

Gardiner C. Means and the 1980s Shareholders' Attempted Revolution

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***Abstract:** Gardiner C. Means was one of the first twentieth-century economists to have noticed the concentration of corporate power in the hands of managers. He believed that this power arrangement caused production inefficiency and inappropriate resource allocation. Means advocated for the redistribution of control among four groups of stakeholders—consumers, workers, managers, and shareholders. He believed an equitable distribution of economic power will increase macroeconomic stability and growth. During the 1980s Deal Decade, shareholders and corporate raiders attempted to take power away from the managers by mean of hostile takeovers. The shareholders did not succeed because managers retaliated by erecting legal barriers to protect themselves. I argue that the shareholders' revolution failed because shareholders did not heed Means' advice. If the shareholders had been more willing to share power with workers and consumers, they could have defeated the managers.*

Keywords: Gardiner C. Means, 1980s merger movement, financial speculation, corporate power

Introduction

Academics have presented many interpretations of the 1980s wave of corporate takeovers. One interpretation, which is very popular among legal and business scholars, has argued that the 1980s were characterized by the assertion of the shareholders' power in the corporation (Johnson 1987 [1986]; Yago 1991; Davidson 1985). For too long, managers and directors had free rein over the corporation; they kept retained earnings to build massive, inefficient conglomerate empires to suit their egos. They gave themselves large salaries, stock options, corporate perks, and elected their friends to the board of directors. For a group of people who were hired to conduct the corporation's business, the managers and directors forgot that they had bosses. The 1980s—with its corporate raiders, aggressive targeting firms, and active institutional investors—changed everything. Managers and directors had to do whatever it took to keep stock prices at (or even above!) the appraised value of the corporation's assets. Shareholders

were willing to assert their unhappiness with the incumbent managers' performances by selling their stocks to corporate raiders. And when raiders took over the corporation, they fired the managers and replaced the board of directors.

There are some historical inconsistencies with the "shareholders' revolt" interpretation presented above, however. It is true that by the end of the Deal Decade, as the 1980s was called, 143 firms on the Fortune 500 list in 1980 were acquired by other firms (Kamarck 2001: 49). Americans also have learned some colorful terms, including but not limited to: hostile takeover, junk bond, greenmail, poison pill, white knight, and tender offer. Besides these minor additions to the mainstream vocabulary and the disappearances of a sizeable number of firms, however, things in corporate America now look about the same as they did in 1980. Managers still receive outrageous salaries and compensation packages; directors are still hand-picked by CEOs. Shareholders still have very little influence over the use of the corporation's profit; they rarely get to decide how much of the profit should be paid out as dividend and how much should be retained for investment purposes. Whatever their grievances were against the managers and directors in 1980, the shareholders had not solved the problem by the end of the Deal Decade or, for that matter, by the beginning of the twenty-first century.

Hence, it seems that "the shareholders' revolt" interpretation is not correct. It is true that shareholders in the 1980s really thought they could alter managers' and directors' interests to be more in line with theirs, but this belief did not transcend into desired outcomes. The curious readers are, therefore, inclined to ask why the shareholders did not succeed. In my opinion, I believe that the shareholders approached the issues of massive conglomerates, economic inefficiency, and managers' discretion from the wrong angle. Instead of trying to augment their power and pitting themselves against the managers and directors, the shareholders should have focused on making the distribution of control more equitable inside and outside the corporation. Gardiner C. Means was the first person to have this insight; he argued that the flaw of

the modern corporate system lies in the concentration of control in the managers' hands. Means advocated for government regulations that would distribute control among all stakeholders—workers, consumers, shareholders, and managers—and rejected calls that favor one group over others.

In this essay, I will use Means' insight to show that the shareholders' attempt to assert control over managers and directors in the 1980s did not work because the shareholders excluded all other stakeholders. The shareholders' attempt to transfer power wholesale from the managers to themselves evoked retaliation from the managers. When going to war, it pays to have allies. One's capacity to form alliances, however, depends on one's willingness to share (or at least to promise to share) the spoils of war with one's allies. The 1980s shareholders did not form alliances with any group of stakeholders identified by Means. Furthermore, shareholders did not want to share power with anyone else. This is why the shareholders' revolution failed. Had they been more willing to cooperate with the workers and the consumers, shareholders could have loosened managers' firm control over the corporation.

