Chapter 1

Corporate Governance: Linking Corporations and Society

1.1 The U.S. Corporate Governance System

Today's U.S. **corporate governance**[1] system is best understood as the set of fiduciary and managerial responsibilities that binds a company's management, shareholders, and the board within a larger, societal context defined by legal, regulatory, competitive, economic, democratic, ethical, and other societal forces.

Shareholders

Although **shareholders**[2] own corporations, they usually do not run them. Shareholders elect directors, who appoint managers who, in turn, run corporations. Since managers and directors have a fiduciary obligation to act in the best interests of shareholders, this structure implies that shareholders face two separate so-called principal-agent problems—with management whose behavior will likely be concerned with its own welfare, and with the board, which may be beholden to particular interest groups, including management.Agency theory explains the relationship between principals, such as shareholders and agents, like a company's executives. In this relationship, the principal delegates or hires an agent to perform work. The theory attempts to deal with two specific problems: first, that the goals of the principal and agent are not in conflict (agency problem) and second, that the principal and agent reconcile different tolerances for risk. Many of the mechanisms that define today's corporate governance system are designed to mitigate these potential problems and align the behavior of all parties with the best interests of shareholders broadly construed.

The notion that the welfare of shareholders should be the primary goal of the corporation stems from shareholders' legal status as residual claimants. Other **stakeholders**[3] in the corporation, such as creditors and employees, have specific claims on the cash flows of the corporation. In contrast, shareholders get their return on investment from the residual only after all other stakeholders have been paid. Theoretically, making shareholders residual claimants creates the strongest incentive to maximize the company's value and generates the greatest benefits for society at large.

Not all shareholders are alike and share the same goals. The interests of **small (minority) investors**[4], on the one hand, and large shareholders, including those holding a controlling block of shares and institutional investors, on the other, are often different. Small investors, holding only a small portion of the corporation's outstanding shares, have little power to influence the board of the corporation. Moreover, with only a small share of their personal portfolios invested in the corporation, these investors have little motivation to exercise control over the

1. A set of fiduciary and managerial responsibilities that bind a company's management, shareholders, and the board within a larger societal context that is defined by legal, regulatory, competitive, economic, democratic, ethical, and other societal forces.
2. Individuals or groups who own or hold shares or stock in a company. They legally own but do not run the company.
3. Nonshareholder individuals or groups who are involved in or affected by the company's actions. They include suppliers, creditors, tax authorities, and the community in which the corporation operates.
4. Individuals or groups who hold only a small portion of a corporation's outstanding shares and who have little power to influence the corporation's board of directors.

corporation. As a consequence, small investors are usually passive and interested only in favorable returns. They often do not even bother to vote; they simply sell their shares if they are not satisfied.

In contrast, **large shareholders**[5] often have a sufficiently large stake in the corporation to justify the time and expense necessary to monitor management actively. They may hold a controlling block of shares or be **institutional investors**[6], such as mutual funds, pension plans, employee stock ownership plans, or—outside the United States—banks whose stake in the corporation may not qualify as majority ownership but is large enough to motivate active engagement with management.

It should be noted that the term "institutional investor" covers a wide variety of managed investment funds, including banks, trust funds, pension funds, mutual funds, and similar "delegated investors." All have different investment objectives, portfolio management disciplines, and investment horizons. As a consequence, institutional investors both represent another layer of agency problems and opportunity for oversight. To identify the potential for an additional layer of agency problems, ask why we should expect that a bank or pension fund will look out for minority shareholder interests any better than corporate management. On the one hand, institutional investors may have "purer" motives than management—principally a favorable investment return. On the other hand, they often make for passive, indifferent monitors, partly out of preference and partly because active monitoring may be prohibited by **regulations**[7] or by their own internal investment rules. Indeed, a major tenet of the recent governance debate is focused on the question of whether it is useful and desirable to create ways for institutional investors to take a more active role in monitoring and disciplining corporate behavior. In theory, as large owners, institutional investors have a greater incentive to monitor corporations. Yet, the reality is that institutions failed to protect their own investors from managerial misconduct in firms like Enron, Tyco, Global Crossing, and WorldCom, even though they held large positions in these firms.

