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Gregory Jackson

Understanding Corporate Governance in the United States

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An Historical and Theoretical Reassessment

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Kurzfassung

The U.S. is often seen as being the paradigmatic case of the shareholder-oriented or market-based model to corporate governance, and described in terms of several interrelated elements: activist institutional investors, an open market for corporate control, independent outside directors on the board, long-term equity-based compensation for executives, and gatekeepers who monitor the process of market disclosure. However, scandals surrounding Enron generated criticism and induced substantial changes through the Sarbanes-Oxley (SOX) legislation. This report reexamines the history and empirical evidence on U.S. corporate governance, showing how its evolution has been shaped by a negative form institutional complementarities – the limited effectiveness of one element creating externalities or limiting the effectiveness of other related elements, eventually leading to a systemic crisis. This perspective helps make the Enron case more understandable, but also shows the limited impact of SOX in fixing the system. The implications for the current economic crisis are explored.

Preface

The system of corporate governance in the United States is a moving target. Although the U.S. is often taken as a key benchmark for shareholder-oriented corporate governance and sometimes also equated with a “model” for good corporate governance, international audiences have often failed to appreciate the continuous evolution and debates in the U.S. itself regarding the reality of corporate governance in practice.

This report was commissioned by the Hans-Böckler-Foundation as an attempt to partially fill this gap in order to provide a more complete view of the U.S. debates and better assess the influence of recent developments on Europe and Germany, in particular. This task proved more challenging than was initially anticipated. While the historic legislative turning-point of the Sarbanes-Oxley (SOX) act was already in place, empirical evidence on the influence of SOX only began to emerge after the research for this report already began. The downpour of new studies also presented a puzzling picture, showing important aspects of change and continuity that defied both supporters and critics of the legislation. In following this development, many people supported this project with advice, comments, logistical help, and their patience. Several deserve particular thanks – Masahiko Aoki, John Cioffi, Nicola Ebert, Ronald Gilson, Howard Gospel, Bruce Kogut, Richard Marens, Karsten Schneider and Sigurt Vitols.

Before the dust of the post-SOX debates could settle, U.S. corporate governance now faces another historic cross-roads through the onset of the banking crisis and resulting financial and economic crisis, which was marked by the collapse of Lehman Brothers in 2008. While the work of social scientists seems to always remain one step behind the developments of the real world, I hope that this report helps put the current crisis into a longer term perspective of how U.S. corporate governance has evolved both in terms of a theoretical ideal and as a more complex set of practices. Once again, corporate governance practices in the United States are open for debate, their future up for grabs, and the “model“ remains incomplete.

Gregory Jackson

0 Introduction: Understanding Corporate Governance in the USA

The U.S. is often seen as being the paradigmatic case of the shareholder-oriented or market-based approach to corporate governance. Ownership of corporations is dispersed, but involves high engagement from institutional investors, such as pension funds. Corporate boards are small, have a high proportion of outside or independent members, and utilize committees to improve board processes. Executive pay links pay to top managers' salaries to shareholder returns. The internal and external aspects of corporate governance are linked through the monitoring of gatekeepers, such as audit firms, that certify the flow of information from managers to capital markets. And the market for corporate control exerts a final discipline on poorly performing firms, who face a heightened risk of takeover. These different elements are also thought have strong institutional complementarities, operating as a positive and mutually reinforcing system of effective corporate governance. These stylized characteristics of the U.S. model are widely cited as best practices or even a global standard for good corporate governance.

Scandals surrounding Enron and Worldcom focused substantial criticism on the U.S. corporate governance. Some critics and scholars used these events to mount a strong challenge to the prevailing wisdom about market-based systems of corporate governance (Blair, 2003, Bratton, 2002). Others stress the overall good performance of the U.S. economy, and see the rise of equity-based pay for managers and the stock market boom as triggering short-term and sometimes illegal behavior as "side effects" of a basically sound system (Holmstrom & Kaplan, 2003). The political reaction, development of Sarbanes Oxley (SOX) legislation, and subsequent changes in SEC listing requirements have also altered the way U.S. corporate governance practices operate. The consequences of SOX have remained hotly debated. Yet the onset of the subprime financial crisis and resulting global economic downturn has raised renewed questions about the fundamental effectiveness of U.S. corporate governance institutions.

The era after SOX also greatly increased awareness of the differences between the U.S. and British approaches to corporate governance. While both are considered to be broadly similar shareholder-oriented models, the U.S. regulatory regime is based much more on hard law and a regulatory state, unlike the British approach that relies more on soft law and self-regulatory mechanisms, such as Codes. The "one size fits all" approach of U.S. law sparked debate over the benefits of mandatory rules relative to more flexible sets of principles based on enabling set of rules (Anand, 2006). New U.S. regulation gives greater power and institutional scope to the state agencies such as the SEC to regulate important 'gatekeepers' and professional intermediaries who are central to market-based mechanisms of monitoring (Baker, Bealing Jr, Nelson & Staley, 2006). Finally, takeover rules are also very different, since the U.S. allows but regulates a range of anti-takeover defenses, which are not allowed under UK rules.

Recent developments remind us that U.S. corporate governance is not a static system in equilibrium, but has evolved continuously over the past decades. Prior to the 1980s, the U.S. was characterized by strong managers and weak owners. Top managers tended to view themselves as loyal to the corporation, rather than as agents of shareholders. The 1980s saw a huge wave of hostile takeovers that threatened the hegemony of U.S. managers. Likewise, institutional investors and particularly public-sector pension funds such as CALPERs became much more active players in corporate governance, using their growing blocks to exercise greater voice in corporate management (Useem, 1996). By the 1990s, managers had fought back by lobbying state governments to enact anti-takeover legislation, which made hostile takeovers much more costly (Useem, 1993). But managers also accepted the notion of "shareholder value" as a new underlying ideology for corporate America. In particular, the rise of equity-based pay such as stock options gave managers a greater stake in promoting restructuring and orientating their strategies toward the stock market. This shift went hand-in-hand with the catalysed role of independent, outside directors in the boardroom (Gilson, 2006). This system continues to evolve today.

This Report to the Hans-Boeckler-Foundation aims to outline the long-term changes in the U.S. system of corporate governance that culminated in SOX legislation and continue into the current period of the financial crisis. The report will also highlight some implications for corporate governance debates in Germany, either by the direct application of U.S. rules to German companies or indirectly by setting symbolic benchmarks for corporate governance reform. The main findings highlighted in the report are as follows:

- the various elements of the U.S. corporate governance system have emerged in a piecemeal historical fashion, often showing substantial misalignment among its various elements leading to waves of speculative activity (e.g. junk bonds, the dot. com bubble, and collateralized debt obligations) and subsequent collapse;
- the crisis of Enron substantially altered the understanding of how the U.S. corporate governance system operates in the academic literature;
- the regulatory response of SOX has sharpened the differences between U.S. and British approaches;
- SOX legislation has made some genuine, if costly improvements regarding the role of gatekeepers, but has not fundamentally altered the weak linkages among limited shareholder engagement, excessive managerial incentives for risk taking, and conflicted role of independent directors within U.S. boards;
- Overall, the market for corporate control may play a lesser role within the U.S. than is often hypothesized based on the experience of the 1980s.

1 The Recent History of U.S. Corporate Governance, 1960-2001

The U.S. system of corporate governance has evolved continuously over the last several decades. Unlike many treatments that see the U.S. model as a well-established, coherent and stable model of corporate governance, the historical facts suggest a much more piecemeal evolution.

1.1 Managerial Capitalism: 1960s-1970s

The **1960s and 1970s** were decades characterized by strong managers and weak owners. Corporate ownership became dispersed as early as the 1930s. The resulting separation of ownership and control was seen as giving power to managers and resulting in what came to be called agency problems (Berle & Means, 1932). **Table 1** shows individual share ownership remained the dominant form well into the 1980s. Individuals rarely were actively engaged in corporate governance. Despite a few pioneering efforts, shareholder proposals had slowly climbed to around 200 per year by 1970 but the SEC excluded "ordinary business" from such proposals and ultimately shareholder activism achieved little influence (Marens, 2002, p.380). Hostile takeovers remained very rare. Only in 1974 did a top investment bank take on a hostile bidder as a client, when Morgan Stanley represented International Nickel in its bid for Electronic Storage Battery (Gilson, 2006). Meanwhile, those outside the corporate establishment had little ability to raise sufficient funds to launch a hostile takeover.

U.S. corporate law is a matter of state rather than federal regulation. Only securities law is regulated at the federal level, and the emphasis of the SEC is usually on disclosure rather than substantive provisions regarding company structure (Hollister, 2005). Many investor rights are essentially vested with the board, yet companies have great latitude in shaping the structure and powers of boards in practice. The federal nature of corporate law laid the foundations for managerialism within U.S. corporate governance, since shareholders rights remained relatively weak under this competitive structure despite the existence of stronger national regulation over securities trading (Cioffi, 2010).

Corporate boards were predominately made up of insiders, chosen from company executives and former executives, or friends of the CEO from the "old boys' network" (Mace, 1971). These directors had a largely advisory role, and would rarely overturn or even mount major challenge to CEO decisions. While the strong board interlocks between major banks and non-financial companies characteristic of the era of J.P. Morgan, these declined sufficiently to the point were bank control seems to have been negligible by the 1960s (Mizruchi, 1982).[1] Meanwhile, shareholders had little direct say on the election of board members, since legal rules required them to go through an expensive process of proxy voting rather than having direct access to propose candidates (Gordon, 2007, p.1496-1497). **Table 2** shows that outside directors remained very rare –making up 25 % or less of all directors up through the 1970s. Among these outsiders, the concept of independence did not yet play much role. Rather directors were defined as "outsiders" if they were not employed by the firm as full-time executive officers or so-called non-management directors (ABA Committee on Corporate Law, 1978). Of course, some debate emerged regarding the idea of a "monitoring board" and the concept of independence (Eisenberg, 1976). In 1974, the SEC began requiring disclosure of the existence of an audit committee and published guidelines about the activities of audit committees in 1978. Likewise, only in 1977 did the NYSE require an audit committee with "directors independent of management" as part of its listing requirements—although directors from affiliated firms could serve among these directors unless such relationships "would interfere with the exercise of independent judgement…" (Gordon, 2007, p.1480). These requirements were only introduced to NASDAQ at the end of the 1980s.

Meanwhile, no regulations existed regarding compensation committees. Executive remuneration consisted mostly of fixed salaries and bonuses tied to annual performance of the company. Salaries were strongly correlated to the size of company revenues, and remained relatively insensitive to corporate performance or long-term value creation (Jensen & Murphy, 2004). For example, only 20 % of CEO compensation was tied to stock market performance in 1980 (Hall & Liebman, 1998), and accounting managers like sales growth and earnings were widely used to set long-term incentives.

This era of managerial control was associated with the rise of a particular set of business practices. The strategy and structure of large corporations shifted dramatically through the spread of the unrelated business diversification and the conglomerate form. During the 1960s, conglomerate mergers involved moves into unrelated industries and the creation of diversified groups by (Steiner, 1975). The theory behind these mergers was to internalize the capital market, so that firms could reduce risks and achieve efficient allocation of resources among different businesses internally by a central office. These mergers occurred during a period of high stock market valuation and generally were financed through exchange of shares (Shleifer & Vishny, 2003). These very large firms had high excess capacity and often underperforming assets. Boards had little incentive to improve their financial performance. But the "firms-as-portfolio" helped firms overcome the limits of previous functional corporate structures, becoming more diversified and effectively administered under the multi-divisional form (Fligstein, 1990).

1 The networks among outside directors became even less dominated by commercial banks over the coming decades (Davis & Mizruchi, 1999).

Although the U.S. never developed a stakeholder model of corporate governance, managerial capitalism did allow scope for certain elements of quasi-stakeholder orientation. Firms remained relatively sheltered from capital markets and followed the strategy of retaining profits and reinvesting them into the firm (Lazonick, 2007). Alongside this, firms developed paternalistic forms of 'welfare capitalism' characterized by stable employment and large internal labour markets, particularly for white-collar employees (Jacoby, 2004). Large corporations developed strong internal labor markets with relatively high pay, low turnover, training, and administered rules (Berger & Piore, 1980, Doeringer & Piore, 1971). Although blue-collar employees had narrow job definitions, employees could gain seniority-based promotions and firms sought to avoid layoffs (Osterman, 1987). Among white collar employees were the so-called men and women of the corporation, who served in the offices enjoying job security and promotion opportunities in exchange for loyalty and commitment (Kanter, 1978, Whyte, 1956). However, unions remained relatively distant from management and sought to secure benefits and limit managerial prerogatives inside the firm largely through collective bargaining and workplace rules, rather than employee participation or other forms of worker representation in the governance of the firm (Aguilera & Jackson, 2003, O'Sullivan, 2000). U.S. law enshrined a strict distinction between firm governance and contractual bargaining relationships with employees, who were seen as external to the corporation and restricted the scope of collective bargaining in ways that protected managerial prerogative (Cioffi, 2010). Still, union strength and commitments to core employees exerted some check on managerial authority and retained some significance in managerial decision making during this period (Mizruchi & Kimeldorf, 2005).

1.2 Investor Capitalism and the Deal Decade: 1980s

During the **1980s**, the power of managers was challenged by a variety of new developments. Macroeconomic growth has slowed, and U.S. industry came under growing pressure from foreign competition. Interest rates were high, and stock market returns had stagnated. In this climate of economic crisis, power began to shift substantially toward investors due to the rise of new types of institutional investors and the advent of hostile takeovers.

Institutional investors emerged as an important new category of shareholder. Since the funding requirements imposed by Employee Retirement Income Security Act of 1974 (ERISA), private pension funds had become more important as investors in the U.S. By 1985, pension funds owned 28 % of corporate equity (see Table 1). Institutional investors had diversified portfolios and disliked the existing U.S. conglomerates. Alongside individual shareholders prone 'exit', institutional investors began to exercise 'voice' in the affairs of corporations. Public-sector pension funds such as CALPERs became much more active players in corporate governance, using their growing blocks to exercise greater voice in corporate management (Useem, 1996). Other new socially-oriented and union-backed initiatives also played a pioneering role in adopting an enlightened shareholder-value approach to make a business case for ending unethical business practices.[2] Meanwhile, major investment banks also shifted their business away from supporting long-term investment through corporate bonds and toward more fee-based strategies involving increased trading in equity (O'Sullivan & Lazonick, 2000).

Most strikingly, a wave of hostile takeovers threatened the dominance of U.S. managers. The diversified conglomerates of the past decades proved to be undervalued in the stock market by the emerging institutional investors – the so-called "conglomerate discount." Diversified firms were taken over at high rates, split into component business, and sold to firms within the same industry (Davis, Diekmann & Tinsley, 1994). This unprecedented takeover wave was spurred by changes in anti-trust law, but also major financial innovations around so-called junk bonds (Blair, 1993). Michael Milken and Drexel Burnham developed the public offering of non-investment grade debt, which was eventually used to finance leveraged acquisitions.[3] Junk bonds were purchased by mutual funds, and later also pension funds, insurance companies and savings and loans banks as each sought to combat the low stock market returns during the 1970s (O'Sullivan & Lazonick, 2000). This new supply of finance meant that large companies could be potentially taken over by outside investors for the first time, who were often aiming at financial gains by planning to sell off the target firms' assets to repay the acquisition debt. Debt financing became widespread and was used to retire over $500 billion in corporate equity, as firms repurchased their own shares, borrowed to finance takeovers or were taken over through leveraged buy-outs (LBOs) (Holmstrom & Kaplan, 2003). Outside investors could aim at financial gains by selling off the target firms' assets to repay the acquisition debt (Bhagat, Shleifer & Vishney, 1990). A paradigmatic case was KKR's acquisition and "bust-up" of Beatrice Foods in 1986 (Baker, 1992), as well as their takeover of RJR Nabisco that was famously documented in the book *Barbarians at the Gate* (Burrough & Helyar, 1990). Few target firms resumed diversification strategies, and others sought to avoid takeover by proactively divesting unrelated assets, engaging in mergers, or buying back shares (Fligstein, 2001).

Parallel to these changes, the role of the board also underwent a critical examination (Business Roundtable, 1978). The board room of large companies was previously seen as an "inner circle" of corporate insiders, wherein banks played a central role through interlocking directorates (Useem, 1986). Yet between 1982 and 1994, the centrality of banks sharply declined as corporations gained access to newly regulated financial markets (Davis & Mizruchi, 1999). Meanwhile, **Table 2** shows the rapid increase in the proportion of independent directors from 30 % in 1985 to 60 % by 1990. Likewise, studies

2 Possibly the earliest example of union activism concerned the campaign to abolish segregated seating at the Greyhound bus company via a shareholders' resolution starting in 1948. The AITU union also campaigned to pressure AT&T to bargain regarding pension rights, but these efforts were cut short by a regulatory revision by the SEC excluding "ordinary business" from shareholder proposals (Marens, 2002)..

