

# The Overstated Promise of Corporate Governance

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*Corporate Governance: Promises Kept, Promises Broken*  
Jonathan Macey, Princeton, 2008. Pp vii, 334.

Corporate governance is in trouble. The implosion of Bear Stearns and Lehman Brothers, the near collapse of Citigroup and other large commercial banks, the bankruptcy of the US auto industry, and the massive overexposure of AIG to subprime risk have wreaked unprecedented turmoil in the capital markets and a widespread crisis of confidence in the quality of operational decisionmaking at US corporations.

Poor corporate governance may be a contributing factor.<sup>1</sup> Critics have described the corporate governance culture at Bear Stearns, for example, as “straight out of the 1920s.”<sup>2</sup> Bear’s board of directors met just six times a year, leaving primary oversight of the company to Bear’s all-insider executive committee.<sup>3</sup> Bear did not create a finance and risk committee until January 2007, just a year before its failure.<sup>4</sup> Two members of Bear’s audit committee served on the audit committees of five and six other companies, respectively, yet the board determined that, based upon their “wealth of financial experience,” this service did not “impair their ability to effectively serve on the Company’s Audit Committee.”<sup>5</sup> In short, the board was “another one of these all male clubs that acts like a throwback to black and white movies.”<sup>6</sup>

Citigroup’s board led the company to a string of quarterly losses, three government bailouts, and a share price that dipped to 97 cents in

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<sup>1</sup> But see Brian R. Cheffins, *Did Corporate Governance “Fail” during the 2008 Stock Market Meltdown? The Case of the S&P 500* \*36–37 (ECGI Working Paper, July 2009), online at <http://ssrn.com/abstract=1396126> (visited Sept 15, 2009) (arguing that corporate governance did not fail).

<sup>2</sup> J. Richard Finlay, *Outrage of the Week: Leadership Fiddles while Bear Stearns Burns* (Mar 14, 2008), online at <http://finlayongovernance.com/?p=423> (visited Sept 20, 2009).

<sup>3</sup> See *Bear Stearns 2007 Proxy Statement* 4 (Mar 27, 2007), online at [http://www.bearstearns.com/includes/pdfs/investor\\_relations/proxy/proxy2007.pdf](http://www.bearstearns.com/includes/pdfs/investor_relations/proxy/proxy2007.pdf) (visited Oct 15, 2009).

<sup>4</sup> See *id.* at 6.

<sup>5</sup> *Id.* at 5.

<sup>6</sup> Finlay, *Outrage of the Week: Leadership Fiddles while Bear Stearns Burns* (cited in note 2).

March 2009.<sup>7</sup> Professor Jack Coffee describes Citigroup's "extreme risk-taking," which caused it to become the largest issuer of collateralized debt obligations worldwide by 2007, as motivated by the bonus compensation paid to its senior executives.<sup>8</sup> Despite the company's problems, the board was reelected in April 2009 by more than 70 percent of shares voted.<sup>9</sup> The company nominated four new directors for its board in response to government pressure,<sup>10</sup> but it retained ten board members, four of whom were opposed by proxy advisory firm RiskMetrics, and six of whom were opposed by Glass Lewis.<sup>11</sup> Subsequently, despite widespread criticism of executive compensation packages at the big investment banks, Citigroup announced that it was restructuring its compensation to enable it to pay its employees as much as they received in 2008 while adhering to new government restrictions on bonuses.<sup>12</sup>

Are existing mechanisms of corporate governance ineffective and, if so, what explains the inability of US corporations to establish effective mechanisms? Because of the centrality of business performance to the national and global economies, as Andrei Shleifer and Robert Vishny observe, "the subject of corporate governance is of enormous practical importance."<sup>13</sup> This importance has led commentators to debate governance reforms for decades. Critics attributed the many examples of corporate misconduct in the late 1990s, of which

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<sup>7</sup> Madlen Read, *Citi Shareholders Show Rage at Annual Meeting*, Bus Wk (Apr 23, 2009), online at [http://www.businessweek.com/investor/content/apr2009/pi20090421\\_257312.htm](http://www.businessweek.com/investor/content/apr2009/pi20090421_257312.htm) (visited Oct 15, 2009).

<sup>8</sup> John C. Coffee, Jr, *What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis*, 9 J Corp L Stud 1, 17 n 54 (2009).

<sup>9</sup> See Bradley Keoun and Ian Katz, *Pandit Says Citigroup to Rebound as Board Is Elected*, Bloomberg (Apr 21, 2009) online at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aMn8wmi1HSJw&refer=home> (visited Oct 15, 2009).

<sup>10</sup> Josh Fineman and Elizabeth Hester, *Citigroup Nominates Four Board Members in Revamp*, Bloomberg (Mar 16, 2009) online at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aWKRiWimvaQA> (visited Oct 16, 2009) (describing the "government-induced shakeup").

<sup>11</sup> Keoun and Katz, *Pandit Says Citigroup to Rebound as Board Is Elected* (cited in note 9). See also David Reilly, *Jobs for Bankers Go Begging at Off-Limits Club*, Bloomberg (May 20, 2009), online at <http://www.bloomberg.com/apps/news?pid=20601039&sid=aNHxTHiTOQHo8&refer=home> (visited Oct 16, 2009) (stating that only 15 percent of directors at the ten largest US commercial banks have banking experience and arguing that bank board members should have more financial expertise).

<sup>12</sup> See *Citi Boosting Salaries to Offset Lower Bonuses*, LA Times (June 25, 2009), online at <http://articles.latimes.com/2009/jun/25/business/fi-citipay25?pg=1> (visited Sept 20, 2009) (describing pay controversy and Citigroup's changes to its executive compensation).

<sup>13</sup> Andrei Shleifer and Robert W. Vishny, *A Survey of Corporate Governance*, 52 J Fin 737, 737 (1997).

Enron and WorldCom are the most prominent examples, to continued and widespread deficiencies in corporate governance—from defectively structured boards of directors and conflicted auditors to inadequate internal controls.<sup>14</sup> As Jack Coffee explains: “In the 2001–2002 crisis that led up to the Sarbanes-Oxley Act, managers at literally hundreds of companies inflated earnings, typically by prematurely recognizing income, which behavior resulted in the number of annual financial statement restatements growing hyperbolically over the period from 1996 to 2002.”<sup>15</sup> In an effort to redress these deficiencies, Congress passed the Sarbanes-Oxley Act of 2002, the most comprehensive federal regulation of corporate governance ever.<sup>16</sup>

Although many commentators criticized Sarbanes-Oxley as a legislative overreaction,<sup>17</sup> agency costs, conflicts of interest, and fundamental failures in corporate decisionmaking persisted. Many of these failures have come to light since 2008, as the widespread effect of the credit crisis has unearthed problems ranging from egregious errors in risk management at AIG<sup>18</sup> and Bear Stearns<sup>19</sup> to the decision by auto industry executives who, unable to maintain their businesses as solvent entities, flew to Washington in their private jets to beg for a government bailout.<sup>20</sup>

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<sup>14</sup> See, for example, David A. Skeel, Jr., *Governance in the Ruins*, 122 Harv L Rev 696, 722–23 (2008) (describing weaknesses in WorldCom’s corporate governance).

<sup>15</sup> Coffee, 9 J Corp L Stud at 2 (cited in note 8).

<sup>16</sup> Sarbanes-Oxley Act of 2002, Pub L No 107-204, 116 Stat 745, codified at 15 USC § 7201 et seq. See, for example, Mark J. Roe, *Delaware’s Competition*, 117 Harv L Rev 588, 590 (2004) (stating that Congress passed Sarbanes-Oxley “in reaction to the corporate governance failures at Enron and WorldCom”).

<sup>17</sup> See Cheryl L. Wade, *Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?*, 39 Loyola U Chi L J 595, 595 (2008) (describing the “business community’s criticism of SOX [as] almost virulent”); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L J 1521, 1528 (2005) (describing Sarbanes-Oxley as “emergency legislation”); Frank O. Bowman, III, *Pour Encourager Les Autres?: The Curious History and Distressing Implications of the Criminal Provisions of the Sarbanes-Oxley Act and the Sentencing Guidelines Amendments that Followed*, 1 Ohio St J Crim L 373, 435 (2004) (stating that Sarbanes-Oxley was a “hasty and ill-considered law”).

<sup>18</sup> See Carrick Mollenkamp, et al, *Behind AIG’s Fall, Risk Models Failed to Pass Real-World Test*, Wall St J A1 (Nov 3, 2008) (detailing failures in AIG’s risk management).

<sup>19</sup> See Kara Scannell, *Crisis on Wall Street: Bear Stearns Is Faulted on Its Valuations in 2007*, Wall St J B3 (Oct 18, 2008) (describing improper asset valuations as a deficiency in Bear Stearns’s risk management).

<sup>20</sup> See, for example, Josh Levs, *Big Three Auto CEOs Flew Private Jets to Ask for Taxpayer Money*, CNN.com (Nov 18, 2008), online at <http://www.cnn.com/2008/US/11/19/autos.ceo.jets> (visited Sept 15, 2009) (describing criticism directed at CEOs of Big Three auto companies “for flying private jets to Washington to request taxpayer bailout money”).

These failures will, in turn, spawn a new wave of corporate governance reforms. It has been less than two years since the United States Treasury Department proposed its blueprint for financial regulation,<sup>21</sup> which was premised largely upon the relaxing of regulatory standards in order to increase the global competitiveness of US businesses.<sup>22</sup> Now, instead, businesses face the potential for still more extensive regulatory intervention. Congress and regulators are already taking steps to monitor issuer transactions involving risky financial products,<sup>23</sup> to control the level and structure of executive compensation,<sup>24</sup> and to increase shareholder input into the selection of corporate directors.<sup>25</sup>

In light of these new reform efforts, it has become vitally important to understand US corporate governance better—the existing mechanisms and how they work, the regulatory and structural attributes that limit their potential effectiveness, and the extent to which corporate governance failures contributed to the most recent economic crisis. Toward that end, Jonathan Macey offers a valuable tool with his latest book—*Corporate Governance: Promises Kept, Promises Broken*. Macey, a leading scholar in corporate law, provides a critical assessment of existing corporate governance mechanisms: from independent boards of directors, to gatekeepers such as audit firms and credit rating agencies. The core thesis of *Promises Kept* is that government regulation has sponsored ineffective governance mechanisms while, at the same time, disfavoring or even interfering with effective market-based mechanisms (pp 275–76). Macey’s prescription for corporate governance failures is simple: enhance the disciplinary effect of the capital markets and embrace governance mechanisms that make market pricing more efficient and more powerful, while reducing reliance on governance institutions that are unreliable (p 278).

*Promises Kept*, which comprehensively evaluates thirteen different corporate governance mechanisms, should be required reading for

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<sup>21</sup> Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Mar 2008), online at <http://www.treas.gov/press/releases/reports/Blueprint.pdf> (visited Sept 15, 2009).

<sup>22</sup> See Martha Graybow, *Deregulation Calls Go Silent as Wall St Reels*, Reuters (Sept 23, 2008), online at <http://in.reuters.com/articlePrint?articleId=INTRE48L09R20080922> (visited Sept 15, 2009) (noting how “pro-business advocates fretting about the future of Wall Street went on the warpath to try to roll back post-Enron corporate reforms they saw as a threat to U.S. competitiveness”).

<sup>23</sup> See Kara Scannell and Serena Ng, *Derivatives Plan Is Expected*, Wall St J C7 (July 30, 2009) (recounting the progress of legislation to regulate derivatives).

<sup>24</sup> See Jonathan Weisman and Joann S. Lublin, *Obama Lays out Limits on Executive Pay*, Wall St J A1 (Feb 5, 2009) (discussing the limits on executive pay for firms that receive TARP bailout funds).

<sup>25</sup> SEC, *Facilitating Shareholder Director Nominations* (June 10, 2009), online at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf> (visited Sept 15, 2009).

policymakers considering the adoption of new regulations. Macey offers a wealth of historical background and institutional detail. He illustrates his analysis with numerous examples—classic corporate law cases such as *Dirks v SEC*<sup>26</sup> and *Smith v Van Gorkom*,<sup>27</sup> as well as modern battles such as Carl Icahn’s effort to break up Time Warner in 2005 (pp 254–64). Macey persuasively explains how easy it is for regulators to get it wrong and demonstrates how even well-intended regulations can have perverse effects. Political pressure and interest group forces are likely to render regulation even less effective.

At the same time, Macey’s project does not go far enough. Although Macey is correct in championing market discipline over regulatory solutions, the history of US business suggests that market incentives alone may be insufficient to constrain—and may even exacerbate—some forms of managerial wrongdoing, including fraud, self-dealing, and excessive risk-taking. Going forward, the challenge for regulatory reform is to address and improve the effectiveness of capital market discipline.