To extend my argument for why the shareholders' revolution failed, I have divided the following essay into five sections. The first examines Means' contributions to economics in general and his insight about the distribution of economic power in particular. The second explores the battle for control between shareholders and managers and directors in the 1980s. The third looks at the economic consequence of the attempted revolution. The fourth examines why shareholders failed in their attempt to take control from managers. The fifth concludes the essay.

Means' Insight

To truly understand Means' economics, one has to begin with his view of the evolution of the economy. Means believed society had experienced four different types of economic arrangement by the middle of the twentieth century. These different

arrangements can coexist in society, but one tends to dominate the others. The first economic arrangement, which exists in many pre-capitalistic societies, is known as the subsistence economy. The subsistence economy is defined by an individual producing for his own consumption and participating in no to few buying or selling activities. The roles of the consumer, owner, manager, and worker are embodied in the same individual. The individual ignores any of the four roles at his own peril.

The second economic arrangement is called the atomistic economy, and it was the predominant arrangement in Adam Smith's time. Production in this economy is carried out primarily by the one-man enterprise. The individual produces goods for sale and buys goods from others, but no one works directly for anyone else. The individual remains as the worker-owner-manager, but the role of the consumer has been separated from the production process. The consumer must now rely on market forces to ensure that his needs and wants are met at the desired prices. For the most part, the market in the atomistic economy is capable of satisfying all stakeholders' interests.

The third economic arrangement, the factory system, evolved into being in the nineteenth century. In this arrangement, the factory owner manages the production process but hires the worker to do the producing. The worker's interest is now separated from the production process, and he, like the consumer, must depend on the market for the fulfillment of interests. The consumer's and worker's interests are often ignored in the factory system. Marx's *Das Kapital* is perhaps the best historical record of the separation of the owner-manager's interest from the worker's interest in the factory.

By the time Means and his coauthor, Adolf A. Berle, published *The Modern Corporation and Private Property* in 1932, Means believed a new economic arrangement had emerged. He had two interchangeable names for this new system, collective capitalism and the corporate system. The managers and directors make production policy and control the instruments of production in the corporate system; in effect, managers and directors have replaced the market mechanism with administrative

coordination and concentrated control in themselves. The owners, whose stock ownership is quite dispersed, have little influence over production policy. The corporate system, thus, has four distinct groups of stakeholders—owners/shareholders, managers, workers, and consumers—and there is no reason to assume that one group's interest automatically aligns with another's (Berle & Means 1986 [1932]: 1-116; Means 1962: 47-73).

Means thought that the concentration of control in management's hands has three consequences for the economy: administered prices, inefficient resource allocation, and ex-risk profit. He noted that any particular market in the corporate system is dominated by a few multidivisional corporations. These large corporations produce many lines of products to serve millions of consumers. The top managers and directors do not have time to—nor do they want to—engage in all the details of producing and selling every product. Instead, they determine the target rate of return on investment capital and the standard rate of operation in their plants. Hired subordinates then estimate the average cost of production per unit and add in the predetermined target rate of return to arrive at the target price for a given product. Next, the subordinates examine the market to see the volume of sales expected at the target price. If the expected sales volume is equal to or above the standard rate of operation, the subordinates have the green light to produce the product. In the case of demand being higher than the standard rate of operation, the managers and directors will direct the subordinates to expand the plants' capabilities to increase supply. If the expected sales volume is below the standard rate of operation, however, the managers have to decide whether to shelve the new product or set a lower price and direct efforts to decrease the cost of production. Management, then, decides what gets produced and sold on the market, the rate of return on investment, and the prices charged for the goods. The market forces that are supposed to channel the interests of consumers, workers, and owners are weak in comparison to the managers' powers. Consequently,

firms would rather lay off workers and cut back production during economic downturns than lower their prices. Consumers are not always able to find desired products because firms have allocated resources to producing goods with higher target rates of return (Means 1962: 155-176).

