

CORPORATE GOVERNANCE AND FINANCIAL CRISIS IN THE LONG RUN

Centre for Business Research, University of Cambridge
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By

Simon Deakin
Centre for Business Research
Top Floor
Judge Business School
Trumpington Street
Cambridge
CB2 1AG

s.deakin@cbr.cam.ac.uk

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Abstract

Prior to the global financial crisis which began in 2007, corporate governance reforms of the preceding thirty years had promoted a shareholder-value based model of management for which there was little historical precedent. The underlying legal model of the firm retained a vestigial sense of the corporate form as a mechanism for promoting group cooperation, but it became increasingly ill suited to achieving this end in a period of hyper-liquidity in capital and credit markets. The destabilizing effects of the shareholder value norm included growing income inequality for which asset price inflation in the Anglo-American economies served as partial compensation, thereby helping to create the conditions which led to the global financial crisis. The failure of individual financial institutions cannot plausibly be ascribed to poor governance practices in those firms; there were more immediate factors at play, including ineffective regulation. However, the general trend towards shareholder value since the 1980s was implicated in a wider, systemic failure of the corporate governance system, of which the banking crisis was simply the most visible manifestation. Under these circumstances, a reassessment of the shareholder value based approach to the governance and management of large corporations is urgently required.

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1. Introduction

The corporation is the basic organisational unit of a market economy and one of its most fundamental legal institutions. It should be capable of contributing both to economic growth and, arguably, to human development in a broader sense. There are, however, influential voices which doubt its capacity to do this. Joel Bakan's description of the corporation as a 'pathological institution, a dangerous possessor of the great power it yields over people and societies', might have seemed exaggerated to some. Yet Bakan's point was precisely grounded in what he described as the company's 'legally defined mandate ... to pursue, relentlessly and without exception, its own self interest, regardless of the often harmful consequences it might cause to others'.¹ Behavioural economics defines a sociopath as one who 'treats others instrumentally, caring only about what he derives from the interaction, whatever the cost to the other party'.² Such behaviour, while regarded as universal and in some sense 'natural' by the axioms of neoclassical economics, is probably confined to a minority of human beings; around a quarter of participants in ultimatum game experiments display entirely self-regarding behaviour in this sense.³ Somehow, at the beginning of the twenty-first century, the corporation had evolved to the point of being a sociopathic institution, at odds with deep-rooted pro-social tendencies in human psychology and behaviour.

The point was not lost on certain commentators occupying a pivotal position in the contemporary practice of corporate governance. According to Leo Strine, Vice Chancellor of the Delaware Court of Chancery, the subject-matter of corporate governance – the matters which interest the 'haves of the corporate governance world' who include institutional investors, non-executive directors, CEOs, and activist shareholders – were not addressing the questions 'most relevant to ordinary people'. These included: 'Will the [US] economy continue to produce well-paying, decent jobs in the face of international competition? ... Can the [American] nation afford to honour the promises made to retirees as the percentage of the population that is elderly markedly increases? How can citizens of western nations maintain their current lifestyles while reducing their disproportionate consumption of the Earth's natural resources?'.⁴ Yet, according to Strine, it was 'simply silly to believe that questions like these will be fairly and justly considered in the corporate polity itself, in which the only constituency with a vote is capital and in which the only other constituency with real power are the directors and top managers'.⁵

The orthodox position of corporate governance theory is that companies exist to maximise shareholder returns. Strine, as 'someone from Delaware steeped in the evolution of corporate behaviour during the last forty years', acknowledged a 'sweeping victory' for the claim that the purpose of the company is to

‘maximise corporate profits for stockholders’.⁶ During the forty years’ ascendancy of shareholder value described by Strine, the human person disappeared from the economic theory of the firm. Economic theory had formerly stressed the distinctiveness of the firm as an organisational entity, emerging out of but also separate from market forms of governance, and had seen the employment relationship as the firm’s main defining feature.⁷ The argument that the firm was after all just a ‘nexus of contracts’, which began to gain ground in the 1970s, represented a turning point.⁸ By the mid-1990s the predominant theory was describing employees, or human assets as they had become known, as strictly ‘non-essential’ to the firm, the essence of which was seen as the control of intellectual and physical property by managers acting as the shareholders’ agents.⁹

The financial crisis of 2008-9 highlighted the fault lines within corporate governance. The growing influence of the shareholder value norm on corporate practice had exacerbated the asset price bubbles of the 1990s and 2000s¹⁰ and heightened the fragility of financial sector firms.¹¹ Failing firms had not, on the whole, suffered from inadequate governance as that was defined by the consensus of the time; most of them had independent boards, separate chair and CEO roles, and limited defences, if any, against hostile takeover.¹² Yet, the immediate response of policy makers was to suggest a strengthening of the shareholder value norm, with a growing role for independent directors and external shareholder monitoring proposed as measures likely to prevent future corporate failures.¹³ As the immediate crisis receded in the course of 2009-10, so did the pressure for reform, which in any case had arguably failed to address principal contribution of governance to the crisis, namely the shareholder value norm itself.

This chapter aims to put recent events in a wider perspective by considering the relationship between corporate governance and financial crisis in the long run. Crises and scandals have shaped much of modern company legislation and, more recently, of corporate governance codes. Over the long run, however, the corporate form has responded, if imperfectly, to the context provided by industrialisation and the growth of the market economy, and to the functional needs of business organisations to which these developments gave rise.¹⁴ Modern corporate law is the product of these dual pressures, short-term and long-term, and they will both play a role in shaping corporate governance in the post-crisis period. To develop this theme, section 2 below provides an overview of the relatively recent development of the shareholder value norm in the last decades of the previous century and the first decade of the present one, and contrasts it with the longer-run co-evolution of company law and the industrial market economy. Section 3 focuses on the anatomy of corporate failure during the 2000s and the role of governance within it. Section 4 considers the

evolution of corporate governance in the aftermath of the crisis. Section 5 concludes.

2. Shareholder Value: An Aberration in the Evolution of Corporate Law?

The so-called ‘shareholder value’ norm is not simply or even principally a legal rule or principle. It is above all a practice which came to shape managerial behaviour in large, listed American and British firms, and increasingly those in other jurisdictions, in the last decades of the twentieth century. During this period, institutional investors began to refer to themselves as corporate ‘owners’.¹⁵ Share options accounted for an increasing proportion of top executive remuneration.¹⁶ Corporate performance was evaluated using shareholder-value based metrics, which are continuously evolving.¹⁷ Hostile takeover bids and the interventions of activist shareholders were invoked to ensure that corporate assets are being efficiently used within firms and, if they were not, that they were then redeployed elsewhere in the economy.¹⁸ Employees were encouraged to hold corporate stock in a variety of forms and to see their pensions as investments dependent on stock market performance.¹⁹

As recently as the 1960s, the mission statements of large companies and the public declarations of industry bodies such as the CBI in Britain and the US Business Roundtable referred to corporate objectives in entirely different terms.²⁰ Companies should, it was suggested, be providing secure jobs and good working conditions; they should minimise environmental damage; and they should seek close ties with local communities. They should accept their fiscal obligations in a responsible way, knowing that the maintenance of public infrastructure ultimately depended on the surplus which they generated. These corporate mission statements normally did not mention shareholders at all. This was deliberate. Shareholders were seen not just as passive, but as *irrelevant* to the running of the company.²¹ In the middle decades of the twentieth century, company law in the UK and the USA took the clear view that management was the responsibility of the board alone. The practice was for the board to delegate that power to a cadre of professional, salaried employees, few of whom would hold stock in the company. The shareholders not only had no legal right to intervene in management issues; they rarely exercised the few voice rights they had. AGMs were largely formalities.