Part I of this Review considers several of the governance mechanisms most heavily criticized by Macey—boards of directors, shareholder voting, and litigation. Part II examines Macey’s preferred “market-based” alternatives—the takeover market, the initial public offering, and hedge funds. In Part III, this Review considers the effect of the Financial Crisis of 2008–2009 on Macey’s analysis. While the crisis offers compelling evidence of the failure of several traditional governance mechanisms, it also highlights weaknesses in the capacity of the markets to provide effective discipline. This Review identifies several reasons for these weaknesses and argues that addressing these reasons should be the focus of regulatory reform efforts.

## I. MACEY’S THEORY OF CORPORATE GOVERNANCE

The core thesis of *Promises Kept* is that regulatory interventions have interfered with corporate governance—limiting those mechanisms that are most effective and encouraging those that are least effective. The thesis is summarized in a chart in which Macey details thirteen corporate governance mechanisms and classifies them according to whether they are (1) effective and (2) regulatorily encouraged (p 50). The two right hand columns highlight Macey’s conclusion: there is no overlap between column one—those mechanisms that are effective—and col-

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<sup>26</sup> 463 US 646 (1983).

<sup>27</sup> 488 A2d 858 (Del 1985).

umn two—those that are encouraged. Regulators, in Macey’s view, have consistently gotten corporate governance wrong.

Macey goes on to examine the various governance mechanisms in detail, devoting, in most cases, a separate chapter to each. His methodology, which draws on a mixture of theoretical analysis, academic literature, and case study illustrations (but not extensively on empirical analysis<sup>28</sup>), explains the operation of each governance device and the extent to which its role has been the subject of regulatory encouragement or limitations.

The governance institution that receives Macey’s most extensive attack is the board of directors (pp 51–89). Macey correctly observes that corporate governance scholarship has focused considerable attention on the composition, quality, and particularly the independence of the board of directors. As Macey explains, “The board of directors is at the epicenter of U.S. corporate governance” (p 51).

Macey argues forcefully that this reliance is misplaced. Corporate boards are, he claims, subject to capture as a result of management ties, cognitive biases, and social norms that undermine directors’ ability to exercise independent judgment. Directors are, for example, bound by norms of collegiality that make it difficult to question management (p 61). Directors’ access to corporate information is generally subject to management control (p 60).<sup>29</sup> Directors and senior executives operate at close proximity, through a web of professional and social ties (p 57).<sup>30</sup> As a result of these forces, boards are unlikely to serve as effective monitors (p 57).<sup>31</sup>

At the same time, the increased importance of board monitoring impedes the directors’ ability to serve as strategic advisors. Macey describes the “dual role” of boards as both monitors and advisors and explains that these roles are internally inconsistent (pp 53–54). Board involvement in a managerial function limits the board’s capacity to serve as a monitor. As Macey puts it, the directors face an inherent conflict when

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<sup>28</sup> Macey’s project would benefit from a more detailed discussion of the extensive empirical literature addressing the efficacy of various corporate governance mechanisms. See, for example, Romano, 114 *Yale L J* at 1529–43 (cited in note 17) (summarizing the empirical studies of the corporate governance provisions that were addressed in the Sarbanes-Oxley legislation).

<sup>29</sup> Macey describes the resulting potential for management to bias the flow of information to the board (p 60).

<sup>30</sup> Macey explains the “trade-off between objectivity and proximity” (p 57).

<sup>31</sup> Macey distinguishes dissident directors who, he argues, are not subject to managerial capture (p 90). Dissident directors are generally activist investors, such as principals at hedge funds. While these directors may bring an expertise to the board in enhancing firm value through restructuring transactions such as spin-offs, sales, and mergers, dissident directors typically lack the operational skills that would allow them to add long-term value through strategic advising.

they are called upon to evaluate decisions in which they previously participated (p 54). In addition, board participation in strategic planning strengthens the board's commitment and ties to the current management team, increasing the likelihood of board capture (p 63).

Although Macey is not the first scholar to recognize the inherent tension between the board's monitoring and managing functions,<sup>32</sup> he is clearly correct in his claim that the two functions are largely irreconcilable. That battle, however, has long been lost. Corporations largely have sacrificed the potential value of managing boards in favor of the independent monitoring board.<sup>33</sup> What is less clear, however, is that the monitoring board has been a failure on its own terms.

Concededly, monitoring boards do not offer corporations strategic advice, operational analysis, or other types of managerial support. As a result, large-scale empirical studies are unlikely to find a link between board monitoring and firm performance.<sup>34</sup> Rather, monitoring boards are likely to provide the most value in deterring managerial self-dealing and responding to crises. Assessing the deterrent value of board monitoring requires an impossible counterfactual analysis—would management have engaged in misconduct but for the monitoring?<sup>35</sup> Assessing the value of the board in crisis management presents similar challenges. Corporations for which crisis management is important are a subset of all corporations. Within this subset, the absence of a benchmark makes it difficult to know if the board's actions were appropriate—did the board respond soon enough, and were the steps it took effective?

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<sup>32</sup> Indeed, I made this point myself more than a decade ago. See Jill E. Fisch, *Taking Boards Seriously*, 19 *Cardozo L Rev* 265, 280 (1997) (stating that “there is a natural inconsistency between the board's monitoring and managing functions”). See also Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 *Harv L Rev* 597, 632–39 (1982) (recognizing this tension and warning of the dangers of privileging the board's monitoring function).

<sup>33</sup> See, for example, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 *Stan L Rev* 1465, 1469 (2007) (“[F]rom the post-World War II era to the present . . . the board's principal role shifted from the ‘advising board’ to the ‘monitoring board,’ and director independence became correspondingly critical.”).

<sup>34</sup> One of the most careful and extensive studies in this area, conducted by Bernie Black and Sanjai Bhagat, found “no convincing evidence that increasing board independence . . . will improve firm performance.” Sanjai Bhagat and Bernard Black, *The Uncertain Relationship between Board Composition and Firm Performance*, 54 *Bus Law* 921, 922 (1999). See also Sanjai Bhagat and Bernard Black, *The Non-correlation between Board Independence and Long-Term Firm Performance*, 27 *J Corp L* 231, 233 (2002) (finding that poorly performing firms often increase the independence of their boards, but there is no evidence that this strategy improves performance).

<sup>35</sup> Eric Helland and Michael Sykuta do find that issuers with more independent boards are less likely to be sued by shareholders. Eric Helland and Michael Sykuta, *Who's Monitoring the Monitor? Do Outside Directors Protect Shareholders' Interests?*, 40 *Fin Rev* 155, 157 (2005).

More significantly, as Jeff Gordon suggests, the evolution of the monitoring board appears to be more a product of market forces than regulatory intervention.<sup>36</sup> To be sure, the Delaware courts have encouraged the use of independent directors in the context of specific decisions, such as evaluating tender offers or responding to derivative litigation,<sup>37</sup> but these decisions neither require a majority independent board nor limit the board's role to monitoring. Sarbanes-Oxley and the self-regulating organization (SRO) rules mandate increased board independence,<sup>38</sup> but these requirements are of relatively recent origin and largely reflect preexisting corporate norms. Indeed, probably the most substantial factor in the move to independent monitoring boards has been the market pressure imposed by institutional investors.<sup>39</sup>

Whether those pressures were misguided remains an open question.<sup>40</sup> Several empirical studies have shown that independent boards function more effectively in specific situations.<sup>41</sup> James Cotter, Anil Shiv-

<sup>36</sup> See Gordon, 59 Stan L Rev at 1477–99 (cited in note 33) (describing various factors contributing to increased board independence). Alternatively, one could view the monitoring board as a low cost accommodation to the political pressure imposed by state pension funds—a perspective that is consistent with some of Macey's observations in other parts of the book about the role of political forces (pp 33, 45, 126).

<sup>37</sup> See, for example, *In re Oracle Corp Derivative Litigation*, 824 A2d 917, 942–46 (Del Ch 2003) (rejecting the dismissal recommendation of a special litigation committee based on lack of evidence that committee members were sufficiently independent); *Unocal Corp v Mesa Petroleum Co*, 493 A2d 946, 954–55 (Del 1985) (holding that the existence of a majority of independent directors on the board “materially enhance[s]” the proof needed to satisfy the burden of “good faith and reasonable investigation” upon judicial review of a board's rejection of a tender offer).

<sup>38</sup> See 15 USC § 78j-1(m)(3) (mandating that “[e]ach member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent”); *Listed Company Manual* § 303A.05(a) (NYSE, July 2009), online at <http://nysemanual.nyse.com/LCM/Sections> (visited Oct 16, 2009) (“Listed companies must have a compensation committee composed entirely of independent directors.”); *Nasdaq Marketplace Rules* § 4200(a)(15) (NASDAQ, Jan 13, 2006), online at [http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp\\_1\\_1\\_4\\_1&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F](http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_1&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F) (visited Oct 16, 2009) (defining an “[i]ndependent [d]irector” as “a person other than an Executive Officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director”).

<sup>39</sup> See, for example, Symposium Transcript, *The Institutional Investor's Goals for Corporate Law in the Twenty-first Century*, 25 Del J Corp L 35, 40 (2000) (Carolyn Brancato) (explaining how “many major U.S. corporations and institutional investors have come to agree on certain fundamental corporate governance values . . . in such areas as the long-term mission of the board of directors [and] the need for independent non-executive directors”).

<sup>40</sup> See, for example, Bhagat and Black, 27 J Corp L at 257 (cited in note 34) (describing evidence on value of independent boards as “equivocal”).

<sup>41</sup> In that vein, Macey's evidence of board failure appears to be anecdotal. Even accepting that the case studies discussed in Chapter 5 are evidence of board capture, they represent four of the thousands of publicly traded companies in the United States. See, for example, *NYSE Euro-next: Listings*, online at <http://www.nyse.com/about/listed/1170350259411.html> (visited Sept 15,

dasani, and Marc Zenner find that independent boards enhance target shareholder gains from takeovers.<sup>42</sup> Michael Weisbach shows that independent boards are more likely to respond to poor performance by replacing the CEO.<sup>43</sup> John Byrd and Kent Hickman report that firms with a majority of outside directors make better acquisitions.<sup>44</sup> More recent analysis suggests that the regulatory mandates for independence may themselves provide independent value. For example, Vidhi Chhaochharia and Yaniv Grinstein find that the imposition of SRO board independence rules upon companies reduced CEO compensation.<sup>45</sup>

More generally, increased board independence may have been a factor in modernizing corporations away from the overdiversified and inefficient conglomerates of the 1970s. One contributing factor is the ability of outside directors to respond to the information provided by the capital markets through stock prices. As Jeff Gordon observes, “the increasing informativeness and value of stock market signals” gave the outside directors an easy tool to use in their effort to enhance shareholder value.<sup>46</sup> Transparent and efficient stock prices enable directors to use “stock price maximization as the measure of managerial success.”<sup>47</sup> This in turn simplifies the board’s role as monitor.<sup>48</sup>

Relying on stock price as the metric for evaluating governance complicates Macey’s case analysis, however. Specifically, although Macey describes TransUnion and Disney as involving “monumentally bad decision-making” and providing evidence of board capture, both cases, as Macey concedes, involved substantial shareholder gains (p 69). In TransUnion, the board approved a merger that provided a substantial

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2009) (stating that the NYSE Euronext alone has approximately 8,500 listed companies). A corporate governance mechanism with that sort of failure rate would appear to be an unparalleled success.

<sup>42</sup> James F. Cotter, Anil Shivdasani, and Marc Zenner, *Do Independent Directors Enhance Target Shareholder Wealth during Tender Offers?*, 43 J Fin Econ 195, 214 (1997).

<sup>43</sup> Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J Fin Econ 431, 457 (1988).

<sup>44</sup> John W. Byrd and Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J Fin Econ 195, 195 (1992). Byrd and Hickman suggest, however, that it is possible to have boards that are too independent. *Id.* at 199.

<sup>45</sup> Vidhi Chhaochharia and Yaniv Grinstein, *CEO Compensation and Board Structure*, 64 J Fin 231, 232 (2009).

<sup>46</sup> Gordon, 59 Stan L Rev at 1472 (cited in note 33).

<sup>47</sup> *Id.* at 1470–72. See also Vidhi Chhaochharia and Yaniv Grinstein, *Corporate Governance and Firm Value: The Impact of the 2002 Governance Rules*, 62 J Fin 1789, 1814 (2007) (finding that Sarbanes Oxley’s requirement of an independent audit committee benefited large and medium size firms but not small firms).