The third consequence of the domination of managerial power is the problem of ex-risk profit. In Book Four of the *Modern Corporation*, Means asked, "But what if profits can be made more than sufficient to keep the security holders satisfied, more than sufficient to induce new capital to come into the enterprise?" (Berle and Means 1968 [1932]: 301). In another word, ex-risk profit is the corporation's profit left over after managers have paid out a sufficient dividend to placate shareholders. Means wanted to know who should have the right to this ex-risk profit. From a legal point of view, the shareholders should be the recipients of the ex-risk profit. The owners hold the right to property in the corporation. But from an economic standpoint, the answer is not so clear cut. The shareholders surrendered control over their wealth when they voluntarily bought stock certificates. Means did not see the logic in protecting the shareholders' right to ex-risk profit: "Must it necessarily follow that an owner who has surrendered control of his wealth should likewise be protected to the full?" (ibid: 298). Even if the corporation returns the ex-risk profit to the owners, there is no reason to believe shareholders would increase their investments or encourage better allocation of resources and production processes than managers (ibid: 301).

In *The Modern Corporation*, Means advocated giving the ex-risk profit to managers and directors. Giving this group of stakeholders an additional monetary incentive would theoretically motivate them to run the corporations more efficiently. Means said, "Any surplus which can be made over a satisfactory return to the investor would be better employed when held out as an incentive to action by control than when handed over to the 'owners' who have surrendered control" (ibid: 301). In the theoretical chapters of his 1933 proposed doctoral dissertation, however, Means changed his mind.

Means wrote, “To the question raised in the body of this chapter—‘To whom should the ex-risk profit be distributed?’ we counter with the question, ‘Should such profits be made at all?’” (Lee & Samuels 1992: 28). Means had realized that giving managers the ex-risk profit will not make them run the corporation more efficiently; it would just give managers more money to pursue their personal interests—paying themselves larger salaries, building grander offices, and constructing bigger conglomerates.

In his report to the Senate entitled *Industrial Prices and Their Relative Inflexibility*, Means had figured out a superior alternative for ensuring production efficiency without giving managers the ex-risk profit. He said, “The problem is primarily the distribution of controls, not the locus of ownership” (ibid: 45). Means called on the government to assist in the organization of advocacy groups to represent the workers’, consumers’, and investors’ interests. Organized advocacy groups can pressure managers to adopt production policy that benefits the entire community. In other words, Means wanted to reallocate control equally among all stakeholders. “The public interest,” said Means, “. . . calls primarily for a balancing of the business, labor, and consumer interests which together constitute industry” (ibid: 62). The only way to ensure efficiency is to put an end to the domination of any stakeholder group over the production process.

The Attempted Revolution

For almost half a century after Berle and Means first observed the separation of ownership from control, shareholders were dominated by managers and directors. Three events happened in the late 1970s and early 1980s that changed the shareholders-managers relationship and made it possible for shareholders to initiate war against managers. First, investment bankers and corporate managers had discovered in the late 1970s that asset-stripping was more profitable than diversifying into new lines of business. Since the stock prices of many corporations were substantially lower than the appraised value of their assets, aggressive managers had figured out that the parts were

more valuable than the whole. Managers could buy ailing firms, break off and sell the acquired firms' assets, and make handsome profits for themselves and the target shareholders (Johnson 1987 [1986]: 5).

Second, Michael Milken, an investment banker for the financial firm Drexel Burnham, popularized the use of junk bonds to finance hostile takeovers in 1983. Junk bonds are fixed-rate high yield bonds that are considered less than investment grade by bond rating agencies such as Moody or Standard and Poor's; only 800 companies, or five percent of the 23,000 companies with sales over \$35 million, can issue investment grade bonds (Yago 1991: 4). Junk bonds had been used to raise capital for growing firms and to finance friendly takeovers prior to 1983. The rates of return on junk bonds were substantially higher than yields on government bonds or investment grade bonds. Investors, however, were averse to junk bonds because the bonds were not guaranteed by corporate assets or cash flows. If firms did have to file for bankruptcy, holders of junk bonds would be among the last people to receive a payout because the bonds were considered "junior debts" (ibid: 18-20). Consequently, few investors were willing to buy junk bonds unless the risks were offset by other factors. Usually, these other factors took the form of high expected earnings (of growing firms) and promises of friendly takeovers.

