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WHEN “GOOD” CORPORATE GOVERNANCE MAKES “BAD” (FINANCIAL) FIRMS: THE GLOBAL CRISIS AND THE LIMITS OF PRIVATE LAW

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INTRODUCTION

In the aftermath of the global financial crisis of 2008–2009, investors, analysts, legislators, and pundits have spotlighted “good” or “improved” corporate governance as a remedy for all that presently ails us. It is one remedy in a long wish list that includes tougher requirements for risk capital, liquidity, and leverage; compensation and bonus reform; reimposition of the Glass-Steagall-like separation of bank “utility” and “casino” functions; the downsizing or breakup of institutions deemed “too big to fail;” enhanced consumer protection; securities law liability for secondary violators (like credit rating agencies); direct taxation of proprietary trading; “macro-prudential” regulation; and new transparency requirements for derivatives trading and clearance.

This time, the proposed objects of corporate governance reform are not Michael Eisner’s personal “magic kingdom” at the Walt Disney Company or Andy Fastow’s self-dealing and ultimately self-deceiving Enron Corporation, but the global financial institutions that saw their balance sheets degraded—and the global credit markets put at risk—by proprietary trading in so-called “toxic” assets and other high-risk, high-reward, “casino” activities. The renewed focus on good corporate governance pertains not only to the perceived asymmetry between the outlandish compensation dished out at now bankrupt or massively bailed-out firms, but also to the traditional, broader roster of corporate governance mechanisms designed to enhance director-manager accountability to firm “owners”—the shareholders. In this case, however, more effective corporate governance may not be a serious part of the solution; instead, “good” (or effectively functioning) corporate governance may have been one of the major factors that contributed to the global financial meltdown. This insight highlights the existence of unalterable constraints on any corporate governance system, and emphasizes the

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need for even more robust government regulation of private businesses—especially firms that function at the core of a global capital allocation system.

I. THE RHETORICAL RUSH FOR IMPROVED CORPORATE GOVERNANCE

The focus on corporate governance reform as a remedy for the global financial disaster is embodied in the text of the Shareholder Bill of Rights Act introduced in the U.S. Senate in May 2009. The legislation states that “[a]mong the central causes of the financial and economic crises that the United States faces today has been a *widespread failure of corporate governance*.” (emphasis added) Like the Compensation Fairness statute passed by the U.S. House of Representatives in July 2009, the Senate bill uses the global financial crisis as the justification for a long list of measures advocated by shareholder activists over the past two decades. The statute seeks not only to promote checks on, and accountability for, executive compensation, but also to “provide shareholders with enhanced authority over the nomination [and] election . . . of public company executives” and to incentivize executives “to appropriately analyze and oversee enterprise risk, and . . . prioritize the long-term health of their firms and their shareholders.” The statute would amend the 1934 Securities Exchange Act to (i) mandate “say on pay” and “golden parachute” advisory shareholder votes, the separation of the offices of chairman and chief executive officer, majority affirmative voting in director elections, and the creation of a new “risk committee” composed of independent directors responsible for overseeing risk management practices; (ii) eliminate the possibility of staggered boards (so effective at blocking changes to corporate control); and (iii) permit the inclusion of shareholder nominees to the board of directors in corporate proxies.

This rush to improve corporate governance structures, as exemplified by the Senate’s Shareholder Bill of Rights Act, is entirely understandable as a gut response to the crisis and the crippling worldwide recession-depression that followed. No one can deny the power of the idea underlying initiatives such as the Shareholder Bill of Rights: that firm managers are accountable to, and should work in the interest of, the bearers of residual risk—the equity holders. Yet, in the wake of the sudden collapse of Lehman Brothers and the near-demise of Merrill Lynch, Citigroup, and AIG, that obligation has been narrowed to focus on the duty of managers to avoid bankruptcy and maintain continuing business operations. At the same time, and because of these shocking failures, the equally powerful and complementary idea that well-governed firms and their managers should produce the highest returns for shareholders is largely ignored. The current chorus urging improved corporate governance at financial firms thus places too much emphasis on the first motive (avoiding terminal failure in times of desper-

tion) while ignoring the perverse incentives produced by the latter (boosting current profits in boom times).