The latest development in the capital markets is the rise of **private equity**[8]. Private equity funds differ from other types of investment funds mainly in the larger size of their holdings in individual investee companies, their longer investment horizons, and the relatively fewer number of companies in individual fund portfolios. Private equity managers typically have a greater degree of involvement in their investee companies compared to other investment professionals, such as mutual fund or hedge fund managers, and play a greater role in influencing the corporate governance practices of their investee companies. By virtue of their longer investment horizon, direct participation on the board, and continuous engagement with management, private equity managers play an important role in shaping

5. Individuals or groups who often have a large enough stake in a company to justify the time and expense to actively monitor management. They may hold a controlling block of shares.
6. An organization that pools large financial resources to invest in stock or bond markets, such as mutual funds or pension plans.
7. A set of laws or rules set forth by a governing body.
8. Equity capital that is not publicly traded. Equity capital is money invested in a company in exchange for part ownership of the company.

governance practices. That role is even stronger in a buyout or majority stake acquisition, where a private equity manager exercises substantial control—not just influence as in minority stake investments—over a company's governance. Not surprisingly, scholars and regulators are keeping a close watch on the impact of private equity on corporate performance and governance.

State and Federal Law

Until recently, the U.S. government relied on the states to be the primary legislators for corporations. **Corporate law**[9] primarily deals with the relationship between the officers, board of directors, and shareholders, and therefore traditionally is considered part of private law. It rests on four key premises that define the modern corporation: (a) *indefinite life*, (b) *legal personhood*, (c) *limited liability*, and (d) *freely transferable shares*. A corporation is a legal entity consisting of a group of persons—its shareholders—created under the authority of the laws of a state. The entity's existence is considered separate and distinct from that of its members. Like a real person, a corporation can enter into contracts, sue and be sued, and must pay tax separately from its owners. As an entity in its own right, it is liable for its own debts and obligations. Providing it complies with applicable laws, the corporation's owners (shareholders) typically enjoy **limited liability**[10] and are legally shielded from the corporation's liabilities and debts.This section is based on Kenneth Holland's May 2005 review of the book *Corporate Governance: Law, Theory and Policy*.

The existence of a corporation is not dependent upon whom the owners or investors are at any one time. Once formed, a corporation continues to exist as a separate entity, even when shareholders die or sell their shares. A corporation continues to exist until the shareholders decide to dissolve it or merge it with another business. Corporations are subject to the laws of the state of incorporation and to the laws of any other state in which the corporation conducts business. Corporations may therefore be subject to the laws of more than one state. All states have corporation statutes that set forth the ground rules as to how corporations are formed and maintained.

A key question that has helped shape today's patchwork of corporate laws asks, "What is or should be the role of law in regulating what is essentially a private relationship?" Legal scholars typically adopt either a "contract-based" or "public interest" approach to this question. Free-market advocates tend to see the corporation as a contract, a voluntary economic relationship between shareholders and management, and see little need for government regulation other than the necessity of providing a judicial forum for civil suits alleging breach of contract. Public interest advocates, on the other hand, concerned by the growing impact of large corporations on society, tend to have little faith in market solutions and argue

9. A branch of law that deals primarily with the relationship among a corporation's officers, board of directors, and shareholders.

10. A type of liability in which shareholders' liability is limited to the value of their investment in the corporation.

that government must force firms to behave in a manner that advances the public interest. Proponents of this point of view focus on how corporate behavior affects multiple stakeholders, including customers, employees, creditors, the local community, and protectors of the environment.

The stock market crash of 1929 brought the federal government into the regulation of corporate governance for the first time. President Franklin Roosevelt believed that public confidence in the equity market needed to be restored. Fearing that individual investors would shy away from stocks and, by doing so, reduce the pool of capital available to fuel economic growth in the private sector, Congress enacted the Securities Act in 1933 and the Securities Exchange Act in the following year, which established the **Securities and Exchange Commission (SEC)**[11]. This landmark legislation shifted the balance between the roles of federal and state law in governing corporate behavior in America and sparked the growth of federal regulation of corporations at the expense of the states and, for the first time, exposed corporate officers to federal criminal penalties. More recently, in 2002, as a result of the revelations of accounting and financial misconduct in the Enron and WorldCom scandals, Congress enacted the Accounting Reform and Investor Protection Act, better known as the **Sarbanes-Oxley Act**[12].