3 In 1988, for example, an amount equal to 1.25% of total stock market capitalization was available to non-investment grade issuers to fund takeovers (Gilson & Black, 2000).

by the SEC show that the proportion of firms with nominating committees increased from 19 % in 1979 to roughly 30 % in 1989 (Gordon, 2007, p.1498). While a growing number of outside directors were appointed, CEOs still retained almost complete control over the actual selection process (Lorsch & MacIver, 1989). Thus, outside directors remained very much as an "advisory board" where inside management retained most of the power. CEOs continued to see directors nominated by shareholders as lacking independence and representing the particular interests of a shareholder group.

The growing attention to stock prices and 'shareholder value' also placed executive pay under growing scrutiny, and shifted attention to strengthening links between pay and company performance. A key development here was the introduction of share options and other equity-based incentives (Jensen & Murphy, 2004). Whereas the value of stock options represented 10 % of CEO pay in 1980, this proportion increased to 48 % by 1994 (Hall & Liebman, 1998, p.661). Equity based incentives became thus widespread, in part as a result of hostile takeovers. As Congress placed legal limits on cash-based compensation during takeovers, equity-based incentives came to constitute a growing proportion of total remuneration (Coffee Jr., 2003). Equity-based incentives were also used to reward managers under leveraged buy-out schemes. Finally, to weaken their resistance to hostile bids, managers were offered 'golden parachutes' that awarded bonuses to those managers who lost their jobs in association with changes in corporate control. Such change in control agreements were in place at 41 % of the largest 1000 firms in 1988, and continued to spread to 57 % in 1996 and 70 % in 2000 (Jensen & Murphy, 2004). However, shareholders have no direct 'say on pay' under corporate law, hence leaving it to the board to influence the size and form of managerial pay schemes. This opened the door for the explosion of managerial compensation in the 1990s.

The so-called deal decade of he 1980s was associated with a large wave of corporate restructuring and associated job losses centred on the highly unionized blue-collar workers in the manufacturing industries (Baumol, Blinder & Wolff, 2003, Montgomery, 1991). Many of the large firms known for their welfare capitalist practices, such as IBM or Delta, abandoned these policies in favour of substantial workforce reductions (Weinstein & Kochan, 1995). Unionization rates dropped from 47.4 % of the labor force in 1970 to just 27.8 % in 1983 and 18.2 % in 1994 (O'Sullivan & Lazonick, 2000, p.19). Corporations increasingly abandoned their "retain and reinvest" strategy in favour of "downsize and distribute" (see discussion in O'Sullivan & Lazonick, 2000). Dividend pay-out ratios increased from 42 % of profits during the 1970s to over 49 % in the 1980s and thereafter. In addition to dividends, corporations distributed a growing amount of corporate profits through share buybacks, which increased from around 5 % of profits in 1980 to a peak of over 25 % in the late 1980s. Whereas average factory wages shrank by 5 % in real terms, CEO pay increased by some 415 % in the same period.

1.3 Executive Defence and the Ideology of Shareholder Value: the 1990s

By the **1990s**, the trend toward greater shareholder influence continued, but was reshaped by the responses of managers. On one hand, executives sought to defend their own power by shielding firms from unwanted takeover bids. On the other hand, managers aligned themselves increasingly with the interests of shareholders through new forms of executive pay and adopting the ideology of shareholder value (Dobbin & Zorn, 2005). Shareholder value refers to the concept that the primary goal for a company is to increase the wealth of its shareholders by paying dividends and/or causing the stock price to increase.[4] Somewhat paradoxically, although shareholder power was tamed, shareholder value became a powerful new ideology.

In terms of share ownership, institutional investors continued to gain in significance. Pension fund ownership had already peeked during the 1980s, but ownership by mutual funds became ever more widespread (see **Table 1**). Institutional investors not only grew in size, but gradually began voting more actively against takeover defences proposed by management and even supported initiatives to remove such defences (Bainbridge, 2008). Thompson and Davis (1997) find that shareholder resolutions totaled 275 in the 1984 proxy season with an average vote of 5.7 %, but increased to 487 resolutions with an average vote of 24.1 % by 1991. Some public pensions such as CALPeRS became famous for their high degree of engagement. Initial studies suggested that activism lead to increases in shareholder wealth, although not necessarily in improved operating performance of targeted companies (Smith, 1996).

In 1992, federal proxy rules were revised to give shareholders enhanced latitude to communicate amongst themselves (Schwab & Thomas, 1998). The scope of issues targeted by shareholder activism expanded further to cover changes in board structure and function, as well as executive and director compensation. Pension funds with labor union representation have been at the forefront of innovation—for example, filing 75 out of the 265 proposals tracked by the Investor Responsibility Research Center (IRRC) in 1995 (Schwab & Thomas, 1998). The threat of takeover also gave institutional investors more leverage to make informal demands, and lead to board members putting more emphasis on investor relations, even going on road shows to maintain loyal investors. Despite these trends, the influence of shareholder activism remained tantalizing, but modest on the whole. Even the most activist investors have limited resources devoted to corporate governance and institutional investors rarely get involved in matters of company specific policy, make shareholder proposals or seek direct representation by nominating candidates to the board of directors (Black, 1998, Choi & Fisch, 2008).

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4 More specific concepts suggest that returns to shareholders should outperform certain bench-mark rate of return for investments carrying similar levels of risk (Rappaport, 1986).

A second important shift during the 1990s was that the number of hostile takeovers had started to decline. **Figure 1** shows takeovers during the 1990s and subsequent decline in both the US and UK. During the 1990s, mergers became less hostile, were largely in related industries, and used stock swaps to consolidate industry structures (Holmstrom & Kaplan, 2001). The new M&A wave of the mid-1990s led to a doubling of the transaction value of M&A activity from 5.4 % of GDP in 1991-1997 to some 10.8 % of GDP in 1998-2005, but was focused on growing industries and new technologies, sparked by the IT revolution and so-called DOT.COM bubble (Jackson & Miyajima, 2007). Hence, while the market for corporate control remained very active, hostile bids became rather rare since the mid-1990s. At least three reasons exist for this decline: the collapse of junk bond markets, the enactment of state-level antitakeover laws and consequent spread of poison pill takeover defenses, and the changing attitudes of managers toward shareholder value. Each of these will be discussed in turn.

One reason for the slowdown was that the junk bond market began to collapse. A major source of investment in junk bonds had been the de-regulated Savings & Loans funds, but their collapse in the late 1980s brought significant political attention to the risks of the junk bond market. Michael Milken and Drexel Burham Lambert were arrested in 1988 for violating a series of securities laws, including racketeering, market manipulation, and insider trading. In 1989, following several junk bond defaults, Drexel Burham Lambert became insolvent and filed for bankruptcy. Michael Milken was convicted for lesser offences in 1991. In the early 1990s, the default rate on junk bonds rose to around 9 %, and the LBO market cooled.

Another reason for the declining number of hostile bids was the "executive defence" mounted by managers by lobbying state governments to enact anti-takeover legislation (Useem, 1993). These new state anti-takeover laws allowed a much wider range of defensive actions. These made hostile takeovers more difficult and costly, as defensive measures such as poison pills, golden parachutes and staggered boards protected the position of management (see legal details in Cioffi 2010). **Table 3** shows that of the 332 hostile takeovers attempted in the U.S. between 1991 and 2005, only 22 % were successful. Notably, the success ratio was far lower than in the UK, where 176 hostile deals were attempted leading to 42 % of target firms being sold to the raider. Did takeover defenses play a substantial role in this story? Further analysis of these data shows that takeover defenses were involved in at least 130 bids, which is somewhat over 1/3 of all hostile bids. In 76 cases, these were poison pill defenses that are forbidden in the UK. A statistical analysis of hostile attempts shows that the presence of a poison pill reduced the likelihood of a successful bid from 50 % to around 33 % (Jackson & Miyajima, 2007). Thus, the legal changes influenced but did not fully shield managers from the discipline of the takeover market. While 47 % of target firms remained independent, another 31 % of targets were sold to alternative bidders. Poison pills, in particular, do not necessarily frustrate a deal entirely, but lead to further negotiations and may improve the price of a bid.[5] And despite the new power of the board to "just say no" in hostile bids, takeover activity reached new all time highs during the 1990s despite relatively few hostile bids. In the end, evidence suggests that firms targeted by hostile bids were no more likely to be sold to raiders in the 1980s than in later decades (Bratton, 2007).[6] These facts suggest that the executive defence was only achieved by their partial agreement in helping to institutionalize the role of the shareholder and the importance of "shareholder value" for corporate America. To understand the emergence and triumph of shareholder value as a managerial ideology, one must also look at the parallel changes in share ownership and the role of the board of directors.

Finally, a third and often neglected reason for the decline in hostile takeovers relates to the broader changes in the role of the board (Gilson, 2004, Gordon, 2003). Fewer bids may be hostile because board resistance to takeover bids was softened by the widespread use of "golden parachutes" that compensate managers who loose their position following a takeover. These packages are often considered an important element of executive compensation aligning managerial interests with those of shareholders. So-called change of control contracts were in place at 41 % of the top 1000 companies in 1988, but have since increased to 57 % in 1996 and 70 % in 2000 (Jensen & Murphy, 2004, p.29). Likewise, directors tend to be paid through stock options that give them incentives to seek high bidders. Independent or outside directors also increased the salience of shareholder interests during M&A.

By the early 1990s, well over half of listed firms had a majority of independent outside directors (Linck, Netter & Yang, 2008). Table 3 shows that the proportion of independent directors increased from 60 % in 1990 to 67 % by 2000. Among the largest firms, only around 10 % had insider-dominated boards. Meanwhile, this trend slowly spread to smaller firms, particularly after the mid to late 1990s. Despite the growing importance of independence, two facts are worth noting. First, the legal definition of an independent director remained rather weakly developed and was specified only in state corporation law. Second, **Table 4** shows that a majority of U.S. firms still combined the role of CEO and Chairman within the board. This fact puts some doubt on the genuine independence of other board members. A number of studies from this period note that outside directors felt strong loyalty to the CEO regarding issues such as "golden parachutes" (Wade, Charles A. O'Reilly & Chandratat, 1990) and that CEO influence led to boards with demographically similar (Westphal & Zajac, 1995) or from related firms (Shivdasani & Yermack, 1999).

5 For example, in 2000, MGM Grand Inc initially offered a choice of $17 in cash or a combination of $7 in cash and $10 in common stock per share in Mirage Resorts Inc (MR). MR's board rejected the original offer, and adopted a poison pill plan giving shareholders the right to purchase stock at a deep discount in the event of an acquisition or an attempt to acquire a stake of 10% or more of the company. MGM later offered a sweetened $21 in cash per share, or a total value $6.483 bil, including the assumption of approximately $2 bil in liabilities.

6 Takeover rules may nonetheless have had a deterrent effect in reducing the total number of hostile bids, raising the quality of those bids, and leaving the actual success ratio unchanged (Bratton, 2007).

Still, other economic changes began to catalyse the role of outside directors in the boardroom in very significant ways (Gilson, 2006). A number of legal decisions focused on the importance of outside directors in monitoring takeover bids. This role was particularly clear for management buy-outs, in which the outside directors played a critical role. For example, the Delaware Supreme Court ruled to allow target boards to "just say no" to a hostile bid, as long as independent directors were a majority in the board and sufficiently involved in these decisions – starting in the 1980s cases of Unocal and Moran, but culminating in the 1990 decision in Paramount Communication vs. Time (**see Appendix A**). Inside directors thus became ever more vulnerable to shareholder lawsuits, and exposed the discipline of the takeover market. Gilson argues that these factors helped trigger more active role from corporate boards more generally. In particular, outside directors were responsible for helping the diffusion of a number of new managerial practices, such as equity-based pay schemes, golden parachutes, M&A activity, and board nominations (Davis & Greve, 1997, Westphal, 1998, Westphal & Zajac, 1995). CEO turnover increased and a number of high profile incidents emerged where CEOs were ousted, such as General Motors.

In particular, the rise of equity-based pay such as stock options had given managers a greater stake in promoting restructuring and orientating their strategies toward the stock market. The real explosion in the relative value of stock options came from the mid-1990s onward, constituting 33 % of total CEO compensation among New Economy firms in 1992 but 83 % in 2000 (Gordon, 2003). In 1991, the SEC changes rule 16(b) making it possible for executives to exercise stock options and sell their stocks at the same time, thereby exploiting very short-term movements in stock prices to their own advantage. Despite attempts to limit the amounts of tax deductible executive pay (Jensen & Murphy, 2004), other tax incentives encouraged stock options, as did the fact that corporations could avoid expensing options in their financial statements (Suchan, 2004, p.8). Very few restrictions are placed on the form of stock options, nor the performance standards that should be met. As Coffee (2003, p.9) argues,

> "…the 1990s was the decade in which senior executive compensation shifted from being primarily cash-based to being primarily stock-based. With this change, management became focused not simply on the relationship between market price and break-up value (which the advent of the bust-up takeover compelled them to watch), but on the likely future performance of their firm's stock over the short-term. Far more than the hostile takeover, equity compensation induced management to obsess over their firm's day-to-day share price."

As late as 1990, the Business Roundtable, a group of chief executives of the largest firms, advocated the notion that "the directors' responsibility to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation or to the long-term interests of its shareholders." Yet by 1997, they argued that "the paramount duty of management and of boards of directors is to the corporations' stockholders; the interests of other stakeholders are relevant as a derivative of the duty to the stockholders" (quotes take from Fourcade & Khurana, 2009). The era of shareholder value had arrived.

The rise of shareholder value reinforced the "downsize and distribute" strategy of the previous decade - dividend payout ratios remained high, downsizing continued despite the general economic recovery[7], and corporations remained focused on their core businesses. CEO continued to increase, while average wages stagnated (Hallock, 1998). Ideologically, organized labor no longer posed a great challenge to management and both unions and individual employees increasingly sought empowerment through the channel of pension fund ownership or employee share schemes. Still, the concept of shareholder value evolved and became infuse with range of new techniques of "speculative management" designed to influence company share prices, including road shows, stock splits, name changes, mergers, spin-offs, changes to in company pension plans (Krier, 2005). Among these techniques, the most influential was the expansion of share repurchases or buy-backs after 1984 (Dittmar & Dittmar, 2008, Lazonick, 2007). The value of repurchases increased in value from 13 % of corporate earnings in 1984 to 35.8 % in 1999, thus eventually surpassing the total volume of dividends paid or the value of new shares being issued. A recent review demonstrates that the rising earnings of both CEOs and other financial market-driven occupations such as lawyers and investment bankers have made a major contribution to the rising inequality in the U.S. (Gordon & Dew-Becker, 2008).

These changes both reflected and contributed to the wider context of "financialization" of the U.S. economy (Krippner, 2005). In terms of GDP and corporate profits, the central shift in the structure of the U.S. economy has been toward FIRE (finance, insurance and real estate) sectors. For example, the ratio of profits in the financial sector relative to the non-financial sector more than doubled since the mid-1980s. Among corporations, the share of portfolio income (e.g. income from interest, dividends, and capital gains) relative to cash flow has increased roughly three to five times in the 1980s and 1990s compared to the 1960s and 1970s. Looking at U.S. non-financial corporations over the period 1973-2003, Orhangazi (2008) finds a sharp rise in the ratio of financial to tangible assets (from roughly 30 to over 100 %), an increase in dividend and interest income relate to internal funds (from roughly 20 % to around 50 %), and a growing ratio of financial payments in interest, dividends and share buy-backs relative to profits (from under 40 % to peaks around 100 %).

In sum, the 1990s had a paradoxical effect on corporate governance. While the executive defence tamed the market for corporate control through poison pills and "just say no" defences, a new set of market mechanisms entered the board itself—new forms of executive pay, greater executive turnover, and golden parachutes. These mechanisms

7 For example, corporate downsizing remained pervasive, particular in manufacturing industries (for an overview see Baumol, et al., 2003). After controlling for profitability and growth, U.S. firms remained twice as likely to cut employment levels by 10 % or ore relative to German firms during the 1990s (Jackson, 2005).

shifted managerial interests away from the long-term development of the firm, and linked their own interests with shareholder value (see also Gordon, 2007). The seeming success of this system put corporate governance on the reform agenda world-wide, culminating in the OECD principles in 1997 that were largely modelled upon a stylized version of current U.S. practices.

