Corporate Governance Reform in a Time of Crisis

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I. INTRODUCTION

The financial and economic crisis that emerged in 2007 wrought havoc on banking systems around the world, and leading global financial centers in the United States and the United Kingdom were hardly spared. To the contrary, New York and London found themselves at the very heart of the crisis, their banks similarly crippled by extraordinary levels of debt and losses on complex mortgage-backed securities. In the wake of the crisis, both countries have engaged in wide-ranging regulatory efforts to contain the damage and prevent such a catastrophe from occurring again, and these efforts have included corporate governance reform proposals intended to curb risk-taking. On both sides of the Atlantic these proposals have sought to empower shareholders—not only in financial firms, but in all public companies—evidently in the belief that this would permit the shareholders to constrain reckless managers of banks and other types of entities in the

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future.

In light of the historical, cultural, and financial ties between the United States and the United Kingdom, it is perhaps unsurprising that the two countries would pursue broadly similar strategies in response to the crisis. What is certainly surprising, however, is that policymakers in both countries would seek to empower the very stakeholder group whose incentives are most skewed toward the kind of excessive risk-taking that led to the crisis in the first place. All the more baffling is the tendency to conflate financial and non-financial firms in these reform efforts, when risk incentives and associated regulatory problems differ substantially between the two domains.

This Article explains why U.S. and U.K. policymakers have reacted to the crisis as they have. The matter is far less straightforward than it might appear at first blush, because although broadly similar by global terms, the U.S. and U.K. corporate governance systems in fact differ considerably on some fundamental matters—the U.K. system proving to be far more shareholder-centric than the U.S. system. This means that shareholder-oriented reforms are more in keeping with the status quo in the United Kingdom than in the United States, where managers have traditionally possessed greater autonomy. This in turn suggests that the political dynamics motivating shareholder-oriented reforms in each country must differ in fundamental respects.

The Article proceeds as follows. Part II describes the risk incentives of shareholders and managers in financial firms, examines how excessive leverage and risk-taking in each country's financial system led to the crisis, and summarizes corporate governance reforms proposed to remedy these problems. Part III outlines core distinctions between the U.S. and U.K. corporate governance systems. It examines the far greater power and centrality that U.K. shareholders have historically possessed relative to their U.S. counterparts, and highlights three factors explaining this distinction: the earlier rise to power of U.K. institutional investors, the relative proximity and homogeneity of U.K. market actors, and broader differences in how each country's corporate governance system relates to external regulatory structures conditioning relationships among stakeholders in the firm. Critically, the more robust U.K. welfare state has tended to deflect political pressure to accommodate non-shareholders' interests within the corporate governance system, whereas weaker social welfare policies in the United States have brought about the opposite result, diminishing the emphasis on shareholders. Part IV argues that such dynamics loom large in the crisis responses observed in each country—the U.K. initiatives reflecting reinforcement of the more shareholder-centric status quo, and the U.S. initiatives reflecting a populist backlash against managers fueled by middle class anger and fear in a far less stable social welfare environment.

Part V offers conclusions. Ultimately this Article suggests that the principal challenge facing U.K. policymakers will likely be the need to re-conceptualize the more shareholder-centric U.K. corporation in the financial setting as a means of curbing risk-taking in banks. In the United States, on the other hand, the principal challenge facing policymakers will likely be resisting populist pressure to empower shareholders further in financial and non-financial settings alike. In the financial sector, such a move would not only fail to remedy the problem, but in fact would likely exacerbate risk-taking. And in the non-financial sector, where the case for reform remains weak in any event, the intrinsic relationship of corporate governance to social welfare goals in the United States would ultimately render this a considerably more comprehensive and complex regulatory undertaking than policymakers appear to recognize.

II. CORPORATE GOVERNANCE DIMENSIONS OF THE CRISIS

The causes and consequences of the crisis have been broadly similar in the United States and the United Kingdom, and the role of corporate governance practices and executive compensation structures in the financial sector has been hotly debated in each country.[1] This Part outlines the peculiar risk incentives of investors and managers in financial firms, describes how excessive leverage and risk-taking in each country's financial system caused the crisis, and summarizes corporate governance reforms proposed in each country to address these problems.

A. Moral Hazard, Risk, and the Financial Crisis

Modern banking regulation aims, first and foremost, to manage the moral hazard problem arising from deposit insurance.[2] Banks are in the business of maturity transformation—that is, rendering short-term capital (in the form of deposits) useful for long-term purposes (in the form of loans). This mismatch between long-term assets and short-term liabilities naturally leaves them vulnerable to "bank runs," in which depositors losing faith in the institution seek to withdraw their deposits en masse.[3] Having lent out most of the money, even solvent banks cannot repay all depositors at once, giving rise to a prisoners' dilemma—while depositors as a group may be better off leaving their money with the bank, each depositor as an individual fears receiving nothing if limited reserves

1. *See, e.g.*, Renee Adams, *Governance and the Financial Crisis*, 3–4 (Eur. Corp. Governance Inst., Finance Working Paper No. 284/2009, 2009), *available at* http://ssrn.com/abstract=1398583 (observing that the perception of "strong investor protection and good governance" in the United States before the crisis "raises the question whether and to what extent governance can be considered to be a cause of the financial crisis"); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010) ("There is widespread concern that executive compensation arrangements could have encouraged excessive risk-taking and that fixing these arrangements will be important in preventing such excesses in the future."); Letter from Lochiel Crafter, Chief Executive Officer, Australian Reward Investment Alliance et al., to the Honorable Barack Obama, President of the United States et al. (Feb. 13, 2009), at 1, *available at* http://www.calpers-governance.org/docs-sof/marketinitiatives/initiatives/financial-reform/2009-02-13-us-financial-market-and-cg-reforms.pdf (expressing "strong support for critical legal reforms to the United States financial markets and corporate governance practices"); Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 338–39 (2009) (describing advisory shareholder votes as a response to concerns regarding excessive executive compensation); Org. for Econ. Co-Operation & Dev., *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (June 2009), at 18, *available at* http://www.oecd.org/dataoecd/3/10/43056196.pdf (describing concerns regarding "bonus payments at . . . financial institutions that have received financial assistance" from the government); ADAIR TURNER, FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 79 (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf (describing the "intense public focus" on financial firm compensation structures following the crisis); DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE in U.K. BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES 5 (2009), *available at* http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf (reviewing "corporate governance in the UK banking industry" at the Prime Minister's request and recommending improvements).

2. *See* Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 FRBNY ECON. POL'Y REV. (Apr. 2003) 91, 97.

3. *See id.*

are exhausted. Deposit insurance systems—like those administered through the Federal Deposit Insurance Corporation in the United States and the Financial Services Compensation Scheme in the United Kingdom—aim to resolve this collective action problem by guaranteeing deposits up to some specified amount.[4]

Deposit insurance itself, however, gives rise to an equal and opposite problem—insufficient incentive to monitor risk exposure. Unlike typical corporate creditors, depositors secure in the knowledge that deposits are guaranteed by the government have little reason to concern themselves with how the bank is managed. Bank shareholders, for their part, strongly prefer risk-taking because, due to limited liability and deposit insurance, they can capture the entire upside while avoiding much of the downside.[5] Governments, as the principal creditors of insured banks, would seem to have ample incentive to monitor, and have indeed imposed supervisory regimes and regulatory capital requirements to address the moral hazard problem created by deposit insurance.[6] As Frederick Tung observes, however, the regulators' incentives may not be so "finely honed" as private lenders' would be, given that regulatory agencies' efforts are to some degree "politically determined" and susceptible to capture.[7] Lucian Bebchuk and Holger Spamann further note that "regulators are bound to be at an information disadvantage vis-à-vis bank executives"—particularly given the increasing complexity of modern financial products and firms.[8]

Commercial banks, as William Bratton and Michael Wachter explain, "historically have been low-beta stocks," profiting simply by lending at higher rates than they pay to depositors—making them "steady earners with high dividends."[9] Over the last few decades, however, regulations constraining the size, geographic markets, and activities of U.S. commercial banks have been steadily dismantled. Beginning in the 1970s,

4. *See id.* (describing the origin of U.S. deposit insurance through the Federal Deposit Insurance Corporation); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation* 6–8 (Emory Public Law Research Paper No. 10-93, Emory Law and Economics Research Paper No. 10-60, 2010), *available at* http://ssrn.com/abstract=1546229 (describing the role of deposit insurance in maintaining depositors' confidence in banks). *See also Are My Deposits Insured?*, FDIC, http://www.fdic.gov/deposit/deposits/index.html (last visited Feb. 16, 2010) (providing information and resources relating to U.S. deposit insurance); *What is the FSCS?*, FIN SERVS. COMPENSATION SCHEME, http://www.fscs.org.uk/what-we-cover/about-us (last visited Feb. 16, 2010) (describing "the U.K.'s compensation fund of last resort for customers of authorized financial services firms"); TURNER, *supra* note 1, at 21 (describing the "complex and interrelated set of risk management devices" used to manage the risk of bank runs).

