Leo Strine's Third Way: Responding to Agency Capitalism

Ronald J. Gilson*

Ten years ago, Tony Blair's "New Labour" government sought an agenda that replaced ideology with a pragmatic focus on both the creation of wealth and its distribution. Not surprisingly, part of this effort involved proposals to bridge the gap between capital and labor through reframing corporate governance. A "third way" as it was then styled, would walk a fine line between privileging markets and allocational efficiency at the cost of social justice on the one hand, and accepting less for everyone as long as the distribution was fair on the other. Motivated by changes in how we save for retirement that have made workers "forced capitalists," Vice Chancellor Leo Strine in *Common Sense and Common Ground* offers his own third way: an approach to corporate governance that reflects the dual status of worker-shareholders.

But more is needed than the shift in the position of workers from creditors under a defined benefit plan to shareholders under a defined contribution plan, to prompt a strategy for making corporate governance more worker friendly. After all, the U.S. corporate governance system generally privileges shareholders. Whichever side may have won the legal fight in the 1980s over the objective function of the corporation, as a practical matter even the Business Roundtable has come to acknowledge that the corporation's purpose is to maximize shareholder value. If workers are shareholders, their interests will be protected just like those of other shareholders.

So, to set up the need for changes in corporate governance to address the needs of forced capitalists, the Vice Chancellor needs to find a set of problems with the current system that peculiarly disadvantages worker-shareholders. He identifies three.

First, workers are not entirely like other shareholders. They share with others an interest in the appreciation of their stock, but they also have an interest in stable employment. Workers' more complicated agenda, Vice Chancellor Strine argues, requires that management focus on the long-term success of the corporation even if the market applies too high a discount rate to future earnings and therefore renders myopic profit maximizing based on the market's measures of the corporation's cost of capital.

Second, Vice Chancellor Strine believes that some major players in the capital markets may not share workers' concern with the long-term value of the corporation. If these players, exemplified by activist hedge funds, believe that current market value undervalues the future, they will focus on short-term profits, not long-term value. Thus, Vice Chancellor Strine's analysis requires a meaningful and observable difference between a long-term and short-term strategy, taking into account that the parties to a dispute over a corporation's existing strategy will derogatorily label each other's position.

Third, the very mutual funds in which workers invest must lend their support and

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* Charles J. Meyers Professor of Law and Business, Stanford Law School; Marc and Eva Stern Professor of Law and Business, Columbia Law School; and member of European Corporate Governance Institute (ECGI). I am grateful to Jeffrey Gordon and Michael Klausner for helpful comments on an earlier draft of this Comment.

their votes in order for the activist hedge funds to succeed. The claimed disregard of mutual funds for some of their investors' interests raises issues of agency costs with respect to the behavior of financial intermediaries on whom workers rely for protection. We live in a system of "agency capitalism," to borrow the title of a recent conference at Stanford Law School. Shareholders are increasingly sandwiched between two different sets of agency problems–those associated with corporate managers' potential to disregard the interests of their shareholders, and those associated with the managers/owners of financial intermediaries' potential to disregard the interests of their investors.[1]

The roots of Vice Chancellor Strine's efforts, he tells us, are found in his own background. He came to the chancery court not from corporate law practice, but from a position as counsel and policy director for a Democratic governor who apparently shared some of Tony Blair's impatience with ideology. Vice Chancellor Strine learned that focusing on the parties' interests, rather than their rhetoric, identified deals that would make both sides better off, although often at the cost of ideological inconsistency.

Common Sense and Common Ground holds out the potential for such a deal between workers and corporate management. In Vice Chancellor Strine's analysis, both groups share a stake in the long-run performance of the corporation, which is quite different than what Vice Chancellor Strine views as the short term orientation of institutional investors and is only inexactly measured by short-term movements in a corporation's stock price.[2] The framing of the familiar corporate governance debate over each new tool to make managers more accountable to shareholders–for example, just say no campaigns, majority voting for director elections, and shareholder adopted bylaws–typically puts management and labor on opposite sides, and cloaks in ideology the pragmatic conclusion that both share a common interest in allowing corporations to maximize long-term value. How long a leash managers are given to achieve long-term value is the kind of rough judgment that lends itself to pragmatic "political" compromise.

