Union Activism: Do Union Pension Funds Act Solely in the Interest of Beneficiaries?

By David F. Larcker and Brian Tayan
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THE FIDUCIARY DUTIES OF PENSION FUNDS

Union pension funds manage retirement assets on behalf of public and private sector employees covered by collective bargaining agreement. Examples of union pension funds include the American Federation of State, County, and Municipal Employees (AFSCME), the California Public Employees' Retirement System (CalPERS), and the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). Collectively, union pension funds oversee approximately \$3.5 trillion in investment assets in the United States.[1]

The investment assets of union pension funds are held in trust, with the management of these funds overseen by a board of trustees or administration. The federal and state laws that govern the management of these funds stipulate that "the primary responsibility of fiduciaries is to run the plan solely in the interest of participants and beneficiaries."[2]

Pension plan administrators fulfill their fiduciary duties in multiple ways. One is by maintaining a prudent investment strategy that seeks an appropriate return while minimizing the risk of large loss. A second is by exercising the voting rights associated with a fund's shareholdings in a way that furthers the economic interests of plan beneficiaries. This includes not only specific voting decisions that a plan administrator makes with regard to shares owned by the trust, but also the decision whether to sponsor a shareholder proposal for inclusion on a company's proxy. For example, in a 1997 commentary letter to the Securities and Exchange Commission (SEC), CalPERS explains that:

> *Pursuant to the California Constitution, in making and managing investments CalPERS' Board must meet a "prudent expert" fiduciary standard that is comparable to that imposed upon trustees of private pension plans governed by the Employee Retirement Income Security Act of 1974. This standard governs both our investment decisions and the exercise of our voting rights for equity securities. Generally, we consider these voting rights to include not only the execution of proxies solicited from us, but also our rights under [SEC] Rule 14a-8 to sponsor shareholder proposals. In other words, the right to present shareholder proposals to our fellow shareholders is, we believe, subject to the same fiduciary responsibilities as our other plan assets. This conviction has led CalPERS to be an active participant in what has been characterized as the "corporate governance movement" for over 10 years.*[3]

Recent history demonstrates the active role that CalPERS and other union pension funds take in the governance process. According to Proxy Monitor, union pension funds are the second most active sponsors of shareholder proposals, introducing 33 percent of shareholder proposals between 2006 and 2012. By comparison, individual investors sponsored 41 percent of proposals during this period, religious and socially responsible investment funds 25 percent, and other institutional investors (such as Fidelity and Vanguard) only 1 percent.[4] Union-sponsored shareholder proposals are typically initiated using general funds accumulated through union dues and other sources rather than pension assets.

Most pension funds do not publish a policy that outlines the specific criteria used to determine which governance proposals are put forward and which companies are targeted.[5] For example, while the AFL-CIO devotes extensive effort detailing how it votes on proposals put forward by management and other shareholders, it states simply that its own "shareholder activism can have a significant positive impact" and that "trustees should make sure that when taking ownership actions—such as introducing corporate resolutions and pursuing proxy campaigns—they thoroughly analyze and decide on their policy positions in accordance with ERISA."[6] The AFL-CIO also states that "the union status of a company's employees is not a factor in proxy voting by the AFL-CIO."[7]

AFL-CIO ACTIVISM

Historically, the AFL-CIO has been an active sponsor of shareholder proposals, although the proposals that it brings forward are generally not supported by its fellow shareholders. For example, between 1998 and 2011, the AFL-CIO filed a total of 320 shareholder resolutions. Many of these were either withdrawn or omitted. 165 came to a vote. Of those voted, only 26 (16 percent) received majority support. The average level of support across all proposals was only 28 percent.[8]

AFL-CIO proxy proposals commonly involve issues of executive compensation, board representation, corporate responsibility, and social issues. While these are topics of interest to most shareholders in general, the positions that the AFL-CIO specifically advocates often are not. Among 19 subcategories of governance proposals issued by the AFL-CIO, only three received majority support on average: requirements to repeal classified boards, requirements to expense stock options, and limits on golden parachute severance payments. Social issues and issues of corporate responsibility received the lowest support. For example, a proposal that companies advocate on behalf of U.S. healthcare reform in 2009 received only 5.5 percent support among the 18 companies where the proposal was filed (see Exhibit 1).