5. *See* Bebchuk & Spamann, *supra* note 1, at 255–57. *See also* Jeffrey N. Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay* 6–7 (Columbia Law Sch. & European Corp. Governance Inst. Working Paper No. 373, 2010), *available at* http://ssrn.com/abstract=1633906 (arguing that undiversified financial firm blockholders and managers more strongly prefer risk-taking than do diversified shareholders with greater exposure to the associated systemic risks).

6. *See* Macey & O'Hara, *supra* note 2, at 97–98; Tung, *supra* note 4, at 8–12.

7. Tung, *supra* note 4, at 11.

8. Bebchuk & Spamann, *supra* note 1, at 281.

9. William M. Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 719 (2010). "Beta," a variable in the Capital Asset Pricing Model, reflects the relationship between performance of a given stock and performance of the market as a whole, a low beta reflecting greater stability relative to market movements. *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION 22–23 (2d ed. 2008).

restrictions on branching and interstate banking were lifted, greatly facilitating the growth of banks and enhancing competition through the 1980s. The 1999 Gramm–Leach–Bliley Act went substantially further, permitting the creation of full-service financial firms with investment and commercial banking activities under the same roof. These developments "pushed commercial banks further out of their cozy protected markets, forcing them not only to compete with one another . . . but also to compete with diversified financial firms with insurance and securities businesses."[10] This led to what Bratton and Wachter call "management to the market"—that is, prioritizing maximization of the stock price.[11]

While a full explanation of the crisis lies well beyond the scope of this Article—and likely far in the future—it is patently clear that excessive risk-taking to boost financial firm stock prices must figure prominently in any account of the financial and economic crisis emerging in 2007. Lord Adair Turner, in his review of the crisis, describes the dangerous build-up of leverage and risk in the U.S. and U.K. financial systems over the last decade. Turner observes that the "reduction in real risk-free rates of interest to historically low levels"—as oil-rich nations and East Asian exporters plowed substantial surpluses back into U.S. and U.K. government debt—led both to credit expansion and "a ferocious search for yield" among investors.[12] This, Turner concludes, was "met by a wave of financial innovation, focused on the origination, packaging, trading and distribution of securitised credit instruments"—notably, residential mortgage-backed securities.[13]

Securitization essentially involves pooling income-generating assets and then selling interests in the pool that derive their value from those underlying assets. Ironically, as Turner notes, securitization was viewed in the 1980s as a means of stabilizing the banking system—because risks associated with banks' loan portfolios could be transferred off their balance sheets and spread across a diversified investor base.[14] In reality, securitization has been used quite differently. Substantial mortgage risks remained within the banking system, as the commercial banking arm of one full-service financial firm sold to the trading desk of another. But those risks took on "increasingly complex and opaque" forms, as pools of mortgages were sliced and diced into numerous tranches with varying claims on the pools' income,[15] often bolstered by credit enhancements, including guarantees obligating the sponsoring bank to cover defaulting mortgages in the pool.[16] Meanwhile, more complex pools-of-pools (collateralized debt obligations, or CDOs)—and even pools-of-pools-of-pools (so-called "CDO-squared")—emerged to meet sustained investor demand for yield.[17]

10. *See* Tung, *supra* note 4, at 16–18.

11. *See* Bratton & Wachter, *supra* note 9, at 659.

12. *See* TURNER, *supra* note 1, at 11–14.

13. *See id.* at 14. Lord Turner is Chairman of the U.K. Financial Services Authority. For more information about Lord Turner, see *Adair, Lord Turner*, FIN. SERVS. AUTH., http://www.fsa.gov.uk/pages/About/Who/board/turner.shtml (last visited Feb. 25, 2010). *See also* ROBERT POZEN, TOO BIG TO SAVE? HOW TO FIX THE U.S. FINANCIAL SYSTEM 7–12 (2010) (describing how low short-term interest rates drove up housing prices, while low long-term interest rates fueled investor demand for high-yield debt securities).

14. *See* TURNER, *supra* note 1, at 15.

15. *See id.* at 16.

16. *See* POZEN, *supra* note 13, at 52.

17. *See* TURNER, *supra* note 1, at 16. For additional background on the securitization process, see POZEN, *supra* note 13, at 47–69.

The events that followed are now widely known. Between 1996 and 2007 the stock of outstanding securitized credit in the United States would expand almost five-fold, and between 2000 and 2007 securitization issuance in the United Kingdom would expand almost ten-fold.[18] Notional amounts of outstanding credit default swaps—derivative contracts equally suitable for hedging risks on mortgage-related securities and speculating against them—literally skyrocketed from under $1 trillion in 2001 to over $62 trillion in 2007.[19] Eager to generate additional mortgages for pooling in order to meet investor demand and to please their own stockholders, mortgage lenders substantially expanded lending to so-called "subprime" borrowers with weak credit histories. In 2006 and 2007 mortgage default rates increased substantially, and the U.S. housing bubble burst—neither having been predicted by the rating agencies whose credit ratings, critical to the marketing and pricing of such complex securities, were built on quantitative models assuming low default rates and rising home values.[20]

To the surprise of institutional investors, sponsoring banks—which had kept these asset pools safely tucked away in "special purpose vehicles"—increasingly brought them onto their own balance sheets in 2007 and 2008 as credit guarantees and other credit enhancement liabilities came home to roost.[21] This resulted in "a significant one-off increase in measured leverage" at many banks.[22] Meanwhile the rating agencies—whose faulty ratings drove mispricing of these securities in the first place—proceeded to downgrade such securities, slashing their market value and sharply diminishing their liquidity.[23] By August 2007, "broader credit markets began to freeze up as lenders became wary of extending additional credit." The U.S. Federal Reserve sought to boost the availability of credit by expanding the money supply and lowering interest rates, but to little avail. In March 2008, investment bank Bear Stearns—having sustained billions in mortgage-backed securities related losses—required a government-orchestrated buyout by J.P. Morgan to avoid bankruptcy.[24] At the time of its collapse, Bear Stearns' leverage

18. *See* TURNER, *supra* note 1, at 14. *See also* POZEN, *supra* note 13, at 5, 47–49 (providing additional data on U.S. mortgage-backed securities issuances).

19. *See* POZEN, *supra* note 13, at 71–73; *Summaries of Market Survey Results*, INT'L SWAPS AND DERIVATIVES ASS'N, http://www.isda.org/statistics/recent.html (last visited Nov. 29, 2010) (summarizing survey data from 1995 to date).

20. *See* Christopher M. Bruner, *States, Markets, and Gatekeepers: Public-Private Regulatory Regimes In an Era of Economic Globalization*, 30 MICH. J. INT'L L. 125, 145–46 (2008); POZEN, *supra* note 13, at xi–xix, 58–65.

21. *See* POZEN, *supra* note 13, at 51–53. Pozen explains that while accounting rules following the Enron scandal required disclosure of significant off-balance sheet obligations, sponsoring banks limited their disclosures thinking it unlikely that credit guarantees and other credit enhancement obligations would be triggered. New rules implemented in 2009 "would effectively force all financing of mortgages by banks on their balance sheets." *Id.* at 53.

22. TURNER, *supra* note 1, at 20.

23. *Id.* at 22; POZEN, *supra* note 13, at 60.

24. *See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 471–77 (2009). The government's facilitation included guaranteeing a $30 billion, 28-day loan from J.P. Morgan to Bear Stearns, pursuant to authority in section 13 of the Federal Reserve Act permitting the Federal Reserve to open the discount window to non-bank financial institutions under "unusual and exigent circumstances." This constituted "the legal authority that would be used for each of the government's ad hoc bailouts." *See id.* at 477.

ratio (the ratio of its assets to capital) was an extraordinary 33 to 1.[25]

In early September 2008, mortgage giants Fannie Mae and Freddie Mac—government sponsored but privately owned—would be nationalized.[26] Later that month, the investment bank Lehman Brothers would be allowed to collapse while insurance giant AIG would be bailed out.[27] Their contrasting fates vividly illustrated the government's struggle to manage the negative ramifications of bailouts, on the one hand, and the systemic consequences of the collapse of enormous financial institutions, on the other—the so-called "too big to fail" problem, in which implicit government guarantees through bailouts give rise to a moral hazard dilemma closely analogous to that created by explicit government guarantees in deposit-taking commercial banks.[28]

As the contagion spread from firm to firm, it quickly became apparent that a more comprehensive approach would be required. On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act, which among other things created the Troubled Asset Relief Program (TARP) under which the Secretary of the Treasury could purchase up to $700 billion worth of "troubled assets from any financial institution."[29] TARP funds would in fact be used to inject capital directly into troubled financial institutions themselves, an approach permitted through a creative reading of the term "troubled asset," which the statute defined to include not only mortgages and mortgage-backed securities, but "any other financial instrument . . . the purchase of which is [deemed] necessary to promote financial market stability"[30]—say, equity stakes in the likes of Citigroup and Bank of America.[31]

The crisis has, in general respects, unfolded similarly in the United Kingdom. While mortgage-backed securities would catch on later than in the United States, U.K. securitization and financial sector debt grew substantially between 2000 and 2007, and the United Kingdom "experienced a credit and property price cycle similar to that seen in the US," with "rapid credit growth in the household sector."[32] Lord Turner concludes that U.K. banks were ultimately "as exposed as US banks and investment banks to the loss of confidence, disappearance of liquidity, and fall of assets prices which gradually gathered pace from summer 2007 but which became catastrophic after the collapse of Lehmans in

25. *See* POZEN, *supra* note 13, at 132.

