes in areas that passive investors view as beneficial for their long-term interests; in particular, effective boards, good governance, and a strong market for corporate control.”).

¹¹⁷ *Id.*

¹¹⁸ See Brav et al., *Hedge Fund Activism*, *supra* note 115, at 1744–45 (“Governance issues, including rescinding takeover defenses, ousting CEOs, promoting board independence, and curtailing executive compensation, are also commonly cited as reasons for activism.”).

¹¹⁹ See *supra* note 116 and accompanying text.

without board approval.¹²⁰ Practically, selling to a raider who intends to replace the board amounts to a vote to fire the management. Thus, common owners see poison pills as entrenching boards and preventing shareholders from holding corporate managers accountable by selling.¹²¹ Indeed, while poison pills became widely popular after Marty Lipton invented them in the 1980s,¹²² they have since come under fire from institutional investors.¹²³ Not only do proxy advisors suggest voting against poison pills, but they also recommend voting against any *director* who votes to adopt one without shareholder approval.¹²⁴ Consequently, the 299 S&P 500 companies with poison pills in 2000 dwindled to 17 by 2017.¹²⁵

ii. *Staggered Boards*—Staggered or classified boards are elected in classes: A third of the board comes up for election each year, rather than all at once.¹²⁶ As such, they protect corporate managers by preventing shareholders from replacing the entire board at once.¹²⁷ A shareholder who gains control of a company with a staggered board must wait for two rounds of annual director elections to gain a board majority.¹²⁸ Because of their entrenching effect, staggered boards have drawn the ire of common owners.¹²⁹ Consequently, institutional investors provided the momentum

¹²⁰ Effectively, poison pills stand between a willing seller—the shareholder—and a willing buyer—the tender offeror. See Scott Hirst, *The Wrong Prescription? Revisiting the Justification for Poison Pills*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 18, 2009), <https://corpgov.law.harvard.edu/2009/11/18/the-wrong-prescription-revisiting-the-justification-for-poison-pills/>.

¹²¹ See Aquila, *supra* note 25, at 24–25.

¹²² David Futrelle, *Corporate Raiders Beware: A Short History of the “Poison Pill” Takeover Defense*, TIME (Nov. 7 2012) <https://business.time.com/2012/11/07/corporate-raiders-beware-a-short-history-of-the-poison-pill-takeover-defense>.

¹²³ Appel et al., *Passive Investors*, *supra* note 79, at 114 (finding that companies with higher levels of index fund ownership were less likely to have takeover defenses or dual-class structures).

¹²⁴ See Aquila, *supra* note 25, at 25.

¹²⁵ Michael Useem, *The Ascent of Shareholder Monitoring and Strategic Partnering: The Dual Functions of the Corporate Board*, in THE SAGE HANDBOOK OF CORPORATE GOVERNANCE 136, 143 (Thomas Clarke & Douglas Branson eds., 2012).

¹²⁶ See THOMSON REUTERS, *Staggered Board of Directors* (Practical Law Glossary Item 7-382-383, 2020) (defining a staggered or classified board as a “board which is comprised of directors that have different overlapping, multi-year terms, so that not all of the directors’ terms expire in the same year.”).

¹²⁷ See Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, 83 J. FIN. ECON. 501, 528 (2007) (concluding that “classified boards benefit management at the expense of shareholders” and “a movement toward greater accountability demands the destaggering of corporate boards”).

¹²⁸ See *Carmody v. Toll Bros.*, 723 A.2d 1180, 1186 (Del. Ch. 1998) (noting that “a classified board would delay—but not prevent—a hostile acquiror from obtaining control of the board”).

¹²⁹ See Guhan Subramanian, *Delaware’s Choice*, 39 DEL. J. CORP. L. 1, 13 (2014) (claiming that institutional investors dislike staggering boards because it leaves them with “‘little recourse’ in the everyday course of business against specific directors that they wish to punish”).

for the “de-staggering movement”¹³⁰ that left fewer than 10% of the S&P 500 corporations with staggered boards in 2017,¹³¹ compared to 60% in 2002.¹³²

iii. Dual Class Structures—Common owners oppose issuing classes of stock that create disparate voting rights.¹³³ Dual- or multi-class stock structures tend to entrench control in a few shareholders, often aligned with management.¹³⁴ For instance, using a dual-class structure, Mark Zuckerberg holds majority voting rights in Facebook even though institutional investors hold nearly 80% of its equity.¹³⁵ In this way, dual-class structures can block a firm’s equity majority owners—those holding more than half of the economic stake—from removing its managers; they are thus strong-governance kryptonite.¹³⁶

¹³⁰ Lucian Bebchuk et al., *Toward Board Declassification in 100 S&P 500 and Fortune 500 Companies: The SRP’s Report for the 2012 and 2013 Proxy Seasons*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 25, 2014), <https://corpgov.law.harvard.edu/2014/02/25/toward-board-declassification-in-100-sp-500-and-fortune-500-companies-the-srps-report-for-the-2012-and-2013-proxy-seasons>.

¹³¹ *Governance Trends at Russell 2000 Companies*, BD. MATTERS Q., Jan. 2017, at 4, <https://www.eycom.ch/en/Publications/20170901-Board-Matters-Quarterly-January-2017/download> (91% of S&P 500 companies have annual elections rather than staggered elections).

¹³² Martijn Cremers et al., *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J. FIN. ECON. 422 (2017) (finding that staggered boards promote value creation for some firms by committing the firms to undertaking long-term projects and bonding them to the relationship-specific investments of their stakeholders).

¹³³ See, e.g., *Dual-Class Enablers*, COUNCIL INSTITUTIONAL INVS., <https://www.cii.org/dualclassenablers> (last visited Jan. 15, 2021).

¹³⁴ See Blair Nicholas & Brandon Marsh, *Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 17, 2017), <https://corpgov.law.harvard.edu/2017/05/17/dual-class-the-consequences-of-depriving-institutional-investors-of-corporate-voting-rights/> (describing how dual-class structures “create a bulwark for managerial entrenchment”). Institutional Shareholder Services, an influential advisor to common owners, recommends voting down proposals to create new classes of stock with disparate voting rights. INSTITUTIONAL S’HOLDER SERVS., UNITED STATES PROXY VOTING GUIDELINES: BENCHMARK POLICY RECOMMENDATIONS 30 (2019) <https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf>.

¹³⁵ *Facebook Inc*, CNN BUS., <https://money.cnn.com/quote/shareholders/shareholders.html?symb=FB&subView=institutional> (last viewed Mar. 19, 2020); see also *infra* notes 165–167 and accompanying text.

¹³⁶ A number of studies have found that a dual-class structure encourages management to invest in innovation. See Lindsay Baran et al., *Dual Class Share Structure and Innovation* (U. Tex. Rio Grande Valley Robert C. Vacker Coll. Bus. & Entrepreneurship, Acct. Fac. Publ’ns & Presentations, December 8, 2019), https://scholarworks.utrgv.edu/cgi/viewcontent.cgi?article=1005&context=account_fac (finding a positive association between disproportionate insider control and patent output, quality, and creativity; the efficient use of R&D in innovation; and patent filings by managers, representing personal innovative risk); Xiaoyan Cheng et al., *Investment Efficiency: Dual-Class vs. Single-Class Firms*, 45 GLOBAL FIN. J. 1 (2020) (finding that dual-class firms invest more efficiently than single-class peers); Xiaping Cao et al., *The Innovation Effect of Dual-Class Shares: New Evidence from U.S. Firms*, 91 ECON. MODELLING 347 (2020) (finding dual-

Common owners have vocally—and successfully—lobbied against multi-class structures. For example, after Snap Inc. decided to issue shares with no voting rights in its 2017 initial public offering, institutional investors convinced stock indices to exclude dual-class firms altogether.¹³⁷ More recently, the Council of Institutional Investors, an industry group representing asset managers, has petitioned the New York Stock Exchange to require all dual-class firms already listed to transition over seven years to a one-share one-vote model.¹³⁸

The mechanisms detailed above are by no means exhaustive of common owners’ forty-year campaign for strong governance. However, these mechanisms and many others—pushed as part of a one-size-fits-all policy to strengthen corporate governance across the board¹³⁹—serve to subject managers to their shareholders’ will. Consequently, it is no exaggeration to say that common owners have reshaped the corporate hierarchy, putting shareholders at the top. Part II shows how this fundamental shift has led to a downturn in investment, with inauspicious effects for American workers.

II. STRONG GOVERNANCE AND LABOR MARKET MONOPSONY

The rise of common ownership coincided with a troubling shift in the American labor market. While workers became more and more productive, wages stopped growing.¹⁴⁰ Income inequality climbed to its highest levels since the Roaring Twenties,¹⁴¹ even as firms enjoyed blockbuster profits and growing profit margins.¹⁴² Moreover, wage elasticity—a measure of labor market competitiveness—has fallen over recent decades, suggesting that

class shares have significant innovation effect in high-tech sectors, hard-to-innovate industries, firms with higher external takeover threat, and firms heavily dependent on external equity financing).

¹³⁷ See Goshen & Hannes, *supra* note 78, at 281–82.

¹³⁸ Letter from Council Institutional Invs. to Elizabeth King, Chief Regul. Off., Intercontinental Exch. Inc. 1 (Oct. 24 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf.

¹³⁹ See, e.g., Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 101 (2007) (describing how institutional shareholders, with the help of governance advisory firms, have developed a “one-size-fits-all model [that] essentially standardizes corporate governance and discourages company-specific (or even industry-specific) governance policies”).

¹⁴⁰ See Simcha Barkai, *Declining Labor and Capital Shares*, 75 J. FIN. 2421, 2454 (2020) (“The decline in the labor share since the early 1980s measures the growing gap between labor productivity (which has continued to grow) and compensation (which has stagnated).”).

¹⁴¹ See *infra* note 204 and accompanying text.

¹⁴² See Barkai, *supra* note 140, at 2434 fig.3 (modeling firms “profit share”—profits over gross value added—to show it has grown at least since the 1980s). “The profit margin for the S&P 500 Index, or income as a percentage of revenue, swelled to 10.2% in 2018, the highest since 1990. The ratio of corporate profits as a percentage of GDP hit the highest on record in 2012, according to the U.S. Bureau of Economic Analysis, and that ratio has remained elevated.” Kaissar, *supra* note 2.

employers have cartelized the labor market.¹⁴³ So far, scholars who have pointed to common ownership as a cause of stagnating wages and rising income inequality have focused on product-market monopolies and concentration,¹⁴⁴ a theory that is highly debated.¹⁴⁵ Thus, despite the magnitude of the shift to common ownership, observers have failed to find a convincing explanation linking it to the struggling labor market.¹⁴⁶ After all, if common owners were rigging the market—against either workers or consumers—one would think they would leave some traces.¹⁴⁷ If common owners are indeed the source of labor market malaise, where is the evidence?

This Article provides a simple answer: Because of their size and influence, common owners need not *act* as a cartel to have a cartel’s effects. Instead, those effects flow naturally from common owners’ push for strong governance. Under strong governance, both loyal and disloyal managers will refrain from investing for fear that shareholders will (mis)perceive their investments as inefficient pet projects.¹⁴⁸ Under a strong-governance regime, a rational manager—regardless of loyalty—will distribute profits instead of investing them to avoid running afoul of shareholders and risking termination. By pushing firms toward strong governance, then, common owners create an investment shortfall.¹⁴⁹ Less investment means less hiring,¹⁵⁰ less hiring means lower labor demand,¹⁵¹ and lower labor demand

¹⁴³ One set of researchers surveyed recent scholarship of wage elasticity and found that “even if one takes a conservative approach and believes the studies with weaker findings, it remains clear that monopsony causes considerable harm both to the economy and to workers.” Suresh Naidu et al., *Antitrust Remedies for Labor Market Power*, 132 HARV. L. REV. 536, 568 (2018) (reviewing the empirical data on mergers and suggesting an antitrust remedy).

¹⁴⁴ See, Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11, and Azar et al., *Anticompetitive Effects*, *supra* note 13.

¹⁴⁵ See the studies cited *infra* note 253.

¹⁴⁶ See, Gutiérrez and Philippon, *supra* note 11, at 108 n.24 (noting that “the exact mechanisms through which common ownership reduces competition remain to be identified”).

¹⁴⁷ See Hemphill & Kahan, *supra* note 44, at 1426 (noting that the anticompetitive effects of common ownership, “if important in practice, would leave a visible trace.”).

¹⁴⁸ See *infra* section II.A.1.

¹⁴⁹ See, e.g., Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11 (finding that the lack of investment represents a reluctance to invest despite high Tobin’s Q (a measure of profitability) and that the investment wedge is linked to the rise of intangibles, decreased competition, and changes in governance that encourage payouts instead of investment).

¹⁵⁰ See Belo et al., *supra* note 18. Indeed, investment in technology and innovation can decrease employment (say, the development of a robot). This is the essence of the theory associating technology with decreased investment and labor share. However, an empirical study has found that this effect can only explain 25% to 35% of the drop in investment. See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11. This Article contends that the rest is explained by common ownership and governance.

¹⁵¹ See generally Daniel S. Hamermesh, *New Measures of Labor Cost: Implications for Demand Elasticities and Nominal Wage Growth*, (Nat’l Bureau Econ. Rsch., Working Paper No. 821, 1981), <https://www.nber.org/papers/w0821.pdf> (measuring labor elasticity, or the responsiveness of labor prices to labor demand).

leads to stagnant wages. Thus, common owners' push for strong governance has exacerbated—if it has not altogether caused—the last forty years of labor market stagnation.

