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Interview: The Future of Corporate Governance in the United States

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INTERVIEW

THE FUTURE OF CORPORATE GOVERNANCE IN THE UNITED STATES

*Ronald J. Gilson**

*Cheryl L. Conner:*** Where do you think corporate governance is headed in the United States?

Gilson: In a number of directions at the same time. To see this, keep in mind that a corporation's governance structure is composed of the group of decision makers who determine corporate policy, the incentives that influence their behavior, and the feedback and monitoring structures which evaluate corporate performance and cause future adjustments in strategy and implementation. The structure is animated by three different mechanisms: the operation of the market—the force of competition in the product or service markets in which the corporation operates; the legal framework—the formal rules of conduct established by governing statutes and their corresponding enforcement techniques; and shareholder direct action—the use by shareholders of the electoral process. Each of these mechanisms is best suited to different circumstances and can be expected to be the primary response to different kinds of problems. Thus, there is not a model of corporate governance in which one size fits all.

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For example, the governance model that we observe in high technology companies is radically different from the model we observe in more traditional segments of the economy, and my guess is that in some ways they are moving in different directions.

The single most effective governance mechanism is market competition. Rather than the intermittent operation of control contests or proxy fights, product market competition operates continuously to evaluate the corporation's performance and penalize lapses in execution. In many high technology markets, if poor performance lasts long enough that more formal governance mechanisms can be invoked, it will already be too late. The corporation will have missed a generation of technology, or the industry standard will already have been established. The traditional techniques of governance are going to play a less significant role in these circumstances.

In contrast, more traditional formal governance mechanisms will play a primary role where product market competition is less effective. In an oligopolistic setting like the automobile industry, General Motors could continue to perform abysmally for years before the board of directors finally acted to alter the corporation's course. In terms of speed of invocation, the control market sits somewhere between product and formal governance mechanisms, capable of acting with great speed once initiated, but still operative only after a substantial value gap has emerged.

With respect to these more traditional areas, I expect we will continue to watch a tension play out between, on the one hand, a judicial attitude which seems inclined to give directors more discretion in fending off capital market monitoring and, on the other, the efforts by institutional shareholders to impose discipline on the board's behavior. The tension will be played out through disputes over the rules governing proxy contests, and it will continue to be played out through disputes over the rules governing defensive tactics, and, in particular, the poison pill. Unfortunately, it seems the Delaware courts are moving in the wrong direction, favoring less efficient, more slow moving governance mechanisms, like proxy fights, over speedier mechanisms like takeovers.[1]

Conner: Looking at the institutional investors, you seem to agree with the concerns about whether they are actually successful in reforming corporate governance.[2] Do you also agree with the analysis that they are not really representing all shareholders, but just institutional investors like themselves?

Gilson: The argument that institutional investors do not represent small shareholders has always struck me as nonsense. In my experience, the argument is typically invoked by those threatened by effective shareholder oversight—either corporate managers who are the object of governance oversight or plaintiff class action lawyers who resist displacement by institutional investors acting as "lead" plaintiffs pursuant to recent federal securities law reform.[3] Institutional investors are simply acting for small holders. Mutual funds and pension funds are acting as fiduciaries for individual investors who channel their savings into the capital market through intermediaries. It is an extremely sensible investment strategy. I have never understood why the intermediaries' interests are different from those of their investors. In the end, it seems to be a one sentence slogan, an exercise in rhetorical flourish, not analysis.

Conner: If small shareholders do not feel that they are being represented, what is the possibility they could implement some of the minimalistic programs, such as "Just Vote No" or "Just Don't Vote"?[4]

Gilson: I think that the likelihood is basically zero. Most individual shareholders, quite sensibly, don't read the material presented to them; they simply own too little stock to warrant the

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1. *See, e.g.*, Unitrin Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995).

2. *See* Ronald J. Gilson & Reiner Krackman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 868-76 (1991).

