Brian R. Cheffins

Corporate Governance since the Managerial Capitalism Era

Executives of today's public companies face a considerably different set of opportunities and constraints than did their counterparts in the managerial capitalism era, which reached its apex in the 1950s and 1960s. The growing importance of corporate governance featured prominently as circumstances changed for those running public companies. This article explores these developments, taking into account high-profile corporate scandals occurring in the first half of the 1970s and the early 2000s, the 1980s "Deal Decade," the "imperial" chief executive phenomenon, and changes to the roles played by directors and shareholders of public companies.

Corporate governance encompasses the checks and balances that affect those who run companies.[1] Issues that prompt corporate governance responses are endemic to the corporate form, particularly in a publicly traded company. As long as this sort of firm lacks a dominant shareholder—the typical if not universal situation in large U.S. public companies since the mid-twentieth century—it is unlikely that any one investor will have the wherewithal to keep executives in line.[2] Hence, for at least three-quarters of a century, managerial agency costs generated by inattentive or self-serving executives have constituted the core governance risk in the United States.[3]

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[1] Robert E. Wright, *Corporation Nation* (Philadelphia, 2014), 152. For more background on defining corporate governance see Donald C. Clarke, "Nothing but Wind: The Past and Future of Comparative Corporate Governance," *American Journal of Comparative Law* 59, no. 1 (2011): 75, 78–79 (reviewing leading definitions and saying "Corporate governance can mean many things to many people").

[2] Brian Cheffins and Steven Bank, "Is Berle and Means Really a Myth?" *Business History Review* 83, no. 3 (2009): 443, 455–58.

[3] Ibid., 443–44. The pioneering work on managerial agency costs was Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (1976): 305.

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While corporate governance concerns might be endemic to the corporate form, the now ubiquitous term "corporate governance" was largely unknown in the United States until the 1970s—and not until the 1990s in the rest of world. The basic chronology of the development of corporate governance from the 1970s onwards has been canvassed.[4] Little work has been done, however, on why events unfolded in the manner they did. Conceivably, the reason for this lack of analysis could be that nothing more was going on than the adoption of a handy catchphrase encompassing already familiar topics and themes. In fact, the new terminology was accompanied by a reconfiguration of governance arrangements in American public companies. These important changes coincided with and were related to the demise of a managerial capitalism era that reached its apex in the United States during the middle of the twentieth century. This article correspondingly considers how and why corporate governance became a prominent feature in debates concerning public companies as well as identifying the implications for executives, directors, and shareholders.

Some factors that account for the emergence and subsequent prominence of corporate governance have in fact been identified. For instance, various observers have noted that reaction to and analysis of corporate scandals during the first half of the 1970s helped to lift the phrase "corporate governance" from linguistic obscurity and that egregious misbehavior affecting companies such as Enron and WorldCom in the early 2000s served to lock in corporate governance institutionally by prompting a concerted regulatory response.[5] Similarly, it has been acknowledged that dramatic growth in the proportion of shares owned by institutional shareholders as the twentieth century drew to a close helped to bring corporate governance to the forefront in discussions of managerial power and accountability.[6]

This article will focus on additional, largely unexplored factors that contributed to the growing prominence of corporate governance. Particular emphasis will be placed on market and regulatory trends affecting the

[4] See, for example, Brian R. Cheffins, "Introduction," in *The History of Modern U.S. Corporate Governance*, ed. Brian R. Cheffins (Cheltenham, 2011), ix; Brian R. Cheffins, "The History of Corporate Governance," in *The Oxford Handbook of Corporate Governance*, ed. Mike Wright, Donald Siegel, Kevin Keasey, and Igor Filatotchev (Oxford, 2013), 46. On corporate governance developments in the United States prior to the term's deployment, see Wright, *Corporation Nation*; Eric Hilt, "History of American Corporate Governance: Law, Institutions, and Politics," *Annual Review of Financial Economics* 6, no. 1 (2014): 1.

[5] See, for example, Mariana Pargendler, "The Corporate Governance Obsession" (Stanford Law and Economics Olin Working Paper No. 470, FGV Direito SP Research Paper Series n. 111, last modified 11 Feb. 2015), 10–11, 20–21, available at http://ssrn.com/abstract=2491088.

[6] Brian R. Cheffins, "Delaware and the Transformation of Corporate Governance," *Delaware Journal of Corporate Law* 40 (forthcoming). Working paper version available at http://ssrn.com/abstract=2531640, see pp. 13–16.

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"opportunity set" (the menu of options available for choice) of senior executives of public companies.[7] Despite neither boards nor shareholders—both staples of corporate governance discourse—providing meaningful oversight of executives during the managerial capitalism era, it was relatively rare that executives engaged in the sort of misbehavior that could jeopardize, at least in the short term, the future of their companies. Various factors that constrained executives in the 1950s and 1960s—such as a "boring" banking industry that prioritized the reduction of risk, union power, and robust industry-level regulation—would be displaced or reconfigured in ensuing decades in a manner that simultaneously expanded the managerial options available to executives and increased the potential magnitude of agency costs. As the managerial capitalism era drew to a close, corporate governance, primarily in the form of more active boards and shareholders, introduced a substitute set of checks and balances. These failed to preclude either the rise of the "imperial CEO" (chief executive officer) in U.S. public companies or the corporate calamities such as Enron and WorldCom. Corporate governance–related checks and balances became more robust, however, in the wake of the corporate scandals of the early 2000s and the 2008–2009 financial crisis. This could mean that, for the foreseeable future, the managerial agency cost problem will be less acute than it has typically been since the end of the managerial capitalism era.

Governance in the Managerial Capitalism Era

According to distinguished business historian Alfred Chandler, during the late nineteenth century and the opening decades of the twentieth century there was a "managerial revolution" in which a growing division between ownership and control was accompanied by the flourishing of sophisticated managerial hierarchies and the development of an increasingly professional ethos among senior executives of large corporations.[8] A byproduct was that managerial capitalism prevailed in the United States in the decades immediately following World War II, at least among large business enterprises.[9] A hallmark of managerial capitalism was that it was the norm for large public companies to lack

[7] On the definition of "opportunity set" see Nicolas Gravel, "Ranking Opportunity Sets on the Basis of Their Freedom of Choice and Their Ability to Satisfy Choices: A Difficulty," *Social Choice and Welfare* 15, no. 3 (1998): 371.

[8] Alfred D. Chandler Jr., *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass., 1977), 9, 484; Alfred D. Chandler Jr., "The Competitive Performance of U.S. Industrial Enterprises since the Second World War," *Business History Review* 68, no. 1 (1994): 1, 14.

[9] Alfred D. Chandler Jr., *Scale and Scope: The Dynamics of Industrial Capitalism* (Cambridge, Mass., 1991), 620; Gerald F. Davis, *Managed by the Markets: How Finance Re-Shaped America* (Oxford, 2009), 63, 72–74.

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dominant shareholders capable of and motivated to impose meaningful checks on top executives. What Adolf Berle and Gardiner Means referred to in their famous 1932 book *The Modern Corporation and Private Property* as a separation of ownership and control correspondingly became the core fissure in U.S. corporate governance.[10]

During the heyday of managerialism there was awareness that the core fissure affecting public companies gave rise to the risk of managerial misbehavior.[11] As economist Edward Mason said in 1959, the "independence of corporate management from any well-defined responsibility to anyone carries with it the possibilities of abuse."[12] Theoretically, the shareholders in widely held firms who were prepared to act collectively could have used their right to elect the directors and other shareholder powers to keep executives in check, but the prospects for shareholder activism were bleak because retail investors lacking both the appetite and aptitude to intervene in corporate affairs collectively owned most of the shares.[13] Advocates of shareholder democracy, such as Lewis Gilbert, received substantial newspaper coverage, but the shareholder democracy movement was "small" (if "loud") and faced "rather astounding obstacles."[14]

Boards of directors also theoretically could have reduced the possibilities of abuse of managerial discretion. For instance, Robert Gordon, in his 1945 book *Business Leadership in the Large Corporation,* said that boards structured to be independent of management should function as "management auditors" that reported on a corporation's progress and the quality of its leadership, reasoning that such an arrangement would "provide in good part the check on decision-making officials which is now too frequently lacking."[15] During the 1950s and 1960s, however, boards were ill suited to scrutinize executives. The chairman of an eastern manufacturer was quoted in a 1960 *Wall Street Journal* article on a trend in favor of appointment of outside (nonexecutive) directors as saying, "Too many boards still meet in secret so that they can pass all of the resolutions at once, and spend most of the time talking about shooting, fishing, and women."[16] A 1968 study of directors indicated it was

[10] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York, 1932); Mark J. Roe, "The Inevitable Instability of American Corporate Governance," *Corporate Governance Law Review* 1, no. 1 (2005): 1, 2.

[11] Jeffrey N. Gordon, "The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices," *Stanford Law Review* 59, no. 6 (2007): 1465, 1511.