The previous Part showed how the market has shifted from retail to primarily common ownership and how common owners have brought on an era of strong governance. This Part shows that strong governance holds wages below their competitive level, effectively denying workers the fruits of their labor. The empirical evidence for the monopsony effect can be broken into two categories: evidence that strong governance has led to an investment shortfall and evidence that the labor market has become less competitive due to common owners' influence. Section II.A addresses the former, examining the evidence that strong governance depresses investment. Section II.B. looks at the latter, showing how stagnant wages and rising income inequality can be attributed directly to common owners. Together, these observations supply a coherent explanation for rising inequality and stagnating wages over the past four decades: By pushing for strong governance, common owners have created a sluggish labor market that allows shareholders to capture increases in productivity, causing profits to soar even as wages stall.

A. Strong Governance and Investment

Prior to the rise of institutional investors, directors and officers ran corporations more or less exactly how they saw fit. The poster-children of this era were domineering corporate leaders like longtime Chrysler chief Lee Iacocca, whose initials were famously said to spell out “I am Chairman of Chrysler Corporation Always.”¹⁵² Managers like Iacocca were free to build empires and hoard private benefits of control, or otherwise, nurture bold visions of the future and undertake daring investments.¹⁵³ As ownership concentrated in the hands of savvy financial institutions with the wherewithal to oversee corporate affairs,¹⁵⁴ managers became less likely to invest. Empirical evidence shows that strong governance has indeed resulted in a serious investment shortfall, which in turn hamstring wages and redirects wealth from labor to capital. This section first examines the mechanism by which strong governance decreases investment and next details the evidence that it indeed has had that effect.

¹⁵² *I Am Chairman Of Chrysler Corporation Always: 8 Facts About Lee Iacocca*, REUTERS (July 2, 2019) <https://www.reuters.com/article/us-people-lee-iacocca-facts/i-am-chairman-of-chrysler-corporation-always-8-facts-about-lee-iacocca-idUSKCN1TY06X>.

¹⁵³ See Roe, *supra* note 54, at 14 (describing the criticism that, under dispersed ownership, “[m]anagers build empires and pursue bad strategies without shareholder intervention until matters are so out-of-hand that the violence of the hostile takeover or the instability of the leveraged buyout results”).

¹⁵⁴ See Gilson & Gordon, *supra* note 46, at 865 (noting that, because of the concentration of ownership in the hands of a few financial institutions, “the Berle-Means premise of dispersed share ownership is now wrong”).

1. *The Manager's Dilemma: To Invest, or Not to Invest?*

Managers, broadly, face a choice between two options: reinvest any surplus cash in projects that will hopefully pay off later or distribute that surplus to shareholders in the form of dividends and share buybacks.¹⁵⁵ When shareholders do not interfere, managers can decide based on their conscience and best judgment: Loyal managers will make beneficial, efficient investments, and disloyal managers will make self-serving, inefficient investments and consume private benefits.¹⁵⁶ However, when shareholders are breathing down managers' necks, this choice is much more fraught. An investment that causes shareholders to doubt a CEO's loyalty could cost the CEO's job.¹⁵⁷ Under strong governance, then, managers will disproportionately choose to distribute profits.¹⁵⁸

Key to this insight is the fact that shareholders are imperfect judges of manager performance and loyalty: Being human, they will sometimes make mistakes.¹⁵⁹ Even sophisticated investors can mistake a loyal manager for a disloyal one. Steve Jobs' early tenure at Apple is illustrative.¹⁶⁰ Jobs was the company's visionary but was notoriously difficult to work with, and lost his job after the board of directors sided against him and with the CEO. More than a decade later, he took back the company's helm as it teetered on the edge of bankruptcy and reasserted Apple's tech dominance by releasing the

¹⁵⁵ See William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV. (Sept. 2014), <https://hbr.org/2014/09/profits-without-prosperity> (describing how the "retain-and-reinvest" approach to corporate resource allocation gave way to a "distribute-and-downsize" approach in the 1970s).

¹⁵⁶ See, e.g., Jarrad Harford et al., *Corporate Governance and Firm Cash Holdings in the U.S.*, 87 J. FIN. ECON. 535 (2008) (finding that in the U.S., weakly controlled managers choose to spend cash quickly on acquisitions and capital expenditures, rather than hoard it); Matthew T. Billett et al., *The Influence of Governance on Investment: Evidence from A Hazard Model*, 102 J. FIN. ECON. 643 (2011) (findings that poor governance associates with overinvestment).

¹⁵⁷ See, e.g., Heitor Almeida et al., *The Real Effects of Share Repurchases*, 119 J. FIN. ECON. 168 (2016) (finding that managers are willing to trade off investments and employment for stock repurchases that allow them to meet analyst earning-per-share forecasts); Huasheng Gao et al., *CEO Turnover-Performance Sensitivity in Private Firms*, 52 J. FIN. & QUANTITATIVE ANALYSIS 583 (2017) (finding that CEOs in public firms have higher turnover rates and exhibit greater turnover-performance sensitivity than private firms, mainly due to investors' myopia).

¹⁵⁸ See, Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11, at 4 (showing that firms with higher passive institutional ownership have higher payouts and lower investment); Todd A. Gormley & David A. Matsa, *Playing It Safe? Managerial Preferences, Risk, and Agency Conflicts*, 122 J. FIN. ECON. 431, 432 (2016) (arguing that managers are motivated by their career concerns to "play it safe" by taking on less risk—and thus lower return—than shareholders would prefer in order to avoid being fired).

¹⁵⁹ See Goshen & Squire, *supra* note 23, at 803 ("[I]nvestors could misattribute disloyalty, bad measurements, or bad luck to incompetence, and then generate principal costs by firing a competent manager."); Roe, *supra* note 54, at 13–14 ("[D]ispersed investors cannot cheaply distinguish egoistic empire-building from a high net present value project.").

¹⁶⁰ See Matt Weinberger, *This Is Why Steve Jobs Got Fired from Apple—and How He Came Back to Save the Company*, BUSINESS INSIDER (July 31, 2017), <https://www.businessinsider.com/steve-jobs-apple-fired-returned-2017-7>.

iMac.¹⁶¹ Even sophisticated and deeply informed directors with a real stake in Apple's continuing performance were wrong about Jobs: Despite his domineering attitude and exacting attention to detail, he was a good bet.¹⁶² In their capacity as shareholders, managers of institutional investors spread their attention across hundreds or thousands of portfolio corporations and, consequently, are even more likely to make these types of mistakes than Apple's onetime directors.¹⁶³

By maintaining the status quo, disloyal (loyal) managers eliminate the possibility they will be perceived (misperceived) as disloyal and fired. Even for loyal managers, undertaking a complex, long-term, or innovative investment project introduces a chance of failure, reprimand, and removal.¹⁶⁴ Thus, under strong governance, CEOs will rationally choose to distribute profits instead of taking a career risk by reinvesting them.

By contrast, the managers of weak-governance firms do not have to worry about being removed by shareholders, whether in response to an inefficient investment or to a bold, visionary one. Another tech company—Facebook—illustrates this point. In 2019, Facebook's Chairman and CEO, Mark Zuckerberg, introduced the cryptocurrency project Libra as an important new objective for the company and a revolution in digital finance. Critics saw it as a pet project with no apparent benefits to the company.¹⁶⁵ The same month that Facebook announced Libra, outside investors attempted to strip Zuckerberg of the chairmanship as a check on his leadership. More than two-thirds of outside investors voted in favor of the move.¹⁶⁶ However, while Zuckerberg owned only a small minority of Facebook's economic value, he held 58% of its voting power by virtue of a dual-class structure and easily blocked the measure.¹⁶⁷ Of course, only time will reveal who was right, but the Libra saga illustrates that in weak-governance firms such as Facebook, managers can invest in projects they

¹⁶¹ *Id.*

¹⁶² See Goshen & Hamdani, *supra* note 23, at 580 (citing Jobs as an example of idiosyncratic vision being inefficiently disrupted by shareholders).

¹⁶³ John C. Wilcox & Morrow Sodali, *Getting Along with BlackRock*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 6, 2017), <https://corpgov.law.harvard.edu/2017/11/06/getting-along-with-blackrock> (noting that BlackRock's "Investment Stewardship" team of thirty employees votes in about 17,000 shareholder elections and meets with 1,500 companies each year).

¹⁶⁴ See Goshen & Squire, *supra* note 23, at 786–87.

¹⁶⁵ See Lionel Laurent, *Facebook's Answer to Bitcoin Poses a Double Threat*, BLOOMBERG OPINION (June 17, 2019), <https://www.bloomberg.com/opinion/articles/2019-06-17/facebook-libra-crypto-currency-is-another-zuckerberg-threat> (noting that the "bid to launch an online payments revolution carries plenty of risks, from antitrust concerns to the threat that it might pose to financial stability").

¹⁶⁶ See Betsy Atkins, *Facebook Strong Arms Investors Who Want Zuckerberg Out*, FORBES (June 7, 2019), <https://www.forbes.com/sites/betsyatkins/2019/06/07/facebook-strong-arms-investors-who-want-zuckerberg-out/#37f0d85b5901>.

¹⁶⁷ *Id.*

see as worthwhile, without worrying that shareholders might disagree—and fire them.

In sum, because shareholders can remove managers under strong governance, those managers generally will refrain from investing and choose instead to distribute any excess cash. In weak-governance companies, managers can invest according to their business sense and conscience (loyal or disloyal) without worrying about discipline from shareholders and are likely to invest more. This logic predicts that, by moving firms *en masse* towards strong governance, common owners will create an investment shortfall. Indeed, the following subsection shows that they have done just that.

2. Strong Governance and the Investment Shortfall

Different measures track the beginning of the investment shortfall to different periods. Investment as a portion of the U.S. GDP has fallen since 1980.¹⁶⁸ Investment relative to firms' profitability has declined since the middle of the 1990s¹⁶⁹ or, at the latest, since 2000.¹⁷⁰ The nature of this downturn suggests that strong governance is to blame: Consistent with the monopsony effect, firms are funneling free cash to shareholders instead of investing it.

While empiricists so far have not directly shown causation between common ownership and declining investment as a portion of GDP, they have linked common ownership to decreased investment on a firm level, measured against profitability.¹⁷¹ Indeed, investment has declined relative to profitability (lower investment per dollar of profit) at least since the early 2000s, as common ownership steadily grew¹⁷² and hedge-fund activism gained dominance in the market.¹⁷³ Rather than reinvest profits, firms in the past two decades have increasingly distributed them to shareholders,

¹⁶⁸ *Total Investment (% of GDP)*, THE WORLD BANK, https://tcdata360.worldbank.org/indicators/inv.all.pct?country=USA&indicator=345&viz=line_chart&years=1980,2024 (last visited Apr. 14, 2020); Jordan Brennan, Rising Corporate Concentration, Declining Trade Union Power, and the Growing Income Gap: American Prosperity in Historical Perspective 12 fig.3, (February 2016) (unpublished manuscript), http://www.levyinstitute.org/pubs/e_pamphlet_1.pdf.

¹⁶⁹ Lee et. al. find that the decline had already started in the middle of the 1990s. See Dong Lee et al., *Why Does Capital No Longer Flow More to the Industries with the Best Growth Opportunities?* (Fisher Coll. Bus., Working Paper No. 2016-03-15, 2016), <https://ssrn.com/abstract=2839832> (showing that since the middle of the 1990s, firms in high-Q industries increasingly repurchase shares and decrease capital expenditures).

¹⁷⁰ See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11.

¹⁷¹ *Id.* (finding that higher quasi-indexer, common owners, ownership *leads* to higher buybacks and less investment).

¹⁷² *Id.*

¹⁷³ Brian Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds* 34 (U. Cambridge Fac. L., Legal Studs. Rsch. Paper Series No. 38/2011, 2011), https://ssrn.com/abstract_id=1932805 (addressing the rise to prominence of hedge fund activism in the 2000s).

including through share buybacks.¹⁷⁴ Moreover, in industries with high proportions of common ownership, one study found, “firms spend a disproportionate amount of free cash flows buying back their shares.”¹⁷⁵ That is, firms in industries with more concentrated ownership invest even less than the norm. In sum, economic trends suggest that firms are investing less than they once did *because of common owners’ influence*.

Indeed, empirical studies support the claim that companies are reducing investments because of the influence of strong governance.¹⁷⁶ Increased shareholder rights are associated with lower capital expenditures¹⁷⁷ and less R&D spending.¹⁷⁸ More recent studies have confirmed the negative correlation between strong governance and investment, finding, as one example, that strong-governance firms less frequently make large investments.¹⁷⁹ In short, firms with more empowered shareholders invest less, supporting the claim that strong governance is to blame for the investment shortfall.¹⁸⁰

¹⁷⁴ See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11; Kathleen Kahle & René M. Stulz, *Why Are Corporate Payouts So High in the 2000s?* (Nat’l Bureau Econ. Rsch., Working Paper No. 26958, 2020), <https://www.nber.org/papers/w26958> (finding that inflation-adjusted amount paid out through dividends and repurchases by public industrial firms was three times larger from 2000 to 2018 than from 1971 to 1999); Ilan Strauss and Jangho Yang, *The Global Investment Slowdown: Corporate Secular Stagnation and the Draining of the Cash Flow Swamp* (OMPTEC, Working Paper No. 2019-5, 2019), <https://www.oxfordmartin.ox.ac.uk/downloads/academic/The-Global-Investment-Slowdown.pdf> (finding that firms are increasingly net external “releasers” of funds to shareholders, creditors, and bondholders, reflecting cross-cutting exogenous factors creating a chronic excess of cash flow over weakening investment opportunities).

¹⁷⁵ GERMÁN GUTIÉRREZ & THOMAS PHILIPPON, DECLINING COMPETITION AND INVESTMENT IN THE U.S. 1 n.1 (March 2017), https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Macro%20Lunch/IK_Comp_v1.pdf.