Furthermore, many of the issues advocated by the AFL-CIO are not supported by the research literature. For example, the AFL-CIO filed 13 proposals requiring companies to separate the chairman and CEO positions, even though the research literature shows no conclusive evidence of the economic benefits of this decision.[9] Similarly, the AFL-CIO filed proposals to discontinue entirely the use of stock options at three companies (American Express, Baker Hughes, and Wells Fargo), even though there is evidence that shows that stock options provide important incentives for long-term investment and value creation (see Exhibit 2).[10]

Finally, while there is no discernible pattern in the companies that the AFL-CIO chooses to target, the pension fund frequently sponsors proposals among large, prominent corporations rather than small corporations. This suggests that it might seek to make examples of its targets, rather than reform the most egregious practices among all of its portfolio companies. Furthermore, AFL-CIO actively files shareholder proposals against companies whose workforces it is trying to organize. For example, between 2004 and 2011, it filed six proposals at Comcast, a company targeted by the International Brotherhood of Electrical Workers (an affiliate of the AFL-CIO).[11] Similarly, the AFL-CIO filed 11 proposals at largely non-union Wal-Mart and Target, while filing only three at unionized grocery store chains Safeway and Kroger.[12]

RESEARCH AND COMMENTARY

Empirical research suggests that union fund activism might not be value-increasing and, indeed, might be value-destroying. Woidtke (2002) finds that companies with large ownership by public pension funds have lower valuations than companies with large ownership by private corporate pension funds. She notes that the valuation discount is more pronounced when the public pension fund is an activist focusing "on social or 'poor' corporate governance issues." She interprets these results as "consistent with the view that these administrators' actions may be motivated more by political or social influences than by firm performance."[13]

Barber (2007) studies companies that were the target of CalPERS activism between 1992 and 2005. He finds no discernible impact (positive or negative) on long-term performance as a result of their activism.[14] In a controversial study, Agrawal (2011) examines the voting record of the AFL-CIO between 2003 and 2006. He finds that the union is significantly more likely to vote against directors at companies that are in the middle of a labor dispute, particularly when the AFL-CIO represents the workers. He concludes that the union does not make voting decisions from a purely shareholder-centric perspective but instead "oppose[s] directors partly as a means of supporting union workers who face opposition from management during collective bargaining and union recruiting effort."[15]

Some labor advocates defend an activist approach. One commentator recently wrote in *The Washington Post*:

> *Ironically, the one arena in which unions have made some headway this year is shareholder capitalism: By using the voting power of their pension funds, and by organizing shareholder opposition to excessive executive pay and corporate political donations, unions have begun to restore a modicum of accountability for out-of-control business leaders… Shareholders' rights—aggregated through the investments of their retirement funds—remain one of the few ways in which popular power can be expressed. It's a tortuously indirect, largely inadequate and rather ludicrous way for workers to assert their interests, but at a time when democracy in the workplace and polling place has been diminished, it's what they have left.*[16]

Still, the U.S. Department of Labor is clear that using a pension's ownership position in a firm for advocacy purposes is a violation of ERISA. A 2008 guidance letter states that:

> *In creating an investment policy, a fiduciary shall consider only factors that relate to the economic interest of participants and their beneficiaries in plan assets, and shall not use an investment policy to promote myriad public policy preferences… Plan fiduciaries risk violating the exclusive purpose rule when they exercise their fiduciary authority in an attempt to further legislative, regulatory or public policy issues through the proxy process… The mere fact that plans are shareholders in the corporations in which they invest does not itself provide a rationale for a fiduciary to spend plan assets to pursue, support, or oppose such proxy proposals. Because of the heightened potential for abuse in such cases, the fiduciaries must be prepared to articulate a clear basis for concluding that the proxy vote, the investment policy, or the activity intended to monitor or influence the management of the corporation is more likely than not to enhance the economic value of the plan's investment before expending plan assets.*[17]