<sup>48</sup> I have criticized the reliance on stock price as the exclusive measure of firm value elsewhere. See Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J Corp L 637, 673 (2006) (arguing that stock price may be an overly narrow measure of firm value and that overreliance on stock price may lead to poor management decisions).

premium for stockholders—41 percent more than the highest price at which the stock had traded in the previous five years (p 73). In Disney, the market value of Disney's stock increased by more than \$1 billion in a single day in response to the announcement that Michael Ovitz had been hired (p 78).<sup>49</sup>

Moreover, if informed stock prices enhance market discipline, perhaps board effectiveness should be understood in terms of price quality, not absolute price. The monitoring board focuses the role of independent directors on assuring the reliability of firm financial disclosure.<sup>50</sup> Evolving governance norms and regulations such as Sarbanes-Oxley both address financial transparency and prescribe specific requirements for the board generally, and the audit committee in particular, designed to increase information flow and reduce capture of the independent directors.<sup>51</sup> These reforms appear consistent with Macey's conception of effective governance.

Macey's second major target is shareholder voting (pp 199–222). Macey summarizes the traditional theoretical arguments against greater shareholder voice—shareholders suffer from collective action problems, lack sufficient stakes to research election issues adequately, and engage in rational apathy (pp 202–04). He also challenges Lucian Bebchuk's claim that meaningful democratic voice is necessary to con-

<sup>49</sup> Concededly the terms of Ovitz's employment contract—specifically the amount of his severance package—were not part of the public announcement.

<sup>50</sup> Elsewhere, Macey rejects the effectiveness of accounting firms, arguing that they suffer from cartelization and capture (pp 155–64). The failure of accounting firms might as easily be attributed to insufficient regulation. Although the SEC has authority to regulate both accounting and auditing directly, historically it has delegated this responsibility to the industry. See George J. Benston, *The Regulation of Accountants and Public Accounting before and after Enron*, 52 *Emory L J* 1325, 1333 (2003). The failures at Enron, including the lax accounting rules that permitted Enron to mask a large percentage of its liabilities and losses, were promulgated by the industry itself. See *id.* at 1336–38 (describing Enron's abuse of GAAP). See also John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 *BU L Rev* 301, 319 (2004) (describing the decline in auditor accountability during 1990s). More recently, critics have attributed many of the financial industry failures to a lack of transparency associated with derivatives and other risky financial products—a lack of transparency that impeded capital markets monitoring. See, for example, Gordon L. Clark and Eric R.W. Knight, *Implications of the UK Companies Act 2006 for Institutional Investors and the Market for Corporate Social Responsibility*, 11 *U Pa J Bus L* 259, 262 (2009) (“Indeed the current global credit crisis, which has its origins in widespread defaults on subprime mortgage loans in the United States, is an example where the lack of transparency in financial markets resulted in asymmetric information and the mispricing of the real risk behind traded mortgage-backed derivatives.”).

<sup>51</sup> See, for example, Adriaen M. Morse, Jr., *Breaking the Circle: The Problem of Independent Directors Policing Public Company Financial Disclosure under the SEC's New Rules Governing Public Company Audit Committees*, 23 *Ann Rev Bank & Fin L* 673, 691–712 (2004) (discussing the manner in which Sarbanes-Oxley attempts to increase independent director effectiveness in monitoring financial disclosure).

fer legitimacy on corporate directors (pp 211–12).<sup>52</sup> Nonetheless, Macey recognizes that traditional economic theory likely overstates collective action problems to the extent that investors face similar issues with respect to many of their portfolio companies, or evaluate director candidates over multiple terms or in multiple companies (p 208). Indeed, Macey appears to accept that enhanced shareholder voting rights with respect to takeovers in general and poison pills in particular might be an effective governance mechanism (p 205).<sup>53</sup> Macey also observes that the capital markets consistently afford a premium to voting shares (pp 220–21).<sup>54</sup> Nonetheless, Macey's support for shareholder voting is lukewarm at best, leading him to classify it as an ineffective governance mechanism (p 50).

Macey also describes voting as favored by regulation, a description that is in tension with the many regulatory limitations on shareholder voting power. The SEC, for example, has limited the ability of shareholders to overcome collective action problems by mandating extensive disclosure in connection with the solicitation of proxies.<sup>55</sup> Through its shareholder proposal rule, the SEC has interposed its staff as the primary determinant of what constitutes a proper subject for the exercise of shareholder voting power.<sup>56</sup> In 2007, the SEC amended its rules to overturn the effect of a federal court decision permitting shareholders to modify the director nomination process through direct nomination bylaws,<sup>57</sup> although the new Democrat-controlled SEC recently proposed a rule that would provide shareholders with proxy access under specified circumstances.<sup>58</sup>

Other regulatory interventions further limit shareholder voting power. The statutory default rule for electing directors in all states is

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<sup>52</sup> See, for example, Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va L Rev 675, 676 (2007); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv L Rev 835, 837 (2005).

<sup>53</sup> Macey states that “poison pills should not be adopted unless shareholders are allowed to vote on them first” (p 205).

<sup>54</sup> More precisely, the capital markets impose a discount on nonvoting shares.

<sup>55</sup> See, for example, Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 Vand L Rev 1129, 1139–41 (1993) (summarizing federal regulation of the proxy solicitation process). Rule 13(d) also chills shareholder collective action by imposing a disclosure requirement on shareholders who form a group for the purpose of influencing control of a corporation. See id at 1170, 1198 n 318 (noting the “potential chilling effect of Rule 13(d) on collective action by shareholders in connection with voting”).

<sup>56</sup> See id at 1157–59 (describing several controversial staff determinations).

<sup>57</sup> See SEC, *Shareholder Proposals Relating to the Election of Directors* (Dec 7, 2007), online at <http://www.sec.gov/rules/final/2007/34-56914.pdf> (visited Sept 20, 2009) (overturning the result in *AFSCME v American International Group, Inc*, 462 F3d 121 (2d Cir 2006)).

<sup>58</sup> SEC, *Facilitating Shareholder Director Nominations* (cited in note 25).

plurality voting.<sup>59</sup> Under plurality voting, shareholder efforts to oppose management-nominated directors outside the mechanism of a proxy contest are ineffective—by definition shareholders cannot defeat a management candidate without nominating an alternative candidate.<sup>60</sup> The ability of incumbent management to use corporate resources, virtually without limit, to solicit proxies also creates a substantial funding imbalance that deters election contests and other challenges.<sup>61</sup> Until recently, even the rules of the SROs reduced the effectiveness of the shareholder vote by granting brokers the discretion to vote custodial shares for which they lacked explicit voting instructions—shares that historically were voted in favor of management.<sup>62</sup>

Because of these restrictions, shareholder voting has traditionally been relatively ineffective, as Macey argues (pp 199–200). Arguably, however, shareholder voting offers the potential to serve as a mediated market constraint on managerial power, mediated in the sense that it enables shareholders collectively to exercise control in a more moderated fashion than by selling their stock, either to a hostile bidder or into the open market. For shareholders who believe a corporation's strategic direction is misguided, a shift in board representation may

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<sup>59</sup> See, for example, Joseph McCafferty, *Majority Voting for Director Elections*, Directorship (Dec 16, 2008), online at <http://www.directorship.com/majority-voting-for-director-elections> (visited Oct 17, 2009) (“Under the corporate law of all U.S. states, the default voting threshold for director election—the one that applies unless the company provides otherwise—is a plurality.”).

<sup>60</sup> See Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians inside the Gates*, 45 Stan L Rev 857, 904–05 (1993) (describing plurality voting and explaining that, under plurality voting, “even if the overwhelming majority of shareholders withhold authority from management’s unopposed slate, those unopposed nominees will still successfully gain a plurality of the votes cast as long as a small minority of shareholders supports management’s nominees”).

<sup>61</sup> See Lucian Arye Bebchuk and Marcel Kahan, *A Framework for Analyzing Legal Policy toward Proxy Contests*, 78 Cal L Rev 1073, 1134–35 (1990) (describing the existing funding structure and proposing alternative funding rules).

<sup>62</sup> See, for example, Vincent Falcone, Note, *Majority Voting in Director Elections: A Simple, Direct and Swift Solution?*, 2007 Colum Bus L Rev 844, 870–71 (describing broker discretionary voting); Marcel Kahan and Edward B. Rock, *Embattled CEOs* \*29 (ECGI Working Paper, Dec 2008), online at <http://ssrn.com/abstract=1281516> (visited Sept 15, 2009) (stating that brokers typically voted custodial shares in favor of management). On July 1, 2009, the SEC approved a rule change by the NYSE and NASDAQ eliminating discretionary voting in director elections. SEC, *Order Approving Proposed Rule Change, as Modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered under the Investment Company Act of 1940, and to Codify Two Previously Published Interpretations that Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts with an Investment Company* \*6 (July 1, 2009), online at <http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf> (visited Sept 15, 2009).

carry that message.<sup>63</sup> For shareholders who believe management is overly entrenched, governance changes, such as increasing shareholder nomination power or dismantling takeover defenses, may be appropriate.

Indeed, Macey's discussion of dissident directors illustrates the potential power of shareholder voting. As Macey explains, hedge funds and other activist shareholders have begun to nominate short slates of director candidates for the purpose of changing the dynamic of the boards of underperforming companies (p 90). In most cases, the dissident slate is nominated on the platform of an identified strategic or structural change for the issuer—a financial restructuring, cost-cutting, or a proposed sale of the company.<sup>64</sup> By electing the dissident slate, shareholders are, in effect, voting their support for the activist's platform. Although the empirical analysis of this activism has, to date, been limited, early studies suggest that such activism may increase firm value.<sup>65</sup> Moreover, improving corporate governance through proxy contests is far less costly than a hostile takeover, making it potentially viable at large public companies.

Concededly, the case for shareholder voting has not yet been made. Institutional investors may have conflicts of interest or agendas that render increased shareholder power problematic, as Macey illustrates with his example of empty voting (pp 214–19).<sup>66</sup> Other commentators have raised similar concerns about the incentives of hedge funds,<sup>67</sup> public pension funds,<sup>68</sup> and union funds.<sup>69</sup> At the end of the day, however, Macey's own analysis suggests that shareholder voting offers

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<sup>63</sup> This message is the impetus for Joseph Grundfest's proposed "just vote no" campaigns. See Grundfest, 45 Stan L Rev at 865 (cited in note 60).

<sup>64</sup> See William W. Bratton, *Hedge Funds and Governance Targets*, 95 Georgetown L J 1375, 1379, 1390–97 (2007) (describing activist objectives with respect to target companies).

<sup>65</sup> See, for example, Alon Brav, et al, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J Fin 1729, 1771 (2008) (reporting that hedge fund activism "generates value on average"); Bratton, 95 Georgetown L J at 1381–82 (cited in note 64) (finding mixed results but considerable success by hedge funds both in achieving their objectives and in financial performance).

<sup>66</sup> See also Henry T.C. Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S Cal L Rev 811, 828–35 (2006) (discussing empty voting in more detail); Shaun Martin and Frank Partnoy, *Encumbered Shares*, 2005 U Ill L Rev 775, 778 (describing how equity derivatives enable investors to separate economic interest from voting rights).

<sup>67</sup> See, for example, Martin Lipton and William Savitt, *The Many Myths of Lucian Bebchuk*, 93 Va L Rev 733, 746 (2007) (criticizing hedge funds for their short-term investment orientation).

<sup>68</sup> See, for example, David L. Gregory, *The Problematic Status of Employee Compensation and Retiree Pension Security: Resisting the State, Reforming the Corporation*, 5 BU Pub Intl L J 37, 66 (1995) (considering incentives of public pension fund managers and potential conflicts of interest).

<sup>69</sup> See, for example, Stewart J. Schwab and Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 Mich L Rev 1018, 1019–25 (1998) (outlining potential concerns raised by union fund activism in corporate governance).

considerable potential for inducing management to keep its promises to shareholders. Reducing current regulatory restrictions may increase that potential.

Macey also considers shareholder litigation (pp 130–54). He states that, according to conventional wisdom, shareholder litigation is second only to corporate boards in importance as a corporate governance mechanism (p 130). Macey believes that this conventional wisdom is simply “wrong” (p 130). In support, Macey describes a litigation system that is badly broken, one in which large amounts of money are transferred between investors with little overall benefit.<sup>70</sup> He further explains that the system is plagued by agency costs that leave plaintiffs’ lawyers in control of the system and create substantial incentives for abuse. The result, in his words, is a “litigation crisis” that increases the cost of capital (p 153).

Criticisms of shareholder litigation for its excessive agency costs are widespread.<sup>71</sup> In his own prior work, Macey proposed an innovative mechanism for reducing these costs by auctioning off shareholders’ claims.<sup>72</sup> Regulators have devoted extensive attention, however, to reducing agency costs through procedural restrictions and substantive limits on shareholder litigation. Indeed, the extent of these limits raises a reasonable question as to whether Macey is fair in characterizing litigation as regulatorily encouraged.

With respect to state court derivative litigation, traditional procedural limits include a limitation on standing (the contemporaneous ownership requirement), a requirement that the plaintiff post, in some states, security for expenses, and most importantly, a requirement that the plaintiff either make a demand that the board of directors initiate the suit or demonstrate why such a demand would be futile.<sup>73</sup> The significance of these procedural limits pales beside the most important

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<sup>70</sup> This transfer has been described as the “circularity problem.” See Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis L Rev 333, 337–38 (describing the circularity problem and offering a response).