¹⁷⁶ The discussion above excludes the effects of governance on mergers and acquisitions because while strong governance decreases inefficient *buying* of other corporations (a demand side effect) it increases efficient *selling* of corporations (a supply side effect). It is inconclusive which effect dominates. Moreover, the welfare effects of merger are also unresolved. See Bronwyn H. Hall, *The Effect of Takeover Activity on Corporate Research and Development*, in *CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES* 69, 70 (Alan J. Auerbach, ed., 1988) (available online at <https://www.nber.org/chapters/c2053.pdf>) (“The question whether increased merger activity is a good thing for the economy in general remains unresolved and unlikely to be resolved by focusing solely on the experience of the firms involved.”).

¹⁷⁷ Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 133–34 (2003).

¹⁷⁸ See Florence Honoré et al., *Corporate Governance Practices and Companies’ R&D Intensity: Evidence from European Countries*, 44 RSCH. POL’Y 533 (2015) (finding that strong governance measures are negatively correlated with R&D intensity, and are detrimental to long-term R&D investments.); Tao-Hsien Dolly King & Min-Ming Wen, *Shareholder Governance, Bondholder Governance, and Managerial Risk-Taking*, 35 J. BANKING & FIN. 512, 513 (2011), and the studies cited *supra* note 27.

¹⁷⁹ Matthew T. Billett et al., *supra* note 156, at 644 (“[W]eak shareholder protection (managerial entrenchment) [] associates with more frequent investment spikes.”).

¹⁸⁰ See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11, at 30 (estimating that common ownership and governance explain 80% of the reduced investment effects).

The fact that investment has declined even as profits-per-worker have increased provides further evidence that common owners are to blame. In 2019, companies captured \$15,000 *more* in profits for each worker than they did in 1980—an increase in corporate profits totaling \$13 trillion.¹⁸¹ With labor so profitable, firms in a competitive economy should hire more workers and undertake additional investment projects; investment and hiring should be going *up*, not down. Instead, investment has trended steadily downward.¹⁸² And while public corporations employed 40% of the American workforce in 1980, they only employed 29% in 2019.¹⁸³

Declining investment has had profound economic consequences. Lower investment across the board means less hiring, and less hiring means lower wages. The following section shows how reduced investment has created a wage monopsony, taking money out of the pockets of workers and putting it into the hands of shareholders.

B. Strong Governance and Wage Stagnation

The previous section showed how strong governance had created an investment shortfall, which naturally reduces hiring. Indeed, since the 1980s, as investment declined compared to GDP,¹⁸⁴ the percentage of employees working for public firms has fallen sharply.¹⁸⁵ This section looks at direct evidence linking common ownership to wage stagnation.

The monopsony effect makes a powerful set of predictions that are borne out in labor-market data.¹⁸⁶ In particular, it predicts that pay will remain fixed even as worker productivity rises, resulting in stagnant wages and increasing income inequality. Under common ownership, even when workers become more productive—that is, when their marginal productivity increases—firms will *still* refrain from increased hiring because the strong-governance regime makes investing (hiring) risky for managers.¹⁸⁷ Hiring and wages will remain low even as marginal productivity rises, with shareholders capturing the difference. In short, the monopsony effect predicts wages will remain flat as productivity and shareholder returns grow—a prediction borne out in macroeconomic data.

¹⁸¹ See Barkai, *supra* note 140, at 2.

¹⁸² See *supra* note 168–170 and accompanying text.

¹⁸³ See Schlingemann & Stulz, *supra* note 17.

¹⁸⁴ See *supra* note 168 and accompanying text.

¹⁸⁵ See Schlingemann & Stulz, *supra* note 17 (finding that at “the beginning of that period, more than 41.4 percent of non-farm workers in the private sector work for public firms, but in 2019, that percentage is 29.0 percent.”)

¹⁸⁶ For one study offering an alternative explanation of the data focused on the decline of “worker power,” see Anna Stansbury & Lawrence H. Summers, *The Declining Worker Power Hypothesis: An Explanation for the Recent Evolution of the American Economy* (Nat’l Bureau Econ. Rsch., Working Paper No. 27193, 2020), <https://www.nber.org/papers/w27193>. However, since the study defined “worker power” as the product of de-unionization and changes in *corporate ownership*, it partially overlaps with the explanation of this Article.

¹⁸⁷ See *supra* section I.A.1.

The so-called “productivity-pay gap” provides perhaps the most damning evidence of the monopsony effect.¹⁸⁸ Before the 1980s, the higher their marginal output, the more workers were paid—that is, the more revenue they netted for their employers, the more money they took home.¹⁸⁹ At about the same time common owners came on the scene, productivity and wages began to diverge.¹⁹⁰ Since then, wages and productivity have drifted apart, a telltale sign of anticompetitive labor pricing.¹⁹¹ In the last forty years, one study estimates, labor has become four-and-a-half times more productive, while wages stalled.¹⁹²

With wages flat-lined and worker-productivity on the rise, common owners are taking a bigger and bigger cut of corporate revenue. Profits-per-worker have grown year-over-year since at least the 1980s, but they have accrued to shareholders rather than workers.¹⁹³ In the early 1980s, workers took home about eighty cents of every dollar earned by the corporate sector. By the mid-2010s, that figure was down to seventy cents.¹⁹⁴ In short, while workers are bringing greater returns to their employers, shareholders are taking a larger and larger cut of each corporate dollar, suggesting that investors (common owners) are exercising market power to reduce hiring and keep wages down.¹⁹⁵

Figure 1 puts this correlation in stark relief: As the average percentage of shares held by common owners passed the 20% mark in the late 1970s, compensation and productivity, both of which had previously risen in concert, decoupled from each other, leaving workers providing increasing economic value to corporations as their hourly compensation has stagnated.

¹⁸⁸ *The Productivity-Pay Gap*, ECON. POL’Y INST., <https://www.epi.org/productivity-pay-gap/> (last updated July 2019).

¹⁸⁹ Barkai, *supra* note 140, at 36 (“A decline in the demand for labor inputs (which results in a decline in the labor share) and a simultaneous decline in the demand for capital inputs (which results in under-investment) are distinctive traits of declining competition.”).

¹⁹⁰ *Id.* For a discussion of market concentration as a possible cause of the productivity-pay gap, see *infra* Section III.E.3.

¹⁹¹ Barkai, *supra* note 140, at 36.

¹⁹² Abdul A. Erumban & Klaas de Vries, *Wage-Productivity Growth Gap: An Analysis of Industry Data 14–15* (The Conf. Bd., Econ. Program Working Paper Series 16-01, 2016), https://www.conference-board.org/pdf_free/workingpapers/EPWP1601.pdf.

¹⁹³ See *supra* note 181 and accompanying text.

¹⁹⁴ Elise Gould, *The State of American Wages 2017*, ECON. POL’Y INST. (Mar. 1, 2018), <https://www.epi.org/publication/the-state-of-american-wages-2017-wages-have-finally-recovered-from-the-blow-of-the-great-recession-but-are-still-growing-too-slowly-and-unequally/>.

¹⁹⁵ In aggregate, this trend is captured by the labor share of income—the portion of annual economic output that goes to labor as opposed to capital. After holding more or less steady since World War II, that figure saw a significant decline since the 1980s, from near 60% to closer to 50%, driven by a decrease in earnings for the lowest earners. Michael W. L. Elsby et al., *The Decline of the U.S. Labor Share*, Brookings Paper on Economic Activity, Fall 2013, 1,2, <https://www.brookings.edu/bpea-articles/the-decline-of-the-u-s-labor-share/>.

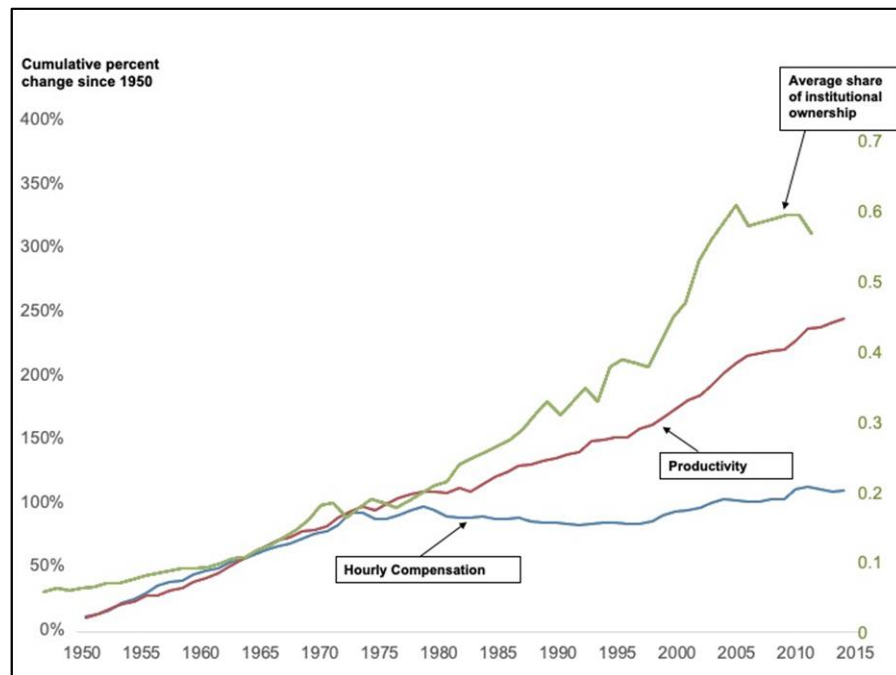


Figure 1. Common Ownership, Productivity, and Hourly Compensation

To see how a rising pay-productivity gap suggests a labor monopsony,¹⁹⁶ imagine a market where wages and marginal productivity are initially equal at x , but productivity rises to $2x$. In a competitive economy, firms would compete to hire up workers until wages rose to $2x$, at which point wages would equal marginal product, and firms would stop hiring.¹⁹⁷ However, under a monopsony, firms could refrain from hiring in order to keep wages at or near x and pocket the difference.

Hedge-fund activism provides a vivid example of how strong-governance mechanisms allow shareholders to capture value from workers. Being a strong-governance mechanism, hedge-fund activism campaigns supported by institutional investors reduce investments, either by cutting inefficient investments of disloyal managers¹⁹⁸ or deterring efficient investments of loyal managers.¹⁹⁹ These campaigns often lead to layoffs and

¹⁹⁶ See Naidu et al., *supra* note 143, at 556 (explaining that a monopsonist will set wages below marginal revenue).

¹⁹⁷ *Id.* (“In a competitive labor market, firms equate the going wage of workers to their ‘marginal revenue product,’ the amount of additional revenue the worker can generate.”).

¹⁹⁸ See, Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015).

¹⁹⁹ See, e.g., John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 603–07 (2016) (describing the activist hedge fund practice of slashing research and development in pharmaceutical industry targets).

other spending cuts,²⁰⁰ and even as productivity increases, wages at target firms stagnates.²⁰¹ The firm gets more profitable, shareholders get richer, and workers get—you guessed it—*nothing*.

The monopsony theory makes one final prediction: rising income inequality.²⁰² By holding wages below their competitive rates, the labor monopsony shifts wealth from labor-earners to capital-earners, who tend to be already wealthier.²⁰³ Like Robin Hood in reverse, it steals from the poor and gives to the rich. Indeed, it hardly needs to be recounted here that income inequality has reached historic rates. The wealth-to-income ratio—a measure of economic wealth captured by the highest earners—has skewed sharply upward, doubling between 1970 and 2010 and appearing to return to its 1920 level.²⁰⁴ Similarly, the income Gini index, which measures the degree of income inequality, has consistently risen from 36.5% in 1980 to more than 45% in 2016, a record high.²⁰⁵

This Part outlined the empirical evidence that common ownership contributes to wage stagnation and economic inequality. The following Part lays out the theory behind these effects. In particular, it presents a stylized economic model that explains the connection between wages and governance—and shows how common owners act, inadvertently or not, to break that connection and profit from decreased wages.

III. WAGE AND GOVERNANCE: BREAKING THE COMPETITIVE EQUILIBRIUM

To better understand common ownership and the monopsony effect, this Part outlines how common owners disrupt the relationship between wages and governance structure. Section III.A models how the choice between weak and strong governance depends on the wage rate. Section III.B explains how the wage rate depends on which governance structures shareholders choose. Section III.C outlines the competitive equilibrium and explains that even though it imposes management agency costs on shareholders, it maximizes social welfare. Section III.D explains how

²⁰⁰ Mark R. Desjardines & Rodolphe Durand, *Disentangling the Effects of Hedge Fund Activism on Firm Financial and Social Performance*, 41 STRATEGIC MGMT. J. 1054, 1070–71 (2020).

²⁰¹ Alon Brav et al., *The Real Effects of Hedge Fund Activism*, 28 REV. FIN. STUDS. 2723, 2753 (2015) (“[O]n average, workers at target firms do not share in the improvements associated with hedge fund activism. They experience stagnation in wages, while their productivity improves significantly.”).

²⁰² The focus of this Article is on inequality between wage-earners and capital-earners and not between different classes of wage-earners. For the latter, see Jae Song et al., *Firming Up Inequality*, 134 Q. J. ECON. 1 (2019).

²⁰³ See Naidu et al., *supra* note 143, at 537 (arguing that labor monopsony “reduces the incomes of workers relative to those of people who live off capital, and the latter are almost uniformly higher earners than the former”).

²⁰⁴ Thomas Piketty & Gabriel Zucman, *Capital is Back: Wealth-Income Ratios in Rich Countries 1700-2010*, 129 Q. J. ECON. 1255, 1257 (2014).

²⁰⁵ Kaissar, *supra* note 2.

common owners break the competitive equilibrium and create a labor monopsony. Finally, Section III.E compares the explanatory power of the common ownership monopsony theory with other, alternative theories.