Vice Chancellor Strine's analysis leads him to a set of plausible reforms that share a common theme: give corporate managers some limited protection from what Vice Chancellor Strine sees as activist investors' demand for instant returns, but reduce the barriers to shareholder action if management continues to perform worse or even differently than shareholders expect. Management would give up staggered boards but be allowed to retain a poison pill;[3] elections for directors would occur only every three

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1. As we will see in Part II, the situation is really a little worse—in fact, there are actually three levels of agency cost between the ultimate investor and the investment of funds in a corporation's business activities.

2. The phenomenon of an alliance between management and the labor representatives on a German corporation's supervisory board because of co-determination has been one of the central criticisms of co-determination.

3. This returns the law roughly to where things stood immediately after *City Capital Assocs. v. Interco, Inc.*, 696 F. Supp. 1551 (D. Del. 1988), the high water mark of shareholder influence over takeovers: the pill could be used to conduct an auction, find an alternative, or persuade shareholders that management was right about the long-term value of the firm. When this effort ended, however, the pill had to be pulled and the shareholders allowed to decide whether to accept a hostile offer. In Vice Chancellor Strine's current proposal, the decision would be made through a proxy contest rather than through a decision on whether to accept a tender offer. While I prefer a market, as opposed to an electoral, safety valve, *see* Ronald J. Gilson & Alan Schwartz, *Sales and Elections as Methods for Transferring Corporate Control*, THEORETICAL INQUIRIES IN LAW, July 2001, at 1, the increasing sophistication of institutional investors has reduced the importance of the difference in techniques.

years, but on these occasions the playing field between incumbents and challengers would be significantly leveled; shareholders would be allowed to adopt binding bylaws, including a bylaw that would require shareholders to approve executive pay; and, in a variety of ways, institutions would be pushed toward longer time horizons.[4]

For those who inhabit the middle ground in American corporate politics, the idea of a third way has a powerful attraction. Do we really believe that all of the costs associated with a reduction in well-paying jobs are fairly measured by the corporation's savings and therefore the shareholders' gain? Ten years ago Bernard Black and I stressed that the efficiency of an acquisition is measured not by the net abnormal returns experienced by bidder and target shareholders, but rather by the net of the acquisition's impact on all those who are affected by it.[5] Do we really believe that standard economic assessments of the costs and benefits of global outsourcing fairly include the costs associated with the loss of the positive externalities associated with long-term employment? Henry Hansmann, in the pages of this Journal, recently noted that a country might well choose the social (and therefore economic) benefits of stable jobs rather than "lower prices on MP3 players,"[6] putting aside for the moment whether the choice is any longer feasible. It is in this gap between the social and stock market measure of corporate performance that Vice Chancellor Strine finds the potential for a deal: labor and management versus pure financial investors. On at least the positive level, Vice Chancellor Strine is in good company. Mark Roe's pioneering demonstration that populist-motivated political deals have repeatedly constrained the ability of U.S. capital markets to directly influence corporate management is by now a respected theme in the academic literature.[7]

The critical question, however, is at the normative level: Is there really a problem to be solved? In my comment I will briefly address three subjects touched on in Vice Chancellor Strine's interesting essay. Part I considers whether workers as forced capitalists really have a different interest than other shareholders. This necessarily addresses the coherence of the premise that underlies Vice Chancellor Strine's analysis: a significant and readily observable difference between long-term and short-term

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4. Among others, Vice Chancellor Strine suggests requiring activist investors to disclose their short positions so shareholders can better understand what action by the corporation will make them money; to hold a net long position for a specified period before being allowed to make a shareholder proposal or a books and records request; and taxing more highly short term securities trades.

5. RONALD J. GILSON & BERNARD BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 610 (2d ed. 1995)

> [E]ven positive net returns to both acquiring company and target company shareholders may reflect only wealth transfers from corporate stakeholders, like employees, to shareholders. Thus, the absolute magnitude of acquisition premia or the fact of positive net abnormal returns earned jointly by acquirer and target shareholders bear *no necessary relationship* to the efficiency gains created by takeovers if takeovers can also have a negative impact on non-shareholder groups.

