

Corporate Governance versus Real Governance

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Abstract

The rough coincidence of the 50th anniversary of Milton Friedman's Sunday New York times Magazine article – “the Social Responsibility of Business is to Increase Profit” – and a movement advocating that corporations should have a broader purpose than maximizing shareholder value headlined by the British Academy's project on the Future of the Corporation and especially the corporation's obligation to other stakeholders, raises questions concerning to whom the corporation is accountable and for what. This essay broadly distinguishes between the corporation's allocation and distributive decisions: on the one hand, how it goes about creating value; and on the other, whether it chooses to allocate the value created in a fashion different than would result from factor market outcomes. This distinction roughly highlights the difference between *corporate* governance, which serves to allocate accountability for the profitability of the corporation's business to the market, and *real* governance, which allocates accountability for distributive decisions ultimately to elected officials.

The essay then addresses the relative effectiveness of corporate and real governance and, in particular, in the context of whether corporate governance could be effective in responding to Facebook's massive data breach in connection with Cambridge Analytica.

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Corporate governance has been an especially productive academic field over the 40 some years since the term took on prominence.¹ This should not be surprising. The organizational design of the largest business enterprises in history should command our attention and would explain the unusually wide range of academic disciplines and methodological techniques – for example, economics and finance, organizational theory, management, accounting, law, network theory, modeling, empiricism, social theory – for which corporate governance has provided scholarly agendas for those of us in the academy.²

But it's been a better gig than that. Had corporate governance been a problem that lent itself to a single stable solution, we would have written one best practices code and been done with it some time ago. Instead, the debate over whether there will be convergence of corporate governance across different countries and in one or more directions has died down, because real world developments over the past twenty years have pretty clearly outrun the end of history conjecture. For example, we observe the shift from the single-minded focus on policy channeling in the heyday of classic postwar Japanese corporate governance, to the slow but palpable recent shift in orbit toward shareholder value maximization, most recently illustrated by the successful shareholder revolt at Toshiba that displaced the non-executive chair of the board. In China, efforts to make the capital market more complete by creating the institutions needed to allow state-owned or influenced companies to raise funds from the public market have also served the policy goal of expanding Communist Party influence over corporate management. More broadly, we observe the reversal of the 1980s shift away from state owned enterprises, to their reemergence in the new century; by the end of 2015, the central governments of 40 countries, excluding China, were full or majority owners of nearly 2,500 SOEs collectively valued at \$2.4 trillion and employing over 9 million people.³

Most recently, the corporate governance debate in the U.S. and the U.K., has centered on the tension between an overriding goal of maximizing shareholder value on the one hand and, on the other, a stakeholder focus on how the governance system can be used instrumentally to influence the distribution of the value created by corporate activity among all those affected by it. Colin

¹ I will take advantage of the opportunity to participate in a Festschrift for Rolf Skog, whose work I have admired and whose friendship I have appreciated for many years, to offer an essay, rather than a standard law review article. This will allow me to eschew the large number of footnotes associated with law review articles that provide support for claims in the text (and sometimes interesting asides) at the cost of slowing down a reader's progress. That said, I nonetheless pass on an idiosyncratic arithmetic inquiry I made some years ago concerning the central role that corporate governance had come to play in financial economics scholarship. For the years 1995 through August 29, 2013, more than a quarter (414 out of 1513 [27%]) of all articles published in the *Journal of Financial Economics*, one of the leading financial economics journals, dealt with corporate governance.

² The length of the footnote that would be necessary to support the uncontroversial statement in the text is an example of the attraction of the freedom that participating in this Festschrift volume provides.

³ Gilson & Milhaupt, *supra* note *. The measures of the new role for state owned enterprise are drawn from the OECD, *The Size and Sectoral Distribution of State-Owned Enterprises* 8 (2017), available at <http://dx.doi.org/10.1787/9789264280663-en>. For a comprehensive overview of the ownership structure in the world's listed companies, see De La Cruz, A., A. Medina and Y. Tang (2019), "Owners of the World's Listed Companies", OECD Capital Market Series, Paris.