A. Corporate Governance: The Risk of Management Disloyalty

Shareholder exposure to manager disloyalty depends on the governance structure they choose. Weak governance increases the risk of manager disloyalty, as managers can invest inefficiently and expropriate private benefits without being disciplined by shareholders. Strong governance minimizes this risk, as shareholders can hold disloyal managers accountable.²⁰⁶ But, as explained above, weak or strong governance will have parallel effects on *loyal* managers.²⁰⁷ Weak governance increases the incentive for both loyal and disloyal managers to invest, while strong governance minimizes that incentive. The choice between strong and weak governance thus depends both on the probability and cost of management disloyalty and the relative gains from investing. In the absence of common ownership, each firm's shareholders will make governance choices the same way they would make any other decision: Which option will maximize the corporation's value? In other words, shareholders will choose between weak and strong governance based on which structure increases their expected returns.

A stylized economic model serves to illustrate this choice.²⁰⁸ Assume a market with 100 corporations where none of the corporations has market power over either products or resources.²⁰⁹ Shareholders—without market power over ownership of firms²¹⁰—must choose a governance structure for their respective corporations. Of course, corporate governance is a spectrum of structures allocating various levels of control between shareholders and managers.²¹¹ However, for simplicity, assume that only

²⁰⁶ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 327–328 (1976) (describing how shareholders can invest in monitoring and bonding in order to reduce the cost of manager disloyalty).

²⁰⁷ See *supra* section I.A.1.

²⁰⁸ The model presented here draws on the work of Goshen and Levit, *supra* note 22.

²⁰⁹ That is, firms are price takers inasmuch as they hire at the competitive rate determined by the market. See David W. Berger et al., *Labor Market Power* 34 (Nat'l Bureau Econ. Rsch, Working Paper No. 25719, 2019), nber.org/papers/w25719.pdf (noting that all firms in a competitive equilibrium are price takers).

²¹⁰ See *Market Power*, OECD GLOSSARY STATISTICAL TERMS, <https://stats.oecd.org/glossary/detail.asp?ID=3256> (last updated March 16, 2002) (“Market power refers to the ability of a firm (or group of firms) to raise and maintain price above the level that would prevail under competition . . .”).

²¹¹ See Goshen & Squire, *supra* note 23, at 802–04 (explaining the concept of corporate governance as a spectrum, rather than a binary).

two poles of governance structures are available for shareholders:²¹² Either they can easily fire a manager (“strong governance”), as in dispersed-ownership firms without staggered boards or poison pills,²¹³ or they cannot fire a manager (“weak governance”), as in dual-class firms²¹⁴ where public shareholders own only non-voting or low-voting shares.²¹⁵ Shareholders want to hire only loyal managers but cannot distinguish beforehand between a loyal and a disloyal CEO.²¹⁶ Suppose, further, that half of all candidates for the CEO job are loyal and half are disloyal.²¹⁷

Managers, once hired, face a discrete set of investment decisions. They can either choose project A or project B. Both require the firm to spend \$1,000,000 to hire a team of workers. Project A is a good investment. At the end of the project, it will yield \$1,500,000, representing \$500,000 in profits after accounting for the \$1,000,000 in labor costs—a 50% profit. Project B is a pet project that allows the manager to travel in style, hire relatives, elevate their social status, and so on. It will yield an expected value of \$500,000, representing \$500,000 in losses after accounting for the \$1,000,000 investment—a 50% loss. However, these investments take time to pan out, and at least initially, shareholders cannot easily tell the difference between the two. Both cost \$1,000,000 and otherwise resemble each other, so shareholders cannot tell whether managers have invested in the good project, A, or the bad project, B, until it is too late.

Managers face a third option: do nothing. They can sit back and run the company as usual, make no new investments, and distribute to the shareholders the \$1,000,000 that would otherwise be spent on labor. While shareholders cannot distinguish between project A and project B, they can distinguish between a manager who invests and one who distributes free cash.

Shareholders now must choose between strong and weak governance given the risk of disloyalty—that is, the risk that they will hire a disloyal manager who will select project B. As mentioned, shareholders that choose weak governance face a 50% chance of disloyalty: If they hire a loyal manager (50% chance), he or she will invest in project A, generating

²¹² The model’s conclusions will not change if shareholders can choose any governance structure along the spectrum between weak and strong governance. See Goshen & Levit, *supra* note 22, at 27–28.

²¹³ See *supra* Section I.B.3.

²¹⁴ See *supra* Section I.B.3.

²¹⁵ For simplicity, we use the two poles of the governance spectrum. However, as mentioned, the model’s conclusions will not change if shareholders can choose any governance structure along the spectrum between weak and strong governance. See *supra* note 212.

²¹⁶ See Goshen & Squire, *supra* note 23, at 770–71 (“When investors exercise control, they make mistakes due to a lack of expertise, information, or talent, thereby generating principal competence costs.”).

²¹⁷ Of course, this represents an uncharitable view of human nature. As will be shown in the following section, the model will work the same way with any proportion. See *infra* section III.B.

\$500,000 in profits for the firm. If they hire a disloyal manager (50% chance), he or she will invest in project B, generating \$500,000 in losses. The expected value²¹⁸ of choosing weak governance, then, is zero.²¹⁹

If shareholders choose strong governance, however, managers are not likely to invest. Disloyal managers will not invest for fear that shareholders will recognize the investment as project B, while loyal managers will not invest in project A because shareholders may misperceive it as project B, thus potentially resulting in termination.²²⁰ Instead, managers will distribute any free cash through dividends and buybacks rather than investing it.²²¹ On the margin, they will neither make nor lose money. The expected value of choosing strong governance, then, is also zero.

Under these conditions, shareholders will be indifferent between strong and weak governance. Strong governance yields an expected return of zero because managers will have an incentive not to invest. Weak governance also produces zero expected returns because a loyal manager's potential gains are wiped out by the risk of losses from a disloyal one. Either way, shareholders realize an expected value of zero and will thus be indifferent between strong- and weak- governance.²²²

Of course, the indifference here is only due to the assumptions made: 50% loyal managers, with losses and gains that cancel one another out. The following sections account for what happens when these inputs change. The key insight will be that the choice of governance structure is contingent: The most profitable governance structure depends on market conditions.

B. The Feedback Between Wages and Governance Structure

Previously, we assumed that both investment projects—A and B—cost \$1,000,000 in outlays on labor. Suppose, for example, that each project demands ten employees be hired at \$100,000 per employee. Given the other market conditions, this rate makes strong and weak governance equivalent in terms of expected return. Suppose, however, that wages decline to

²¹⁸ Expected value is calculated by multiplying the value of any given outcome by its probability, and totaling the weighted outcomes. So here, \$500,000 times 50% plus negative \$500,000 times 50% is zero. For an explanation of how to calculate expected value, see Will Kenton, *Expected Value*, INVESTOPEDIA, <https://www.investopedia.com/terms/e/expected-value.asp> (last updated Jun. 27, 2020).

²¹⁹ The assumption is that the expected return on project A provides an appropriate return to compensate for both the investment risk of project A and the risk of hiring a disloyal manager who will invest in project B.

²²⁰ See Goshen & Levit, *supra* note 22, at 14 (modeling the possibility that shareholders will “get the wrong signal” from investments and mistakenly fire a manager).

²²¹ *Id.* at 22–23 (showing that as long as they care about their jobs, managers will refrain from investing in strong-governance corporations).

²²² The assumption is that for every level of risk an investment yields the appropriate return to compensate for that level of risk. In other words, all investments yield market returns (zero net present). This is true for the current investments already undertaken by strong governance firms and for the new investments contemplated by weak governance firms.

\$80,000 per employee. Each investment project will now cost \$800,000 but will still yield the same returns. Project A will yield \$1,500,000, and subtracting \$800,000 in labor costs leaves a profit of \$700,000 (as opposed to \$500,000 before). Project B will yield \$500,000; subtracting \$800,000 in labor costs leaves a loss of \$300,000 (as opposed to \$500,000 before).

Shareholders now face a different choice when making decisions about governance structure. Under strong governance, loyal and disloyal managers will continue to refrain from investing.²²³ The expected value of strong governance, therefore, remains zero. Weak governance, however, now yields a positive expected value. Shareholders stand a 50% chance of making \$700,000 with a loyal manager and a 50% chance of losing \$300,000 with a disloyal manager, for an expected return of \$200,000 in profits. When wages are low, then we can expect that shareholders will prefer weak governance to strong governance.

At first, this result seems counterintuitive. Typically, shareholders prize the right to fire and replace corporate managers.²²⁴ However, when wages are low, they may wish to tie their own hands through weak-governance measures, allowing managers to capitalize on discounted wages without fear of being fired.²²⁵ In other words, manager entrenchment makes good business sense if the goal is to encourage investment.²²⁶

Notice that, under these conditions, shareholders would prefer weak governance *in spite of* the management agency costs it generates. While half of the weak governance companies will make \$700,000 due to loyal managers investing in project A, the other half will lose \$300,000 from disloyal managers investing in project B. This \$300,000 loss represents the management agency costs of weak governance. However, where investment is particularly attractive—as here, with discounted wages—weak governance is *still* preferable to strong governance due to the outsized gains from investing.²²⁷ Thus, rational shareholders may want to cede control to

²²³ See Goshen & Levit, *supra* note 22, at 13–16 (showing that in equilibrium managers will maintain the status quo as long as shareholders have the right to fire them).

²²⁴ Simone M. Sepe, *Board and Shareholder Power, Revisited*, 101 MINN. L. REV. 1377, 1380 (2017) (“Shareholder advocates, in particular, defend the need for a strong shareholders’ power of removal—exercisable virtually at any time—in order to ensure that the exercise of this power (or even just the threat of it) can serve an effective disciplinary function.”).

²²⁵ See, e.g., Valentin Dimitrov & Prem Jain, *Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns*, 12 J. COR. FIN. 342 (2006) (studying a sample of 178 firms that changed from a one-share-one-vote (strong governance) into a dual-class structure (weak governance) during 1979–1998, and finding that dual-class recapitalizations are shareholder value enhancing corporate initiatives).

²²⁶ Raymond J. Fisman et al., *Governance and CEO Turnover: Do Something or Do the Right Thing?*, 60 Mgmt. Sci. 319, 320–21 (2014) (presenting a model that suggests some level of boards entrenchment may be optimal, as it protects CEOs from bad firing decisions by shareholders).

²²⁷ Dimitrov & Jain, *supra* note 225 (finding that upon a switch from one-share-one-vote to dual-class, shareholders, on average, earn significant positive abnormal returns, and these

encourage managers to make investments where they otherwise would refrain—even though some companies will lose money because of management agency costs.

A depressed labor market thus makes governance choices *relevant*: Weak governance is preferable given low wages. In a depressed labor market, we expect shareholders in at least some strong-governance companies to switch to weak governance so that their managers have the freedom to invest. As the number of weak governance companies rises, investment levels will increase, pushing up wages. Firms will continue to move to weak governance until wages rise to \$100,000 per employee, where, as shown above, weak and strong governance have the same expected value. Once wages reach this rate, firms will once again be indifferent between weak and strong governance, and they will stop switching. In other words, they will have reached a new equilibrium, this time with more weak-governance firms.²²⁸

Conversely, strong governance is preferable when wages are high. Suppose that wages rise to \$120,000 per employee, for an aggregate labor cost of \$1,200,000 for each project. Now, the potential profits and losses will flip: Project A yields only \$300,000 in profits while project B yields \$700,000 in losses on average. While the expected return of strong governance remains zero, as above, the expected return of weak governance is now \$200,000 in losses. In this market, strong governance is preferable, and thus weak-governance firms will switch to strong governance, causing investment levels and hiring to fall and consequently lowering wages.²²⁹ Firms will continue to switch, and labor prices will continue to decrease until wages fall to \$100,000 per employee, making shareholders once again indifferent between strong and weak governance. At this point, there will be more strong-governance companies than before, but both governance structures will yield an expected value of zero. This, in essence, is the feedback loop between wages and governance structure.

In equilibrium, then, shareholders will be indifferent between weak and strong governance regardless of the wage rate. The same can be said of the distribution between loyal and disloyal managers: Shareholders will adjust until they are indifferent between governance structures. For instance, assume that 70% of managers are loyal, and 30% are disloyal (as opposed to fifty-fifty before), and the wage level is \$100,000 per employee.

returns are even larger for firms that issue equity—a clear indication of engaging in substantial investments).

²²⁸ See Goshen & Levit, *supra* note 22, at 17 (“Essentially, the irrelevance is obtained because in equilibrium market clearing requires the price of resources to be fair in the sense that a change to the status quo is a zero net present value (NPV) investment from the shareholders perspective.”).

²²⁹ See, e.g., Martijn Cremers, et al., *The Life-Cycle of Dual Class Firm Valuation*, at p. 42 (2020) (Unpublished manuscript), available at <https://ssrn.com/abstract=3062895> (finding that 20% of dual-class firms (weak governance) unify their shares (strong governance) and experience increase in value).

Under these conditions, weak governance will be more profitable: 70% of managers (the loyal ones) will invest in project A and make \$500,000 in profit, while 30% (the disloyal ones) will invest in project B and lose \$500,000. The expected value of weak governance would then be a profit of \$200,000 while the expected value of strong governance remains \$0. Companies would switch to weak governance, pushing up wages. Wages would once again rise until they cancel out any gains from weak governance. Thus, in a world with a higher proportion of loyal managers, we can expect that there will be more weak-governance corporations, but the expected value of either governance choice will remain zero.²³⁰

In short, just as wages impact the choice of governance structure, governance structure impacts wage rates. Strong governance discourages investment, whereas weak governance incentivizes it. Investment requires labor to build factories, launch divisions, open stores, build supply chains, and conduct research.²³¹ Thus, if many companies move towards weak governance, investment and hiring will rise, pushing up wages. Conversely, if many firms switch to strong governance, investments will fall, and wages along with it. These symmetrical forces push wages to a competitive level.