26. *See* Davidoff & Zaring, *supra* note 24, at 486–90; POZEN, *supra* note 13, at 27–46.

27. *See* Davidoff & Zaring, *supra* note 24, at 491–500; POZEN, *supra* note 13, at 205–15. By the end of 2008, none of the five stand-alone U.S. investment banks remained. "Two effectively failed (Lehman and Bear Stearns), another two converted to bank holding companies (Goldman and Morgan Stanley), and the fifth (Merrill Lynch) was acquired by a bank holding company." POZEN, *supra* note 13, at 131–32. By converting to bank holding companies, Goldman Sachs and Morgan Stanley submitted to Federal Reserve oversight but gained access to its lending facilities. Andrew Ross Sorkin & Vikas Bajaj, *Shift for Goldman and Morgan Marks the End of an Era*, N.Y. TIMES, Sept. 22, 2008, at A1 (New York Edition).

28. *See supra* notes 2–8 and accompanying text (discussing the moral hazard dilemma created by deposit insurance); POZEN, *supra* note 13, at 170–85, 205–33.

29. Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Cong. §§ 101, 115 (2008).

30. *Id.* § 3(9).

31. *See* U.S. Department of the Treasury, *About the Financial Stability Plan*, http://www.financialstability.gov/about/index.html (last visited Sept. 30, 2010); Davidoff & Zaring, *supra* note 24, at 512–31 (describing comprehensive bailout efforts and their aftermath); POZEN, *supra* note 13, at 215–31 (describing government efforts to recapitalize the U.S. banking system and consequences for taxpayers).

32. TURNER, *supra* note 1, at 14, 18, 29, 32.

September, 2008."[33] Like the U.S. government, the U.K. government found itself bailing out a number of enormous financial institutions, including Bradford & Bingley, Lloyds Banking Group, Northern Rock, and Royal Bank of Scotland.[34]

B. The Role of Equity-Based Compensation

Government officials and taxpayers reeling in the wake of this catastrophe have naturally sought to determine why the crisis occurred, and who is to blame. Unsurprisingly, bank boards and officers have found themselves in the crosshairs—not least due to widespread outrage at the continued payment of substantial bonuses in financial firms dependent on public largesse.[35] How could financial systems as sophisticated as those in the United States and the United Kingdom have run so horribly amok? More specifically, how could those managing U.S. and U.K. financial firms have permitted such extraordinary levels of leverage and risk to have built up over so short a period of time (historically speaking)? Risk-taking and related incentive structures in the financial sector have come under intense scrutiny in both countries, and wide-ranging financial reform efforts have included proposals aimed at focusing the minds of financial firm decision-makers more intently on the shareholders' interests—including by empowering shareholders to intervene more effectively in corporate affairs. Specifics of these efforts are discussed below, but to facilitate their evaluation this Subpart of the Article builds on the foregoing discussion by delving further into risk incentives within financial firms.

As a legal matter, boards and managers of financial firms owe the same level of duty to shareholders as that owed by their non-financial counterparts.[36] Shareholder relations are not so well understood in the financial context, however, because the empirical literature on corporate governance has tended to focus elsewhere.[37] As Luc Laeven and Ross Levine observed in 2009, "researchers have not assessed how standard corporate governance mechanisms . . . interact with national regulations in shaping the risk taking behavior of individual banks."[38]

History, however, is suggestive. In addition to the deregulatory trend discussed above, Tung identifies another important trend affecting risk-taking in financial firms—equity-based pay.[39] In the United States, Congress—as a response to perceived executive compensation excesses in public companies—amended the Internal Revenue Code in

33. *Id.* at 29.

34. Andrew Grice, *£850bn: Official Cost of the Bank Bailout*, INDEP., Dec. 4, 2009, http://www.independent.co.uk/news/uk/politics/163850bn-official-cost-of-the-bank-bailout-1833830.html; TURNER, *supra* note 1, at 35; George A. Walker, *Financial Crisis—U.K. Policy and Regulatory Response*, 44 INT'L LAW. 751, 753–55 (2010).

35. *See, e.g.*, Grice, *supra* note 34; David Ellis, *Goldman's Blankfein Collects $9 Million Bonus*, CNN.COM (Feb. 5, 2010), http://money.cnn.com/2010/02/05/news/companies/blankfein_bonus/.

36. *See* Adams, *supra* note 1, at 7.

37. *See id.* at 5 ("[B]ecause of the special nature of financial services, most academic papers exclude firms in the financial services from their data and focus on the governance of nonfinancial firms."); Macey & O'Hara, *supra* note 2, at 91 ("Oddly enough, . . . very little attention has been paid to the corporate governance of banks.").

38. Luc Laeven & Ross Levine, *Bank Governance, Regulation and Risk Taking*, 93 J. FIN. ECON. 259, 259 (2009).

39. *See* Tung, *supra* note 4, at 13–15.

1993 to provide that only the first $1 million of pay would be deductible. The limit did not apply, however, to performance-based pay[40]—the result being not a reduction in overall compensation, but a substantial increase in the equity-based component of compensation.[41] The finance literature tends to suggest that increased alignment of bank managers' interests with those of shareholders through equity-based pay should increase the managers' risk appetite, for the reasons discussed above—with limited liability, and in the presence of deposit insurance, equity gets the entire upside while avoiding much of the downside. For example, the association of investor protection with greater risk-taking in non-financial firms is empirically documented.[42] Similarly, while management equity ownership is associated with higher bond premia (suggesting greater perceived risk among bondholders),[43] "CEOs who are insulated from shareholder pressure and do not receive high-powered pay are less prone to engage in risk-taking."[44]

Consistent with these insights, post-crisis research has tended to indicate that equity-based pay and greater emphasis on shareholders' interests more generally resulted in greater risk-taking by financial firms leading up to the crisis. Laeven and Levine, for example, find that "banks with more powerful owners tend to take greater risks."[45] Renee Adams similarly has found that, among other things, "banks with TARP funds have more independent boards, larger boards, more outside directorships and greater incentive pay for CEOs."[46] Andrea Beltratti and René Stulz likewise found that "banks with more pro-shareholder boards performed worse during the crisis."[47] Strikingly, Rüdiger Fahlenbrach and Stulz have also found that "banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return on equity" during the crisis—findings perhaps suggesting that "CEOs focused on the interests of their shareholders in the build-up to the crisis and took actions that they believed the market would welcome."[48]

C. Curbing Risk-Taking in Financial Institutions

In light of the build-up of leverage and risk in the financial system of each country, it is not surprising that reform efforts would aim not only to stabilize the banking system,[49] but to curb risk-taking moving forward. What is certainly surprising, however,

40. 26 U.S.C.S. § 162(m) (West 2010).

41. *See* Tung, *supra* note 4, at 13–15. The irony has not been lost on scholars in the area. *See, e.g.*, Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 365 (2009); Tung, *supra* note 4, at 14 n.44.

42. *See* Kose John et al., *Corporate Governance and Risk-Taking*, 63 J. FIN. 1679, 1708 (2008).

43. *See* Tung, *supra* note 4, at 15 n.50.

44. Bebchuk & Spamann, *supra* note 1, at 262.

45. Laeven & Levine, *supra* note 38, at 273.

46. Adams, *supra* note 1, at 13.

47. Andrea Beltratti & René M. Stulz, *Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation* 3 (Eur. Corp. Governance Inst. Working Paper Series in Fin., Working Paper No. 254, 2009), *available at* http://ssrn.com/abstract=1433502.

48. Rüdiger Fahlenbrach & René Stulz, *Bank CEO Incentives and the Credit Crisis* 1 (Fisher Coll. of Bus. Working Paper Series, Working Paper No. 2009-03-013, 2010), *available at* http://ssrn.com/abstract=1439859.

49. For additional background on crisis responses to date, see Davidoff & Zaring, *supra* note 24; U.S. Department of the Treasury, *supra* note 31; Dodd–Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010); *Tackling the Financial Crisis*, HM TREASURY, http://www.hm-

in light of the foregoing discussion of risk incentives in the financial sector, is that reform efforts aimed at curbing risk-taking would, in both the United States and the United Kingdom, include initiatives to empower shareholders.[50]

In his review of corporate governance in U.K. financial firms, Sir David Walker recommends, among other things, a "Stewardship Code" for institutional investors aimed at rendering management more directly responsive and answerable to shareholders.[51] The idea, generally speaking, is to promote more active "engagement" by institutional investors in the affairs of the firm,[52] and the Financial Reporting Council (FRC) in fact decided to implement the proposal through amendments to the U.K. Corporate Governance Code—a best practices code applicable on a "comply or explain" basis to any listed company.[53] As such, the initiative is not limited to financial firms. In December 2009, the FRC accepted the proposal and indicated its intention to remove the section of the Code dealing with institutional investors' role in favor of the distinct Stewardship Code that Walker recommended.[54] In June 2010, the FRC issued a new edition of the U.K. Corporate Governance Code moving that section to a schedule and indicating that it would be removed entirely "when the Stewardship Code for institutional investors being developed by the FRC comes into effect."[55] Among other changes, the revised Code also states that "[a]ll directors of FTSE 350 companies should be subject to annual election by shareholders."[56] The FRC describes this change, together with the new Stewardship Code, as "part of a drive to improve engagement between boards and

treasury.gov.uk/fin_finstability_actions.htm (last visited Jan. 13, 2010).