<sup>71</sup> See, for example, Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vand L Rev 133, 148–57 (2004) (discussing the litigation agency costs in shareholder litigation); Joseph A. Grundfest and Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 Ariz L Rev 559, 566–72 (1996) (same).

<sup>72</sup> Jonathan R. Macey and Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U Chi L Rev 1, 6 (1991) (arguing that the winner of an auction would have similar litigation incentives as a traditional claimholder).

<sup>73</sup> See, for example, Jill E. Fisch, *Teaching Corporate Governance through Shareholder Litigation*, 34 Ga L Rev 745, 753–54 (2000) (describing the procedural requirements of derivative litigation).

substantive limit on shareholder litigation under state law: the business judgment rule. Corporate law essentially prohibits shareholders—outside a few narrow contexts—from using litigation to challenge operational or strategic decisions unless they can demonstrate a conflict of interest, the absence of an informed decisionmaking process, or a lack of good faith. The business judgment rule has the practical effect of limiting state law litigation to transactions involving self-dealing or conflicts of interest. As a result of this limitation, it is unsurprising that empirical studies of derivative litigation find it to be relatively ineffective.<sup>74</sup>

Federal securities litigation has, to some degree, supplanted derivative litigation as a corporate governance mechanism by focusing, not on the substance of management decisions, but on the manner in which they were disclosed. Hillary Sale and Robert Thompson explain that federal securities litigation has increasingly offered shareholders a basis for enforcing duty of care claims that might previously have been litigated under state law.<sup>75</sup>

Congress and the courts have repeatedly cut back on the scope of private securities litigation, however. As Justice Sandra Day O'Connor recently observed: "To be successful, a securities class-action plaintiff must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action."<sup>76</sup> Restrictions imposed by the Supreme Court include the *Dura Pharmaceuticals, Inc v Broudo*<sup>77</sup> decision on loss causation, and *Central Bank of Denver v First Interstate Bank of Denver*<sup>78</sup> and *Stoneridge Investment Partners, LLC v Scientific-Atlanta, Inc.*<sup>79</sup> which, together, limit the range of defendants that private litigants can hold liable.<sup>80</sup> Congress has imposed

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<sup>74</sup> See, for example, Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J L, Econ, & Org 55, 84 (1991).

<sup>75</sup> Robert B. Thompson and Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 Vand L Rev 859, 904 (2003).

<sup>76</sup> *Alaska Electrical Pension Fund v Flowservice Corp.*, 572 F3d 221, 235 (5th Cir 2009).

<sup>77</sup> 544 US 336 (2005).

<sup>78</sup> 511 US 164 (1994).

<sup>79</sup> 128 S Ct 761 (2008).

<sup>80</sup> Some lower courts have, through expansive interpretations of these precedents, imposed even greater restrictions. See, for example, *In re Flag Telecom Holdings*, 574 F3d 29, 40 (2d Cir 2009) (rejecting the inclusion of "in-and-out" traders in plaintiff class on the theory that they could not properly establish loss causation); *Fener v Operating Engineers Construction Industry and Miscellaneous Pension Fund (Local 66)*, 579 F3d 401, 411 (5th Cir 2009) (stating that the plaintiff has suffered no injury unless the fraud caused the price of the stock to increase and its disclosure caused the price to go down); *Oscar Private Equity Investments v Allegiance Telecom, Inc.*, 487 F3d 261, 270 (5th Cir 2007) (requiring the plaintiff to establish, at the class certification

a heightened pleading requirement and a stay on discovery pending the court's resolution of the motion to dismiss, as well as limitations on liability and damages.<sup>81</sup>

At the same time, institutional investors, particularly public pension funds, have become increasingly involved in shareholder litigation. Early empirical studies suggest that these institutions have been remarkably effective in reducing the agency costs associated with private litigation.<sup>82</sup> Cases involving institutional lead plaintiffs are settled for larger amounts and, at the same time, fee awards to plaintiffs' counsel are lower, leaving a greater percentage of the settlement to compensate class members.<sup>83</sup> Indeed, Macey discusses the landmark *In re Cendant Corp Litigation*<sup>84</sup> decision, in which three public pension funds jointly supervised litigation that led to a record settlement, and a surprisingly low fee award (p 150). Although Macey is not explicit on this point, the *Cendant* fee award was only 1.7 percent of the class recovery,<sup>85</sup> far less than the traditional benchmark of 25 to 30 percent.<sup>86</sup>

Reducing the costs of private litigation increases its capacity to deter corporate misconduct. As a variety of commentators have observed, this deterrent effect, although difficult to quantify, operates as

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stage, by appropriate expert testimony, that it was the corrective disclosure of the fraud and not unrelated negative statements, that caused a significant amount of the stock price decline).

<sup>81</sup> Private Securities Litigation Reform Act of 1995, Pub L No 104-67, 109 Stat 737, codified at 15 USC § 77a et seq.

<sup>82</sup> See, for example, James D. Cox and Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 Colum L Rev 1587, 1636 (2006) (finding that institutional lead plaintiffs appear to add value by increasing settlement size, although finding that settlements have declined as a percentage of provable losses); Stephen J. Choi, Jill E. Fisch, and A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 Wash U L Q 869, 900 (2005) (finding that involvement of public pension funds as lead plaintiffs is correlated with a greater likelihood of a high-value outcome).

<sup>83</sup> See Cox and Thomas, 106 Colum L Rev at 1599, 1624 (cited in note 82) (noting that institutional lead plaintiffs "often able to lower counsel fees to one-half to one-third of the historical average of 32% of the recovery" and demonstrating statistically that "institutional investor cases exhibit much larger settlements"). But see Choi, Fisch, and Pritchard, 83 Wash U L Q at 900-01 (cited in note 82) (questioning whether the identified correlation is caused by institutional investor monitoring).

<sup>84</sup> 243 F Supp 2d 166 (D NJ 2003).

<sup>85</sup> *Id* at 172-73.

<sup>86</sup> Consider Declaration of John C. Coffee, Jr, *In re Cendant Litigation*, Civil Action No 98-CV-1664, n 4 (D NJ filed Aug 18, 1998), online at <http://securities.stanford.edu/1002/CD98/001.html> (visited Oct 17, 2009) (reporting that 32 percent is the prevailing fee award benchmark), cited in Jill E. Fisch, *Aggregation, Auctions and Other Developments in the Selection of Lead Counsel under the PSLRA*, 64 L & Contemp Probs 53, 59 n 39 (2001).

a powerful corporate governance device.<sup>87</sup> Importantly, the deterrent effect of litigation is supplemented by its role in increasing the efficiency (and thereby the discipline) of the capital markets.

In a recent article, I explain that private securities litigation, by compensating investors who engage in reliance-based trading, increases their incentive to uncover, analyze, and rely on corporate disclosures in their trading decisions.<sup>88</sup> This activity performs a key role in enabling the trading markets to incorporate information into securities prices. Macey's model of capital markets discipline depends critically upon informationally efficient markets which, in turn, require investors to engage in firm-specific research and to trade on the basis of that research. Although indexing and other passive investment strategies can reduce an investor's risk of fraud-based losses, such strategies do not promote market efficiency. Private litigation can compensate informed traders who bear disproportionately the costs of research and of fraud because those traders, through their actions, create a positive corporate governance externality.

## II. MARKET-BASED CORPORATE GOVERNANCE

A fundamental premise of *Promises Kept* is the superiority of capital market discipline to traditional corporate governance mechanisms such as boards, gatekeepers, and external institutions. As Macey explains, private sector market participants have the appropriate economic incentives to address corporate governance in order to increase firm profitability (p 47).<sup>89</sup> Moreover, these very incentives reduce the susceptibility of market actors to the political pressures that Macey blames for corrupting regulation.

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<sup>87</sup> See, for example, Merritt B. Fox, *Why Civil Liability for Disclosure Violations when Issuers Do Not Trade?*, 2009 Wis L Rev 297, 302 (rejecting as "weak" the compensation rationale for liability in favor of the deterrence rationale); Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 Wis L Rev 243, 246 (describing "detering managerial misconduct" as "a major purpose of class-action lawsuits"). See also A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va L Rev 925, 929-30 (1999) (arguing that deterrence rather than compensation should be the primary goal in securities fraud litigation).

<sup>88</sup> Fisch, 2009 Wis L Rev at 347 (cited in note 70). As I note, this justification does not square with the scope of liability permitted under *Basic Inc v Levinson*, 485 US 224 (1988). See Fisch, 2009 Wis L Rev at 348 (cited in note 70) (observing that this defense may require a reformulation of *Basic*).

<sup>89</sup> Others question whether the 2008 economic crisis provides evidence to the contrary. See, for example, Edmond L. Andrews, *Greenspan Concedes Error on Regulations*, NY Times B1 (Oct 24, 2008) (describing testimony by former Federal Reserve Chairman Alan Greenspan stating that he had put "too much faith in the self-correcting power of free markets").

Macey reserves his highest praise for the takeover market (p 118).<sup>90</sup> As he repeatedly explains, takeovers provide a market-based discipline for managers by enabling shareholders to replace managers of underperforming companies. A takeover bidder buys such a company and improves performance by effecting strategic changes, such as replacing management, cutting costs, or making structural changes. Because the company's poor performance will have been reflected in a low stock price, and because efficient strategic changes will cause the stock price to increase, the bidder profits, as do shareholders who remain invested in the company. Selling shareholders benefit as well; as Macey explains, they generally receive a premium of around 50 percent of the pre-bid trading price when they sell their stock in a tender offer (p 119).

Macey's defense of the hostile takeover is consistent with the dominant law and economics view of the 1980s—presented most famously by Frank Easterbrook and Daniel Fischel.<sup>91</sup> Scholars such as Easterbrook and Fischel argued that, because of the clear benefits of the takeover market, incumbent management should be precluded from interfering with hostile takeovers. Accordingly, they advocated a policy of management passivity.<sup>92</sup>

Other commentators disagreed, arguing that not all takeovers were efficient.<sup>93</sup> Some takeovers, they argued, were economically irrational—funded by cheap debt and leading to excessive leverage. These concerns have renewed resonance in today's market. According to takeover critics, some takeovers consist largely of wealth transfers—from one group of shareholders to another,<sup>94</sup> from creditors to shareholders, and from employees to shareholders. Some takeovers take advantage of market

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<sup>90</sup> Macey states, "The most important market-inspired component of the U.S. corporate governance infrastructure is the market for corporate control" (p 118).

<sup>91</sup> Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv L Rev 1161, 1164 (1981) (advocating required management passivity in response to a takeover bid).

<sup>92</sup> *Id.* at 1164.

<sup>93</sup> Perhaps the best known advocate of management discretion in response to an unsolicited takeover offer is Martin Lipton. See Martin Lipton and Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 Del J Corp L 1, 29 (2002) (observing that managers may have better information than shareholders about firm value); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus Law 101, 107 (1989) (finding that in over half of the failed takeover attempts studied, shareholders were better off than they would have if the takeover bid had been successful).

<sup>94</sup> See Sara B. Moeller, Frederik P. Schlingemann, and René M. Stulz, *Do Shareholders of Acquiring Firms Gain from Acquisitions?* \*23 (NBER Working Paper Series, Feb 2003), online at <http://www.nber.org/papers/w9523.pdf> (visited Sept 15, 2009) (finding that shareholders of acquiring companies lose from acquisitions).

conditions to buy out shareholders at a temporary premium reflecting an unfair or bargain price. Shareholder collective action problems, coupled with, in some cases, incomplete disclosure and coercive structures, make it difficult for shareholders to identify these situations and to distinguish them from truly value-enhancing transactions.

To date, the empirical analysis of takeovers has failed to resolve the dispute over their efficiency. Although the literature is too extensive to review in detail here, some empirical studies support Macey's claim that many takeovers are efficient, resulting in improved governance and producing synergistic gains.<sup>95</sup> Others cast doubt on the efficiency hypothesis. A well-known article by Shleifer and Vishny suggests that irrational stock market misvaluation rather than synergies drives most takeovers.<sup>96</sup> Research by Ming Dong, et al, finds that bidders tend to expropriate value from target shareholders, either by "buying undervalued targets for cash at a price below fundamental value, or by paying equity for targets that, even if overvalued, are less overvalued than the bidder."<sup>97</sup> Several studies have found that although target shareholders may profit from a takeover, shareholders of the acquiring firm lose money.<sup>98</sup> Empirical studies also suggest that takeovers, at least in some cases, adversely affect consumer welfare.<sup>99</sup>

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<sup>95</sup> See, for example, Sanjai Bhagat, et al, *Do Tender Offers Create Value? New Methods and Evidence*, 76 J Fin Econ 3, 6 (2005) (finding empirical results that "are consistent with the importance of both synergies and target-specific improvements such as removal of bad management"); Cong Wang and Fei Xie, *Corporate Governance Transfer and Synergistic Gains from Mergers and Acquisitions*, 22 Rev Fin Stud 829, 842 (2009) (finding that acquisitions of firms with poor corporate governance by firms with good corporate governance generate higher synergy gains).