1.4 Enron: 2001

By the early **2000s**, most of the key pillars in the U.S. "model" of corporate governance were in place, and conventional wisdom began to see these elements as a normative benchmark for "good" corporate governance practices around the world. Shareholder engagement would be supplied by active institutional investors. Boards would be increasingly independent and rewarded through long-term equity based incentives linked to share price performance. The flow of information from the board was certified by outside gatekeepers, such as auditors and accountants. Taken together, these elements also served as a foundation for an effective market for corporate control. The stock market boom and rise of the "new economy" seemed to demonstrate the superiority of this model, both for established firms but also for stimulating investment in new entrepreneurial ventures. In fact, the wave of speculation had created too many opportunities for short-term profit making through IPO – soften at the cost of U.S. households who were the "greater fools" investing in the stock market at historically high levels (Lazonick, 2007).

The crisis and collapse of Enron sparked a wide-ranging re-examination of corporate governance around the world. Many detailed accounts have been given of the Enron case and no comprehensive review of these studies can be given here (Bratton, 2002, Coffee Jr., 2003). In terms of the U.S. "model" of corporate governance, Enron exposed the fact that the various elements of this system were not functioning together in a complementary fashion. In fact, the weaknesses or limits in the effectiveness of each element seemed to potentially undermine the other (see Gordon, 2002). Shareholders failed to rationally value Enron. The Enron board failed to protect the integrity of financial disclosure, despite the presence of fourteen members of which only two were insiders. These board members also had high levels of relevant competence, and were incentivized by stock options or other equity-based incentives. The executives of Enron were incentivized to adopt high-risk strategies oriented to earnings management and propping up an overvalued stock in order to maintain the value of their stock options. Gatekeepers such as the auditing firm of Arthur Anderson critically failed as an effective interface between management and investors. A key aspect of this failure was the aggressive use of the mark-to-market (MTM) accounting for Enron's energy contracts, which allowed Enron to report expected benefits from future transactions into current period income (Dharan & Bufkins, 2008). Enron likewise reported the entire value of each trade on its on-line trading system as revenue, rather than reporting only its trading or brokerage fees. The factors allowed Enron to report a phenomenal growth in revenues, fuelling its high share price growth. Finally, unlike situations were corporations underperform, the market for corporate control provided little effective discipline or remedy for the "over-valued" stock prices at Enron (Jensen, 2004). The agency costs of over-valued equity ensue when managers cannot deliver profits in line with unrealistic and inflated investor expectations. As a result, managers will turn to short-term measures to bolster stock prices:

> "It becomes ever more clear to the managers of such organizations that it is difficult to generate the performance necessary to support the sky-high stock price. And knowing that the market will hammer the stock price if it becomes clear the expected performance will not be realized, managers begin to take actions that will at least appear to generate the required performance. They use the firm's overvalued equity as currency to make acquisitions to satisfy growth expectations. They use access to cheap capital to engage in excessive internal spending in risky greenfield investments. They make increasingly aggressive accounting and operating decisions that shift future revenues to the present and current expenses to the future. Eventually when these fail to resolve the issues, managers, under incredible pressure, turn to further manipulation and even fraud. None of these actions truly improve performance. In fact when they are taken not to create real value, but to give the impression of value-creating growth, they destroy part or all of the firm's core value." (Jensen & Murphy, 2004, p.45)

A Historical Overview of Corporate Governance in the USA

	1960s-1970s	1980s	1990s	2000s
	Managerial Capitalism	Investor Capitalism	"Shareholder Value"	Crisis of "shareholder value" paradigm
Ownership	Dispersed, individual	Institutional investors	Institutional investors	Institutional investors
Market for Corporate Control	Weak	Strong	Medium	Medium
Boards	Insider - "advising board"	Insider- "advising board"	Outsider- "monitoring board"	Outsider- "monitoring board"
Executive Remuneration	Fixed	Stock options	Stock options	Stock options
Gatekeepers	Weakly regulated	Weakly regulated	Weakly regulated	Strongly regulated

2 The Crisis of the Shareholder Value Paradigm: Post-Enron Debates.

The concept of shareholder value, both in economic theory and as a normative paradigm, is closely linked to the agency view of the corporation. Specifically, this perspective argues that that only shareholders are residual claimants to the activities of the corporation, thus shareholders alone have incentive to bear risk investing in resources that will increase the economic performance of the firm. A large body of work related to the so-called stakeholder theory of the firm now takes issue with this view (O'Sullivan, 2000). For example, early critiques stressed that employees were also residual claimants to the extent that firm-specific investments are made in human capital, making employees dependent on the particular enterprise (Blair, 1995). This insight has been elaborated within theories of the firm based in corporate power and the asymmetrical nature of the employment relationship (Parkinson, 1993, Parkinson, 2003, Parkinson & Kelly, 2001).[8] As an alternative to the principle-agent view, the "team production" model likewise suggests that the corporation embodies a number of stakeholders who invest firm-specific resources, but jointly relinquish control over those resources to a board of directors for their own benefit in order to solve the problem of coordinating efforts within the team (Blair & Stout, 1999). Along similar lines, the concept of essentiality has been used to elaborate the idea that where human assets are essential to the productivity of the firm, control based on ownership of the physical assets or legal entity of the corporation cannot act as a substitute for cooperation or employee voice in decisions (Aoki & Jackson, 2008). Others have developed a wider theory of innovative enterprise stressing how corporate governance may or may not support the strategic, organizational, and financial perquisites of innovation (Lazonick, 2007, O'Sullivan, 2000).

Rather than continue these debates, this section will look at the shareholder value paradigm in its own terms. The aim here is to review some of the more recent U.S. debates on corporate governance that *agree with the normative idea of shareholder value, but critique contemporary corporate governance practices for their failure to deliver corporate accountability* or economic efficiency. The analysis is based on the five dimensions of corporate governance: shareholder activism, the market for corporate control, boards, executive remuneration and the role of gatekeepers. The paper will argue that the effectiveness of each governance mechanism has very substantial limits in practice. Perhaps more critically, the paper argues that these limits may be mutually reinforcing such that the limits of one mechanism detract from the effectiveness of other key mechanisms of corporate governance. Next, we take each of these points in turn.

8 While beyond the scope of this paper, theories of corporate social responsibility also argue that corporate decisions may have negative externalities on stakeholders who are not party to those decisions. Thus, CSR theories argue for greater dialogue, participation and responsibility toward stakeholders in company decision making (Vogel, 2006).

2.1 Limits of shareholder activism.

Market-oriented corporate governance is premised upon well-informed and active shareholders, who engage in corporate governance both through exit and voice. Yet despite the growing size and concentration of ownership stakes held by institutional investors, such as pension funds and mutual funds, numerous studies have now suggested that the level of shareholder engagement has remained low and the influence on corporate behaviour less straight-forward than often hypothesized (Dalton, Daily, Certo & Roengpitya, 2003, Gillan & Starks, 2000, Wei-Ling & Szewczyk, 2003). For example, institutional investors faced growing criticism for their acceptance of unrealistic share valuations during the IT bubble. Institutional investors held over 60 % of Enron shares, but did not see that Enron was overvalued or at least had incentives to engage in herding behaviour of holding the stock (Coffee Jr., 2003).

One conventional but important explanation for low shareholder engagement concerns market failure (Black, 1990). Mutual funds have diverse portfolios and stand to gain only a portion of the value added through investing in shareholder activism, while other shareholders may be free riders. Information sharing and coordination of strategies among investors may be limited since such information may also give proprietary advantages in trading. Thus, institutional investors face traditional collective action problems that may lead to a sub-optimal level of engagement. U.S. law also discourages coordination amongst shareholders in several ways. The Securities Exchange Act § 13(d) requires extensive disclosures from any person or group that acts together to acquire beneficial ownership of more than 5 percent of shares. While shareholders elect the board of directors, they have little power to directly nominate their own candidates to the board and have few incentives to engage in proxy contests (Bainbridge, 1992, p.1075-84). Despite liberalization of legal restrictions in 1992, communication among shareholders remains relatively limited (Choi, 2000). Ultimately, controlling shareholders can be held liable for failing to protect the interest of other minority shareholders, which thereby discourages the formation of large blocks and exercise of control by institutional investors (Bainbridge, 2008).

A further institutional explanation for limited shareholder engagement is linked to the distinction between pressure-resistant and pressure-sensitive investors (David, Kochhar R. & Levitas, 1998, Kochar & David, 1996). Pressure-resistant institutional investors are those who are unlikely to have strong business links with the corporate sector. Thus, these investors they may have a stronger influence on the strategy and performance of corporations (Hoskisson, Hitt, Johnson & Grossman, 2002). Yet many institutional investors remain pressure-sensitive and even face strong conflicts of interest. For example, new studies have investigated the voting record of U.S. mutual funds, showing them to be highly pressure sensitive due to their management of corporate pension funds (Davis & Kim, 2007). Receiving funds from the corporate sector gives rise to conflicts of interest with regard to shareholder engagement – leading to the adoption of policies that are generally more pro-management than one might expect. Another study from 2004-2006 shows that only 13 % of shareholder proposals on executive remuneration were successful—on average, only around 17 % of shareholders supported these proposals, whereas 54 % rejected them and 29 % abstained or failed to vote at all (Ashraf, Jayaraman & Ryan, 2009). The same study also shows that mutual funds with business ties to pension funds were much less likely to support successful proposals.

Meanwhile, the more activist types of funds are those with the greatest independence from the corporate sector. Pressure-resistant funds are largely limited to public sector pension funds, such as CalPERS, or funds with strong union control. But even among these funds, the degree of activism varies widely and does not generally extend to core issues, such as nominating directors (Choi & Fisch, 2008). Public employee pension funds increased from 700 to at least 2,625 by 2005. Yet survey results show that while a majority of funds do engage in low cost forms of activism (e.g. participating in corporate governance organizations, writing comment letters to the SEC or withholding votes), over 80 % never sponsor or solicit proxy votes on shareholder proposals, roughly 88 % have never created focus lists for activism, and 90 % never nominate names of director candidates (Choi & Fisch, 2008). The same study found that only around 11 % of funds engaged in activism to fulfill fiduciary duties or pursue the public interest. Rather, funds engage in corporate governance to improve shareholder returns, but more often than not cite a lack of resources (44 %) or negative cost-benefits (31 %) as reasons for not participating. Moreover, even among public pension funds, only around one-third of trustees were member elected by 2000 (Hess, 2005). The story is rather different among private pension funds with union representation among trustees, who tried to remove directors or influence corporate policy at over 200 corporations in 2004 and tried utilizing shareholder proposals to obtain employee benefits outside the realm of collective bargaining (Bainbridge, 2006, p.1755). Despite the potential positive role of such engagement, union pension funds have not succeeded to form wider coalitions with other activist shareholders or gain support from institutional investors for most of their proposals.

A third set of reasons is that many institutional investors *lack the organizational capacity* to engage with a large portfolio of companies. Engagement is expensive. Small pension funds are much less likely to engage with firms than larger funds (Choi & Fisch, 2008). But perhaps more importantly, funds often operate with very high levels of delegation. Survey evidence suggests that public pension funds have 84 % of their assets externally managed, only 15 % vote their own proxies, and 42 % even outsource the preparation of their own voting guidelines (Choi & Fisch, 2008). ISS has a particularly central role, serving 69 % of public pension funds as clients (Choi & Fisch, 2008). In fact, Ashraf et al. (2009) found that no shareholder proposals were successful without receiving favorable ISS recommendations. Other institutional investors also often delegate management of particular portfolios to outside specialists or rely on external service providers to rate companies, inform their corporate governance policies, or make voting recommendations. Given the limited expertise and capacity to engage with company specific issues, shareholder activism retains a quite *generalized orientation*. Even the most active institutional investors, such as CALPERs, usually advocate across-the-board guidelines, and have explicit policies for voting their shares in line with certain principles (Jacoby, 2007). However, the influence of those strategies on a particular firm is relatively limited. Even when a crisis emerges at a particular firm, institutional investors still face the substantial barriers to coordination discussed above.

A more realistic picture of institutional investor influence is that investors rely largely on *informal engagement*, rather than formal exercise of control. A recent and innovative study of Hermes pension fund in the UK found significant benefits to shareholder intervention, but equally stressed the largely informal character of such engagement (Becht, Franks, Mayer & Rossi, 2006). Even large shareholders like Hermes rarely have enough votes to openly challenge management, given that most investors will remain passive supporters of management apart from during exceptional crises. Investors may also eschew open public criticism of firms whose stock they own. Rather, institutional investors may prefer to operate behind the scenes through informal communication and personal access to top executives by virtue of their potential influence over share prices, if the investor chooses to sell. Here the threat of exit conditions voice. Indeed, studies of the influence of foreign institutional investors on stakeholder-oriented firms in countries like Japan demonstrate the importance of growing transparency and increasing dialogue of a largely informal nature (Ahmadjian, 2007, Ahmadjian & Robbins, 2005).

Taken together, institutional investors face severe limits with regard to shareholder engagement. The stock market mechanism services to transform illiquid investments in tangible assets into liquid claims to tradable rights over investments that have already been made (Lazonick, 2007).

2.2 Limits of the market for corporate control.

One set of motivations for takeovers relate to the agency costs associated with the separation of ownership and control (Fama, 1980, Fama, 1983).[9] Through a takeover, shareholders may regain control of poorly performing firms and replace inefficient management (Shleifer & Summers, 1988). Henry Manne (1965) first described the governance function of takeover markets:

9 A large literature describes the strategic motivations for M&A, such as synergy effects (Chatterjee, 1986), gaining market access or power (Hitt, Hoskisson, Johnson & Moesel, 1996, Stigler, 1982), diversification (Marris, 1964), exit strategies for entrepreneurs (Thornton, 1999), or restructuring in response to changes in the technological, economic or institutional environment (Fligstein, 1990, Pfeffer, 1972, Stearns & Allan, 1996).

"The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently."

Manne posited a strong relation between share prices and managerial performance. As shareholders exit poorly performing firms, lower share prices create incentives for outsiders to accumulate control rights, replace the management, and restructure the firm. These outsiders can recoup their investment through a share price premium, selling their equity stakes later at a higher price. When exposed to the threat of hostile takeover, management must therefore improve returns to capital and stop investment in "underperforming" assets, or else managers risk their jobs. The market for corporate control is central to market-based systems of corporate governance, since investors may retain capital liquidity and diversified portfolios but benefit from monitoring in the market. Takeovers thus substitute for direct monitoring by large blockholders or banks, as a key feature of market-based corporate governance systems (Baums, 1993, Höpner & Jackson, 2001).

The market for corporate control has also faced strong critics. A broad consensus exists that share price premiums for the shareholders' of target firms are large, perhaps as 20-30 percent (Bruner, 2002). Meanwhile, shareholders of acquiring firms have zero or negative returns both (Forsyth & Raj, 2002, Forsyth & Raj, 2003, Gerke, Garz & Oerke, 1995, Goergen & Renneboog, 2004, Gregory & McCorriston, 2002, Higson & Elliot, 1998, Sudarsanam, Holl & Salami, 1996). Target firms gains are offset by acquiring firm losses to net a statistically insignificant change in performance (Andrade, Mitchell & Stafford, 2001, Draper & Paudyal, 1999, Franks & Harris, 1989, Sudarsanam, et al., 1996).

One interpretation suggests that while net gains may be zero, some cases of M&A still produce positive gains and thus there is no harm to having a strong takeover market. Yet even Henry Manne (1965) anticipated the enormous impact of takeovers on the distribution of wealth: "...we can see how this mechanism for taking control of badly run corporations is one of the most important 'get-rich-quick' opportunities in our economy today." Several criticisms question whether takeovers produce net gains to society (Jarrell, Brickley & Netter, 1988). Gains to a given party may be simple re-distributions resulting from losses to someone else. The transfer of wealth from stakeholders to shareholders may account for a large proportion of takeover premiums, but lead to net losses of efficiency due to breaches of trust (Shleifer & Summers, 1988).