Mayer's recent writings, stressing the need to reinvent the public corporation, and his leadership of the current British Academy project on the future of the corporation, which seeks to accomplish "a radical reformulation of the concept of the firm", as well as Martin Lipton's "new paradigm" for corporate governance that has been adopted by the Davos World Economic Forum, reflect the views of both a leading academic and those of an influential practitioner that a corporation should have a broader purpose than simply maximizing shareholder value. Larry Fink, CEO of BlackRock, the largest U.S. institutional investor with assets under management of some nine trillion dollars, now echoes these themes in his yearly missives to investors in BlackRock's funds and to the management of BlackRock's portfolio companies.

An easy explanation for the continuing high-profile debate over corporate governance and corporatize purpose might be their recent high-profile entry into the political debate. Both Elizabeth Warren, a serious candidate for the 2020 Democratic nomination for President in the United States, and Jeremy Corbyn, the unsuccessful Labor Party leader in the last United Kingdom election, proposed legislation with significant overlaps that would have moved U.S. and U.K. governance sharply in the stakeholder direction. But there is more to it than that. As Curtis Milhaupt and I have argued,⁴ corporate governance has a built-in dynamic that drives a cycle between governance structures that support maximizing shareholder wealth and those that take seriously a corporate obligation to stakeholders.

The Business Roundtable's shifting position over the last 30 years on the role of shareholder versus stakeholder value in corporate governance nicely illustrates that dynamic. The Roundtable's 1978 and 1981 statements on the purpose of the corporation tried to walk a tightrope between the competing claims of shareholders and stakeholders. The 1981 statement explained that:

balancing the shareholder's expectations of maximum return against other priorities is one of the fundamental problems confronting corporate management. The shareholders must receive a good return but the legitimate concerns of other constituencies also must have appropriate attention.

Then sixteen years later, in 1997, the Roundtable moved to a flat shareholder value maximization framing: "the principal objective of a business enterprise is to generate economic returns to its owners", only to bounce back a couple of decades later with a broader 2019 framing of the corporation's obligation that added stakeholders to the corporate purpose brew: "a fundamental commitment to *all* of our stakeholders." In explaining the 2019 move back to a stakeholder orientation, the Roundtable frankly acknowledged that its 1997 shift toward shareholder value maximization had been "partly in response to growing pressures from corporate raiders". Its 2019 return to a broader framing that encompasses concern with a lengthy list of stakeholders was said to "better reflect the way corporations can and should operate today". Similar tension can be observed in other countries.

⁴ Gilson & Milhaupt, *supra* note *.

In this essay, I will suggest that the actual corporate governance cycle should be less dramatic than the rhetorical cycle, because the tension between shareholders and stakeholders reflects an imprecision in the framing of the shareholder-stakeholder debate. The attention paid to the 50th anniversary of Milton Friedman's iconic, but itself rhetorical, 1970 essay, "The Social Responsibility of Business is to Increase its Profits", published not in an academic journal but in the New York Times Sunday magazine,⁵ has resulted in an easy foil for the stakeholder position.⁶ A more careful framing shows that there is less open water between the two positions than the current dialogue reflects.

I. The Stakeholder Income Statement

The exaggeration of the differences between a stakeholder system and a shareholder value system appears clearly from the "Stakeholder Income Statement" set out below.⁷ Each line item in this caricature of a traditional income statement reflects a different category of stakeholder participation in the corporation. In turn, each category of stakeholder participation is mediated through a different factor market.

A Stakeholder Income Statement		
Line item	Amount	Stakeholder
Sales	XXXXXX	Customers
Wages	XXXXXX	Employees
Cost of goods	XXXXXX	Suppliers
Taxes	XXXXXX	Community
Net Income	XXXXXX	Shareholders

Now suppose that each factor market is perfectly competitive. In this hypothetical world, management need not, indeed cannot, referee the process by which the value created by the corporation is divided among competing stakeholders. And little imagination is required to think of how all but the shareholders' interests are conditional on circumstances: the particular production function best suited to the business at a particular time. Different events will differentially affect the value of different stakeholders' inputs. Only the shareholders have an

⁵ Milton Friedman, A 'Friedman Doctrine—The Social Responsibility of Business is to increase it Profits, "New York Times Sunday Magazine, September 13, 1970, p. 17.

