

# The History of Modern U.S. Corporate Governance

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(Seminar based on the introductory chapter for *The History of Modern US  
Corporate Governance* (Edward Elgar, forthcoming))

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# What is Corporate Governance?

- The systems by which companies are directed and controlled: Cadbury Report, 1992
- “(W)hat the board of a company does and how it sets the value of the company, and is to be distinguished from the day to day operational management of the company by full-time executives”: UK Corporate Governance Code
- Corporate governance focuses on publicly traded companies

# Risk and Corporate Governance

- UK Corporate Governance Code illustrates that containment of risk is perceived as an important element of good corporate governance:
  - “The board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed” (Supporting Principle A.1)
  - “The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems” (Principle C.2)
- Ownership structure of companies defines the risks good corporate governance will be addressing

# Ownership Structure and Corporate Governance

- In most countries, most publicly traded companies lack a “core” investor with a sizeable ownership stake
- The cheating of minority shareholders is the primary corporate governance risk
- In the UK and the US most publicly traded firms lack “core” investors, so extraction of private benefits of control is not a serious concern

# Corporate Governance and Risk in the UK and the US

- If executives running a publicly traded company own only a small % of the shares, they will be tempted to pursue their own agenda
- Shareholders will likely have little appetite to intervene
- Managerial diversion of corporate assets/self-entrenchment/"shirking" can thus potentially impose agency costs on investors
- Corporate governance operates as a means of controlling the risk that executives will impose sizeable agency costs on those who own shares

# Why Focus on the History of US Corporate Governance?

- Corporate governance first gained prominence in the US, this being in the 1970s
- In the UK the 1992 Cadbury Report was the key
- The literature dealing with US corporate governance is voluminous but tracing the history is challenging
- Today's talk is based on the introductory chapter of a forthcoming sourcebook on the history of US corporate governance
- The sourcebook, and today's talk, only covers from the 1970s onwards

# Basic Chronology

- Corporate governance was not a priority amidst the post-WWII economic boom the US experienced
- Corporate governance moved on the agenda in the 1970s when doubts arose about management's ability to run sprawling corporate empires (e.g. Penn Central)
- Concerns about the US losing out to Germany and Japan encouraged interest in corporate governance
- Corporate governance achieved unprecedented prominence with scandals in early 2000s
- The financial crisis has kept the topic in the headlines

# Shareholder Orientation of U.S. Corporate Governance

- The tenor of debate with US corporate governance has been strongly shareholder-oriented
- This was not pre-ordained
- By 2000 there was a consensus “that ultimate control over the corporation should rest with the shareholder class (Hansmann and Kraakman, 2000)”
- But the 1950s and 1960s reputedly were “The heyday of stakeholder capitalism and corporate managerialism” (Gordon, 2007)



# Why Did US Corporate Governance Become Shareholder-Centric?

- During the 1980s takeovers underscored the importance of shares as bidders offered large premiums to win bids and incumbent managers characterized their defensive efforts in terms of shareholder value
- “Contractarian” thinking began to dominate theorizing about the public company
- While shareholders were just one aspect of the corporate “nexus of contracts”, they were “residual claimants” and could not bargain in the same way as fixed claimants (e.g. creditors and employees)

# The Board of Directors

- The board of directors stands out as arguably the pivotal corporate governance institution
- The board delegates managerial authority
- “Outside” directors nevertheless can potentially act as “watchdogs” to enhance managerial accountability
- From the 1970s onwards various reforms were introduced to fortify the “monitoring” model of the board

# Executive Pay as a Corporate Governance Issue

- “Executive compensation is one of the most controversial topics in corporate governance (Paredes, 2005)”
- Executive pay can help to reduce agency costs by linking pay with corporate performance
- This was a key theme in the 1980s and 1990s
- Executive compensation can generate agency costs with senior managers benefitting from loyal or lazy boards
- The notion that executives were taking shareholders “for a ride” gained credence when executive pay remained high despite poor shareholder returns in the 2000s

# Executive Pay Reform

- One reform theme was to try to ensure that the board played a constructive role (e.g. 1993 tax reform)
- Another was to enhance shareholder involvement area
- One tactic: bolster disclosure so shareholders would have the facts required to take corrective action (e.g. 1992 SEC reforms)
- A second tactic: provide shareholders with “say on pay” (e.g. Dodd-Frank Wall Street Reform Act of 2010)
- The UK experience with “say on pay” suggests the change will have little, if any, impact

