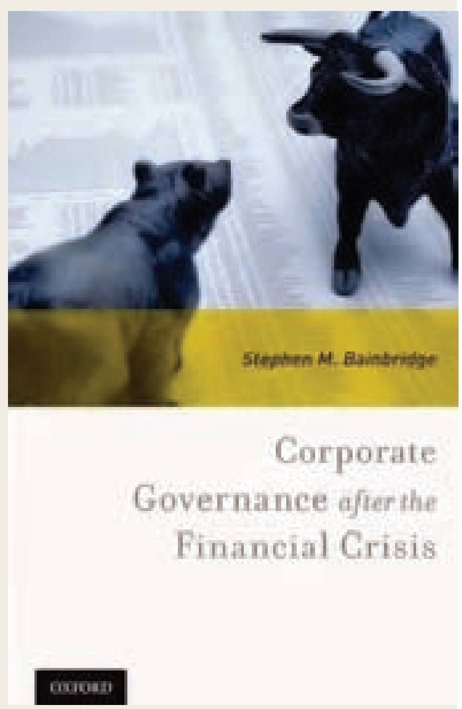
Corporate Governance
After the Financial Crisis
Q&A with Professor Stephen Bainbridge

IN HIS NEW BOOK, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* (Oxford University Press, 2012), William D. Warren Distinguished Professor of Law Stephen Bainbridge proves expert at turning conventional wisdom on its head. His argument—that federalizing corporate governance impinges on state sovereignty, hobbles corporate efficiency and shortchanges both investors and the American taxpayer—advances a critical dialogue about the limits of crisis-driven public policy. Professor Bainbridge offers an incisive analysis of the landscape-altering Sarbanes-Oxley and Dodd-Frank acts, responses to the near-cataclysmic economic downturns of the last decade. By crystallizing the connection between federal intervention and bad public policy, he makes a strong case for the need for smart corporate governance reform.

Professor Bainbridge, who joined the UCLA Law faculty in 1997 and has been named one of the 100 most influential people in the field of corporate governance, is a renowned teacher and scholar whose expertise includes the law and economics of public corporations.



How do you define "quack" corporate governance laws or regulations?

Unwise federal laws or SEC rules that meet these criteria: (1) The law was supported by a powerful interest group coalition, which used a financial crisis such as the post-Lehman Bros. credit crunch in 2007-2008 to achieve longstanding policy goals essentially unrelated to the causes or consequences of the financial crisis. (2) The new law or rule lacks strong empirical or theoretical justification. To the contrary, there are theoretical and empirical reasons to believe that each is bad public policy. (3) The new law or rule erodes the system of competitive federalism that is the unique genius of American corporate law by displacing state regulation with federal law.

Why are the corporate governance provisions of federal financial reform laws like Sarbanes-Oxley and Dodd-Frank so misguided?

In ordinary times, Washington typically has more important issues on its plate than corporate governance. After a financial bubble bursts, however, investors burnt by losses from the breaking of the bubble and outraged by evidence of misconduct by corporate insiders and financial bigwigs create populist pressure for new regulation. Accordingly, it is in the post-bubble environment, when scandals and economic reversals are in the headlines, that Congress typically acts. Because such periods typically involve an upswing in populist anger and accompanying intense public pressure for action, they offer windows of opportunity for well-positioned policy entrepreneurs to market their preferred solutions when there is little time for reflective deliberation. As a result, you end up with laws meeting criteria for quack corporate governance laws. Indeed, according to our colleague Stuart Banner's wonderful book, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690-1860* (1998), the same pattern of boom, bust and regulation can be seen far back into the nineteenth century.

You argue against the conventional wisdom that problems of corporate governance led to the financial crisis of 2008. Why?

There is little evidence that poor corporate governance practices contributed to either the economic turmoil of the last decade in general or the declining competitiveness of U.S. capital markets. In the wake of the tech stock bubble, Bengt Holmstrom and Steven Kaplan published a comprehensive review of U.S. corporate governance that concluded the U.S. corporate governance regime was "well above average" in the global picture.[1] Even when the fallout from the bubble was taken into account, returns on the U.S. stock market equaled or exceeded those of its global competitors during five time periods going back as far as 1982. Likewise, U.S. productivity exceeded that of its major Western competitors. In general, the trend with respect to major corporate governance practices had been toward enhanced management efficiency and accountability. Pay for performance compensation schemes, takeovers, restructurings, increased reliance on independent directors and improved board of director processes all tended to more effectively align management and shareholder interests.