<sup>96</sup> Andrei Shleifer and Robert W. Vishny, *Stock Market Driven Acquisitions*, 70 J Fin Econ 295, 307 (2003).

<sup>97</sup> Ming Dong, et al, *Does Investor Misvaluation Drive the Takeover Market?*, 61 J Fin 725, 726 (2006).

<sup>98</sup> See, for example, Sara B. Moeller, Frederik P. Schlingemann, and René M. Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J Fin 757, 758–59 (2005) (finding losses to acquiring firm shareholders of \$240 billion from 1998 through 2001); Sara B. Moeller, Frederik P. Schlingemann, and René M. Stulz, *Firm Size and the Gains from Acquisitions*, 73 J Fin Econ 201, 202, 226 (2004) (finding average loss to acquiring firm shareholders of \$25.2 million that is not reversed over time); Gunther Tichy, *What Do We Know about Success and Failure of Mergers?*, 1 J Industry, Competition & Trade 347, 347 (2001) (summarizing various empirical studies and concluding that "[t]argets' shareholders win, while bidders' shareholders break even upon the announcement of a merger, but lose significantly in the long run"). But see Shantanu Dutta and Vijay Jog, *The Long-Term Performance of Acquiring Firms: A Re-examination of an Anomaly*, 33 J Bank & Fin 1400, 1400 (2009) (finding no negative long-term abnormal stock market returns for Canadian acquiring firms).

<sup>99</sup> See, for example, Tichy, 1 J Industry, Competition & Trade at 347 (cited in note 98) (finding that a quarter of mergers increase prices and half reduce the value of the firm).

Thus, from an efficiency perspective, the existing empirical evidence is equivocal as to whether takeovers are an effective governance device and the extent to which existing regulatory restrictions are undesirable (p 122).<sup>100</sup> In addition, existing restrictions have not eliminated the takeover. Macey reveals a degree of nostalgia for the transactions that characterized the mid-1980s (pp 236–37). Concededly, the two-tiered offers of that era are largely extinct, but hostile offers are not. Indeed, hostile takeovers hit record levels in 2008 in response to falling stock prices.<sup>101</sup> More generally, although the poison pill and judicial decisions have reshaped the form of takeovers, they have not dissuaded hedge funds, private equity firms, and other bidders from pursuing attractive targets.<sup>102</sup> Even with the existing regulatory restrictions, the market for corporate control continues to function as a governance device.

In addition, the takeover market is limited in its applicability as a corporate governance mechanism. Takeovers are costly, and some companies are just too big to buy. The cost of financing requires appropriate credit market conditions. Most importantly, takeovers are only effective if a company's stock price is undervalued. If stock price is too high, whether because of a general market bubble or company-specific fraud, the takeover market does not offer a mechanism for correction. For

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<sup>100</sup> Antitakeover regulation has been defended as a defense to inefficiencies in the takeover market. See David Millon, *Theories of the Corporation*, 1990 Duke L J 201, 237 (noting that proponents of antitakeover regulation cite the lack of consideration for non-shareholder losses in the takeover market). Poison pills, staggered boards, the Williams Act, Pub L No 90-439, 82 Stat 454 (1968), codified at 15 USC § 78 et seq, and state antitakeover statutes enable the board to interpose itself on the shareholders' behalf, both identifying inefficient transactions and negotiating to extract the maximum possible premium in efficient deals. The extent to which these mechanisms impede efficient transactions depends on the quality and independence of the board. Thus, as Macey correctly observes, antitakeover devices can enable entrenched management to delay and in some cases block takeovers entirely, even takeovers that were arguably efficient (such as Paramount's bid for Time) (p 125). *Paramount Communications, Inc v Time, Inc*, 571 A2d 1140, 1147–49 (Del 1998). Empirical studies have shown that firms with extensive antitakeover protections tend to underperform the market, suggesting that such protections are at least correlated with management entrenchment, although it is difficult to determine the direction of causality. See, for example, Paul Gompers, Joy Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q J Econ 107, 144–45 (2003) (finding that firms with more takeover protection have lower profit margins, lower returns on equity, and slower sales growth).

<sup>101</sup> See Jessica Hall, *Hostile Takeovers Hit Record as Market Swoons*, Reuters (Sept 29, 2008), online at <http://www.reuters.com/article/innovationNews/idUSTRE48S2P120080929> (visited Sept 20, 2009) (stating that, as of September 2008, hostile deal activity had reached a record high of \$211 billion, and that unfriendly deals for the year accounted for 22.1 percent of all US mergers).

<sup>102</sup> See Steven M. Davidoff, *The SEC and the Failure of Federal Takeover Regulation*, 34 Fla St U L Rev 211, 237 (2007) (describing the “fifth wave” of takeover activity as continuing from the mid-1990s through 2007, with \$1.6 trillion in completed takeover activity in 2006).

companies like Enron and WorldCom, for example, takeovers were not an answer (although short selling might have been).<sup>103</sup>

Macey also defends the IPO market, arguing that the rigorous monitoring by investment banks and other gatekeepers serves a valuable gatekeeping function (p 127).<sup>104</sup> In describing IPOs as an effective governance mechanism, Macey appears largely to support the fundamental premise of federal securities regulation: rigorous disclosure requirements—imposed primarily at the time a firm issues securities to the public and enforced through liability for the firm, firm officials, and other gatekeepers—are the most effective method of promoting sound capital markets. At least according to Macey, the “due diligence” process, by which underwriters and other gatekeepers protect investors, results from statutory obligations imposed by the Securities Act of 1933 (p 127).<sup>105</sup> In imposing these obligations, Congress determined that market-based incentives, reputational constraints, and norms were insufficient to prevent gatekeepers from engaging in deceptive sales practices, market manipulation, or outright fraud.<sup>106</sup> Indeed, in regulating the IPO market, Congress used strict liability (mediated by affirmative defenses), a particularly strong form of regulation.<sup>107</sup>

The recent financial meltdown suggests that the regulatory interventions of the public offering process serve a valuable function in curbing market excess. The overwhelming majority of financial instruments that turned out to be excessively risky or outright fraudulent were sold through private placements or were specifically exempted—by Congress or SEC rule—from regulatory oversight.<sup>108</sup> The vast

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<sup>103</sup> Indeed, an active takeover market may create additional incentives for incumbent management to commit fraud in an effort to maintain a sufficiently high enough stock price to prevent a hostile bid.

<sup>104</sup> Commentators continue to debate the effectiveness of gatekeepers. See, for example, John C. Coffee, Jr., *Understanding Enron: “It’s about the Gatekeepers, Stupid,”* 57 Bus L 1403, 1408–16 (2002) (identifying various reasons for gatekeeper failure).

<sup>105</sup> Macey explains that underwriters and others engage in due diligence in order “to avoid legal liability” (p 127).

<sup>106</sup> See *Federal Supervision of Traffic in Investment Securities in Interstate Commerce*, HR Rep No 85, 73d Cong, 1st Sess 2 (1933) (“The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise.”). See also Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ‘33 and ‘34 Act Claims*, 76 Wash U L Q 537, 592 (1998) (describing IPOs as “analogous to insider trading”).

<sup>107</sup> See Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U Cin L Rev 139, 154–55 (2004) (identifying the strict liability nature of a § 11 claim, but noting that the due diligence defense creates liability akin to negligence).

<sup>108</sup> See *Geithner Cracks Down on Derivatives*, CNNMoney.com (July 10, 2009), online at [http://money.cnn.com/2009/07/10/news/economy/regulate\\_derivatives.reut/index.htm?postversio](http://money.cnn.com/2009/07/10/news/economy/regulate_derivatives.reut/index.htm?postversio)

\$450 billion global derivatives market, which included the now infamous credit default swaps that led to AIG's collapse, operated completely outside the authority of the SEC, the CFTC, and the Federal Reserve.<sup>109</sup> Most collateralized debt obligations (CDOs) are sold pursuant to an exemption from the registration requirements of the Securities Act of 1933, such as Rule 144A, which exempts securities sold exclusively to qualified institutional buyers.<sup>110</sup> Absent regulatory supervision, it appears that even the most sophisticated investors, such as the world's largest investment banks, could not protect themselves adequately.

At the same time, it is necessary to be cautious in extolling the virtues of the IPO market. As many scholars have observed, the informational efficiency upon which Macey relies in defending capital market discipline is more limited in the IPO market.<sup>111</sup> Scholars have identified evidence of possible inefficiencies, including underpricing,<sup>112</sup> the so-called "hot issues market,"<sup>113</sup> and long-term underperformance of IPO stocks.<sup>114</sup>

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n=2009071013 (visited Feb 22, 2010) (describing Timothy Geithner as acknowledging that the derivatives market had been virtually unregulated).

<sup>109</sup> See *id.* (noting the role of credit default swaps in the collapse of AIG); Jill E. Fisch, *Top Cop or Regulatory Flop?: The SEC at 75*, 95 Va L Rev 785, 808 (2009) (describing the process by which regulators exempted credit default swaps and most derivatives from regulation as either securities or commodities).

<sup>110</sup> 17 CFR § 230.144A. See, for example, J.P. Morgan Securities Inc, *CDO Handbook* \*31 (May 29, 2001), online at [http://www.docstoc.com/docs/7802583/JP-MORGAN-Collateralized-debt-obligations-\(CDOs\)-Handbook](http://www.docstoc.com/docs/7802583/JP-MORGAN-Collateralized-debt-obligations-(CDOs)-Handbook) (visited Sept 20, 2009) (stating that most CDOs are sold through exemptions or in transactions not subject to the registration requirements).

<sup>111</sup> See, for example, *In re IPO Securities Litigation*, 471 F3d 24, 42 (2d Cir 2006) (stating that "the market for IPO shares is not efficient").

<sup>112</sup> Underpricing refers to the difference between the IPO price and its subsequent market price. Studies have documented typical IPO underpricing at around 15 percent. See, for example, Jay R. Ritter, *The Long-Run Performance of Initial Public Offerings*, 46 J Fin 3, 3 (1991) (noting that the average underpricing is 16.4 percent), citing Roger Ibbotson, Jody Sindelar, and Jay Ritter, *Initial Public Offerings*, 1 J Applied Corp Fin 37, 41 table 1 (1998). This underpricing represents a cost to the issuer. See Tim Loughran and Jay R. Ritter, *Why Don't Issuers Get Upset about Leaving Money on the Table in IPOs?*, 15 Rev Fin Stud 413, 413 (2002) (describing underpricing as proceeds foregone by the issuer). See generally Jonathan A. Shayne and Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 Vand L Rev 965 (1995) (arguing that the IPO market is inefficient).

<sup>113</sup> See *Billing v Credit Suisse First Boston*, 426 F3d 130, 139 n 7 (2d Cir 2005) (defining a "hot issue" as a security for which investor demand exceeds supply, so that the stock trades at an immediate premium after the IPO).

<sup>114</sup> See, for example, Alexander Ljungqvist, Vikram Nanda, and Rajdeep Singh, *Hot Markets, Investor Sentiment, and IPO Pricing* \*21–22 (NYU Working Paper, Sept 2001), online at <http://archive.nyu.edu/bitstream/2451/26536/2/FIN-01-007.pdf> (visited Sept 20, 2009) (attributing pricing anomalies in the IPO market to underwriters taking advantage of irrational investors).

These inefficiencies suggest irrationality on the part of IPO investors and favoritism rather than gatekeeping by investment bankers.<sup>115</sup>

In addition, the IPO market offers some difficulty for Macey's assessment of takeover defenses. Jonathan Karpoff finds that a majority of IPO firms have antitakeover defenses in place at the time they go public.<sup>116</sup> The extent to which these defenses are priced-in is unclear, but this evidence suggests either that the market's pricing of takeover defenses in an IPO is inefficient<sup>117</sup> or that takeover defenses are not wealth-destroying for shareholders. In his work on the role of lawyers in drafting these provisions, John Coates raises further questions about the effectiveness of gatekeepers in protecting investor interests.<sup>118</sup>

As for hedge funds and other activist investors, Macey is clearly right in identifying their valuable role in finding market inefficiencies and other arbitrage opportunities (p 246). Macey's characterization of hedge funds as focused on corporate governance is, however, something of an overstatement (pp 244–45). To be sure, Carl Icahn, Relational Investors, Crescendo Partners, and several others have impressive track records in identifying undervalued corporations and employing strategies designed to improve their performance.<sup>119</sup> This form of activism is not new—many securities litigators from the mid-1980s recognize hedge funds as employing strategies previously used by so-called “strategic investors.”<sup>120</sup> Yet activist hedge funds represent only a

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<sup>115</sup> Id at \*1. See also Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* 187 (Oxford 2000) (describing the ability of managers to manipulate earnings and fool IPO investors into excessive optimism).