Notwithstanding the policy focus in recent years on the strengthening of shareholder rights, company law regimes continue to provide that the directors, and not the shareholders, have the principal responsibility for the management of the company.²² Thus company law sees the corporation as an exercise in group cooperation based on delegation. Property rights are pooled and held in the form of collective assets which are ring-fenced or ‘partitioned’ for the

benefit of the organisation.²³ The company exists to take advantage of the mutual specialisation of the assets thereby placed at its disposal. Without such specialisation, it has no comparative advantage over contractual or ‘market-based’ forms of economic organisation. For specialisation to create a surplus, there must be a governance structure which recognises that each of the relevant inputs has value to the firm.²⁴ The principal objective of this governance structure is to avoid mutual defection by the owners of those inputs. The permanence of the corporation as a legal form, and its separation from each of the groups supplying inputs (including the shareholders), is the basis for its continuity. This averts the end-game problem and with it the threat of non-cooperation.²⁵

Although this core feature of corporate form is sometimes referred to as ‘permanence’, ‘indeterminacy’ might be a better term. Company law and employment law both recognise the importance of indeterminate or open-ended commitments. Capital is tied up, not permanently, but for an indeterminate period. The shareholders can neither simply demand it back, nor is there a sunset clause.²⁶ Likewise, the so-called ‘permanent’ or ‘lifetime job’ is better understood as the indeterminate-duration contract of employment, with no clear end point identified. In a market economy, no company, and possibly no other organisation, can guarantee permanent employment, because restructuring is an ever-present possibility; but no more can the company guarantee to produce returns for its investors. The company is nevertheless more than the sum total of the contracts entered into on its behalf.

Employees are formally absent from Anglo-American company law, by and large, as are creditors, and it is only the shareholders, as members, who have the right to hold the board to account and to replace it if they are not happy with the direction of the company. To say that the directors, let alone the managers or employees, are thereby constituted as the ‘agents’ of the shareholders, as contemporary economic theory does, is, however, to glide over a complex bundle of rights, obligations and expectations which make up the ‘default terms’ of the corporate contract. Agency implies delegation and, conversely, accountability, but not necessarily unilateral control. Company law traditionally shielded managers and employees from direct shareholder control, using the concept of separate and permanent corporate personality to this end.²⁷ To argue that directors’ fiduciary duties were owed to the company and not to the shareholders, as company law did (and in principle still does, although there are a growing number of situations where shareholders are owed duties directly, as in the case of takeover bids), was more than just a rhetorical device. It preserved the autonomy of management, leaving it free to mediate between the different corporate constituencies, with only the most minimal of judicial or regulatory supervision. As long as the enterprise was a going concern, company

law had almost nothing to say about the distributional arrangements made to ensure its continuation; intervention was generally confined to endgame situations, such as insolvencies and takeovers.

The corporation or company can therefore be defined as *a legal mechanism for promoting group cooperation in production*. It is important to note that the legal or juridical concept of the company is narrower here than the economic concept of the firm. Thus there are legal aspects of the ‘firm’ as a productive entity which are not captured by company law, but which are to be found in complementary and related fields such as employment law, insolvency law and tax law. Although employees and creditors do not feature much if at all in core company law, they are inescapably present in the economic or organisational entity the ‘firm’. Employment law, insolvency law and tax law may be defined separately from the field of company law, but they interface with company law at numerous points, and the law of the business enterprise cannot be viewed in the round unless the interactions between these areas of law are taken into account.²⁸

The legal idea of the corporation is the result of developments, mostly incremental but occasionally involving radical breaks with previous practice, over many centuries. There is a tendency to see the present-day corporate form as a pinnacle of evolutionary fitness – as the culmination, in other words, of a process of institutional selection, which has made it uniquely well suited to its current tasks. The basic features of the modern corporation – separate personality, centralised management, limited liability, free transfer of shares – have come into being, it is said, to meet the needs of the modern business enterprise, and, as such, will be found whenever and wherever that model exists.²⁹ A historical perspective tells us, however, that the features of the corporate form did not evolve in this way, and that its current features are not inevitably and universally linked to the currently prevailing form of the business enterprise.

The individual elements of the modern corporate form existed independently of each other, in different contexts, and at different times.³⁰ Joint stock, in seventeenth and eighteenth century England, did not always entail either limited liability or free transferability. In the British industrial revolution, few manufacturing companies had either limited liability or separate corporate personality. Trading companies and utilities, which did have these features, were set up by Act of Parliament and, as a result, tightly regulated, often by reference to what were understood to be ‘public interest’ criteria. Free incorporation with limited liability, once established (only in stages in the 1840s and 1850s), was, to start with, largely ignored by industrial firms. Enterprises which incorporated as commercial companies had to define their objectives

tightly and, for much of the nineteenth century and early parts of the twentieth century, were tightly regulated by the *ultra vires* doctrine and associated judicial techniques.

Thus the modern business enterprise appeared, in Britain at least, at a time when many of the supposedly essential features of the company law of today had not yet been invented or at least had not been unified within a single juridical form. Moreover, the emergent corporate forms of that earlier period were buttressed by mechanisms which have since been discarded, such as the public interest requirements of the private Acts that were used to establish many companies. The idea that the corporation of today represents the last word in legal efficiency is highly misleading. Legal institutions develop over time in an uneven and imperfect way. They are as much the product of lock-in and contingency as they are of competitive, ex-post selection. An appropriate biological metaphor would see them not as evolutionary peaks but as ‘frozen accidents’,³¹ configurations reflecting the original conditions of their emergence, which have only with great difficulty, and at some cost, been adjusted to later environments.

There are good reasons for thinking that the current legal form of the business enterprise is not well suited to its environment. The legal form of the company assumes a set of external conditions (external, that is, to the law) which no longer hold. The company limited by share capital is a structure which locks the shareholders in, in return for conferring upon them, and them alone, voice and decision-making rights which enable them to hold management to account. In such a structure the shareholders are the residual claimants in the sense that they are exposed to the residual risk of the failure of the corporate venture. They are entitled, conversely, to the residue of the surplus if the company is successful.³² This symmetry between risk and reward explains much about the traditional legal structure of the enterprise, in particular company law’s silence on other corporate constituencies, whose interests are left to be protected by contract and by regulation in complementary areas such as employment law.

This model is appropriate for cases where there is shareholder lock in. Examples include founder-controlled or family-owned firms in which the principal shareholders are also contributing their Labor and skills to the firm, and larger, listed companies in which the predominant shareholder or blockholder represents a family interest, another enterprise, or a commercial bank either acting in its own right or on a large body of individual shareholders. In the final decades of the nineteenth century and the early decades of the twentieth, a period, like the present, when financial markets were exerting a growing influence over corporate management, most listed companies in Britain and America still had significant family or other controlling interests; this was

also the case in Germany and to a lesser degree in France.³³ There were debates in a number of countries around this time concerning the dangers of excessive managerial autonomy at a time of increased ownership diffusion. The US debate, associated with Berle and Means's classic work, although it is today the best known, was one of the last to begin.³⁴ In the last decades of the twentieth century and the first decade of the current one, up to the onset of the crisis in 2007, similar concerns were raised within the framework of the debate over ownership and control, alongside a degree of liquidity in capital markets which was historically unprecedented. Particularly in the British and American systems, but to a growing extent in France and Germany too along with other civil law or coordinate regimes, family ownership had declined. It was replaced initially by institutional ownership in the form of widely diversified pension funds and mutual funds. A growing share of publicly-traded equities was held on a short-term basis by hedge funds, although in forms far removed from any straightforward notion of ownership: share lending, securitised instruments, and various kinds of options and futures contracts.³⁵

The traditional legal model of the company is ill designed for such an environment. This is not because of the so-called agency problem which arises from the separation of ownership from control. This position argues, following Berle and Means, that dispersed owners are not in a position to control over-powerful managers. The true problem, however, lies elsewhere: it is that in capital markets characterised by a high degree of liquidity – and above all in the super-liquid capital markets of recent times – shareholders are no longer the residual risk bearers which the traditional company law model assumes them to be.