C. The Competitive Equilibrium and its Parameters

The stylized model illustrates that governance structure and labor prices will reach an equilibrium where shareholders are indifferent as to governance structure. In this equilibrium, some number of weak- and strong-governance companies will coexist, with none gaining the upper hand by switching from one governance structure to another. Because this equilibrium reflects a labor price determined through competition among hiring firms—where none of the players, corporations, shareholders, and employees, enjoy market power—it maximizes social welfare reflected in the distribution of wealth between labor and capital.²³²

To be sure, this equilibrium imposes certain inefficiencies on corporations and their shareholders because some proportion of firms will adopt weak governance.²³³ Returning to the model where 50% of firms had

²³⁰ For instance, one could set the prior probability that a manager is disloyal equal to a generic variable between zero and one, and obtain the irrelevance result regardless. See *id.* at 8–9.

²³¹ For example, labor costs amount to 13% of the revenue of S&P 500 companies. Connor Smith, *Higher Pay is a Rising Threat to Stocks, Goldman Sachs Says*, BARRON'S (July 10 2019), <https://www.barrons.com/articles/higher-pay-is-a-rising-threat-to-stocks-goldman-sachs-says-51562752800>.

²³² See Berger, *supra* note 209, at 44 (concluding that households are worse off in an anticompetitive labor market where firms wield market power than in a competitive labor market).

²³³ See, e.g., Kevin C. W. Chen et al., *Agency Costs of Free Cash Flow and the Effect of Shareholder Rights on the Implied Cost of Equity Capital*, 46 J. FIN. & QUANTITATIVE ANALYSIS 171, 200–01 (2011) (concluding that firms that employ takeover defenses—a weak governance measure—experience higher costs of equity capital).

weak-governance structures and 50% of managers were disloyal, probabilistically, twenty-five firms would hire disloyal managers who will destroy value by investing in pet projects (project B). In this case, \$500,000 in losses per firm at twenty-five firms would total \$12.5 million in management agency costs.

These costs to shareholders, unavoidable in a competitive equilibrium, can be considered an inadvertent subsidy to workers. If shareholders could avoid management agency costs by switching to strong governance *only* in the firms with disloyal managers, they could prevent those managers from making outlays on labor. In other words, disloyal managers—twenty-five in our example—invest in pet projects when shareholders would prefer that they do not invest at all. This investment represents a benefit to workers, as it increases hiring and bolsters wages. Because shareholders cannot preempt only disloyal managers, corporations spend more on labor than their owners would prefer.²³⁴

While this balance is not optimal from the shareholders' point of view, from a social perspective, it represents a competitive allocation of wealth between labor and capital. Importantly, the equilibrium with higher social welfare includes some level of inefficient management agency costs.²³⁵ But, as long as shareholders cannot perfectly identify management's loyalty, management agency costs can only be reduced by creating a greater detriment to some other group of stakeholders.²³⁶ That is, even though this equilibrium is not optimal for shareholders, it is efficient overall.

So far, this Part has demonstrated that labor prices and governance structure will counterbalance one another to reach a competitive equilibrium in the absence of common owners. The following section describes how common owners alter this balance by increasing the number of strong-governance companies, resulting in a new and less efficient equilibrium.

D. Breaking the Competitive Governance Equilibrium

Common owners and the push for strong governance represent a departure from the equilibrium described in the economic model above, where governance structure and wages interact in a *competitive* market. With competition, the number of strong governance companies is determined by the prevailing market wage. However, common owners push for strong governance *regardless of market wages*. As a result, the number of companies adhering to either governance structure—and thus, the wage

²³⁴ See Goshen & Hamdani, *supra* note 23, at 566–67 (outlining the information and competence problems that prevent shareholders from being perfect arbiters of managerial effectiveness and loyalty).

²³⁵ See Goshen & Levit, *supra* note 22, at 18 (showing mathematically that a competitive equilibrium of control rights maximizes social welfare).

²³⁶ *Id.*

rate—is determined not by competition but by the governance preferences of a handful of asset managers.

Recall that we assumed the market contained fifty strong-governance and fifty weak-governance firms, and half of the potential managers were disloyal. None of the players had the market power to change the equilibrium unilaterally.²³⁷ As demonstrated, labor prices reach a level such that no firm can boost profits by switching from weak to strong governance or vice versa.²³⁸

Now assume that a handful of common owners hold large stakes in each of the 100 companies in the model.²³⁹ No single owner needs to hold a controlling stake in all the relevant companies so long as together they wield significant influence. Suppose that, at the urging of common owners, twenty firms switch from weak to strong governance.²⁴⁰ From fifty-fifty, then, the market will now consist of seventy strong-governance and thirty weak-governance firms.

Before, managers could choose to invest in project A and project B, either creating or destroying \$500,000 in value, such that the expected value of weak governance after labor costs was zero. However, as common owners switch more firms to strong governance, investments will fall and the labor market will slacken, causing wages to decrease. Suppose that now each employee costs \$80,000 instead of \$100,000, for an aggregate labor cost of \$800,000 for either project. Strong governance continues to net an expected value of zero since managers will continue to refrain from investing. However, weak governance will now yield an expected return of \$200,000 in profits.²⁴¹

In a competitive market, shareholders would adjust to these abnormal returns by switching their companies to weak governance to take advantage of low wages, eventually pushing wages back up to equilibrium.²⁴² However, in this new market, shareholders (common owners) prefer strong governance in spite of the wage rate. Regardless of the expected abnormal returns to any one firm from weak governance, common owners will oppose any move in that direction, meaning that wages will remain

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ The number of common owners is irrelevant for our purposes. However, if we were to set the number at three, for instance, it would be a good approximation of the American equity markets. Recall that three firms, BlackRock, Vanguard, and State Street together form the largest stockholder in nine out of ten S&P 500 companies. See *supra* note 14 and accompanying text.

²⁴⁰ This is not an unrealistic assumption: common owners tend to endorse shareholder rights for their portfolio companies regardless of market conditions. See *supra* section I.B.

²⁴¹ Half the time, the weak-governance companies will hire a disloyal manager who invests in project B for a gross return of \$500,000, netting a loss of \$300,000. The other half of the weak-governance companies, headed by loyal managers, will make a gross return of \$1,500,000, for a net profit of \$700,000. Thus, the expected value of choosing weak governance is a gain of \$200,000.

²⁴² See Goshen & Levit, *supra* note 22, at 4–5.

consistently low. In effect, common owners have deactivated the market mechanism—choice of governance structure—that previously corrected any imbalance in the labor market.²⁴³ Therefore, common owners will have created a new equilibrium with lower investment and lower wages—in other words, a labor market monopsony.²⁴⁴

The model above predicts that when the dust settles on this new world of common ownership, there will be more strong governance firms, a lower level of investment, and lower wages. Strong-governance firms will refrain from investing while weak governance firms will continue to invest—except now, the latter will enjoy a substantial labor discount. Because common owners own a market portfolio, they enjoy the extra profits accrued by weak-governance firms.

Note that strong-governance firms are not likely to benefit in this new equilibrium. Even in the face of low wages, loyal and disloyal managers of strong-governance companies still face a risk of being fired if they invest, correctly or incorrectly. Thus, in spite of the abnormally positive returns to investment, strong-governance firms will still refrain from investing and will not enjoy the benefit of depressed labor prices.²⁴⁵ Strong-governance

²⁴³ Like in any cartelized market the abnormal returns will attract new entries which the cartel will need to block. Indeed, while dual-class IPOs were on average 4.4% of total IPOs in the years 1980-1989, they increased to 8% in the years 1990-1999, to 9.7% in the years 2000-2009, and they reached 16.4% in the years 2010-2017. Calculated based on Jay R. Ritter, *Initial Public Offerings: Updated Statistics*, available at <https://files.bastter.com/Grupos/Documento/a935d88d-3374-4d35-a797-da9620ee24eb.pdf>, Table 23 page 57. Not surprisingly, institutional investors declared a war on dual-class IPOs. See *supra* the text following note 136. For a different explanation for the rise of dual-class IPOs see, Aggarwal, et al., *The Rise of Dual-Class Stock IPOs* (September 12, 2020), available at <https://ssrn.com/abstract=3690670>.

²⁴⁴ Importantly, although our model is framed in terms of firms adopting either weak governance or strong governance, the model's conclusions are valid even if firms can choose governance structures along a spectrum. Assume governance can range from weak to strong along a spectrum, according to the level of managerial freedom to invest. On the limited managerial freedom end, investment is zero, and on the unlimited managerial freedom end, investment is at its maximum. In this structure, firms can adopt any governance on the spectrum, with the corresponding level of investment. For instance, if a firm is on the middle of the spectrum, its manager will invest half of the maximum investment. In such a case, if all firms increase the strength of their corporate governance, the aggregate level of investment will decrease and each firm will increase its profitability on the investments it is still making. In short, the monopsony effect will work the same way.

²⁴⁵ The abnormal profitability implies that there will be incentives for firms to go private or stay private and avoid the public market in order to enjoy the abnormal profitability from investments. Indeed, these two phenomena are empirically documented. See CREDIT SUISSE, *THE INCREDIBLE SHRINKING UNIVERSE OF STOCKS: THE CAUSES AND CONSEQUENCES OF FEWER U.S. EQUITIES*, (2017), https://www.cmwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf (providing the data on the growth of the private market); and John Asker et al., *Corporate Investment and Stock Market Listing: A Puzzle?* 28 REV. FIN. STUD. 342 (2015) (finding that compared to private firms, public firms invest substantially less and are less responsive to changes in investment opportunities); Ofer Eldar & Jillian Grennan, *Common Ownership and Entrepreneurship* (January 8, 2021). AEA PAPERS AND PROCEEDINGS, available at

firms neither lose nor gain any revenue: They did not invest before and do not invest now. However, the remaining thirty weak-governance firms in this economy will now benefit from anticompetitive wages. Each firm will net, on average, an extra \$200,000, or an extra \$6 million in the aggregate. Because common owners hold a stake in each company, their portfolio values will rise as the weak-governance firms become more profitable and the strong governance firms lose nothing. This money did not appear out of thin air but rather came out of workers' paychecks: It represents a \$6 million subsidy from workers to the shareholders of the companies that employ them. In general, then, it is a \$6 million transfer from the lower and middle classes to the rich.

Worse yet, this transfer of wealth to shareholders will also inflict a deadweight loss on society: the twenty firms that switched from weak to strong governance will not invest and thus will not employ 200 employees. The severity of the deadweight loss depends on the alternative employment of these employees. If 10 employees stay unemployed, the loss would be \$1 million ($10 \times \$100,000$). Alternatively, if all employees will find employment but with a \$10,000 lower annual salary, the deadweight loss would be \$2 million ($200 \times \$10,000$). That is, the cost of transferring \$6 million to shareholders includes an additional substantial deadweight loss.

Notably, common owners have expropriated value from the labor market without resorting to any collusion. Instead, the monopsony results from shareholders behaving as they otherwise would: firing disloyal managers, as they perceive them, and retaining loyal ones. However, because of the increased number of strong-governance firms, this everyday behavior results in underinvestment relative to a competitive market, and thus in lower wages.

By shifting value from the labor market to the capital market, common owners create a new, less efficient equilibrium.²⁴⁶ While the equilibrium determined by competitive markets maximizes social welfare,²⁴⁷ the new market order imposed by common owners diverges from the maximally efficient distribution. Thus, not only do common owners divert value from the labor market to the capital markets, but they do so at the cost of reducing aggregate social welfare in the economy at large.

Essentially, common owners have externalized some of their management agency costs to employees. Management agency costs are

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3762218 (finding that common ownership is forming in the private market to pose competition to the common ownership anticompetitive effects in the public market as “common ownership of startups tends to be higher in industries with higher common ownership among public firms”). Given the empirical findings that investment levels are still low, it is reasonable to assume that there are frictions in the private market that prevent this market from returning the economy to the competitive equilibrium.

²⁴⁶ See Goshen and Levit, *supra* note 22, at 19 (showing that “any deviation from the competitive allocation is socially inefficient”).

²⁴⁷ See *supra* note 232 and accompanying text.

minimized because fewer disloyal managers are investing in inefficient projects, and the loss from these inefficient projects is smaller, given the labor discount. Moreover, the efficient investments of the remaining loyal managers will be disproportionately profitable. However, what shareholders experience as management agency costs, workers experience as a boost to hiring and wages. By cutting these management agency costs, common owners have made the market work more efficiently for them—but less efficient for everyone else.²⁴⁸

E. Common Ownership Monopsony Compared to Other Explanations

Thus far, this Part has explained how common owners operate to create a labor monopsony and shift wealth from labor to capital. However, other explanations have certain explanatory power. This section examines some of the alternative explanations for macroeconomic trends such as wage stagnation and increased economic inequality and shows how common ownership either supplants or complements these alternatives.

