

Keeping the Faith: Corporate Governance After the Credit Crisis

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But alas! I never could keep a promise. I do not blame myself for this weakness, because the fault must lie in my physical organization. It is likely that such a very liberal amount of space was given to the organ which enables me to make promises, that the organ which should enable me to keep them was crowded out.

– Mark Twain, *The Innocents Abroad*¹

INTRODUCTION

In his new book, *Corporate Governance: Promises Kept, Promises Broken*,² Jonathan Macey analyzes the explicit and implicit agreements governing the relationship between shareholders and the corporations in which they invest.³ The formal contracts, including the articles of incorporation and bylaws, that define a corporation are sparse.⁴ Shareholders who invest huge sums of money in corporations, furthermore, have no legal right to dividend payments from the cor-

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1. MARK TWAIN, *THE INNOCENTS ABROAD, OR THE NEW PILGRIMS' PROGRESS* 239 (1875).
2. JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* (2008).
3. Other scholars have also discussed these explicit and implicit agreements. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 12 (“More often than not a reference to the corporation as an entity will hide the essence of the transaction. So we often speak of the corporation as a ‘nexus of contracts’ or a set of implicit and explicit contracts. This reference, too, is shorthand for the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves.”).
4. See MACEY, *supra* note 2, at 18, 29.

poration.⁵ Thus, Macey argues, shareholders willing to invest under such a scheme must be relying on more than just the few explicit legal rights contained in formal agreements.⁶ They must have rational expectations garnered from past experience as to how corporations will behave. These expectations become implicit promises between shareholders and corporate decisionmakers.⁷ The primary unstated promise is that the corporation is run to maximize profits.⁸ In addition, managers and directors implicitly promise they will not use corporate funds to entrench themselves or give themselves excessive benefits.

Macey finds, however, that American corporations share Twain's fundamental weakness: an inability to keep promises when left unchecked. Similarly, this weakness is due to the corporation's peculiar organization, specifically the separation between ownership and control. While the shareholders of the firm are its owners, professional managers, chosen by a board of directors, run the firm. They do not have the same incentives as the shareholder-owners. This so-called agency problem is at the heart of why American law needs corporate governance.⁹ Effective corporate governance encourages corporate decisionmakers to honor their promises to shareholders or credibly commits them to doing so.¹⁰ Ineffective corporate governance either ignores these promises or reduces decisionmakers' incentives to keep them.¹¹

Macey's analysis of prominent American corporate governance mechanisms finds, with startlingly little exception, that the most effective corporate governance mechanisms are the most regulated by government.¹² Macey blames this paradox on a combination of interest-group politics and regulators trying to mollify citizens outraged by corporate greed and failures.¹³ Lawmakers pass

5. *Id.* at 29-30, 40-41.

6. *Id.* at 18.

7. *Id.* at 8. The "promises" terminology is not unique to Macey's work. For example, Easterbrook and Fischel also use it. *See, e.g.,* EASTERBROOK & FISCHEL, *supra* note 3, at 6. Their use of "promises," however, is limited to promises made in explicit contracts, although they note that managers "also promise, explicitly or otherwise, to abide by the standards of 'fair dealing' embedded in fiduciary rules of corporate law." *Id.* (emphasis added).

8. MACEY, *supra* note 2, at 2-3.

9. For an early rigorous and canonical treatment of corporations' agency problem, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

10. Credible commitments are promises that involve some sort of detriment to a promisor who breaks the promise. Without such credible commitment devices, the promisee has no reason to believe the promisor will stick to the promise.

11. MACEY, *supra* note 2, at 1.

12. *Id.* at 15.

13. *Id.* at 16-17, 272-73.

regulation that seems to keep corporations in check but that, in reality, does not threaten the supremacy of directors or management.¹⁴

This Review first describes Macey's finding that those corporate governance structures most successful at ensuring promises to shareholders—in other words, those effective as promissory corporate governance mechanisms—are the most regulated and discouraged by government. It then turns to the implications of Macey's analysis in light of the drastic changes in the economy since the publication of *Corporate Governance*.

I. PROMISSORY CORPORATE GOVERNANCE AND GOVERNMENT REGULATION

Through case studies of particularly popular corporate governance mechanisms, Macey demonstrates that effective corporate governance is regulated or discouraged by the government while ineffective corporate governance is encouraged. Figure 1 visually displays the relationship between effectiveness and regulation.