The agency costs of dispersed ownership are generally put forward as the justification for corporate governance reforms affecting listed companies. The response to corporate failures and scandals, which have grown in number and significance since the 1970s and in particular since the early 1990s, has been to confer more oversight powers on shareholders, and to impose tighter accountability and reporting requirements on managers.³⁶ Shareholders have gained significant new powers and influence. This is highly paradoxical: shareholders have become more powerful at a time when the contribution of equity capital to the financing of the corporate sector has been in decline; and the decline has been greatest in those countries, Britain and America, which have spearheaded the corporate governance revolution.

It is well known from empirical studies, but insufficiently recognised by theory, that large firms in almost all countries rely mostly on retained earnings to finance physical investment projects.³⁷ External finance plays a relatively minor role and new equity issues are even less significant. It is less well

known, but again equally clear empirically, that the net contribution of equity finance to new investment projects in the UK and US has been negative since around 1980.³⁸ In the early 2000s the trend intensified. The proportion of net equity issues to gross fixed investment in non-financial companies was positive, although never more than around 10%, between 1950 and 1979. It turned negative after 1980 and between 1985 and 1989 net issues were fully 25% less than investment; parity was almost achieved in the early 1990s but the relationship became negative again, to the extent of nearly 15% between 1995-99 and over 20% between 2000 and 2006.³⁹ This change was brought about by increased dividend payments, and in particular through share buy-backs (in which the company itself purchases some of its issued stock from the present shareholders), from the early 1980s onwards. As capital has been retired through share buy-backs and as a consequence of mergers and takeovers, equity has been replaced by debt. The growing indebtedness of firms has exacerbated their financial fragility.

There are two ways of interpreting the phenomenon of increasing shareholder power being coupled with decreasing shareholder contribution to the financing of firms. One is to see it as the vindication of agency theory and of the corporate governance reforms which began in the 1990s. Shareholders are now in a position to ensure that managers do not divert free cash flow. Projects which do not earn a rate of return at or above the returns available elsewhere on the market, even if they are profitable in themselves and create stable jobs, can be terminated on the grounds that they 'destroy shareholder value'. Dividend payments and share buy-backs do not just benefit shareholders; they assist in the recycling of capital to growing areas of the economy most in need of it.⁴⁰ Another way of viewing the process is to see it, more prosaically, as rent-seeking by shareholders, exploiting the liquidity which is at their disposal to extract value from the firm. This need not be, but may well be, done at the expense of the company's longer-term organisational goals, and to the detriment of other constituencies. Survey evidence suggests that managers of listed companies in the US are becoming more reluctant to engage in long-term projects, citing the need to meet earnings targets on a yearly or even quarterly basis.⁴¹ Short-term performance targets may be being met at the expense of long term value maximization.

Since this is not in shareholders' interests, how can it be happening? If the capital market were perfectly efficient, it would not be (by definition). Asymmetric information is one possible explanation for investors' short-term focus; shareholders cannot easily evaluate managers' claims to be investing for the longer-term, and managers may not be able to send credible signals of the value-maximising potential of projects. Less abstractly, fund managers acting as the agents of shareholders have few incentives to look beyond the point at

which they are performance-assessed (often the next quarter) while managers remunerated through share options and bonuses linked to share price movements would simply be behaving rationally if they had regard to the same short-term time horizon, at least in cases where share options have short vesting periods.⁴²

The current negative contribution of equity finance to physical investment in the US and UK is a new phenomenon – between the 1950s and late 1970s the contribution of equity finance to investment was positive⁴³ – and appears to be specific to the Anglo-American economies: it plays a positive if small role in funding investment in continental European and east Asian systems, and in the developing world it plays a positive and substantial role.⁴⁴ In Britain and the United States, new firms, start-ups seeking listings, benefit from direct infusions of capital from the stock market. The complex institutional architecture of venture capital funding, with venture capitalists acting as agents of institutional investors and others to oversee a tournament-style competition between start-ups, could not work without a liquid capital market which enables the venture capital firm to cash out its gains and reward the tournament winners.⁴⁵ Yet, what works for start-ups at a pre-market stage does not work once the same firms enter the stock market: many high technology firms insert anti-takeover devices and retain weighted voting rights for insiders in an attempt to deflect short-term shareholder pressures.⁴⁶ This trend would be troubling if it were indeed the case that venture capital funding for start-ups required the continuous recycling of ‘free cash flow’ from established companies.

What do the capital markets offer mature firms? Agency theory suggests that they provide mechanisms of discipline and evaluation. Shareholders monitor performance and are in a position to discipline weak management by exiting the company. Share price captures expectations of future managerial performance. Failing firms or those likely to fail will be subject to a takeover bid or, in the absence of a direct third party intervention, a restructuring initiated by the existing management team. Successful firms, or those seen as likely to succeed in future, can deploy the liquidity which a rising share price provides them to fund new acquisitions.

According to this point of view, shareholder value extraction works in the public interest, by inducing superior corporate performance, and recycling capital to more highly valued uses. It is far from clear empirically that this is the case. The balance of evidence suggests that hostile takeovers in Britain and America do produce added value – just. Firms subject to hostile takeover outperform the industry average, but only by a small margin, and this is an average effect. The variation in outcomes is extreme, in both directions. Hostile takeovers at least do better than agreed ones, which on average lead to a

loss of value. Taking agreed mergers and hostile takeovers together, the returns to shareholders in acquiring firms remain negative in a significant proportion of cases. There is also a highly contingent relationship between financial performance and the introduction of ‘good practice’ corporate governance changes by firms, such as the increasing the number of non-executive directors or separating the chair/CEO roles.⁴⁷

Hostile takeovers and restructurings almost invariably lead to asset disposals and hence to downsizing.⁴⁸ Downsizing has been linked to higher dividend payouts.⁴⁹ Restructuring can lead to more efficient use of Labor in the short run, as empirical studies point to productivity improvements post-takeover.⁵⁰ It is more difficult to measure the possible longer-term impact of a ‘breach of trust’ on the part of the firm, in the sense of a reneging on implicit contracts entered into by the previous management. The cost of displacement for workers made redundant also has to be taken into account. There is evidence for the UK and USA that job loss through redundancy entails a drop in earnings lasting several years, suggesting that workers dismissed as a result of restructuring lose part of the value of the firm-specific human capital they had previously accumulated.⁵¹

Downsizing, in general, has been one of the factors behind growing wage inequality in Britain and America, where the gap between white collar and blue collar wages has been increasing since the 1970s. The growth of shareholder influence over the firm in Britain and America has gone hand in hand with a historic reversal of the trend for a growing proportion of national income to be taken by Labor; since the early 1980s, the factor share of capital has been going up. Wage levels in America have been stagnant in real terms across the board during this period, and the median wage has fallen at the same time as CEO pay has risen rapidly in large part as a result of the growing use of share options and other equity-based remuneration systems in top executive pay. The top 1% of earners in America saw their pay rise by 181% between 1972 and 2001 while median earnings fell by 0.4%.⁵² More generally, and notwithstanding the importance of institutional share ownership, shares are disproportionately held groups higher up the income scale, with the effect being particularly skewed at the top.⁵³ This is partly why the share of national income taken by the top 1% in Britain and America, which was 20% in 1925 and declined to 7% and 10% respectively by 1980, has risen to 13% and 17% respectively by 2004. Top income shares were stable over the same period in continental Europe and Japan.⁵⁴