<sup>116</sup> Laura C. Field and Jonathan M. Karpoff, *Takeover Defenses at IPO Firms* \*3 (working paper, June 2000), online at <http://ssrn.com/abstract=236043> (visited Sept 15, 2009) (finding that 53 percent of over one thousand firms that went public over a four-year period had at least one antitakeover device in place).

<sup>117</sup> See Robert Daines and Michael Klausner, *Do IPO Charters Maximize Firm Value?: Antitakeover Protections in IPOs*, 17 *J L, Econ, & Org* 83 (2001) (suggesting this possibility).

<sup>118</sup> John C. Coates, IV, *Explaining Variations in Takeover Defenses: Blame the Lawyers*, 89 *Cal L Rev* 1301, 1313, 1383 (2001) (concluding that key terms in IPO charters result from lawyer-client agency costs and are not efficient).

<sup>119</sup> Phred Dvorak and Joann S. Lublin, *Boards Give Up Taming Act—Activist Investors Take Seats Increasingly without Fight*, *Wall St J C1* (Apr 7, 2008).

<sup>120</sup> See, for example, *Gillette Co v RB Partners*, 693 F Supp 1266, 1271 (D Mass 1988). The *Gillette* court explained strategic investing as follows:

In the parlance adopted for the purposes of this litigation, in making strategic block investments, GTO identifies companies whose shares are selling below what GTO believes the company as a whole could be sold for. GTO buys a large block of the company's stock. It then seeks to influence management to sell the company at a premium. If successful, this strategy would generate a quick and big profit for GTO and its investors.

Id at 1271.

small percentage of the industry,<sup>121</sup> and corporate governance-type activism is only one of a variety of hedge fund strategies.

Even activist hedge funds focus primarily on financial engineering rather than long-term operating strategies.<sup>122</sup> While it may make sense to sell off a subsidiary, engage in a stock repurchase, or increase corporate borrowing, these are the strategies of former investment bankers, not long-term “strategic partners” (pp 248–49)<sup>123</sup> and it is unclear whether they truly enhance long-term corporate performance.<sup>124</sup>

For example, one of the more common changes advocated by hedge funds is increasing corporate leverage. Leverage has the effect of multiplying shareholder returns so long as the firm’s profits exceed its cost of borrowing. It is an effective strategy as long as profits are high and interest rates are low. When the credit markets dried up in the fall of 2008, firms that had relied on credit rather than cash reserves found it difficult to weather the economic crisis. Studying hedge fund activism before the credit crisis, April Klein and Emanuel Zur found negative effects on firm creditworthiness including a reduction in bondholder

<sup>121</sup> See Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U Pa L Rev 1021, 1046 (2007) (citing a J.P. Morgan study stating that as little as 5 percent of hedge fund assets are invested in activist strategies). From a pool estimated to contain about 8,500 funds, for example, Alon Brav, et al, identified a total of 236 activist hedge funds for the period 2001–2006, and Klein found 101 for the period 2003–2005. Brav, et al, 63 J Fin at 1739 (cited in note 65); April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors* \*14 (working paper, Nov 2008), online at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=913362](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913362) (visited Nov 3, 2009). See also Amanda Cantrell, *Hedge Funds Launch, Close in Record Numbers*, CNNMoney.com (Mar 1, 2006), online at [http://money.cnn.com/2006/03/01/markets/hedgefund\\_stats](http://money.cnn.com/2006/03/01/markets/hedgefund_stats) (visited Feb 24, 2010) (reporting that, as of the end of 2005, there were roughly 8,500 hedge funds in existence).

<sup>122</sup> See Lipton and Savitt, 93 Va L Rev at 746 (cited in note 67) (describing hedge fund activists as “financial engineers”).

<sup>123</sup> In analyzing the strategies of activist investors, Macey does not distinguish sharply between hedge funds and private equity (indeed, he argues that the strategies of the two have converged) (p 245). Private equity operates quite differently from hedge funds, however. Increasingly, private equity firms bring in former public company executives, who focus more on operational strategy. See Emily Thornton, *Going Private*, Bus Wk 52 (Feb 27, 2006) (describing private equity executives as having the freedom to “repair [the] compan[y] for the long term”). This focus is possible, in part, because of the longer time frame associated with private equity investments. See *‘True Turnaround Specialists’ Are Poised to Survive in Today’s Challenging Private Equity Market*, Knowledge@Wharton (July 23, 2009), online at <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2303> (visited Sept 15, 2009) (describing how, in light of current financial conditions, the time frame for private equity investments has expanded from 3–5 years to 5–8 years).

<sup>124</sup> See Chris Serres, *Targeting Target*, Star Trib D1 (Jan 13, 2008) (criticizing a hedge fund for advocating the sale of one of Wendy’s fastest growing units and observing that, although the sale generated substantial gain for the hedge fund, Wendy’s price subsequently fell by almost 50 percent).

returns and a dramatic increase in firm risk.<sup>125</sup> Furthermore, if pressuring issuers to increase leverage is a common hedge fund strategy, it is likely to increase systemic as well as firm-specific risk.<sup>126</sup>

Even hedge fund strategies that do not involve leverage can contribute to systemic risk. Moreover, the secrecy of a particular hedge fund's strategy does not prevent its position from being correlated with those of other hedge funds. In particular, hedge funds control a tremendous amount of money that is often deployed in the form of market-based bets. To the extent that they are able to find willing counterparties, hedge funds dramatically increase the level of speculative market activity. Even if their bets are right, the losses may be devastating for the counterparties. The subprime crisis offers an example. A substantial number of hedge funds bet against the housing market by purchasing credit default swaps. AIG served as the counterparty on these swaps. When the housing market collapsed, not only did AIG suffer huge losses, but the hedge funds made collateral calls that created an immediate liquidity crisis.<sup>127</sup> This lack of liquidity, in turn, threatened the entire banking system, necessitating immediate government action.<sup>128</sup>

Moreover, hedge funds historically have been virtually unregulated, although the financial crisis will likely lead to increased regulation in the future.<sup>129</sup> Macey's citation to the Williams Act<sup>130</sup> as a regulatory restriction on hedge fund activism is unpersuasive (p 122); for most hedge fund activism, the Williams Act is simply irrelevant. Unless a hedge fund is making a tender offer, the Williams Act does not require it to disclose anything until after it acquires its stock, at which point disclosure does not increase the fund's acquisition costs. Activist hedge funds often welcome this disclosure as providing a vehicle for making

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<sup>125</sup> April Klein and Emanuel Zur, *The Implications of Hedge Fund Activism on the Target Firm's Existing Bondholders* \*26–27 (working paper, Nov 2008) (on file with author) (finding that within a year of being targeted by a hedge fund, 29 percent of the targets' credit ratings are downgraded).

<sup>126</sup> Macey, however, argues that hedge funds pose no systemic risk "because of the incredible diversity in their investment strategies" (p 268).

<sup>127</sup> See Serena Ng, *Hedge Funds May Get AIG Cash: Some Bailout Money Is Set aside to Pay Firms That Bet Housing Market Would Crater*, Wall St J A1 (Mar 18, 2009) (describing the liquidity crisis created by hedge funds' transactions with AIG).

<sup>128</sup> See Joe Nocera, *Propping up a House of Cards*, NY Times B1 (Feb 28, 2009) (describing government's bailout of AIG and explaining why the bailout was necessary).

<sup>129</sup> See Hedge Fund Adviser Registration Act of 2009, 2009 HR 711, 111th Cong, 1st Sess (Jan 27, 2009) (proposing to extend the registration requirement under the Investment Advisors Act to hedge funds).

<sup>130</sup> Williams Act of 1968 § 3, Pub L No 90-439, 82 Stat 454, 456.

their case public. Hedge funds that do not have an interest in affecting the control of a publicly traded issuer—the vast majority of hedge funds—often need not disclose anything under the Williams Act.

Macey's concern that required disclosure will increase the cost of purchasing control appears at odds with his defense of takeovers as benefitting target shareholders. If a hedge fund purchases control, pre-acquisition disclosure enables public shareholders to share some of the benefits of the fund's activism by demanding a higher price. If a hedge fund could purchase control without disclosing its intentions, the benefit to target company shareholders would be reduced. This would have the effect of converting the takeover market into a private arbitrage opportunity for bidders rather than a corporate governance mechanism.<sup>131</sup>

Perhaps the most creative part of *Promises Kept* is the chapter on Quirky Governance (pp 165–98). In this chapter, Macey draws an analogy between whistle-blowing and insider trading as tools for exposing corporate misconduct. He compares the actions and motives of Raymond Dirks, whom the SEC charged with insider trading, with those of Sherron Watkins in the Enron case. Although he does not “vilify” her, Macey portrays Watkins far less favorably than he portrays Dirks (p 172).

Generalizing from this comparison, Macey argues that the motives of insider traders and whistle-blowers are typically quite similar. Insider trading, he explains, is, however, a potentially more effective governance mechanism than standard whistle-blowing, both because it creates a financial incentive to expose wrongdoing and because the employee's financial investment increases the credibility of his or her disclosure (pp 175–76).

Macey goes on to consider the legitimacy of permitting a limited form of insider trading—short selling by innocent employees with knowledge of corporate misconduct. He argues that such selling is technically consistent with at least the property rights view of insider trading because a company does not have a proprietary interest in maintaining the secrecy of its ongoing fraudulent behavior (p 184). Drawing upon sources ranging from John Locke to John Rawls, he also addresses fairness considerations (pp 189–93).

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<sup>131</sup> This concern is potentially applicable to private equity investing as well. To the extent that private equity firms take their portfolio companies private before making operational changes, the gains from those changes do not inure to the benefit of public shareholders. Indeed, public shareholders may sell their stock in a “trough,” only to see the company subsequently go public at a much higher price.

Macey's defense of short selling is one of the most important components of *Promises Kept*. As Macey notes, short selling has traditionally been denounced by issuers and regulators (p 165).<sup>132</sup> The SEC has responded to issuer complaints of short selling by opening investigations and, in some cases, bringing enforcement actions against hedge funds and other investors who sell short.<sup>133</sup> Recently, Overstock.com sued a research firm that issued negative reports on its stock and a hedge fund that sold its stock short.<sup>134</sup> One of the SEC's first (and only) responses to the market crisis during the summer of 2008 was to introduce repeated bans on short selling, seemingly with the idea that, if investors could not sell short, prices would not fall.<sup>135</sup> Yet, as Macey explains, short sellers provide a critical role in detecting overpricing and improving capital market efficiency (p 173).<sup>136</sup> Their ability to do so currently remains in jeopardy.

Macey's defense of short selling is limited to the whistle-blower context, yet if his goal is to provide financial incentives that will encourage insiders to reveal fraud, insider trading is an imprecise solution. Among other concerns, there is no correlation between the whistle-blower's reward from insider trading and the social value of the disclosure; the whistle-blower's payoff depends only on the amount of money that he or she is willing to invest. A more finely tuned solution would incentivize low-level employees with a bounty tied to the value

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<sup>132</sup> See Bruce V. Bigelow, *Angry CEO Takes Aim at Short-Sellers and Cohorts: Columnist from San Diego Swept up in Controversy*, San Diego Union-Trib H1 (Mar 19, 2006) (describing the "war . . . between publicly traded companies and traders who bet against them").

<sup>133</sup> Short selling is legal, but the SEC's actions have been predicated on allegations of abuse or manipulation. See Kenneth M. Breen, et al, *NYAG and SEC Announce Wide-Ranging Market Manipulation Probes; SEC Adopts New Rules to Combat Abusive Short Selling* \*3 (Paul Hastings, Sept 2008), online at [http://www.paulhastings.com/assets/publications/1010.pdf?wt.mc\\_ID](http://www.paulhastings.com/assets/publications/1010.pdf?wt.mc_ID) (visited Sept 20, 2009) (describing SEC enforcement actions against short sellers).

<sup>134</sup> See *Overstock.com, Inc v Gradient Analytics, Inc*, 61 Cal Rptr 3d 29, 34 (Cal App 2007). The SEC opened an investigation into the matter but terminated it with a recommendation that no enforcement action be taken. See Gradient Analytics, *SEC Terminates Investigation of Gradient Analytics, Say No Enforcement Action Recommended* (Feb 14, 2007), online at [http://www.gradientanalytics.com/news/GA\\_PR\\_SECDropsInvestigation.pdf](http://www.gradientanalytics.com/news/GA_PR_SECDropsInvestigation.pdf) (visited Sept 15, 2009) (announcing termination of SEC investigation).

<sup>135</sup> See Fisch, 95 Va L Rev at 803-04 (cited in note 109) (describing short selling bans).