⁶ A recent compilation of short articles revisiting Friedman's essay provides a useful retrospective. Milton Friedman 50 Years, a Reevaluation (Nov. 17, 2020), available at <https://promarket.org/2020/11/17/ebook-milton-friedman-50-years-later/>

⁷ The Stakeholder Income Statement concept and its presentation is taken from Ronald J. Gilson, From Corporate Law to Corporate Governance, Oxford Handbook of Corporate Law and Governance 3, 24 (eds. J. Gordon & Georg Ringe, 2018).

incentive to adjust the returns other stakeholders receive for their inputs, because the residual returns will depend on the success of that adjustment. Put differently, one could substitute for the term “maximizing shareholder value” that of “Kaldor–Hicks efficiency” as a description of the operative governance model, and so match the label to the measure of social welfare.

At this point, there is a common objection to my analysis. Getting the corporation’s production function right makes all the stakeholders, including shareholders, better off. As a result, maximizing stakeholder interests and maximizing shareholder interest converge. As Alex Edmans has put it in a recent book, in this circumstance, “profits are an outcome, not a goal.”⁸ The problem, however, is that companies do not necessarily share Edmans’ analysis of their goals.

The best example of this, which Edmans also addresses, is the different business strategies of Costco and Sam’s Club. Both are U.S. big box membership grocery, hard goods and soft good stores. Sam’s Club is the big box strategy for Walmart, among the largest retailers in the world. Costco and Sam’s Club are direct competitors, but nonetheless have one critical difference: how they treat stakeholders, especially employees. Costco treats its employees better; it provides higher wages, better healthcare, including to part-time workers, and more employee-friendly scheduling.

Costco recently raised its minimum starting wage to \$16 per hour from \$15. Its average wage is \$24 per hour. Until recently, Walmart’s minimum wage was \$11 per hour. Walmart then raised the wages of 435 000 workers; half of U.S workers would earn at least \$15 per hour, but did not raise its minimum hourly wage for all employees to \$15.

So why does Costco have such a different strategy concerning its employees than does Walmart? Edmans’ view, quoted above, is that its ability to maintain profits and successfully compete with the very much larger Walmart is the outcome of its efforts, not their goal. But Costco has a very different explanation of its business strategy. Testifying before the U.S. Congress following Costco’s most recent company-wide pay increase, which Walmart did not match, W. Craig Jelineck, Costco’s CEO, explained that Costco has “some of the highest employee retention rates of any retailer”. Jelineck went on to offer a very different explanation than Edmans. “This isn’t altruism”, Mr. Jelineck told the Senate Budget Committee. “At Costco, we know that paying employees good wages and providing affordable benefits makes sense for our business and constitutes a significant competitive advantage for us.”⁹ Edmans quotes Costco’s Chief Financial Officer telling the Wall Street Journal that

From day one, we’ve run the company with the philosophy that if we pay better than average, provide a salary people can live on, have a positive environment and good benefits, we’ll be able to hire better people, they’ll stay longer and be more efficient.¹⁰

⁸ Alex Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit* 43 (2020).

⁹ Michael Corkkery, *Chief says Costco Will Lift Starting Pay to \$16 an hour*, NY Times, February 26, 2021, at B\$.

¹⁰ Edmans, *supra* note 8, at 85.

Costco's position is that company profits are higher if their workers like their jobs and want to keep them; in substance this resembles a business person's account of the economist's efficiency wage theory.¹¹ Reordering Edmans' characterization, for Costco profits are a goal and treating their workers better is a very successful strategy by which to achieve it. In terms of outcome, the tendentious debate over maximizing shareholder value or pursuing a broader corporate purpose ends up, except for the rhetoric, in the same place. As the Costco versus Sam's Club discussion illustrates, there is more than one way to run a company. In markets with real world frictions, differing distributions among stakeholders can be successfully sustained in the same markets. Sam's Club treats its workers' less well but still performs adequately. As Charles Sabel, Robert Scott and I have previously argued, "[T]here is more than one organizational response to particular transaction costs. The relationship is, at least, one to many."¹²

II. Corporate Governance and Real Governance: The Political Economy Perspective

The Accountability of Those Making Distributive Decisions. A second concern about a stakeholder approach to corporate strategy, as opposed to Costco's value creation approach, is more political economy than financial economics. To see this, we can recharacterize maximizing shareholder value and balancing stakeholder participation in corporate value creation in a more general fashion: allocative decisions that address efficiency and value creation, and distributional decisions that allocate value created by a corporation in a fashion different than would result from factor market outcomes.