In principle, share price increases, which are not supported by underlying corporate performance, are ‘virtual wealth’ which cannot be accessed without triggering a stock market fall.⁵⁵ However, from the mid-1980s, a high and

rising share price began to be a source of value in itself for companies, which they could use to lever access to debt finance. Rises in the nominal value of shares were accompanied by increased flows of debt-based finance and consumer credit, enabling firms and households to realize the virtual gains stemming from equity ownership.⁵⁶ Companies used a rising share price as collateral and as a cash equivalent in order to raise financing for takeover bids, while households used rising asset values (in equities initially and, more recently, in property) in the same way to increase their indebtedness. In Britain and America levels of household debt had reached unprecedented levels by the mid-2000s, compensating to some degree for falling or stagnant earnings (in America); although, again, the effect of this process on household wealth was uneven, and skewed towards the higher income groups. In America the highest 20% of households by income, which disproportionately benefited from rising share price values, also accounted for most of the rise in household indebtedness and the corresponding overall fall in the personal savings rate.⁵⁷

In part as a consequence of the changes to corporate governance just described, the British and American economies of the 2000s experienced a process of financially-driven growth similar to that of earlier phases of rapid stock market development, such as 1920s America: with growing access to credit, asset values were inflated, firms and households took on additional debt, and growing inequality of earnings and wealth were the result.⁵⁸ There was economic growth, but on fragile foundations. These conditions set the scene for the corporate failures of the 2000s.

3. Shareholder Value and Corporate Failure: from Enron to the Global Financial Crisis

In Enron's case, an inflated share price, the result of the bubble in new economy stocks of the late 1990s, distorted the company's priorities beyond the point where its highly ambitious business plan could be maintained. The company, initially a utility, came to act if it was principally a clearing house for energy futures. Enron was the market intermediary for futures contracts and other risk-allocation devices which it claimed to be able to price uniquely efficiently, thanks to its combination of an underlying utility business with a market trading 'overlay'. It was undoubtedly innovative, as numerous business school case studies of the time pointed out, although some of its claims to have invented 'new markets' and a 'new corporate model' should in retrospect have been a warning sign. Enron's business plan failed not because its executives were paying themselves huge sums, nor because its non-executive board members were paid high consulting fees, nor even because universities and hospitals to which board members were connected were given generous donations. It failed because it used its rising share price to finance off-balance sheet transactions,

the aim of which, in the company's final stages, was to inflate the share price by exaggerating the company's earnings. The strategy could not survive the general stock market fall which began in early 2000: as Enron was using its own stock to capitalise its SPVs, the fall in the value of its shares, made these SPVs, and ultimately the company's own balance sheet position, unsustainable.⁵⁹

Enron was a company 'laser focused on earnings per share' to the degree that, in its final stages, the underlying business ceased to matter except as a means of maintaining the impression of high earnings. But Enron was simply taking to extremes a strategy which many other companies were to follow in the course of the 2000s. The lessons of the Enron case were missed in part because its failure, while catastrophic, was confined in its effects. State pension funds which had over-invested in Enron stock suffered significant losses, but institutional shareholders with diversified holdings had limited exposure to the failure of a single firm. Those bearing the greatest residual risk were Enron employees who not their jobs and also much of their retirement incomes. Enron's practice of pension fund 'self-investment', coupled with a pensions 'blackout' in force during the weeks prior to its bankruptcy, left these employees doubly exposed to the consequences of the company's failure.

Enron's fall was interpreted as an isolated case of corporate fraud or, alternatively, as a corporate governance failure which stemmed from conflicts of interest among senior managers and board members. The company's collapse undoubtedly revealed fraud and conflicts of interest which would otherwise have been undiscovered. However, the more fundamental causes were a combination of the context the company was operating in – the dotcom boom and related share price bubble of the late 1990s – and its strategy of pursuing share price maximisation through the aggressive use of self-capitalised SPVs.

The view that Enron was a corporate governance 'scandal' found clear expression in the Sarbanes-Oxley Act of 2002. But this legislation made the basic problem – the tendency for share price maximisation to displace productive activity as a corporate strategy – worse. Almost every change made by the Sarbanes-Oxley Act, from requiring additional and more frequent reporting to loading new obligations upon corporate governance actors from boards to advisers, strengthened the shareholder value norm. Sarbanes-Oxley, and the associated changes introduced to listing rules, reinforced the idea that the board should consist as far as possible of outside directors with limited contact with the company whose job was to monitor the executive team. This was despite the absence of any evidence to link ineffective monitoring to the lack of independence of directors, either at Enron or elsewhere. A *better informed* audit committee when told by Enron's auditors in the late 1990s that

its SPV structures were ‘at the edge’ of acceptable practice, might not have replied that they were, instead, ‘leading edge’.⁶⁰

Sarbanes-Oxley followed a familiar pattern in company law. The history of company legislation in Britain in the twentieth century has very largely been one of successive responses to high-profile corporate failures. British Companies Acts have largely been backward looking, and have rarely been successful in anticipating the form of future failures.⁶¹ Shortly after the passage of one such Act, a commentator complained that ‘one of the evils of the system of “boom” finance... is the interlocking of companies whose balance sheets are designed to conceal their mutual relations. Under this system it is possible to buttress up the credit of A company of the group by B company of the group operating in A’s shares on the Stock Exchange. Such methods of finance cannot always be detected or eliminated’.⁶² It was unfortunate then that ‘the new Companies Act... failed to require a holding company to publish a consolidated balance sheet and income account or an interlocking company to publish details of its holdings. It is, of course, impossible to legislate the unscrupulous promoter out of the City, but his operations would be rendered less easy if an amendment to remedy this defect of the Companies Act were brought on the Statute-book’.⁶³

This commentator was writing about the events not of 2008 but of 1929. The requirement that companies should produce consolidated balance sheets was one of the reforms put in place in the UK by the 1947 and 1948 Companies Acts and which paved the way for the modernization of company accounts and the post-war rehabilitation of stock markets based on a disclosure regime. The same process was a pivotal part of the New Deal reforms to company and securities law in the United States, following the Great Crash. How then was it possible for companies in the early 2000s to be using special purpose entities and other off-balance sheet vehicles to conceal potential liabilities, as Enron did? Financial regulators had been persuaded to accept the relevant changes to accounting auditing principles in order to facilitate off-balance sheet modes of financing. The move was triggered by the interdependence between rising stock market values and new forms of financial intermediation.

In the more recent financial crisis, the first significant corporate failure was that of the British bank and former building society, Northern Rock. As in 1929, this had been preceded by the adoption of a (huge) Companies Act which turned out to be mostly irrelevant to the crisis. Yet, a failure such as that of Northern Rock had been predicted. At the point when building societies legislation was liberalised in the late 1980s, it was argued (although to little avail at the time) that inadequate controls were being placed over the process of their conversion into listed companies. From their earliest beginnings in the British industrial

revolution, building societies were attractive to savers and borrowers alike precisely because they were not commercial banks, which were prone to take greater risks with deposits and had a much high failure rate. Building societies had unique corporate arrangements, underpinned by legislation from the Victorian period, which were designed to minimize the risks of such failures. Their legal structure ensured that the surplus generated from their operation was preserved for future generations of house buyers. The depositor-members of a building society, despite being ‘shareholders’ in a formal sense, had no means of accessing that surplus, until the passage of deregulatory legislation in 1986. This allowed building societies to become listed companies and make an almost immediate cash disbursement to their members. Because it was possible to become a member by paying a small deposit into a savings account, and accessing, on the conversion of the society to public listed company status, a sum several times the amount of that deposit, it did not take long for building societies to come under pressure to convert to commercial bank status, and many did. Incentives for managers, whose pay rose considerably upon conversion, also helped drive the process. Mass conversion from mutual to commercial bank status took place in the face of evidence that long-term savers and borrowers preferred mutuals for their long-term orientation and local links. It also gave rise to a rare natural experiment for corporate governance forms. The risk of moral hazard posed by deregulatory legislation was much discussed when the conversions of the 1990s were at their height. The failure of Northern Rock demonstrated that these concerns had been more than merely theoretical.⁶⁴

Northern Rock publicly made strong claims for the effectiveness of its corporate governance arrangement as a listed company. After its failure, it was argued by senior members of its board that the circumstances of its collapse could not have been foreseen. The bank had insufficient reserves to cope with the freezing up of the inter-bank credit market which began in the summer of 2007. While this can be characterised as an unusual event, the point remains that the ‘straitjacket’ of the traditional building society structure had been there to minimise exposure to precisely such risks. The nature of the rescue of Northern Rock was also significant. During the winter of 2007-8, UK government intervention safeguarded the bank’s depositors. The government also went to extreme lengths to safeguard the interests of its shareholders, even those of the speculative funds which purchased Northern Rock stock in the anticipation of a government-led rescue, only accepting after a considerable interval that de facto nationalisation of the bank was unavoidable. As in the case of Enron, the residual risk fell mostly on the employees who were made redundant, and on the taxpayer.