Milken understood that few investors were attracted to the idea of targeting firms raising junk bonds to finance hostile takeovers of targeted firms. Hostile takeovers were speculative business. If investors bought junk bonds and then the hostile takeover attempts did not go through, investors would lose money. To reduce the risks associated with using junk bonds to finance hostile takeovers, Milken devised two plans. First, Milken convinced investors that junk bonds were safer than they thought; he developed statistics and models to show that junk bonds, especially when they were issued by growing firms, consistently earned higher returns than investment grade bonds. Second, Milken came up with the "standing by" strategy. Milken told investors

that they only had to agree to buy a certain number of junk bonds if the takeover went through and money was needed to buy the targeted firm's stocks. In return, Drexel Burnham agreed to pay three-fourths of one percent of the investors' total commitment for just "standing by" (Johnson: 146-7; Skeel 2005: 107-142; Yago: 18-26). Investors were delighted at Milken's plan and became more accepting of the notion of using junk bonds to finance hostile takeovers. As a result, the financial constraints on hostile takeovers were loosened. Targeting firms were no longer at the mercy of conservative bankers; they were now able to raise the funds necessary to finance takeovers with junk bonds.

Third, the numbers of institutional investors in the corporate equities market rose substantially in the 1980s. For most of the twentieth century, stock ownership was a dispersed activity. As late as the early 1970s, eighty percent of stocks were held by individuals (Hawley & Williams 2000: 1). But by 1985, that number had declined to fifty-six percent (ibid: 54). The rise in institutional ownership in the corporate sector came about for two reasons. State pension funds began shifting a significant part of their investments out of conservative U.S. government bonds and into the corporate equities market in the 1970s; private investors also increased their interest in equity mutual funds in the mid-1980s (ibid: 52-59). Furthermore, as people moved their money into fiduciaries, institutional investors changed stock ownership from a passive to an active activity. In the 1980s, institutional investors' activities accounted for an estimated seventy percent of daily volume on the New York Stock Exchange (Johnson 1987 [1986]: 67). Shareholders were now organized and ready for an opportunity to assert their power over managers.

When the famous corporate raiders—Carl Icahn, T. Boone Pickens, and James Goldsmith—arrived in the 1980s, shareholders realized they could use the raiders to their own advantage. The raiders were not interested in managing the corporation; they just wanted to maximize the monetary return on their investment. From my

perspective, I see no significant difference between the raiders and the shareholders. Both groups were willing to sacrifice the corporation's future and other stakeholders to make a quick buck. Both groups were willing to fight the managers to gain control of the corporation. The only possible distinction between raiders and shareholders is that the former were more active and manipulative investors than the latter. Consequently, for my own purposes, I lump raiders and shareholders into one group of stakeholders.

During the Deal Decade, a takeover attempt always began with the raiders announcing their intention to buy a certain amount of a targeted firm's stock at a premium above the market price; the raiders needed to have this crucial number of stocks so they could gain minority or majority ownership status in the target corporation. Milken and Drexel Burnham were on the sidelines gathering "standing by" commitments to finance takeover attempts. Arbitrageurs joined the game by buying up as many target stocks as possible. In doing so, arbitrageurs bid up the target stock price to higher and higher levels. Institutional investors, whose job was to make money for the ultimate shareholders, felt compelled to sell their blocks of stock to the raiders and arbitrageurs. If institutional investors such as mutual funds did not join the takeover game, their shareholders could immediately take their money out and invest it with their competitors. The ultimate shareholders of the target firm were delighted; they were earning a premium on their stocks and showing managers and directors that they could not be ignored any longer (Johnson 1987 [1986]: 1-13; 146-150). Managers and directors who were too busy building conglomerate empires needed to worry. The shareholders had found a way to oust unwanted management.

Of course, managers and directors did not share the owners' enthusiasm; they saw the raiders as thieves. Many managers were angry that raiders were auctioning off pieces of their corporate empires to pay for the debts incurred during the takeover process. They were outraged that some raiders would offer to sell back their acquired blocks of stock to the targeted firm at a higher premium than what the raiders had

bought them for from institutional investors. To keep their firms, managers had to pay this greenmail and then spent years figuring out how to pay for the debts. And on top of these nuisances, managers and directors were losing their most prized possession: job security. Managers realized they had to fight back to keep control over their corporations.