<sup>136</sup> Jonathan M. Karpoff and Lou Xiaoxia, *Short Sellers and Financial Misconduct* (working paper, Aug 5, 2009), online at <http://ssrn.com/abstract=1102853> (visited Sept 20, 2009) (finding that short sellers provide external benefits to uninformed investors "by helping to uncover financial misconduct and by keeping prices closer to fundamental values"). See generally Alexander Dyck, Adair Morse, and Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?* (The University of Chicago Booth School of Business Working Paper No 08-22, Oct 2008), online at <http://ssrn.com/abstract=1133771> (visited Sept 15, 2009) (discussing the role of employees, short sellers, and others in uncovering fraud).

of their disclosure. This approach would resemble the qui tam system currently in place under the federal False Claims Act.<sup>137</sup>

Macey's proposal also creates a potential moral hazard problem in that insiders might be encouraged to disseminate negative information in order to create trading opportunities. Distinguishing good faith whistle-blowing from vindictiveness is already difficult without the added motive of personal financial gain. If regulators view the potential for manipulation as significant, the risk of sanctions is likely to have a substantial chilling effect on whistle-blower trading. Nonetheless, the basic premise of this proposal—providing financial incentives for corporate insiders to reveal information that increases capital market transparency—is sound. As such, Macey's suggestion warrants further development.

### III. THE FUTURE OF CORPORATE GOVERNANCE

The core premise of *Promises Kept* is that market discipline is a more effective corporate governance mechanism than gatekeepers or procedural mechanisms mandated by external regulators. Developments subsequent to the publication of Macey's book, specifically the Financial Crisis of 2008–2009 and its impact on the broader global economy, attest to the accuracy of many of Macey's criticisms.

The dramatic failure of the credit agencies is particularly notable. Before the revelations in the summer of 2008,<sup>138</sup> Macey observed that credit rating agencies “provid[e] no information of value” (p 115). Subsequent developments revealed not only that the rating agencies had modeled the risk of structured financial products inappropriately, but they had also, in some cases, designed the very products they were rating in collaboration with the issuers. Moreover, Macey is spot on in attributing the failure of the rating agencies to the regulatory structure within which they operate. As Macey explains, the SEC's Nationally Recognized Statistical Rating Organization<sup>139</sup> (NRSRO) designation empowers the rating agencies to designate which securities are suitable for a host of regulated investors including banks, money market funds,

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<sup>137</sup> Act of March 2, 1863, 12 Stat 696, codified as amended at 31 USC §§ 3729–33. See Dyck, Morse, and Zingales, *Who Blows the Whistle on Corporate Fraud?* at \*25–27 (cited in note 136) (proposing qui tam provision to increase financial incentives for uncovering and reporting fraud); Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 L & Contemp Probs 167, 169–70 (1997) (proposing qui tam provision to address agency problems in private securities fraud litigation).

<sup>138</sup> See Aaron Lucchetti, *S&P Email: 'We Should Not Be Rating It,'* Wall St J B1 (Aug 2, 2008) (reporting that analysts at S&P would rate every deal, no matter how bad).

<sup>139</sup> 17 CFR § 240.17g1–6 (2008) (requiring NRSROs to register with the SEC).

and pension funds (p 115).<sup>140</sup> These regulations have the effect of substituting the agency for the market, as well as creating an artificial demand for ratings irrespective of their underlying accuracy.<sup>141</sup>

Recent events also add fuel to Macey's criticisms of the accounting industry.<sup>142</sup> Macey argues that Sarbanes-Oxley does not adequately address problems of firm capture and the absence of sufficient reputational constraints on accounting firms, reasoning that the cartelization of the industry prevents a market-based response to the demand for quality auditing services (pp 161–63).<sup>143</sup> Concededly, audit fees have gone up,<sup>144</sup> and auditors have reportedly become more conservative.<sup>145</sup> Yet the accounting industry has substantially contributed to the lack of transparency in the financial statements of large financial institutions through deficiencies and inconsistencies in its standards for reporting off-balance-sheet transactions, derivatives, and toxic assets.<sup>146</sup>

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<sup>140</sup> See John P. Hunt, *The SEC's Proposed Rating Agency Rules: Unresolved Conflicts* (Berkeley Center for Law, Business and the Economy Working Paper, June 28, 2008), available at <http://ssrn.com/abstract=1284709> (visited Oct 18, 2009) (describing the importance of an NRSRO rating).

<sup>141</sup> See Charles Calomiris, *The Subprime Turmoil: What's Old, What's New and What's Next* \*27 (working paper, Oct 2, 2008), online at [http://www.williams.edu/Economics/seminars/Calomiris\\_10\\_02\\_08.pdf](http://www.williams.edu/Economics/seminars/Calomiris_10_02_08.pdf) (visited Sept 20, 2009):

[Rating agencies were] transparently understating risk and inflating the grading scale of their debt ratings for securitized products so that institutional investors—who are constrained by various regulations to invest in debts highly rated by NRSROs—would be able to invest as they liked without being bound by the constraints of regulation or the best interests of their clients.

<sup>142</sup> The downturn has not uncovered a major accounting scandal to date. As the Financial Times notes, however, “PwC’s role as auditor and consultant for Northern Rock has been questioned, as has Ernst & Young’s audit of Lehman Brothers.” *Accountants*, Fin Times 14 (Sept 8, 2009) (noting that “litigation tends to lag behind a recession”).

<sup>143</sup> The evidence on whether auditor reputation matters is mixed. See Joseph Weber, Michael Willenborg, and Jieying Zhang, *Does Auditor Reputation Matter? The Case of KPMG Germany and ComROAD AG*, 46 J Acct Rsrch 941, 943, 945–48 (2008) (summarizing existing literature but finding evidence that, in Germany, reputation matters).

<sup>144</sup> See Michael Ettredge, Chan Li, and Susan Scholz, *Audit Fees and Auditor Dismissals in the Sarbanes-Oxley Era*, 21 Acct Horizons 371, 372 (2007) (reporting increases in required auditing work and in auditing fees for public companies following Sarbanes-Oxley).

<sup>145</sup> *Accountants*, Fin Times at 14 (cited in note 142) (stating that accounting firms have become more conservative since the downturn).

<sup>146</sup> See David Reilly, *Financial Crisis May Reach Auditors*, Wall St J Online (Mar 14, 2010), online at <http://online.wsj.com/article/SB10001424052748703457104575121920770049774.html> (visited Mar 26, 2010) (describing the focus in the Lehman bankruptcy examiner’s report on Lehman’s accounting policy and Ernst & Young’s audits of that accounting). See also Tammy Whitehouse, *Lawmakers Rap FASB on Sub-prime; More*, Compliance Wk (Feb 20, 2008), online at <http://www.complianceweek.com/article/3959/lawmakers-rap-fasb-on-sub-prime-more> (visited Oct 18, 2009) (“Collapsing credit markets have exposed a weakness that remains in accounting rules, even after Enron’s collapse first underlined the need for more transparency around off-

Anecdotal evidence suggests the industry is unable even to keep its own house in order. On July 31, 2009, Huron Consulting (which was formed by former partners at Arthur Andersen and which specializes in forensic accounting) announced expected material weaknesses in its own internal controls over financial reporting.<sup>147</sup> It disclosed errors that required it to restate three years of financial statements and to reduce its reported income by almost 50 percent.<sup>148</sup> Clearly neither the Sarbanes-Oxley reforms nor the founders' prior association with Arthur Andersen provided adequate incentives for Huron's partners to invest sufficient effort in maintaining the firm's reputation. As Bloomberg reporter Jonathan Weil put it, "The curse of Andersen . . . lives on."<sup>149</sup>

Finally, as I have detailed elsewhere,<sup>150</sup> developments suggest that Macey is perhaps charitable in characterizing the recent enforcement performance of the SEC as "anemic" (p 106). The revelation, in November 2008, of the \$50 billion fraud at Bernard Madoff Investment Securities LLC shocked the investment community, not merely because of the extent of Madoff's massive Ponzi scheme, but because the SEC had received and ignored "[c]redible and specific allegations regarding Madoff's financial wrongdoing going back to at least 1999."<sup>151</sup> A report by the SEC Inspector General revealed further deficiencies in connection with the SEC's oversight of Bear Stearns and its administration of the Consolidated Supervised Entities Program.<sup>152</sup> Macey's charge about

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balance-sheet activity."); Fisch, 95 Va L Rev at 806–07 (cited in note 109) (describing lack of transparency under FASB accounting rules and controversy over shifting to mark-to-market).

<sup>147</sup> See Huron Consulting Group, *Huron Consulting Group Announces Intention to Restate Financial Statements and Management Changes; The Company Provides Preliminary Second Quarter and Estimated Full Year 2009 Revenues* (July 31, 2009), online at <http://ir.huronconsultinggroup.com/phoenix.zhtml?c=180006&p=RssLanding&cat=news&id=1315063> (visited Sept 20, 2009) ("[M]anagement . . . expects that it will identify one or more material weaknesses in the Company's internal control over financial reporting.").

<sup>148</sup> Id (reporting reduction of \$57 million in income from 2006 to the first quarter of 2009).

<sup>149</sup> Jonathan Weil, *Blowing up Your Company Gets Raised to Art Form*, Bloomberg (Aug 6, 2009), online at <http://www.bloomberg.com/apps/news?pid=20601039&sid=afQBMs5AIpvc> (visited Sept 15, 2009).

<sup>150</sup> See Fisch, 95 Va L Rev at 803–15 (cited in note 109) (evaluating the SEC's recent enforcement efforts).

<sup>151</sup> *Congress Plans to Investigate Madoff Scheme; Mukasey Recuses Himself from Justice Probe*, Law.com (Dec 18, 2008), online at <http://www.law.com/jsp/article.jsp?id=1202426854578> (visited Sept 21, 2009).

<sup>152</sup> SEC, *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program* \*ix–xi (Sept 25, 2008), online at <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf> (visited Feb 23, 2010) (identifying a variety of oversight failures).

politicization (p 110) also appears supported by recent Commission votes on controversial issues that were split along party lines.<sup>153</sup>

Yet it would be overly simplistic to attribute the financial crisis to a failure in corporate governance. The crisis revealed substantial weaknesses in capital market discipline as well. In particular, the markets appeared unable to assess and price the riskiness of financial firms, to value derivatives, swaps, and other financial products, and to cope with the potential effect of systematic, as opposed to firm-specific, risk.<sup>154</sup> An unprecedented number of firms engaged in unsound business practices and took on enormous amounts of risk without the corresponding check of market discipline reducing their stock prices. Indeed, the inflated stock prices enjoyed by these firms enabled their managers to justify collecting huge compensation packages as they drove their companies toward collapse.<sup>155</sup>

Can it truly be said, as Macey claims, that “share prices provide the best lens with which to evaluate corporate performance” (p 155) when Bear Stearns traded for almost \$170 per share in January 2007, Lehman’s stock price was over \$65 per share at the beginning of 2007 before falling by more than 70 percent in the next six months (and subsequently becoming worthless when the company declared bankruptcy), and Enron traded for over \$90 per share in August 2000? Effective capital markets discipline requires more than informational efficiency; it requires sufficient firm-specific information to be available to the market and for investors to incorporate that information into their pricing and trading decisions. In particular, three develop-

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<sup>153</sup> Most recently, the Commission split 3-2 on a proposed rule providing shareholder access to the proxy. See Sara Hansard, *SEC Commissioners Approve Proposal to Allow Shareholders to Nominate Directors*, Investment News (May 20, 2009), online at <http://www.investmentnews.com/article/20090520/REG/905209985> (visited Oct 18, 2009) (describing party line vote). Under the prior administration, a differently composed SEC restricted proxy access, again voting along party lines. See Jill E. Fisch, *The Transamerica Case*, in Jonathan R. Macey, ed., *The Iconic Cases in Corporate Law* 46, 64–65 (West 2008) (describing the history of proposed Rule 14a-11).

<sup>154</sup> See Dominique Strauss-Kahn, *A Systemic Crisis Demands Systemic Solutions*, Fin Times 13 (Sept 22, 2008) (describing the financial crisis as “the result of regulatory failure to guard against excessive risk-taking in the financial system, especially in the US”); Adair Turner, *The Financial Crisis and the Future of Financial Regulation*, The Economist’s Inaugural City Lecture (Jan 21, 2009), online at [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121\\_at.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml) (visited Sept 15, 2009) (describing the biggest regulatory failure as “the failure to identify that the whole financial system was fraught with market-wide, systemic risk”).

<sup>155</sup> See, for example, *CEO Pay and the Mortgage Crisis*, Hearing before the House Committee on Oversight and Government Reform, 110th Cong, 2d Sess 110-81 (2008) (testimony of Nell Minow) (describing how inflated earnings reported by companies like Countrywide and Citigroup enabled executives to receive excessive compensation).

ments threaten the effectiveness of capital market discipline: a decline in transparency, an increase in the percentage of equity held by investor intermediaries, and a decrease in accountability.