	Encouraged or Unaffected by Law and Regulation	Discouraged by Law and Regulation
Effective	Hedge Funds and Private Equity	Market for Corporate Control Insider Trading on Fraud
Not Effective	Board of Directors Independent Directors Derivative and Class Action Suits Whistle-Blowing Shareholder Voting Credit-Rating Agencies	

Figure 1: Division of corporate governance mechanisms along the effective/not effective and encouraged/discouraged dimensions.¹⁵

A. Encouraging Ineffective Corporate Governance

Macey's primary example of ineffective corporate governance reform is the regulation of corporate boards of directors.¹⁶ He attacks the blind hope that the

14. *Id.* at 16.

15. This table is adapted from *id.* at 50. The table on that page puts "Hedge Funds and Private Equity" in the "Discouraged by Law and Regulation" column. I have added "Unaffected" to the first column, as it seems to represent Macey's point more accurately. There are certainly movements to regulate hedge funds and private equity, which would move them into the "Discouraged" column. See *infra* note 42 and accompanying text.

16. See, e.g., MACEY, *supra* note 2, at 57, 104.

investing public places in boards of directors, specifically in the efficacy of “independent” directors.¹⁷ Macey argues that the board of directors is asked to serve two functions in constant tension with each other: helping management run the corporation and monitoring management.¹⁸ Unable to discharge both functions, boards will err on the side of aiding management and neglecting oversight duties due to structural impediments to boards’ overseeing function. First, boards choose the managers they are meant to oversee. Firing managers or signaling their incompetence by restricting their ability to act discredits the directors’ initial choice and indicates the directors’ own incompetence.¹⁹ Directors faced with an objectively unsuccessful board, signaled by a decline in stock price, may, to the detriment of shareholders, choose to believe managerial assurances about future improvement rather than attribute the failure to management’s incompetence. Second, boards rely on senior management for the information needed and to oversee operations.²⁰ Self-interested managers will be more forthcoming with such information to boards they perceive to be friendly, and thus it will be less likely that those boards with the ability to monitor management effectively will actually do so.²¹ In short, boards of directors are “captured” by managers and are not an effective check on management.²² Regulating board composition, therefore, is a way for politicians to appease constituents while not upsetting the strong management and director lobbies.

Macey dismisses another favorite cause of shareholder activists: shareholder voting.²³ He attributes its failure to the free-rider problem plaguing dispersed shareholders, which makes it economically infeasible for small individual stakeholders to amass enough information about a particular vote to make an informed decision.²⁴ Instead, shareholders tend to defer to management and the board of directors.²⁵

Even without direct regulation, the conventional wisdom is that fiduciary duties—particularly the duties of loyalty and good faith—require directors and

17. *Id.* at 102 (“The argument is that the current trend of touting independent directors as some sort of corporate governance panacea is misguided.”).

18. *Id.* at 52, 82.

19. *Id.* at 60 (“When management performs well, the directors who have selected, recruited, and compensated these managers are viewed as able. When management performs poorly, its performance casts a long and negative shadow on the directors.”).

20. *Id.* at 60–61.

21. *Id.* at 71.

22. *Id.* at 57, 83.

23. *Id.* at 199 (“[W]hile shareholder voting probably does not do shareholders much harm, it doesn’t do them much good either.”).

24. *Id.*

25. See *supra* note 22 and accompanying text.

managers to keep their promises to shareholders. Macey argues, however, that holding directors and officers accountable as fiduciaries requires solving the problem of dispersed ownership.²⁶ Dispersed ownership, a hallmark of American corporations, results in cost impediments to litigation.²⁷ While the class action derivative suit has arisen in response to these challenges, Macey argues that these suits only benefit the plaintiff's bar.²⁸ The proliferation of settlements²⁹ and the derivative suit requirement of demand (or proving futility of such a demand) on the board³⁰ make it clear that fiduciary duties cannot explain why investors are willing to put their money in the hands of corporations. Credible commitment to promises must be involved.

B. Discouraging Effective Corporate Governance

While Macey believes that independent directors, lawsuits, and shareholder voting rights are a waste of corporate governance energy, he finds that the market for corporate control is a useful corporate governance tool.³¹ The success of corporate boards can be easily measured with one metric: the corporation's stock price.³² Stock prices represent the market's determination of a firm's worth; a maximized stock price, therefore, is a signal that the corporation is upholding its promise to maximize profit.³³ When corporate leadership fails, stock prices decrease. The corporation then becomes a takeover target.