Here the analysis somewhat tracks Friedman's approach, although without his tax metaphor. As a general principle, allocative decisions are left to the market, in our context, to managerial decisions made through the *corporate* governance structure and policed by the product, labor and capital markets. Distributional decisions – the transfer of value among stakeholders in a fashion different than would be dictated by the relevant factor markets – are made through *real* governance by transfer payments, minimum wage requirements, regulation of working conditions and the like.

The difference between the two forms of governance is to whom the decision makers in each category are accountable. Accountability for allocative decisions take place through the product markets in which the corporation participates, the factor markets in which the corporation acquires necessary inputs including the capital market, and through the corporation's governance structure. I want to focus now on the governance structure. If the corporation performs poorly, decisionmakers are held accountable most directly through the capital market: hostile takeovers and, increasingly, activist-led proxy fights. The board of directors can be replaced or at least heavily

¹¹ See, e.g., Carl Shapiro & Joseph E. Stiglitz, Equilibrium Unemployment as a Worker Disciplinary Device, 74 Am. Econ. Rev. 433 (1984).

¹² Ronald J. Gilson, Charles Sabel & Robert E. Scott, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, 109 Col. L. Rev. 431, 494 -501 (2009).

influenced, through a proxy challenge in which the corporation's performance is held up for review and in which only shareholders vote. In turn, executives can be replaced by the board of directors in light of the board's evaluation of the executive's performance.¹³

In contrast, accountability for distributive decisions, made by the legislature, takes place through *real governance*: elections. The political dimension of the difference between corporate and real governance arises when distributive decisions, based not as with Costco on the value creation consequences of decisions concerning input providers, but on social decisions based on something other than value creation. In corporate governance, these are made, ultimately, by corporate boards of directors, but in real governance they are made by elected representatives. The difference is significant. Putting distributive decisions in the hands of public company boards of directors who, however diverse their social or political views, are still made up predominately of aging white males, seems an odd, and hardly progressive, group to whom to delegate the making of social policy. As of 2019, males held 73 percent of the board seats of S&P 500 companies, and 81 percent of the seats of Russell 3000 companies.¹⁴ Eighty percent of S&P 500 directors were white.¹⁵ The average board age of an S&P 500 board director in 2019 was 63.5 years.¹⁶ To be sure, new directors named to these boards reflect greater gender and ethnic balance, in part due to a California statutory mandate of board diversity¹⁷ and a less aggressive proposal by Nasdaq,¹⁸ and in part due to the retirement and replacement of older board members.

The Efficacy of Corporate and Real Governance. Friedman's 1970 statement of the corporation's purpose turns importantly on the intersection of corporate governance and real governance. The corporation should maximize value creation subject to obeying legal rules and ethical obligations. Maximizing value creation is in the realm of corporate governance; complying with legal constraints is a matter of real governance, since setting and enforcing the legal rules are at the core of real governance. A recent case of misbehavior by Facebook illustrates both the distinction between the two governance modes that influence corporate behavior and something of their relative efficacy.

After an embarrassingly long silence following disclosure that Facebook apparently had faulty controls over who had access to members' personal data or what was done with it – the Cambridge Analytica data breach – the two top Facebook officials went on a humility tour. Referring to the astonishingly broad privacy breach, Sheryl Sandberg, Facebook's chief operating officer, said "that's on me." She "felt deeply and personally responsible". Mark Zuckerberg, Facebook's CEO

¹³ In the U.S., the courts play virtually no role in reviewing allocative decisions, which are protected from judicial review by the Business Judgment Rule that gives the board virtually complete protection against claims of poor business decisions.

¹⁴ Institutional Shareholder Services, Inc., U.S. Board Diversity Trends in 2019, June 18, 2019, available at <https://corpgov.law.harvard.edu/2019/06/18/u-s-board-diversity-trends-in-2019/>.

¹⁵ Spencer Stuart Board Index, https://www.spencerstuart.com/-/media/2019/ssbi-2019/us_board_index_2019.pdf.

¹⁶ <https://insights.diligent.com/board-composition/sp-500-trend-report-board-composition-diversity-and-beyond>.