With respect to market transparency, Macey accepts and even endorses the role of regulation in mandating disclosure (p 158). Yet existing regulatory gaps reduce the quality and quantity of disclosure. Exemptions from the registration process such as Rule 144A allow issuers to sell both traditional securities and new financial instruments without the gatekeepers and disclosure requirements mandated by the IPO process.<sup>156</sup> The Commodities Futures Modernization Act exempts swaps and most over-the-counter derivatives from regulation by either the SEC or the CFTC<sup>157</sup> and facilitated the dramatic growth of the virtually unregulated private credit markets as a source of capital before their collapse in the summer of 2008. Similarly, unregulated counterparties, including hedge funds, have enabled issuers to buy, sell, and repackage unprecedented quantities of risk, often with limited disclosure of that risk to the public markets and regulators.<sup>158</sup>

Even publicly traded companies have become less transparent. Enron dramatically demonstrated that if the market is given fraudulent information, share prices cannot provide reliable information about firm value. Apart from the fraudulent aspects of its financial statements, however, Enron showed how accounting rules and structured transactions allow issuers to obfuscate the nature of their operations and the level of risk to which they are exposed.<sup>159</sup>

Enron is neither an isolated nor outdated example. The recent debate over the appropriate methodology in valuing so-called toxic assets

<sup>156</sup> See Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Va L Rev 1025, 1059 (2009) (describing the 144A market as a “private market [that is] the economic equivalent to a registered public offering”).

<sup>157</sup> Commodity Futures Modernization Act of 2000 § 1(a)(5), Pub L No 106-554, 114 Stat 2763, 2763A-365, codified at 7 USC §§ 1–27.

<sup>158</sup> See Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market and Corporate Governance*, 34 J Corp L 641, 676 (2009):

[T]he private credit market is comprised of investors, such as hedge funds, who fall outside of regular review. Regulations or industry initiatives that enhance transparency—in pricing, secondary trading, and ownership—may help address systemic concerns arising from the possibility of accumulations of risk over which neither regulators nor market participants today are aware. Doing so may also enhance the availability of information in the private credit market and the informational content of trading prices.

<sup>159</sup> See, for example, William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 Tulane L Rev 1275, 1309–11 (2002) (describing Enron’s transactions involving special purpose entities and stating that the types and magnitudes of the transactions were disclosed in Enron’s financial statements).

for the purposes of financial disclosure illustrates the continued difficulty—practically and politically—in achieving transparency.<sup>160</sup> After the Financial Accounting Standards Board (FASB) changed its requirements on fair value accounting,<sup>161</sup> not surprisingly, the major financial institutions reported dramatically improved financial results.<sup>162</sup> Despite the fact that these changes were purely cosmetic, the market responded to them favorably.<sup>163</sup> Revelations about Lehman’s “Repo 105” maneuver raise similar concerns about the lack of transparency.<sup>164</sup>

A second concern is the increase in investor intermediaries. Transparency is not enough; disclosed information must be incorporated into share price through the actions of informed traders. There is reason to believe, however, that the percentage of such trading has declined. A growing amount of US equity is effectively controlled by intermediaries—mutual funds, hedge funds, pension funds, and so forth.<sup>165</sup> The incentives and objectives of these intermediaries, and their agents who make trading decisions, differ from those of traditional retail investors.<sup>166</sup> Some intermediaries invest passively in accordance with an index, some engage in herding, some seek to maximize their performance relative to a benchmark or a peer group, some seek absolute returns, and some may take advantage of momentum and irrationality to engage in trading strategies that actually drive prices away from true value, as in riding a bubble.<sup>167</sup>

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<sup>160</sup> See Fisch, 95 Va L Rev at 806–07 (cited in note 109). See also Jonathan Weil, *Wells Fargo’s Profit Looks Too Good to Be True*, Bloomberg (Apr 16, 2009), online at <http://www.bloomberg.com/apps/news?pid=20601039&sid=a6sv0hG.nW7g&refer=home> (visited Sept 20, 2009) (describing the lack of transparency in Wells Fargo’s financial statements proclaiming the company’s most profitable quarter ever).

<sup>161</sup> See Kara Scannell, *FASB Eases Mark-to-Market Rules*, Wall St J C1 (Apr 2, 2009) (reporting FASB change easing requirement that banks market assets to the market).

<sup>162</sup> See, for example, Susan Pulliam and Tom McGinty, *Congress Helped Banks Defang Key Rule*, Wall St J A1 (June 3, 2009) (reporting that Citigroup stated that the rule change “added \$413 million to first-quarter earnings”).

<sup>163</sup> See *id* (stating that the FASB accounting change “helped turn around investor sentiment on banks”).

<sup>164</sup> See Reilly, *Financial Crisis May Reach Auditors* (cited in note 146) (describing the bankruptcy examiner’s allegations that the “Repo 105” maneuver made Lehman “appear financially stronger than was really the case”).

<sup>165</sup> See generally Jill E. Fisch, *Rethinking the Role of Intermediaries in the Securities Markets*, 158 U Penn L Rev (forthcoming 2010) (describing the increasing intermediation of US capital markets).

<sup>166</sup> See Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 Seattle U L Rev (forthcoming 2010) (describing differing incentives and objectives of securities intermediaries such as pension funds and mutual funds).

<sup>167</sup> Ronald J. Gilson and Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J Corp L 715, 729 (2003) (explaining how the effect of arbi-

Although the literature on price formation and market efficiency has become increasingly sophisticated, it does not yet incorporate the effect of these intermediaries on the price efficiency upon which Macey's governance structure depends. Increasing investor passivity, in the form of indexed investors who buy without regard to firm information, reduces the market's responsiveness, while leveraged investors who trade on momentum may increase market volatility. In addition, to the extent the price setters in the current market are concerned with financial results other than long-term corporate performance, operational decisions that cater to the interests of these shareholders may be inconsistent with broader conceptions of social welfare. This inconsistency threatens the standard economic story, in which shareholder primacy maximizes firm value because the interests of the shareholders are most closely aligned with the long-term interests of the corporation.<sup>168</sup> Most importantly, investors who are evaluated on the basis of relative returns or market benchmarks may be insufficiently sensitive to systemic risk. This in turn precludes the market from imposing adequate discipline on firm managers who engage in excessive risk-taking.

Finally, the incentives of issuers and their agents to provide full and accurate disclosures are reduced by the limited accountability they bear for misinformation. As Macey recognizes, accurate share prices allow the market to discipline corporate decisionmakers (pp 155–56), yet accurate share prices depend on honest disclosure by those same decisionmakers. As a result, corporate officials have a strong incentive to manipulate their disclosure in order to reduce market discipline.<sup>169</sup> Meaningful accountability for disclosure violations is a critical component of efficient capital markets.

Under the current system, corporations and corporate officials face only limited accountability for incomplete and inaccurate disclosures.<sup>170</sup> Macey justifiably criticizes the SEC's enforcement record in

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trage trading may be "to drive up the price of already overvalued stocks, and to prolong the length and increase the extent of bubbles").

<sup>168</sup> See Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 Ohio St L J 1009, 1013–14 n 19 (1994) (summarizing the standard economic defense of shareholder primacy).

<sup>169</sup> Officials may have an additional incentive to manipulate disclosure in order to maximize their personal compensation, particularly to the extent that compensation structures such as stock options are tied to share price.

<sup>170</sup> The problem is particularly acute with respect to individual accountability. As some critics have noted, the SEC's most recent actions have targeted firms, but the agency has failed to hold individual wrongdoers accountable. See, for example, Rachel Beck, *SEC Looks Tough, but Actions against Individual Misdeeds Will Prove That*, Associated Press (Aug 7, 2009), online at [http://www.startribune.com/lifestyle/yourmoney/52773477.html?elr=KArks7PYDiaK7DUdcOy\\_nc:D](http://www.startribune.com/lifestyle/yourmoney/52773477.html?elr=KArks7PYDiaK7DUdcOy_nc:D)

recent years, and studies suggest that the SEC has played a very limited role in uncovering corporate fraud.<sup>171</sup> As Macey observes, one explanation is the extent of political influence over the SEC's activities (p 110). Policymakers have considered moving to a system in which the SEC is self-funded rather than dependent on Congress for budget increases.<sup>172</sup> The recent crisis has renewed consideration of this option, which might provide a start toward greater independence.<sup>173</sup> I have also argued that SEC appointments should incorporate broader constituency representation and diversity of focus to reduce the agency's susceptibility to interest group capture.<sup>174</sup>

One potential check on political influence and agency capture is private litigation, which serves as a backstop for retaining accountability during periods when public enforcement is politically costly.<sup>175</sup> The benefit of private litigation is twofold. First, by increasing the potential cost of fraud, litigation deters potential misconduct. Second, by compensating traders who are misled by fraud, litigation allows uninformed and nontrading investors to share the costs borne by informed traders who produce a governance externality through information-based trading. The financial crisis offers an opportunity to evaluate whether restrictions on private litigation have gone too far. Congress would do well to consider, for example, whether existing limitations on secondary actor liability, strict pleading requirements, and narrow understandings of causation and reliance are consistent with maintaining adequate capital market discipline.

The foregoing concerns are only a starting point in considering reforms to improve the effectiveness of the capital markets as a corporate governance mechanism. Commentators have identified many other areas of concern: the high levels of leverage in the markets, excessive volatility, black pools of capital, and other methods of rapid

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KUiacyKUzyaP37D\_MDua\_eyD5PcOiUr (visited Sept 20, 2009) (stating that "the SEC must not only extract settlements out of companies but also individuals responsible for corporate misdeeds").

<sup>171</sup> See Dyck, Morse, and Zingales, *Who Blows the Whistle on Corporate Fraud?* at \*2 (cited in note 136) (finding that the SEC accounts for disclosure of only 7 percent of corporate frauds).

<sup>172</sup> See Suzanne Barlyn, *Compliance Watch: Idea of SEC Self-funding Raises Questions*, Dow Jones Newswires (Aug 11, 2009) (discussing pros and cons of SEC self-funding).

<sup>173</sup> See Joanna Chung, Brooke Masters, and Francesco Guerrera, *SEC Chief in Call for Funding Shake-Up*, Fin Times 1 (Aug 6, 2009) (reporting SEC Chair Mary Schapiro's statement that the SEC should self-fund from industry fees).

<sup>174</sup> Fisch, 95 Va L Rev at 821-24 (cited in note 109).

<sup>175</sup> See Edward Labaton and Jesse Strauss, *The Role of Private Securities Class Actions in Financial Market Reform*, Lead Counsel (Labaton Sucharow LLP, Summer 2009), online at [http://www.labaton.com/en/ourpeople/upload/LeadCounsel\\_S09\\_PrivSecurities\\_nopage-s.pdf](http://www.labaton.com/en/ourpeople/upload/LeadCounsel_S09_PrivSecurities_nopage-s.pdf) (visited Nov 3, 2009) ("Relying solely on government regulation to prevent such catastrophes is only a half measure.").

and surreptitious trading. The key message of *Promises Kept* is that reform efforts are best directed to enhancing market discipline rather than imposing external governance mechanisms. Concededly, any regulatory reform bears with it the risk of political influence, industry capture, and simple government error—risks that suggest policymakers should tread carefully. The message of the financial crisis, however, is that fear of these risks should not result in blind complacency about the effectiveness of market-based governance.

#### CONCLUSION

As policymakers struggle to respond to the Financial Crisis of 2008–2009, and to implement reforms designed to increase the stability and productivity of US corporations, understanding corporate governance can help. *Promises Kept* offers a valuable history and analysis of traditional corporate governance mechanisms, explaining how they work and why they often do not. More important for current reform efforts, *Promises Kept* identifies critical weaknesses that may thwart even the best intentioned efforts at regulation, such as capture, political pressure, and regulatory arbitrage. Many of these weaknesses have been highlighted in the recent economic turmoil, and Macey's book should serve as a warning to those who might seek solutions in greater board independence or regulatory agency restructurings.

Yet it would be a mistake to attribute the financial crisis to a governance failure. As recent events have demonstrated, the capital markets offer increasingly high-powered incentives for issuers and their agents to structure, trade, and speculate in risk, and new financial products increase the probability that the effects of excessive risk-taking will not be isolated within a single firm. The systemwide externalities imposed by firm failure belie the claim that shareholders are protected adequately from risk through proper diversification and call for reforms that increase governance responses to risky behavior, both within the firm and within the market.

Here is where *Promises Kept* delivers. The appropriate objective of governance regulation is an efficient capital market. Regulatory reforms should focus on enhancing share price accuracy by mandating transparency, providing incentives for informed trading, and increasing accountability for misinformation. Changes to market structure, the development of new financial products, and globalization all serve to test the efficacy of traditional governance mechanisms. Understanding the deficiencies of the current system offers the promise of structuring markets that are better able to meet the challenges of the future.