Not to be misunderstood, I should declare my strong affection for the concept of good corporate governance. The fact is, however, that good corporate governance, and what we yearn for as improved corporate governance, only really functions effectively in two limited areas: protection against opportunistic or conflicted behavior by insiders—agents, and internal firm monitoring. In the first area, those aspects of corporate governance which restrict ex ante, or identify and punish ex post, loyalty breaches, conflicts of interest, related party transactions, asset stripping, oppression and the like, are appropriately directed at protecting the interests of minority shareholders. (Of course, oftentimes conflicted, related party or apparently “disloyal” transactions may serve the interest of the firm and ultimately even the minority shareholders. Corporate governance works most effectively in these situations by helping firm owners understand the prospect of such transactions ex ante and allowing them informed approval powers with respect to the same. The same mechanisms also provide ex post sanctions which incentivize conflicted insiders to seek either such approval ex ante or immediate ratification.) Thus, restrictions or approval powers on sky-high compensation doled out by boards to executives who dominate or who have selected the same boards—or protections against backdating executive options to ensure they are “in the money”—are entirely appropriate and effective in battling (and publicly shaming) insider opportunism. In the second area, effective corporate governance also functions to increase transparency inside firms, so that vigilant managers can understand, monitor, and direct the activity of firm agents. This is what the U.S. Senate bill refers to in alluding to the responsibility of public company executives “to appropriately analyze and oversee enterprise risk.” To the extent the global financial crisis truly resulted from “rogue” traders taking on too much risk under the noses of their unknowing managers, any monitoring duty that conforms to the standard articulated by Chancellor Allen in *In re Caremark Int’l Inc. Derivative Litigation*¹ is a net positive, and could function to increase internal firm transparency, while helping top executives and the board of directors to actually monitor and direct such trading.

II. THE HARM ARISING FROM “GOOD” CORPORATE GOVERNANCE

Sadly however, most other aspects of traditional corporate governance—good or improved, indifferent or idealized—are quite *irrelevant* to what occurs at modern firms. The irrelevance of corporate governance with respect to large, widely held, insider-dominated corporations is the subject of a huge literature, which I will not rehearse here. Suffice to say that the problems of information asymmetry, an overly accommodating business judgment rule that emasculates duty of care, collective action constraints, and cost-sharing obstacles are well understood. And such problems have been alleviated only

1. 698 A.2d 959, 970 (Del. Ch. 1996)

in part by the U.S. securities regulatory establishment dating from the New Deal, the derivative lawsuit action imported into U.S. state corporate law from England, and the combination of a robust class action mechanism and lawyers’ contingency fee arrangements allowing for cost-fronting and cost-sharing. (Perhaps unfortunately, the power of these remedies has been significantly diluted with the higher burdens created for private attorneys general in the Private Securities Litigation Reform Act of 1995 and the broad legislative and doctrinal assault on private securities litigation starting in the 1980s.) Even large institutional investors, long anointed as the saviors of “shareholder-oriented” corporate law and governance, proved largely absent in the attempt to monitor or rein in the likes of AIG, Citigroup, Merrill Lynch, and many other similar financial firms. In the financial sector specifically, this failure results not only from the same collective action obstacles encountered by minority shareholders in traditional industrial firms, but also from the mind-boggling complexity of world-spanning financial institutions and their businesses. Even if inspired to monitor operations, few institutional investors (and perhaps few senior executives at the financial firms themselves) possess the technical expertise and breadth of knowledge to understand the financial products and trading strategies they are charged with overseeing, not to mention the global risk profile of the firm.