Most of the major state court decisions involving corporate governance are issued by the Delaware Chancery Court, due to the large number of major corporations incorporated in Delaware. In the 21st century, federal securities law, however, has supplanted state law as the most visible means of regulating corporations. The federalization of corporate governance law is perhaps best illustrated by the provision of the Sarbanes-Oxley law that bans corporate loans to directors and executive officers, a matter long dominated by state law.

The Securities and Exchange Commission

The SEC—created to protect investors; maintain fair, orderly, and efficient markets; and facilitate **capital**[13] formation—is charged with implementing and enforcing the legal framework that governs security transactions in the United States. This framework is based on a simple and straightforward concept: All investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This promotes efficiency and transparency in the capital market, which, in turn, stimulates capital formation. To ensure efficiency and transparency, the SEC monitors the key participants in the securities trade, including securities exchanges, securities brokers and dealers, investment advisers, and mutual funds.http://www.sec.gov/about/whatwedo.shtml

11. A federal agency whose primary responsibility is to implement regulatory security laws to regulate stock and other securities markets, protect investors, and monitor corporate takeovers.
12. An act passed by the U.S. Congress in 2002 that provides additional rules and enforcement policies to protect investors from the potential for fraudulent activities.
13. Money or property that represents the value of goods or an investment.

Crucial to the SEC's effectiveness in each of these areas is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions against individuals and companies for violation of the securities laws. Typical infractions include **insider trading**[14], accounting **fraud**[15], and providing false or misleading information about securities and the companies that issue them. Although it is the primary overseer and regulator of the U.S. securities markets, the SEC works closely with many other institutions, including Congress, other federal departments and agencies, self-regulatory organizations (e.g., the stock exchanges), state securities regulators, and various private sector organizations. Specific responsibilities of the SEC include (a) interpret federal securities laws; (b) issue new rules and amend existing rules; (c) oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies; (d) oversee private regulatory organizations in the securities, accounting, and auditing fields; and (e) coordinate U.S. securities regulation with federal, state, and foreign authorities.

The Exchanges

The **NYSE Euronext**[16] and **NASDAQ**[17] account for the trading of a major portion of equities in North America and the world. While similar in mission, they are different in the ways they operate and in the types of equities that are traded on them.http://www.investopedia.com

The NYSE Euronext and its predecessor, the NYSE, trace their origins to 1792. Their listing standards are among the highest of any market in the world. Meeting these requirements signifies that a company has achieved leadership in its industry in terms of business and investor interest and acceptance. The Corporate Governance Listing Standards set out in Section 303A of the NYSE Listed Company Manual were initially approved by the SEC on November 4, 2003, and amended in the following year. Today, NYSE Euronext's nearly 4,000 listed companies represent almost $30 trillion in total global market capitalization.

The NASDAQ, the other major U.S. stock exchange, is the largest U.S. electronic stock market. With approximately 3,200 companies, it lists more companies and, on average, trades more shares per day than any other U.S. market. It is home to companies that are leaders across all areas of business, including technology, retail, communications, financial services, transportation, media, and biotechnology. The NASDAQ is typically known as a high-tech market, attracting many of the firms dealing with the Internet or electronics. Accordingly, the stocks on this exchange are considered to be more volatile and growth-oriented.

While all trades on the NYSE occur in a physical place, on the trading floor of the NYSE, the NASDAQ is defined by a telecommunications network. The fundamental

14. The illegal use of information available only to those within a corporation to gain financially from trades made using that privileged information.
15. An act of deceit typically carried out to gain some advantage.
16. A European-American corporation that operates securities exchanges, such as the New York Stock Exchance (NYSE) and Euronext. It is the largest stock exchange in the world.
17. An American stock exchange that originally stood for "National Association of Securities Dealers Automated Quotations." It is the second-largest stock exchange in the world.

difference between the NYSE and NASDAQ, therefore, is in the way securities on the exchanges are transacted between buyers and sellers. The NASDAQ is a dealer's market in which market participants buy and sell from a dealer (the market maker). The NYSE is an auction market, in which individuals typically buy from and sell to one another based on an auction price.