Id.

This is the general view of economists. *See* Marco Becht et al., *Corporate Governance and Control* 8 (ECGI Finance, Working Paper No. 02/2002, 2002) (stating that corporate governance structure is "efficient if it generates the highest possible joint payoff for all the parties involved, shareholders, creditors, employees, clients, tax authorities, and other third parties that may be affected by the corporation's actions"), *available at* http://ssrn.com/abstract=343461.

6. Henry Hansmann, *How Close is the End of History?*, 31 J. CORP. L. 745, 747 (2006).

7. MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994).

management. Part II takes up the question of agency capitalism, and in particular the role of mutual funds in Vice Chancellor Strine's analysis. Finally, Part III briefly considers a broader question: the nature of the global economy in which companies operate. Here my concern is that in our current economic environment, and for the foreseeable future, the concept of a long-term strategy may be at best a nostalgic indulgence and at worst a destructive mirage. From this perspective, a governance structure that maximizes the speed with which a corporation responds to economic change may be in everyone's interest even at the cost of shortening the planning horizon.[8]

I. THE SPECIAL INTERESTS OF WORKERS AND THE DISTINCTION BETWEEN LONG-TERM AND SHORT-TERM MANAGEMENT

As Vice Chancellor Strine stresses, workers are increasingly shareholders, forced into this status by a shift in the structure of retirement savings. The move from defined benefit plans to defined contribution plans transforms workers from creditors of their employer to investors in the overall economy. To understand Vice Chancellor Strine's point, it helps to take a moment to explain this shift in a little more detail. For most of the post-World War II period, employees of large companies saved for their retirement through defined benefit plans. In this regime, a worker's wages consisted of two elements: current pay and a promise of retirement benefits in an amount typically specified as a percentage of average pre-retirement wages measured over a specified period. The idea was that each year the company would put away the actuarially determined amount that, after investment, would yield the funds necessary to make retirement payments as they became due. In effect, the company took the investment risk (retirement payments were not pegged to the performance of the company's investments), and the employee took the credit risk (that the company would have the funds to make the retirement payments).

The difficulties with the defined benefit system are by now familiar. Many companies cheated. Either they simply did not make the payments necessary to fund their pension plans on an actuarially sound basis (leading to large unfunded past service costs),[9] or they assumed too high a return on investment in order to minimize the amount they actually had to put aside. In both cases, either workers ended up with reduced pensions or shareholders ended up bearing the shortfall.

Defined contribution plans, in contrast, shift the investment risk to the employees. In such a plan, the company is obligated only to make an annual payment on behalf of an employee, who then manages the investment of the funds contributed to his account. The employee's retirement income then is a function of his investment acumen; the company satisfies its obligation by making the annual payment. As I will discuss in Part II, this seems an odd tradeoff. It does eliminate the potential for and the difficulty of evaluating large unfunded past service costs, but achieves it through what seems a strange kind of risk transfer—the safety of securing sufficient retirement income was shifted from a sophisticated investor (the company) to an unsophisticated investor (the worker).

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8. The reader will note that I will not take up the particular proposals the Vice Chancellor proffers. Precisely because each warrants extended discussion, the best course is to leave their assessment to others.

9. This resulted in a vicious political fight, perhaps the first time accounting got the attention of Congress, over whether the unfunded liability to workers had to be shown on a company's financial statement.

Without more, forced worker stock investments do not seem to pose the governance problems that concern Vice Chancellor Strine. Like any other diversified shareholder, the employee would want to maximize the value of the stock he holds; all shareholders are thus in the same boat. However, one can imagine, at least in theory, two kinds of differences between workers and other shareholders, one which could be but is not serious, and one which might be.

The potentially but not actually serious problem arises if the employee invests his retirement contributions in his employer's stock. Then the employee's preference will be to maximize a combination of the value of his stock and his ongoing investment, with respect to neither of which the employee will be diversified. In that event, risk matters for employee-shareholders: unlike risk neutral diversified shareholders, the employee will not want the company to accept all positive net present value projects regardless of a project's risk. A corporate governance system designed to maximize value for diversified public shareholders would not well serve the employee-shareholder.