¹⁷ S.B. 826, 2017–2018 Leg., Reg. Sess. (Cal. 2018) https://leginfo.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB826.

¹⁸ <https://listingcenter.nasdaq.com/assets/Board%20Diversity%20Disclosure%20Five%20Things.pdf> (April 14, 2021). The U.S. Securities Exchange Commission on August 10, 2021 approved the Nasdaq proposal.

and Board Chair, said he was sorry more times in his congressional testimony on the subject than the Chicago Cubs fan whose reaching for a foul ball cost the Cubs a shot at the 2003 World Series and a potential end to a then 95 year World Series drought. A PR and legal team said to number in the hundreds choreographed the response. Fair enough. It is on them both and saying you're sorry is a good place to start.

But is it enough for Sandberg and Zuckerberg just to say they're sorry? The consequences to Facebook of this mess were potentially huge. What does one think the chances were, before the deluge, that Zuckerberg would have more or less (in the end less) committed to applying the European General Data Protection Regulation to its U.S. operations?¹⁹ Did anyone really think that the Federal government would impose an across the board opt-in as a precondition to Facebook's data gathering, the outcome of applying the GDPR?²⁰ If a user gets tired of going through what will be a detailed process of showing that she really understands what Facebook will do with her personal data and who will have access to it, she may just give up and keep her data private by default. The immediate result will be that big data shrinks just a little, but if that pattern is multiplied by millions, perhaps it shrinks a lot. Just floating these concessions on behalf of the company, and ultimately its shareholders, in the course of the humility tour are significant and potentially very expensive even if it only affects the political balance concerning the future of U.S. privacy regulation.

So what happens to Zuckerberg and Sandberg as a result of their taking responsibility for the data breach? When a company's most senior executives acknowledge making financially very large mistakes, something usually happens. In Facebook's case, the Federal Trade Commission required a \$5 billion fine, then the largest fine in FTC history. The most common penalties are that the board reduces their compensation, limits their authority or fires them. So in the first instance, the imposition on senior executives of real consequences for making large mistakes raises questions of corporate governance, not real governance like congressional or state legislative action.

What happened to Zuckerberg? So far, nothing, Facebook insisted that the FTC settlement that specified the terms of the fine release not just Facebook, but Zuckerberg personally, from liability for the misbehavior. At present, shareholder litigation is being pursued in Delaware against the Facebook directors, alleging that Facebook agreed to a larger fine in order to secure Zuckerberg's personal release.

But the answer to this question of corporate governance is important to real governance as well. As a practical matter, real governance steps in only when corporate governance fails, the perception with respect to the Sarbanes-Oxley legislation. And a preference that responsibility be imposed through corporate governance rather than real governance makes good sense. Corporate governance should be faster, more capable of gathering the facts, and more capable of nuance, than

¹⁹ Mark Scott & Nancy Scola, Facebook Won't Extend Privacy Rights Globally No Matter What Zuckerberg Says, Politico, April 19, 2018, <https://www.politico.eu/article/facebook-europe-privacy-data-protection-mark-zucend> Prkerberg-gdpr-general-data-protection-regulation-eu-european-union/.

²⁰ In fact, Apple may have made that decision for Facebook through its most recent changes in its cell phone operating system.

real governance. We can expect a small, talented and experienced board of directors to do a faster and better job than can Congress, an expectation that was reinforced by listening to the interlocutors' during Zuckerberg's Congressional testimony. You can't duck questions in a well-functioning board room. And most important, Congressional action typically petrifies. Once Congress acts, whether wisely or not, that action turns to stone. It becomes very hard to change whether because it was a mistake or because the problems have morphed into something else or because Congress suffers from institutional attention deficit disorder.