The impact of takeovers on employees is central to the controversy over the market for corporate control. From the agency theory perspective, the disciplinary role of takeovers should reduce excess employment and enhance labour productivity. Takeovers are argued to shift assets to more efficient uses while also enhancing the accountability of managers to shareholders. Alternatively, from the resource-based view of the firm or stakeholder theory, takeovers may diminish firm-specific human capital and knowledge, particularly in the case of hostile takeovers. If employees and other constituencies with asset-specific investments are not adequately protected by law, takeovers will serve to transfer wealth to shareholders at the expense of long-term performance of the enterprise (Deakin, Hobbs, Nash & Slinger, 2002). Shleifer and Summers (1988) suggest that, following a successful hostile bid, a new management team comes in and finds itself able to realize short-term gains to meet the costs of the takeover through asset disposals. They argue that, "Hostile takeovers are external means of removing managers who uphold stakeholder claims. Takeovers then allow shareholders to appropriate stakeholders' ex post rents in the implicit contracts. The gains are split between the shareholders of the acquired and the acquiring firms. At least in part, therefore, the gains are wealth redistributing and not wealth creating". More generally, the threat of hostile takeover may decrease the level of investment in firm-specific assets by managers, employees and other stakeholders, thereby offsetting any gains in the reduction of agency costs (Schnitzer, 1995). Likewise, mergers are also associated with an increased likelihood of layoffs on an aggregated industry level (Fligstein & Shinn, 2007).[10]

The effectiveness of the market for corporate control may also be diminished by several factors. First, the stock market may often fail to effectively value corporations (Kraakman, 1988). Capital markets often take myopic, short-term views of investments, follow speculative trends that make valuations very volatile, or fail to respond to bad management because shareholders are uninformed (Miles, undated). Second, management may react negatively to takeovers through costly defensive strategies such as golden parachutes, poison pills and legal protections (Bittlingmayer, 1998). Third, management may adopt short-term strategies to bolster share prices, thereby sacrificing beneficial long-term projects and investments. Fourth, bidding firms may themselves pursue selfish managerial interests, as suggested by the so-called hubris theory of M&A (Roll, 1986).

In retrospect, the conditions producing the wave of hostile takeovers during the 1980s and early 1990s seem quite unique. Few takeovers justify the very high premiums paid to target shareholders in hostile deals, which often range from 30 to 50 %. Such takeovers must be facilitated by other macroeconomic factors, including structure mispricing of stocks. Whereas in the 1990s, 32 % of U.S. firms with negative ROA received (friendly or hostile) takeover bids, this percentage declined to just 11 % in the period 2000-2005—similar to levels in Germany or France (see **Figure 1**). Still, little direct link can be established between the hostility of transactions and their link to poor performance (Bratton, 2007). Today, most disciplinary takeovers are achieved by private

10 A wide range of other evidence supports the 'breach of trust' argument, and generally suggests casts doubt on the efficiency of the market for corporate control. Conyon et al. (2001, 2002) examined hostile takeovers in the UK between 1987 and 1996, reporting significant falls in both employment and output. Deakin et al. (2002) conducted case studies of 15 UK takeovers in 1993-1996, reporting substantial job losses and short-term sale of assets. Their study gives qualitative insights into the marginal role of employee interests within the decision-making process, and subsequent losses of employee morale.

equity firms without the need for hostile bids. Given the high costs of hostile transactions, arguments for a more open market for corporate control seem unwarranted.

2.3 Limits of board independence.

Given the limits to shareholder engagement, a key element of market-oriented corporate governance is the presence of outside, independent members of the Board to represent shareholder interests. From the agency theory perspective, boards of directors (and particularly independent or outside members) are put in place to monitor managers on behalf of shareholders (Lynall, Goden & Hillman, 2003). The board of directors has the formal authority to ratify management initiatives, to evaluate managerial performance and to allocate rewards and penalties to management on the basis of criteria that reflect shareholders' interests. Agency theory suggests that a board comprised of independent directors (e.g., board members who are not dependent on the current CEO or organisation) is more likely to provide an effective oversight of the firm's CEO and other executive directors. These arguments see board independence largely as a potential *substitute* for formal engagement by large shareholders.

A substantial number of empirical studies try to verify whether independent directors perform their governance functions effectively by linking board structure with performance (Bhagat & Black, 1999). While a number of studies find a positive relationship between outside directors' representation and firm performance (Baysinger & Butler, 1985, Pearce & Zahra, 1991), other studies find a negative relationship between board independence and firm performance (Baysinger, Kosnik & Turk, 1991, Kesner, 1987). Some authors tried to verify the relationship between board independence and performance using meta-analytical methodology (Dalton, Daily, Ellstrand & Johnson, 1998, Dalton, Daily, Johnson & Ellstrand, 1999, Rhoades, Rechner & Sundaramurthy, 2000). For example, Dalton et al. (1998) used 54 empirical studies of board composition and financial performance, and did not identify any significant effects of board composition on performance. This conclusion holds across the many ways in which financial performance has been measured in the literature. The results of other meta-analyses (e.g., Dalton et al. 1999; Rhoades et al. 2000) are inconclusive. Another different stream of research suggests that, rather than examining a board's monitoring effectiveness by using the firm's financial performance as a proxy, a more accurate evaluation can be gained by examining discretionary decisions or "critical decisions" that involve a potential conflict of interest between management and shareholders. For example, Deutsch (2005) reviewed 16 different studies to show that independent boards have a higher probability of the CEO turnover. Still, the evidence remains inconclusive or even sometimes negative regarding how board structure influences other critical decisions around executive pay, earnings management, R&D investment, or M&A strategies (Beasley, 1996, Bryd & Hickman, 1992, Core, Holthausen & Larcker, 1999, Gordon, 2007).

The weak evidence regarding the benefits of independent boards raises a question of why their effectiveness appears to be limited. Indeed, the failure of the Enron board to heed the warning signs as the company slid deeper into trouble remains something of a mystery. At least two issues are important in this regard. First, board members may not be sufficiently independent from the CEO (Bhagat & Black, 1999). Gilson (2006) describes the situation in the 1980s as follows,

> "The chief executive officer, rather than being selected by the board, effectively selected who would be a director, and the shareholders passively endorsed the choice. The result was that directors saw themselves as advisers to senior management, not their monitors. If a director disagreed with the CEO's strategy, the proper response was the resignation of the director, rather than that the replacement of the CEO".

More recently, Bebchuk (2005) finds that only a small fraction of public companies in the USA faced contested board elections that were designed to oust existing directors. One of the barriers to contested board elections is associated with financial and organisational difficulties shareholders face when trying to place their own directors on a company's proxy statement. Bearing this in mind, Bebchuk supports suggestions that companies should be able to choose to provide shareholders with proxy statements via the Internet. This argument suggests the problem is that outside board members may remain insufficiently independent, particular since outside directors have little direct mandate to represent key shareholder or broader stakeholder constituencies. In other words, independence should be seen as having *complementarities* with stronger shareholder engagement or representation of corporate stakeholders, rather purely than as a substitute. Consequently, in the estimations of Langevoort (2007), "…entrenched CEOs find it easy to populate the board with outsides who meet the formal definition of independence, but remain loyal to them for social or psychological, if not economic, reasons or who are insufficiently informed or motivated to upset the status quo" (p.11). In the absence of stronger controls on the nominating process, most independent directors maintain a stance of "dysfunctional deference" to the CEO that limits their contribution of effective corporate governance (Sharfman & Toll, 2008).

A second issue concerns the more inherent limits of independence per se. Outside directors may simply lack the amount and quality of information that insiders have. The information available may be too dependent on formal disclosure, too focused on finance rather than strategy and operations, and undervalue long-term future projects. Conversely, other studies have found that a majority of inside directors may lead to more effective evaluation of top managers (Hill & Snell, 1988, Hoskisson, Johnson & Moesel, 1994). The result is also borne out by studies regarding codetermination in Germany (Addison, Schnabel & Wagner, 2004). For example, financial economists have shown that employee representation on German boards is associated with higher capital market valuation due to the fact that employees have strong inside knowledge of company operations that aid in the monitoring of management (Fauver & Fuerst, 2006).

In sum, the limits of independent directors may also relate to differences among firms in their capacity to absorb costs or make use of board-level resources (Aguilera, Filatotchev, Gospel & Jackson, 2008). Still, when viewed in a historical context, the changing structure of U.S. boards from an "advising" to a "monitoring" board has been part of a long-term shift in corporate governance toward shareholder value as a dominant corporate ideology (Gordon, 2007).

2.4 Limits of board incentives.

The growth in executive pay in the U.S. since the 1990s is well known, and has sparked a wide range of public debate. Changes in executive compensation were ostensibly introduced to create more appropriate incentives for executives to act in the interests of shareholders through stock options and other equity-based incentive mechanisms. The average salary of CEO of S&P 500 firms increased from $3.7 million in 1993 to a peak of $17.4 million in 2000 (Bebchuk & Grinstein, 2005). For these same firms, the proportion of equity based compensation increased from 41 % to 78 %. On aggregate, the value of stock options held by U.S. executives grew from $50 billion in 1997 to $162 billion in 2000, representing around fifteen percent of all shares outstanding (Coffee Jr., 2003).

Criticism of executive pay is not new in itself, but a new wealth of evidence has accumulated to suggest that executive pay is itself a core problem of contemporary corporate governance (for the most comprehensive critical assessment, see Bebchuk & Fried, 2004). The core argument is that executives have a substantial influence over their own salaries, and have used this power to weaken the link between pay and performance. For example, recent studies have shown the size of stock options outstanding had a very strong influence on the prevalence of earnings restatements (Efendi, Srivastava & Swanson, 2004) {Dennis, 2006, page 1564}. Thus, a number of authors now closely link the problems surrounding gatekeeper failure to the growing incentives of managers to inflate earnings. Even advocates of share options, such as Michael Jensen, have started telling executives to "just say no" to Wall Street, and criticized managers' focus on short-term earnings games (Fuller & Jensen, 2002).

A number of factors contributed to this shift in executive pay. Executive compensation is set by the Board of Directors. For reasons discussed above, the lack of genuine independence of outside directors gives them a variety of incentives to acquiesce to the compensation packages of the CEO. Directors also typically have low levels of equity holdings in the firm, and thus little incentive to actively intervene against negative policies. Empirical studies have now shown that weak boards are correlated with higher executive salaries, such as where boards are very large or a high proportion of Directors have been nominated by the CEO (Bebchuk & Fried, 2003). But even where compensation committees are formally independent, the use of consultants remains pervasive and creates potential problems. Consultants may feel beholden to the CEO who hired them, thus fearing that unfavourable recommendations of pay increase their risk of not being rehired in the future. This fear may further increase if consultants supply multiple services to the firm, such as other consulting on human resource practices. Benchmarking techniques used by consultants also make it easy for firms to "ratchet" up executive pay trying to beat perceived market rates. Recent studies confirm that the use of consultants is associated with higher levels of executive pay, and greater reliance of large equity-based incentives (Conyon, Peck & Sadler, 2009).

But can managers simply discount the influence of social norms or the potential disapproval of outsiders toward their pay packages? Bebchuk (2003) argues that another factor facilitating the growth of CEO pay is the ability of executives to camouflage their pay increases, drawing upon shareholder-oriented ideologies and hiding behind the rapid growth in stock market capitalization during the 1990s. Existing accounting rules create misperceptions of the true costs of stock options (Jensen & Murphy, 2004). Although a proposal for mandatory expensing of option was removed from SOX, among firms where shareholders introduced resolutions to expense stock options in the company accounts in 2003 CEO pay declined and stock options were smaller (Ferri & Sandino, 2009). This finding suggests that lack of transparency regarding the expense of options may be one factor driving pay rises. Meanwhile, the stock market boom provided a convenient justification for pay rises – even when these increases were outstripping stock market growth (Bebchuk & Grinstein, 2005). Moreover, the enthusiasm of investors for performance-based incentives provided an opportunity to introduce new pay elements on top of existing schemes, yet designing them to avoid many downward risks. Taken together, the shift in payment schemes and the lack of critical monitoring by boards over these schemes significantly altered the incentives of top U.S. managers toward short-term share prices and associated efforts to manage earnings.

While many thus see the growth in executive pay as reflecting the opportunism of managers, this interpretation is not undisputed. In a hotly debated article, Steven Kaplan (2008) has defended CEO pay, arguing that the high salaries of CEOs are not unique and have moved in line with increases in both CEO turnover and stock market value in ways that establish clear links between pay and performance. Kaplan cites several important facts in support of his argument – average CEO has declined since its peak in 2001, payment levels are linked to stock market performance, and average tenure of CEOs has declined from over ten years to just around six years as CEO turnover has increased in the face of greater performance pressures. These factors are meant to suggest that executive compensation is driven by market forces rather than insider collusion, and hence not unlike other highly paid occupations like lawyers, hedge fund managers and investment bankers. CEO pay is highly correlated with the size of firm, as measured by stock market capitalization – the 600 % increase of U.S. CEO pay between 1980 and 2003 is argued to be linked with the identical increase in market capitalization during this period (Gabaix & Landier, 2008).[11] Critics suggest, however, that these points are misleading. First, **Table 6** shows that (according to Kaplan's own data) although average CEO pay has declined since the stock market bubble of 2001, median pay has actually been increasing, doubling from $4 million to $8 million per year. Pay levels have increased 400 % since 1993. Second, a recent historical study has shown that CEO pay was not linked to stock market capitalization during the 1950s and 1960s, but after 1976 this relationship is very closely linked (Frydman & Saks, 2008). This change is due to the transformation of managerial pay toward stock options, but has not actually increased the relative sensitivity of pay to performance (see also Walsh, 2009). Third, other studies show that the relative talents of CEOs have little influence of stock market capitalization, which are driven by firm size and market sentiment (Kolev, 2008, Tervio, 2008). The money paid to attract "top" executives doesn't improve market returns relative to the "less talented" and cheaper executives (Wyld & Maurin, 2008). Fourth, even the relationship between pay and performance found by Kaplan exists for the smallest firms in his sample, but this effect is near zero for the largest firms.

These debates have been very important in policy discussions around "say on pay." Many scholars argue that CEOs' fiduciary duties place a moral limit regarding their compensation, which should not go beyond the minimum effective compensation to attract and retain managers (Moriarty, 2009). Most conventional policy suggestions stress further increasing the involvement of independent board members and improving the design on equity-based plans (for a very thorough discussion, see Jensen, 2004). The policy idea behind "say on pay", however, revolves around shareholder involvement. The policy would allow a non-binding up-or-down vote by shareholders on executive compensation packages. In 2006, seven proposals came to a vote, receiving average support of 40 percent. But investors voted on 51 proposals in 2007, gaining an average of 43 percent support (Tse, 2008). Congress passed legislation calling for a shareholder vote on pay, but the bill stalled in the Senate. In 2008, resolutions went to a vote at over 80 companies and averaged 42 percent support, but only received a majority at 11 companies. However, the financial crisis of banks and resulting American Recovery and Reinvestment Act of February 2009 has led to "say on pay" for roughly 400 companies receiving funds under the Troubled Asset Relief Program (TARP). A small but growing number of other companies are also voluntarily agreeing to hold shareholder votes. The SEC has also expressed support of wider adoption of "say on pay." Most recently, Senator Donald Schumer announced his intention to introduce the Shareholder Bill of Rights Act of 2009, which would require all listed companies:

11 The consulting company Towers Perrin reports that CEO salary among a sample of Fortune 500 companies declined by 2 % in 2009 as a result of the economic crisis. http://www.towersperrin.com/tp/showdctmdoc.jsp?country=global&url=Master_Brand_2/USA/News/Spotlights/2009/April/2009_04_30_spotlight_exec_comp.htm

- To hold annual stockholder advisory votes on executive compensation,
- facilitate a federal requirement that stockholders be granted access to every corporation's proxy to nominate their own candidates to boards of directors,
- end staggered boards at all companies,
- require that all directors receive a majority of votes cast to be elected, and
- order that all public companies split the CEO and board chair positions

2.5 Limits of gatekeepers as informational intermediaries.

Gatekeepers are reputational intermediaries who provide services related to the certification of corporate information to investors (Coffee Jr., 2003), including independent auditors, debt rating agencies, securities analysis, or investment bankers. While these gatekeepers are often paid by the corporation to certify their information, their independence is supported by their own reputational capital. Gatekeepers should be unlikely to sacrifice their reputation for the benefit of any single client. However, the corporate governance literature paid little attention to gatekeepers until recently. During the 1970s, the professions became largely deregulated and intertwined within a large international network of the "Big Five" auditing firms (Windsor & Warming-Rasmussen, 2009).

Nonetheless, during the 1990s, growing evidence suggested a growing prevalence of conflicts of interest and gatekeeper failure. The quality of audits declined from the mid-1990s, while the marketing of non-audit services by auditing firms increased in parallel.[12] For example, the number of earnings restatements issued by listed corporations more than tripled (Coffee Jr., 2003, p.17), and has continued to climb through 2002. More worrying was the fact that the magnitude of earnings restatements increased greatly, revealing that income smoothing had given way to much more aggressive accounting practices aimed at the earlier realization of income. This fact is arguably related to the loosening of legal liability of auditors following the Supreme Court's Central Bank decision in 1994 and subsequent Private Securities Litigation Reform in 1995 (Langevoort, 2007). But perhaps more important for explaining this phenomenon is the explosion of non-audit income through consulting services (Coffee Jr., 2003). The main issue here is not necessarily the desire of auditors to retain the larger share of consulting-related income, but the fact that mixing these two services give client firms a low visibility way of firing (or reducing the income) to auditing firms (Gordon, 2002). This factor was reinforced by the fact that the audit market was very concentrated around the Big Five firms.