Prior to March 8, 2006, a major difference between these two exchanges was their type of ownership: the NASDAQ exchange was listed as a publicly traded corporation, while the NYSE was private. In March of 2006, however, the NYSE went public after being a not-for-profit exchange for nearly 214 years. In the following year, NYSE Euronext—a holding company—was created as part of the merger of the NYSE Group Inc. and Euronext N.V. Now, NYSE Euronext operates the world's largest and most liquid exchange group and offers the most diverse array of financial products and services (see NYSE Web site at http://www.nyse.com). It brings together six cash equities exchanges in five countries and six derivatives exchanges and is a world leader for listings, trading in cash equities, equity and interest rate derivatives, bonds, and the distribution of market data. As publicly traded companies, the NASDAQ and the NYSE must follow the standard filing requirements set out by the SEC and maintain a body of rules to regulate their member organizations and their associated persons. Such rules are designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and provide a means by which they can take appropriate disciplinary actions against their membership when rule violations occur.

The Gatekeepers: Auditors, Security Analysts, Bankers, and Credit Rating Agencies

The integrity of our financial markets greatly depends on the role played by a number of "**gatekeepers**[18]"—external **auditors**[19], analysts, and **credit rating agencies**[20]—in detecting and exposing the kinds of questionable financial and accounting decisions that led to the collapse of Enron, WorldCom, and other "misreporting" or accounting frauds.This section draws on Edwards (2003). A key question is whether we can (or should) rely on these gatekeepers to perform their roles diligently. It can be argued that we can and should because their business success depends on their credibility and reputation with the ultimate users of their information—investors and creditors—and if they provide fraudulent or reckless opinions, they are subject to private damage suits. The problem with this view is that the interests of gatekeepers are often more closely aligned with those of corporate managers than with investors and shareholders. Gatekeepers, after all, are typically hired and paid (and fired) by the very firms that they evaluate or rate, and not by creditors or investors. Auditors are hired and paid by the firms they audit; credit rating agencies are typically retained and paid by the firms they rate; lawyers are paid by the firms that retain them; and, as we learned in the aftermath

18. External entities, such as auditors, analysts, and credit rating agencies, whose job is to protect investors by uncovering financial fraud and earnings manipulation.

19. Individuals or a group authorized to examine and verify a corporation's financial accounting. They help ensure that firms are run efficiently, public records are accurate, and taxes are paid properly and on time.

20. Companies that issue credit ratings for those that issue debt obligations. They provide investors with objective data about companies and countries that issue securities.

of the 2001 governance scandals, until recently the compensation of security analysts (who work primarily for investment banks) was closely tied to the amount of related investments banking business that their employers (the investment banks) do with the firms that their analysts evaluate.Citigroup paid $400 million to settle government charges that it issued fraudulent research reports; and Merrill Lynch agreed to pay $200 million for issuing fraudulent research in a settlement with securities regulators and also agreed that, in the future, its securities analysts would no longer be paid on the basis of the firm’s related investment-banking work. A contrasting view, therefore, holds that most gatekeepers are inherently conflicted and cannot be expected to act in the interests of investors and shareholders. Advocates of this perspective also argue that gatekeeper conflict of interest worsened during the 1990s because of the increased cross-selling of consulting services by auditors and credit rating agencies and by the cross-selling of investment banking services.Coffee (2002, 2003a, 2003b). Both issues are addressed by recent regulatory reforms; new rules address the restoration of the “Chinese Wall” between investment banks and security analysts, and mandate the separation of audit and consulting services for accounting firms.

1.2 Corporate Governance Elsewhere in the World

In Germany, labor unions traditionally have had seats on corporate boards. At Japanese firms, loyal managers often finish their careers with a stint in the boardroom. Founding families hold sway on Indian corporate boards. And in China, boards are populated by Communist Party officials.Bradley, Schipani, Sundaram, and Walsh (1999).

The German and Japanese corporate governance systems are very different from that in the United States. Knowing how they function is important. The German and Japanese economies play host to many of the world's largest corporations. Moreover, their governance systems have had substantial spillover effects beyond their respective borders. Many countries in Europe, such as Austria, Belgium, Hungary, and, to a lesser extent, France and Switzerland, and much of northern Europe, evolved their governance systems along Germanic, rather than Anglo-American, lines. Moreover, the newly liberalizing economies of Eastern Europe appear to be patterning their governance systems along Germanic lines as well. The spillover effects of the Japanese governance system are increasingly evident in Asia where Japanese firms have been the largest direct foreign investors during the past decade. In contrast, variants of the Anglo-American system of governance are only found in a few countries, such as the United Kingdom, Canada, Australia, and New Zealand.