So is Facebook governance a viable alternative to real governance to imposing consequences for mistakes for which Zuckerberg and Sandberg embraced responsibility? Here's the rub. Facebook's corporate governance is not up to the task. Put simply, Zuckerberg controls Facebook. No one becomes a director without him supporting their candidacy. We call directors who do not have a financial relationship to the company independent. But in companies with control arrangements like Facebook – Uber's original governance also comes to mind – the independent directors can be fired by the controlling shareholder at any time and for any reason. And that is why being an "independent" director in a company with a controlling shareholder is the hardest job in corporate governance. Your job is to throw your body in front of a train that well may not stop. Imagine the conversation between Zuckerberg and the Facebook independent directors when he can fire the board but they can't fire him.²¹

Good corporate governance keeps bad behavior out of Congress and so it plays a quasi-real governance role. Facebook-style corporate governance cannot play that role absent a supportive real governance regime. It's not that the board is necessarily compromised. It's just that independent directors are not up to taking on an 800-pound gorilla. Good corporate governance thus plays an important public role – if it works well, Congress can stay out of it. When controlling shareholder governance structure is not up to the task, the cost of the mismatch is more, and less effective, regulation.²²

III. Will Stakeholder-Oriented Governance Work?

A final question is whether the adoption by the board of a formal corporate purpose has the promise to improve the position of stakeholders – that is, will it work better for employees than does Costco's strategic use of efficient wage concepts? While Professor Mayer has suggested that courts will enforce the board's broader fiduciary duty to stakeholders if expressed in a charter-specified purpose, American corporate lawyers will understand that the choice between Costco's and Sam's Club's different strategies will be protected by the business judgment rule that instructs courts not to evaluate the business strategies chosen by corporate managers, in effect allocating

²¹ As the Facebook example shows, the concept and operational consequences of director independence becomes complicated in governance systems in which controlling shareholders are commonplace.

²² This complementarity between corporate and real governance is one I have drawn with respect to Swedish corporate governance, arguing that a controlling shareholder corporate governance regime can be efficient when it operates in a jurisdiction with "good law." Ronald J. Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harv. L. Rev. 1641 (2006).

responsibility for assessing strategic wisdom and business success to the market rather than to the courts.

The more difficult question is what happens if the market concludes that management's chosen pro-stakeholder strategy results in a lower stock price but one that is not Kaldor-Hicks inefficient. In this case, the capital market may intervene by generating a hostile takeover bid, or a hedge fund campaign to change the board. Absent a change in the inclination of institutional investors to accept a premium bid or support a hedge fund's proxy contest to change the board and hence the strategy, a stakeholder's corporate purpose likely will need to be protected by giving existing management the power to block hostile takeovers or render proxy fights ineffective.

Martin Lipton, who has built a wonderfully successful career in supporting a target board's ability to block a takeover or an activist's proxy challenge for any good faith reason including especially protecting stakeholders, recognized that, in the end, his agenda and the Davos "New Paradigm" depends on attracting the cooperation of large institutional investors:

If BlackRock and State Street and Vanguard all come out and say, we're for purpose and culture and we agree with all of this, but then continue to vote for proposals by activist hedge funds, then we don't accomplish anything. There's nothing new in the New Paradigm. And there really is nothing new in the last 30 years. But the competing features of the investment management business have essentially prevented a real resolution of the problem. Unless we can get the major investment institutions to buy into supporting purpose and culture, we will not solve the problem.²³

From this perspective, a stakeholder oriented corporate purpose ultimately is dependent on stakeholder oriented corporate control. Here, however, matters get seriously more complicated. Under the Investment Company Act of 1940, the advisers to a mutual funds owe a fiduciary duty to the mutual fund shareholders. To be sure, the fund advisor – for example, BlackRock in the case of their enormous index fund franchise – confronts the problem of whether to tender the fund's shares into a hostile takeover at a premium. And here the advisor's quandary goes to its need to match a competitor's relative performance, lest it lose assets under management. To be sure, this would not interfere with a fund advisor voting in favor of ESG-premised shareholder proposals, as has recently been the case in connection with proposals to increase the amount of a portfolio company's environmental disclosure. The decision becomes more complicated with environmentally-based challenges to existing directors, as was the case with the recent successful proxy fight to replace a number of directors at Exxon. Then the environmental and performance related issues form a kind of double helix where the difficulty of separating performance and strategy issues from straightforward environmental issues attract both environmental sponsors and economically motivated activists. It is with respect to such double helix issues that institutional investors – Lipton's major investment institutions – confront their most difficult choices and where

²³ Remarks of Martin Lipton, in Symposium on Corporate Purpose and Governance, 31 J. Appl. Corp. Fin. 10, 23 (2019).

they may find it most difficult to meet Lipton's challenge to "buy into supporting purpose and culture".