Yet the market for corporate control has been rendered powerless by law and regulation encouraged by directors and managers. They know that a functioning market for corporate control, unlike independent boards of directors, could have detrimental effects on their ability to evade meaningful corporate governance.³⁴ For example, the Williams Act makes takeovers more expensive by requiring outsiders to announce publicly when they have obtained a 5% stake in a company.³⁵ Macey argues that this transparency makes takeovers less likely because bidders must provide competitors with information about their strat-

26. MACEY, *supra* note 2, at 131.

27. *Id.*

28. *Id.* at 136-45.

29. *Id.* at 145-47, 151-53.

30. *Id.* at 134-36.

31. *Id.* at 118.

32. *Id.* at 120.

33. *Id.*

34. *Id.* at 118.

35. An Act Providing for Full Disclosure of Corporate Equity Ownership of Securities Under the Securities Exchange Act of 1934 was passed on July 29, 1968. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2006)).

egy.³⁶ He similarly blasts the Delaware courts' acceptance of "poison pills," corporate defensive mechanisms that make it harder to mount successful takeovers against management.³⁷ He considers the cases upholding poison pills "judicial fiat [by which] the Delaware courts have removed from the marketplace the hostile tender offer, which is the most powerful corporate governance device in the shareholders' corporate governance arsenal."³⁸

According to Macey, the newest heroes of corporate governance are private equity funds and hedge funds that have turned from passive investors into corporate governance activists.³⁹ Some of these funds take stakes in corporations believing they can force governance change and profit off the resulting increase in share value.⁴⁰ Like the actors in the market for corporate control, private equity funds and hedge funds step in when they see a disconnect between share price and the assets of the corporations.⁴¹ Consistent with Macey's hypothesis regarding regulation of successful corporate governance mechanisms, legislators and corporate boards have for many years agitated for regulation of these heretofore lightly regulated investment vehicles.⁴²

II. PROMISSORY CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS

The current financial crisis, which has significantly changed the economic world since Macey published *Corporate Governance* one year ago, will undoubtedly test Macey's promissory theory.⁴³ In the short term, multiple factors point to increased oversight of corporations: the slowdown in capital markets for project funding, public attention to a struggling economy and resulting bailouts,

36. MACEY, *supra* note 2, at 122.

37. *Id.* at 123-24.

38. *Id.* at 126.

39. *Id.* at 272 ("Private equity and hedge fund investors appear to be the great, shining beacon of hope on an otherwise bleak landscape.").

40. *Id.* at 272.

41. *Id.* at 246.

42. *Id.* at 243-44; see also *Direct Regulation of Hedge Funds is Under Study*, WALL ST. J., Mar. 4, 1999, at C18 (describing attempts to regulate hedge funds); Deborah Solomon, *SEC Pushing Proposal to Regulate Hedge Funds*, WALL ST. J., July 1, 2004, at C4 (same). The SEC's attempt to regulate hedge funds was struck down by the D.C. Circuit in 2006. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

43. Macey acknowledged this fact in an audio interview discussing the book. Interview by Kaitlin Thomas, Assistant Dir. of Pub. Affairs, Yale Law Sch., with Jonathan R. Macey, Deputy Dean and Sam Harris Professor of Corporate Law, Corporate Fin., & Sec. Law, Yale Law Sch., in New Haven, CT. (Oct. 27, 2008), available at <http://cs.law.yale.edu/files/folders/yvspodcasts/entry253.aspx>.

the discovery of massive Ponzi schemes,⁴⁴ and the increased scrutiny of corporations and financial institutions promised by the Obama Administration.⁴⁵ The eyes of the American public are focused on corporate executives who profited in boom times and are now expected to suffer in a recession. This focus has already led to bank managers taking no or nominal bonus pay for 2008. This symbolic gesture signals their inability to work unfettered from external oversight.⁴⁶

Corporations will face increasing impediments to debt financing in the post-credit crisis world. The calling card of this crisis is the inability of borrowers to repay debts and the way in which such an inability propagates through the financial system. As the crisis continues to move from Wall Street to Main Street, many more American corporations are likely to fail and declare bankruptcy. Unpaid creditor banks will tighten lines of credit more readily in a world where “nightmare scenarios” seem far more likely than before. As the supply of debt shrinks, interest rates will rise in equilibrium. Companies that could have borrowed in the pre-credit crisis world may no longer be able to do so at affordable rates.