[12] Edward S. Mason, "Introduction," in *The Corporation in Modern Society*, ed. Edward S. Mason (Cambridge, Mass., 1959), 1, 11.

[13] Cheffins, "Introduction," xix.

[14] Daniel J. Baum and Ned B. Stiles, *The Silent Partners: Institutional Investors and Corporate Control* (Syracuse, 1965), 14–15.

[15] Robert A. Gordon, *Business Leadership in the Large Corporation* (Berkeley, 1945), 347.

[16] Richard F. Janssen, "Working Directors," *Wall Street Journal*, 30 Nov. 1960, 1.

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unwise "to assume all is well at the corporate pinnacle," citing "outside-director absenteeism, one-hour or even briefer regular sessions, and not-too-frequent meetings."[17] Likewise, Myles Mace reported in 1971 that boards of public companies rarely asked discerning questions or engaged in meaningful measurement of executive performance and would contemplate dismissing the CEO only in the event of a crisis.[18]

Perhaps not surprisingly, given that neither shareholders nor boards were likely to impose meaningful checks on executives, there were instances of egregious managerial misbehavior during the managerial capitalism era. In the mid-1950s, financier Lowell Birrell used complex corporate merger transactions as a platform from which to loot a dozen corporate treasuries of millions of dollars before fleeing to Cuba.[19] In the late 1950s, Earl Belle, a youthful director of publicly traded Cornucopia Gold Mines, engaged in share price manipulation to increase the company's share price before absconding to Brazil with nearly $1 million in company funds.[20] Edward Gilbert, having relied on family backing to gain control of hardwood manufacturer E. L. Bruce & Co., stole $2 million from the corporate till in 1962 and fled to Brazil when a bid to acquire a larger company foundered.[21] There were also less obvious forms of managerial opportunism. These included "perks" such as lavish corporate headquarters and executive airplanes as well as ill-advised managerial empire building in the form of a 1960s trend in favor of diversification by merger, exemplified by the creation of sprawling conglomerates such as International Telephone & Telegraph (ITT), Gulf & Western, and Litton Industries.[22]

While neither boards nor shareholders were doing much to keep executives in check during the heyday of managerial capitalism, and while managerial misbehavior was by no means unknown, there was little appetite for substantial change to the governance arrangements of public companies. The dean of Yale Law School said of large public companies in 1959 that "enlightened lay opinion could be summarized in these terms":

> Yes, there are paradoxes and anomalies in the ways boards of directors are elected in some large, publicly-held companies. But what of it? . . . [M]ost boards of directors are not so bad. Business seems energetic. . . . All in all, the system may be illogical, but it works.[23]

[17] Stanley Vance, *The Corporate Director: A Critical Evaluation* (Homewood, Ill., 1968), 24.

[18] Myles L. Mace, *Directors: Myth and Reality* (Boston, 1971), 206.

[19] Homer Bigart, "Birrell Ends Exile of 7 Years," *New York Times*, 24 Apr.1964, 52.

[20] Hillel Black, *The Watchdogs of Wall Street* (New York, 1962), 168–92.

[21] John Brooks, *The Go-Go Years* (New York, 1973), 58–80.

[22] George P. Baker and George David Smith, *The New Financial Capitalists: Kohlberg Kravis Roberts and the Creation of Corporate Value* (Cambridge, U.K., 1998), 14–17.

[23] Eugene V. Rostow, "To Whom and for What Ends Is Corporate Management Responsible?" in *The Corporation in Modern Society*, ed. Mason, 46, 59.

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Corporate success does much to explain the perception that the system "worked." When World War II ended, the United States experienced a prolonged economic boom, most leading corporations grew rapidly, and, as an incidental byproduct, shareholders did well.[24]

Confidence that, aside from a few "pirates" and "buccaneers," top executives were unlikely to take improper personal advantage of their positions reinforced the belief that the system "worked."[25] A 1965 study of institutional shareholders that specifically cited the examples of Birrell, Belle, and Gilbert to make the point there was a need for checks on executives nevertheless indicated that "the vast majority of professional managers are undoubtedly faithful to the responsibilities imposed by their stewardship."[26] With conglomerate mergers, while a divestiture wave in the 1980s provided strong evidence that many were misguided, perceptions were different when the deal making was occurring.[27] During the late 1960s, Harold Geneen, head of ITT, was acclaimed as the greatest businessman of his time.[28] More generally, the conglomerate was thought of as a superior organizational structure, benefiting from reduced risk due to diversification and functioning as an internal capital market that supposedly could allocate capital more swiftly and adeptly among divisions than the market could.[29]

Even Adolf Berle, having identified the separation of ownership and control in public companies as a potentially serious problem in 1932, acknowledged during the managerial capitalism era that things had worked out better than he had anticipated. He observed in 1959 that "the principles and practice of big business" were "considerably more responsible, more perceptive and (in plain English) more honest than they were in 1929."[30] Likewise, he said in 1962 that serious corporate scandals were, "happily, rare" and acknowledged that conflicts of interest between managers and shareholders likely were less pronounced three decades after the publication of *The Modern Corporation and Private Property*,

[24] Mary O'Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (Oxford, 2000), 105–7; Ira M. Millstein, "The Evolution of Corporate Governance in the United States—Briefly Told," in *Corporate Governance: Critical Perspectives on Business and Management*, ed. Thomas Clarke (Abingdon, U.K., 2005), 263, 271.

[25] Black, *Watchdogs of Wall Street*, 19.

[26] Baum and Stiles, *Silent Partners*, 7.

[27] Baker and Smith, *New Financial Capitalists*, 17.

[28] Robert Sobel, *The Rise and Fall of the Conglomerate Kings* (New York, 1984), 127.

[29] Mark J. Roe, "From Antitrust to Corporation Governance? The Corporation and the Law: 1959–1994," in *The American Corporation Today*, ed. Carl Kaysen (New York, 1996), 102, 109–10; Brian Cheffins and John Armour, "The Eclipse of Private Equity," *Delaware Journal of Corporate Law* 33, no. 1 (2008): 1, 30.

[30] Adolf A. Berle, "Foreword," in *The Corporation in Modern Society*, ed. Mason, ix, xiii.

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even though increasingly diffuse share ownership meant the separation of ownership and control had become more acute.[31]

Given the weak checks shareholders and boards imposed on executives, why did the potential for abuse not translate into more of the sort of misbehavior that would subsequently prompt calls for corporate governance reform? The nature of corporate leadership prevalent during the managerial capitalism era likely played a significant role. The prototypical executive of this era was a bureaucratically oriented "organization man" who subordinated personal aspirations to promote corporate goals.[32] The chief executive functioned not as a charismatic leader but as an industrial statesman well suited to accommodating a wide range of constituencies, including regulators and politicians.[33] CEOs were, in turn, cornerstones of "a moderate, pragmatic corporate elite . . . based primarily in the largest American corporations."[34]

Various factors helped to keep top management on the straight and narrow during the managerial capitalism era. Values such as duty, honesty, service, and responsibility that were fostered under the testing conditions of the Great Depression and World War II likely contributed to a sense of moral restraint among mid-twentieth-century executives.[35] Restrictions on access to finance helped to keep managerial ambition in check, with commercial banks experiencing an era of "boring" banking due to tight regulation and with investment banks having a partnership-based organizational structure in which personal liability of partners discouraged risk taking in the form of adventurous financing of companies.[36] Organized labor was a force to be reckoned with in many industries, and executives, fearful of debilitating lengthy strikes, frequently agreed to changes to work rules that could

[31] Adolf A. Berle, "Modern Functions of the Corporate System," *Columbia Law Review* 62, no. 3 (1962): 433, 437, 438n9.

[32] Amanda Bennett, *The Death of the Organization Man: What Happens When the New Economic Realities Change the Rules for Survival at Your Company* (New York, 1990), 13–14. The term "organization man" was coined in this context by William Whyte in *The Organization Man* (New York, 1956).

[33] Rakesh Khurana, *From Higher Aims to Hired Hands: The Social Transformation of American Business Schools and the Unfulfilled Promise of Management as a Profession* (Princeton, N.J., 2007), 205–6, 355; Robert Reich, *Supercapitalism: The Battle for Democracy in an Age of Big Business* (New York, 2007), 45–46.

[34] Mark S. Mizruchi, *The Fracturing of the American Corporate Elite* (Cambridge, Mass., 2013), 43.

[35] Tom Brokaw, *The Greatest Generation* (New York, 1998); Robert Sobel, *The Great Boom: How a Generation of Americans Created the World's Most Prosperous Society* (New York, 2000), 48–50, 127–28.

[36] See Mizruchi, *American Corporate Elite*, 136; Brian R. Cheffins, "The Corporate Governance Movement, Banks and the Financial Crisis," *Theoretical Inquiries in Law* 16, no. 1 (2015): 1, 19–21.