50. For ease of reference, I refer to various types of shareholder-centric initiatives as forms of empowerment, even where a given initiative might more precisely be described as enhancing their influence—non-binding "say on pay" votes being one example. *See infra* notes 62–69 and accompanying text. As discussed below, the aim of such proposals is to render management more directly answerable to the shareholders, and in this general sense I take them on their own terms.

51. WALKER, *supra* note 1, at 17–19 (recommendations 16–22). Walker is a senior advisor to Morgan Stanley. He previously held various public posts including Assistant Secretary at the U.K. Treasury, various posts at the Bank of England, and Chairman of the Securities and Investment Board (predecessor to the Financial Services Authority). For more information on David Walker, see *Biography of David Walker*, HM TREASURY, http://www.hm-treasury.gov.uk/walker_review_biography.htm (last visited Feb. 25, 2010).

52. WALKER, *supra* note 1, at 68–89.

53. *See* Financial Reporting Council, The U.K. Corporate Governance Code, 2010, at 1–5 (U.K.) [hereinafter FRC, U.K. Corporate Governance Code]; FINANCIAL SERVICES AUTHORITY HANDBOOK, Listing Rule 9.8.6 (Aug. 6, 2010) (U.K.). *See also id.* at Rule 9.8.7 (Apr. 6, 2010) (extending the requirement to any "overseas company with a premium listing").

54. Financial Reporting Council, 2009 Review of the Combined Code: Final Report, 2009, at 34 (U.K.). Previously called the "Combined Code" because it built on prior codes, the name was changed to the "U.K. Corporate Governance Code" in 2010 to "make the Code's status as the UK's recognised corporate governance standard clearer to foreign investors." *Id.* at 10, 36. For the sake of clarity, I refer to it as the U.K. Corporate Governance Code throughout this Article.

55. *See* FRC, U.K. Corporate Governance Code, *supra* note 53, at 36 n.28 (Schedule C); Financial Reporting Council, Revisions to the UK Corporate Governance Code (Formerly the Combined Code), 2010, at 5, 10 (U.K.) [hereinafter FRC, Revisions]. The new edition of the U.K. Corporate Governance Code applies to reporting periods starting June 29, 2010 or later. *See id.* at 1.

56. FRC, U.K. Corporate Governance Code, *supra* note 53, at 17 (provision B.7.1). The Financial Times Stock Exchange (FTSE) 350 index follows the largest 350 companies (by market value) in the United Kingdom. *See* INSIGHT INVESTMENT, INVESTMENT GLOSSARY, "FTSE 100 (FTSE 250/FTSE 350/FTSE SMALL CAP)," http://www.insightinvestment.com/uk/investmentglossary?letter=F (last visited June 14, 2010).

shareholders," and more specifically to "increase accountability to shareholders."[57]

The U.K. Stewardship Code itself was issued in July 2010.[58] The FRC explains in a preface to the Code that it "aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities" through a "comply or explain" approach similar to the U.K. Corporate Governance Code.[59] The Stewardship Code itself consists of seven principles, each followed by the FRC's guidance on their application, urging (1) disclosure of investors' stewardship policies; (2) adoption of "a robust policy on managing conflicts of interest;" (3) active monitoring of companies in which they invest; (4) adoption of "clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value;" (5) willingness to "act collectively with other investors where appropriate;" (6) adoption of voting policies; and (7) periodic reporting on "stewardship and voting activities."[60] With respect to escalation, the FRC explains that "if boards do not respond constructively when institutional investors intervene," then they should consider holding meetings with management, the chairman, and/or independent board members; undertaking joint action with other institutional investors; making public statements in advance of shareholder meetings; submitting shareholder resolutions; and "in some cases proposing to change board membership."[61]

In the United States, shareholder-oriented reform proposals have been more numerous and wide-ranging. With respect to TARP firms, the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 imposed outright restrictions on pay, provided for oversight of compensation practices by the Secretary of the Treasury, and mandated a non-binding shareholder vote to approve executive compensation (often termed "say on pay").[62] Senator Charles Schumer (a Democrat from New York) introduced in May 2009 a bill intended to "provide shareholders with enhanced authority over the nomination, election, and compensation of

57. FRC, Revisions, *supra* note 55, at 2–5. The previous standard of reelection at least every three years remains in place for smaller companies. *See id.* at 3–4. It should be noted that even some U.K. institutional investors voiced concerns that annual elections might promote short-term thinking among directors. *See, e.g.*, Nyree Stewart, *Pension funds concerned over FRC call for annual re-elections*, INVESTMENT & PENSIONS EUROPE, May 28, 2010, http://www.ipe.com/home/login.php?type=noaccess&extra=&page=http%3A%2F%2Fwww.ipe.com%2Fnews%2Fpension-funds-concerned-over-frc-call-for-annual-re-elections_35543.php.

58. *See* Press Release, Financial Reporting Council, Financial Reporting Council Publishes First U.K. Stewardship Code, FRC PN 306 (July 2, 2010), *available at* http://www.frc.org.uk/press/pub2306.html.

59. *See* Financial Reporting Council, The UK Stewardship Code, 2010, at 1–2 (U.K.).

60. *Id.* at 5–9.

61. *Id.* at 7. This approach to escalation is well established among U.K. institutional investors, reflecting the fact that the FRC hewed closely to a preexisting code promulgated by the Institutional Shareholders Committee (ISC). *See* Financial Reporting Council, Implementation of the UK Stewardship Code, 2010, at 1–2 (U.K.); *Shareholder or Shareowner?*, HERMES EQUITY OWNERSHIP SERVS., *available at* http://www.hermes.co.uk/files/pdfs/shareowner_or_shareholder_311003.pdf (endorsing the ISC guidelines and describing a similar escalation framework) (last visited Oct. 8, 2010).

62. *See* Emergency Economic Stabilization Act, Pub. L. 110-343, §§ 111, 302, 2008 U.S.C.C.A.N. (122 Stat.) 3765, 3776–77, 3803–06 (2008); American Recovery and Reinvestment Act, Pub. L. No. 111-5, § 7001, 2009 U.S.C.C.A.N. (123 Stat.) 115, 516–20 (2009). For additional background on proposed and enacted corporate governance reforms, see Bebchuk & Spamann, *supra* note 1, at 249–51; Bhagat & Romano, *supra* note 41, at 360; Bratton & Wachter, *supra* note 9, at 657–58; Tung, *supra* note 4, at 21–23.

public company executives" through enactment of a new "Shareholder Bill of Rights Act."[63] Among other things, the Act would shore up the legal authority of the Securities and Exchange Commission (SEC) to expand proxy access; mandate "say on pay" (and golden parachute) votes; and mandate exchange listing rules requiring an independent board chair, annual election of all directors (effectively barring exchange traded companies from having staggered boards), and majority (rather than plurality) voting in board elections.[64] Some of these proposals ultimately found their way into the broader financial reform package included in the Dodd–Frank Wall Street Reform and Consumer Protection Act. Signed into law by President Obama in July 2010,[65] the Dodd–Frank Act introduced a variety of shareholder-oriented executive compensation and corporate governance reforms, notably "say on pay" (and golden parachute) votes; enhanced disclosures regarding "the relationship between executive compensation actually paid and the financial performance of the issuer;" a three-year clawback of incentive-based pay following accounting restatements; and clear authority for the SEC to expand proxy access.[66] The SEC, having proposed greater access to the company's proxy statement for shareholders desiring to nominate directors in 2009,[67] responded promptly to the grant of explicit authority in the Dodd–Frank Act, adopting a new proxy access rule in August 2010. Assuming it survives the predictable legal challenge,[68] Rule 14a-11 will, under certain circumstances, permit shareholders or groups holding 3% voting power for three years to include in the company's proxy their own nominees for up to 25% of the board (or a nominee for one seat, whichever is greater). At the same time, the SEC amended Rule 14a-8(i)(8) in order to facilitate shareholder proposals relating to nomination procedures.[69]

There is, of course, an appealingly simple logic to such proposals. In styling the matter a corporate governance problem, we inevitably conceptualize it in binary terms

63. Shareholder Bill of Rights Act of 2009, S.1074, 111th Cong. pmbl., § 1 (2009).

64. *See id.* §§ 3–5. *See also* POZEN, *supra* note 13, at 286–91 (expressing support for majority voting, annual elections, proxy access, and "say on pay" votes).