Faced with high interest rates, corporations will be unable to borrow and will be under tighter watch by nervous directors and shareholders. Mistakes will be more critical and more likely to lead to directors firing management. Fraud will be more easily detectable as profit margins disappear, and fraud will not be tolerated. It seems, then, that the credit crisis might have a beneficial effect on the efficacy of corporate governance mechanisms, at least while the crisis continues.

As capital markets revive, however, decreased debt availability will not mean an end to funding but instead that corporations will have to turn more fully to the equity markets to fund new projects. Macey’s theory predicts that this shift to equity will improve corporate governance for upstart companies; initial public offerings, which should become more frequent after the economy

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44. While the focus on Bernard Madoff’s \$50 billion fraud is the primary example of recent public attention to Ponzi schemes, a rash of other Ponzi schemes has been subsequently uncovered. The Madoff scandal, therefore, provides an excellent example of how the increased awareness of fraud (in this case, investors attempting to remove their money) can lead to an avalanche of discovered malfeasance. See, e.g., Leslie Wayne, *The Mini-Madoffs: Troubled Times Are Bringing More Ponzi Inquiries to Light*, N.Y. TIMES, Jan. 28, 2009, at B1. See generally Amitai Aviram, *Counter-Cyclical Enforcement of Corporate Law*, 25 YALE J. ON REG. 1 (2008) (discussing the increased attention to corporate fraud during economic downturns).
45. The government, which can demand document production and does not have the dispersed shareholder problem, has forcefully entered the corporate governance fray. See, e.g., David Enrich & Damian Paletta, *Crisis on Wall Street: Agreement Boosts Citi Oversight*, WALL ST. J., Jan. 29, 2009, at C3.
46. See, e.g., Dan Fitzpatrick & Amy Or, *BofA’s Chief Decides To Forgo Bonuses—Action Mirrors Other Banks’ Moves*, WALL ST. J., Jan. 7, 2009, at C1.

improves, provide the investing public with basic information that investors require to form proper expectations.⁴⁷

The story for mature corporations inspires less hope. Economists since the 1980s, most notably Michael Jensen, have argued that debt financing decreases the inherent agency problems between shareholders and management.⁴⁸ Debt limits managerial freedom to engage in projects that are not in shareholders' best interest by requiring management to produce, each period, at least the money necessary to pay interest on the debt. If the corporation does not pay its debtholders, it faces bankruptcy. Thus, according to Jensen's free cash flow theory, the increase in stock price when corporations issue debt⁴⁹ is due to the fact that shareholders benefit when managers have less free cash with which to benefit themselves.⁵⁰ Since shareholders have no legal right to demand dividends but creditors have the right to put delinquent debtor corporations into bankruptcy, debt financing is a credible commitment while equity financing is not. One using Macey's vocabulary would say that having a significant amount of debt is an effective corporate governance mechanism because it provides a credible commitment that managers will keep promises to shareholders.

Contrary to initial perceptions, therefore, the decrease in available debt financing sure to result from the current crisis might well *increase* the financial freedom of managers and, by extension, the directors that hire them. Shareholders will be left without the protection of keeping management under the constantly looming specter of high interest payments. As a result, it will be more difficult to credibly commit management and directors to keep promises made to investors. Corporate governance will suffer.

In a post-credit crisis world, therefore, Macey's criticisms of the hope placed in independent directors holds special relevance. The little benefit that independent directors currently provide when overseeing management will disappear as the natural limitations on managers imposed by debt financing disappear. Thus, Macey's promissory theory predicts that captured directors will have even less incentive to monitor management closely in the post-crisis world. Small mistakes will be cushioned by voluntary dividend payments rather than exposed by mandatory interest payments on debt.

Hedge funds and private equity are unlikely to be able to assist significantly in corporate governance in a post-crisis economy. These investment vehicles are likely to be among the institutions most affected by the decrease in debt financ-

47. MACEY, *supra* note 2, at 127-29 (discussing the positive corporate governance effects of due diligence associated with initial public offerings).