3. For an example of the argument, see Melvyn I. Weiss, *What the Contract with America Means for Securities Lawyers: 'Common Sense Legal Reform,'* 907 PLI CORP. 285, 305 (1995) (observing that large investors have different interests from "average investors").

4. *See generally* Joseph A. Grundfest, *Just Vote No or Just Don't Vote: Minimalist Strategies For Dealing with Barbarians Inside the Gates*, 729 PLI CORP. 827 (1991).

time and energy involved. The advantage of institutions is less that their incentives are always perfectly aligned with their investors, than that they can capture the economics of scale possible with respect to monitoring management. In most major corporations, institutions own a majority of the stock. So, if their attention is attracted, you can actually accomplish something. Small shareholders, in contrast, face a massive collective action problem. Who do we imagine is going to organize and pay for their effort?

Conner: Do you feel that this is a problem resulting from the proxy rules or just a lack of incentive on the part of the shareholders?

Gilson: I really do not feel that there is a problem with the proxy rules as they apply to small investors. Because of the expense of organizing small shareholders into a ten or twelve percent block, little would change in this respect even if the proxy rules were eliminated entirely. The Securities and Exchange Commission acted wisely in amending the proxy rules to reduce barriers to collective action by institutional shareholders in the electoral environment. The next step would be to extend the initiative into the control market by loosening the circumstance when aggregation is required under § 13(d) of the Williams Act.[5]

Conner: If you had the power to make one change in corporate governance, what would that change be?

Gilson: In the end, I think the place to start is where the Delaware Supreme Court lost its way in declining to follow Chancellor Allen's roadmap in *Interco*[6] of the allocation of power between shareholders and managers.[7] The Chancellor explained quite eloquently that the ultimate decision about whether to sell the company belongs to the shareholders. If the Delaware Supreme Court could get that allocation straight, the rest

5. 15 U.S.C. § 78(m)(d) (1994).

6. City Capital Assoc., Ltd. Partnership v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988), *appeal dismissed*, 556 A.2d 1070 (Del. 1988).

7. *See, e.g.*, Paramount Comm., Inc. v. Time, Inc., 565 A.2d 280 (Del. 1989) (affirming the court of chancery's decision allowing a target corporation's board to act contrary to the wishes of the shareholders where the court was satisfied that the directors were acting in the long term interests of the corporation).

should take care of itself. For example, the balance between friendly and unfriendly offers begins to move back to friendly because there is little to be gained by dragging things out.[8] The uncertainty that is associated with ITT screwing around for seven months[9] disappears and transactions take place based upon their underlying merits, and not upon lawyers' court room histrionics. It is crazy that the outcomes of the largest business transactions in history are being decided in courtrooms in Wilmington or in Reno. These are issues for the market, not for judges.

Conner: Do you feel that the laws are uncertain in this area or that the courts are simply stepping in where they do not belong?

Gilson: Corporate law is constitutional law. The statute creates a skeleton, to which the courts add flesh. Thus, the bulk of corporate law appropriately is judge-made. The courts need to clearly delineate the allocation of decision making, as did Chancellor Allen, and then stay out of the way.

Conner: In light of the developments in the last few years, how relevant is the Japanese model of corporate governance to the American model?

Gilson: I think the Japanese model, putting aside for a moment what we actually mean by that,[10] has a great deal of rele-

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8. *See* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

9. The Wall Street Journal reported on February 25, 1997 that Hilton Hotels filed proxy material with the Securities Exchange Commission (SEC), asking shareholders to approve Hilton's hostile takeover of ITT. *See Hilton Hotels Files ITT Proxy Material*, WALL ST. J., Feb. 25, 1997, at A8. The ITT shareholders did not vote on the Hilton plan until seven months later. *See* Christina Binkley, *ITT Holders' Vote is Defeat for Hilton*, WALL ST. J., Nov. 13, 1997, at A3. To be sure, the auction ITT ultimately conducted generated a significantly higher price than originally offered by Hilton, but bear in mind that the auction took place only because the courts blocked ITT's efforts to defeat the Hilton offer. The auction could have been conducted months before.