In a related analysis of proxy voting, a 2011 report by the Department of Labor Office of Inspector General finds that these standards are generally not being upheld. It cites numerous examples of proxy voting among pension funds where "the economic benefits… are not apparent and neither the investment managers nor fiduciaries could provide documented economic rationale for the proxy-voting decisions." It concludes that, "it is questionable whether the fiduciary or investment manager making the proxy-voting decision complied with EBSA requirements to consider only the economic benefits to the plan when making proxy-voting decisions." It recommends that the labor department have the authority to assess monetary penalties against fiduciaries for failing to comply with the proxy-voting requirements of ERISA.[18]

WHY THIS MATTERS

1. Shareholder activism is an important mechanism for imposing market discipline on the decisions of corporate executives and directors, and union pension funds take an active role in this process. Are union-sponsored proposals made solely in the interest of their pension beneficiaries? Or are they used to further social and political priorities that are important to union leadership? How can the general public or a pension beneficiary assess the motives of funds that sponsor proxy proposals?
2. How do union pension funds determine which positions to advocate and which companies to target? How do they respond and adjust their future strategy after receiving very low shareholder

support for a proposal?

3. Research evidence suggests that the proposals sponsored by the AFL-CIO and other pension programs are at best value neutral, and might even be value destroying. Are unions violating their ERISA duties by sponsoring these proposals?
4. The AFL-CIO believes that shareholder sponsored proposals "encourage and facilitate dialogue between shareholder and companies." In a written response to this Closer Look, they point out that while some of their proposals receive low support, others demonstrate growing support grow over time. In some cases, AFL-CIO recommendations are adopted by regulators and legislators as required practices. Does this indicate that AFL-CIO proposals might be forward looking best practices? Read the AFL-CIO's full response to this Closer Look here. ■

[1] Comprised of $2.31 trillion public pension fund assets, $890 billion single-employer pension fund assets, and $340 billion multiemployer pension fund assets. Sources: Pew Center of the States, "The Widening Gap Update," (June 2012); and Diana Furchtgott-Roth and Andrew Brown, "Comparing Union-Sponsored and Private Pension Plans: How Safe Are Workers' Retirements?" Hudson Institute (Sep. 2009).

[2] The fiduciary duties of private employer plans are dictated by federal law, specifically the Employee Retirement Income Security Act of 1974 (ERISA). The duties of public sector plans are dictated by state law, which contains similar protections to ERISA. The preceding quote is from ERISA. See: U.S. Department of Labor, "Frequently Asked Questions about Pension Plans and ERISA" (2012).

[3] Rule 14a-8 specifies the conditions and process by which a shareholder is allowed sponsor proposals for inclusion in the annual proxy. Source: "CalPERS Comments on SEC Amendments to Rules on Shareholder Proposals," Letter to the SEC (Nov. 10, 1997), Available at: http://corpgo.fatcow.com/calpers/CalPERS14a-8comments.html.

[4] Sample includes Fortune 200 companies. The statistics on individual sponsorship are somewhat misleading: 26 percent were sponsored by only three individual investors and their relatives and families (i.e., a small group of "corporate gadflies") while 15 percent were sponsored by other individuals. See: James R. Copland, Yevgeniy Feyman and Margaret O'Keefe, "A Report on Corporate Governance and Shareholder Activism," Proxy Monitor (2012).

[5] Pension funds do issue proxy voting guidelines that explains their general position on various corporate governance issues.

[6] AFL-CIO Proxy Voting Guidelines (2012).

[7] Facts about the AFL-CIO's Proxy Votes (2012).

[8] Compilation by the authors. Data from Investor Responsibility Research Center (IRRC), accessed through Wharton Research Data Services (WRDS).

[9] See: B. Ram Baliga, R. Charles Moyer, and Ramesh S. Rao, "CEO Duality and Firm Performance: What's the Fuss?" *Strategic Management Journal* (1996); Brian K. Boyd, "CEO Duality and Firm Performance: A Contingency Model," *Strategic Management Journal* (1995); Yaniv Grinstein and Yearim Valles Arellano, "Separating the CEO from the Chairman Position: Determinants and Changes after the New Corporate Governance Regulation," available at: http://ssrn.com/abstract=1108368; and James A. Brickley, Jeffrey L. Coles, and Gregg A. Jarrell, "Corporate Leadership Structure: On the Separation of the Positions of CEO and Chairman of the Board," Simon School of Business working paper FR 95-02 (1994).