In this setting, supporting a negative Kaldor-Hicks effect of distributive decisions among stakeholders will need to be protected by giving existing management at least some power to block hostile takeovers or render proxy fights ineffective and which would give large institutions cover for deciding to support management. The easiest way to accomplish this is straightforward: with a controlling shareholder. Here we should note that Mayer's appreciation of the impressive performance of the Swedish Bank Handelsbanken may be influenced by the fact that existing management controls the bank. Two management-related shareholders, one of whom represents the holdings of the bank's pension fund whose beneficial interests will not be distributed until the beneficiaries reach retirement age, hold over 20% of Handelsbanken's voting power with a charter limit of 10% on the votes that can be cast by any single shareholder. This example presents the difference between good management and mere control. AIG, the U.S. insurance company that received the largest U.S. government bailout in the financial crisis – some \$85 billion -- had essentially the same ownership structure and incentive compensation structure as Handelsbanken but with a dramatically different result. The difference in outcome that roughly parallels the difference between Costco's ability to succeed with a strategy that takes employees seriously and Walmart's ability to succeed with a different approach to its employees.²⁴

IV. Conclusion: Back to Political Economy.

A recent short essay by Colin Mayer, Leo E. Strine, Jr., and Jap Winter ("MSW"), in a compilation aptly titled "Milton Friedman 50 Years Later", with contributors representing a full spectrum of views on the role of stakeholders in corporate governance, takes on directly my skepticism concerning a shift in favor of explicit recognition of a central role for stakeholders in corporate governance, rather than the strategic role buried (but accurately) in an efficiency theory of the role of input providers. Recognizing that the current distribution of equity ownership in the U.S. and the structure of the asset management business and its regulation simply don't provide a viable route to their favored outcome, I argued that their focus ultimately needed to be on control.

In this regard, the MSW essay comes with credibility. No other contributor to the Friedman compilation can match Leo Strine's deep experience with the legal and institutional structure of corporate control and how it is practically applied. Strine, formerly Chancellor of Delaware and then Chief Justice of the Delaware Supreme Court, and his co-authors recognized that a frontal attack on the centrality of shareholders in the mechanics of corporate governance was the only way forward.

Their solution: federal legislation mandating that large corporations – the authors suggest those with revenues in excess of one billion dollars – be required to become a public benefit corporation (PBC), with a stated purpose broader than maximizing shareholder value. The PBC would have a requirement to report on its efforts to achieve its broader purpose but little in the way of

²⁴ Remarks of Colin Mayer in Symposium on Corporate purpose and Government, 31 J. Appl. Corp. Fin. 10, 17 (2019).

accountability for that performance.²⁵ I want to put aside the design elements of the solution and instead briefly raise questions concerning the solution's likely success.

The support offered for the conclusion that the solution would work is essentially that other countries, especially Germany and the Scandinavian countries, have succeeded economically with systems more favorably attuned to stakeholders than the U.S. (and the U.K.). For present purposes, and recognizing that MSW were limited in the space needed to address why their solution might work to successfully move the U.S. toward a system that both took stakeholders seriously and were consistent with seriously well-performing economies, I conclude with a final point that should at least invite skepticism. The economies MSW hold out as offering a better balance between capital and labor arose out of radically different political contexts than those that gave rise to the U.S. system.

Governance systems develop path-dependent complementarities, not only internally among a company's factors of production, but also among a country's corporate governance system and other social and economic institutions including, importantly, the state.²⁶ Put simply, different countries have different varieties of capitalism,²⁷ a fact that MSW acknowledge by their admiration of the German and Scandinavian systems in comparison to the Anglo-Saxon systems.

Capitalist systems necessarily have more or less coordination among labor markets, corporate governance arrangements, capital markets, and the educational system that provides worker training both outside and inside the firm that fit the skill sets associated with firm organization and production. The state's political and social system — for example, the government's role in the economy through the regulatory structure — must fit with the overall structure dictated by the interaction of the other elements. In turn, the institutions through which government and social influences operate are both forged through the relationships among the various inputs to the particular form of capitalism, and serve as the field on which those controlling the inputs strategically interact.