1. Product Monopolies

Emerging literature attributes anticompetitive effects to common owners by suggesting that they influence *product markets* rather than labor markets.²⁴⁹ To be sure, this theory would also explain the declining investment and stagnant wages: By decreasing output in order to raise prices on products, common owners would also incidentally reduce investment, hiring, and wages. Monopsony and monopoly, after all, “are two sides of the same coin, and both harm labor and product markets.”²⁵⁰ Because common owners hold stakes in competing corporations, they could theoretically benefit by incentivizing their portfolio companies to raise consumer prices by not competing with one another.²⁵¹ For instance,

²⁴⁸ To add a note of absurdity, the common owners that create this monopsony effect are the same institutions that champion “ESG investments” (Environmental, Social, and Governance). It is hard to miss the irony in pushing ESG as a *unified strategy* across all corporations in order to mediate the harmful effects on workers and communities arising out of maximizing shareholder value. While the “ES” aspects are indeed a proper response to the problem—asking managers to consider the effects of their business decisions on the environment and the welfare and diversity of their employees—part of the “G”—namely, increasing managements’ responsiveness to shareholders—is the source of the problem, continuing to push toward restricting managerial freedom and bolstering the negative effects of the monopsony on the economy.

²⁴⁹ See Hemphill & Kahan, *supra* note 44, at 1401–08 (outlining the theories regarding the anticompetitive effects of common ownership and reviewing the evidence supporting them).

²⁵⁰ Naidu et al., *supra* note 143, at 559.

²⁵¹ See Hemphill & Kahan, *supra* note 44, at 1402–03 (describing how common owners stand to gain by discouraging portfolio companies from competing with one another).

economists have noted anticompetitive effects of common ownership on the prices of airline tickets.²⁵²

However, the monopoly theory faces a key limitation not shared by the monopsony theory: It requires common owners to take explicit or implicit steps to facilitate a monopoly in the product markets. In other words, the monopoly theory contends that household names, such as Blackrock and Vanguard, participate in an illegal conspiracy to raise prices. So far, scholars have not provided convincing evidence that such systematic anticompetitive behavior exists,²⁵³ and absent this evidence, it is difficult to believe those common owners could rig the product markets for four decades without attracting notice.

By contrast, the monopsony theory explains wage stagnation and income inequality without pointing to collusion. Rather, this Article contends that common owners create a labor monopsony by doing what they always do: pushing for strong governance and disciplining disloyal managers. In other words, strong governance is not the benefit of common ownership against which we must weigh the anticompetitive costs. Rather, the costs and benefits of common ownership are *both* generated by institutional investors' policy of pushing public corporations to adopt strong governance.

²⁵² See Azar et al., *Anticompetitive Effects*, *supra* note 13, at 1518. This study has been strongly challenged. See generally, e.g., Patrick Dennis et al., Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry (Jun. 26, 2020) (unpublished manuscript), https://ssrn.com/abstract_id=3063465; Hemphill & Kahan, *supra* note 44, at 1397. And for counterarguments to these challenges, see Einer Elhauge, *How Horizontal Shareholding Harms Our Economy—And Why Antitrust Law Can Fix It*, 10 HARV. BUS. L. REV. 207, 209–55 (2020).

²⁵³ See, e.g., Erik Gilje et al., *Who's Paying Attention? Measuring Common Ownership and Its Impact on Managerial Incentives*, 137 J. FIN. ECON. 152 (2020) (showing that properly measured, common ownership does not affect managers' incentives to consider employing anticompetitive devices); Hemphill & Kahan, *supra* note 44, at 1402–1403 (providing a comprehensive challenge and criticism of the studies suggesting anticompetitive behavior by common owners); Edward Rock & Daniel Rubinfeld, *Does Common Ownership Explain Higher Oligopolistic Profits?* (Eur. Corp. Governance Inst., Working Paper No. 528/2020, 2020), <https://ssrn.com/abstract=3627474> (criticizing the anticompetitive monopolies claim and offering alternative explanations for the data); John Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407 (2019) (explaining why large institutional investors cannot be activists); Thomas Lambert & Michael Sykuta, *The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms* (U. Mo. Sch. L., Legal Studs. Rsch. Paper No. 2018-21, 2018), <https://ssrn.com/abstract=3173787> (criticizing the studies claiming that common ownership leads to anticompetitive monopolies); Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L. J. 221 (2018) (criticizing the economic analysis and findings of the anticompetitive monopolies claim); Daniel P. O'Brien & Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less than We Think* (Feb. 22, 2017) (unpublished manuscript), https://ssrn.com/abstract_id=2922677 (“[T]he emerging research at present does not scientifically establish that an increase in common ownership involving minority shareholdings causes higher prices in the industries examined.”). For a conflicting view, see Einer Elhauge, *The Causal Mechanisms of Horizontal Shareholding*, 82 Ohio State L.J. (forthcoming 2021), <https://ssrn.com/abstract=3370675>.

Viewed in this light, it is clear that the monopsony effect does not share the monopoly theory's limitations. Common owners increase shareholder profits at the expense of other stakeholders not through illegal coordination in the pricing of products (output) but more plausibly through strong governance resulting in monopsony pricing of labor (input).

2. Shareholder Primacy

The shift to shareholder primacy has been blamed for increasing income inequality.²⁵⁴ The argument is that as managers started to maximize shareholders' value, they were doing so at the expense of other stakeholders, such as employees. Indeed, today "shareholders versus stakeholders" is at the center of academic debate, with many arguing in favor of shifting corporations back to maximizing stakeholders' value.²⁵⁵

While shareholder primacy was a contributing factor to the rise of strong governance,²⁵⁶ it cannot explain income inequality in itself. No amount of attention lavished on shareholders could transfer wealth away from other stakeholders in a competitive market. Where wages are determined by competition among rival employers, even the most zealous efforts by management could not lower those wages in the interest of enriching shareholders. Only by incapacitating the feedback loop between wages and corporate governance have common owners been able to transfer value from employees to shareholders. Shareholder primacy alone cannot explain these trends.

3. Classic Labor Monopsony

Commonly, the theory of labor monopsony focuses on firms' market power over labor—that is, on the relative bargaining power of firms versus employees and the factors affecting it.²⁵⁷ While this brand of explanation has some explanatory power, it does not conflict with the explanation offered by the common ownership monopsony theory.

i. Market Concentration—A firm's market power is commonly achieved through market concentration, either in a geographic area, a production technology, or the product market.²⁵⁸ When the employee's bargaining

²⁵⁴ See, e.g., Ezra Wasserman Mitchell, *Corporate Governance and Income Inequality: The Role of the Monitoring Board*, 3 BUS. & FIN. L. REV. 49 (2019); Matthew T. Bodie, *Income Inequality and Corporate Structure*, 45 STETSON L. REV. 69 (2015).

²⁵⁵ See, e.g., Lucian Bebchuk & Reberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. (forthcoming 2021), <https://ssrn.com/abstract=3544978> (presenting the stakeholders' arguments and rejecting them).

²⁵⁶ See *supra* section I.B.2.

²⁵⁷ See, e.g., Orley Ashenfelter et al., *Labor Market Monopsony*, 28 J. LABOR ECON. 203 (2010) (explaining the theories of labor market monopsony).

²⁵⁸ See, e.g., Azar et al., *Labor Market Concentration*, *supra* note 8 (finding geographic concentration in labor markets throughout the U.S.); Efraim Benmelech et al., *Strong*

power is low, the firm can offer a lower salary. For instance, imagine a geographic area where there used to be ten factories, and now there are only two.²⁵⁹ As the competition among factories over employees in an area decreases, so does the employee's bargaining power. Although this theory potentially explains wage stagnation and income inequality, studies increasingly challenge the empirical evidence of labor market concentration.²⁶⁰

By contrast, this Article contends that the monopsony is driven by shareholders' market power (common ownership). Thus, firms' market concentration (geographic or product) is unnecessary for the labor monopsony to work. Indeed, common ownership has the greatest effect of lowering investments in industries that are less concentrated at the firm level.²⁶¹

ii. De-unionization—Another source of firms' increased market power over employees is the de-unionization of the U.S. labor market. Collective bargaining increases employees' market power, allowing them to receive competitive salaries according to their productivity.²⁶² Moreover, strong unions also have a spillover effect on other nonunion firms, forcing them to increase wages as well. However, the percentage of employees represented by unions fell rapidly in the 1980s and continued to fall in the 1990s and the

Employers and Weak Employees: How Does Employer Concentration Affect Wages? (Nat'l Bureau Econ. Rsch., Working Paper No. 24307, 2018), <http://www.nber.org/papers/w24307> (exploring the sources of firms' market power over labor).

²⁵⁹ Thus, mergers have been a major focus as the driving force behind concentration that leads to labor monopsony. See, e.g., David Arnold, *Mergers and Acquisitions, Local Labor Market Concentration, and Worker Outcomes* (Jan. 13, 2020) (unpublished manuscript), <https://scholar.princeton.edu/sites/default/files/dharnold/files/jmp.pdf> (finding that mergers that increase concentration also decrease wages).

²⁶⁰ See, e.g., Brad Hershbein et al., *Concentration in U.S. Local Labor Markets: Evidence from Vacancy and Employment Data* 33 (Soc'y Econ. Dynamics, 2019 Meeting Papers No. 1336, 2019) https://economicdynamics.org/meetpapers/2019/paper_1336.pdf (finding that in the last decade, at most 5% of new U.S. jobs are in moderately concentrated local markets, and that local labor market concentration has decreased by at least 25% since 1976); Kevin Rinz, *Labor Market Concentration, Earnings Inequality, and Earnings Mobility* (Ctr. Admin. Recs. Rsch. & Applications, CARRA Working Paper Series 2018-10, 2018), <https://kevinrinz.github.io/concentration.pdf> (finding that local industrial concentration has generally been declining from 1976–2016); Esteban Rossi-Hansberg et al., *Diverging Trends in National and Local Concentration* (Fed. Rsrv. Bank Richmond, Working Paper Series 18-15R, 2018), <https://ssrn.com/abstract=3258967> (finding that labor market concentration is falling in the U.S. economy).

²⁶¹ See, Germán Gutiérrez & Thomas Philippon, *Ownership, Governance and Investment* 3 (March 2017) (unpublished manuscript), https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=AFA2018&paper_id=1448 (finding that common ownership has a substantial effect on industries that appear competitive according to traditional measures).

²⁶² See, e.g., Henry S. Farber et al., *Unions and Inequality over The Twentieth Century: New Evidence from Survey Data*, (Nat'l Bureau Econ. Rsch., Working Paper No. 24587, 2018), <http://www.nber.org/papers/w24587> (finding consistent evidence that unions reduce inequality).

early 2000s.²⁶³ The falling rate of unionization, and the decreased spillover effect that followed, have contributed to lower wages.

This theory's critics ascribe the decline in workers' power not to the de-unionization itself but to parallel trends that separately eroded the unions' bargaining power, such as global trade pressures, the shift to services, and ongoing technological change.²⁶⁴ In that vein, our theory can add another trend affecting the bargaining power during the same period. Powerful institutional investors shifting firms to strong governance and shareholder primacy changed labor negotiation dynamics—employers took a militant stance against unions and employees.²⁶⁵ Notably, this may be because the market is less competitive: When there are fewer investments, employees have less bargaining power in the first place.

iii. Globalization and Immigration—Employees' bargaining power also decreases when they compete with a greater number of other employees: The greater the number of employees (higher supply), the lower the wages. Competition with employees from other countries can take the form of either production moving to another country (globalization²⁶⁶) or employees moving to the U.S. (immigration²⁶⁷). While immigration cannot explain the decrease in investments and the lower percentage of employees working in public corporations, globalization can. However, a study of the causes of decreased investments assigned a low explanatory power to globalization.²⁶⁸ These trends may be a parallel cause of wage stagnation, along with common ownership.

iv. Technology—Technology affects labor in two related ways. First, it displaces some employees (via automation, robots).²⁶⁹ Second, it differentiates between employees—educated employees who can produce or operate technology (and get high salaries and equity) and employees who cannot (and get stagnant wages).²⁷⁰ Studies have found that technology can explain about a third of the effects on labor.²⁷¹ The common ownership monopsony theory aims to explain the other two-third.

In sum, while other theories may hold some purchase, common ownership monopsony greatly contributes to some of the more troubling

²⁶³ See, e.g., Mishel, *supra* note 5.

²⁶⁴ See *id.*

²⁶⁵ See *id.*; Stansbury & Summers, *supra* note 186 (defining the decrease in “worker power” as the product of de-unionization and changes in *corporate ownership*).

²⁶⁶ See, e.g., Jonathan Haskel et. al., *Globalization and U.S. Wages: Modifying Classic Theory to Explain Recent Facts*, 26 J. ECON. PERSPS. 119 (2012).

²⁶⁷ See George Borjas, *The Labor Demand Curve Is Downward Sloping: Reexamining the Impacts of Immigration on the Labor Market*, 118 Q. J. ECON. 1355 (2003).

²⁶⁸ See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11.

²⁶⁹ See, e.g., Acemoglu & Restrepo, *supra* note 9 (showing that automation may reduce employment and wages).

²⁷⁰ See, e.g., Lankisch et al., *supra* note 9 (finding that automation contributes to rising inequality).

²⁷¹ See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 11.

macroeconomic trends of this day and age. The detrimental effect of common ownership on labor markets and the economy requires a rethinking of how the law treats common owners and strong governance. The following Part begins to analyze the policy implications of the monopsony effect.

IV. REVERSING THE MONOPSONY EFFECT: BREAK UP BLACKROCK?

Given the inherent tradeoff of strong governance—reducing management agency costs while creating a labor monopsony—policymakers face a dilemma. Should they side with employees or shareholders? If shareholders’ interests are the primary concern, nothing should be done. Common owners’ power will continue to grow, and with it, the destructive effects of strong governance. If the interests of employees are the primary concern, however, policymakers should act.

To restore markets to their previous equilibrium—where shareholders have no market power and workers benefit from their increased productivity—policymakers must eliminate the monopsony effect by increasing the number of market players. Fragmenting the market reduces each individual player’s influence—thereby shifting the balance back toward weak governance and managerial freedom.²⁷² That is, to solve the problems caused by common ownership, the answer is to break up common owners.