65. *See* Ross Colvin, *Obama Signs Sweeping Wall Street Overhaul into Law*, REUTERS (July 21, 2010, 3:43 PM), http://www.reuters.com/article/idUSTRE66K1QR20100721.

66. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong., §§ 951 (say on pay and golden parachute votes), 953 (executive compensation disclosures), 954 (clawback), 971 (proxy access) (2010). The Dodd–Frank Act also requires risk committees in certain larger financial firms, *id.* § 165(h), and imposes heightened compensation regulation and disclosure requirements for incentive-based compensation in financial firms that regulators conclude "could lead to material financial loss to the covered financial institution." *Id.* § 956. For a useful summary of these and other executive compensation and corporate governance provisions included in the Dodd–Frank Act, see David S. Huntington, *Corporate Governance and Executive Compensation Provisions of the Dodd–Frank Act*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG. (July 8, 2010, 9:23 AM), http://blogs.law.harvard.edu/corpgov/2010/07/08/corporate-governance-and-executive-compensation-provisions-of-the-Dodd–Frank-act/.

67. *See* Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29024 (June 18, 2009); Yin Wilczek & Phyllis Diamond, *Thorny Issues on SEC's Regulatory Agenda Could Make for Long Year; Short Sales Vote Soon*, SEC. L. DAILY (BNA), Jan. 25, 2010.

68. *See* Jessica Holzer, *SEC Awaits Court Ruling on Proxy Rule*, WALL ST. J., Oct. 4, 2010 (reporting the SEC's decision to "halt implementation" pending the outcome of a suit filed by the U.S. Chamber of Commerce and the Business Roundtable, which "sued to overturn the rule").

69. *See* Securities and Exchange Commission, Facilitating Shareholder Director Nominations, Release Nos. 33-9136, 34-62764, IC-29384 (Aug. 25, 2010); Christopher Bruner, *Proxy Access Forum: Christopher Bruner*, CONGLOMERATE BLOG, Aug. 26, 2010, http://www.theconglomerate.org/forum-proxy-access/.

because our corporate governance system largely revolves around two power constituencies—the board and the shareholders. Thus, to the degree the crisis was caused by board oversight failures, the answer must be more shareholder monitoring of boards themselves.[70] In this spirit, Senator Schumer's bill declares that "among the central causes of the financial and economic crises . . . has been a widespread failure of corporate governance," and that "a key contributing factor . . . was the lack of accountability of boards to their ultimate owners, the shareholders."[71] Similarly the SEC, in the adopting release for its new proxy access rule, indicates that when it proposed such a move in 2009, it "recognized at that time that the financial crisis . . . heightened the serious concerns of many shareholders about the accountability and responsiveness of some companies and boards of directors to shareholder interests," raising "questions about whether boards . . . were appropriately focused on shareholder interests, and whether boards need to be more accountable for their decisions regarding issues such as compensation structures and risk management."[72] The new proxy access rule, the SEC suggests, "will significantly enhance the confidence of shareholders who link the recent financial crisis to a lack of responsiveness of some boards to shareholder interests."[73] Such views have been echoed by institutional investors and their supporters in the United States,[74] and the same general theme animates calls for greater "stewardship" by shareholders in the United Kingdom.[75]

The fundamental question is why the pro-shareholder theme has gained such traction in reform efforts following the crisis, particularly given the growing body of finance studies indicating that excessive focus on the interests of risk-preferring equity holders

70. On the binary division of U.S. corporate governance power, involving only boards and shareholders, see Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1392, 1422–24 (2008); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 906–07 (1990).

71. Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 2 (2009).

72. Securities and Exchange Commission, *supra* note 69, at 7.

73. *Id.* at 10.

74. *See, e.g.*, Letter from Jeff Mahoney, General Council, Council of Institutional Investors, and others, to the Honorable Nancy Pelosi (Dec. 2, 2008), at 1 *available at* http://www.calpers-governance.org/docs-sof/marketinitiatives/initiatives/cii-corporate-governance-reform-advocacy-letter.pdf (advocating greater shareholder power to "restore trust and ensure that such a crisis never happens again"); Nell Minow, Editor, The Corporate Library, Testimony before the Committee on Financial Services Hearing on Compensation Structure and Systemic Risk (Jan. 22, 2010), at 5 *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/minow.pdf (advocating greater shareholder power in part because "the very same directors who approved the outrageous pay packages that led to the financial crisis continue to serve on boards"); Malini Manickavasagam, *Corporate Governance Experts Urge Congress to Stop Excessive Corporate Pay*, SEC. L. DAILY (BNA), Jan. 25, 2010.

75. *See, e.g.*, WALKER, *supra* note 1, at 70–71 (arguing that "the board and director shortcomings" leading to the crisis "would have been tackled more effectively had there been more vigorous scrutiny and engagement by major investors"); Institutional Shareholders' Committee, *Code on the Responsibilities of Institutional Investors* (Nov. 16, 2009), *available at* http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCcodeexpressrelease161109.pdf (advocating greater dialogue with shareholders as a means of "reduc[ing] the risk of catastrophic outcomes due to bad strategic decisions"); Institutional Shareholders' Committee, *Improving Institutional Investors' Role in Governance* (June 5, 2009), *available at* http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCImprovingInstitutionalInvestorsRoleInGovernance50609.pdf (advocating greater dialogue with shareholders as an "improvement[] that could be made to corporate governance in the wake of the banking crisis").

was a big part of the problem.[76] In this light the shareholder-empowerment position appears self-contradictory, essentially amounting to the claim that we must give shareholders more power because managers left to themselves have excessively focused on the shareholders' interests.[77] It should also be observed that this position has implicitly tended to equate corporate governance in financial and non-financial firms[78]—a dubious position in light of the foregoing discussion of highly skewed risk incentives in financial firms. Indeed, in a study of companies removed from the S&P 500 in 2008, Brian Cheffins finds, among other things, that "institutional shareholders were largely mute as share prices fell," while "directors of troubled firms were far from passive, as they orchestrated CEO turnover at a rate far exceeding the norm in public companies." These findings indicate that "corporate governance functioned tolerably well in companies removed from the S&P 500," leading Cheffins to conclude that "the case is not yet made for fundamental reform of current corporate governance arrangements."[79] To be sure, revelation of Lehman Brothers' use of repurchase agreements to reduce quarter-end debt levels (by booking asset loans as sales) may lead to civil and criminal proceedings by the SEC and Department of Justice, respectively.[80] But in any event, Cheffins' findings retain their force for non-financial firms, given that "financials not only suffered the largest share price declines," but "also dominated the roster of companies removed from the index."[81]

While managers on both sides of the Atlantic are obvious targets for public outrage in a time of crisis, the remainder of this Article argues that meaningfully reforming U.S. and U.K. corporate governance will require a far more nuanced understanding of how each system has historically functioned. Though reform proposals in both countries have focused on shareholder empowerment, and similarly blur the critical distinction between financial and non-financial firms, this Article argues that such efforts amount to very different reform approaches in each country. Though similar by global standards, the U.S. and U.K. corporate governance systems have less in common than is typically assumed, and these reform proposals in fact arise amidst very different background conditions. To understand why each country has responded as it has, and to evaluate whether reforms proposed in each country represent wise policy choices, it is critical to appreciate the differing histories, cultures, and politics that gave rise to the U.S. and U.K. approaches to corporate governance.

76. *See supra* notes 45–48 and accompanying text.

77. *Cf.* Fahlenbrach & Stulz, *supra* note 48, at 1–2 (finding that "banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return on equity" during the crisis, and speculating that "CEOs focused on the interests of their shareholders in the build-up to the crisis and took actions that they believed the market would welcome").

78. *See supra* notes 51–61, 65–69 (describing shareholder empowerment initiatives extending to both financial and non-financial firms in the United Kingdom and the United States, respectively).

79. Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1, 1 (2009).

80. *See* Michael J. de la Merced, *Findings on Lehman Take Even Experts by Surprise*, N.Y. TIMES, (Mar. 12, 2010), http://www.nytimes.com/2010/03/13/business/13lehman.html (describing Lehman's so-called "Repo 105" transactions); Michael Baron, *SEC's Lehman Probe Keys on Repo 105: Report*, THESTREET, (Sept. 9, 2010, 8:16 PM), http://thestreet.com/print/story/10857176.html.

81. Cheffins, *supra* note 79, at 51–52.

III. SHAREHOLDERS AND CORPORATE GOVERNANCE

The comparative corporate governance literature has tended to depict the world in binary terms. In most countries we find concentrated ownership systems, in which blockholders typically dominate large companies through control over substantial blocks of voting stock. Corporate governance, then, aims to constrain the blockholders' innate power by strongly emphasizing the interests of other "stakeholders" such as employees and creditors.[82] In the United States and the United Kingdom, by contrast, we find dispersed ownership systems, in which stock ownership tends to be considerably more fragmented. In this setting, the principal aim of corporate governance becomes protecting minority shareholders, who by definition lack substantial voting power—an approach to corporate governance often described as uniquely "Anglo-American."[83]

Building on this core Anglo-American commonality, financial economists often define "corporate governance" in starkly shareholder-centric terms—it is simply the set of mechanisms through which corporations are directed toward the pursuit of shareholders' interests.[84] The reality, however, is far more complex, as U.S. and U.K. corporate governance in fact differ substantially in their relative degrees of shareholder orientation.