This pattern of deregulation leading to financial fragility and eventually to corporate failure has been repeated several times as the financial crisis

developed. The US investment banks most affected by the crisis of 2008 were among those which had lobbied most strongly for the repeal of the Glass-Steagall Act and for the lifting of minimum deposit requirements a few years before. The British bank HBOS, like Northern Rock, was a creature of building society deregulation. As bankruptcy proceedings for Lehmann Brothers continued into 2010, documents revealed a now-familiar pattern of the use of SPVs to give a false impression of earnings growth in the bank's final months.⁶⁵ In many of the failed or near-failed banks, there is evidence that managerial incentives were skewed towards the short-term, as executives came under pressure from boards to maintain share-price growth through aggressive trading strategies, increasing leverage, regular restructurings, and participation in mergers and takeovers.⁶⁶

Although by no means the sole cause of the corporate failures of the late 2000s, shareholder-value oriented corporate governance significantly contributed to them, providing an important part of the external context of financial instability, and exacerbating the misalignment of incentives within firms. Yet neither the various government-led rescues, nor the wider regulatory response, have addressed the role played by corporate governance norms and structures in precipitating the crisis. In the UK, the Walker review⁶⁷ of banking sector corporate governance recommended additional powers for non-executive directors and a strengthening of the role of the board in monitoring executive decision-making as means of averting a future crisis. Stricter rules on director independence in the UK and USA have brought about a situation in which many non-executive directors 'lack industry-specific experience or knowledge'. Thanks also to these same changes, 'corporate directors – in contrast to their predecessors of decades past – now have a clear focus on one constituency, the equity holders, and that is the constituency most interested in aggressive risk taking'.⁶⁸ Thus as with Sarbanes-Oxley earlier in the decade, Walker's response does not address, and indeed is likely to exacerbate, the underlying problem of excessive focus on shareholder returns.

An alternative solution, the remutualisation of parts of the banking sector, has been canvassed in the UK,⁶⁹ but has yet to be adopted. The rescue of Northern Rock set a pattern of government subsidy for depositors and shareholders, displacing losses on to employees and taxpayers. Scaled up, this is now being repeated as western governments respond to the costs of the wider economic rescue package of 2008-9 by cutting welfare state expenditure. Under these unpromising circumstances, what are the prospects for post-crisis corporate governance?

4. Corporate Governance after the Crisis

In the absence of a new regulatory framework, corporate governance practice is likely to respond in the near future to developments within financial markets, which include changes in the composition of share ownership and shifts in investment strategy. A first factor to consider is the increasingly rapid disintegration of the defined-benefit pension scheme model. This is both cause and effect of shift to shareholder-value oriented corporate governance.

The defined-benefit pension scheme has been the standard form of the private-sector occupational pension fund in Britain for most of the twentieth century.⁷⁰ As recently as the mid-1990s, there was still near-universal support in official and employer circles for the defined benefit model. Unlike the social insurance schemes of the continent of Europe, which, at that stage, were mostly in deficit and facing considerable future liabilities thanks to demographic factors (the so-called ‘ageing’ of the working population), the UK system was thought to be stable and sustainable. The long-term liabilities of the state scheme had been limited by cuts carried out in the 1980s, and employer-based schemes, being funded through investments as opposed to being paid out of current contributions in contrast to the ‘pay as you go’ schemes of the continent, provided an apparently secure basis for future retirement incomes.

Fifteen years on, the UK route no longer appears such an attractive option. Numbers in defined benefit schemes are now only a third of the level they reached at their height in the 1960s, and are falling quickly. Employers are closing defined benefit schemes to new entrants and offering them less secure defined contribution options instead. In some cases, defined benefit schemes are also being closed to future contributions from current members. In others, employers are ending any involvement in their schemes by selling the assets in funds to insurance companies and to pension buyout firms which have recently emerged to specialise in this type of transaction. Where this happens, liabilities attaching to the vested rights of pensioners and remaining active members are absorbed by the purchaser, which may continue to keep schemes open to current employees on the same terms as before, but generally will not do so.

In the 1980s and 1990s, employers used pension scheme surpluses to take contribution ‘holidays’. In the 2000s, most schemes have been in deficit. A significant factor here has been a tighter regulatory framework coupled with a new accounting standard, FRS17. Beginning in the 1990s, regulation imposed new costs on funds, requiring limited indexation of benefits with inflation, and tightening reporting and disclosure standards. Shortfalls in schemes were reclassified as debts owed to the fund by the employer. From 2003, it became possible for trustees, backed up by powers granted to the pension regulator, to

claim these amounts as a sum due from the employer, even if the employer was paying out and the fund was solvent. Pension schemes now began to appear as a significant long-term constraint on the financial stability of sponsor companies, with the potential to affect their share price and credit ratings.

Under the original trust model, the employer had considerable flexibility to set the terms of pension scheme contributions and entitlements.⁷¹ It could set the rules of the scheme and reserve discretionary powers both to itself as settlor and to the trustees, both over the level of contributions and over the content of the basic pension promise outlining the terms on which retirement and other benefits would be paid. Employees, their contributions notwithstanding, were in the position of passive beneficiaries. While not volunteers (since they contributed financially to schemes), their contractual rights were limited, since employment contracts were drafted in such a way as to reserve powers of amendment to the employer in the same way as trust deeds reserved similar powers to trustees. There was little or no standardisation of the terms of trust deeds and limited external regulation of their contents. The trustees were normally senior managers and directors of the sponsor. This apparent conflict of interest was perhaps less of a problem than it seemed: trustees and beneficiaries had a common interest in maintaining the viability of the sponsor-employer and in ensuring that it was in a position to continue supporting the scheme, since it could not be legally compelled to do so. Overlapping membership of the main company and the board of trustees gave expression to an underlying identity of interest between the sponsor and the fund.

The legal nature of the defined benefit pension fund changed decisively in 2003 when new legislation deemed pension fund shortfalls to be debts owed by employers to schemes, with the regulator given extensive powers to oversee their collection. From the government's perspective, such powers were essential if employers were not to load liabilities on to the Pension Protection Fund which had shortly before been set up to meet the liabilities of insolvent schemes. But the problem was that while employers now faced additional liabilities, they still had the option, inherent in the trust model, to end their commitments with regard to rights yet to vest, and this is what they have been doing in increasing numbers.