More importantly, and the idea which animates this writing, is the worry that so-called “good” or improved corporate governance might be not simply *irrelevant* but actually *harmful*, and something which directly contributed to the 2008–2009 systemic dysfunction of the global financial sector. How is this so? The language of the Senate bill cited above provides a strong hint of the problem, specifically where the statute invokes improved corporate governance so that managers will “prioritize the long-term health of their firms *and their shareholders*.” There is no doubt that the traditional menu of corporate governance mechanisms—designed to make management more responsive to the interests of shareholders—will cause those managers to “prioritize [the interests of] . . . their shareholders.”

However, at the same time, there is very significant doubt as to whether that prioritization, or those interests, have anything whatsoever to do with the long-term health *of the firms*, much less with the long-term health and stability of the financial system more broadly. Indeed, for financial firms, the *short-term* shareholder interest is focused almost exclusively on reported profits and the directly related stock price. On this point, we may want to draw a distinction between industrial companies and financial sector firms. Industrial and manufacturing firms engage in the production and marketing of material goods and related services, and thus managers of such firms might truly be interested in long-term growth and continuing presence in a given products market. Conversely, financial firms engage in activities related to relatively instantaneous capital allocation, and increasingly the proprietary trading of financial instruments, where there is no long term interest for investors-shareholders (other than franchise and reputation, pri-

marily important in the service of procuring short-term revenues.) Even if some rare species of financial firm shareholders took a long-term firm view, investors in financial firms are not interested in the health and viability of the entire financial (and credit) system. In a word, most financial firm shareholders are interested in the current profits of the firm in which they invest, with little regard for the long-term health of the firm itself, and no identifiable interest whatsoever in the entire financial system—sectoral, national, or global.

III. THE PURSUIT OF CURRENT SHAREHOLDER RETURNS AND SYSTEMIC RISK

What is the key implication arising from this rather common sense insight? Simply this: insofar as much-celebrated corporate governance norms make firm managers *responsible* to their shareholders, the same mechanisms incentivize managers to be *irresponsible* vis à vis the entire system, implicating *systemic* risk. Lest these concerns seem entirely theoretical, let me invoke two illustrative examples from the recent global financial crisis: BNP Paribas and AIG.

Before the depth of the crisis became apparent, French banking giant Banque National de Paris (BNP Paribas) implemented its own highly conservative risk capital and liquidity requirements (conservative and idiosyncratic, i.e., more stringent than those required under the Basel II Accords). Because of this wise course, profits at BNP Paribas lagged significantly behind those of high-flying European competitors Deutsche Bank and Société Generale (SocGen). BNP Paribas endured a drumbeat of criticism in the financial press, a sickly and static stock price, and disruptive shareholder efforts to change senior management. With the onset of the global financial crisis, however, both Deutsche Bank and SocGen were laid low along with the global financial sector, while BNP Paribas survived in far better shape and as a mainstay of the new, more responsible, global financial order. This is one example of how traditional corporate governance principles rewarded managers at Deutsche Bank and SocGen for irresponsible risk-taking, higher short-term profitability, and a dynamic stock price, while punishing (and almost deposing) managers at BNP Paribas who implemented wisely crafted prudential structures designed to ensure, inter alia, long-term firm and overall market stability and health.

A second example invokes the now notorious AIG, widely recognized as “ground zero” for the crisis. Starting in the 1980s, AIG investors and senior managers alike were happy to allow the firm’s little-noticed (and even less-governed or regulated) London-based Financial Products Division (FPD) to write guarantees structured as “credit default swaps” (CDSs) on collateralized debt obligations—securitized instruments that, after the 1990s, were increasingly created on the back of an exploding volume of new mortgages sourced from the U.S. real estate bubble built on artificially low interest rates. Because so many of these CDS guarantees and the underlying obligations were initially deemed, and rated as, low risk (because the initial