10. The Japanese model is an interlocking structure of process-oriented technology, lifetime employment for core workers, cross shareholdings, and a bank-centered capital market. *See generally* Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, J. ECON. LIT., Mar. 1990, at 1. (1990); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993) [hereinafter Gilson & Roe, *Understanding the Japanese Keiretsu*]; Ronald J. Gilson and Mark J. Roe, Lifetime Employ-

vance. That is, one of the interesting things about the Japanese governance system is how the governance system is shaped by the nature of production on the shop floor. The fit between lean manufacturing techniques and the governance system is very persuasive. That does not mean that we have to match the Japanese governance system in order to undertake lean manufacturing, but we do have to recognize that governance is not just a slip-cover that fits over any production process. Governance has to mesh with the nature of the underlying production process. For me, the fit between governance and production is the Japanese model's most important lesson.

Conner: Are we moving toward this kind of model?

Gilson: Well, I think we can already see how governance mechanisms adapt to the character of production. High technology companies have a very different governance structure than companies in more mature industries. Companies that have gone through a leveraged buyout retain a characteristic governance structure even after they have sold stock to the public.[11] You are beginning to see an increasingly different governance process on the part of some of the older industrial companies as their boards of directors become reenergized. What you are getting is a greater range of governance processes that reflect the different contexts in which these companies operate. That seems to be a very good thing—governance and production are simultaneously determined.

Conner: In an article you wrote with Professor Mark Roe about understanding the Japanese system,[12] you mentioned that the best candidate for the Japanese-type strategies are the high technology areas. However, these are also the areas that need the least reform. Do you still see the possibility of using these techniques in heavy industries, such as automobile and steel?[13]

Gilson: We have begun to see that the relationship between the

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ment: Labor Peace and the Evolution of Japanese Corporate Governance (1998) (Columbia University Working Paper) [hereinafter Gilson & Roe, Lifetime Employment].

11. *See generally* Steven Kaplan, *The Staying Power of Leveraged Buyouts*, 29 J. FIN. ECON. 287 (1991).

12. *See* Gilson & Roe, *Understanding the Japanese Keiretsu*, *supra* note 10, at 882.

13. *See id.* at 883.

automobile industry and its suppliers has changed dramatically over the last seven or eight years in the direction of Japanese lean production processes. Also, simultaneously we have seen a more active board involvement, parallel to Aoki's punctuated main bank monitoring in Japan.[14] So I think that you are beginning to see this, but shaped differently. We have not moved to a Japanese governance model. Rather, our governance model has been sufficiently adaptable to accommodate lean production.

Conner: Are strategies used in Silicon Valley and the automobile industry generally applicable to all industries, or can they only be applied in such discrete circumstances?

Gilson: It is a continuum. The critical point is simply that there are a much larger number of templates than anyone ever thought. Where you end up along this continuum is going to depend upon the local characteristics of the industry. It is going to be very hard to sit at a great distance and make broad statements about the way corporate governance should be. Analysis has to be increasingly textured and tailored to the particular circumstances of an industry.

Conner: You have done much work in developing a political and economic model of corporate governance. How well do you think that model applies to multi-national corporations in a global economy?

Gilson: I do not believe in multi-national corporations in a governance sense; I just don't think I have ever seen one. To be sure, I have seen national corporations that do business internationally, but I cannot think of a corporation whose governance I would consider multi-national. For example, co-determination, a central feature of German corporate governance, applies only to give German workers a role in the corporation's governance structure, even if a majority of the employees of a German corporation's employees are outside Germany. Thus, I think the multi-national characterization refers to the markets in which a corporation does business, not to its governance

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14. See Masahiko Aoki, *The Japanese Firm as a System of Attributes: A Survey and Research Agenda*, *in* THE JAPANESE FIRM: THE SOURCES OF COMPETITIVE STRENGTH 11 (Masahiko Aoki & Ronald Dore eds., 1994).

structure.