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significantly limit their managerial prerogatives.[37] Federal securities laws introduced in the mid-1930s may also have had a role to play. David Skeel, drawing in 2005 upon the Greek myth of the ill-fated Icarus to characterize as "Icaran" historically noteworthy U.S. executives who took bold and, ultimately, ill-advised risks, wrote that disclosure obligations federal securities regulation introduced made it "much harder for an Icaran entrepreneur to disguise what he was doing and take desperate gambles."[38]

Market structure imposed a final significant check on executive overreach during the managerial capitalism era. Oligopolistic arrangements prevailed in many industries due to a dearth of foreign competition and what amounted to a "managed national economy" where regulators were dictating prices and enforcing standards in telecommunications, transport, utilities, and other key sectors.[39] Market power provided insulation from competition, fostering among top executives of dominant firms a bias to hold a steady course as long as possible.[40] This likely stored up trouble because the circumspect executives of companies that were dominant during the managerial capitalism era were probably failing to treat cost reduction, the changing needs of customers, and product innovation as sufficiently high priorities.[41] On the other hand, with corporate culture favoring bureaucrats over entrepreneurial dissenters, Icaran executives prone to taking bold risks that could jeopardize the future of their companies if things went wrong were unlikely to move to the forefront.[42] The author of a 1963 book entitled *The Managed Economy* even suggested that "the individual entrepreneur has disappeared from all but marginal areas of enterprise."[43]

The Cracks Begin to Appear

A management consultant, writing in 1996, characterized the business environment of the 1950s in the following terms:

> There was easy access to cheap raw materials, the cost of money was low and stable, and the major markets of the world were cut off from each other by poor communications and expensive distribution. A reasonably well-made product was always able to find a ready

[37] Mizruchi, *American Corporate Elite*, 98–110; Eli Ginzberg and George Vojta, *Beyond Human Scale: The Large Corporation at Risk* (New York, 1985), 79–80, 85–86.

[38] David Skeel, *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From* (Oxford, 2005), 106.

[39] Khurana, *From Higher Aims*, 206; Reich, *Supercapitalism*, 47.

[40] Ginzberg and Vojta, *Beyond Human Scale*, 136–37.

[41] Baker and Smith, *New Financial Capitalists*, 12.

[42] Skeel, *Icarus in the Boardroom*, 171.

[43] Michael D. Reagan, *The Managed Economy* (New York, 1963), 6.

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> market, so that the producer could easily charge more than its costs and make a profit. And constant growth covered up most of our mistakes. It was indeed rather difficult to fail.[44]

Matters changed as the 1960s turned into the 1970s. Meaningful foreign competition emerged for the first time in decades, and the margin for error was reduced further for U.S. companies because resources relied upon for production were becoming increasingly scarce and more expensive.[45] Early casualties of these changing conditions would set the scene for both initial regular usage of "corporate governance" terminology and increased emphasis on governance mechanisms largely ignored during the heyday of managerial capitalism.

Railways, to a greater extent than firms in many other industries, were put under intense competitive pressure in the 1950s and 1960s as airlines expanded and highway construction flourished.[46] The Pennsylvania Railroad remained sufficiently on track to keep intact its record of more than a century's worth of uninterrupted dividends, but its fate was sealed by a disastrous 1968 defensive merger with the New York Central.[47] Penn Central was a management mess, with a chairman of the board who was more interested in real estate holdings acquired as part of a diversification plan than in railways, a president who was ignored, and railway foul-ups and misroutings.[48] The Penn Central directors were asleep at the switch throughout, with one admitting that the board was little more than a rubber stamp and a horrible example.[49] In what was characterized as "the most spectacular case of corporate mismanagement in recent history," Penn Central became in 1970 what at that time was the largest bankruptcy in history.[50]

Though Penn Central's problems were particularly egregious, impropriety was in no way restricted to the troubled railway. By 1976 the Watergate special prosecutor's office had successfully prosecuted nearly twenty companies for violating campaign finance laws, meaning the infamous Watergate scandal shook public confidence in the business community as well as in politicians.[51] Dozens of American public

[44] Mike Davidson, *The Transformation of Management* (Boston, 1996), 55–56.

[45] Ibid., 59–62.

[46] Robert Sobel, *When Giants Stumble* (Paramus, N.J., 1999), 199–200.

[47] Joseph R. Daughen and Peter Binzen, *The Wreck of the Penn Central* (Boston, 1971), 256.

[48] Sobel, *When Giants Stumble*, 208.

[49] Daughen and Binzen, *Wreck of the Penn Central*, 9–10; "Penn Central: The Unanswered Question," *Forbes*, 15 July 1970, 18; "To Resign or Challenge," *Forbes*, 15 May 1976, 104.

[50] "The Old Penn Central Gang," *Forbes*, 15 Dec. 1973, 22 (quotation); Paul Blustein, "The Reincarnation of Penn Central," *Forbes*, 1 May 1977, 50.

[51] Leonard Silk and David Vogel, *Ethics and Profits: The Crisis of Confidence in American Business* (New York, 1976), 17.

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corporations, motivated at least partly by fears of losing business to aggressive competitors, made illegal or questionable foreign payments during the first half of the 1970s.[52] In many of these companies, one or more members of senior management knew of or approved the illicit practices while the outside directors were uniformly ignorant of what was going on.[53] According to the U.S. Securities Exchange Commission (SEC), this represented "frustration of our system of corporate accountability" that would help to put corporate governance in the spotlight.[54]

Corporate Governance on the Agenda

The Penn Central bankruptcy and the revelations of corporate corruption ensured that corporate governance became part of the official reform agenda in the mid-1970s. The SEC attacked on various fronts what it considered to be negligence in the boardroom. These included the launching of proceedings against three of Penn Central's outside directors in 1974 and the resolving of numerous foreign corrupt-practices cases by settling proceedings on the condition that the companies would make board-level changes, such as appointing additional outside directors and creating an audit committee.[55] In addition, due to SEC prodding, the New York Stock Exchange (NYSE) amended its listing requirements in 1977 to obligate each listed company's board to have an audit committee composed of directors independent of management.[56] The commission also held six weeks' worth of public hearings that year to examine "shareholder participation in the corporate electoral process and corporate governance generally."[57]

Harold Williams, chairman of the SEC, warned as the 1977 hearings got underway that if public companies did not upgrade managerial accountability voluntarily the result could be "a watershed shift toward governmental control and policing of the corporate governance process."[58] Ultimately a 1980 SEC staff report based on the hearings

[52] "The Global Costs of Bribery," *Business Week*, 15 Mar. 1976, 22. For a list see Lester A. Sobel, ed., *Corruption in Business* (New York, 1977), 150–55.

[53] Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Boston, 1982), 537.

[54] Ibid., 542.

[55] "A New, Sterner Standard," *Business Week*, 11 May 1974, 158; B. E. Calame and Eric Morgenthaler, "The Hot Seat: Outsider Directors Get Tougher, More Careful after Payoff Scandal," *Wall Street Journal*, 24 Mar. 1976, 1; A. A. Sommer, "The Impact of the SEC on Corporate Governance," *Law and Contemporary Problems* 41, no. 3 (1977): 115, 130–31.

[56] Burt Schorr, "Corporate Directors Scored for Lax Scrutiny of Managements' Acts," *Wall Street Journal*, 10 Apr. 1978, 1.

[57] Harold Williams, "Forward," in Securities and Exchange Commission, *Staff Report on Corporate Accountability* (Washington, D.C., 1980), 1–2.

[58] "Corporate Governance—New Heat on Outside Directors?" *Business Week*, 1 Oct. 1977, 33.

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refrained from recommending legal reform concerning board structure or related issues.[59] Others, however, were proposing corporate governance–related legislation. In 1980, Senator Howard Metzenbaum, having previously appointed a blue-ribbon advisory committee on corporate governance in his capacity as chairman of a congressional subcommittee, introduced to Congress the Protection of Shareholders' Rights Act.[60] This draft legislation, if enacted, would have mandated an independent-director majority on boards, required the establishment of audit and nomination committees made up exclusively of independent directors, and gave shareholders novel rights to nominate candidates for election to the board of directors.[61] These were also features of the Corporate Democracy Act of 1980, a bill introduced to Congress by Representative Benjamin Rosenthal that was designed to reform the governance structure of corporations so they would act in more democratic and accountable ways.[62]

Corporate governance was not merely a topic of interest in Washington, D.C. Use of the term "corporate governance" in newspapers and academic journals began in earnest in the late 1970s (Figure 1). The American Bar Association and the Business Roundtable, an association of CEOs of leading U.S. firms, acknowledged in separate reports in 1976 and 1978, respectively, that boards of public companies should typically have a majority of outside directors and should establish audit, compensation, and nomination committees dominated by outside directors.[63] The American Law Institute (ALI), the mission of which is to undertake projects that clarify and modernize areas of the law, committed itself in principle in 1978 to address corporate governance.[64]

The United States was a first mover with the corporate governance nomenclature. The term came into general usage elsewhere only in the 1990s, even in Britain, the corporate governance reform strategies of which would turn out to be influential globally in that decade.[65] Crucially, the growing popularity of the term corporate governance was in

[59] Securities and Exchange Commission, *Staff Report,* 34.

