

Protecting the Corporate Establishment

Statement by James Goldsmith, Chairman General Oriental Investments Ltd Before the Sub-Committee on Securities of the Committee on Banking, Housing and Urban Affairs US Senate, 12th June, 1985

MR CHAIRMAN AND MEMBERS of the Subcommittee. As a foreigner, based in Europe, I appreciate the opportunity of testifying here today. For many years, I have been a substantial participant in business throughout Europe and more recently have become an active investor in the United States. Therefore, I have witnessed the decline of Europe and the contemporaneous resurgence of the United States and this gives me a particular perspective from which to testify.

The dominant ideology of Europe has fluctuated between Socialism and State Corporatism. These have been the root causes of the European economic disease. State Corporatism is based on the conviction that the activities of a nation can best be managed through the triangular cooperation of the state, business and trade unions. For example, corporatists believe that salaries and prices in whole industries and nationwide can be settled annually by negotiations between employer associations and trade unions, presided over by government. They do not believe in the mechanisms of the marketplace which they feel are brutal and destabilizing.

At the base of the pyramid or triangle is big business and big unions. At the peak is government. As a result, a mutuality of interest, indeed a certain complicity, has evolved between big corporate management, trade union leaders and government bureaucrats. They need each other. Small and medium sized business has no natural place in such a system. In Great Britain, for example, an official inquiry on small firms has revealed that small businesses accounted for a smaller proportion of output and employment than in any other industrialized country.

Here in the USA, you have followed a very different route, a route which has led to a new industrial revolution. Some call it a techno-scientific revolution. Some call it an entrepreneurial revolution. Since 1965, while Europe has been losing jobs at a truly alarming rate, your revolution has created 35 million new jobs. The new jobs are coming from small and medium sized businesses usually run by innovators and entrepreneurs whereas large and mature industries are shedding employment each year. This shift is fundamental because, contrary to Europe, it reduces the role and power of the megacorporations and the trade unions. It creates a polyculture of businesses all competing one against the other. It creates a truly competitive economy and in a truly competitive economy either you do it right or you get eliminated. Mega-companies either get it right or they get taken over. Trade unions have to agree to competitive practices or unionized companies perish and trade union membership is correspondingly reduced.

During the past few months in the United States, there has been a national debate about hostile takeovers. It seems to me that this debate is really about your new entrepreneurial revolution and the freedoms that have engendered it. The question really being asked is whether or not large corporations should be treated like institutions and should be granted special protection from the marketplace.

Who would have believed a few years ago that conglomerates, created at the time by freewheeling entrepreneurs, today are described by some as sacrosanct institutions which should be protected from the marketplace by special legislation. All that has changed in many of these companies is that the flame of the founder has been replaced by the complacency of the bureaucrat. And because the members of such bureaucracies control the disposition of vast amounts of other people's money and the power and patronage that accompany it, they feel they are part of the establishment and therefore deserve special privileges.

Mr Chairman, I speak on this subject with some emotion because I have seen it all before. In France, the combined results of the largest forty corporations which include the leaders in every field of industrial and commercial endeavor, was a loss of over two billion dollars. These are the corporations which were treated like institutions and which were protected from change by government action. Any takeover attempt on these corporations would be met with howls of anguish and indignation. Their management would run to the Government to plead for special protection, and in most cases, would receive it. Among these companies are a small minority which are excellent. But as for the others, the best thing that could happen to France and to those directly or indirectly affected, would be that they should be taken over and that their constituent parts be liberated from the dead hands of establishment bureaucrats. I believe that this is another way of describing what some witnesses who have appeared before you have called 'bust-up, hostile takeovers.'

For many years conventional wisdom has been that bigness, in itself, is somehow good. It allowed for magnificent investment projects without recourse to leverage; it allowed companies to diversify and this was supposed to protect them against cyclical swings, and as far as management was concerned, bigness put their companies beyond the threat of hostile takeovers.

That thinking has now been challenged. Big investment, in itself, is not necessarily a virtue. Recently in Britain, Mrs Thatcher said that when she first became a government minister, the conversations were about how many billions were needed to expand national corporations like British Steel. A few years later, the conversations were about how many billions were needed to shrink the same corporations.

Diversification can sometimes protect groups against such cyclical swings but also many companies have proved unable to handle the diversity of problems and opportunities which arise in multi-industry corporations.

Even the effects of leverage have been reconsidered. For example, in Japan the debt-to-equity ratio in the leading 350 companies is three to four times greater than that for the average of the Forbes 1,000 US companies.

Finally, the financial markets now are big enough to finance a challenge even to huge corporations. The market will put up the money if it believes that the fundamental value of a company is much greater than its market value and that the fundamental values can be liberated.

Some corporate managements react to this situation by creating a panoply of artificial devices to entrench themselves. They also appear before your committee to plead for special protection. Others take the positive steps which are needed to deploy their assets properly. ARCO, Litton, Gulf and Western are good recent examples of companies that are doing the right things. Free market forces either force management to get to work or alternatively allow new owners and new management to take over. Artificial devices which inhibit such changes do no more than protect the unsatisfactory. They lead to ossification and decline.

Mr Chairman, I will not review the particularities of abuses and counter-abuses which automatically occur during takeover contests. You have already heard learned testimony about all of this.

I would only like to make one obvious point. Corporations are owned by their shareholders. Management is employed by shareholders to look after shareholder interests. Devices like poison pills, paying greenmail, scorched earth, defensive acquisitions, super majority voting, staggered boards, etc ... , should all be subject to a prior and free vote by shareholders and should not be imposed unilaterally by management as a method of entrenchment. When management acts unilaterally, without consulting shareholders, it is seeking protection not for their shareholders but from their shareholders. Often management will have a good case to make. If so, it should make it and convince its constituents.

My only qualification to this is that the effects of such special resolutions, even if approved by shareholders, should not become permanent. Management should not be entrenched forever. Life tenure is seldom healthy.

It must be remembered that almost always, directors are not chosen and elected by shareholders. Normally, shareholders are asked to vote on a list of directors proposed by management. There are no primaries and only very rarely, and at a great cost, is an alternative list of candidates proposed to shareholders and this is within the context of proxy fights. So in effect, directors are co-opted by their future colleagues and shareholders do no more than ratify the proposals.

If, during a period of relative calm and prosperity, directors can obtain a vote from shareholders on the permanent application of some of the entrenchment devices that I mentioned earlier, then in effect, they and their co-opted successors are there for life - whether or not subsequently that management is successful.

That is why I would strongly recommend that although management entrenchment and anti-takeover devices are legitimate when approved by shareholders, nonetheless they should be the subject of a regular vote and therefore, should be submitted annually to shareholder consideration. This would avoid life tenure of corporate management.

Shareholders on the other hand would be wise to eliminate conflicts of interest with management. Management sometimes is tempted by size, shareholders want value. Management is fearful of takeovers because of the inevitable uncertainties of change after many years of loyal service to their company. Shareholders should align the interests of management with their own by substantial incentive schemes and fair termination agreements, sometimes called 'golden parachutes.'

Mr Chairman, your new industrial revolution is deep and vigorous. It is based on freedom. My most fervent hope is that one day my fellow Europeans will learn that freedom works and I also hope that Americans will never forget it.