12 Empirically, the link between non-audit fees and audit quality remains contested. Published studies have used data from different time periods and different empirical methodologies, leading to conflicting results (see discussion in Langevoort, 2006).

2.6 Absence of Employee Voice

A strong body of evidence now links employee voice in corporate governance to improved outcomes for employees and high productivity for companies (for a review of the statistical evidence, see Filatotchev, Jackson, Gospel & Allcock, 2007). While the issue of stakeholder involvement remains controversial, the shareholder-orientation of U.S. or UK corporate governance has been widely criticized by stakeholder theorists. What is less well known are the set of arguments linking increased employee involvement in the U.S. with improved functioning of various shareholder-oriented mechanisms of corporate governance in the long-term. A few examples can be mentioned.

In terms of shareholder engagement, union representation on pension funds has been associated with strong engagement on corporate governance issues. Union representation is not only a vehicle for promoting employee interests, but also helps progress a number of agendas where employee shareholders and other shareholder have common interests – avoiding excessive management pay, promoting transparency, assuring independent audits, etc.

In terms of takeover markets, employee protection may help limit the scope of opportunistic strategies during takeovers, where new owners engage in breaches of trust to create short-term gains.

In terms of boards, European experience has shown that employee representatives on the board of directors, either those elected via the workforce or appointed by unions, tend to be relatively independent of top management. Employee board members directly represent independent stakeholders and have access to information and knowledge of the employees, rather than being solely dependent on disclosure from management. While employees are often discussed as being company "insiders," they are in fact quite independent relative to some "outside" board members who are essentially recruited by the top management. Similarly, debates on corporate social responsibility in the U.S. have long advocated the idea of "constituency directors" elected directly by shareholders to give weight to stakeholder interests (Brudney, 1982).

In terms of managerial pay, **e**mployee representation on boards seem to have both more modest pay, but also more strictly defined long-term performance criteria than in countries without employee representation (Buck & Shahrim, 2005, Fiss & Zajac, 2004, Sanders & Tuschke, 2006). Employees do not have an interest in avoiding incentivized or variable pay, but do have a strong interest in making sure such incentives are long-term, consistent with the strategic goals of the organization, and compatible with the social norms of other employees in the firm.

2.7 A Complementary System?

Corporate governance in the United States has not been a static system. Despite the relatively few legal reforms to the formal system, the evolution of corporate governance practices has been very dynamic, in part due to the fact that very little in the formal structure shields firms from the economic changes in markets (Gilson, 2006). The slow changes in ownership patterns starting in the 1970s and 1980s created a new market for corporate control, and thereby called forth further changes in the structures of boards, executive compensation and the role of gatekeepers. Most observers agree that this system has disadvantages in terms of supporting long-term commitments among stakeholders and thus supporting incremental forms of innovation. Yet the dynamic and market-orientated nature of the U.S. system is argued to be superior in coping with more discontinuous forms of economic change (Gilson, 2006, p.158).

In its positive form, the resulting "model" of corporate governance in the U.S. is considered to have a number of tightly coupled and mutually reinforcing elements—strong shareholder engagement, independent board members, strong financial incentives for managers, gatekeepers as key informational intermediaries, and ultimately an effective market for corporate control. At a more theoretical level, the U.S. paradigm relies largely on three tools or mechanisms – market incentives, disclosure and independence. Market players are thought to act efficiency as long as corporations disclose sufficient information. The quality and depth of this disclosure is, in turn, enhanced by the independence of board members and gatekeepers. These links assure that the incentives from the market enter into the firm, but also that information exits the firm to shape market expectations. Yet much hinges here on independence as a crucial element of checks and balances for the interface between firms and markets. For example, Gordon argues (2007, p.1563):

> "Stock prices are taken as the measure of most things. In this environment, independent directors are more valuable than insiders. They are less committed to management and its vision. Instead, they look to outside performance signals and are less captured by the internal perspective, which as stock prices become more informative, become less valuable… In the United States, independent directors have become a complementary institution to an economy of firms directed to maximize shareholder value."

Similarly, Gilson (2006) argues that the incentivizing of managers with stock options and growing independence of directors were complementary developments – since greater incentives may lead to both higher performance or more cheating, the independent scrutiny of directors became increasingly important. However, independence is equally intended to operate not just as a conduit, but also as a counterbalance to shareholder demands as a more enlightened version of the shareholder value approach. As Gorden (ibid) continues:

> "…it also opens up space for a distinctive role of the independent board: deciding when prevailing prices misvalue the firm and its strategies. In light of imperfectly efficient capital markets, such a role may be efficiency based…For a particular firm, a disfavoured strategy may in fact maximize shareholder value over a reasonable time horizon. If the market got it wrong, rejecting its signals may lead to putting the firm's assets to highest and best use."

An alternative interpretation suggests that these linkages may, in fact, be quite weak. A large body of social scientific evidence now suggests that under conditions prevailing through the 1990s, shareholders are not very engaged, outside board members face dangers of capture by the CEO, the incentives for executives are very biased toward high-powered short-term gains, and gatekeepers are complicit with this situation due to their own conflicts of interest. The limited effectiveness of each element individually may have knock-on effects that reduce the effectiveness of other interrelated corporate governance mechanisms. This situation can be described in terms of *complementarities* between corporate governance mechanisms or institutions, but in a negative sense of mutual reinforcement toward a sub-optimal equilibrium pattern.[13] For example, the scandal of Enron can be interpreted as an imbalance between management incentives and director monitoring, whereby independent outsiders were insufficient to counterbalance the power of equity incentives (Holmstrom & Kaplan, 2003). This situation was, in turn, driven by the over-valuation of U.S. equities by institutional investors during the stock market bubble, which generated massive short-term pressures on firms to meet unrealistic shareholder expectations (Jensen, 2004). Some preliminary evidence suggests that stock market valuations are systematically higher in the US and UK relative to Germany for firms of similar size and performance levels – although further research is needed on this point (Höpner & Jackson, 2001).[14]

Rather than creating positive complementarities that are mutually reinforcing, the interactions among the various elements of U.S. corporate governance created *complementarities* in a more negative sense of externalities that mutually *reduced* the effectiveness of these practices but locking actors into these choices. Weakness in shareholder engagement contributed to the lack of director independence. Complacent outside directors contributed to problems of executive compensation. Executives had strong incentives to manage earnings, and utilized gatekeepers in ways that led to key conflicts of interest. Viewed in this systemic way, the crisis surrounding Enron was not merely a local crisis or isolated phenomenon. Rather, the crisis became systemic and challenged the basic linkages between key corporate governance practices.

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13 From a technical perspective, this case is the inverse of strategic complementarities. Complementarities suggest that the efficiency of A is enhanced by the presence of B and vice versa. This idea can be extended to argue that the efficiency of A is negatively influenced by the absence of B.

14 For example, a quick inspection of share prices at the end of 2008 among a sample of firms with over 10,000 employees suggests that U.S. firms had price-book values 27 % higher than German firms after controlling for firm size and return on assets.

The next section shall deal with SOX legislation as a reaction to this crisis. As shall be argued below, SOX correctly tries to address the systemic failures in corporate governance by strengthening the links from auditors and to some extent the role of directors. SOX rules do much less to address issues around shareholder engagement or executive compensation. As such, SOX did little to alter the basic underlying "model" of U.S. corporate governance and leaves a number of weak links untouched.

3 Sarbanes-Oxley and its Influence on Corporate Governance

The legislative process leading to SOX was a reaction to the scandals at Enron and Worldcom, and has since rise to a heated debate over its meaning and legitimacy. The hasty legislative process lasted just 29 days (Haller, Ernstberger & Kraus, 2006; Cioffi, 2010). While the Sarbanes-Oxley Act of 2002 was enacted by a Republican congress and President, SOX is generally seen as a piece of "progressive" regulation (Baker, 2008). Commentators have seen it both as a brief window for necessary reforms that have far-reaching potential to bring about positive change (Mitchell, 2003), or as an ill-considered overreaction leading the "quack" corporate governance (Romano, 2005). The SOX reform undoubtedly represents a fundamental change in the pattern of U.S. regulation, replacing traditional disclosure requirements with direct regulatory mandates for corporate governance. The Federal government has taken on a greater role, since the SEC has now moved into areas that had been exclusively regulated by the states. And finally, the role of largely self-regulated or unrelated professional groups (e.g. accountants, auditors, analysts, middle managers, etc.) has been brought into the forefront of the corporate governance discussion.

Table 7 provides a summary of the major provisions of SOX (Coates IV, 2007). The law has five main objectives (American Bar Association, 2004): 1) to strengthen the independence of auditing firms, 2) to improve the quality and transparency of financial statements and corporate disclosure, 3) to enhance corporate governance, 4) to improve the objectivity of research, and 5) to strengthen the enforcement of the federal securities laws, including the use of criminal penalties.[15]

A major element of SOX was to reform the audit process. A ban was placed on non-audit fees. A new regulatory agency Public Company Accounting Oversight Board (PCAOB) was created to increase public supervision of auditors. PCAOB is now involved in the registration of accounting firms, the inspection of those firms with relation to audits, the setting of standards for the accountancy profession, and enforcement of violations through disciplinary sanctions. The relationship between the company and the auditors was also placed under the oversight of the board's audit committee. The audit committee must also be composed entirely of independent directors, and firms must disclose whether at least one member of the committee has financial expertise. The provisions of SOX thus largely stress the role and independence of auditors, while giving some but relatively less attention to how boards operate (Fogel & Geier, 2007).

15 Although SOX greatly increased the maximum criminal penalties for white collar fraud, no steps were taken to standardize actual sentencing application. Thus, the number of white-collar crime prosecutions increased from some 6,000 annually before SOX to over 8,000 in 2007—suggesting that SOX has little deterrent effect as judges refuse to impose high penalties and engage in substantial plea bargaining, as in the case of Jeff Skilling at Enron (2009).

Another key area for new requirements concerns internal control systems. Section 302 of SOX requires the CEO and CFO to attest to the effectiveness of internal controls, and report any deficiencies to both the auditors and the board audit committee. Section 404 also requires management to report on the effectiveness of internal controls, and the auditor must attest to and report on their assessment. The SEC has subsequently issued a number of rules to interpret these requirements, particularly with regard to reporting of "material weaknesses" in the internal controls. PCAOB has further defined these weaknesses with regard to the obligations for auditors. These rules were widely criticized as being very costly or even the source of rent seeking behaviour by auditors and lawyers involved in their implementation (Langevoort, 2006). Since 2007, however, the SEC and PCAOB have revised these rules to be more principles-based and oriented to firm-specific risk factors.

One interesting aspect of SOX has been the absence of any increase in shareholder rights and responsibilities, either in terms of voting rights, ability to nominate directors, or legal liabilities. SOX has been less about redistributing private power from managers to shareholders, and more about diffusing private power into a more public system of checks and balances (Langevoort, 2007; Cioffi, 2010). Public regulation has sought to counterbalance the high power incentives and resulting risk factors that have become built into the U.S. system of corporate governance. The regulations on audit firms, independent directors, and top corporate executives have all sought to make these actors more public-regarding and curtail their private power. Practitioners therefore sometimes distinguish the shareholder-oriented model in the UK, which leaves governance to the interactions between investors and managers, and the more regulator-oriented model in the U.S., where the SEC plays a more direct role of corporate governance by enforcing disclosure rules (Institute of Chartered Accountants of England and Wales, 2005). Although these reforms may benefit shareholders or reduce capital market risks, one legacy of SOX may be to introduce a substantial public interest element into the U.S. corporate governance systems that is often associated with the 'stakeholder' models of Continental Europe.

3.1 The Influence of SOX and Related SEC Regulations on U.S. Firms

The influence of SOX is potentially wide ranging. In this section, we first look at the external aspects of this influence related to the interactions between companies and investors. Here the evidence is at least somewhat positive, suggesting improved disclosure, less earnings management by companies, and improved investor confidence. We also look at the influence of SOX on the internal organization of corporations, including the issue of compliance costs. Here the evidence confirms the very substantial costs in compliance that must be weighed against the benefits discussion above. In terms of both internal and external aspects, the effect of SOX differs greatly across different types of firms making a uniform analysis problematic.

3.1.1 External aspects: Disclosure, Earnings Management and Investor Reactions.

In terms of disclosure, SOX helped to increase the level of disclosure, such as in the reports by audit committees (Pandit, Subrahmanyam & Conway, 2006). Firms have been more likely to report deficiencies in the internal control systems (Stephens, 2008). Likewise, auditor approved improvements to internal control systems have been associated with more favourable risk assessments by investors and lower costs of equity capital (Ashbaugh-Skaife, Collins, Kinney Jr. & Lafond, 2009). Firms have also been more likely to use ethical terminology within their disclosures, although such firms were more likely to be in high impact industries and score low of corporate governance measures (Loughran, McDonald & Yun, 2009).

In terms of earnings management, some empirical evidence suggests that following SOX, the degree of earnings management has been reduced, as hoped for by policy makers (Chang & Sun, 2008, Li, Pincus & Rego, 2008, Lobo & Zhou, 2006). These studies look at the degree of discretionary accruals by firms, showing that firms are less aggressive in reporting gains and move more quickly to report losses. These results suggest that greater auditor independence and the increased personal liability of the CEO and CFO for the earnings statements of listed companies have led to more conservative accounting practices. For example, Cohen et al. (2008) show the total level of discretionary accruals of U.S. firms increased continuously from the 1990s until the Enron scandal. However, these accruals declined following the passage of SOX. A number of additional studies also link lower levels of earnings management with some of the specific measures introduced by SOX. First, while stock options were associated with increased earnings manipulation before SOX, this incentive seems to have disappeared following SOX perhaps due to the increased liability of the CEO and CFO acting as a positive signal (Cohen, et al., 2008, Zhang & Wiersema, 2009).[16] Conversely, former CFOs of firms restating their earnings face higher penalties in the labor market following SOX, suggesting that CFOs are now being held more accountable (Collins, Masli, Reitenga & Sanchez, 2009). Second, other post-SOX studies have shown that financial expertise of directors helps to curb earnings management (Hoitash, Hoitash & Bedard, 2009). SOX rules requiring greater accounting expertise within the audit committee have led to more conservative accounting practices, although this result is contingent on firms' having strong boards with more independent directors (Krishnain & Visvanathan, 2008) and does not rule out the importance of alternative corporate governance mechanisms (Carcello, Hollingsworth & Klein, 2006). Finally, a number of studies have shown some evidence that the number of independent members of the accounting committee is associated with lower earnings management (Agrawal & Chadha, 2005, Chang & Sun, 2008, Klein, 2002).

16 Provisions in Sections 302 and 304 of SOX mandate the return of any incentive compensation owing to material noncompliance with any financial reporting requirement.

While the picture of earnings management seems positive, Cohen et al. (2008) find that firms have become *more likely to undertake real earnings management* through abnormal changes in cash from operations, production costs, or discretionary expenses such as R&D. As accounting rules have tightened, discretionary shifts in earnings have been substituted by real shifts in earnings. Executives with unexercised stock options were more likely to manage real earnings post-SOX. Consequently, the existing rules may assist in curbing fraudulent reporting, but may do less to address broader issues such as short-termism. Hence, looking at accounting practices in isolation is insufficient unless complemented with other corporate governance practices that work in conjunction (Aguilera, et al., 2008).

In terms of investor confidence, a number of empirical studies have examined how financial markets reacted to SOX using event study methodologies. While some studies show a positive reaction (Jain & Rezaee, 2006, Li, et al., 2008) and greater sensitivity of investors to firm-specific risks (Akhigbe & Martin, 2008), other studies show that negative returns following SOX that may be related to the increased costs of compliance (Zhang, 2007). These mixed results can be explained in part by studies that differentiate between different types of firms. Firms with weak shareholder protection experienced positive returns after SOX, whereas firms with strong protection had no positive benefit (Choi, Frye & Yang, 2008). Small firms may have a harder time shouldering the costs and hence faced more costs and recouped fewer benefits from investors (Small, Ionici & Hong, 2007). Larger firms with more independent directors prior to SOX were able to act more quickly and reap greater benefits from being perceived as compliant (Akhigbe & Martin, 2006).