The German Corporate Governance System

The goals of German corporations are clearly defined in German corporation law. Originally enacted in 1937, and subsequently modified in 1965, German corporate law defines the role of the board to govern the corporation for the "good of the enterprise, its multiple stakeholders, and society at large." Until the 1965 revision, the German corporate law said nothing specific about shareholders. The law also provides that if a company endangers public welfare and does not take corrective action, it can be dissolved by an act of state. Despite the relatively recent recognition that shareholders represent an important constituency, corporate law in Germany makes it abundantly clear that shareholders are only one of many stakeholder groups on whose behalf managers must run the firm.

Large public German companies—those with more than 500 employees—are required to have a two-tier board structure: a supervisory board (*Aufsichtsrat*) that performs the strategic oversight role and a management board (*Vorstand*) that performs an operational and day-to-day management oversight role. There are no overlaps in membership between the two boards. The supervisory board appoints and oversees the management board. In companies with more than 2,000 employees, half of the supervisory board must consist of employees, the other half of shareholder representatives. The chairperson of the supervisory board is, however, typically a shareholder representative and has the tie-breaking vote. The management board consists almost entirely of the senior executives of the company. Thus, management board members have considerable firm- and industry-specific knowledge. The essence of this two-tiered board structure is the explicit representation of stakeholder interests other than of shareholders: No major strategic decisions can be made without the cooperation of employees and their representatives.

The ownership structure of German firms also differs quite substantially from that observed in Anglo-American firms. Intercorporate and bank shareholdings are common, and only a relatively small proportion of the equity is owned by private citizens. Ownership typically is more concentrated: Almost one quarter of the publicly held German firms has a single majority shareholder. Also, a substantial portion of equity is “bearer” rather than “registered” stock. Such equity is typically on deposit with the company’s *hausbank*, which handles matters such as dividend payments and record keeping. German law allows banks to vote such equity on deposit by proxy, unless depositors explicitly instruct banks to do otherwise. Because of inertia on the part of many investors, banks, in reality, control a substantial portion of the equity in German companies. The ownership structure, the voting restrictions, and the control of the banks also imply that takeovers are less common in Germany compared to the United States as evidenced by the relatively small number of mergers and acquisitions. When corporate combinations do take place, they usually are friendly, arranged deals. Until the recent rise of private equity, hostile takeovers and leveraged buyouts were virtually nonexistent; even today antitakeover provisions, poison pills, and golden parachutes are rare.

The Japanese Corporate Governance System

The Japanese economy consists of multiple networks of firms with stable, reciprocal, minority equity interests in each other, known as *keiretsus*. Although the firms in a *keiretsu* are typically independent companies, they trade with each other and cooperate on matters, such as governance. *Keiretsus* can be vertical or horizontal. Vertical *keiretsus* are networks of firms along the supply chain; horizontal *keiretsus* are networks of businesses in similar product markets. Horizontal *keiretsus* typically include a large main bank that does business with all of the member firms and holds minority equity positions in each.

Like Anglo-American companies, Japanese firms have single-tier boards. However, in Japan a substantial majority of board members are company insiders, usually current or former senior executives. Thus, unlike the United States, outside directorships are still rare, although they are becoming more prevalent. The one exception to outside directorships is the main banks. Their representatives usually sit on the boards of the *keiretsu* firms with whom they do business. In contrast to the German governance system where employees and sometimes suppliers tend to have explicit board representation, the interests of stakeholders other than management or the banks are not directly represented on Japanese boards.

Share ownership in Japan is concentrated and stable. Although Japanese banks are not allowed to hold more than 5% of a single firm's stock, a small group of four or five banks typically controls about 20% to 25% of a firm's equity. As in Germany, the market for corporate control in Japan is relatively inactive compared to that in the United States. Bradley, Schipani, Sundaram, and Walsh (1999) found that disclosure quality, although considered superior to that of German companies, is poor in comparison to that of U.S. firms. Although there are rules against insider trading and monopolistic practices, the application of these laws is, at best, uneven and inconsistent.Bradley, Schipani, Sundaram, and Walsh (1999).