For present purposes, however, and despite the experience of Enron employees who misguidedly invested their defined contributions in Enron stock, the problem is not important unless the employee is investing in his employer's stock. This is plainly not the problem that concerns Vice Chancellor Strine.

The second problem, which is what I think Vice Chancellor Strine has in mind, requires a social conscience on the part of the worker. Even though an individual worker with a diversified defined contribution plan will be best served if his portfolio companies maximize the value of equity even at the risk of reduced employment by those companies (because the employee likely does not work for any of his portfolio companies), the employee may have some sense of solidarity with workers at those companies, and also may recognize that if all workers made the same assessment, all workers, including himself, would suffer (I recognize that this is the opposite of the free rider analysis usually applied in this situation–that is why the solidarity is necessary). Then each worker will prefer that all of their portfolio companies behave as if each actually was their own employer. It is this preference that provides the common ground between managers and workers on which Vice Chancellor Strine's corporate governance deal depends: both managers and worker-shareholders will want to maximize something more complicated than the value of equity, and activist and institutional investors will be single-mindedly devoted to maximizing only equity value.

As will appear in Part III, I am skeptical about the ability to predictably differentiate between corporations that have sensible long-term strategies that the market misunderstands and so undervalues (those of concern to Vice Chancellor Strine), and a company that is simply following a bad strategy however long its horizon. For this Part, however, I will simply assume that management and workers may accord a lower discount rate to corporate strategies than does the market, whether because of market myopia or because management and workers are maximizing something different than purely financial investors. Here I want only to question the feasibility of the Vice Chancellor's deal.

Let me start with an anecdote. The Pennsylvania anti-takeover statute is by some measure the most virulent of the state efforts to protect local employers from out-of-state bidders. I had a personal, albeit ineffectual, experience during its consideration by the Pennsylvania legislature. In my first (and only) experience as a lobbyist, I spent two days

in Harrisburg trying to persuade legislators that the proposed statute would disadvantage Pennsylvania companies. I also tried to explain to Democratic legislators that the legislation in fact did not protect workers. Large layoffs result from changes in a company's market; the proposed statute only protected against layoffs that acquirers would make but that targets would not. Labor was left entirely exposed to being fired by existing mangers.[10] Despite the eloquence of my presentation, most legislators I spoke with politely waited until I was finished, and then explained that they were not voting against any legislation jointly sponsored by the state Chamber of Commerce and the AFL-CIO.

So there is the opportunity Vice Chancellor Strine has in mind. When labor and management get together, they can usually accomplish what they want. Here I add only a corollary: when labor and management get together in order to make corporate governance more favorable to management, labor may not end up with the protection Vice Chancellor Strine envisions.

I have a second pragmatic concern about prospective governance deals between management and labor: who speaks for labor? The shareholder activism and litigation Vice Chancellor Strine describes is necessarily undertaken by organized labor. I simply raise the question whether organized labor, which represents an increasingly small portion of the work force, fairly represents the non-union workforce that, among other industries, is dominant in technology companies.

II. AGENCY CAPITALISM

Vice Chancellor Strine stresses that institutional investors, particularly mutual funds, hold their shares on behalf of their beneficiaries, and that these representative arrangements also raise agency problems. Our corporate governance system therefore may be fairly characterized as "agency capitalism," where two levels of agency relationships separate the beneficial owners from the actual assets in which their funds are invested: both the investment decisions concerning which companies to invest in, and the investment decisions made by those companies in their actual business activities, are made by agents.[11] I want to focus my brief remarks here on the mutual fund facet of the agency capitalism phenomenon for two reasons. The first is simply that Vice Chancellor Strine emphasizes this segment. The second is that I know something about it. The Vice Chancellor was refreshingly candid about his background, and I want to meet that standard. For some ten years I have been an independent director on the boards of a number of the funds advised by a large mutual fund adviser, and have devoted significant attention to the funds' voting policies.[12] While I cannot represent that my experience

10. In contrast, statutes like the Maine plant closing statute, which require severance pay to workers at a closed plant regardless of who fired them, do not suffer from this defect.