A. Shareholder Power in the United States and the United Kingdom

John Armour and David Skeel observe that, "when it comes to business and finance, the United States and the United Kingdom arguably have more in common than any other pair of developed economies."[85] This is undoubtedly correct. Yet, institutional shareholders navigating both corporate governance systems find them to be two very

82. *See, e.g.*, Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, 50 VA. J. INT'L L. 579, 580–81, 643–46 (2010); Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 HARV. INT'L L.J. 129, 154–56 (2009).

83. *See, e.g.*, John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1751 (2007) (observing the "separation of ownership and control" common to the United States and the United Kingdom but "uncommon elsewhere"); Bruner, *supra* note 82, at 580–81, 643–46 (describing the protection of minority shareholders as "a shareholder-centric and market-oriented approach to corporate governance that may fairly be described as uniquely 'Anglo-American'"); Brian R. Cheffins, Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom 9–11 (2000) (unpublished manuscript), http://papers.ssrn.com/paper.taf?abstract_id=218655 (explaining that the United States and the United Kingdom "share an 'outsider' or 'arms-length' system of ownership and control"); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 511 (1999) (concluding that dispersal of stock ownership is observed "only . . . in the richest common law countries"); Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England*, 1998 COLUM. BUS. L. REV. 51, 51 (1998) ("When viewed against the backdrop of corporate governance systems worldwide, the similarities between England and the United States are more pronounced than the differences."). *See also generally* PETER A. HALL & DAVID SOSKICE (EDS.), VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE (2001) (similarly contrasting "liberal market economies" with "coordinated market economies").

84. *See, e.g.*, Jean Tirole, *Corporate Governance*, 69 ECONOMETRICA 1, 1 (2001) ("The standard definition of corporate governance among economists and legal scholars refers to the defense of shareholders' interests.").

85. Armour & Skeel, *supra* note 83, at 1751.

different worlds, because shareholders in the United Kingdom enjoy a degree of governance power and explicit centrality to the corporate enterprise far exceeding what one finds in the United States.

Though the points of distinction are numerous,[86] three examples will suffice: the greater power of U.K. shareholders to remove directors, their greater power to accept hostile takeovers, and the greater emphasis on their interests in the formulation of directors' duties. In the United Kingdom, shareholders representing just 5% voting power can always demand a meeting, at which any director may be removed by a simple majority vote.[87] This strong removal power has long permitted U.K. shareholders to impose their will on corporate boards[88] in a direct manner effectively unknown to U.S. shareholders. In Delaware, where most U.S. public companies are incorporated,[89] shareholders possess no default power to call special meetings.[90] And while Delaware shareholders do have a default right to remove directors "with or without cause," many public company boards are staggered into three classes elected in subsequent years—in which case the statutory default reverses, and directors may be removed only for cause.[91]

A takeover regime in which shareholders possess near-total discretion to accept or reject hostile bids for the company reinforces the governance authority of U.K. shareholders. The City Code on Takeovers and Mergers (the City Code)—enforced by a self-regulatory body of market actors called the Panel on Takeovers and Mergers (the City Panel)—provides that when a target board "has reason to believe that a bona fide offer might be imminent," the board cannot without shareholder approval "take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits."[92] This, again, vastly exceeds the authority of U.S. shareholders, whose ability to accept hostile bids is effectively undercut by court rulings in Delaware and statutes elsewhere that permit boards to deploy defensive tactics to insulate pre-existing business plans from outside threats. U.S. boards generally also have explicit latitude to consider the interests of other stakeholders, such as employees and creditors, in deciding how to respond to a hostile bid.[93]

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86. I explore them more comprehensively in Bruner, *supra* note 82, at 593–611.

87. *See* Companies Act (2006), c. 46, §§ 168, 282, 303–04 (U.K.); Companies (Shareholders' Rights) Regulations 2009, S.I. 2009/1632, ¶ 4 (U.K.) (amending Companies Act § 303 to reduce the threshold to 5%).

88. PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 371, 425 (8th ed. 2008).

89. Delaware is the jurisdiction of choice for most large U.S. public companies. *See* Delaware Division of Corporations, *Why Choose Delaware as Your Corporate Home?*, http://corp.delaware.gov (last visited Nov. 11, 2010) ("More than 850,000 business entities have their legal home in Delaware including more than 50% of all U.S. publicly-traded companies and 63% of the Fortune 500.").

90. Such power must be granted by the charter or bylaws. *See* DEL. CODE ANN. tit. 8, § 211(d) (2010).

91. *See* DEL. CODE ANN. tit. 8, § 141(d), (k)(1). Companies may provide in their charter for removal of staggered directors without cause, but the statute requires that charter amendments be proposed by the board. *See* DEL. CODE ANN. tit. 8 §§ 141(k)(1), 242(b). This contrasts with the ability of U.K. shareholders to amend the company's constitution unilaterally by a 75% vote. *See* Companies Act (2006), c.46, §§ 21(1), 283 (U.K.).

92. PANEL ON TAKEOVERS AND MERGERS, THE TAKEOVER CODE B1, I18 § 21.1 (2009).

93. Seminal Delaware opinions establishing board discretion to deploy takeover defenses include Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173 (Del. 1986); Paramount Commc'ns v. Time Inc., 571 A.2d 1140 (Del. 1990); Paramount Commc'ns v. QVC Network Inc., 637 A.2d 34 (Del.

While equity-based pay no doubt functions to align managers' interests with the shareholders' interests in U.S. companies just as it would elsewhere, the far greater legal centrality of U.K. shareholders relative to their U.S. counterparts is readily apparent in the respective formulations of directors' duties. Consistent with their substantial capacity to discipline management through removal or by accepting a hostile bid, U.K. company law expressly requires that the shareholders' interests be paramount in board decision-making. Section 172 of the Companies Act 2006 states that a director "must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members [i.e., the shareholders] as a whole."[94] Regard is to be had, among other things, for various other stakeholder groups, as well as environmental issues and "long term" consequences for the company, but ultimately such things are relevant only to the extent they impact shareholders' interests.[95] Meanwhile Delaware's courts have left the issue of corporate purpose considerably less clear, stating that directors owe duties of care and loyalty "to the corporation and its stockholders" simultaneously[96]—a formulation reflecting deep-seated ambivalence regarding the degree to which shareholders' interests ought to dominate corporate decision-making in the United States.[97] Notwithstanding talk of a single "Anglo-American" approach to corporate governance, these and other points of divergence demonstrate that U.S. and U.K. corporate governance in fact differ starkly in their relative degrees of shareholder orientation.[98] Consequently, shareholder-centric reform proposals depart from fundamentally different baselines, and effectively represent different approaches to reform, in each country.

B. Culture, Politics, and Corporate Governance

Understanding how this divergence arose—and what its ramifications might be for crisis-driven reform proposals—in turn requires a deeper consideration of the historical, cultural, and political factors that drove the U.S. and U.K. corporate governance systems in the directions they have taken. While a full reckoning lies beyond the scope of this Article, this Subpart identifies three factors giving rise to these divergences that are

1994); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995). For a discussion of Delaware's takeover jurisprudence and the statutory approach pursued elsewhere, see Bruner, *supra* note 70, at 1415–21; Bruner, *supra* note 82, at 596–98, 635–41.

94. Companies Act (2006), c.46, § 172 (U.K.).

95. *Id.*

96. Guth v. Loft, 5 A.2d 503, 510 (Del. 1939); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007).

97. *See* Bruner, *supra* note 70, at 1425–27.

98. While the far greater capacity of U.S. shareholders to sue might appear to narrow the gap somewhat, there is reason to doubt that U.K. shareholders would rationally trade stronger ex ante governance rights for such an ex post remedy—notably, the lack of any strong push among U.K. institutions for greater latitude to sue. *See* Bruner, *supra* note 82, at 609–10. For a blog exchange addressing this issue in some depth, see generally Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, OPINIO JURIS (Apr. 14, 2010), http://opiniojuris.org/2010/04/14/power-and-purpose-in-the-%e2%80%9canglo-american%e2%80%9d-corporation/; Brian Cheffins, *A Response to Christopher Bruner*, OPINIO JURIS (Apr. 14, 2010), http://opiniojuris.org/2010/04/14/a-response-to-christopher-bruner-by-brian-cheffins/; Christopher M. Bruner, *A Response to Brian Cheffins*, OPINIO JURIS (Apr. 14, 2010), http://opiniojuris.org/2010/04/14/a-response-to-brian-cheffins/.

particularly relevant to post-crisis reform proposals: the earlier rise to power of U.K. institutions, the relative proximity and homogeneity of U.K. market actors, and broader differences in how each country's corporate governance system relates to external regulatory structures conditioning relationships among stakeholders in the firm.