The fate of defined benefit pension funds casts into sharp relief the wider transformation of corporate governance which has taken place in the UK. In many respects they mark its *terminus ad quem*. Since the 1960s, institutional investors have been to the fore in pressing for corporate governance standards which they saw as necessary to protect their position as residual risk bearers. To safeguard themselves against what they saw as over-mighty managers, they won greater voice for external directors, the separation of chair and CEO roles,

and a clearer internal audit function. They ensured that shareholders would decide the outcome of takeover bids on financial grounds alone, with the board playing an informational role. Governance and management were not just to be separated, but placed in a clearly hierarchical relationship, with the latter subject to the former. All this was apparently being done in the name of the beneficiaries of pension funds and other mechanisms for collective saving and insurance. Employees might be made more insecure by the threat of restructuring the end of expectations of permanent employment, but they benefited from enhanced returns to the pension funds. Insecurity of employment would be compensated for by greater security of savings and retirement income.

That idea has not survived successive takeover waves and the metamorphosis of the market for corporate control into new forms for extracting value from companies, of which the pensions buy-out market is one of the recent manifestations along with private equity and hedge fund activism. Shareholder-value led corporate governance has become one of the main drivers behind the erosion of pension fund security and of employment security more generally. The new accounting standards for pension funds have crystallised risks which, in the recent past, were managed through a combination of fiscal subsidies and supportive regulation. The closure of defined benefit schemes is now justified in shareholder-value terms.⁷²

The decline of the defined benefit model will most likely see a reduced role for pension funds as capital market actors, and a growing one for private equity and hedge funds. In principle, a defined benefit pension fund should take a long-term view of its investments. In practice, pension fund trustees delegated investment decision to specialist asset managers who were set quarterly performance targets. Churning of shares was common. There nevertheless remained a sense in which a defined pension fund (at least before the recent trend in pension scheme abandonment) had an indefinite investment horizon; it had to take a view of the sustainability of the fund based on the returns it would be making when contributors retired in several decades' time. Private equity investment firms, which take listed companies private and then seek to capitalize returns from restructuring via a trade sale or re-flotation, and activist hedge funds, which take medium-sized stakes in companies with a view to triggering dividend increases or share buy-backs, again on the basis of restructuring, generally seek to exit their investee companies within a four to five period at most. Their time horizons are therefore relatively short-term by comparison with that of the defined benefit pension schemes, and are finite.

Private equity investment and hedge fund activism are becoming complementary strategies, both of which depend on an approach to value

extraction which is justified in shareholder-value terms, but which also results in the displacement of losses on other corporate constituencies.⁷³ Private equity-led buy-outs almost invariably lead to short-term redundancies and a longer-term loss of job security and undermining of collective employee representation. Interventions by hedge fund activists also tend to trigger job losses as companies downsize as part of a restructuring process or divert capital from reserves to pay for increased dividends and share buy-backs. Hedge fund interventions of this kind are associated with short-run abnormal returns for shareholders,⁷⁴ but inferior performance, reflected in reduced returns on assets, by target firms over the medium to long term.⁷⁵

These approaches are, nevertheless, becoming part of the corporate governance mainstream. Private equity investment companies may account for as much as a fifth of private-sector employment in the UK.⁷⁶ Almost half of US listed companies have a hedge fund investor with 5% or more of the company's stock. Although total hedge fund holdings are a small proportion of the overall market, trades by hedge funds just before the financial crisis accounted for 18-22% of turnover on the New York Stock Exchange and 30-35% of turnover on the London Stock Exchange. In addition they were responsible for 55% of all credit derivatives trading.⁷⁷

Under these circumstances, it is difficult to be optimistic about the prospects for an investment strategy which would see shareholders playing a role, either directly through activist interventions or indirectly through the information effect of share prices, in monitoring the effectiveness of firms' human resource strategies, or their approach to wider issues of social and environmental sustainability, over the long run. It is possible to imagine 'a different kind of stock exchange, a social stock exchange... that shows which companies are especially successful in the social arena'.⁷⁸ Metrics exist by which companies' social and environmental records are ranked and benchmarked.⁷⁹ Stock exchanges have developed indices for ethical stocks. The methods developed, initially by private actor, are gradually being incorporated into accounting standards. There is a degree of fusion between corporate governance norms, which focus on accountability, and SRI norms which focus on the financial and reputational risks to companies of social and environmental harm. But in systems which treat the corporation as the shareholders' private property, the highest-valued companies will continue to be those which are most effective in externalising the costs of their activities on to others.

5. Conclusion

The company is a complex, multi-functional institution. In the fairly recent past it has provided a basis for technological innovation and the recycling of capital, while also offering meaningful, stable employment and long-term financial security. It seems increasingly unlikely that the corporation of the near future will be able to fulfil all these goals. Contemporary economic theory tells us that the human dimension is inessential to corporations, the core of which is the control exercised by property holders over the non-human assets of the firm; and that enduring organisational identities are irrelevant in what is simply a space for contracting. The reality of the contemporary corporation increasingly mirrors this view. Company law retains a vestigial sense of the corporation as an organisational entity which is greater than its constituent parts, but this idea is under pressure from an alternative conception of the corporate form, which sees it as an object of financial arbitrage. The economic growth which shareholder-value based management helped to stimulate has nevertheless turned out to be fragile, and one of its principal consequences, growing inequality, threatens social cohesion.

Under these circumstances, some urgent rethinking about the goals and modes of operation of corporate governance is required. For the time being, the logic of shareholder value is still playing itself out. A long-run perspective, however, suggests that financial upheavals trigger fundamental changes of direction in company law and policy, and the crisis of the late 2000s is unlikely to be an exception.

Notes

¹ J. Bakan, *The Corporation. The Pathological Pursuit of Profit and Power* (London: Constable, 2004), at pp. 1-2.

² H. Gintis, *The Bounds of Reason: Game Theory and the Unification of the Behavioral Sciences* (Princeton, NJ: Princeton University Press, 2009), at p. 49.

³ G. Bolton and R. Zwick, 'Anonymity versus punishment in ultimatum games' (1995) 10 *Games and Economic Behavior* 95.

⁴ L. Strine, 'Human freedom and the two Friedmen: musings on the implications of globalization for the effective regulation of corporate behaviour' Torys Lecture, University of Toronto, 20 September 2007, at pp. 41-2.

⁵ *Ibid.*

⁶ *Ibid.*, at p. 26.

⁷ R.H. Coase, 'The nature of the firm' (1937) 4 *Economica* (NS) 386.

⁸ M. Jensen and W. Meckling 'Theory of the firm: managerial behaviour, agency costs and capital structure' (1976) 3 *Journal of Financial Economics* 305.

⁹ O. Hart, *Firms, Contracts and Financial Structure* (Oxford: Clarendon Press, 1995).

¹⁰ S. Jacoby, 'Finance and Labor: perspectives on risk, inequality and democracy' (2008) 30 *Comparative Labor Law and Policy Journal* 17.

¹¹ W. Bratton and M. Wachter, 'The case against shareholder empowerment' (2010) 158 *University of Pennsylvania Law Review* 653.

¹² B. Cheffins, 'Did corporate governance "fail" during the 2008-9 stock market meltdown?' ECGI Law Working Paper No. 124/2009.

¹³ *Walker Review of Corporate Governance of UK Banking Industry* http://www.hm-treasury.gov.uk/walker_review_information.htm (London: HM Treasury, 2009).

¹⁴ M. Aoki, *Corporations in Evolving Diversity: Cognition, Governance and Institutions* (Oxford: Oxford University Press, 2010).

¹⁵ The International Corporate Governance Network, an association predominantly consisting of institutional shareholders, refers to ‘responsible ownership’: (then) ICGN Chair Peter Montagnon, quoted in *FT Fund Management*, 20 August 2007.

¹⁶ L. Bebchuk and J. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004); see also the chapter by William Lazonick – in this volume.

¹⁷ J. Froud, S. Johal, A. Leaver, and K. Williams *Financialisation and Strategy: Narrative and Numbers* (London: Routledge, 2006), ch. 3.

¹⁸ L. Summers, *London Stock Exchange Bicentennial Lecture* (2001).