obligations that were fed into the securitized instruments, and were risk-modeled by underwriters and rating agencies, were corporate rather than homeowner obligations), and because AIG was not directly regulated as a bank or non-bank financial institution, AIG never hedged against or collateralized its growing exposure. By 2008, the AIG FPD had exposure on these “insurance” contracts backing a wide variety of highly rated paper aggregating in the billions of U.S. dollars. Indeed, for AIG managers (and investors) this appeared to be “win-win”—a rich source of fees and premium income with no implication of serious risk given the ratings bestowed on the guaranteed collateralized debt obligations. By the summer of 2008, however, as the U.S. housing market collapsed, mortgagor home buyers obligated to pay into the mortgage-backed securities began defaulting in huge numbers. With default rates on the rise, rating agencies immediately downgraded the originally low-risk mortgage-backed securities, thereby triggering demands that AIG post ever-increasing amounts of collateral to protect the CDS purchasers, and finally causing the U.S. government to bail out AIG with \$150 billion. Once again, the sorry story of AIG and its wildly “successful” and current profits-generating FPD shows how traditional corporate governance principles incentivized irresponsible and almost completely unmonitored risk-taking, higher short-term profitability, and a dynamic stock price, while ultimately putting at risk the continuing viability of CDS counterparty mainstays of the global financial system (Goldman Sachs, Morgan Stanley, Bank of America, etc.), not to mention the global financial system itself.

IV. THE LIMITS OF PRIVATE LAW

Improved corporate governance at financial firms, then, is not a panacea for righting the global financial sector, and in fact may have contributed directly to the global financial crisis. As noted above, corporate governance norms are important and effective for the protection of shareholders (in particular minority shareholders) against insider opportunism and controlling shareholder–insider oppression. However, these near-perfect corporate governance conventions pushed financial firms and their managers into high risk, high (short-term) reward areas *for shareholders*—areas that ultimately gave rise to the most significant threat to the health, stability, and allocation efficiency of financial markets *for the world*. The problem is not simply that judges construing corporate duties cannot take account of the interests of “other (non-shareholder) constituencies.” That consideration has become entirely permissible in the United States (and has for many years been accepted in continental Europe and Japan) at least since *Unocal Corporation v. Mesa Petroleum Company*,² and in the wake of many state anti-takeover statutes (albeit tempered by the subsequent warning delivered in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* against the protection of

2. 493 A.2d 946, 955 (Del. 1985).

“other” interests over and above shareholder interests in a sale-of-company scenario³). Instead, the real difficulty is that directors and managers are not well situated to think systemically or act in the long-term, national, or global public interest. And judges evaluating management decisions *ex post* are not competent to evaluate conformity with system-protecting (as against profit-enhancing) standards in any predictable way. For example, should AIG’s apparently successful managers have turned away assured profits *for AIG shareholders* arising from CDSs written virtually non-stop on AAA-rated collateralized debt obligations because of some inchoate fear that the “going was too good,” or that a property bubble fed by U.S. Federal Reserve monetary policy was going to burst? Similarly, how could any judge evaluate such management decisionmaking *ex post* and declare that the AIG managers were wrong to prioritize certain, short-term shareholder returns over a speculative (or completely unanticipated) medium-term global meltdown? The answer in both cases, unfortunately, is that what we wish for our management decisionmakers and *ex post* judicial evaluators is near impossible. Accordingly, our corporate governance norms only ask managers to work for shareholder profits, as we only ask judges to attend to shareholder welfare (which usually focuses on value of shareholder participation in the firm) in evaluating conformity with controlling legal duties and applicable standards.

Recognition of this complex reality highlights the role of public-interested regulators and the limits of private law. Because only a regulator—independent, expert, not shareholder-focused—has the chance to ensure that value-enhancing, profit-seeking activities do not risk systemic injury and market collapse. Corporate governance, private law, and judges simply cannot do this, and as I have suggested here, may actually work against it. The global financial system has long benefited from the existence of such regulators and their prudential regulation of the increasingly globalized financial sector—even if we have also seen periods of disenchantment and frustration with the particular burdens of the regulatory state on “free markets” and (financial product) “innovation.” The global financial crisis of 2008-2009 should teach us once again—at least with respect to financial institutions—that we are well advised to enhance prudential regulation by public authorities, over and above the intuitively appealing but wrong-headed desire for “better” or more vigorously enforced corporate governance.

3. 506 A.2d 173, 184 (Del. 1986).