48. Michael C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

49. This comparison is relative to issuing equity.

50. Jensen, *supra* note 48, at 323 ("Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow.").

ing availability.⁵¹ Activist hedge funds, in particular, rely heavily on the ability to borrow. They use such leverage to turn their capital into an interest in a company in order to agitate for corporate governance change. This leverage and the ability to take short positions⁵² differentiate these funds from highly regulated mutual funds. Without the leverage needed to take these positions, hedge funds and private equity funds may be rendered as ineffective as mutual funds in the corporate governance arena.

Political and public sentiment also militate against looking to hedge funds and private equity funds as the post-crisis corporate governance saviors. Rightly or wrongly, investors and analysts have placed a sizable amount of blame on these “speculative” investors and their lack of regulation for the economic downturn.⁵³ Predictably, lawmakers have called for regulation and have recently introduced regulatory legislation in Congress.⁵⁴ Corporate directors and managerial lobbies may thus support such regulation.

What, then, happens to corporate governance? If Macey’s promissory theory is a guide, perhaps corporate governance activists should work towards the reemergence of the market for corporate control. Some corporate control transactions, such as stock-for-stock mergers, are not strongly predicated on the ability to borrow. These corporate control transactions, which allow the market to eliminate bad management using objectively determinable stock prices, are unlikely to be as affected by the credit crisis as transactions affected by hedge funds and private equity. Managers and directors will always seek to protect themselves from corporate raiders. They will always, therefore, want to keep shareholders happy with high share prices. To reinstate the market for corporate control in full force, however, requires repealing regulation that disrupts natural market processes. For example, lawmakers could weaken the Williams Act and judges could be more critical of poison pills. Due to the current climate

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51. The difficulties have already begun. For a discussion of financing problems for hedge funds, see Susan Pulliam & Jenny Strasburg, *Brokerages Tighten Hedge Fund Financing*, WALL ST. J., Feb. 17, 2009, at A1.
 52. Short-selling stock allows an investor to bet on a downward movement in share price by, in the most typical case, borrowing stock and immediately selling it. To return the borrowed stock, the investor purchases a share in the open market, profiting from the decrease in share price between the sale of the stock and its purchase.
 53. Blaming hedge funds started early in the chronology of the current crisis. See, e.g., Gregory Zuckerman, *Are Hedge Funds Root of All Evil or Convenient Scapegoats? Wall Streeters Urge Regulators To Apply Heat to Managers*, WALL ST. J., July 18, 2008, at C2 (“Members of Wall Street’s establishment, including J.P. Morgan Chase & Co. Chairman James Dimon and top corporate-attorney Martin Lipton, have urged regulators to step up their patrol [of hedge funds] . . .”).
 54. See, e.g., Jenny Strasburg, *Legislators Seek Hedge-Fund Disclosure*, WALL ST. J., Feb. 2, 2009, at C2 (discussing the bipartisan introduction of the Hedge Fund Transparency Act by Senators Carl Levin and Charles Grassley).

of increased regulation rather than deregulation,⁵⁵ however, these steps appear unlikely to occur within the next few years.

CONCLUSION

In *Corporate Governance*, Jonathan Macey argues that managers engaged in interest-group politics have created a paradoxical result: regulating effective corporate governance mechanisms while promoting ineffective ones. Although this paradox would be dangerous in a thriving economy, it is even more problematic when economic changes weaken the few remaining effective governance mechanisms. Specifically, shareholders benefit from activist hedge funds and private equity funds. They also benefit from management needing to make required interest payments on debt. By decreasing debt availability and the ability of funds to obtain leverage, the credit crisis threatens to remove these important shareholder tools. If there are no changes to corporate governance, managers will be free to break their most fundamental promises to shareholders.

Government policymakers, therefore, should use the upheaval in the financial markets as an opportunity to reexamine their basic beliefs about market processes. In order to institute useful—rather than simply popular—legislative and regulatory change, these policymakers need a comprehensive theory of corporate governance that explains the difference between effective and ineffective rules. *Corporate Governance* is a strong step forward in developing such a theory.

55. Increased regulation was a major theme of the 2008 presidential election. In the first presidential debate, then-U.S. Senator Barack Obama said that the financial crisis “is a final verdict on eight years of failed economic policies—promoted by George Bush, supported by Senator McCain—a theory that basically says that we can shred regulations and consumer protections and give more and more to the most, and somehow prosperity will trickle down.” Laura Meckler, Elizabeth Holmes & Amy Chozick, *Obama, McCain Spar on War, Financial Crisis in First Debate*, WALL ST. J., Sept. 27, 2008, at A1.