11. In fact, there is yet a third level of agents: financial advisers who influence or actually make the decision concerning the mutual funds in which an individual invests. As of 2004, approximately 80% of mutual fund investors "hold fund shares purchased through professional financial advisors, including full-service brokers, independent financial planners, insurance agents, bank or savings institution representatives, and accountants." INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK 33 (2005), *available at* http://www.ici.org/pdf/2005_factbook.pdf. Only 14% of investors acquire all of their shares directly from the fund company (and without the additional fees paid to an adviser). *Id.*

12. Vice Chancellor Strine rather harshly evaluates a range of professionals, including academics,

generalizes, it is at least one data point.

As to the corporate governance elements that Vice Chancellor Strine considers—the poison pill, staggered boards, executive compensation, shareholder proposals—voting policy is set by the mutual fund board. In my case the boards are composed entirely of independent directors, with the exception of the chief executive of the adviser, and have an independent chair.[13] These policies, rather than the recommendations of advisory services, dictate fund votes on governance issues. On investment related voting, such as the approval of a merger like the contested Hewlett Packard-Compaq transaction, the decision is made fund by fund by each portfolio manager, and different funds may vote differently on the same transaction because of different holdings and different investment strategies.

Are mutual funds short-term oriented in the sense Vice Chancellor Strine claims? I think the short answer, at least for the good ones, is not if they can help it, but the extent to which they can help it is complicated. Financial advisers evaluate the performance of mutual funds, and mutual funds evaluate the performance of portfolio managers, and portfolio managers evaluate the performance of portfolio companies and potential portfolio companies. In each case, the evaluator must determine the period of time over which to measure performance. Mutual funds that seek to outperform the market will not always succeed; being smarter than the market only some of the time is a significant accomplishment. Portfolio managers are subject to the same phenomenon. And there is always the danger that a fund or a portfolio manager may be tempted to take on more than the appropriate risk in order to game the performance standard. Indeed, one should be as concerned about funds and portfolio managers who over-perform as those who under-perform; both may signal inappropriate behavior.

My point is simply that, absent significant market inefficiency in pricing stocks, short term strategies by companies, portfolio managers, or mutual funds are not likely to succeed. As a result, I remain skeptical of the familiar, but never documented assertion, that the market is systematically myopic. Activist investors and hedge funds may sometimes be wrong, but as with any investment decision, that is in the nature of the game. Campaigns to force companies to pay more to shareholders may be wise when management is badly investing its free cash flow, and may be harmful if the company has better opportunities than otherwise available in the market. I am aware of no basis for a conclusion that the strategies pursued by activist investors, private equity firms, or institutional investors systematically get it wrong.

Finally, I wonder whether at least some of the governance initiatives Vice Chancellor Strine offers really need a "third way" coalition for their adoption. For

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journalists, independent directors, and financial intermediaries as being influenced by their personal interests in pursuing their work. Inevitably, we all face self-interest in our work; it is the mark of a professional to overcome it. Regrettably, every field presents too many examples of failure, but a danger also exists that constant immersion in the reality of governance causes pragmatism to dissolve into cynicism, where no one's motives or performance survive scrutiny. Judges also have been the victim of this phenomenon. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). Pragmatism is harder than it looks; perhaps that is why there is so little of it.

13. Mutual funds disclose on their web sites in more or less detail their voting policies concerning governance matters. *See, e.g.*, Vanguard Personal Investors Homepage, http://flagship.vanguard.com/VGApp/hnw/content/Home/WhyVanguard/AboutVanguardProxyVotingGuidelinesContent.jsp (last visited Sept. 25, 2007).

example, I do not recall a circumstance when a company came to one of the funds on whose board I sit and inquired whether the fund would support a poison pill that was "chewable"–that is, the shareholders would get to decide whether an acquisition should go forward after the company had a reasonable period of time to secure a better bid or to convince the shareholders that the company was worth more if it remained independent. Perhaps companies underestimate the potential to persuade mutual funds to support such a pill, or perhaps the Vice Chancellor's deal is not what management wants.