# Activating Shareholders

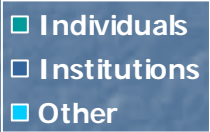
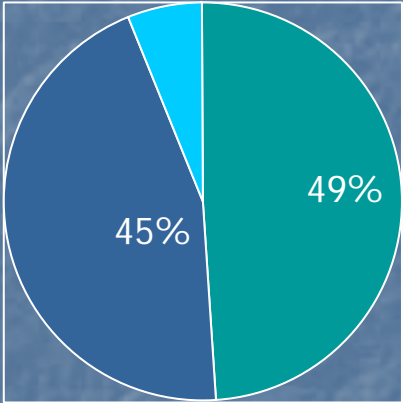
- Promoting shareholder involvement in the setting of executive pay was part of a broader theme: ensuring shareholders fulfilled their potential as promoters of improved managerial accountability
- The logic seems sound
- However, private investors dominated stock ownership in the US in following WWII and they were ill-suited to be activist shareholders because they lacked both the aptitude and inclination to intervene and could always sell if a company was performing poorly

# Institutional Shareholders and Corporate Governance

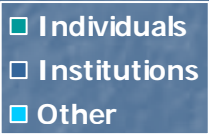
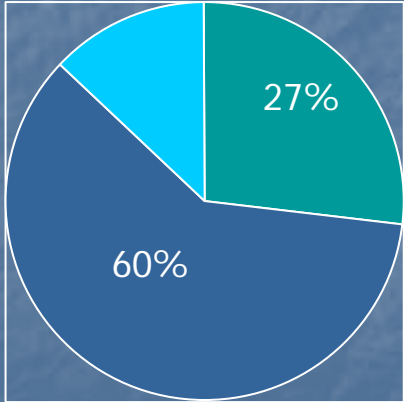
- Institutional shareholders (e.g. pension funds, mutual funds) increasingly dominated share ownership
- SEC regulations thought to deter institutional intervention were relaxed
- Still there were various related obstacles to intervention:
  - Investment managers were under competitive pressure to generate superior risk-adjusted returns
  - A successful intervention would have only a marginal impact on the value of a diversified share portfolio
  - Not all interventions succeed
  - Activist shareholders captured only a tiny fraction of any gains

# Share Ownership %s, US Public Companies

1985



2006



# Hedge Fund Activism

- Hedge funds stepped forward as shareholder activists in the 2000s
- Unlike mutual funds and pension funds they would seek out underperforming companies, buy large stakes and agitate for change
- The aggressive approach taken generated debate as to whether empowering shareholders was a good thing



# Shareholder Activism and the Financial Crisis

- Hedge funds were side-swiped by the financial crisis, meaning concerns about their activism exploits could be merely transitory
- The financial crisis strengthened the hand of those who supported legal reform to empower shareholders
- Dodd-Frank Act of 2010/SEC reforms make it easier for dissident shareholders to nominate directors
- Given tough ownership thresholds and a tradition of passivity, it seems doubtful this reform will foster robust shareholder activism

# The Takeover Controversy of the 1980s

- 1980s takeover artists were denounced as scheming financiers intending to use leverage and crude “break up” techniques to make quick profits and exit
- Takeovers had their defenders, who argued that the mere threat of an unwelcome bid imposed beneficial discipline on corporate executives and provided at least a partial solution to the managerial agency cost problem
- Takeovers inspired a backlash from management and lawmakers: “The takeover wars are over. Management won (Grundfest, 1993)”

# Takeover Substitutes

- During the 1990s there was little appetite for a return to the freewheeling 1980s takeovers
- Optimistically, takeover bids were “no longer needed” (Holmstrom and Kaplan, 2001)
- Greater board independence and increased use of performance-oriented compensation arguably were ensuring that executives were focusing closely on shareholder value
- This soon seemed too complacent

# Sarbanes-Oxley Act of 2002

- Sarbanes-Oxley Act of 2002 (SOX) was enacted to restore confidence in the markets after the collapse of the dot.com stock market boom and corporate governance scandals
- SOX prohibited corporate loans to executives, required CEO certification of financial statements and bolstered regulation of audits and audit committees
- “The most far-reaching reforms of American business practice since Franklin Delano Roosevelt” (President Bush)

# Corporate Governance and the Financial Crisis

- Some argued that the financial crisis of 2008 proved that the U.S. system of corporate governance was fundamentally flawed
- Corporate governance in fact was probably not that bad (Cheffins, 2009, examining companies removed from the S&P 500 in 2008)
- Nevertheless, the momentum in favour of reform meant corporate governance was one aspect of the Dodd-Frank Act of 2010

# Afterword

- The financial crisis prompted unprecedented direct government intervention in the affairs of particular firms to dictate governance outcomes
- Arguably, this might mean that going forward concerns about corporate governance will shift increasingly from “Type I” problems focusing on matters internal to companies to Type II problems, which involve state-led exploitation of corporations and their investors (Lamoureaux, 2009)