As Bradley et al. (1999) observe, although there are significant differences, there also is a surprising degree of similarity between the German and Japanese governance systems. Similarities include the relatively small reliance on external capital markets; the minor role of individual share ownership; significant institutional and intercorporate ownership, which is often concentrated; relatively stable and permanent capital providers; boards comprising functional specialists and insiders with knowledge of the firm and the industry; the relatively important role of banks as financiers, advisers, managers, and monitors of top management; the increased role of leverage with emphasis on bank financing; informal as opposed to formal workouts in financial distress; the emphasis on salary and bonuses rather than equity-based executive compensation; the relatively poor disclosure from the standpoint of outside investors; and conservatism in accounting policies. Moreover, both the German and Japanese governance systems emphasize the protection of employee and creditor interests, at least as much as the interests of shareholders. The market for corporate control as a credible disciplining device is largely absent in both countries, as is the need for takeover defenses because the governance system itself, in reality, is a poison pill.Bradley, Schipani, Sundaram, and Walsh (1999).

As recent history has shown, however, the stakeholder orientation of German and Japanese corporate governance is not without costs. The central role played by both employees (Germany) and suppliers (Japan) in corporate governance can lead to inflexibility in sourcing strategies, labor markets, and corporate restructurings. It is often harder, therefore, for firms in Germany and Japan to move quickly to meet competitive challenges from the global product-market arena. The employees' role in governance also affects labor costs, while a suppliers' role in governance, as in the case of the vertical *keiretsu* in Japan, can lead to potential problems of implicit or explicit vertical restraints to competition, or what we would refer to as antitrust problems. Finally, the equity ownership structures in both systems make takeovers far more difficult, which arguably is an important source of managerial discipline in the Anglo-American system.

1.3 Corporate Governance in America: A Brief History

Entrepreneurial, Managerial, and Fiduciary Capitalism

In the first part of the twentieth century, large U.S. corporations were controlled by a small number of wealthy entrepreneurs—Morgan, Rockefeller, Carnegie, Ford, and Du Pont, to name a few. These "captains of industry" not only owned the majority of the stock in companies, such as Standard Oil and U.S. Steel, but they also exercised their rights to run these companies. By the 1930s, however, the ownership of U.S. corporations had become much more widespread. **Capitalism**[21] in the United States had made a transition from **entrepreneurial capitalism**[22], the model in which ownership and control had been synonymous, to **managerial capitalism**[23], a model in which ownership and control were effectively separated—that is, in which effective control of the corporation was no longer exercised by the legal owners of equity (the shareholders) but by hired, professional managers. With the rise of institutional investing in the 1970s, primarily through private and public pension funds, the responsibility of ownership became once again concentrated in the hands of a relatively small number of institutional investors who act as fiduciaries on behalf of individuals. This large-scale institutionalization of equity brought further changes to the corporate governance landscape. Because of their size, institutional investors effectively own a major fraction of many large companies. And because this can restrict their liquidity, they de facto may have to rely on active monitoring (usually by other, smaller activist investors) than trading. This model of corporate governance, in which monitoring has become as or more important than trading, is sometimes referred to as **fiduciary capitalism**[24].This section is based on the essay by Hawley and Williams (2001).

21. An economic system marked by private or corporate ownership of goods whose production and distribution are mainly determined by free market competition.

22. An economic system of capitalism marked by intellectual capital (as opposed to labor and industry) and the increasing development of technology.

23. An economic system in which hired, professional managers effectively control and manage a corporation, as opposed to the corporation's being managed by shareholders.

24. An economic system in which shareholders, especially large shareholders acting on behalf of smaller shareholders, influence the actions of a corporation.

The 1980s: Takeovers and Restructuring

As the ownership of American companies changed, so did the board-management relationship. For the greater part of the 20th century, when managerial capitalism prevailed, executives had a relatively free rein in interpreting their responsibilities toward the various corporate stakeholders and, as long as the corporation made money and its operations were conducted within the confines of the law, they enjoyed great autonomy. Boards of directors, mostly selected and controlled by management, intervened only infrequently, if at all. Indeed, for the first half of the last century, corporate executives of many publicly held companies managed with little or no outside control.