3.1.2 Internal aspects: Corporate Boards and Employee Whistleblowers

Since the time of Enron, the structure of U.S. boards has undergone a number of reforms introduced through SOX. In order to avoid further legislation, the NYSE and NASDAQ also undertook parallel reforms in the listing requirements in 2002. First, the board of directors listed firms must have a majority of independent directors. Moreover, the compensation and the nominating committees must consist entirely of independent directors. The requirements of both exchanges are largely identical, but NASDAQ is slightly more flexible in certain aspects. Second, independent directors must now meet a definition of independence according to Federal law. In particular, SOX defines an "independent" director as someone who may not "accept any consulting, advisory, or other compensatory fee from the issuer; or be a person affiliated with the issuer or any subsidiary thereof" (SOX Article 301). Similarly, NYSE listing rules define independence as someone with "no material relationship with the listed company…including a partner, shareholder or officer of an organization that has a relationship with the company" (Gordon, 2007, p.1483). Third, the audit committee must have a minimum of three members from among the independent directors. In addition, each member must be financially literate and one member an "audit committee financial expert" or the company must disclose why it doesn't have such an expert. The duties of the audit committee also go beyond the general duties of care within state corporation law. Taken together, these requirements make a substantial step toward greater independence. Yet notably, these reforms have not introduced any rules on regarding board size or separation of the CEO and Chair positions. CEOs also successfully blocked proposals from the SEC in 2003 that would have given shareholders greater access to nominating independent directors.

The chief executive officer and chief financial officer must also now to certify the financial statement of the corporation. The requirement imposes a new substantial duty of these officers, and links the fulfilment of these duties with the public audit process in a new way. The SEC may thus require that the CEO or CFO return to the corporation any bonus, incentive, or equity based payment paid during the 12 months following the issuance of any restated financials. Similarly, SOX also placed a ban on loans to directors for the purposes of buying shares, as companies who make loans to board members are more likely to restate earnings (Cullinan, Du & Wright, 2006).

These measures not only introduce stricter rules, but introduce a new layer of federal regulation of directors' duties that displace state corporation law (Bainbridge, 2003, Mitchell, 2003). The aim of these reforms has been to reaffirm the importance, but redefine the role of independent directors within the board. The reforms do nothing to increase the direct accountability of directors to the shareholders. Rather, the board has been given a broader role in promoting external transparency in the public interest. SOX has led independent directors to take on a number of additional tasks that promote transparency to outside constituencies, as well as bearing greater liability for the information disclosed by the company.

What effect has reform had on the structure of U.S. boards? As noted in the previous section, the typical structure of U.S. boards since the mid-1990s revolved around a majority of outside directors, but a relatively weak legal definition of independence and a lack of separation between the role of the CEO and Chairman of the Board. Since the passage of SOX and new listing rules, the historical trend toward independent directors has continued (Valenti, 2008), particularly among small companies (Linck, et al., 2008). Whereas share ownership by the CEO decreased the size and independence of the board pre-SOX, this effect seems to have disappeared post-SOX. While SOX and related reforms seem to have had a broad effect of increasing board independence[17], some notable limits exist. Looking at **Table 4** suggests that as of 2005, the degree of separation between CEO and Chair of the Board had increased but remains relatively low. Various estimates show that the roles remain combined in some 70 % of large listed firms (Linck, et al., 2008, Valenti, 2008).

17 More generally, Linck (2008) has shown that post-SOX boards have become slightly larger to incorporate a greater number of outsiders and reflect various requirements for committees. Fewer current executives were directors, and more directors were retired executives, directors with financial expertise, lawyers, and academics.

These remaining problems regarding independence of board members are further reflected in the fact that SOX did nothing to increase the accountability of board members to shareholders (see also Cioffi). Hence, few conclusions can be drawn given the fact that the scope for CEO capture of independent directors may remain through informal means. More positively, independent directors nonetheless face greater checks and balances from gatekeepers such as auditors, who take an interest in independent directors devoting greater resources to processes such as internal controls and auditing. Whether or not this interaction will gradually redefine the role of independent directors more substantially remains an open question. The key issue is not just the relative balance between acting in the interests of shareholders or company insiders, but also whether directors will see themselves as acting as a new sort of "public director" (Langevoort, 2007).

The development toward a more independent and public regarding board has also faced a number of substantial criticisms, particularly with regard to the "one size fits all" approach reflected in these reforms. Critics note that these rules take no account is taken of the diversity and variance among firms (Bainbridge, 2003). Much research now shows that firms choose their board structures in ways contingent upon their strategies and critical internal and external resources (Aguilera, et al., 2008). Firms may try to balance the benefits and costs of external monitoring, but also the functions of the board in providing critical knowledge and resources relative to the more arm's length control and monitoring role. For example, smaller firms may be less able to shoulder the high costs of more outside board members. Along these lines, Wintoki (2007) finds that the increase in independent directors after SOX led to higher market valuation among larger and older firms in mature industries, but led to lower returns for firms with high growth opportunities and more uncertain operating environments. This evidence does suggest some potential opportunity costs associated with a uniform board structure.

Beyond the board, SOX aimed at facilitating some internal mechanisms of accountability through protections for employee whistleblowers. Indeed, employees have a potentially strong interest in public interests aspects of SOX. Limiting the capacity for fraud and increasing the transparency of risks to the company is consistent with the interests of long-term employees. As noted above, the issue here is not the increase in shareholder control but a public interest in transparency that could serve both the interests of employees and investors.[18] In terms of its provisions, SOX had only a very limited influence on the direct involvement of stakeholders such as employees in U.S. corporate governance. One aspect explicitly related to employees concerns the protections for whistleblowers. Analysis of the detailed regulations and initial application by the Department of Labor suggest that the protection offered is limited and falls short of the

18 A number of recent works discuss the common interests of investors and employees in promoting greater transparency and accountability of top managers (Aguilera & Jackson, 2003, Gourevitch & Shinn, 2005, Höpner, 2003).

ideals envisioned by Congress (Watnick, 2007). A recent study of whistleblower cases shows that the percentage of employees among them declined from 20 % before SOX to just 15 % (Alvarado, 2007). Another channel for employee voice relates to Codes of Ethics required by SOX. Yet initial studies suggest that SOX has made their content and structure more orientated toward legal compliance than previously (Canary & Jennings, 2008). Thus, an initial conclusion is that SOX probably has a limited influence on corporate culture and the power of employees in promoting responsible practices.

3.1.3 Costs of Compliance

A frequently mentioned aspect of the SOX legislation is the high costs of compliance associated with the law. It should be mentioned that the actual costs and benefits of the legislation are very hard to calculate on a scientific basis. However, it seems clear that the cost of compliance with SOX has far exceeded the initial estimates by the SEC of roughly $91,000 per company in internal person hours, hourly charges for external auditors, and auditing fees (Janson & Scheiner, 2007, Orcutt, 2009). One study found the person hours involved in assessment to be 12 times higher, and the monetary cost of attestation in auditor fees to be some 1.4 times higher (Sneller & Langendijk, 2007). One survey of 217 firms regarding the first year of compliance with Section 404 of SOX reported costs of $4.3 million U.S. dollars in 2005 distributed roughly equally between internal labor costs, external consulting expenses, and additional audit fees. Over time, however, these costs have decreased (Financial Executives International, 2008). It remains to be researched as to whether this effect is the result of new rules from the SEC and PCAOB since 2007. It may also be the case that firms became better at eliminated rent-seeking by audit firms and lawyers, who seek to use the new rules to increase their own fees.

The high cost of compliance with SOX has a number of sources. First, the controversial requirement of Section 404 has mandated an audit of firms' internal control systems, which has proven very costly in terms of increased audit fees and internal preparations. While firms have been required to have "reasonable" internal control systems in place since the 1970s, these were interpreted quite narrowly by the SEC. The new requirements of SOX and subsequent set of rules issued by the SEC and PCAOB have given rise to a very intensive set of requirements (Langevoort, 2006). As noted above, new rules in 2007 have sought to make these processes more focused and less costly. But it will be some time before the long-term effects are clear. Second, the ban in some non-audit work has given rise to a strong increase in audit fees among the remaining Big 4 firms, who have tried to shift their source of income (Pandit, 2007). Third, firms face additional costs from attracting and retaining a greater number of qualified independent directors.

As a consequence of these costs, one of the strongest criticisms of SOX is that it creates excessive expenses for public companies and thereby disadvantages smaller firms, as well as deterring foreign firms from listing their shares in the U.S. Some evidence exists for these points. First, more firms have delisted from U.S. stock exchanges after SOX to avoid the increased costs of regulation. Second, the rate of U.S. firms going private has increased following SOX (Engel, Hayes & Wang, 2007). Third, the number of IPOs has declined since SOX, although the performance of these firms is better on average and thus suggests that SOX may has improved the quality of companies or at least reduced some information asymmetries among investors (Johnston & Madura, 2009). Last, smaller firms may have changed their behaviour to remain small to take advantage of postponed compliance with SOX through 2008 (Gao, Wu & Zimmerman, 2009). Overall, a survey in 2005 reported that 94 % of survey firms reported that the costs of SOX outweigh the potential benefits (Glaum, Thomaschewski & Weber, 2006, p.42).

3.2 The Influence of SOX on Foreign Firms

SOX had an indirect but profound influence the agenda for EU rules and German corporate governance reform – leading to new requirements for auditor rotation, disclosure of non-audit fees, and increased public oversight of auditors that departs with some national traditions of professional self-regulation (for a detailed comparison, see Haller, et al., 2006).[19] But SOX has a direct influence on foreign companies because its provisions have been incorporated into the listing rules and corporate governance standards of the NYSE or NASDAQ. Hence, the rules also apply directly to foreign firms listed on a U.S. stock exchange, as well as indirectly to foreign subsidiaries of U.S. firms that are subject to SOX requirements. The SEC has a long history of granting exemptions to its rules for foreign companies. Consequently, observers were particularly surprised at the initial insistence that SOX would be applied uniformly to foreign companies—although exemptions were later granted after all (Hollister, 2005). For example, German corporations wrote to the SEC in 2002 requesting exemptions and were backed by warnings from the German Federation of Industry (BDI). The regulations in SOX go beyond the traditional emphasis of the SEC on disclosure and impose more prescriptive substantive requirements on the internal structure of companies (e.g. audit committees), which may conflict with rules in other countries (Ribstein, 2003). Here we will be concerned with the direct influence of SOX on foreign companies.

Foreign firms often list their shares on U.S. stock exchanges in order to enjoy increased liquidity, greater access to capital, and "bond" themselves to shareholder-oriented corporate governance practices (Baily, Karolyi & Salva, 2006, Coffee, 1999, Gilson, 2000). It now seems undisputed that foreign firms have also begun to deregister from

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19 Some differences remain (Suchan, 2004). In Germany, professional self-regulation still plays a greater role, some non-audit legal services are less restricted, and rules on auditor rotation disqualify auditors certifying financial statements more than six times in ten years (rather than a bad after five consecutive years). Likewise, only SOX required the pre-approval of audit and non-audit services by the audit committee, as well as using less flexible mandatory auditing standards.

U.S. stock exchanges following SOX, often citing the increased compliance costs under SOX, such as disclosure (Leuz, Triantis & Yue Wang, 2008, Marosi & Massoud, 2008). Smaller firms with less shareholder-oriented corporate governance characteristics have become more likely to list on the UK AIM market than NASDAQ following SOX, although larger firms seem unaffected (Piotroski & Srinivasan, 2008). Likewise, public firms became less likely to target U.S. under the jurisdiction of SOX than private firms, who could essentially take target firms private and avoid compliance with SOX (Kamar, Karaca-Mandic & Talley, 2009). Other studies show that firms with high costs for compliance, such as audit related expenditures, and low profitability have a greater propensity to delist, as do firms with higher levels of insider ownership (Khan, 2008). In sum, SOX has reduced the net benefits of a U.S. listing, particularly for smaller foreign firms with lower trading volume and stronger insider control (Marosi & Massoud, 2008).

Still, SOX has a similar benefit at least some types of foreign companies, just as it has on U.S. domestic firms. For example, disclosures and requirements for audit committee independence have been associated with lower levels of earnings management following SOX (Chang & Sun, 2009). Some studies find that foreign firms utilizing high disclosure before SOX experienced declines in market value after SOX, but that high growth firms from poorly regulated countries benefited in terms of increased investor confidence and higher market valuation (Litvak, 2007/Litvak, 2008). Other studies show that foreign firms with high risk factors before SOX experienced lower levels of risk afterwards (Akhigbe, Martin & Nishikawa, 2009)

Table 8 shows the recent development of listed firms in the NYSE, NASDAQ, and London stock exchange. Foreign listings in New York have declined in absolute terms, and went from nearly 20 % of all listings in 2002 to around 14 % in 2008. Total listings on NASDAQ have declined, but foreign listings have actually increased very marginally to around 11 % of firms. Taken together, 102 fewer foreign firms were listed in U.S. exchanges six years after the passage of SOX. Meanwhile, the number of foreign listings in London increased by around 300 firms in the same period.

3.3 Compliance with SOX and Compatibility with German Corporate Governance

SOX created a number of policy issues in Germany, regarding the audit process in particular. German auditors play a slightly different role, both as gatekeepers of the public (investor) interest and as an assistant to the supervisory board in its internal control over management (Suchan, 2004). For example, SOX imposes the registration of auditors with the PCAOB conflict with German rules on data protection and client confidentiality (Haller, et al., 2006, p.112). Likewise, the individual liability of the chief executive and chief financial officer under SOX runs contrary to the collective responsibility of the management board under German law (Hollister, 2005, p.479). Thus, despite some overlap in German and U.S. regulations, German firms had to substantially alter a number of practices in order to comply with SOX, particularly in the area of internal controls and risk management (Stadtmann & Wissmann, 2005).

Initially, SOX audit committee rules were thought to conflict with German law in at least three ways (Ribstein, 2003, p.10-11). First, auditor appointment by the audit committee under SOX conflicts with the powers of appointment of the AGM in Germany. Second, SOX Section 301 makes ineligible anyone who receives any sort of fee from the company, thus potentially excluding certain supervisory board members such as employees. In April 2003, the SEC issued further rules to resolve this problem and extended the period for compliance of foreign companies another year until 2005.[20] The SEC explicitly recognized labor representatives in Germany as "independent" on the grounds that they serve as a counterweight to management power (Glaum, et al., 2006, p.21). Moreover, exceptions were issued to explicitly accommodate two-tier board structures provided their election is independent from management, as well as the allow controlling shareholders within the board. Still, even if the German supervisory board structure is recognized under SOX, the composition of the audit committee is only governed in Germany by the corporate governance code, and thus might in practice change the balance of power away from labor representatives.

Some empirical information exists in the form of a survey carried out by the Deutsches Aktieninstitut (DAI) in 2005, which collected information from 15 out of the 18 German firms listed on U.S. stock exchanges (Glaum, et al., 2006). Most of the basic requirements of SOX were already implemented by German firms, often in compliance with the German corporate governance code. One exception was the area of internal control systems, where SOX requirements under Section 404 are far more detailed and prescriptive than German rules. 100 % of surveyed firms reported taking measures to document internal control processes and 62.5 % of firms reported making substantial changes to their risk management systems. Meanwhile, fewer changes were made regarding other regulations – only 3 firms reported making changes to their whistle blowing procedures (Stadtmann & Wissmann, 2005).

The costs of SOX compliance for German firms are very high. While half of the firms reported less than 25,000 person-hours of work to comply with SOX Section 404, one quarter of firms report up to 50,000 person hours and another quarter more than 50,000 person-hours. The average cost of compliance totaled over 7 million Euro (Glaum, et al., 2006, p.76), although the costs vary widely between 555,000 Euro and 11 million Euro depending on the size of the firm. More than half of all firms spent 2.5 million Euro or more on compliance costs. Roughly three-quarters of firms reported some improvement to their internal control systems, although half of all firms reported only a medium rather than high level of improvement. German firms viewed most positively the requirements concerning reporting of off-balance-sheet entities (Glaum, et al.,

20 The SEC rules are found here: http://www.sec.gov/rules/final/33-8220.htm

2006, p.33). Still, the overall evaluation of SOX was lukewarm at best –most firms neither favored nor disfavored most of the SOX measures (Glaum, et al., 2006, p.37). More than 80 % of firms reported no positive influence on their ability to identify risks, nor reduction in the cost of capital. On the whole, 60 % of firms reported that the attractiveness of the U.S. capital market had declined for their firm after SOX (Stadtmann & Wissmann, 2005). Still, no German firms have delisted as a result of SOX, although the number of new listings has decreased to a near stand still. On the balance, German firms still perceive a number of tangible benefits of U.S. cross-listings, particularly in terms of brand name recognition among consumers and the ability to issue shares to employees in their U.S. operations.

