

## Lawyer's Bookshelf

# Corporate Governance: Promises Kept, Promises Broken

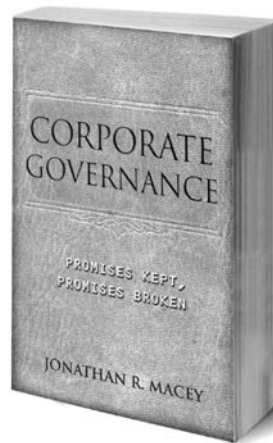
**REVIEWED BY C. EVAN STEWART**

By Jonathan R. Macey, Princeton University Press, Princeton, N.J. 344 pages, \$35

If there ever were a moment in U.S. history for Jonathan Macey's book, "Corporate Governance: Promises Kept, Promises Broken," it is now. Macey, the Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law at Yale Law School, is one of America's most prolific writers on and analysts of corporate governance issues. Against a backdrop of the most pervasive corporate failures since the Great Depression, Macey's book is must-reading for those who want to understand how we got into this mess.

Unlike most members of the legal academy, Macey's prose style is straightforward and unencumbered by professional gobbledeygook. He has three basic themes, which he sets forth clearly and then proves with telling evidence:

- Corporate governance is essentially aspirational in nature; it is based upon promises. Contrary to what most lawyers (and everyone else) think, corporate governance is not really contractual in nature. Rather, Macey posits that the relationships between shareholders and the corporations they "own" are based on trust (and if that trust is illusory or the promise is broken, investors will not invest).



- Assuming this theory of promises and trust, then Macey puts the challenge to the various institutions and the established corporate governance mechanisms as to how well they have worked to ensure that the promises have been kept and the trust protected. Much of Macey's book is directed to reviewing the Sarbanes-Oxley era and giving a score card on how these institutions and mechanisms have performed.

- Finally, Macey weighs in with the law of unintended consequences. In his view, those institutions and mechanisms that are most effective in ensuring effective corporate governance are unpopular (hedge funds) or have been heavily regulated or been made hard to obtain as a practical matter (hostile takeovers, dissident director slates). And those institutions and mechanisms that are least effective (boards of directors, credit rating agencies) have been given relatively free rein.

As for shareholders' "legal" control of their corporations, Macey demonstrates that the complex and conflicted system of shareholder voting is hardly "a panacea for corporate governance." Macey is also spot-on that we need to enhance legal processes that do not let boards get fat, dumb, and happy; allowing challenges to control does have a causal link to better corporate governance. The negative example of Yahoo's 2008 rejection of a generous "hostile" tender-offer from Microsoft proves that proposition. After the Yahoo rejection, its stock price tanked, top management was overhauled, and the company is slowly twisting in the wind; just exactly how did this episode promote shareholder value?

Macey's criticisms of many of the institutions he reviews, moreover, are certainly on the mark and hard to argue with. For example, Macey has been a long-standing critic of the credit-rating agencies; had we listened a tad more carefully to him years ago, perhaps the subprime mortgage mess and resulting chaotic fall-out to the banks and credit markets could have been avoided.

And contrary to recent criticisms of the SEC over its various enforcement failures (Bernie Madoff), Macey documents that the SEC has historically had an "anemic" record with respect to anticipating corporate governance scandals, even in areas of "its own areas of expertise—disclosure and capital market regulation." Nor can

the SEC's recent performance be ascribed to inadequate resources; the SEC's resources today dwarf what they were at the start of the Millennium. This record is likely to get worse as the SEC's new leadership is vowing to "take the handcuffs off" and get into the business of regulating hedge funds and credit default swap instruments; query whether the commission has the knowledge, resources, etc. in order to regulate in those spaces.

Even more important is Macey's incisive focus on corporate boards, of which he properly notes "[m]uch is expected." Macey posits that while much of the focus on directors' failings (and accountability) occurs when there has been corporate fraud, the other side of the equation has profound consequences—recent judicial precedent and legislation "suggest that directors will avoid personal liability even when they fail to exercise due care, as long as they are not disloyal to the corporations."

And while the emphasis of corporate governance vis-à-vis directors in the post-Enron era is to "outperform the Enron board," query whether that is the correct test. Has a greater number of "independent" directors being more directly involved in decision making been a godsend? No, says Macey, because even the best boards get "capture[d] by the managers they are supposed to monitor."

Is Macey Chicken Little about boards, or is he correct? Certainly, in his highlighting of the scandal of boards' complicity in executive compensation, Macey is just shooting fish in a barrel. But executive comp is merely the poster child for a larger problem. At the same time boards have been doling out vast sums to a select few, they have been doing so while seeming to be

asleep at the switch. Just two examples should suffice. At General Motors, during Richard Wagoner's tenure as CEO, the stock price of what used to be the world's most formidable car company went from \$60 per share to \$11 per share—and that was before the financial meltdown (it is now around \$3.50 per share). Yet in 2007, when GM lost billions, the board increased his compensation by 64 percent to \$16 million. And as the company drifted into functional bankruptcy in late 2008, the board (as well as GM's other core constituencies, e.g., the UAW) did Tammy Wynnette proud. What is wrong with that picture?

At least as equally troubling are the board failures at major financial institutions, where huge paydays were sanctioned based almost entirely on leveraged derivative products as to which the directors seemingly had no clue. Put another way, which is worse: that the AIG board understood the credit default swap exposure on its books, or that the AIG board did not understand that exposure?

The foregoing do not arise out of complicity in fraud, malfeasance, or venality. The GM and AIG directors likely believed (and believe) they were "loyal" and discharged their duties as a legal matter. And yet they failed miserably.

Speaking of financial institutions and their boards' failures, said failures in my view are leading to a paradigm shift in corporate governance. With the massive "investments" by the U.S. government in the largest financial institutions, we are on the cusp of a possible nationalization of America's banking system. Although this disturbing notion started out as only a "temporary" program, given the size of the government's investments

in Citigroup and in Bank of America, we have already seen the not-so-invisible hand of the government making business decisions for those two corporations. That their boards have been neutered seems clear; supposing that government bureaucrats will be better stewards of these institutions than their management and directors is anyone's guess (but I know where I am betting my nickel). What is certain is that under this new paradigm the concerns of taxpayers and not shareholders will be paramount.

**M**acey wrote and published his brilliant book before the financial meltdown we are experiencing. For corporations not accepting federal bail-out money, his analyses and conclusions are important. It should be hoped that his well-documented criticisms of those corporate governance mechanisms that investors most heavily rely upon will be heeded; at the same time, I have my doubts as to whether the mechanisms he has identified as more useful in promoting good governance will be embraced. In any event, Macey believes that "the pricing capabilities of capital markets emerge as the greatest corporate governance mechanism we have." Amen.

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