Conner: There is a paradox today on the corporate scene. On the one hand, firms are loosening their ties to employees. On the other hand, new products and processes depend on a well-trained and committed labor force. What role can corporate governance play in resolving that paradox?

Gilson: It's not obvious to me that it is a paradox. Thoughtful observers like AnnaLee Saxenian have argued that the genius of Silicon Valley is the fact that everybody changes jobs all the time.[15] So that, in her view, there is some decrease, I suppose, in loyalty to the corporation, but it is made up for by the benefits of knowledge spill-overs.

More generally though, the issue with respect to investing in human capital depends, in large measure, on whether you are talking about general human capital or firm-specific human capital. It is certainly the case that, if employees view their tenure as less certain, there is less incentive to invest in firm-specific human capital. But as Mark Roe and I have considered in the Japanese context, the puzzle is the extent to which there is really very much firm-specific human capital, as compared to, for example, industry-specific human capital.[16] How long would it take a Toyota worker to actually learn the ropes at Honda? My speculation is not very long because they are industry-specific skills and if the skills are industry-specific skills, the worker retains an incentive to acquire them because, if he learns them, his market value increases even if he moves to a different company in the industry. The extent to which the skills are firm- or industry-specific is an empirical question the answer to which too often has simply been assumed because it makes the model work.

The second issue is the accuracy of the generalization that firms are loosening their ties to employees. This is true in some industries. However, in the high tech industries, the problem is just the opposite. Companies are trying to work out ways to keep their employees. Generalizing across industries is very

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15. *See* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1994).

16. *See* Gilson & Roe, Lifetime Employment, *supra* note 10.

difficult, and the result is that it makes some of the popular reporting on the problem at least a little misleading.

Conner: In light of the layoffs due to corporate restructuring and the fact that employees increasingly face the possibility that they will be laid off, is the problem that their loyalties are to the firm? Is that something that employees need to readjust, dedicating themselves, instead, to their industry?

Gilson: The story in Silicon Valley is that people work for the Valley; they do not work for a firm. Their future is not tied to a particular firm, but to the industry. The incentive for skill acquisition is the same, but it no longer depends on the employee's belief that she will spend her entire career at a single firm.

The other point is that the data I have seen strongly suggests that blue-collar employment did not go down in the layoffs associated with reorganizations in the 80s. Although there is significant variance in the distribution, on average blue-collar employment was not reduced by these transactions. However, white-collar employment—middle management—got hit pretty hard.[17] Much of the political debate seems to turn on particular anecdotes, like Susan Faludi's Wall Street Journal story of KKR's acquisition of Safeway.[18] The data thus suggests that the mean outcome of the LBO phenomenon was favorable—more efficiency without reducing blue collar employment—but there was a lot of variance. The way you deal with a desirable mean outcome but high variance is to provide transition payments to those who bear the brunt of the variance, not to block a process which, on balance, seems to lead toward greater efficiency.

Conner: In light of this, is there a lesson in the recent UPS strike?[19]

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17. *See, e.g.*, Felicity Barringer, *Laid-Off Bosses Scramble in a Changing World*, N.Y. TIMES, July 12, 1992, at A1; Liz Mullin, *Jobless Find an Outlet for Frustration*, L.A. BUS., J. Jan. 7, 1991, at 25 (noting that blue-collar jobs can often be found within a week, while white-collar positions often take three to six months); Stephen S. Roach, *The New Majority: White-Collar Joblessness*, N.Y. TIMES, Mar. 14, 1993, at A3.

18. *See* Susan C. Faludi, *The Reckoning: Safeway LBO Yields Vast Profits But Exacts A Heavy Human Toll*, WALL ST. J., May 16, 1990, at A1.