As far as the economic crisis following the bursting of the housing bubble, "[a] striking aspect of the stock market meltdown of 2008 is that it occurred despite the strengthening of U.S. corporate governance over the past few decades and a reorientation toward the promotion of shareholder value."[2] A recent report commissioned by the New York Stock Exchange reached the same conclusion, finding that "the current corporate governance system generally works well."[3]

In what ways does an expanded federal regulatory role in corporate governance potentially exacerbate the very problems it purports to solve?

Bubble laws like Sarbanes-Oxley and Dodd-Frank tend to be adopted in a hurry. As we have seen, the pressure of time tends to give advantages to interest groups and other policy entrepreneurs who have prepackaged purported solutions that can be readily adapted into legislative form. Hence, for example, many of both statutes' provisions were recycled ideas that had been advocated for quite some time by corporate governance "reformers." Unfortunately, because these so-called reformers tend to be critics of markets and corporations, both statutes imposed regulations that penalize or outlaw potentially useful devices and practices and more generally discourage risk-taking by punishing negative results and reducing the rewards for success.

When it comes to regulating corporations, what is the problem with a one-size-fits-all approach?

Anybody who has ever shopped for a Speedo knows that "one size fits all" simply isn't true. Like people, not all corporations are the same.

What is the link between shareholder involvement and corporate performance? Does an increase in the former always trigger an improvement in the latter?

Actually, the bulk of the evidence is that shareholder involvement does not—outside a few special cases—improve firm performance. I review the evidence at length in Chapter 7 of *Corporate Governance After the Financial Crisis*. While there is little evidence that activism has benefits for investors as a class, there is considerable evidence for the proposition that activist shareholders can profit through private rent seeking.

This result is not surprising, of course. First, the high costs and low success rate of activism suggest that its net gains are substantially lower than many proponents of shareholder activism claim. Second, if activism increases the target firm's stock price, all of its shareholders can free ride on the activist's efforts. It makes no sense for an activist to expend substantial resources when the bulk of the gains from doing so will be captured by others. Instead, we would expect activists to pursue an agenda of private rent seeking rather than altruistic public service. And that's exactly what we tend to see.

The past decade has witnessed a gradual narrowing of the scope of boards of directors and an increasing reliance on director independence. Why is this not a panacea for the ills of corporate governance?

This is such an important question that I devoted an entire chapter to the ever-increasing reliance on independent directors. In it, I argue that director independence rules not only failed to prevent the financial crises of the last decade, but may well have contributed to them. I admit that's a provocative claim, but I'm confident it's correct.

The strict conflict of interest rules embedded in the new definitions of independence made it difficult for financial institutions to find independent directors with expertise in their industry. A survey of eight U.S. major financial institutions, for example, found that two thirds of directors had no banking experience. Given the inherent information asymmetries between insiders and outsiders, the lack of board expertise significantly compounded the inability of financial institution boards to effectively monitor their firms during the pre-crisis period. More expert boards could have done more with the information made available to them and, moreover, would have been better equipped to identify gaps therein that needed filling.

In addition, the need to find independent directors put an emphasis on avoiding conflicted interests at the expense of competence. In other words, the problem was not just that the new definition of independence excluded many candidates with industry expertise. It was also that the emphasis on objective indicia of conflicts dominated the selection process to the exclusion of indicia of basic competence and good judgment. The financial crisis thus appears, in part, to have been an unintended consequence of the Sarbanes-Oxley Act.

1. Bengt Holmstrom & Steven N. Kaplan, The State of U.S. Corporate Governance: What's Right and What's Wrong? 1 (ECGI Finance Working Paper No. 23/2003, Sept. 2003).
2. Brian R. Cheffins, Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500, 65 Bus. Law. 1, 2 (2009).
3. Report of the New York Stock Exchange Commission on Corporate Governance 2 (Sept. 23, 2010).