While institutional investors have loomed large in American capital markets since the 1990s,[99] institutions became dominant players in the United Kingdom decades earlier, and have exerted substantial influence in favor of shareholder-centric structures at critical points in the development of the U.K. corporate governance system. Among other things, high tax rates for individual investment income and more favorable tax treatment of collective investment by pension funds and insurance companies led to massive transfers of equity to these institutions in the decades following World War II.[100] The consequence, as Armour and Skeel observe, was the emergence of a sophisticated and powerful constituency capable of asserting shareholders' interests. "In a range of different contexts," they explain, "U.K. institutional investors have been active either in lobbying regulators or in seeding market norms."[101] Their success is reflected in reliance on market-based self-regulation to police hostile takeovers through the City Code and City Panel described above, and in the use of voluntary codes of best practice, enforced only on a "comply or explain" basis—notably the U.K. Corporate Governance Code.[102]

The dominance of U.K. institutional shareholders has a geographic dimension as well. In the United States, a typical public company might be regulated by corporate law made in Delaware, securities regulation made in Washington, D.C., and exchange rules and market customs made in New York.[103] In the United Kingdom, on the other hand, company law, the regulation of capital markets, and exchange listing rules are all products of London—and of course the institutions are based there as well, in the square-mile area of London referred to as "the City." Armour and Skeel observe of the formation of the U.K. takeover regime in the 1950s that "the close links between the government and the Bank of England, on the one hand, and the Bank and City institutions, on the other, meant that City voices would have been loud advocates in Ministers' ears for non-interventionist solutions."[104] Even today, as Caroline Bradley notes, "[p]eople still talk

99. *See* Bruner, *supra* note 70, at 1432–35. Mark Roe has attributed the late arrival of institutional investors in the United States to banking and securities regulations aimed at fragmenting financial institutions. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 168 (1994).

100. *See* Armour & Skeel, *supra* note 83, at 1767–69; BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED 87, 323–28, 341–49 (2008).

101. Armour & Skeel, *supra* note 83, at 1771.

102. *See id.*; FRC, U.K. Corporate Governance Code, *supra* note 53, at 4–5; FINANCIAL SERVICES AUTHORITY HANDBOOK, *supra* note 53, Listing Rules 9.8.6–.7.

103. *See, e.g.*, WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 89–90, 191, 211 (2d ed. 2007) (observing the dominance of Delaware in attracting incorporations, the role of federal securities law in regulating public company disclosures, and the ability of the New York Stock Exchange to supplement corporate governance rules as a gatekeeper to the public trading market).

104. Armour & Skeel, *supra* note 83, at 1772. *See also* Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2078 (1994) (observing that "U.S. institutions are unlikely to approach the level of concentration or the geographic and cultural cohesion of the City"); Caroline Bradley, *Transatlantic Misunderstandings: Corporate Law and Societies*, 53 U. MIAMI L. REV. 269, 280–81, 299–313 (1999) (attributing greater comfort with self-regulation

about the Governor of the Bank of England controlling participants in the financial markets by raising his eyebrows"[105]—a mode of informal regulation depending critically on geographic proximity and shared cultural understanding. Accordingly, there is prevalent in the City a long-standing and deep-seated distaste for heavy-handed, prescriptive rules of the sort developed for U.S. markets by the SEC and bank regulators, an approach broadly viewed as excessive in light of the relative concentration of the London marketplace.[106]

The earlier rise to power of U.K. institutions and the relative proximity and homogeneity of U.K. market actors offer important insights into the emergence of starkly shareholder-centric corporate governance structures in the United Kingdom, but explaining their political stability over time is another matter.[107] Critically, the larger corporate regulatory environment—of which corporate governance is just one part—differs substantially between the United States and the United Kingdom, reflecting fundamentally differing views on distributional politics and the role of public corporations in delivering social welfare protections. A growing body of corporate governance scholarship recognizes that the formation of a country's corporate governance regime is intimately bound up with larger regulatory issues affecting relationships among corporate stakeholders.[108] In the United Kingdom, where the prevailing politics has been more left-leaning[109] and social welfare protections have been considerably more robust, the corporate governance system has been subjected to considerably less pressure to account for the interests of non-shareholders. As I have explored in prior work, for example, the highly shareholder-centric U.K. takeover regime described above was able to take root and remain politically stable under the Labour government of Harold Wilson precisely because the government believed that external regulatory structures—notably the British welfare state—could mitigate costs borne by employees losing their jobs in the process of corporate consolidation.[110]

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of takeovers to the relative proximity and homogeneity of U.K. market actors and regulators); CHEFFINS, *supra* note 100, at 372 (observing that "[w]hile US institutional shareholders have generally been spread out among various financial centres, most British institutional investors . . . have traditionally been based within a small area in the City of London").

105. Bradley, *supra* note 104, at 309.

106. Sridhar Arcot et al., *Corporate Governance in the UK: Is the Comply or Explain Approach Working?* INT'L REV. L. & ECON. 4–5 (forthcoming 2010), *available at* http://ssrn.com/abstract=1532290; Black & Coffee, *supra* note 104, at 2023; L.C.B. Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1381–82 (1956); TOM HADDEN, COMPANY LAW AND CAPITALISM 361–62 (2d ed. 1977); TURNER, *supra* note 1, at 90.

107. *See* Bruner, *supra* note 82, at 616–18.

108. Hall and Soskice, for example, explore the role of "institutional complementarities" across the political economy. *See, e.g.*, Peter A. Hall & David Soskice, *An Introduction to Varieties of Capitalism*, *in* HALL & SOSKICE, *supra* note 83, at 1, 17–21.

109. *See Anglo-Saxon attitudes,* ECONOMIST (Mar. 27, 2008), *available at* http://www.economist.com/node/10926321?story_id=10926321 (concluding that "Britons tend to have more left-wing views than Americans"); *Anglo-Saxon Attitudes: A Survey of British and American Views of the World*, ECONOMIST (Mar. 29, 2008), *available at* http://www.economist.com/media/pdf/fullpolldata.pdf (providing survey data).

110. *See* Bruner, *supra* note 82, at 621–32. Martin Gelter has similarly explored the impact of employment law on the formation of corporate governance regimes in the United States and the United Kingdom, identifying similar dynamics at work. *See generally* Gelter, *supra* note 82.

In the United States, by contrast, the government has historically provided a less comprehensive set of social welfare protections, relying heavily on corporate employers to provide private pension and health benefits for their employees—an arrangement that David Charny described as the "employee welfare state."[111] As a practical matter, the most critical distinction relates to healthcare—the U.K. National Health Service's universal coverage contrasting starkly with the lack of any public healthcare option for most Americans.[112] Controversial insurance reforms enacted in 2010 may tend to reduce this gap over time by extending health coverage to an estimated 32 million Americans, though tens of millions will remain uninsured, and fundamental issues of implementation remain unaddressed—not least declining interest in primary care among U.S. physicians.[113]

Such dynamics have had a little recognized, though critical, effect on U.S. corporate governance, bringing substantial political pressure to bear on judges and legislators to accommodate the interests of corporate employees in times of perceived crisis. To return to the takeover example, when a wave of hostile tender offers hit in the 1980s, the Delaware courts and a number of state legislatures explicitly permitted corporate boards to consider the interests of non-shareholders in assessing whether to deploy defensive tactics. In some instances, the legislative history makes clear that loss of pension, health, and other benefits—combined with the lack of adequate public safety nets—loomed large in the enactment of such laws, reflecting a politically powerful coalition of employees and managers favoring discretion to impede hostile tender offers.[114] The upshot is that whereas robust social welfare policies in the United Kingdom deflected political pressure from the corporate governance system, permitting a stronger focus on shareholder interests to emerge and remain stable, the opposite occurred in the United States, where relatively weak social welfare policies resulted in substantial pressure to accommodate

111. *See* David Charny, *The Employee Welfare State in Transition*, 74 TEX. L. REV. 1601, 1601–06 (1996).

112. *See* Bruner, *supra* note 82, at 636–39. *See also Expensive Healthcare Is Not Always the Best Healthcare, Says OECD's Health at a Glance*, ORG. FOR ECON. CO-OPERATION AND DEV. (Dec. 8, 2009), http://www.oecd.org/document/23/0,3343,en_2649_37407_44216846_1_1_1_1,00.html ("[A]ll OECD countries provide universal or near-universal coverage for a core set of health services, except the United States, Mexico, and Turkey."); T.R. Reid, *Health Care Systems—The Four Basic Models*, FRONTLINE (Apr. 15, 2008), http://www.pbs.org/wgbh/pages/frontline/sickaroundtheworld/countries/models.html. As Reid observes, the United States' "fragmented national health care apparatus" includes various models for different constituencies. *Id.* Veterans have a national health system; those aged 65 or older, and the very poor, have a national insurance system; many working Americans have an employer-based system; and the remaining 15% of the population have nothing at all. *See id.*

113. *See Health Care Reform Bill Summary: A Look at What's in the Bill*, CBSNEWS.COM, http://www.cbsnews.com/8301-503544_162-20000846-503544.html (last visited Mar. 29, 2010); James Warren, *With Insurance Comes a New Need: More Primary-Care Doctors*, N.Y. TIMES, Mar. 26, 2010, at 21A; Jane Hiebert-White, *52 Million Uninsured Americans By 2010*, HEALTH AFFAIRS BLOG (June 2, 2009), http://healthaffairs.org/blog/2009/06/02/52-million-uninsured-americans-by-2010/. *See also* Parija Kavilanz, *Number of insured drops for first time*, CNNMONEY.COM, Sept. 16, 2010, *available at* http://money.cnn.com/2010/09/16/news/economy/census_latest_uninsured_numbers/index.htm?hpt=T1 (reporting U.S. Census Bureau data indicating that the number of Americans with health insurance "dropped for the first time in 23 years" from 255.1 million in 2008 to 253.6 million in 2009).