At present, Congress to all appearances does not have the political will to break up institutional common owners, as institutional investors have effectively “captured” Congress through political spending. Since the 2008 financial crisis, institutional investors have drastically ramped up both their

²⁷² See, e.g., José Azar & Xavier Vives, *Oligopoly, Macroeconomic Performance, and Competition Policy* 4 (Dec. 18, 2018) (unpublished manuscript), https://ssrn.com/abstract_id=3177079 (“[I]ncreased market concentration—due either to fewer firms or to more common ownership—depresses the economy by reducing employment, output, real wages, and the labor share . . .”). A small but growing literature has begun to examine the effect of oligopolistic (and, by the same token, oligopsonistic) control of the capital markets. Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 *YALE L.J.* 2026, 2032 (2018). To be sure, however, the idea that concentration of ownership has negative economic effects still draws fierce criticism. See Douglas H. Ginsburg, *Why Common Ownership Is Not an Antitrust Problem*, *HARV. L. SCH. F. ON CORP. GOVERNANCE* (Dec. 4, 2018), <https://corpgov.law.harvard.edu/2018/12/04/why-common-ownership-is-not-an-antitrust-problem/> (“[T]he current empirical evidence that common ownership causes anticompetitive harm is limited and hotly disputed.”).

campaign contributions²⁷³ and lobbying expenditures,²⁷⁴ with a particular focus on members of congressional Finance Committees.²⁷⁵ In exchange, institutional investors seem to have bought themselves the servility of congressional decisionmakers, who have stood up for them against regulating agencies.²⁷⁶ It is therefore difficult to imagine that efforts to break up institutional investors would be successful.

Nevertheless, one can hope that with both parties' attention shifting to the hitherto neglected middle class, Congress can find common cause in arresting the decline of the American worker by breaking up common owners.²⁷⁷ This Article therefore presents the breakup alternative and its expected effects.²⁷⁸ Section A outlines the restriction on AUM in order to limit the monopsony effect. Section B shows how breaking up multitrillion-dollar asset managers will affect the relationship between shareholders and management, thereby increasing managerial freedom. Section C concludes that these changes would disrupt the monopsony effect by tipping the market away from strong governance and restoring the competitive equilibrium. Finally, section D will address counterarguments.

²⁷³ Compare Center for Responsive Politics, <https://www.opensecrets.org/industries/summary.php?ind=F07&recipdetail=A&sortorder=U&mem=Y&cycle=2006> (showing that institutional investors spent approximately \$49 million on campaign contributions in the 2006 election cycle) with Center for Responsive Politics, <https://www.opensecrets.org/industries/summary.php?ind=F07&recipdetail=A&sortorder=U&mem=Y&cycle=2012> (approximately \$102 million in the 2012 election cycle) and Center for Responsive Politics, <https://www.opensecrets.org/industries/summary.php?ind=F07&recipdetail=A&sortorder=U&mem=Y&cycle=2020> (approximately \$151 million in the 2020 election cycle).

²⁷⁴ See Center for Responsive Politics, <https://www.opensecrets.org/industries/lobbying.php?cycle=2006&ind=F07> (showing that institutional investors spent approximately \$64 million on lobbying efforts in 2006, compared with approximately \$104 million in 2010 and \$103 million in 2020).

²⁷⁵ See *BlackRock's Washington Playbook* 4–5, CAMPAIGN FOR ACCOUNTABILITY (Sept. 2019), <https://campaignforaccountability.org/work/blackrocks-washington-playbook> (“Unsurprisingly, BlackRock contributed most of its money to members of Congress who sat on committees with jurisdiction over the company.”)

²⁷⁶ See *id.* at 6–7 (recounting how two senators who had received large donations from BlackRock questioned Treasury Department officials about a report finding they were “by far the largest asset manager in the country,” which “represented a major threat to their business model”).

²⁷⁷ See, e.g., Susan Davis, *Top Republicans Work to Rebrand GOP as Party of Working Class*, NPR (Apr. 13, 2021), <https://www.npr.org/2021/04/13/986549868/top-republicans-work-to-rebrand-gop-as-party-of-working-class> (“The battle for the working class is even more urgent for the two parties because it’s a growing bloc of voters.”)

²⁷⁸ We are not the first to suggest that antitrust law could be applied to common owners. See, e.g., Elhauge, *Horizontal Shareholding*, *supra* note 65. However, this Article is the first to suggest capping assets under management as a solution to the ills of common ownership.

A. Break Up BlackRock?

The small group of common owners that control the vast majority of publicly traded corporations prevents any move toward weak governance—even though it would be profitable for individual firms. Capping the AUM that any one firm can manage would require the breakup of large common owners into smaller owners, limiting the extent to which they can influence the governance structure of portfolio firms. Corporations would have the freedom and incentive to shift back to weak-governance regimes, thereby disrupting the monopsony effect.

In other words, policymakers should limit common owners' power by reducing their size, as power is the crucial variable. For example, even under dispersed ownership—with millions of small, diversified shareholders—each diversified investor would benefit from increased returns resulting from the monopsony effect. However, such small shareholders do not have the power to push corporations to adopt strong governance. In other words, diversification creates the *incentive* to push for stronger governance, but it is *size* that provides the *power* to achieve it. Without that power, the monopsony effect is impossible.

Limiting the AUM of any one institution would force large asset managers to break up into smaller ones. For example, capping the AUM of asset managers at half-trillion dollars would require BlackRock—which holds almost eight trillion dollars in AUM²⁷⁹—to break up into fifteen different fund families and State Street, Fidelity, and Vanguard to split into an additional twenty-five fund families.²⁸⁰ With a smaller AUM, no single fund or group of funds could gain dominance over the entire market.²⁸¹ A fund might attain a common owner's status but could no longer act as the type of *powerful* common owner that has led to the monopsony effect.²⁸²

The particular amount at which to cap AUM should take into account the minimum size to achieve economies of scale in investing—an investigation beyond the scope of this Article.²⁸³ However, the fact that the

²⁷⁹ See *supra* note 62.

²⁸⁰ See *supra* note 62.

²⁸¹ The sum of all American public equities (all the companies listed on the New York Stock Exchange plus the NASDAQ and OQTQX Market) is valued at about \$35 trillion. *Total Market Value of the U.S. Stock Market*, SIBLIS RESEARCH, <https://siblisresearch.com/data/us-stock-market-value/> (last visited Sep. 18, 2020).

²⁸² Investors of a certain absolute size are mathematically able to capture significant shares in every *firm*, allowing them to influence governance decisions across the board. See *supra* section I.A. Hence, under a breakup, asset managers could become common owners but could not have the same influence over the whole market.

²⁸³ For a small cross-section of the scholarly discussion on this topic, see, e.g., Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 729 (2019); Patrick Jahnke, *Ownership Concentration and Institutional Investors' Governance Through Voice and Exit*, 21 BUS. & POL. 327, 335 (2019) Jill E. Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PENN. L. REV. 17, 26 (2019).

median AUM of the top 500 asset managers globally is below \$50 billion²⁸⁴ suggests that AUM does not need to be in the trillions to achieve economies of scale. For the sake of discussion, a half-a-trillion dollars is a convenient number—but clearly, as the cap decreases, the number of players in the stock markets increases.²⁸⁵ To maintain the same relative size over time, the AUM cap could also be indexed to the increases in the value of the stock market as a whole.²⁸⁶ While the appropriate cap needs further study, the monopsony effect demonstrates that over the last four decades, the balance has tipped toward *too few* powerful owners. Thus, moving toward *more, smaller* owners—as regulations have historically sought²⁸⁷—would reduce labor market monopsony.

Notably, capping the amount that an asset manager could hold *in any one industry or corporation* could achieve similar effects: Fund families would be prevented from holding huge stakes in competing businesses.²⁸⁸ Such a scheme would preclude common owners within industries, as well as across the entire market. However, capping the amount that institutions could hold in any one corporation or industry would be more disruptive than a global cap. Funds would be forced to sell off huge stock blocks to get below holding limits and diligently maintain their holdings within those limits forever after.²⁸⁹ This is a more complicated task than it seems: Since institutional investors are composed of multiple funds,²⁹⁰ assuming holding caps would apply to the entire institution, asset managers would have to dole out allowances to each fund and ensure the sum of their holdings do

²⁸⁴ BOB COLLIE ET AL., THINKING AHEAD INST., THE WORLD'S LARGEST 500 ASSET MANAGERS 11 (2019), https://www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2019/10/P_I_500_2019_Survey.

²⁸⁵ For instance, the breakup of AT&T in 1984 resulted in a number of smaller, leaner “Baby Bells” coming into existence. See George B. Shepherd et al., *Antitrust and Market Dominance*, 2001 THE ANTITRUST BULL. 835, 860.

²⁸⁶ For an explanation of the relationship between firm size and market concentration, see, e.g., Lina M. Khan & Sandeep Vaheesan, *Market Power and Inequality: The Antitrust Counterrevolution and Its Discontents*, 11 HARV. L. & POL'Y REV. 235, 266 (2017).

²⁸⁷ Roe, *supra* note 54, at 11 (explaining the historical dispersed ownership structure of US corporations as reflecting Americans mistrust of large powerful financial institutions and the political response of enacting rules restricting private accumulations of power by financial institution).

²⁸⁸ This proposal has most prominently been championed by Professors Eric Posner, Fiona Scott Morgan, and E.G. Weyl. See generally Eric A. Posner et al., *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017). Under their proposal, asset managers could hold at most 1% of the shares in any given industry or one company in each industry. *Id.* at 678.

²⁸⁹ For a review of the transaction costs on both the regulatory and the corporate ends of such a proposal, see Lambert & Sykuta, *supra* note 253, at 44–47. While Lambert and Sykuta's concerns that curtailing the influence of institutional investors would increase agency costs is addressed later, see *id.* at 49–50; *infra* section IV.D, they outline the extensive regulation that would go into a proposal like Posner et al.'s, Posner et al., *supra* note 288. Of course, with increased regulation comes increased compliance costs.

²⁹⁰ Hemphill and Kahan explain that any single institutional investor represents a multiplicity of groups and funds. See Hemphill & Kahan, *supra* note 44, at 1421–23.

not exceed the aggregate limits.²⁹¹ Moreover, such a proposal would unduly restrict strategies that institutional investors could use, for example, by preventing them from building large positions in companies or industries with perceived upside. Thus, capping the amount any asset manager could hold in any particular corporation or industry would create more transaction costs than simply capping the absolute amount of AUM of each asset manager.

B. The Impact of Breakup on Common Ownership

The monopsony effect arises not because common owners are diversified but because they can impose their governance agenda on essentially the entire market, impacting the balance of strong- and weak-governance companies.²⁹² A larger group of smaller investors would not have the power to assert similar dominance over the corporate sector. Particularly, smaller asset managers operating under an asset cap could not generate a monopsony effect for at least three reasons: (1) They would lack the incentives to participate in corporate democracy directly; (2) activist investors would face greater transaction costs in pushing for strong governance; and (3) directors would be free to act independently without worrying about the “800-pound gorilla” of institutional-investor voice.

1. Incentive to Vote

A shareholder’s incentive to vote depends on the expected value of voting: the expected benefit of a successful vote minus the cost of being informed about voting options.²⁹³ Because of fixed information costs, smaller asset managers would have less incentive to participate in corporate voting than larger asset managers.²⁹⁴ For small asset managers, the upside of a value-maximizing vote on their rather minute proportion of the corporation does not justify the fixed cost of becoming informed about that vote.²⁹⁵ It may make sense for a family of index funds with cumulative

²⁹¹ In order for any of the funds to increase its stake in one industry, another fund would have to sell some of its holding, requiring an extensive amount of coordination between large number of funds. For instance, BlackRock maintained 927 funds. *Investment Funds*, BLACKROCK, <https://www.blackrock.com/sg/en/products/products-list> (last visited June 15, 2020).

²⁹² See *supra* section III.D.

²⁹³ Michael C. Schouten, *The Mechanisms of Voting Efficiency*, 2010 COLUM. BUS. L. REV. 763, 773 (2010) (“[S]hareholders need to have at least some information to ensure that they are more likely to be right than wrong.”).

²⁹⁴ Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 536 n.19 (2018) (“[R]esearch that adds value is expensive and its fixed cost is best spread across large portfolios. These insights were a boon to the mutual funds and index funds offered by institutional investors.”).

²⁹⁵ John C. Coffee Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (analyzing the incentives to vote); Michael S. Kang, *Shareholder Voting as Veto*, 88 IND. L.J. 1299, 1300 (2013) (“Information is costly, but the

assets in the trillions to invest in the human resources and technology to make informed decisions because the bump in portfolio value (and thus management fees) exceeds the cost of becoming informed.²⁹⁶ The sheer size of their holdings—and the associated upside potential of voting in a way that increases corporate value²⁹⁷—makes participating in corporate governance worthwhile.²⁹⁸ This explains why “passive” asset managers do, in fact, actively participate in the affairs of their portfolio companies.²⁹⁹ Following a breakup, then, smaller asset managers would no longer have the same incentives to participate in corporate governance, and common owners’ effect on the labor monopsony would thus diminish.

2. Increased Transaction Costs for Proxy Fights

Increasing the number of asset managers would also make it more difficult for activist investors to build the coalitions necessary to wage proxy campaigns, limiting one of the central tools common owners use to restrict managerial freedom. Instead of working with the same few repeat players in every proxy fight, activists would have to engage many more shareholders³⁰⁰ and win over a much larger cadre of investors.³⁰¹ A larger

returns to the individual shareholder for improving corporate performance are distributed pro rata, such that shareholders rarely have individual economic incentive to engage more than casually on questions of corporate management.”).