[60] Protection of Shareholders Rights Act of 1980, S. 2567, 96th Cong., 2nd Sess. 126 Cong. Rec. S3,754.

[61] Howard M. Metzenbaum, "Legislative Approaches to Corporate Governance," *Notre Dame Law Review* 56, no. 5 (1981): 926, 929, 932–33.

[62] The Corporate Democracy Act of 1980, H.R. 7010, 96th Cong., 2nd Sess.; Mark Green et al., *The Case for a Corporate Democracy Act of 1980* (Washington, D.C., 1979), 5.

[63] "Corporate Directors' Guidebook," *Business Lawyer* 32, no. 1 (1976): 5, 11; Business Roundtable, "The Role and Composition of Directors of the Large Publicly Owned Corporation," *Business Lawyer* 33, no. 4 (1978): 2083, 2089, 2108.

[64] Seligman, *Transformation of Wall Street*, 342–43.

[65] Brian R. Cheffins, "The Rise of Corporate Governance in the U.K.: When and Why," *Current Legal Problems* 68 (forthcoming). Working paper available at http://ssrn.com/abstract=2598179, see pp. 2–3, 26, 51–53.

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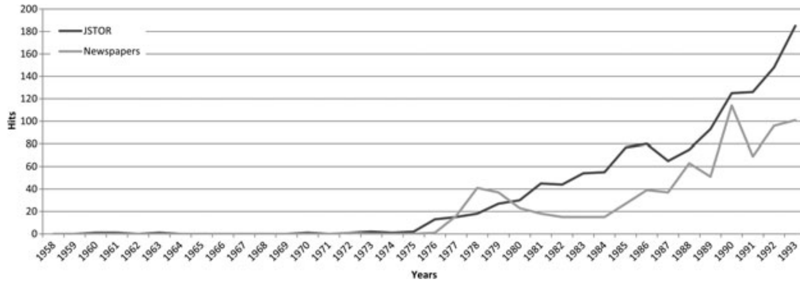

Figure 1. Hits from the term "corporate governance" in newspapers/academic journals in ProQuest and JSTOR databases, 1958–1993. Notes: The end date of 1993 was chosen because coverage ends in the early 1990s for most major newspapers in the ProQuest database. JSTOR hits under headings such as "front matter," "volume information," "back matter," and "books received" have been excluded. (Sources: ProQuest Historical Newspapers Database; JSTOR.)

the United States not merely a change in nomenclature. Instead, debates about corporate governance reflected a new approach to the challenges managerial accountability (or a lack thereof) might pose. Given that neither boards nor shareholders were well situated to intervene, during the 1950s and 1960s little store could realistically be placed in mechanisms associated with corporations as a means of restraining the executives in charge. Instead, constraints would have to be external, whether in the form of law, public opinion, or market forces.[66] Matters changed in the 1970s. There was a shift in emphasis toward reforming corporate decision-making processes, with advocates of corporate governance reform treating the board of directors as a potentially meaningful and beneficial constraint on wayward executives.[67]

Though theoretically shareholders can take steps to keep management in line, they were an afterthought in most fledgling discussions of corporate self-governance.[68] For instance, a prominent New York corporate lawyer suggested in 1982 that "the stockholder's role" was unlikely "to change greatly during the lifetime of the corporate governance

[66] See, for example, Dow Votaw, *Modern Corporations* (Englewood Cliffs, N.J., 1965), 104–15 (identifying potential controls on the exercise of corporate power, and largely dismissing internal constitutionalization as a possibility in so doing); Roy C. Smith and Ingo Walter, *Governing the Modern Corporation: Capital Markets, Corporate Control and Economic Performance* (Oxford, 2006), 73 (saying of Berle and Means that they "did not expect the corporation as they conceived it to restrain itself through corporate governance efforts").

[67] George C. Grenias and Duane Windsor, "Introduction: The Problem of Corporate Governance," in *The Changing Boardroom*, ed. George C. Grenias and Duane Windsor (Houston, 1982), 1, 11; Harold Williams, "A View of Corporate Accountability," in *Changing Boardroom*, ed. Grenias and Windsor, 128, 132.

[68] On the terminology, see Robert S. Hatfield, "The Changing Corporate Environment: Problems and Opportunities," in *Changing Boardroom*, ed. Grenias and Windsor, 18, 30.

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reform debate."[69] Even those who approved of shareholder democracy in theory acknowledged the obstacles created by retail investor domination of share ownership.[70] In fact, shareholders would begin to move into the corporate governance spotlight during the 1980s, the decade to which we turn next.

The Deal Decade

As the 1980s got underway, there was evidence the flurry of interest in corporate governance that occurred in the 1970s might be subsiding. While coverage in academic journals (primarily law reviews) continued to expand, newspaper reporting tailed off (Figure 1).[71] A political shift to the right, exemplified by Ronald Reagan's 1980 election to the presidency, effectively foreclosed the possibility of federal legislative reform and aggressive SEC intervention.[72] The ALI continued with its corporate governance project but, in the face of opposition from the business community and law school academics examining corporate law from a new, market-friendly law and economics perspective, quickly backed away from proposals to endorse mandatory rules concerning board structure.[73] Corporate governance, however, would not be on the ropes for long. Instead, a takeover wave in the United States in the 1980s would set the stage for it to develop further over ensuing decades.

In the 1980s, an era referred to as "the Deal Decade," putative acquirers of companies relied on aggressive, innovative financial and legal techniques to offer generous premiums to shareholders of a wide range of target companies in order to secure voting control.[74] Takeover bids can be a potent external governance mechanism that motivates incumbent managers to keep their corporation's share price up. The incentive will be to foreclose the possibility of a takeover offer by an unwelcome bidder who anticipates that displacing an underperforming management team will generate sufficient additional value to justify proceeding.[75] Takeovers, by motivating executives to focus on shareholder returns,

[69] Joseph Hinsey, "Corporate Governance: Legal Realities and Trends," in *Changing Boardroom*, ed. Grenias and Windsor, 37, 38.

[70] Cheffins, "Introduction," xix.

[71] Of the 119 articles in the JSTOR database published between 1980 and 1982 in which the term "corporate governance" appears, eighty-five were published in law journals.

[72] Joel Seligman, "Introduction," *University of Michigan Journal of Law Reform* 22, no. 1 (1988): 1, 3.

[73] Cheffins, "History of Corporate Governance," 51.

[74] On the "Deal Decade" nomenclature see Margaret M. Blair, *The Deal Decade: What Takeovers and Leveraged Buyouts Mean for Corporate Governance* (Washington, D.C., 1993).

[75] James P. Welsh and James K. Seward, "On the Efficiency of Internal and External Corporate Control Mechanisms," *Academy of Management Review* 15, no. 3 (1990): 421, 434–35.

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can influence the behavior of management in a manner similar to internal corporate governance mechanisms such as monitoring by boards, shareholder activism, and executive compensation that has been structured to align pay with performance.[76] Correspondingly, if the hostile takeover activity occurring during the 1980s had become a permanent feature of the corporate landscape, this could have rendered internal governance mechanisms largely superfluous. In fact, the Deal Decade, and in particular its demise, helped to foster interest in corporate governance.

A nascent recession and a debt market chill helped to bring 1980s merger activity to a halt, and the deployment of judicially sanctioned takeover defenses and the enactment of antitakeover statutes in many states meant hostile bids were hit particularly hard.[77] There was widespread awareness that because the threat of hostile takeovers could keep management in check, their demise might reduce managerial accountability.[78] For instance, the *Washington Post*, having noted in a 1990 article that "the takeover artists have all but disappeared," acknowledged there was apprehension "that, without the raiders standing in the shadows, a key force has disappeared that had served to keep U.S. business lean, energetic and resourceful."[79] Thinking along these lines proved to be a boon for corporate governance as attention turned increasingly to the role the board of directors, shareholder activism, incentivized executive compensation, and related internal governance mechanisms could and should play in keeping managers in check.[80]

The Deal Decade also prompted a rethink of the position of shareholders that ultimately would provide an additional boost for corporate governance. During the heyday of managerial capitalism it was widely accepted that public company executives should not treat shareholder returns as their sole priority but rather take into account the interests of employees, consumers, and even society at large.[81] Shareholders similarly were not accorded special priority in 1970s debates on corporate governance. Ralph Nader, Mark Green, and Joel Seligman's *Taming the Giant Corporation*, a 1976 book that offered one of the earliest theorizations of corporate governance using that term, advocated the

[76] Ibid., 422–24, 445.

[77] Cheffins, "Delaware and the Transformation," 13, 67, 74–83.

[78] Ibid., 68.

[79] Kathleen Day and Robert McCartney, "Who's Minding the Managers?" *Washington Post*, 19 Aug. 1990, H1.

[80] On boards and shareholder activism see Sarah Bartlett, "Life in the Executive Suite after Drexel," *New York Times*, 18 Feb. 1990, F1. On executive pay, see Alfred Rappaport, "The Staying Power of the Public Corporation," *Harvard Business Review* 68, no. 1 (1990): 96, 103.