[10] See: Michelle Hanlon, Shivaram Rajgopal, and Terry Shevlin, "Are Executive Stock Options Associated with Future Earnings?" *Journal of Accounting & Economics* (2003); and Shivaram Rajgopal and Terry Shevlin, "Empirical Evidence on the Relationship Between Stock Option Compensation and Risk Taking," *Journal of Accounting & Economics* (2002).

[11] One of these six was omitted and five came to a vote. The six proposals covered issues including board independence, independent chairman, majority voting standards, and granting shareholders the right to vote on executive death benefits.

[12] Seven of these eleven were omitted and four came to a vote. The 11 proposals covered issues including majority voting in director elections, performance-based vesting of equity awards, clawbacks on executive compensation, restrictions on deferred compensation, whether the companies should report on their efforts to stop global warming, and whether they should advocate for health care reform.

[13] "Poor" corporate governance proposals are not clearly defined but include "board- and compensation-related proposals" with very low voter support. Tracie Woidtke, "Agents Watching Agents?: Evidence from Pension Fund Ownership and Firm Value," *Journal of Financial Economics* (2002).

[14] Brad M. Barber, "Monitoring the Monitor: Evaluating CalPERS' Activism," *Journal of Investing* (2007).

[15] The AFL-CIO quested the validity of Agrawal's results, calling them "very serious and completely false." Agrawal's thesis advisor defended the results, saying that "The union voting behavior that Mr. Agrawal's analysis reports is more consistent with union self-interest than with shareholder value maximization. While any such behavior cannot be proved beyond a shadow of a doubt, the results are very statistically significant." See: Ashwini K. Agrawal, "Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting," *Review of Financial Studies*, (Forthcoming), NYU Stern Working Paper Series (2011). Available at SSRN: http://ssrn.com/abstract=1285084; Daniel F. Pedrotty, "AFL-CIO Proxy Voting," Harvard Law School Forum on Corporate Governance and Financial Regulation, posted Mar. 11, 2008 at 12:08 pm; and Steven Kaplan, "Responses for AFL-CIO's Critique of the Agrawal Study," Harvard Law School Forum on Corporate Governance and Financial Regulation, posted Mar. 18, 2008 at 1:13 pm.

[16] Harold Meyerson, "Unions Wield New Powers as Shareholders," *The Washington Post*, June 4, 2012.

[17] U.S. Department of Labor, "Interpretive Bulletin Relating to Exercise of Shareholder Rights", October 17, 2008.

[18] EBSA stands for Employee Benefits Administration. EBSA is part of the U.S. Department of Labor and responsible for enforcing the fiduciary provisions of ERISA. See: U.S. Department of Labor, Office of Inspector General, "Proxy-Voting May Not Be Solely for The Economic Benefit of Retirement Plans," (March 31, 2011).

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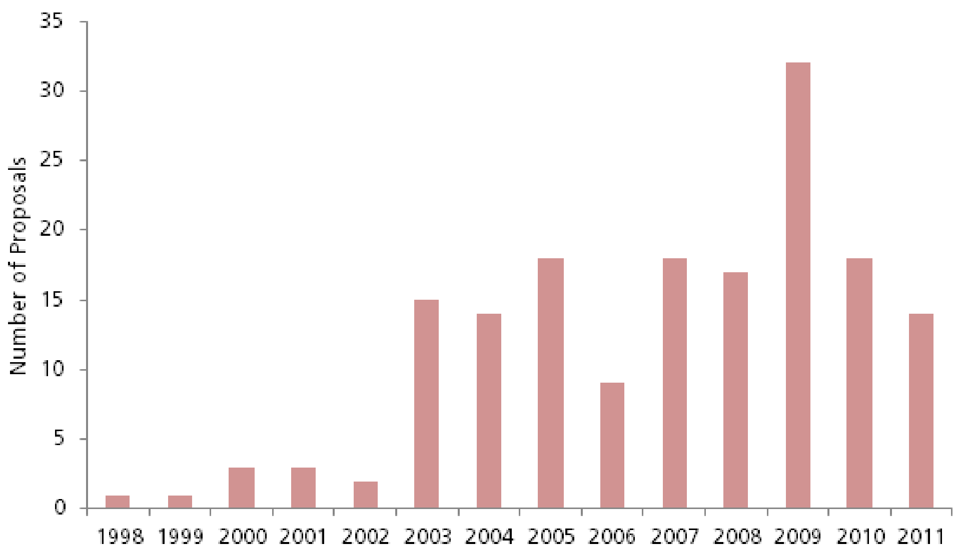
EXHIBIT 1 — SHAREHOLDER PROPOSALS SPONSORED BY THE AFL-CIO (1998-2011)