III. IS THERE A LONG RUN?

In the end, whether there remains a long run, in the sense of projects with so extended a horizon that current investors and analysts cannot fairly evaluate it, is in part an empirical question and in part a question of ideology. The empirical question is easy to frame but not, I think, so easy to answer. Have ever more complete markets and ever more rapidly evolving technology combined to so increase the pace of product market change that the key to success is the corporation's capacity to quickly adapt to changes in its market, not its capacity to stay the course in the face of a doubting capital market? If this is the case, then the direction of corporate reform should be to more completely open the corporation to the capital market, because the more quickly an external response to a corporation's failure to respond internally to change is triggered, the more likely that the corporation will survive and its workers will continue to have jobs. Anecdotes prove nothing, but it is hard not to think of the U.S. automobile industry's decades long hemorrhaging of market share and jobs while completely protected from capital market pressure, save for a single run at Chrysler by the activist investor Kirk Kerkorian quite late in the period.[14]

And precisely because the empirical question is difficult to answer, much of the battle is unavoidably fought on ideological grounds. Renier Kraakman and I recently referred to the conflict as one between Burke and Schumpeter.[15] Referring to Martin Lipton's career-long impassioned and effective defense of assuring management the protection to manage in the long run, we said the following:

> Where Burke celebrates the French monarchy, aristocracy, and clergy, as the architects of France's prosperity, Lipton celebrates the moral and economic leadership of America's CEOs, board members, and investment bankers. Where Burke decries stock jobbers, speculators, and mobs, Lipton's targets are raiders, speculators, and "ad hoc consortiums" of shareholders. And where Burke rejects "popular election" as "the sole lawful source of authority," Lipton rejects share-holder choice as the sole basis for deciding the outcome of hostile tender offers. Even the short-term perspective and lack of attachment to particular companies that Lipton sees as characteristic of raiders and arbitrageurs resembles Burke's earlier critique of France's revolutionary leaders.[16]

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14. Quite recently, Kerkorian also made an ultimately unsuccessful effort to influence GM.

15. Ronald J. Gilson & Reinier Kraakman, *Takeovers in the Boardroom: Burke versus Schumpeter*, 60 BUS. LAW. 1419 (2005).

16. *Id.* at 1423-24 (citations omitted) (citing EDMUND BURKE, REFLECTIONS ON THE REVOLUTION IN

> Schumpeter presents precisely the opposite understanding of the world.
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> For Schumpeter, the essence of capitalism is not the ordinary competition that goes on within an existing industry structure— incremental changes in prices, quality or products that leave the underlying marketplace unchanged. Rather, economic progress comes from revolutionary changes that subvert the *ancien regime*. As Schumpeter put it, "the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them."[17]

The juxtaposition of Burke and Schumpeter brings us back to the concern that motivates Vice Chancellor Strine's essay in the first place: the importance, both economic and social, of providing workers stable and meaningful employment. Schumpeter's "'perennial gale of creative destruction'"[18] does not strike selectively; the existing structures it destroys house workers.

And there, in the end, is my real misgiving about Vice Chancellor Strine's agenda: it is concerned with the wrong kind of governance. Corporate governance is about the efficient allocation of resources. Real governance, the field on which Leo Strine played before joining the chancery court, is concerned with distribution, with politically accountable officials spreading the costs of rapid economic change, what Jeffrey Gordon has called "the transition costs of capitalism."[19] I fear that trying to protect labor through corporate governance rather than real governance runs the dual risk of both increasing the risk that corporations will not quickly adapt, and leaving workers without a safety net when those corporations change too slowly to survive. To be sure, the Europeans have treated the corporation as a social institution as well as an economic institution, concerned about social justice between labor and capital, not just wealth creation. But it requires no crystal ball to see that balance continuing to unravel. If a corporation is to be less efficient (although more fair) than its competitors, then either trade barriers or subsidies (now limited both by the WTO and the European Union) are necessary to protect the corporation's continued survival. In this country, neither is a viable strategy (at least outside the agricultural sector). In Europe, we can expect to see less of both. The burden of addressing effectively the distributional effects of allocational efficiency will have to come from the governance arena that Vice Chancellor Strine left, not the one that has concerned him since joining the chancery court.

FRANCE (Frank M. Turner ed., Yale Univ. Press 2003) (1790)).

17. *Id.* at 1431 (footnotes omitted) (quoting JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 84 (3d ed. 1950)).

18. *Id.* (internal citations omitted).

19. Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1523 (1997).