[81] Gordon, "Rise of Independent Directors," 1511–14; Harwell Wells, "'Corporation Law is Dead': Heroic Managerialism, Legal Change, and the Puzzle of Corporation Law at the Height of the American Century," *University of Pennsylvania Journal of Business Law* 15, no. 2 (2013): 305, 326, 331.

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imposition on directors of oversight responsibilities extending well beyond shareholder interests.[82] SEC chairman Harold Williams indicated that he thought the board of a public company should be a guardian of not only the corporation's stockholders but also the corporation's long-term future and society as a whole.[83] The proposed Corporate Democracy Act of 1980 contained provisions mandating extensive social disclosure by corporations and imposing on directors significant responsibilities regarding the formulation of corporate policy toward employees, the environment, and the community at large.[84]

In contrast with the situation in the 1970s, corporate governance during the 1980s became increasingly associated with shareholder returns, which served to fortify its status in a market-friendly decade. Economists, for instance, recoiled from the 1970s version of corporate governance, as the phrase seemed to have little to do with markets and instead implied the corporation was a political structure to be governed.[85] The situation changed as corporate governance became more closely associated with shareholder interests, with many economists ultimately equating the term with mechanisms designed to ensure that suppliers of finance obtained a satisfactory risk-adjusted return on their investment.[86] This conceptual congruence, combined with the linguistic flexibility of the term "corporate governance," fostered its prominence within economic discourse.[87]

The takeover wave played a prominent role in the reorientation of corporate governance around shareholders. The 1980s surge in the number of hostile bids meant the fate of publicly traded companies hinged to an unprecedented degree on shareholder perceptions of the capabilities of the incumbent management team. Assumptions about the balance of power between management and stockholders in public companies were correspondingly modified in the stockholders' favor.[88] Perceptions of corporate governance evolved accordingly.

[82] William Ocasio and John Joseph, "Cultural Adaptation and Institutional Change: The Evolution of Vocabularies of Corporate Governance, 1972–2003," *Poetics* 33, nos. 3–4 (2005): 163, 167; Ralph Nader, Mark Green, and Joel Seligman, *Taming the Giant Corporation* (New York, 1976), 124–25, 130–31.

[83] "Corporate Governance," *Business Week*; Harold M. Williams, "Corporate Accountability: Board of Directors," *Vital Speeches of the Day*, 15 May 1978, 468.

[84] Green et al., *Case for a Corporate Democracy Act*, 10, 14–15.

[85] Ocasio and Joseph, "Cultural Adaptation," 174.

[86] Andrei Shleifer and Robert W. Vishny, "A Survey of Corporate Governance," *Journal of Finance* 52, no. 2 (1997): 737–38. Subsequently, topics such as corporate social responsibility and employee rights would quite often be discussed in corporate governance terms. See, for example, Marc Goergen, *International Corporate Governance* (Harlow, U.K., 2012), 153–61, 172–90.

[87] Ocasio and Joseph, "Cultural Adaptation," 174.

[88] William W. Bratton, "The New Economic Theory of the Firm: Critical Perspectives from History," *Stanford Law Review* 41, no. 6 (1989): 1471, 1521.

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The association between corporate governance and shareholder value was strengthened further as the 1980s drew to a close, as institutional shareholders were increasingly drawn into the governance arena. While the retail investors who collectively dominated share ownership during the managerial capitalism era were ill suited to engage in activism, during the 1970s pension funds and mutual funds better situated to intervene due to their power and sophistication were steadily displacing retail investors as owners of shares.[89] This trend did not yield radical changes, at least not immediately. Investment managers acting on behalf of institutional shareholders feared that intervening in the affairs of underperforming companies would be a time-consuming activity that was unlikely in the event of success to have a significant beneficial impact on a diversified investment portfolio.[90] Regulation also created various obstacles for those institutional investors otherwise inclined to engage in activism, such as rules creating an onus to diversify.[91] The Deal Decade, however, would bring at least some institutional shareholders off of the governance sidelines.

Institutional investors of the 1980s valued the opportunity to sell their stock in response to a premium-priced takeover offer.[92] Correspondingly, when boards concerned about possible hostile bids began adopting potent takeover defenses, there was shareholder pushback. The battle was an uphill one, particularly given that many states were enacting antitakeover statutes and judges were typically rejecting challenges to managerial defensive tactics.[93] Nevertheless, the initial foray would help to set the stage for further activity. The California Public Employees' Retirement System (CalPERS), prodded by state treasurer Jesse Unruh, was an early and vocal objector to the deployment of takeover defenses and to promote this agenda launched in 1985 an association of public pension funds labeled the Council of Institutional Investors. The Council, which lobbied generally to promote shareholder rights, became in the 1990s a prestigious and influential corporate governance organization.[94]

[89] Melvin Aron Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Boston, 1976), 53, 56–57; Michael Useem, *Executive Defense: Shareholder Power and Corporate Reorganization* (Cambridge, Mass., 1993), 29–32, 55.

[90] Cheffins, "Introduction," xx.

[91] Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton, 1994), 104–5, 138–39.

[92] Emile Geylein and Richard Koenig, "Pension Funds Plot Against Takeover Law," *Wall Street Journal*, 5 Apr. 1989, C1.

[93] Cheffins, "Delaware and the Transformation," 61–67, 76–77.

[94] Stuart L. Gillan and Laura T. Starks, "The Evolution of Shareholder Activism in the United States," *Journal of Applied Corporate Finance* 19, no. 1 (2007): 55, 57; Justin Fox, *The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street* (New York, 2009), 271–72; Brehm v. Eisner, 746 A.2d 244, 256n30 (Del. 2000).

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1990s: The Decade of Corporate Governance

A *Financial Times* columnist observed in 1999 that "the 1990s have been the decade of corporate governance."[95] Given corporate scandals of the early 2000s that would prompt what was for U.S. corporate governance "something like a hundred year flood of reform," such a declaration might seem to have been premature.[96] On the other hand, it was during the 1990s that the term "corporate governance" initially gained prominence internationally.[97] Moreover, in the United States expectations rose under the banner of corporate governance that both boards and shareholders could and would contribute substantially to managerial accountability.

For boards the scene was set because the Penn Central scandal and related developments in the 1970s had prompted substantial changes to board composition and structure.[98] The proportion of directors of public companies who were at least nominally independent of management increased from one-quarter in 1970 to nearly three-fifths in 1990.[99] Over the same period, it became the norm for boards to establish and delegate key tasks to audit, nomination, and compensation committees comprised primarily, if not entirely, of independent directors.[100]

In the early 1990s, dismissals of CEOs from prominent companies such as Goodyear, Westinghouse, American Express, General Motors, IBM, and Kodak indicated that at board level the substance was matching the form.[101] The pattern appeared to be sustained through the remainder of the decade. Jay Lorsch, author of a 1989 book on boards entitled *Pawns and Potentates*, suggested in 2001 that directors in the 1980s "were more like the pawns. Today they are more like the potentates."[102] Law professor Ronald Gilson similarly asserted, "Directors are now energized."[103]

With shareholders, even though the managers of the nation's pension funds were christened as "Wall Street's New Musclemen" in

[95] Moira Conoley, "Moves to Halt Another Decade of Excess," *Financial Times*, 5 Aug. 1999, 10.

[96] Robert B. Thompson, "Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law," *Delaware Journal of Corporate Law* 29, no. 3 (2004): 779, 791; Pargendler, "Corporate Governance Obsession," 16.

[97] Cheffins, "History of Corporate Governance," 57–58.

[98] On the significance of the Penn Central scandal, see "End of the Directors' Rubber Stamp," *Business Week*, 10 Sept. 1979, 72.

[99] Gordon, "Rise of Independent Directors," 1474.

[100] Cheffins, "Delaware and the Transformation," 9.

[101] Ibid., 71.

[102] Jay W. Lorsch, *Pawns and Potentates* (Boston, 1989); "The Professor: Jay Lorsch," *Directors & Boards*, Fall 2001, 18.

[103] Ronald Gilson, "Unocal Fifteen Years Later (And What We Can Do about It)," *Delaware Journal of Corporate Law* 26, no. 2 (2001): 491, 513.

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1989, in the 1990s institutional investors generally shied away from taking on a substantial hands-on corporate governance role.[104] On the other hand, the increased assertiveness by boards at the beginning of the decade resulted at least partly from institutional shareholder pressure.[105] When hostile takeovers subsided, institutional investors were aware that substitute strategies would likely be needed to foster managerial accountability.[106] Leaning on boards to keep executives in check was one such step.