4 Conclusion and Implications for Understanding Corporate Governance

This report has argued that the U.S. corporate governance should be seen as a system of interacting elements. But unlike the stylized shareholder-oriented model found in economic theory, the actual practices in U.S. firms have a more complex and conflicting relationship. Just as each mechanism of the system depends upon support from other mechanisms as a complementary whole, the limited implementation of each mechanism may undermine or lead to dysfunctional linkages within the system. These dysfunctional linkages are manifest in the recent the bubble and scandals surrounding the Enron and Worldcom cases. Despite the strong alignment of managers to shareholder value, the solution to agency problems of the U.S. corporation is too often based on excessive incentives for managers, too little responsibility by investors, and too little genuine scrutiny by independent boards. Gatekeepers received most of the blame during the time of the Enron crisis and SOX represented an almost unprecedented legislative reform targeted at the audit process. Perhaps ironically, the audit firms themselves have been one of the main beneficiaries of this process. While SOX has some demonstrable positive effects on improving disclosure and restricting earnings management, this regulatory approach had only a limited influence on the overall system of corporate governance. The SOX reform has done little to address the fundamental issues regarding investor responsibility, executive compensation, and the tenuous role of the board within this constellation of actors.

From this more systemic perspective of U.S. corporate governance, the current financial and economic crisis is not surprising. Indeed, the current crisis has much in common with the “control frauds” of the past crisis such as the Savings and Loan Scandal or Enron, where managers use their control over firms to create fictional accounting profits and real economic losses in a self-reinforcing but ultimately unsustainable way (Black, 2005). The securitization of mortgages and packaging into collateralized debt obligations (CDOs) gave banks the ability to separate credit risks from market risks, thus allowing them to take bigger bets with less security (Lim, 2008). While individual risks were at least partially traded away, the level of system risk grew to an intolerable level. New patterns of agency were created between borrowers, lenders and credit ratings agencies by this new model of “generate and distribute” loans, where the originators of finance do not bear long-term responsibility for monitoring debt covenants. These systemic risks remained invisible, covered by the misleading appearance of growing profitability despite the growing pressure for a rare but severe adjustment.

While the origins of the financial crisis are a topic of great complexity, it is legitimate to ask what role corporate governance has played, if any? While this question will require detailed future research, a few points can be mentioned. First, accounting standards were proven to be inadequate and so-called “fair value” accounting that benefits shareholders through rising asset prices on the up side also clearly amplified the down-side risks to negative adjustments in equity valuations. Second, a strong link exists between the high power incentives promoted by CEOs and the risk taking behaviour of bank executives, as well as lower level employees and traders. The “bonus culture” of banks has come under severe scrutiny. From a corporate governance perspective, the overall remuneration policy is a responsibility of the board and should have been monitored with a view to potential risks to the long-term value of the enterprise. Third, risk management practices proved insufficient to get boards to monitor and prevent excessive risk taking (see OECD report in particular by Kirkpatrick, 2009). Given the clear responsibilities of the board, this area will clearly need to be addressed in future research and policy considerations. Finally, the role of credit rating agencies suggests that gatekeepers remain very concentrated and still face substantial conflicts of interest (Coffee Jr., 2006). Clearly, these issues concerning the role of corporate governance in the financial crisis will emerge as an important area for new research and debate.

Meanwhile, what future does the shareholder-value model of corporate governance have after the financial crisis? Certainly this question is more interesting and meaning-ful than it was just one year ago. It is highly unlikely that the U.S. model will evolve in the direction of Continental European style stakeholder-oriented corporate governance – nor were these systems immune to the current crisis. Yet the period is one where a more ‘enlightened’ approach to shareholder-value seems possible and hence opportuni-ties exist to address some of the short-term nature of the current system. The analysis in this report suggests, however, that such a more enlightened approach to shareholder value would need to go beyond the traditional emphasis on market disclosure and sys-tems of risk management. Rather, investors would have to be encouraged to act more like owners than traders. Independent directors would have to feel stronger obligations to stakeholder constituents. And the high-power incentives in the name of shareholder interests will need to be fundamentally addressed. In the long run, such a market-oriented and shareholder-centred system could develop many more commonalities with stakeholder-oriented systems by democratizing financial markets and making finance itself accountable to the public interest.

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6 Appendix A: Statistical Tables

Table 1: Ownership of Corporate Equities in the United States

	1945	1955	1965	1975	1985	1995	2001	2002	2003	2004	2005	2006	2007
Individuals	93.1 %	88.1%	83 .8%	69.6%	54.2%	52.3%	41.6%	38.1%	35.9%	32.9%	30.0%	27.7%	25.4%
Government	0.0%	0.0%	0.0%	0.0%	0.0%	0.3%	0.6%	0.7%	0.5%	0.5%	0.5%	0.5%	0.5%
Foreign investors	2.3%	2.3%	2.0%	4.0%	6.0%	5.7%	10.3%	11.2%	11.8%	12.2%	12.6%	13.5%	13.0%
Banks	0.2%	0.4%	0.3%	0.5%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Insurance	2.4%	3.2%	2.9%	5.0%	5.8%	5.2%	6.4%	7.2%	7.1%	7.2%	7.5%	7.8%	8.0%
Pension funds	0.0%	2.2%	5.9%	15.8%	28.0%	23.2%	21.0%	22.4%	22.9%	23.2%	23.3%	23.3%	22.8%
Mutual funds	0.8%	2.4%	4.2%	4.0%	5.0%	12.1%	18.5%	18.4%	19.5%	21.2%	22.8%	23.8%	25.5%
Other	1.2%	1.3%	0.9%	1.1%	0.8%	0.9%	1.3%	1.7%	1.9%	2.5%	2.9%	3.1%	4.4%

Source: U.S. Federal Reserve, Flow of Funds Accounts.

Table 2: Board Composition, 1950-2005

Year	Inside (%)	Affiliated (%)	Independent (%)
1950a	49	26	22
1955	47	30	23
1960	43	31	24
1965	42	33	25
1970	41	34	25
1975	39	31	30
1980	33	30	37
1985	30	31	39
1990	26	14	60
1995	21	15	64
2000	18	15	67
2005	15	11	74

Source: (Gordon, 2007) collected from various sources.

Table 3: Hostile Takeover Attempts in 1991-2005, by Outcome

	Hostile Attempts	Sold to Raider	Sold to Alternative Bidder	Remained Independent
Germany	6	5	0	1
		83 %	0 %	17 %
United Kingdom	176	74	34	68
		42 %	19 %	39 %
United States	332	73	103	156
		22 %	31 %	47 %

Source: (Jackson & Miyajima, 2007)

Table 4: Board Structure of Large U.S. Companies

	1997	2005
Percentage of Independent Board Members	73.4 %	81.4 %
CEO on Nominating Committee	23.3 %	0.8 %
Separation of CEO and Chair	15.8 %	30.3 %

Source: (Valenti, 2008). Based on a sample of 120 Fortune 500 companies.

Table 5: Selected Forms of Non-Litigation Related Activism among U.S. Public Pension Funds

	Activity Never Done	Occasionally	Frequently
Writing Letters to Management	53.9 %	30.8 %	15.4 %
Meeting with Management	64.1 %	20.5 %	15.4 %
Soliciting Support for Activities from Other Institutions (Building Coalitions)	47.5 %	35.0 %	17.5 %
Sponsoring Shareholder Proposal	82.5 %	15.0 %	2.5 %
Soliciting Votes on Shareholder Proposal	85.0 %	10.0 %	5.0 %
Formally Nominating Director Candidate in Opposition to Management	100.0 %	0.0 %	0.0 %
Participating in Proxy Contest in Support of Other Non-Management Nominees	71.8 %	28.2 %	0.0 %
Submitting Names of Director Candidates to Nominating Committee	90.0 %	10.0 %	0.0 %
Withholding Votes from Management Director Candidate	42.5 %	22.5 %	35.0 %
Publicly Announcing Vote Prior to Shareholder Meeting	85.0 %	10.0 %	5.0 %
Lobbying Congress (Formally or Informally) with Respect to Corporate Governance	72.5 %	27.5 %	0.0 %
Creating Focus Lists for Activism	87.5 %	2.5 %	10.0 %
Writing Comment Letter to SEC	50.0 %	35.0 %	15.0 %

Source: (Choi & Fisch, 2008)

Table 6: Trends in Actual CEO Pay

Table 7: Sarbanes-Oxley Act of 2002: Summary of Provisions

Sections	Topics
101-109	PCAOB's creation, oversight, funding, and tasks
302, 401-406, 408-409, 906	New disclosure rules, including control systems and officer certifications
201-209, 303	Regulation of public company auditors and auditor-client relationship
301. 304, 306, 407	Corporate governance for listed firms (audit committee rules, ban on officer loans)
501	Regulation of securities analysts
305, 601-604, 1103, 1105	SEC funding and powers
802, 807, 902-905, 1102, 1104, 1106	Criminal penalties
806, 1107	Whistleblower protections
308, 803-804	Miscellaneous (time limits for securities fraud, bankruptcy law, fair funds)

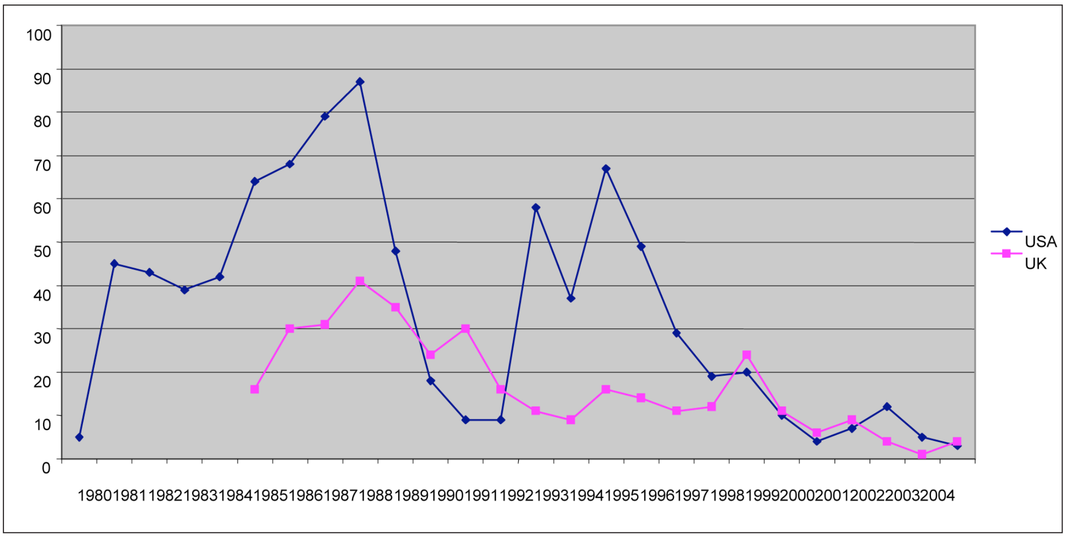
Source: (Coates IV, 2007)

Table 8: Number of Listed Companies, 2002 and 2008

	Total	Domestic	Foreign
2008			
NASDAQ	2,952	2,616	336
NYSE	3,011	2,596	415
London	3,096	2,415	681
2002			
NASDAQ	3,649	3,268	381
NYSE	2,366	1,894	472
London	2,272	1,890	382

Source: World Federation of Stock Exchanges

Figure 1: Number of Hostile Takeover Bids in the USA and UK



Source: Own calculations, Thomson Banker One database.

Table 10: Proportion of Firms with Negative Return on Assets Targeted in M&A

	1991-99	**2000-5**
France	22 %	13 %
Germany	13 %	10 %
Japan	5 %	21 %
UK	18 %	11 %
USA	32 %	10 %

Source: Own calculations, Thomson Banker One database.

7 Appendix B: The Contrast in US and UK Approach to Takeover Regulation

Countries differ in terms of the rights of shareholders and the scope of defensive actions allowed by management during a takeover:

- Shareholder rights relate to principles of equal treatment, mandatory bids, squeeze-out and sell-out rules and disclosure of anti-takeover defenses.
- Pre-bid defenses concern deviations from one-share-one-vote principles (e.g. dual class shares, voting caps, golden shares, preference shares), breakthrough rules, registered shares (e.g. shares can only be transferred with directors' approval), defensive recapitalizations, share issuance or merger with a white knight, repurchase of shares, and defensive acquisition or disposal of assets with the aim of reducing cash, raising regulatory obstacles, or implement poison debt provisions.
- Post-bid rules concern issues of board neutrality (e.g. prohibits action frustrating the bid without shareholder approval), golden parachutes, and the potential for pre-bid authorisation to adopt certain defense measures.

If the board is allowed to mount post-bid defenses, the board may take action toward the bid itself (e.g. seeking a white knight, defensive recapitalization, tactical litigation or making recommendation to target shareholders), the target firm voting rights (e.g. shareholder rights plans, issuance of authorised capital, authorised share repurchase and staggered boards) or toward the target company assets (e.g. crown jewel defense such as disposal of important assets or defensive acquisition or disposal strategy).

Even among the two market-oriented systems of corporate governance, the UK and U.S. follow two very distinct approaches to takeover rules (Kenyon-Slade, 2004). As will be discussed in detail, the UK stresses mandatory bid rules and board neutrality toward bids, while the U.S. essentially gives the board a greater role in the bidding processes and uses other mechanisms, such as anti-takeover rules, to assure fair outcomes

United Kingdom The UK takeover rules include a mandatory bid rule and stress the principle of equal treatment of shareholders, which clearly prohibits defensive measures, such as poison pills, which engage the board and discriminate against the hostile bidder. The key principle under UK takeover rules is the equal treatment of all shareholders within a class. The Principle of Equal Treatment is outlined as General Principle 1 of the City Code, which stipulates similar treatment for shareholders. Specifically, an acquirer must offer minority shareholders the chance to exit on terms that are no less favorable than those offered to shareholders who sell a controlling block. Existing shareholders also have a pre-emptive right of purchase any new shares issued. Equal treatment is enshrined in mandatory bid rules, which offer protection against predatory bidding techniques, such as building hostile stakes and pressuring for changes in control or coercively squeeze other shareholders. Under Rule 9 of the City Code, an acquirer must make a tender offer to all shareholders once a threshold of 30 percent of the shares has been acquired. The mandatory bid rules also restricts partial acquisitions except where explicitly allowed by the UK Takeover Panel.[21]

A further key aspect of the City Code in the UK regards board neutrality, which restricts frustrating actions by the board ("board neutrality"). English case law in the 1960/70s and the 1968 City Code give shareholders the essential power of decision over the outcome. The role of the board is limited to making an informed recommendation to target shareholders (rule 25) to argue why whether price of a cash offer is adequate (or recommend a higher offer from a white knight) or argue why shareholder value is higher if the company remains independent, in the case of a share swap offer. In keeping with the principle of fair treatment for shareholders, the board of has an obligation not to take any action, which could frustrate the offer (rule 21). Likewise, the board must not take any action which may deprive its shareholders of the ability to decide on the merits of the offer, unless its shareholders approve otherwise in general meeting. Examples of 'frustrating action' are set out in rule 21, including issuing new shares, granting options over unissued shares, creating securities carrying rights to convert into (or subscribe for) target shares, selling (or acquiring) assets of a material amount, and entering into contracts otherwise than in the ordinary course of business. For example, defensive recapitalization is only permitted with approval through an ordinary resolution of the shareholder meeting or company articles. The Companies Act of 2006 further strengthens board neutrality by requiring that any payments made to directors, in relation to transfers of control, should be approved directly by the shareholders of the target firm. The "duty of neutrality" imposes rules that are far stricter than the U.S. statute.

United States. The U.S. approach to takeovers differs from the UK regarding both mandatory bids and board neutrality. In important respects, U.S. rules delegate power to directors to deal with the hostile bidder on behalf of the target's shareholders and potentially allow a much wider range of defensive actions. Another important aspect concerns Federalism, and the fact that many aspects of takeover rules fall under the jurisdiction of state corporate law. However, competition among states for incorporations is much less vigorous than often assumed (Kahan & Kamar, 2002). Most public companies incorporate in the state of their headquarters, whereas Delaware is the only state attracting substantial numbers of out of state firms.