In the 1970s and 1980s, however, serious problems began to surface, such as exorbitant executive payouts, disappointing corporate earnings, and ill-considered acquisitions that amounted to little more than empire building and depressed shareholder value. Led by a small number of wealthy, activist shareholders seeking to take advantage of the opportunity to capture underutilized assets, **takeovers**[25] surged in popularity. Terms, such as leveraged buyout, dawn raids, poison pills, and junk bonds, became household words, and individual corporate raiders, including Carl Icahn, Irwin Jacobs, and T. Boone Pickens, became well known. The resulting takeover boom exposed underperforming companies and demonstrated the power of unlocking shareholder value.

The initial response of U.S. corporate managers was to fight takeovers with legal maneuvers and to attempt to enlist political and popular support against corporate raiders. These efforts met with some legislative, regulatory, and judicial success and made hostile takeovers far more costly. As a result, capital became scarce and junk-bond-financed, highly leveraged, hostile takeovers faded from the stage.Thornton (2002, January 14). Hostile takeovers made a dramatic comeback after the 2001 to 2002 economic recession. In 2001, the value of hostile takeovers climbed to $94 billion, more than twice the value in 2000 and almost $15 billion more than in 1988, the previous peak year. Of lasting importance from this era was the emergence of institutional investors who knew the value of ownership rights, had fiduciary responsibilities to use them, and were big enough to make a difference.Romano (1994). And with the implicit assent of institutional investors, boards substantially increased the use of stock option plans that allowed managers to share in the value created by restructuring their own companies. Shareholder value, therefore, became an ally rather than a threat.Holmstrom and Kaplan (2003).

25. The act of seizing or taking control of, as in a corporate acquisition.

1.4 The Meltdown of 2001

The year 2001 will be remembered as the year of corporate scandals. The most dramatic of these occurred in the United States—in companies such as Enron, WorldCom, Tyco, and others—but Europe also had its share, with debacles at France's Vivendi, the Netherlands' Ahold, Italy's Parmalat, and ABB, a Swiss-Swedish multinational company. Even before these events fully unfolded, a rising number of complaints about executive pay, concerns about the displacement of private-sector jobs to other countries through off-shoring, and issues of corporate social responsibility had begun to fuel emotional and political reactions to corporate news in the United States and abroad.

Most of these scandals involved deliberately inflating financial results, either by overstating revenues or understating costs, or diverting company funds to the private pockets of managers. Two of the most prominent examples of fraudulent "earnings management" include Enron's creation of off–balance sheet partnerships to hide the company's deteriorating financial position and to enrich Enron executives and WorldCom's intentional misclassification of as much as $11 billion in expenses as capital investments—perhaps the largest accounting fraud in history.

The Enron scandal came to symbolize the excesses of corporations during the long economic boom of the 1990s.Lindstrom (2008). Hailed by *Fortune* magazine as "America's Most Innovative Company" for 6 straight years from 1996 to 2001, Enron became one of the largest bankruptcies in U.S. history. Its collapse in December 2001 followed the disclosure that it had reported false profits, using accounting methods that failed to follow generally accepted procedures. Both internal and external controls failed to detect the financial losses disguised as profits for a number of years. At first, Enron's senior executives, whose activities brought the company to the brink of ruin, escaped with millions of dollars as they retired or sold their company stock before its price plummeted. Enron employees were not so lucky. Many lost their jobs and a hefty portion of retirement savings invested in Enron stock. Because the company was able to hide its losses for nearly 5 years, the Enron scandal shook the confidence of investors in American governance around the world. Outside agencies, such as accounting firms, credit rating businesses, and stock market analysts had failed to warn the public about Enron's business losses until they were obvious to all. Internal controls had not functioned, either. And Enron's board of directors, especially its audit committee, apparently did not understand the full extent of the financial activities undertaken by the firm and, consequently, had failed in providing adequate oversight. Some experts believed that the federal government also bore some responsibility. Politicians in both the legislative and executive branches received millions of dollars in campaign donations from Enron during the period when the federal government decided to deregulate the energy industry, removing virtually all government controls. Deregulation was the critical act that made Enron’s rise as a $100 billion company possible.