Another was pressing for changes to executive pay. As well as pressuring companies to strengthen the independence of compensation committees, institutional shareholders lobbied companies to use incentive-oriented compensation liberally and not simply pay executives on the basis of the size of the companies they ran.[107] A dramatic surge in the use of equity-based pay—most prominently the awarding of stock options—led to a marked increase in CEO pay-to-performance sensitivity and encouraged executives to adhere to an emerging norm that executives should strive to maximize shareholder value.[108] The legacy was, however, a problematic one. When the abrupt end of a dot-com stock-market frenzy together with a series of corporate scandals caused share prices to fall precipitously in the early 2000s, the dramatic increases in compensation top executives enjoyed during a 1990s bull market were not reversed, leaving executives open to the charge they had manipulated the setting of pay to their own advantage.[109]

Dramatic changes affecting the managerial function in U.S. public companies also contributed to the enhanced profile of corporate governance in the 1990s. By this point in time, key precepts of managerial capitalism had been dislodged in a manner that meant executives had both a wider opportunity set and greater potential for failure. Under such circumstances, executive performance logically would have mattered more for corporate success, meaning in turn that proper functioning of

[104] David Pauly, "Wall Street's New Musclemen," *Newsweek*, 5 June 1989, 46; Cheffins, "History of Corporate Governance," 54.

[105] Mark Potts and Frank Swoboda, "CEOs Turn a Cold Shoulder to Heat Dished Out by Shareholders," *Washington Post*, 11 May 1992, A6; Steve Lohr, "Big Business in Turmoil," *New York Times*, 28 Jan. 1993, A1.

[106] Ronald J. Gilson and Reinier Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors," *Stanford Law Review* 43, no. 4 (1991): 863, 871.

[107] Robert J. McCartney, "When Mega-Pay and Mini-Profits Collide," *Washington Post*, 24 Mar. 1991, H1; Frank Dobbin and Dirk Zorn, "Corporate Malfeasance and the Myth of Shareholder Value," *Political Power & Social Theory* 17 (2005): 179, 189.

[108] Gordon, "Rise of Independent Directors," 1529–31; Michael Useem, "Corporate Restructuring and the Restructured World of Senior Management," in *Broken Ladders: Managerial Careers in the New Economy*, ed. Paul Osterman (New York, 1996), 37–42.

[109] Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, Mass., 2004).

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corporate governance should have been a higher priority than had previously been the case.

Deregulation was one trend that enhanced managerial discretion in a manner that implied a governance response. The regulated capitalism of the 1950s and 1960s was characterized not only by governmental setting of prices and standards but also by antitrust enforcement that essentially precluded horizontal mergers involving firms with a sizable market share.[110] Deregulation, which commenced during the Jimmy Carter administration with the airline and trucking industries, got into full swing under Reagan in areas such as antitrust and oil and gas and continued in the 1990s with electricity and telecommunications.[111] Deregulation increased the importance of the managerial function in firms affected because the unraveling of constraints on pricing, distribution patterns, and product innovation created new opportunities to generate profits while the removal of the regulatory safety net meant substantial downside risk for laggards.[112]

Changes in workplace relations also bolstered the latitude afforded to executives. Union membership among private-sector workers fell from 35 percent in the mid-1950s to 15 percent in the mid-1990s and the number of strikes fell dramatically over the same period.[113] Correspondingly, while many executives operating during the heyday of managerial capitalism had to be mindful of maintaining the goodwill of organized labor, their counterparts in the 1990s had wide discretion to respond to technological change and intensified competition by outsourcing and downsizing.[114]

A reorientation of corporate finance expanded managerial discretion still further. While during the 1950s and 1960s a conservative mind-set prevalent among commercial and investment banks restricted corporate access to debt finance, substantial liberalization had occurred by the 1990s. Most major investment banks had become publicly traded, ending the partner liability regime that had bred caution, and major commercial banks seeking to capture market share in response to deregulation in the banking sector adopted an increasingly bold approach to corporate lending.[115] Companies could also take advantage of a wide

[110] "Rough Road to Capitalism," *Harvard Magazine*, Jan./Feb. 2015, 62; Khurana, *From Higher Aims*, 206–7.

[111] Skeel, *Icarus in the Boardroom*, 119–20, 198.

[112] Ibid., 159–60; Stacey Kole and Kenneth Lehn, "Deregulation, the Evolution of Corporate Governance Structure, and Survival," *American Economic Review* 87, no. 2 (1997): 421, 425.

[113] Steven Greenhouse, "Strikes at 50-Year Low," *New York Times*, 29 Jan. 1996, A12; Barry T. Hirsch and Edward Schumacher, "Private Sector Union Density and the Wage Premium: Past, Present and Future," *Journal of Labor Research*, 22, no. 3 (2001): 487, 488–98.

[114] Reich, *Supercapitalism*, 108–9.

[115] Cheffins, "Corporate Governance Movement," 21–23, 25.

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range of new debt instruments to finance their existing operations, fresh acquisitions, and expansion plans.[116] With increased capacity to borrow, "the opportunities for American executives expanded tremendously."[117]

Improved access to finance could be a curse as well as a blessing for executives, as evidenced by the experience of vertically integrated "first movers" that dominated numerous key sectors of the U.S. economy when managerial capitalism was at its apex. Immediately following World War II such firms appeared to be unassailable, partly because potential upstarts lacked the financial firepower to muster a serious challenge.[118] By the 1990s, in contrast, the erstwhile dominant incumbents, already shaken by surging foreign competition, had to deal with new entrants who could not only rely on technological innovation to replicate rapidly the specialized resources that had previously provided a decisive competitive advantage but also readily secure the funding needed to play catch-up.[119] Accordingly, while during the 1960s and 1970s only about 4 percent of the Fortune 500 was replaced annually, 40 percent of companies on the 1990 Fortune 500 list were off the list by 1995.[120]

The changing circumstances under which executives were operating were heralded widely, with books such as *The Death of the Organization Man, The Transformation of Management*, and *Welcome to the Revolution* imparting the message that "being a CEO 'ain't' what it used to be."[121] Perceptions of top management changed accordingly. The 1990s witnessed the rise of the imperial chief executive, with the definition of an effective CEO reputedly changing "from that of competent manager to charismatic leader."[122] For instance, Robert Monks, an early and prominent advocate of robust corporate governance who had been member of the board of the conglomerate Tyco, said of chief executive Dennis Kozlowski in a favorable 2001 *BusinessWeek* profile of

[116] Raghuram G. Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists* (New York, 2003), 68.

[117] Randall S. Thomas, "Explaining the International CEO Pay Gap: Board Capture or Market Driven?" *Vanderbilt Law Review* 57, no. 4 (2004): 1171, 1228. Credit market borrowing by the nonfinancial corporate sector increased from $191.6 billion in 1975 to $339 billion in 1980 and to $955 billion in 1985 (not adjusted for inflation). See, for relevant years, "Financial Accounts of the United States," Federal Reserve Statistical Release Z.1, table F.1, accessed 28 Apr. 2015, http://www.federalreserve.gov/releases/z1/current/data.htm.

[118] Rajan and Zingales, *Saving Capitalism*, 37–38.

[119] Ibid., 70–72, 77–79.

[120] W. Chan Kim and Renée Mauborgne, "A Corporate Future Built with New Blocks," *New York Times*, 29 Mar. 1998, Business sec., 14; Marina v.N. Whitman, *New World, New Rules: The Changing Role of the American Corporation* (Boston, 1999), 9.

[121] Bennett, *Death of the Organization Man*; Davidson, *Transformation of Management*. Tom Cannon, *Welcome to the Revolution: Managing Paradox in the Twenty-First Century* (London, 1996); J. David Pincus and J. Nicholas DeBonis, *Top Dog* (New York, 1994), 15.

[122] Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs* (Princeton, 2002), 71.

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Kozlowski entitled "The Most Aggressive CEO," "I don't think there is a better CEO in America."[123]

A consensus developed under the new conditions prevailing in the 1990s: that CEOs could do more to influence corporate success than was previously the case.[124] The implications for corporate governance were significant. With executives thought to matter more, boards and shareholders logically would have treated having the right person in charge as a top priority and would have wanted compensation arrangements to provide executives with robust incentives to perform effectively. The growing emphasis on linking managerial pay with performance and a substantial increase in CEO turnover that occurred in the late 1990s implied that there had indeed been a meaningful governance response to the new market environment.[125]

By the end of the 1990s corporate governance had become part of the fabric of corporate life in the United States. Those interested in the topic had a rapidly growing literature to which they could refer and there had been changes on the ground as well.[126] The *Economist* observed in 1999 that the spate of CEO dismissals in the early 1990s had "change[d] the balance of power between shareholders and boards at big American firms" and suggested "incompetent chief executives in large companies [were] rarer than they were in 1990."[127] Economists Bengt Holmstrom and Steven Kaplan struck a similar chord in a 2001 survey of corporate governance, saying that "since the mid-1980s, the U.S. style of corporate governance had reinvented itself" and predicted that "a more market-oriented corporate governance than existed up to the early 1980s is here to stay."[128] Corporate scandals that were beginning to engulf prominent U.S. corporations at the time would soon demonstrate that even though corporate governance had clearly arrived in the 1990s, the arrangements in place were not sufficiently robust to cope with public companies "mass producing new Icaran heroes du jour and . . . giving them the ability to take huge risks almost instantly."[129]

[123] William C. Symonds, "The Most Aggressive CEO," *BusinessWeek*, 28 May 2001, 68, 71.