Summary Statistics (1998-2011)	
Total Proposals Filed by AFL-CIO	320
Withdrawn by AFL-CIO	102
Omitted / Not Filed or Presented	53
Total Proposals Voted	165
Average Support Received	28.3%
Average Dissent or Abstention	71.7%
Number Receiving Majority Support	26

PROPOSALS SPONSORED AND VOTED, BY YEAR



Source: Compilation by the authors. Data from Investor Responsibility Research Center (IRRC), accessed through Wharton Research Data Services (WRDS).

EXHIBIT 1 — CONTINUED

Proposals by Category	Number Voted	Average Support	Number Receiving Majority Support
Accounting & Audit	2	56.0%	1
Board Structure & Procedures	38	31.1%	7
Equity Ownership Requirements	11	25.3%	0
Executive Compensation	66	41.1%	16
Social Issues & Corporate Responsibility	36	11.9%	0
Other	12	27.0%	2
Total	**165**	**28.3%**	**26**

Category Breakdowns	Number Voted	Average Support
Accounting & Audit		
Expense Stock Options (before 2006)	2	56.0%
Board Structure & Procedures		
Separate Chairman & CEO	13	27.4%
Repeal Classified Board	7	64.5%
Committee Structure & Requirements	10	14.3%
Voting Related Measures	4	35.1%
Other	4	22.8%
Equity Ownership Requirements		
Require Equity Awards Held to Retirement	7	24.7%
Other Holding Requirements	4	26.5%
Executive Compensation		
Add Performance Features to Equity Awards	15	36.8%
Adopt Say-on-Pay (before 2010)	11	44.7%
Restrict or Limit Compensation	6	13.8%
Limit or Vote on Golden Parachutes	13	53.1%
Limit or Vote on SERPs	13	38.2%
Other	8	26.5%
Social Issues and Corporate Responsibility		
Advocate for Health Care Reform	18	5.5%
Report on Political Donations and Lobbying	14	21.7%
Other	4	6.5%
Other		
Limit Employment Agreements	3	30.0%
Other	9	26.1%

Note: SERPs (supplemental executive retirement plans) are pension plans that provide benefits to executives above those provided through the defined benefit and defined contribution plans available to other employees.

Source: Compilation by the authors. Data from Investor Responsibility Research Center (IRRC), accessed through Wharton Research Data Services (WRDS).

EXHIBIT 1 — CONTINUED

Companies Targeted Three or More Times	Number of Proposals Voted
Raytheon	8
Comcast	5
JPMorgan Chase	5
Bank Of America	4
Citigroup	4
Marsh & McLennan	4
United Technologies	4
Wal-Mart Stores	4
American International Group	3
Apple	3
Bank Of New York	3
Merck	3
Peabody Energy	3
Pulte Homes	3
Sprint Nextel	3
U.S. Bancorp	3
UnitedHealth Group	3
Verizon Communications	3

Source: Compilation by the authors. Data from Investor Responsibility Research Center (IRRC), accessed through Wharton Research Data Services (WRDS).

EXHIBIT 2 — AFL-CIO PROPOSAL: ABOLISH STOCK OPTIONS AT AMERICAN EXPRESS (2003)

ITEM 4--SHAREHOLDER PROPOSAL.