¹⁹ K. Ambachtsheer and D. Ezra, *Pension Fund Excellence: Creating Value for Stakeholders* (Chichester: Wiley, 1998).

²⁰ S. Jacoby, *The Embedded Corporation: Corporate Governance and Employment Relations in Japan and the United States* (Princeton: Princeton University Press, 2005).

²¹ J. Galbraith, *The New Industrial State* (London: Hamish Hamilton, 1967).

²² See the chapters by Dalia Tsuk Mitchell and William Allen in this volume.

²³ This is formally stated in Delaware law, for example, and may be inferred from the structure of UK company law and from the model articles of association set out in successive Companies Acts (formerly ‘Table A’).

²⁴ H. Hansmann and R. Kraakman (2000) ‘Organisational law as asset partitioning’ (2000) 44 *European Economic Review* 807.

²⁵ See R. Rajan and L. Zingales, ‘The influence of the financial revolution on the nature of firms’ (2001) 91 *American Economic Review* 206, discussing the implications of the emergence of firms within which the core specialised assets are not alienable, since they are bound up with human capabilities (as opposed to the alienable non-human assets at the centre of the property-rights theory of the firm (Hart, *Firms, Contracts and Financial Structure*). Rajan and Zingales stress the sense in which firms in which human capabilities represented all or nearly all of the enterprise’s value constituted a new phenomenon in the 1990s and 2000s, but from the point of view of the resource-based theory of the firm (originating with E. Penrose, *The Theory of the Growth of the Firm* (Oxford: Blackwell, 1959), all firms, to some degree, had core capabilities which included the know-how, expertise and loyalty of employees. For analyses incorporating this point of view into a legal framework, see M. Blair, *Corporate Ownership and Control* (Washington DC: Brookings Institution, 1995); W. Njoya, 2007, *Property in Work: The Employment Relationship in the Anglo-American Firm* (Aldershot: Ashgate, 2007); on the consequences of the financialisation of the firm, see also the chapter by Zumbansen, in this volume.

²⁶ The theory of non-cooperative games predicts that in a context where the individual parties have strong incentives to ‘defect’ because, in terms of their individual well being, they will always be better off doing so, in part because they cannot make perfectly enforceable agreements to share in the rents from cooperation (as in the prisoner’s dilemma game), the possibility of repeated trading can alter the incentive structure and provide the basis for a stable equilibrium in which aggregate welfare is maximised. Under such circumstances, the role of legal institutions is not to provide perfect contract enforcement (the law cannot supply this on its own if there are positive monitoring and verification costs, which there will be in most situations of complex contracting), but to create an indefinite or indeterminate time horizon for contracting. This is what many of the legal institutions of the firm, including the corporate form and the employment contract, do. See S. Deakin, ‘Learning about contracts: trust, cooperation and contract law’, in R. Bachmann and A. Zaheer (eds.) *Handbook of Trust Research* (Cheltenham: Edward Elgar, 2008) for discussion of this point from a law and economics perspective.

²⁷ On shareholder lock-in, see M. Blair ‘Locking in capital: what corporate law achieved for business organizers in the nineteenth century’ (2003) 51 *UCLA Law Review* 51.

²⁸ See Strine, ‘Human freedom’.

²⁹ See on this point already R. C. Clark, *Corporate Law* (1986), at 5; see also P. Zumbansen, 'The parallel worlds of corporate governance and Labor law' (2006) 13 *Ind. J. Glob. Leg. Stud.* 261.

³⁰ R. Kraakman et al., *The Anatomy of Corporate Law* (Oxford: Oxford University Press, 2004; 2nd ed., 2009).

³¹ See R. Harris, *Industrializing English Law: Entrepreneurship and Business Organization 1720-1844* (Cambridge: Cambridge University Press, 2000) and J. Getzler and M. Macnair 'The firm as an entity before the Corporation Acts', in P. Brand, K. Costello and W. Osborough (eds.) *Adventures of the Law: Proceedings of the Sixteenth British Legal History Conference, Dublin 2003* (Dublin: Four Courts Press, 2005) for the evolution up to the eighteenth century. On the legal structure of nineteenth century firms and the nature of managerial techniques in the industrial revolution, S. Pollard, *The Genesis of Modern Management: A Study of the Industrial Revolution in Great Britain* (Cambridge, MA: Harvard University Press, 1965) remains an important reference point.

³² On the idea of the 'frozen accident' in genetics, see F. Crick, 'The origin of the genetic code' (1968) 38 *Journal of Molecular Biology* 367, and on its application to legal evolution, see S. Deakin, 'Evolution for our time: a theory of legal memetics' (2003) 55 *Current Legal Problems* 1; B. Ahlering and S. Deakin, 'Labor regulation, corporate governance and legal origin: a case of institutional complementarity?' (2007) 41 *Law & Society Review* 865.

³³ See E. Fama and M. Jensen 'Separation of ownership and control' (1983) 26 *Journal of Law and Economics* 301.

³⁴ See generally L. Hannah, 'The divorce of ownership from control from 1900 onwards: recalibrating imagined global trends' (2007) 49 *Business History* 404. Hannah argues that the British position was closest to one in which the ownership of large companies was dispersed, followed by the French, at this point. In the US and Germany, family control remained the norm well into the early decades of the twentieth century in the case of most large industrial and financial corporations. Even in Britain, where dispersion of ownership was encouraged by the 'free-float' rule of the London Stock Exchange which required two thirds of the firm's equity to be made publicly available upon a listing, families and other dominant interests retained effective control of boards and hence of companies. Even in industries with widely dispersed share ownership, such as the railway industry, most small shareholders were rentiers or speculators, and boards were entrenched against external control mechanisms such as takeover bids.

³⁵ See L. Hannah, 'The divorce of ownership from control'. The debate over the separation of ownership and control was not phrased in terms of agency costs as it is today, but in terms of the democratisation of ownership, at a point when 'plutocratic' interests were seen as retaining control through various means despite the wider dispersion of ownership which had occurred in the early decades of the twentieth century. Analogies between the debates of the 1980s and today, on the one hand, and those of the period 1900-1930 can be misleading, when it is remembered, for example, that in many British listed companies, a rule of one person, one vote (not the modern one share, one vote which is a priority of institutional investor interests) was the norm, in part as a consequence of listing rules designed to enhance public access to securities markets.

³⁶ See generally F. Partnoy and R. Thomas, 'Gap filling, hedge funds, and financial innovation', in Y. Fuchita and R. Litan (eds.) *Brookings-Nomura Papers on Financial Services* (Washington, DC: Brookings Institution, 2007).

³⁷ On boards, see J. Gordon, 'The rise of independent directors in the United States, 1950-2005: of shareholder value and stock market prices' (2007) 59 *Stanford Law Review* 1465; on takeovers, see J. Armour and D. Skeel, 'Who writes the rules for hostile takeovers, and why? The peculiar divergence of US and UK takeover regulation' (2007) 95 *Georgetown Law Journal* 1727, and the chapter by B. Clarke in this volume. Corporate governance trends in a wider sample of countries are tracked in M. Siems, 'Shareholder protection around the world ("Leximetric II")' (2008) 33 *Delaware Journal of Corporate Law* 111.

³⁸ R. Rajan and L. Zingales, 'What do we know about capital structure? Some evidence from international data' (1995) 50 *Journal of Finance* 1421.

³⁹ J. Corbett and T. Jenkinson, 'How is investment financed? A study of Germany, Japan, the United Kingdom and the United States' (1997) 65 *Manchester School* 69.

⁴⁰ T. Van Treck, 'A synthetic stock-flow consistent macroeconomic model of financialisation' (2009) 33 *Cambridge Journal of Economics* 467.

⁴¹ L. Summers, *London Stock Exchange Bicentennial Lecture* (London: London Stock Exchange, 2001).