These relationships are peculiar to particular countries. Consider Sweden in the post-World War II period. Its variety of capitalism reflected, among other components, an odd political

²⁵ I note that the Delaware PBC statute, recommended by the authors, does not mandate disclosure of the corporation's performance of its broader purpose, in that regard confusing the contractual basis of Delaware corporate law and the real governance effect of mandating PBC organization. There are other design difficulties with the PBC legislation as well, from my perspective most importantly a lack of accountability. For example, those who are the beneficiaries of the public purpose do not have a right of action against the corporation if it fails, however defined, to perform adequately, nor do the beneficiaries participate in the selection of the board. In particular, it would be extremely difficult to develop disclosure standards that would cover the impact of a very wide range of purposes. See Paul Brest, Ronald J. Gilson & Mark Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 *J. of Corp. Law* 206 (2018). I do not address here the difficult set of issues associated with the organizational design of a large PBC that provides for both transparency and accountability. See Jill E. Fisch & Steven Davidoff Solomon, *The "Value" of a Public Benefit Corporation* (April 14, 2021) (forthcoming in *Research Handbook on Corporate Purpose and Personhood* (E. Pollman & R. Thompson, eds.), European Corporate Governance Institute – Law Working Paper No. 585/2021, available at SSRN: <https://ssrn.com/abstract=3712532>.

²⁶ This discussion draws on Gilson, *supra* note 7.

²⁷ See Peter A. Hall & David Soskice, *An Introduction to Varieties of Capitalism*, in *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* 3 (Peter A. Hall & David Soskice, eds., 2001).

marriage between, on the one hand, a high social safety net and a high and highly progressive tax regime to fund it and, on the other, the persistence of the country's large enterprises being controlled by a small number of families. The complementarities among elements of a particular variety of capitalism make it difficult to base reform on cherry picking among pieces of a complimentary system.

In fact, the problem is even more difficult. The relationship between these governance and associated organizational characteristics is supermodular.²⁸ At each point when a new governance characteristic must be added to the existing system, the corporation will choose from among the alternatives the one that best “fits” with the existing pieces of the system. That fit, in turn, is a function not just of the efficacy of the new element standing alone, but also of the new element's effect on the performance of the existing elements—the extent to which it is supermodular.

The complementarity among elements of the system operates as a barrier to reform of the system because changing one element in the system results in degrading the performance of all other system elements to which the changed element was complementary. Just as adding a complementary element can increase system performance by more than its own contribution, removing an element, by regulatory design or voluntarily in response to changed economic conditions, can reduce performance of all elements. Like financial leverage, supermodularity steepens the performance curve both on the upside and on the downside. Short of simultaneously changing all elements of the system, reform can result in reduced system performance until sufficient systemic change takes place to recreate complementarities among the new and remaining elements. This pattern then can give rise to the familiar result of initial disappointment with reform efforts.²⁹

It is a fair criticism of my criticism of MSW's proposal that I am offering a more detailed analysis of a proposal kept short because of the limits of the compilation in which it was included; a 50-year retrospective of a Sunday magazine article imposes constraints that are not imposed by a large festschrift in honor of Rolf Skog's lengthy and productive career. But the notion that the U.S. system can be fundamentally changed through the mandatory imposition of an organizational form that is both new and incomplete might have warranted at least a sentence acknowledging that the proposal is at best a metaphor for the desired direction of reform rather than a blueprint of the organizational design the proposal would require.

A final point. If I am right that a shift in the direction that MSW propose requires the concentration of control that Martin Lipton acknowledges and Professor Mayer's attraction to the Handelsbanken structure suggests, then we are left with a question. A shift back to a system of

²⁸ See Paul Milgrom & John Roberts, *Complementarities and Systems: Understanding Japanese Economic Organization*, 9 *Estudios Economicos* 2 (1994).

²⁹ See Ronald J. Gilson & Curtis J. Milhaupt, *Economically Benevolent Dictators: Lessons for Emerging Democracies*, 59 *Am. J. Compar. Law* 227 (2011).

managerial capitalism, whose development Alfred Chandler chronicles,³⁰ leaves us confronting the same problem that Chandler identified: what are the systems of accountability? Recall that Chandler's work was published at virtually the identical time as Jensen and Meckling's now iconic analysis that then fueled Jensen's support of the market for corporate control as a disciplinary device.

³⁰ Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (1977). A final note about footnotes. To some readers 30 footnotes may seem excessive. To legal academics, the number will seem small. Both are right.