19. *See generally UPS Customers Look for Alternatives*, L.A. TIMES, July 31, 1997, at D11.

Gilson: The UPS strike presents quite a puzzle. I am not entirely sure that I know what the strike was about. The settlement seemed to increase the number of permanent jobs, at the cost of a loss in of the total number of jobs. I am not sure that I understand who was benefited by the outcome.

The newspaper accounts seemed to suggest that a major issue in the strike was the solvency of the multi-employers' pension fund in which UPS participated. Apparently, UPS was the most solvent company in the unit and, as a result, would be on the line for the liabilities of other employers to Teamster members (but not UPS employees) if the other employers failed. UPS was said to have wanted primarily to get out from under the contingent liability and the union felt most strongly about protecting the solvency of the fund, even though it did not affect UPS workers. If this is accurate, it is hard to see what the UPS workers got from the strike. They would have been better off trading increased benefits for themselves in return for a decrease in UPS' subsidy of other companies' employees.[20]

The first question is: what was the fight really about? Publicity about fighting over a pension plan doesn't sell newspapers. The second question is: what was the net effect on employment? The existence of any effect is, to me, at least questionable, but that is an empirical question. The final question is: how much did it cost the union to keep the current pension plan? Whatever that figure it was a transfer from the UPS workers to non-UPS workers who were employed by other employers in the plan who were less solvent. Now that may have been a wonderful thing for workers in general, but the subsidy ran from the people who went on strike.

Conner: Do you see another element, whereby the leadership of the union saw an opportunity, and an issue that would help them entrench themselves as union leaders?

Gilson: We don't have to use the term "entrench;" let's call it "union democracy." The people who elect Mr. Carey[21] are not limited to the UPS workers. The electorate obviously includes

20. *See The Teamsters' Hollow Victory*, WASH. TIMES, Aug. 21, 1997, at A18.

21. Ron Carey is the current General President of the International Brotherhood of Teamsters Union.

the employees of the less solvent participants in the multi-employer pension plan. From the perspective of the entire electorate, the trade-off may have been quite sensible. However, we should not lose sight of the fact that it was, in effect, a tax on the UPS workers.

Conner: In your Allen Chair lecture, you focused on the important role of venture capital in our economy and the importance of stock markets to venture capital. In your view is there another country on the horizon which is capable in the intermediate future of duplicating this financing approach, Silicon Valley-type technology, and the resulting financial successes?

Gilson: Great Britain and Israel have done quite well in this area, although both have stock market-centered economies. Another round of new small capitalization stock markets have been organized in Germany and France. It will be interesting to see how they do. Even if these efforts are no more successful than the prior round, European companies can make use of NASDAQ, thereby piggy-backing off of our differently structured capital market.

Conner: Are there any lessons so far in their development that the U.S. system can learn from? Are there any things that they did right, that we did wrong?

Gilson: On the high-tech side, I think that the answer is no. In general, however, there are a large number of things they do better. We have no vocational training. The U.S. industry could absorb a zillion machine tool operators if we had some way to train them. In contrast, the Germans do an exceptional job of vocational education. There are wonderful, high-paying jobs to be had, but we're not training people for them.

There is an enormous growth in the attention being paid to comparative corporate law, and to issues like comparative training. It remains to be seen whether it attracts any political interest. Corporate governance can't affect schools, even though the quality of vocation training dramatically affects corporate performance and competitiveness. That debate is in the political arena.

Conner: Do you see any potential that the politicians will take note of what the thinkers in this country have already noticed?

Do you see real potential that we will take advantage of the lessons learned in other countries?

Gilson: Boy, I would like to be really optimistic, but few people have given the issue proper attention. There are a couple of people in Congress who have made it an agenda. One is Congressman Tom Campbell who represents Silicon Valley and may be the smartest person in Congress. Hopefully, the Republicans will put him on a committee soon. Tom is articulate and smart. He has a Ph.D. in Economics from Chicago, a Harvard law degree, and is on the law faculty at Stanford. He represents a district that cares a great deal about investment in human capital. We'll have to see if the Republican leadership listens to him.