The managers' response to shareholders and raiders took two forms. First, managers convinced boards of directors to change the corporate bylaws to make it more difficult for takeovers to occur. Second, managers used internal and external funds to execute leveraged buyouts in order to keep raiders away from their firms. With regard to the first response, managers, with the assistance of lawyers and directors, added a poison pill and staggered board regulations to the bylaws. A poison pill was a legal measure that allowed incumbent managers to issue a group of special stocks that convert into the shareholders' right to buy two shares of the targeted firm's stocks for the price of one if a takeover attempt went through. The poison pill was supposed to raise the cost of acquisition to "forbidding levels" for the raiders and discourage institutional investors from doing business with raiders who did not have bottomless war chests. The staggered board measure required only a part of the board of directors to be elected annually so there was no way to replace all the incumbent directors at once (ibid: 12-13). Some managers did not think these bylaw changes were enough, however. These managers pursued a further strategy of leveraging corporate assets and taking out enormous bank loans to buy the company or division they worked for altogether. The managers then restructured the company as they pleased, increased profits, and paid off part of the debt incurred during the buyout. After a couple of years, managers took the company public again and sold stock to investors at a substantial premium. The whole process earned managers profits, and they did it without asking for shareholders' approval (Kamarck 2001: 42-48; Johnson 1987 [1986]: 12).

The battle that raged on between shareholders and managers during the Deal Decade ended the same way it began. The shareholders fought and lost; they did not gain control from the managers. The managers continued to ignore the shareholders' interest as they had done for decades. In fact, one can even argue that the 1980s helped the managers and directors discover power they did not even know they had. The managers added legal measures to make their jobs more secure; they found a way to bypass the shareholders' oversight altogether and earned even more money for themselves. Overall, it was a good decade for managers.

Economic Consequences of the Attempted Revolution

When mainstream academics assess the consequences of the attempted revolution, they talk about widespread unemployment in the 1980s. After the raiders took over the targeted firm, they laid off managers and workers (Kennedy 2000: 49; Nelson 1995: 108-109). Asset stripping is one of those jobs that does not require much labor power. But when heterodox economists examine the 1980s, they see a deeper problem than just unemployment. Heterodox economists discuss the emergence of the trend for shareholders and managers to prefer short term profits and monetary speculation over long term growth and macroeconomic stability. Means understood this problem; he railed against investors and managers who chased after corporate profits instead of being concerned with production efficiency. In a rather poetic paragraph in *Industrial Prices*, Means said:

In changing the rules of the game, the problem is not unlike that of the crowded excursion boat which capsized when a large body of excursionists rushed to one rail to see what was happening. In both industry and excursion boat rugged individualism works well so long as a multitude of different individuals decide individually to do different things. Each passenger can walk where he chooses so long as the passengers choose to scatter over the ship. But when most of the passengers rush to one rail great damage is done. Of course, we might say that God is just and drowns those foolish enough to rush to the rail. This is

exactly what the traditional economist says of business. Yet the boat takes down with its all its passengers, whether they rushed to the rail or not, and so does business (Lee & Samuels 1992: 64).

Means, thus, understood the negative effects of an economy running on monetary speculation.

Furthermore, Means was absolutely right in his prediction of the 1980s shareholders-managers war. Shareholders, managers, and raiders turned the 1980s economy into a game of monetary speculation. Shareholders were interested only in maximizing the return on their investments in the shortest amount of time possible; they pressured mutual and pension funds to sell target shares to raiders even though they knew raiders had no long term interest in the firm. The desire for short term gain reached a fever pitch when conservative savings and loan (S&L) institutions began replacing their mortgage portfolios with junk bonds in the early 1980s (Skeel 2005: 122). Even though the purchase of junk bonds did not cause the 1986 S&L collapse, it was a contributing factor. As the decade progressed, firms with stable, long term growth plans could not get the money to finance their investments; shareholders were interested only in financing risky, get-rich-quick schemes. To return to Means' metaphor, the shareholders were rushing to one end of the ship, putting it in great danger of capsizing.