[124] "The Best . . . and the Rest: A Survey of Pay," *Economist*, 8 May 1999, 14.

[125] The average tenure of a CEO of a *Fortune 500* company fell from 7.9 years between 1992 and 1996 to 5.2 years between 1997 and 2002. See Steven N. Kaplan and Bernadette A. Minton, "How Has CEO Turnover Changed?" *International Review of Finance* 12, no. 1 (2012): 57, 61–62.

[126] See, for example, Douglas M. Branson, *Corporate Governance* (Charlottesville, Va., 1993); Robert A. G. Monks, *Corporate Governance* (Cambridge, Mass., 1995).

[127] "Thank You and Goodbye," *Economist*, 30 Oct. 1999, 91.

[128] Bengt Holmstrom and Steven N. Kaplan, "Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s," *Journal of Economic Perspectives* 15, no. 2 (2001), 121, 140, 141.

[129] Skeel, *Icarus in the Boardroom*, 160.

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The Beginning of the End of the Imperial Chief Executive

Eighteen months after *BusinessWeek* had published its 2001 profile of Kozlowski, and less than a year after the same publication had named him one of the twenty-five best managers of the year, the magazine ran a cover story entitled "The Rise and Fall of Dennis Kozlowski" which, based on revelations of egregious misuse of Tyco funds, tax evasion, and accounting shenanigans, labelled him "a rogue CEO for the ages."[130] The Tyco scandal had a strong corporate governance dimension, in that one director had received a sizable illicit payment from Kozlowski and the other directors had realized much too late that "this guy is doing things we don't know about."[131] Tyco was hardly unique. Lax boardroom oversight also was a feature of scandals at Enron and WorldCom involving senior executives who, being eager to benefit from stock options and related forms of incentive-oriented compensation, tried to game the accounting numbers to ensure their companies met quarterly earnings targets.[132]

With corporate governance having emerged in the 1990s as the term academics, policymakers, and investors would most likely deploy when analyzing issues relating to the enhancement of managerial accountability, media coverage of and academic research on corporate governance jumped sharply as a result of the corporate scandals of the early 2000s.[133] The scandals also "marked the beginning of the end of the imperial chief executive."[134] The Sarbanes-Oxley Act of 2002 (SOX), which was the primary regulatory response to the scandals, imposed various new governance-related requirements on publicly traded companies, such as requiring that chief executives and chief financial officers of public companies certify the accuracy and completeness of quarterly and annual financial reports and mandating the establishment of audit committees composed entirely of independent directors.[135] The same year, the NYSE and NASDAQ, at the behest of the SEC, promulgated rules requiring that listed companies have boards with at least a majority of independent directors.[136] One predicted result of the reforms was

[130] "The Top 25 Managers of the Year," *BusinessWeek*, 14 Jan. 2002, 52; Anthony Bianco, William Symonds, and Nanette Byrnes, "The Rise and Fall of Dennis Kozlowski," *BusinessWeek*, 23 Dec. 2002, 65.

[131] Bianco, Symonds, and Byrnes, "Rise and Fall," 76.

[132] Cheffins, "Introduction," xii; Skeel, *Icarus in the Boardroom*, 60, 163–65.

[133] Cheffins, "Corporate Governance Movement," 5.

[134] Joshua Chaffin, "Exit the Emperor Bosses, Leaving a Legacy of Prudence," *Financial Times*, 19 Mar. 2005, 11.

[135] Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745, §§ 301, 302 (2002).

[136] Thompson, "Delaware," 792–93, 796; Donald C. Clarke, "Three Concepts of the Independent Director," *Delaware Journal of Corporation Law* 32, no. 1 (2007): 73, 89–91.

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"Goodbye, the imperial CEO."[137] This indeed transpired, though only partly due to regulatory change.

Former SEC chairman Arthur Levitt, writing in 2005, said, "Gone are the days of the autocratic, muscular CEO whose picture appeared on the covers of business magazines. . . . The imperial CEO is no more."[138] Levitt acknowledged the significance of the regulatory reforms introduced in the wake of the corporate scandals, but said "they are not what are driving this shake-up. Rather we are experiencing a cultural change in America that has been building slowly, accelerated by Enron, WorldCom, and other corporate debacles."[139] Others agreed that market developments, including the corporate scandals and the sharp stock market correction of the early 2000s, had prompted "a governance revolution."[140] A 2007 *Wall Street Journal* article entitled "After the Revolt" cited a "new, post-revolutionary generation of power in corporate America" exemplified by CEOs "on shorter leashes, more beholden to their boards of directors."[141] Alan Greenspan, chairman of the Federal Reserve of the United States from 1987 to 2006, observed in a 2007 memoir, "In the aftermath of the Enron and WorldCom scandals, the power of the corporate CEO has been diminished and that of the board of directors and shareholders enhanced."[142]

Levitt cited the then recent ousting of CEOs at prominent public companies such as AIG, Hewlett-Packard, and Disney as evidence in support of his claims concerning the reconfiguration of corporate governance in U.S. public companies.[143] While David Skeel expressed concern about "Icaran tendencies" that SOX had "left untouched," fiscal prudence was another indication that the hubris of CEOs was being held in check.[144] During the mid-2000s the balance sheets of large U.S. public companies were in their best shape in decades, due in large part to the fact that many such firms treated the paying down of existing debt as a priority and generally refrained from engaging in fresh short-term borrowing.[145] A 40 percent inflation-adjusted decline in the average annual compensation of CEOs of S&P 500 companies during the 2000s, albeit following on from the executive pay explosion of the

[137] Michael Weiser and Jeff Zilker, "Nader for CEO," *Barron's*, 27 Jan. 2003, 33.

[138] Arthur Levitt, "The Imperial CEO Is No More," *Wall Street Journal*, 17 Mar. 2005, A16.

[139] Ibid.

[140] John Plender, "It's the Revolution, Stupid," *Financial Times*, 21 Mar. 2005, 20.

[141] Alan Murray, "After the Revolt," *Wall Street Journal*, 5 May 2007, A1.

[142] Alan Greenspan, *The Age of Turbulence: Adventures in a New World* (New York, 2007), 429.

[143] Levitt, "The Imperial CEO."

[144] Skeel, *Icarus in the Boardroom*, 190.

[145] Andrew Bary, "Hot Money," *Barron's*, 7 Nov. 2005, 29; Barrett Sheridan, "Big Business Is Not to Blame," *Newsweek*, 15 Dec. 2008, Atlantic ed., 48.

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1990s, implied similarly that imperial CEOs were a much less prominent feature of corporate America post-Enron.[146] A dearth of corporate scandals despite a stress test in the form of a sharp decline in share prices prompted by the financial crisis of 2008–2009 further confirmed that executives of public companies were more boring than they had been pre-Enron.[147]

Banks Belatedly Become Boring

While the imperial CEO was on the run in the wake of early-2000s corporate scandals, deficient corporate governance at U.S. financial firms was cited by numerous observers as a potential cause of the financial crisis that afflicted the United States in 2008–2009.[148] There is some evidence suggesting that the quality of corporate governance at banks did not contribute materially to the onset of the crisis.[149] On the other hand, in contrast with the general trend among post-Enron public companies, domineering proactive top executives such as Stan O'Neal (Merrill Lynch), Chuck Prince (Citigroup), and Angelo Mozilo (Countrywide Financial) remained a prominent feature of the banking industry throughout the mid-2000s. Bank boards also may have been too complacent about the risks their management teams were running as the crisis loomed.

While most firms reeled in the wake of the dot-com crash and corporate scandals of the early 2000s the financial sector continued to deliver strong shareholder returns from 2000 until the financial crisis commenced. This likely explains why the freewheeling celebrity CEO was tolerated in the banking sector in a way that was out of step with general trends. Be that as it may, the onset of the financial crisis ended whatever corporate governance free pass the banks had enjoyed. Criticism of executive pay at financial companies quickly mounted, shareholder activism became more pronounced, and boards dismissed senior executives at a rapid clip.

[146] Steven N. Kaplan, "CEO Pay and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges," *Journal of Applied Corporate Finance* 25, no. 2 (2013): 8, 10.

[147] On the corporate governance response of large U.S. public companies most dramatically affected by the financial crisis, see Brian R. Cheffins, "Did Corporate Governance 'Fail' during the 2008 Stock Market Meltdown? The Case of the S&P 500," *Business Lawyer* 65, no. 1 (2009): 1. Stephen D. Willits and Curtis Nicholls report a sizable drop in the number of newspaper stories dealing with accounting-related fraud in the late 2000s, which indicates that scandals were less prevalent. See "Is the Sarbanes-Oxley Act Working?" *CPA Journal*, Apr. 2014, 38, 40, 42.