In June 2002, shortly after the Enron debacle, WorldCom admitted that it had falsely reported $3.85 billion in expenses over 5 quarterly periods to make the company appear profitable when it had actually lost $1.2 billion during that period.“MCI, Inc.,” Microsoft® Encarta® Online Encyclopedia (2008). Experts said it was one of the biggest accounting frauds ever. In its aftermath, the company was forced to lay off about 17,000 workers, more than 20% of its workforce. Its stock price plummeted from a high of $64.50 in 1999 to 9 cents in late July 2002 when it filed for bankruptcy protection. In March 2004, in a formal filing with the SEC, the company detailed the full extent of its fraudulent accounting. The new statement showed the actual fraud amounted to $11 billion and was accomplished mainly by artificially reducing expenses to make earnings appear larger. After restructuring its debt and meeting other requirements imposed by a federal court, the company emerged from bankruptcy protection in April 2004 and formally changed its name to MCI Inc. Even as it emerged from bankruptcy, industry observers anticipated that MCI would need to merge with another telecommunications firm to compete against larger companies that offered a broader range of telecommunications services. The merger materialized less than a year later, in February 2005, when Verizon Communications Inc. announced its acquisition of MCI for about $6.7 billion in cash, stocks, and dividend payments. MCI ceased to exist as an independent company under the terms of the merger, which was completed in 2006.

As Edwards (2003) notes, these scandals raised fundamental questions about the motivations and incentives of executives and about the effectiveness of existing corporate governance practices, not only in the United States, but also in other parts of the world, including, What motivated executives to engage in fraud and earnings mismanagement? Why did boards either condone or fail to recognize and stop managerial misconduct and allow managers to deceive shareholders and investors? Why did external gatekeepers, for example, auditors, credit rating agencies, and securities analysts, fail to uncover the financial fraud and earnings manipulation, and alert investors to potential discrepancies and problems? Why were shareholders themselves not more vigilant in protecting their interests, especially large institutional investors? What does this say about the motivations and incentives of money managers?Edwards (2003).

Because of the significance of these questions and their influence on the welfare of the U.S. economy, the government, regulatory authorities, stock exchanges, investors, ordinary citizens, and the press all started to scrutinize the behavior of corporate boards much more carefully than they had before. The result was a wave of structural and procedural reforms aimed at making boards more responsive, more proactive, and more accountable, and at restoring public confidence in our business institutions. The major stock exchanges adopted new standards to strengthen corporate governance requirements for listed companies; then Congress passed the Sarbanes-Oxley Act of 2002, which imposes significant new disclosure and corporate governance requirements for public companies, and also provides for substantially increased liability under the federal securities laws for public companies and their executives and directors; and the SEC adopted a number of significant reforms.

1.5 The Financial Crisis of 2008

Just as investor confidence had (somewhat) been restored and the avalanche of regulatory reform that followed the 2001 meltdown digested, a new, possibly even more damaging crisis, potentially global in scale and scope, emerged. While it has not (yet) been labeled as a "corporate governance" crisis, the "financial crisis of 2008" once again raises important questions about the efficacy of our economic and financial systems, board oversight, and executive behavior.

Specifically, as the economic news worsens—rising inflation and unemployment, falling house prices, record bank losses, a ballooning federal deficit culminating in a $10 trillion national debt, millions of Americans losing their homes, a growing number of failures of banks and other financial institutions—CEOs, investors, and creditors are walking away with billions of dollars, while American taxpayers are being asked to pick up the tab (Freddie Mac's chairman earned $14.5 million in 2007; Fannie Mae's CEO earned $14.2 million that same year). Not surprisingly, ordinary citizens who have seen the value of the 401K plans shrink by 40% or more are asking tough questions: How did we get into this mess? Why should we support Wall Street? Where was the government? What has happened to accountability?

While the causes of the current crisis will be debated for some time—Did we rely too much on free markets or not enough? Did special interests shape public policy? Did greed rule once again? Where were the boards of Bear Stearns, Lehman Brothers, and AIG? Were regulators asleep at the wheel? Incompetent?—one thing is for sure. Another wave of regulatory reform—this time possibly global in reach—is around the corner. And once again we will be asking the questions that prompted the writing of this book: What will be the impact on investor confidence? On corporate behavior? On boards of directors? On society?