The American Federation of Labor and Congress of Industrial Organizations, 815 Sixteenth Street, N.W. Washington, D.C. 20006, record owner of 800 common shares, has advised us that it plans to introduce the following resolution:

SHAREHOLDER PROPOSAL.

RESOLVED: The shareholders of the American Express Company (the "Company") urge the Board of Directors (the "Board") to adopt a policy prohibiting future stock option grants to senior executives. The Board shall implement this policy in a manner that does not violate any existing employment agreement or equity compensation plan.

SUPPORTING STATEMENT

Since the accounting scandals at Enron, Worldcom, and other companies, the role of stock options in executive compensation has come controversial. Critics of stock options have argued that they can be a powerful incentive for executives to manipulate earnings or engage in accounting fraud. By timing their stock option exercises, executives can also inappropriately trade on inside information.

Stock options provide incentives to executives that significantly differ from the interests of shareholders. Stock option grants promise executives all of the gain of share price increases with none of the risk of share price declines. For this reason, they can encourage excessive risk taking by executives. In contrast to direct stock holdings, stock options also discourage executives from increasing dividends because option holders are not entitled to dividends.

Our Company allows executives to exercise a portion of their stock option grants after just two years following their grant date. For this reason, senior executives can gain substantial windfalls from the proceeds of their stock option exercises even if the share price later falls under their watch. Executives at our Company can also receive stock option "reloads" if they use stock to cover the exercise price of their options.

We are concerned that our Company's annual stock option grants to senior executives are excessive. In 2001, CEO Kenneth Chenault received stock options with a grant date present value of $13.4 million. He also realized $9.3 million in stock option exercises from previous grants.

Banning stock options for senior executives will decouple executive pay from short-term price movements and the temptation for executives to inappropriately manipulate our Company's stock price in order to exercise their stock options. In our opinion, other forms of compensation, such as restricted stock and long term incentive plans, will better focus senior executives on building the sustained profitability of our Company.

Leading investors and regulators have questioned the appropriateness of using stock options in executive compensation. Portfolio manager Bill Miller, whose Legg Mason Value Trust is the only

EXHIBIT 2 — CONTINUED

mutual fund to beat the S&P 500 Index 11 years in a row, has said “I support the banning of stock options because anything that can be accomplished with options can be accomplished by giving stock directly. And it has none of the downsides of options.”

Former Federal Reserve Chairman Paul Volker has stated that “Given both the very large capricious element inherent in the returns from fixed price stock options and the distorted incentives for management, I believe the use of such options should be strongly discouraged for public companies. There are far better alternatives for seeking and achieving an appropriate alignment of shareholder and management interests.”

THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE AGAINST THIS PROPOSAL FOR THESE REASONS:

The Board believes the foregoing proposal, which calls for a complete ban on any stock options to senior executives, is unduly restrictive and extreme.

Many commentators have criticized the granting of excessive stock options generally, but few have sought to ban them entirely. The proponent’s total prohibition on such grants to senior executives deprives the Company of needed flexibility in designing effective incentives. When used appropriately, as the Board believes they are at the Company, stock options can provide effective incentives to management in alignment with shareholder interests.

The Company has taken a number of steps to further align its executive compensation program with the interests of shareholders:

- Reduced the grant of stock options to executive officers. Overall, the total grant of stock options and restricted stock awards to all employees declined from 2.9% of outstanding shares in January 2002 to 1.1% of outstanding shares in January 2003;
- Committed that it will not grant options below fair market value or reprice them without shareholder approval;
- Adopted share ownership guidelines for senior management; and
- Decided to expense stock options beginning with the Company’s 2003 grants.

Attracting, retaining and providing appropriate incentives to talented senior executives is in the best interests of shareholders. The proponent’s complete prohibition deprives the Board of any ability to incorporate stock options as part of a balanced and effective incentive program.

ACCORDINGLY, YOUR BOARD OF DIRECTORS RECOMMENDS A VOTE AGAINST THIS PROPOSAL.

Source: American Express, form DEF 14A, filed with the SEC Mar. 13, 2003.