[148] What follows draws upon Cheffins, "Corporate Governance Movement," 27–36, which provides detailed footnotes supporting the key propositions advanced here.

[149] Renée Birgit Adams, "Governance and the Financial Crisis," *International Review of Finance* 12, no. 1 (2012): 7.

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Pressure on the banks did not let up markedly when the worst of the financial crisis was over, and the imperial CEO who featured prominently in leading financial companies in the mid-2000s would be a noteworthy casualty. As the *Wall Street Journal* noted in 2013, "Large banks, burned by years of scandal, often with swashbuckling CEOs at the helm, are turning to new bosses who sport well-polished veneers of boringness."[150] The financial crisis correspondingly proved to be something of a corporate governance equalizer for U.S. financial companies. Banks were run less flamboyantly after the financial crisis than had been the case immediately beforehand, much as nonfinancial companies operated in a more restrained way after the corporate scandals and legislative reforms of the early 2000s.

Chronology aside, the parallels between banks and nonfinancial companies were not exact. In the case of nonfinancial companies, pressure from the media and institutional shareholders likely did as much as regulation to prompt a shift away from the celebrity CEOs of the 1990s. Matters were different with the post–financial crisis switch by banks to a more boring managerial approach. To the extent that monitoring of senior executives intensified, the primary catalyst was intervention by regulators such as the Federal Reserve, to which the Dodd-Frank Act of 2010 granted new powers to restrain risk taking by financial companies.[151] Regardless of the precise causes, the imperial CEOs of banks had their wings clipped after the financial crisis in a manner similar to those of nonfinancial companies post-Enron.

Activated Shareholders

While events occurring during the 2000s might have resulted in senior executives being less flamboyant than their 1990s counterparts, they were simultaneously being put under novel pressure from shareholders to refrain from simply standing pat. Shareholder activism might conceivably have been a significant force earlier but, as we have seen, in the 1990s institutional shareholders generally proved reluctant to step forward. The 2000s would be different, due primarily to hedge funds coming to prominence that specialized in targeting underperforming companies and lobbying for changes to boost shareholder returns.[152] The modus operandi of these activist hedge funds was to

[150] Max Colchester, "Today's Bank Chiefs Can Spin a Yawn," *Wall Street Journal*, 12 Aug. 2013, C1.

[151] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

[152] Brian R. Cheffins and John Armour, "The Past, Present, and Future of Shareholder Activism by Hedge Funds," *Journal of Corporation Law* 37, no. 1 (2011): 51, 58, 60–61, 80–82.

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accumulate quietly a sizable strategic holding, make proposals that management unlock shareholder value by off-loading weak divisions, distributing cash to shareholders, or selling the company, and then count on support from other shareholders to maximize pressure on management.[153]

The 2008–2009 financial crisis knocked activist hedge funds off stride but they came back stronger than ever, launching campaigns at more than one-fifth of companies in the S&P 500 between 2009 and 2014.[154] Their targets included corporate icons such as Apple, Microsoft, and PepsiCo.[155] The fiscal prudence in which public companies engaged during the mid-2000s ironically put them in the activist crosshairs because a hedge fund could build up a stake in a firm with plentiful retained earnings and plausibly demand, as a crusader for shareholder rights, that the cash reserves be put to work.[156]

There is intense debate over whether hedge fund activism adds value for shareholders over the long haul.[157] What is clear is that hedge fund activism's rise to prominence had major governance implications. In a 2010 law review article, Marcel Kahan and Edward Rock characterized U.S. chief executives as "embattled," citing hedge fund activism in addition to reforms concerning independent directors and executive pay that had caused CEOs to lose power to boards.[158] The post–financial crisis surge in hedge fund activism disrupted chief executives still further, with press reports indicating "the balance of power has shifted . . . to shareholders" and that "corporate America, previously ruled by chief executives and boards, is racing to do shareholders' bidding."[159] Crucially, the mainstream institutional shareholders who collectively dominate share ownership proved increasingly willing to back hedge fund

[153] Ibid., 60, 64–65.

[154] Ibid., 53, 95; "The Barbarians Return to the Gate," *Financial Times*, 25 Apr. 2014, 10 (citing data from FactSet Research Systems).

[155] Jan Alexander, "In a Crowded Field, Activist Investors Choose Dialogue over Diatribes," *Institutional Investor*, 23 Apr. 2014, available online at http://www.institutionalinvestor.com/article/3333134/investors-endowments-and-foundations/in-a-crowded-field-activist-investors-choose-dialogue-over-diatribes.html#.VZv1yBtFCUk (accessed July 7, 2015).

[156] Ibid.

[157] Compare, for example, Lucian A. Bebchuk, Alon Brav, and Wei Jiang, "The Long-Term Effects of Shareholder Activism," *Columbia Law Review* 114 (forthcoming). Working paper version available at http://ssrn.com/abstract=2291577; Yvan Allaire and François Dauphin, "'Activist' Hedge Funds: Creators of Lasting Wealth?" (working paper, Institute for Governance of Private and Public Organizations, 2014), http://www.wlrk.com/docs/IGOPP_Article_Template2014_Activism_EN_v6.pdf.

[158] Marcel Kahan and Edward Rock, "Embattled CEOs," *Texas Law Review* 88, no. 5 (2010): 987.

[159] Adam Shell, "Rich Activist Investors Go Gunning for Big Game," *USA Today*, 15 Aug. 2013, B1; Steven Davidoff Solomon, "As Activist Shareholders Gain Strength, Boards Surrender to Demands," *New York Times*, 15 Oct. 2014, B10. Davidoff Solomon, "Activist."

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proposals.[160] As long as this "happy complementarity" continues, any sort of comeback for the imperial CEO is unlikely to be in the cards.[161]

Conclusion

While in the United States the managerial capitalism era ended at least a couple of decades before the twentieth century drew to a close, a consensus has yet to emerge on what to call its replacement, with contenders including "fiduciary capitalism," "investor capitalism," and "shareholder capitalism."[162] Regardless of what label ultimately moves to the forefront, corporate governance has emerged as a significant feature of this new era in terms of both nomenclature and an increased emphasis on addressing concerns about managerial accountability by reference to internal corporate decision-making processes. The change in approach can be explained at least partly by a reconfiguration of the business environment affecting executives, directors, and shareholders. The process began in the 1970s, as precepts underpinning the relatively scandal-free system of managerial capitalism that prevailed in the 1950s and 1960s decreased in relevance. The politicized version of corporate governance that emerged in the 1970s was a poor fit with the market-friendly 1980s, but a Deal Decade–prompted reinvention of the concept oriented around promotion of shareholder value changed matters.

In the 1990s, with chief executives capitalizing on deregulation, changes to labor relations, and improved access to finance in order to acquire imperial status, increasingly robust governance stood out as a potentially beneficial check on managerial hubris. The transformation of corporate governance that followed the demise of managerial capitalism was, however, not yet complete. Regulatory and market responses to corporate scandals in the early 2000s and, in the case of banks, the 2008–2009 financial crisis were needed to call time on the imperial CEO. A post–financial crisis surge in hedge fund activism confirmed that chief executives would not be returning to their 1990s pedestal anytime soon.

[160] Brian R. Cheffins, "The Team Production Model as a Paradigm," *University of Seattle Law Review* 38, no. 2 (2015): 397, 430.

[161] Ronald Gilson and Jeffrey Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and Revaluation of Governance Rights," *Columbia Law Review* 113, no. 4 (2013): 863, 898.

[162] For examples of commentators who have used these terms see Davis, *Managed by the Markets*, 63; James P. Hawley and Andrew T. Williams, *Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (Philadelphia, 2000); Michael Useem, *Investor Capitalism: How Money Managers Are Changing the Face of Corporate America* (New York, 1996).

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Evidence concerning the impact of theoretically sound corporate governance on corporate performance is mixed.[163] Still, while the benefits may be difficult to quantify, there can be little doubt that much has changed with U.S. public companies under the mantle of corporate governance. Due to market trends and deregulatory initiatives, senior executives of public companies had a much-expanded opportunity set at the end of the twentieth century as compared with their counterparts in the managerial capitalism era. Corporate governance, in the form of more rigorous oversight by boards, a growing emphasis on incentivized executive pay, and later shareholder activism by hedge funds, functioned as an increasingly robust counterweight. It has even been suggested that "the central problem of U.S. corporate law for the last eighty years—the separation of ownership and control—has largely been solved."[164] It remains to be seen if this bold prediction will be borne out. Regardless, today's public company executives are clearly facing a considerably different menu list of opportunities and constraints than did their managerial capitalism era counterparts, and the growing prominence of corporate governance has contributed substantially to that process.

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[163] See, for example, David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (Upper Saddle River, N.J., 2011), 453–54, 459–60.

[164] Edward B. Rock, "Adapting to the New Shareholder-Centric Reality," *University of Pennsylvania Law Review* 161, no. 7 (2013): 1907, 1909. For a diametrically opposed point of view, see Wright, *Corporation Nation*, 219–20.

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