²⁹⁶ Chester S. Spatt, *Proxy Advisory Firms, Governance, Failure, and Regulation*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 25, 2019), <https://corpgov.law.harvard.edu/2019/06/25/proxy-advisory-firms-governance-failure-and-regulation/> (noting that “asset managers and proxy advisory firms benefit from considerable economies of scale as information production and decision-making scale upward with relatively little additional cost”).

²⁹⁷ See, Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* 12-13 (N.Y.U. Sch. of L., L. & Econ Working Paper No. 18-39, 2019), https://ecgi.global/sites/default/files/working_papers/documents/finalkahanrock.pdf

²⁹⁸ Rock and Kahan point out that there are at least two reasons why larger asset managers have incentives to govern that smaller ones do not: First, a large common owner is much more likely than almost any other shareholder to be able to swing a corporate election (higher probability of a successful vote). Second, common owners are the largest beneficiaries of any stock price increase, giving them a concrete reason to exercise their influence (higher upside of

), <https://promarket.org/2019/01/07/greatest-anticompetitive-threat-horizontal-shareholding>.

³⁰⁰ See generally, John C. Coffee, Jr. *The Agency Cost of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* (Eur. Corp. Governance Inst., ECGI Working Paper Series in L. No. 373/2017, 2017), https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=3058&context=faculty_scholarship (outlining the relationship between activist hedge funds and “permanent shareholders”—BlackRock, Vanguard, and StateStreet).

³⁰¹ John Armour & Brian Cheffins, *The Rise and Fall (?) of Shareholder Activism by Hedge Funds* (Eur. Corp. Governance Inst., Working Paper Series in L. No. 136/2009, 2009), https://ssrn.com/abstract_id=1489336 (describing the “various types of transaction costs” that arise from an activist bid, including “communication costs,” or the costs of communicating with shareholders).

number of investors presents not only a challenge in terms of time, energy, and communication costs but also a strategic difficulty in forming a coalition.³⁰² The larger the number of asset managers, the greater the possible divergence of opinions among them as to both the appropriate governance structure and the quality of investments undertaken by managers.³⁰³ A larger number of investors with differing opinions will also allow managers to counteract activists by persuading a substantial number of shareholders to support management over the activist.³⁰⁴ Consequently, even in corporations with strong governance, the probability of mistakenly firing loyal managers will decrease.³⁰⁵

3. *The 800-Pound Gorilla*

Controlling shareholders have been colorfully described as an 800-pound gorilla—their will may be ignored only at one’s peril.³⁰⁶ Although the Big Three institutional investors rarely exert outright control, together, they are the largest shareholder in 90% of the S&P 500.³⁰⁷ Breaking up the largest asset managers would go a long way toward sidelining the stock markets’ King Kong,³⁰⁸ allowing directors to exercise greater independence in investing and hiring.

³⁰² See Kahn & Vaheesan, *supra* note 286, at 266 (“In short, concentration increases the likelihood that actors will share interests and decreases the costs of organizing to advocate for their agenda.”).

³⁰³ See Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 B.Y.U. L. REV. 1015, 1019 (2015) (observing that widespread shareholder activism is possible only because the rise of institutional investors have reduced collective action problems in assembling a winning coalition); Amir N. Licht, *Corporate Governance*, in HANDBOOK OF KEY GLOBAL FINANCIAL MARKETS, INSTITUTIONS, AND INFRASTRUCTURE 369, 375 (Gerard Caprio, Jr. et al. eds., 2012) (noting that in dispersed-ownership firms, “[m]ounting a proxy fight to promote a proposal not sponsored by the board is a cumbersome, expensive exercise that may be reserved for special occasions”).

³⁰⁴ DELOITTE, *ACTIVIST SHAREHOLDERS: HOW WILL YOU RESPOND?* 3 (2015), <https://www2.deloitte.com/us/en/pages/finance/articles/cfo-insights-shareholder-investor-activism.html> (encouraging management to fend off activists by “proactively engaging with investors,” and especially with “major shareholders, who can be cornerstones of an activist defense”).

³⁰⁵ So, too, will the probability of correctly firing disloyal managers.

³⁰⁶ Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 509 (2002) (describing the controlling shareholder as “an 800-pound gorilla [that] wants the rest of the bananas”).

³⁰⁷ See Fichtner, *supra* note 14, at 313.

³⁰⁸ See Kara Haar, *King Kong Through the Years: How the Giant Gorilla Has Evolved Since 1933*, THE HOLLYWOOD REPORTER (Mar. 9, 2017), <https://www.hollywoodreporter.com/lists/king-kong-years-how-giant-gorilla-has-evolved-1933-982360/item/king-kong-1933-983416> (explaining that King Kong is a gargantuan gorilla who has wreaked cinematic havoc for nearly nine decades).

For example, a director would be unlikely to defy BlackRock without fear of reprisal. That same director might also serve as a director³⁰⁹ or executive³¹⁰ at another firm where BlackRock holds a large stake. Now, multiply that effect threefold if *all* the Big Three oppose a move. Directors with career and reputation concerns cannot risk their relationship with the Big Three or other major asset managers because these same key investors wield influence throughout the corporate sector.³¹¹ Disappointing a controlling shareholder may lead to dismissal from a single board, but a run-in with a giant institutional investor could have more far-reaching consequences.³¹² A smaller asset manager does not create the same career and reputation risks.³¹³ As such, breaking up the largest institutional investors would allay director concerns and allow them to act independently and according to their best judgment, without significant fear of reprisal.

Together, these effects explain why a smaller asset manager lacks the means and incentive to influence corporate governance in the same way that mega-managers such as BlackRock and Vanguard do. The sum of a smaller set of large voices is *greater than* the sum of a larger set of small ones. In short, following a breakup, common owners would no longer have the ability to impact corporate governance to the extent of creating a monopsony effect.

C. The Monopsony Model Revisited

The monopsony model above demonstrates how common owners push the corporate governance balance away from its equilibrium, resulting

³⁰⁹ In 2019, most S&P 500 independent directors sat on more than one board, with 33% sitting on three or more. SPENCER STUART, 2019 U.S. SPENCER STUART BOARD INDEX 17, https://www.spencerstuart.com/-/media/2019/ssbi-2019/us_board_index_2019.pdf.

³¹⁰ A large proportion (41%) of CEOs sit on boards outside their own companies. *Id.* at 22.

³¹¹ This argument is a variation of the same argument that applies to *managers*. See *supra* section II.A.1. Of course, if directors had no career or reputational concern, this would be a non-issue.

³¹² See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1488 (2007) (arguing that directorial independence is limited by the career concerns of directors); see also Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 983 n.60 (2019) (noting that directors' career concerns are magnified because "they are likely to meet the same money managers at other public companies").

³¹³ For instance, industry leaders devote time to decoding Blackrock CEO and Chairperson Larry Fink's famous annual letter. See Larry Fink, *A Fundamental Reshaping of Finance*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter> (last visited Sep. 18, 2020); Dan Pontefract, *Decoding BlackRock Chairman Larry Fink's Letter To CEOs On The Importance Of Purpose*, FORBES, <https://www.forbes.com/sites/danpontefract/2019/01/26/decoding-blackrock-chairman-larry-finks-letter-to-ceos-on-the-importance-of-purpose/#749bf2aa2995>. There would be no great need to decode, analyze, and ultimately act on the annual letter of an asset manager one-fifteenth the size.

in a disproportionate number of strong-governance firms.³¹⁴ After a mandated breakup, common owners would no longer have the same power to influence governance decisions *en masse*. Their ability to create a monopsony effect would be impaired or disrupted altogether. As such, after a mandated breakup, investments would rise, stimulating hiring and pushing labor prices back to equilibrium.

Consider again the model introduced above, where, due to the influence of common owners, wages are \$20,000 below equilibrium.³¹⁵ Employees earn \$80,000 a year despite producing marginal revenue of \$100,000. From an equilibrium of fifty-fifty strong and weak-governance firms, common owners have created a market of seventy strong-governance firms and thirty weak-governance firms. Previously, common owners opposed any attempt to move corporations back toward weak governance, resulting in higher returns to their portfolios due to below-market wages.³¹⁶

Now, however, suppose a mandated breakup has sidelined those common owners. Firms are once again free to make governance decisions that maximize profits. In order to benefit from the \$20,000 marginal profit from each employee hired, some of the strong-governance firms will switch to weak governance so that managers will be empowered to hire up workers and generate abnormal returns.³¹⁷ As more and more firms switch to weak governance, wages will rise until they equal the marginal revenue of each new hire.³¹⁸ That is, wages will climb back to \$100,000. Moreover, as productivity increases over time, so too will wages, eliminating the monopsony effect in the long run.

A mandated breakup would disrupt the central mechanism of the monopsony effect. Capping AUM and separating passive and active investing would restore competition to the labor market and balance to the corporate governance. Thus, breaking up large asset managers is a significant step policymakers could take to eliminate the monopsony effect and return wages to their competitive levels.

D. Breakup, Agency Costs, and Inequality

The breakup proposal goes against the view of agency-costs essentialists that strong governance is an unmitigated good.³¹⁹ This Article

³¹⁴ See *supra* section III.D.

³¹⁵ See *supra* section III.D.

³¹⁶ See *supra* notes 242–244 and accompanying text.

³¹⁷ See *supra* section III.B.

³¹⁸ Under classical economic competitive conditions wages are said to track productivity. Roy J. Rotheim, *Keynes and the Marginalist Theory of Distribution*, 355 J. POST KEYNESIAN ECON. 356–57 (1998) (describing the “orthodox theory of distribution” where the “factors of production receive unique rewards equal to the value of their respective marginal products”).

³¹⁹ See Goshen & Squire, *supra* note 23, at 775 (describing agency-cost essentialism as the belief that “the reduction of agency costs is the essential role of corporate law and of related fields such as securities regulation”).

advocates for breaking up major asset managers for precisely the reasons that other scholars have lauded their interventions. To take one example, scholars have praised institutional investors for providing support for activist hedge funds to implement cost-saving and shareholder-empowering measures.³²⁰ Meanwhile, this Article views the “one-two punch” of common owners and activists as a threat to competitive labor markets, as it leaves directors and managers less willing to invest in hiring workers.

The key to allaying these concerns is the realization that while agents introduce costs, so too do principals. Empowering agents increases agent costs while empowering principals results in principal costs.³²¹ For the past several decades, scholars have focused on how to ameliorate agent costs by empowering principals—that is, how to police corporate malfeasance by empowering shareholders to hold disloyal managers accountable.³²² This Article argues that the fight against agent costs has neglected to consider the principal costs it inflicts in the form of a labor-market monopsony.

To be sure, a return to a more dispersed ownership world would mean greater management agency costs. If activist investors are hamstrung in their ability to wage proxy fights against disloyal managers, more inefficient investments would follow. However, there would also be fewer downsizings,³²³ fewer mass layoffs,³²⁴ and fewer managers *mistakenly* fired for being disloyal.³²⁵ Managers, loyal or disloyal, would be freer to invest in aggregate. Indeed, shareholders would suffer a loss from more inefficient investments by disloyal managers, but shareholders would only be losing the value previously taken from employees.³²⁶ The result would not be a windfall to employees but rather a return to a more efficient and equitable balance between labor and capital.³²⁷

³²⁰ For example, Gilson and Gordon describe activist investors as “governance arbitrageurs” who work alongside institutional investors in the service of “maximizing performance.” Gilson & Gordon, *supra* note 46, at 898–97.

³²¹ Goshen & Squire, *supra* note 23, at 771 (“Principal costs and agent costs are substitutes for each other: Any reallocation of control rights between investors and managers decreases one type of cost but increases the other.”).

³²² See, John Armour et al., *What Is Corporate Law?*, in *THE ANATOMY OF CORPORATE LAW* 1, 2 (Reinier Kraakman et al. eds., 2d ed. 2009)).

³²³ See Lazonick, *supra* note 155 (arguing that the new mantra of activist hedge funds has become “downsize and divest”).

³²⁴ See Brav, *supra* note 201, at 2764 (finding that employees at target firms experience hour cuts and stagnating wages). Mariah Summers, *Employees Often End Up the Losers In Activist Investing Campaigns*, BUZZFEED NEWS (Apr. 21, 2014), <https://www.buzzfeednews.com/article/mariahsummers/employees-often-end-up-the-losers-in-activist-investing-camp>.

³²⁵ See *supra* notes 157–159 and accompanying text.

³²⁶ See *supra* notes 234–236 and accompanying text.

³²⁷ See *supra* section III.C (arguing that the competitive distribution of wealth between labor and capital maximizes social welfare).

In short, agent costs have fallen *too much*, and principal costs have increased too much. In a competitive equilibrium, investors bear some *efficient* level of *inefficient* investments due to agent costs.³²⁸ Under the present equilibrium, those agent costs are *too low*, coming at the expense of lower wages. The claim that muffling institutional voices would increase management agency costs is correct, but it misses the point. Indeed, smaller, weaker asset managers would be less able to promote shareholders' interest in minimizing agent costs. But other interests—particularly those of employees—would be better served, as would the interests of the market as a whole.

CONCLUSION

In addition to explaining macroeconomic trends like wage stagnation and growing income inequality, the monopsony effect of common ownership challenges the conventional wisdom in corporate law scholarship that strong governance is a net economic good. This Article identified the long-suspected—but until now, elusive—anticompetitive implications of common ownership and strong governance. While strong governance reduces management agency costs, it simultaneously discourages investment and hiring. Common ownership brings about a new and less efficient equilibrium, with higher corporate profits, lower wages, and increased income inequality. The inherent tradeoff of strong governance suggests that policymakers must choose between siding with shareholders or employees. If they choose employees, policymakers should consider breaking up common owners. Only by breaking the hold common owners have on the equity markets can policymakers restore wages to their competitive equilibrium.

³²⁸ See *supra* note 235 and accompanying text.

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