No mandatory bid rule exists in the U.S. A substantial body of Federal Securities law addresses the problems of coercive bidding tactics. Particularly in the 1960s, concern grew over aggressive bidding tactics that gave target firm shareholders insufficient time to consider, with too little disclosure, and no obligation to pay fair prices for mi-

21 In lieu of a mandatory bid, purchasers acquiring a stake greater than 15 percent, but less than the 30 percent are subject to Substantial Acquisition Rules (SAR) enforced by the Takeover Panel. Importantly, these rules discourage two-tier takeover attempts and "greenmail" practices, where bidders might use control of an initial stake to gain concessions from other shareholders in gaining further control of the target company.

nority shareholders 'frozen out' during a deal. The Williams Act of 1964 amended the Securities Exchange Act from 1934 to protect target firm shareholders. The spirit of the legislation was 'neutral' toward bids, and prevailed against other more manager-friendly proposals. The Act heightened disclosure of stakes (setting a 5 % threshold), and regulated the process of tender offers by giving a minimum time period of 20 days, setting out certain conditions for such offers, and requiring a response from the target companies' board within 10 days of the offer.[22] However, these rules do not eliminate partial bids for less than 100 % of shares, nor two-tier offers. As such, the potential to freeze out a target firms' minority shareholders with less favorable conditions remains a possibility. This gap was filled by state anti-takeover rules, which essentially seek to regulate the conditions under which a hostile bidder may purchase shares or effect backend merger freeze-outs of target shareholders.

State anti-takeover rules first emerged as a response to coercive bids in the 1960s. The first state takeover statute was enacted by Virginia in 1968. By 1981, a total of 37 States enacted these laws aiming to protect corporations resident in their particular state (Romano, 1987). These laws typically imposed disclosure requirements on bidders intending to pursue a tender offer, and often required an administrative approval for a bid to proceed. While corporate law in the U.S. is the domain of individual states adopting these laws, securities law falls under Federal regulation.[23] However, this first wave of anti-takeover laws was vulnerable to legal challenge for precisely this reason. The broad jurisdiction of these laws led to conflicts with the Commerce Clause and the Supremacy Clause of the U.S. Constitution. For example, some laws related not only to corporations registered within the state, but to any with substantial economic activities, such that these laws were judged as placing an excessive indirect burden on interstate commerce, in violation of the Constitution. Some laws also conflicted directly with the Williams Act by seeking to directly regulate the takeover processes. In particular, some state laws gave government officials direct power to intervene in takeover bids, which preempted by Federal policy of the Williams Act that investors remain free to make their own decisions. In 1982, the Supreme Court case *Edgar vs. MITE Corp* led to the Illinois anti-takeover law being declared unconstitutional (Kenyon-Slade, 2004, p.173-175). Federal courts to subsequently overturn other first generation anti-takeover rules.

A second and more durable generation of state anti-takeover laws emerged following a landmark 1987 Supreme Court case *CTS Corp. vs. Dynamics Corp. of America*. The court judgment upheld Indiana's Control Share Acquisition Statute, and thereby established a legal basis for new types of takeover rules that have survived legal challenge. The Indiana law is a so-called "fair price" statute, which prohibits a merger between the bidder and the target company unless a supermajority shareholder vote approves the

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22 Some of these rules have been amended through the SEC's M&A Release of 2000. In particular, these rules facilitate the use of share exchanges as consideration during tender offers.

23 Many commentators have suggested that this aspect of Federalism has made regulators more vulnerable to the demands of large companies in different states and paved the way for the more manager-friendly system of takeover rules, which contrasts to the UK.

merger or the bidder provides a "fair price" for the remaining shares.[24] This rule eliminates the possibility of freezing out remaining minority shareholders at a lower price. Other states enacted these or other similar second generation statutes. For example, "control share acquisition" statutes require a shareholder vote approving an acquisition of control by a party. Such rules were robust to legal challenge, since it clearly fell in the domain of State's authority over corporate law and operates within the bounds of the Williams Act by maintaining shareholders' sovereignty. Notably, while *Edgar vs. MITE Corp* protected the free market principle across state boundaries, the judgment in *CTS Corp. vs. Dynamics Corp. of America* rejected the idea that the Commerce Clause protects a particular structure of the market:

> "The very commodity that is trade in the securities market is one whose characteristics are defined by state law. Similarly, the very commodity that is trade in the 'market for corporate control'—the corporation—is one that owes its existence and attributes to state law. Indiana need not define these commodities as other states do; it need only provide that residents and nonresidents have equal access to them. This Indiana has done" (*CTS Corp. vs. Dynamics Corp. of America*, 95L.Ed.2d, 67, 89 (1987)).

Overall, 23 states adopted "fair price" statutes, and 25 states adopted "control share" statutes. These second generation defenses influence the ability of bidders to launch two-tiered coercive bids that pressure shareholders to tender by discriminating on price. However, they do less to protect target firms from becoming vulnerable to bids per se. As a result, 23 states adopted a further third generation of very powerful anti-takeover laws known as "business combination" statutes (Bebchuk & Hamdani, 2006), including the states of Wisconsin, Delaware, and New York. These laws prohibit an Acquiror with a large percentage (e.g. 10 or 20 %) from undertaking post-acquisition business combinations transactions with the Target for a specified period (e.g. three or five years), unless the combination is approved by the board of directors or a supermajority of 'disinterested' shareholders. These rules give substantial negotiating power to the target corporation's board, and have been upheld by higher court decisions.[25] The state of Delaware, which is the registered home to the highest number of large corporations, enacted a business combination statute in 1988 prohibiting Acquirors with over 15 % stakes from engaging in business combinations for a three-year period without the approval of the board or a supermajority of 'disinterested' stockholders.

The application of state anti-takeover rules is influenced by a large and sophisticated body of jurisprudence. Directors' duties of loyalty and care are defined in relation to

24 In particular, if an Acquiror's voting rights exceed a certain level, their voting rights are suspended until expressly conferred by a vote of a majority of the Target corporations' 'disinterested' shareholders (Kenyon-Slade, 2004, p.178). If the target shareholders confer such rights, they are guaranteed a price equivalent to that of the previously acquired stake.

25 In particular, the case of Amanda Acquisitions Corp. vs. Universal Foods Corp. in 1989 upheld the validity of the Wisconsin law.

the corporation and its shareholders, but the meaning of those duties is usually subject to the Business Judgment Rule that gives substantial prerogative to management in business contexts. In the special context of takeovers, however, the business judgment rule was seen as giving managers too much free reign so that U.S. courts have sought to develop specific standards under which the usual 'safe harbor' of business judgment can be applied. The Delaware court case of *Unocal* in 1985 was most influential in establishing a test (so-called Unocal test) based on two conditions (Kenyon-Slade, 2004, p.248-255). First, directors must demonstrate that reasonable grounds exist for believing that a danger to corporate policy and effectiveness existed. The law recognizes several types of threats, such as where shareholders are denied a superior alternative transaction, unequal treatment of shareholders under a bid, or when a bid is under-priced due to management misrepresentation (Gilson & Kraakman, 1989). Court decisions surrounding these two tests have come to reject the application of mechanical rules based on the price of bids compared to other alternative bids, and maintained flexibility in applying legal rules such that management maintain potential scope for a 'just say no' defense policy. Second, the defensive action taken by them must be reasonable in relation to the threat posed. Reasonableness may depend on management not trying to force an alternative deal on shareholders, or preclude a hostile bid altogether. Quite unlike the UK approach, the Delaware courts expressly acknowledged in the *Unocal* case that it is legitimate to make distinctions among types of shareholders, such as short-term speculators and other stable shareholders, in using share repurchase programs as defenses. The same standards apply to anticipatory and responsive defenses.

Rather than granting the protection of business judgment, the Unocal test crucially shifts the legal burden shifts back to the directors to justify their actions. The discretion is also limited by Revlon duties, introduced by the Delaware courts ruling in *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.* in 1986. The Revlon duty implies that if the sale of the corporation is inevitable, the board has a duty to auction the corporation at the highest price. In particular, once Revlon duties are triggered, the consideration of non-shareholder constituencies is no longer appropriate. While defensive measures can be maintained under Unocal, if these measures are used to sell to a new controlling shareholder, such as through a white knight or alternative bid, Revlon substantially shifts the duties of directors to require the Board to maximize the company's value in an auction for the benefit of shareholders. In other words, Revlon duties impose a fiduciary duty on the board to evaluate competing proposals and refrain from implementing defensive measures that deprive shareholders of the opportunity to consider competing proposals.

Given the dual set of principles under Unocal and Revlon, defensive measures do not usually prevent takeover bids. Seen in conjunction, Unocal essentially helps managers to strengthen their negotiating position vis-à-vis a bidder, and therefore better take into account shareholder interests that become paramount under Revlon. A number of defenses are know well established under existing legal rules and have made takeovers more expensive. Under this system, US firms have now widely adopted defensive measures such as poison pills, golden parachutes and staggered boards. In 2003, a majority of listed firms have such one or more such measures in place, despite the fact that takeover defenses continue to be seen negatively by institutional investors (Gilson, 2006).

Takeover Defenses.

Within the boundaries of the Revlon and Unocal rules, U.S. corporations have widely adopted a number of takeover defenses with the aim of discouraging hostile bids. These defenses do not make hostile takeovers impossible, but may have the effect of slowing the process down and buy management time for negotiation that leads to friendly mergers.

In terms of pre-bid defenses, US law has been fairly permissive. Delaware law permits dual classes of shares (Art 102(a)(4), 151(a) DEGCL), as well as contractual restrictions of voting and transfer (Art 202 DEGCL). These rules give managers the ability to engage in defensive recapitalization efforts, whereby new shares are issued to management (or third party white knights) with excess voting rights. U.S. boards are given considerably legal power to act in this regard, whereas similar actions are only allowed in the UK following an ordinary resolution of the AGM or prior authorization within the company statutes. However, a one share-one vote principle was initially adopted through SEC Rule 19c-4 in 1988, but later overturned in court. Subsequently, the one-share-one-vote principle was adopted voluntarily by NYSE and NASDAQ in 1994 as part of their listing requirements so as to protect existing shareholders' rights from being diluted (Bebchuk & Hamdani, 2006).[26]

The most central and powerful takeover defense under the Delaware Law remains the ability to adopt a "poison pill." Poison pills or shareholder rights play are mechanisms whereby new shares may be issued, at a heavily discounted price, to shareholders other than the hostile bidder so as to substantially dilute the hostile stake. The pill must first be triggered by an acquirer purchasing a certain threshold amount of voting shares, or making a hostile tender offer. Two regulatory preconditions are important here. First, a poison pill can be adopted by the target firm board without a shareholder vote, and typically the board alone has the power to redeem the rights issued in connection therewith. Second, shareholders under Delaware law have no pre-emptive right to purchase shares, unless provided for under the corporate charter (Kenyon-Slade, 2004, p.377). The poison pill is so effective because it goes beyond "fair price" and "supermajority" anti-takeover defenses because it completely blocks the bidder from acquiring more than a small stake, regardless whether a premium price is paid to all shareholders and

26 Some exceptions are permitted with regard to initial public offerings of securities with disparate voting rights or subsequent public offerings of lesser voting stock.

regardless of the fact that a supermajority of shareholders would like to accept the bidder's offer (Coates IV, 1999). In practice, no hostile bidder has ever bought through a poison pill.

Poison pills became widespread after the Delaware Supreme Court ruling in *Moran v. Household International Inc.* While the case upheld the poison pill as a legitimate takeover defense, other cases have invoked fiduciary obligations and required boards to redeem poison pills and permit shareholders to decide for themselves with regard to a hostile bid. However, the board must satisfy its duties of care and loyalty in adopting a poison pill. Courts have thus applied the Unocal test to evaluate poison pills and also the Revlon duties where poison pills can be used as an auction gavel in order to field higher offers or prepare alternative transactions. This scrutiny does limit the ability for managers to use poison pills as part of a 'just say no' strategy, although courts may sometimes uphold this position (Kenyon-Slade, 2004, p.351-354). Furthermore, bidding firms may try to circumvent the poison pill through a proxy contest, wherein a hostile bid is combined with a proposal to replace the board with its own nominees, who will redeem the poison pill. In such cases, takeover defenses will be more effective to the extent that the target also has a 'staggered board' shark repellent, stipulating that only one-third of the directors may be replaced per year. Staggered boards have continued to grow in popularity to around one-third of all large firms by the end of the 1990s, although these have since become increasingly hard to implement due to opposition of institutional investors (Coates IV, 1999).

In terms of post-bid defenses, the U.S. board has no direct legal obligation to act neutrally toward a bid. As noted in the previous section, defensive measures may only be taken in response to a threat to corporate policy and effectiveness, provided the response is proportionate to the threat (Unocal rule) and directors have a fiduciary duty to evaluate competing proposals and to refrain from implementing defensive measures that deprive shareholders of the opportunity to consider competing proposals (Revlon rule). Shareholders may also authorize the board to undertake particular defensive actions, subject to a "sunset clause" of validity for 36 months. Once a hostile bid has been launched, two defensive strategies are common: search for a white knight or defensive recapitalization efforts, including crown jewel defenses (e.g. disposing of crucial company assets) or engaging in defensive acquisitions that may raise the barriers to the outside bid.

Shareholder rights in takeover regulation

	Germany	**UK**	**US**
Equal treatment, particularly during bidding period (EU)	Yes	Yes	No
Disclosure of anti-takeover provisions (EU)	Yes	Yes	Yes
Mandatory bid rule (EU)	Yes, threshold 30 % of all outstanding shares	Yes, threshold 30 % of all outstanding shares	No
Squeeze out rule (EU)	Yes, 95 % threshold; minimum price	Yes, 90 % threshold; minimum price 8.64 et seq, 8.82 et seq	Yes, but acceptance and minimum price can be altered in statutes
Sell out rule (EU)	Yes	Yes	No

Selected pre-bid takeover defenses

	Germany	**UK**	**US**
Deviations from one share- one vote principle	No, extremely rare.	Yes, but restrictions are discouraged by the stock exchange.	Yes, but not at the detriment of existing shareholders
Dual-class shares (multiple voting rights)	No	Yes, although discouraged by LSE	Yes, permitted in Delaware company law; but prohibited by NYSE and NASDAQ listing rules
Voting right ceilings (voting caps)	No (except for Volkswagen Law)	Yes, but hardly applied	Yes, supermajority voting requirements
Breakthrough rule (EU)	No, but companies can opt-in individually	No, but companies can opt-in individually	No
Restricted registered shares (shares can only be transferred with directors' approval)	Yes, but only applied in few companies	Yes, but only in unlisted companies	Yes, but only voluntary lock-up agreements
Pre-bid defensive recapitalisation, share issuance to white knight, repurchase of shares	Yes, but may require shareholder or supervisory board approval	Yes, but requires ordinary resolution of AGM	Yes, possible without shareholder approval

Scope of Post-bid Action of the Board

	Germany	UK	US
Board neutrality (prohibits action frustrating the bid without shareholder approval)	No, several exceptions to general board neutrality principle	Yes	No
Golden parachutes	Yes, but rare.	Yes, but less important in takeover context	Yes, common means to align board and shareholder interests
Pre-bid authorisation to adopt defence during the offer period	Yes, reserve authorisation delegating any shareholder competence to the management board; valid for 18 months	No	Yes, sunset clause valid for 36 months

Board action with regard to the bid

	Germany	UK	US
White knight or defensive recapitalisation (search for an alternative friendly bidder; maximise the ultimate takeover price)	Yes	Yes	Yes
Tactical litigation (judicial review and civil litigation between parties)	Yes	No, expressively discouraged by all judicial and legislative actors	Yes
Board recommend rejection of bid to target shareholders	Yes	Yes	Yes

Board action with regard to target shares and voting rights

	Germany	UK	US
Shareholder rights plan (Delaware style poison pill; share issuance to shareholders other than the hostile bidder; applied without any shareholder approval)	No, inconsistent with shareholder equality.	No, shares issuance into friendly hands to frustrate an offer is improper; any board action that could frustrate the bid requires shareholder approval	Yes
Issuance of authorised capital	Yes, with supervisory board approval, valid for five years	No, would require shareholder approval	Yes
Authorised share repurchase	Yes, with supervisory board approval, valid for 18 months	No, would require shareholder approval	Yes, subject only to fiduciary duties of the board
Staggered board	Yes, supervisory board and management board may be staggered; members can be removed only with cause	No, directors can be removed in any shareholder meeting with or without cause	Yes

Board action with regard to target assets

	Germany	UK	US
Crown jewels defence (decision during the offer period to dispose of important assets)	Yes, with supervisory board approval; shareholder approval is only required if concrete action involves more than 80 % of the company's assets or changes the company's core business focus (Holzmüller doctrine)	No, transfer of more than 10 % or other material assets not permitted	Yes
Acquisition/disposal strategy defense (continuation of any extraordinary board action which has been started before the offer period)	Yes, shareholder approval is only required if concrete action involves more than 80 % of the company's assets or changes the company's core business focus (Holzmüller doctrine)	No, acquisition or disposal of more than 10 % or other material assets not permitted	Yes

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