⁴² J. Graham, C. Harvey and S. Rajgopal, 'The economic implications of corporate financial reporting' NBER Working Paper no. 10050 (2005).

⁴³ The argument put in the text is not inconsistent with the claim that recent corporate governance reforms have empowered an elite of senior managers who have been provided with new opportunities for personal enrichment (R. Monks, *Corporocracy* (Hoboken, NJ: Wiley, 2008), ch. 5), but it is inconsistent with the argument that the solution to this problem is to strengthen shareholder rights still further (Bebchuk and Fried, *Pay without Performance*). The growing influence of shareholders within corporate governance has been achieved not at the expense of senior managers, many of whom have directly benefited from the ‘alignment’ of executive pay with share price increases, but at the expense of other stakeholder groups and of governmental influence over corporate behaviour. To ‘reduce boards’ insulation from shareholders’ (Bebchuk and Fried, *Pay without Performance*, at p. x) would most likely exacerbate the problem.

⁴⁴ Corbett and Jenkinson, ‘How is investment financed?’.

⁴⁵ Ajit Singh, Alaka Singh, and B. Weisse, ‘Corporate governance, competition, the new international financial architecture, and large corporations in emerging markets’, in N. Allington and J. McCombie (eds) *The Cambridge Handbook of Applied Economics* (Cambridge: Cambridge University Press, 2010)

⁴⁶ M. Aoki and G. Jackson, ‘Understanding an emergent diversity of corporate governance and organizational architecture: an essentiality-based analysis’ (2008) 17 *Industrial and Corporate Change* 1.

⁴⁷ See Google’s SEC filing of 2004:
<http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm>.

⁴⁸ For a recent overview of the evidence, see A. Cosh, P. Guest and A. Hughes, ‘UK corporate governance and takeover performance’, in K. Gugler and B. Yurtoglu (eds) *The Economics of Corporate Governance and Mergers* (Cheltenham: Edward Elgar: 2008).

⁴⁹ S. Deakin, R. Hobbs, D. Nash and G. Slinger, ‘Implicit contracts, takeovers and corporate governance: in the shadow of the City Code’, in D. Campbell, H. Collins and J. Wightman (eds.) *Implicit Dimensions of Contract* (Oxford: Hart, 2003) review this process in the context of the UK takeover wave of the mid-1990s.

⁵⁰ See M. O'Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (Oxford: OUP: 2000); for a more sceptical view on the links between downsizing and shareholder value, which nevertheless points to increases in dividend payouts in the UK from the 1980s onwards (for the US, distributions go up in nominal terms but not when measured against cash flow), see Froud *et al.*, *Financialisation and Strategy*, ch. 4. L. Uchitelle, *The Disposable American: Layoffs and their Consequences* (New York: Knopf, 2006), gives an account based on case studies of the corporate strategies which linked downsizing to increased profitability and shareholder returns in the USA from the 1980s onwards, which, he argues, are intensifying.

⁵¹ See M. Conyon, S. Girma, S. Thompson and P. Wright, 'The impact of mergers and acquisitions on employment on company employment in the United Kingdom' (2002) 6 *European Economic Review*, 31.

⁵² The evidence is reviewed by Njoya, *Property in Work*.

⁵³ See S. Jacoby, 'Finance and labor: perspectives on risk, inequality and democracy', in this volume.

⁵⁴ J. Froud, C. Haslam, S. Johal and K. Williams, 'Accumulation under conditions of inequality' (2001) 8 *Review of International Political Economy* 66.

⁵⁵ Jacoby, 'Finance and labor'.

⁵⁶ A. Bhaduri, K. Laski and M. Riese, 'A model of interaction between the virtual and the real economy' (2006) 57 *Metroeconomica* 412.

⁵⁷ Van Treck, 'Financialisation'.

⁵⁸ *Ibid.*

⁵⁹ Jacoby, 'Finance and labor'.

⁶⁰ On the Enron case, see W. Bratton, 'Enron and the dark side of shareholder value' (2002) 76 *Tulane Law Review* 1275; S. Deakin and S. Konzelmann, 'Learning from Enron' *Corporate Governance: an International Review*, 12: 134-142.

⁶¹ See Deakin and Konzelmann, 'Learning from Enron'.

⁶² This process is comprehensively mapped by A. Lee, *Law, Economic Theory, and Corporate Governance: The Origins of UK Legislation on Company Directors' Conflicts of Interests, 1862-1948*, Ph.D. Thesis, University of Cambridge.

⁶³ E. Davenport, 'After Hatry' (1930) 107 *Nineteenth Century and After*, 353.

⁶⁴ *Ibid.*

⁶⁵ For further detail on the points made in this paragraph, see J. Cook, S. Deakin, and A. Hughes 'Mutuality and corporate governance: the evolution of UK building societies following deregulation' (2002) 2 *Journal of Corporate Law Studies* 110.

⁶⁶ On the use of 'form over substance' transactions by Lehman Bros. in the months prior to its bankruptcy, see the report prepared by the bankruptcy examiner, Anton R. Valukas (available online at: <http://lehmanreport.jenner.com/>), in particular Vol. 3.

⁶⁷ See Bratton and Wachter, 'The case against shareholder empowerment'.

⁶⁸ *Review of Corporate Governance of UK Banking Industry*, available at: <http://www.frc.org.uk/corporate/walker.cfm>.

⁶⁹ L. Strine, 'The role of Delaware in the American corporate governance system, and some preliminary musings on the meltdown's implications for corporate law', lecture to the conference on *Governance of the Modern Firm 2008*, Molengraaff Institute for Private Law, Utrecht University, 13 December 2008, at 26.

⁷⁰ 'Government considers remutualising Northern Rock', *The Guardian*, 4 October 2009.

⁷¹ The account of pension fund governance in the following paragraphs is based on J. Buchanan and S. Deakin, 'Pension fund governance: evolution of the trust model', CBR Working Paper series (forthcoming). See also, for background on pension fund governance in the UK, P. Thornton (ed.) *Good Governance for Pension Schemes* (Cambridge: Cambridge University Press, forthcoming).

⁷² See generally, L. Hannah, *Inventing Retirement: The Development of Occupational Pensions in Britain* (Cambridge: Cambridge University Press, 1986).

⁷³ As in the case of the BT Pension Fund, whose fund management operation became the corporate governance fund, Hermes: 'BT has come under constant pressure from investors to cut its pension scheme free from the business after campaigns to show it acts a barrier to growth' ('Pensions can wipe out BT profits', *The Guardian*, 7 July 2008).

⁷⁴ J. Froud and K. Williams, 'Private equity and the culture of value extraction' (2007) 12 *New Political Economy* 405; P. Thornton, *Inside the Dark Box: Shedding Light on Private Equity* (London: Work Foundation, 2008).

⁷⁵ A. Brav, W. Jiang, F. Partnoy, and R. Thomas 'Hedge fund activism, corporate governance, and firm performance' (2008) 63 *Journal of Finance*: 1729.

⁷⁶ A. Klein and E. Zur, 'Entrepreneurial shareholder activism: hedge funds and other private investors' (2009) 64 *Journal of Finance* 187.

⁷⁷ IE Consulting, *The Economic Impact of Private Equity in the UK* (London: British Venture Capital Association, 2008).

⁷⁸ See J. Armour and B. Cheffins, 'The rise and fall (?) of shareholder activism by hedge funds' ECGI Law Working Paper No. 136/2009.

⁷⁹ Muhammad Yunus, founder of the Grameen Bank, interviewed in Bertelsmann Stiftung, *Topics: Encouraging Social Change*, January 2008.

⁸⁰ S. Lydenberg, *Corporations and the Public Interest: Guiding the Invisible Hand* (San Francisco, CA: Berrett-Koehler, 2005).