Conner: Do you see any of these countries who are doing things right possibly accelerating its technological and corporate development in such a way as to get ahead of the U.S. in the reasonably short term?

Gilson: In the very short term it is hard to see any place that is capable of developing an innovative technology sector that will rival the U.S.

Conner: And in the next twenty or thirty years?

Gilson: In that length of time, all outcomes are up in the air.

Conner: Do you see China or Russia as possibilities?

Gilson: It is entirely possible. They both have the potential for extremely hard working and extremely well-trained workforces. But you are also asking for a prediction about reform of the political system, the development of stable property rights, and the overall stability of the societies: what the strategists call "political risk." As to this, I don't have a clue.

Conner: The companies in Silicon Valley tend not to enforce non-compete provisions . . .

Gilson. They cannot enforce them.

Conner: Yes, because of California law.

Gilson: Correct.

Conner: They do not enforce non-compete provisions against their departing employees despite the high mobility of the workforce there. Also, they often do not apply for patents. In your view, is this an ideological expression of their commitment to the free flow of information? Because there is evidence of the existence of agreements that employers can use to get around the laws disallowing non-compete provisions.

Gilson: It is hard to do effectively, and you are not going to scare off venture capital very much by rattling the litigation sword. On the patent issue, you do see a pattern of cross-licensing, where companies basically believe that, in the end, they are better off having access to everybody's technology, than trying to monopolize their own. I don't think that is ideological. It is driven by what is in their own best interests. They tried like crazy to enforce them; they just failed. The serendipity was that, because of a nineteenth century peculiarity in California law, failing was the best thing that ever happened to them.

Conner: Success was forced upon them?

Gilson: Yes. I don't think it was conscious.

Conner: What do you think of the recent wave of telecommunications consolidations?

Gilson: I cannot make heads or tails out of it. More generally, these transactions are driven by beliefs about real economic value. There are people who genuinely believe putting different combinations of assets under one roof generates real economies. Sometimes people are right, and sometimes they turn out not to be right. Time-Warner believed in something called a "media conglomerate." It turns out that there really hasn't been any special value in having a movie company own a magazine or a record company; in the phrase "media conglomerate," the critical word turned out to be conglomerate. In the telecommunications transactions, people are betting on their perception both of future technology and of the way markets are going to develop. I am going to enjoy sitting back and watching, but I don't have an independent view on whose bets look best.

Conner: Do you think that part of the issue is the fact that modern technology requires larger and larger investments, and larger companies are more capable of staying on top technologically?

Gilson: That assumes some fairly massive inefficiency in the capital markets. You have to tell the story that internal financing is better than external financing. And you can begin to tell some stories where that makes sense. But again, it is not obvious to me that scale alone is driving the phenomenon, particularly if the acquirers are paying for the acquisitions with their own stock. If they can finance an acquisition with their own stock, they can finance internal growth with their own stock. At least for now, I am agnostic.

Conner: You have noted some doubts about success. Are there any potentially serious problems that could result from these consolidations?

Gilson: When acquisitions turn out badly, people lose their jobs. Bob Allen forced AT&T to buy NCR. AT&T loses ten billion dollars and Allen loses his job.[22] It took too long, but it happened. People make internal investments. IBM invests more internally every year than the entire venture capital industry's annual disbursements. It is easier to observe venture capital because it takes place on the outside, but people are making the same kinds of investments on the inside. They are high risk investments; sometimes they lose. You are making technology bets; you are making a bet on consumer preferences. They are risky investments.

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22. *See* Tom Lowry, *Superstars Who Lost Their Luster: CEOs Find Fame, Fortune Fickle*, USA TODAY, Oct. 26, 1995, at 1B.