When speaking of monetary speculation, one cannot leave out the raiders and their posse of investment bankers, merger lawyers, and arbitrageurs. As I mentioned earlier, raiders made money by selling assets of targeted firms and by greenmail; the greenmailing tactic essentially involved the raiders creating a speculative bubble around the target stock and then selling back their shares before the bubble burst. The arbitrageurs had the same intention as the raiders; arbitrageurs bought target stock from institutional investors and waited until the takeover went through. As soon as the merger papers were signed, arbitrageurs sold back their stock and made millions in

profit. Investment bankers and merger lawyers were not so much creators of monetary speculation; they were more like leeches sucking off target stock bubbles. Investment bankers earned anywhere from one half to one percent of the total acquisition cost for their participation in the takeover. Merger lawyers earned \$400 to \$600 an hour for their legal services; the *Wall Street Journal* estimated that law firms representing Conoco in its attempt to ward off unwanted raiders (Conoco lost and was eventually taken over by DuPont) earned \$20 million in legal fees (Davidson 1985: 16-22). In any case, one sees that raiders and their posses of lawyers and investment bankers cared only about instant pecuniary gratification and nothing else.

Managers and directors had always exploited the corporation for their own purposes, but they had never ignored the production process altogether until the Deal Decade. Managers prior to the 1980s understood that if they wanted to build their corporate empires, they had to make a profit first. And the way to do that was to produce and sell goods to the consumers. But in the 1980s, managers had discovered new ways to accumulate money without actually engaging in the production process. Jack Welch sold off General Electric's manufacturing divisions, reduced research and development (R&D) spending to 1.6 percent of revenues by 1988, and invested heavily in GE's financial services during his tenure at the company (Kennedy 2000: 54-59). The managers were just as engrossed as the shareholders and raiders in raising stock value. The lack of concern for R&D spending and production efficiency—things that Means said are important for economic growth—backfired on the managers. The 1980s will forever remain the decade when Japanese manufacturers outsmarted and outdid American manufacturers. To this day, American companies are still suffering from mistakes they made in the Deal Decade.

Why the Revolution Failed

The shareholders' attempt to take control away from the managers did not work because they excluded participation of other stakeholders like the consumers and workers. The shareholders showed no interest in the workers' well-being, and this was demonstrated by their casting a blind eye to the popular "zapping labor" tactics of the 1980s (Nelson 1995: 108-109). As managers and raiders cut wages, reduced employee benefits, and forced part-time schedules on workers, the shareholders did not speak up. Whatever it took to raise the stock price, the shareholders were willing to go along with it. In a time when Honda Motor Company was spending five percent of its revenue on R&D and GE was spending 1.6 percent, American shareholders and raiders did not seem to be bothered by the statistic (Kennedy 2000: 56). They did not consider that American consumers were tired of being sold shoddy products and were turning to Japanese-made goods. In their preoccupation with showing the managers that their interests matter and that the managers needed to get out of their ivory towers and start maximizing stock value, the shareholders forgot that other stakeholders were suffering.

I think it is interesting that the shareholders did not give much thought to the fact that the managers had control of the corporation for decades before the attempted revolution. The managers are insiders; they understood how things work in the corporation better than anyone else. The shareholders did not have this "insider experience." To take control away from the managers, the shareholders needed more than fiduciary institutions and support from the raiders. It is an elementary war tactic that you do not attempt a revolution unless you have won over as many supporters as possible. The 1980s shareholders did not seek assistance from workers and consumers because they did not want to share power; they did not want to compromise with the managers because, once again, they wanted absolute control over the corporation. But as Means had told us decades before the 1980s, no revolution over the managers is

going to work unless there is more equal distribution of power. At the end of the day, the ultimate goals of society should be economic growth and survival of the human race; these goals can be achieved only by compromise and partnership. There is really no other way around the problem.

Conclusion

Economists have an affinity for hindsight bias. *Things should have been done this way* and *things should have been done that way*, economists would say. I must admit that as an economist, I have committed this grave sin. Yet, I would also like to note that my affection for hindsight bias is justified. By examining why the shareholders' revolution failed in the 1980s, I am also able to suggest what should be done differently in the future. Means was always an optimistic economist; he never thought it was too late to change the way a corporation is run. I think this is the way concerned individuals everywhere should approach the problems of improper allocation of resources, production "inefficiency," and concentration of power in corporate America today. If all stakeholders could be brought together and work to find common ground among themselves, society could carry out Means' vision of equal distribution of control.

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