114. *See* Bruner, *supra* note 82, at 639–41. This is not to suggest that management self-interest had nothing to do with the passage of antitakeover laws. It is simply to suggest that employee self-interest led to the formation of such a coalition, and that public receptivity to employees' concerns made the coalition politically effective. *See id.* at 647.

non-shareholders' interests within corporate governance itself.[115]

All three of these core distinctions[116]—the earlier rise of U.K. institutional shareholders, the relative proximity and homogeneity of U.K. market actors, and broader external regulatory differences of the sort discussed above—help to illuminate the meaning, significance, and likely impact of corporate governance reforms pursued in each country in the wake of the crisis. These factors represent the historical, cultural, and political context out of which current reform efforts arise, and before which they must be evaluated.

IV. THE POLITICAL ROOTS OF SHAREHOLDER-CENTRIC REFORM EFFORTS

While both the United States and the United Kingdom have pursued shareholder-centric reforms in the wake of the crisis, the foregoing discussion suggests that shareholder empowerment in fact means something quite different in each country. As this Part of the Article explores, shareholder empowerment in the United Kingdom effectively amounts to shoring up the status quo approach to corporate governance, which has long been heavily shareholder-centric in orientation. In the United States, by contrast, shareholder empowerment represents a dramatic departure from the status quo, which has long remained ambivalent about the precise goals of the corporate enterprise and the merits of shareholder power.

A. Shareholders as Stewards

When Sir David Walker suggested that British institutional investors formally commit themselves to "stewardship" of the companies in which they invest, he did not envision a bank-specific departure from the established U.K. corporate governance model. To the contrary, the aim is to encourage a level of active engagement already expected of shareholders in all U.K. companies. Emphasizing "the importance of discharge of the responsibility of shareholders as owners, which has been inadequately acknowledged in the past,"[117] Walker recommends that the Financial Reporting Council (FRC) develop "principles of best practice in stewardship by institutional investors and fund managers," to be embodied in a "Stewardship Code" distinct from the U.K. Corporate Governance Code (though employing a "comply or explain" approach "akin"

115. It should be noted, however, that these dynamics differ fundamentally in other parts of the world where, unlike in the United States and the United Kingdom, concentrated ownership of large companies predominates. In such countries, the default regulatory posture vis-à-vis shareholders is precisely the opposite, the principal aim being to constrain the innate power that controlling shareholders possess in order to bring the corporate governance system into focus with larger social goals, including the interests of employees and other non-shareholder groups. For additional background on this critical distinction between dispersed ownership and concentrated ownership systems, see *id.* at 643–46.

116. To be sure, there are others. L.C.B. Gower, for example, observes that U.K. company law grew out of partnership law, while U.S. corporate law derives more directly from legislative chartering—the upshot being that "modern American corporation law owes less to partnership and contractual principles than does the British." *See* Gower, *supra* note 106, at 1371–72. *See also* Jennifer G. Hill, *The Rising Tension between Shareholder and Director Power in the Common Law World* 15 (Eur. Corp. Governance Inst. Law Working Paper no. 152/2010, 2010), *available at* http://ssrn.com/abstract=1582258 (discussing Gower's work).

117. WALKER, *supra* note 1, at 12.

to it).[118] He explains that "those who have significant rights of ownership and enjoy the very material advantage of limited liability should see these as complemented by a duty of stewardship."[119] Here Walker styles the proposal as a reflection of the shareholders' responsibility in a corporate governance structure that has long placed shareholders at the heart of the action. As noted above, the FRC has in fact implemented the proposal (in addition to calling for annual board elections in FTSE 350 companies),[120] and the Institutional Shareholders' Committee (representing the four principal groups of U.K. institutional investors) has itself echoed Walker's call for more extensive monitoring and preparedness to intervene on the part of U.K. shareholders.[121] Similarly, in adopting a new Remuneration Code for U.K. financial firms, the Financial Services Authority "recognise[s] the vital importance of the role of shareholders in monitoring and controlling remuneration risks,"[122] implementing a new rule requiring large U.K. banks to maintain policies promoting "effective risk management"—an approach that in no material respect interferes with shareholders' influence over pay policies.[123]

Such responses to the crisis underscore the core reality of U.K. corporate governance, which is that shareholders hold the upper hand; the board's power is, simply and purely, delegated power.[124] Indeed, choice of the word "stewardship" is itself quite illuminating, as it literally denotes oversight[125]—the idea being that shareholders have a right and an obligation to manage management. By the same token, however, the very act of creating a code to encourage such behavior suggests that shareholders left to themselves are reluctant to engage sufficiently. Sridhar Arcot, Valentina Bruno, and Antoine Faure-Grimaud, for example, find (in a study of non-financial firms) that the U.K. Corporate Governance Code's "comply or explain" approach has resulted in far more compliance than explanation, failing to provide the intended corporate governance flexibility. They speculate that this may reflect reluctance on the part of shareholders to expend the effort to assess explanations for any deviations, or to engage in costly monitoring until performance actually suffers.[126] Bernard Black and John Coffee similarly find that British institutions have tended to intervene only when "a company is seriously underperforming," and that "[a]bsent a crisis, the institutions generally stay on the sidelines"[127]—a point that Walker acknowledges.[128] This, of course, is too late to prevent a crisis of the sort prompting the corporate governance reforms discussed here. It

118. *Id.* at 13. *See also* Ben W. Heinenman, Jr., *A Stewardship Code for Institutional Investors*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG. (Jan. 18, 2010), http://blogs.law.harvard.edu/corpgov/2010/01/18/a-stewardship-code-for-institutional-investors/.

119. WALKER, *supra* note 1, at 70.

120. *See* notes 53–61 and accompanying text.

121. *See* note 75 and accompanying text.

122. FIN. SERVS. AUTH., REFORMING REMUNERATION PRACTICES IN FINANCIAL SERVICES: FEEDBACK ON *CP09/10* AND FINAL RULES 7 (Aug. 2009), *available at* http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf.

123. *Id.* at Annex B. *See also* Bebchuk & Spamann, *supra* note 1, at 279–80 (observing that such efforts "fail to recognize . . . that boards fully dedicated and attentive to common shareholder interests cannot be counted on to eliminate incentives for excessive risk-taking").

124. *See* DAVIES, *supra* note 88, at 366–67.

125. *See* OXFORD ENGLISH DICTIONARY ONLINE, steward, *v.* ("To manage, administer") (2nd ed. 1989).

126. Arcot et al., *supra* note 106, at 8–17, 23. *Cf.* Walker, *supra* note 34, at 766, 782 (suggesting that stewardship "may only amount to regulatory 'wishful thinking' in practice").

127. *See* Black & Coffee, *supra* note 104, at 2003, 2047.

128. *See* WALKER, *supra* note 1, at 75.

should also be noted that the relative proximity and homogeneity that has historically promoted British reliance on shareholder-centric self-regulation may itself be eroding. Over recent decades, stock ownership by British pension funds and insurers has declined, while foreign ownership has correspondingly increased—a trend that may itself pose challenges for the shareholder-centric British model of corporate governance in the future.[129] As Cheffins observes, "with the collective ownership stake of domestic pension funds and insurance companies having dropped to just above one-quarter," a "presumption of Stewardship Code effectiveness . . . arguably harks to a bygone age."[130] The FRC expresses "hope" that foreign investors will sign on,[131] but as Cheffins points out, there is little reason to expect this from investors with only a small portion of their global portfolio invested in U.K. equities.[132]

Regardless of the optimal level of shareholder-centrism in non-financial firms, however, there is no reason to believe that shareholder empowerment could help matters in banks—the entities at the heart of the crisis—given the heightened risk appetite among bank equity holders described at the outset. In fact, the excessive build up of leverage and risk in the banks—driven largely by a desire to boost stock prices and please shareholders—would seem to counsel not shareholder empowerment, but if anything, precisely the opposite. Why, then, have U.K. reform efforts taken the shape they have?

The visceral aversion to curbing shareholder orientation likely reflects the fact that shareholder power literally defines and animates the U.K. conception of a corporation. To curb shareholder influence is practically to re-define the U.K. corporation itself—a radical move indeed. Accordingly the FRC finds in its December 2009 review that the U.K. Corporate Governance Code "require[s] some updating," but "remains broadly fit for purpose" and that "the main shortcomings" revealed by the crisis "have been in the way that the Code has been applied."[133] The notion of "sector specific provisions" for banks is rejected in order to "maintain the integrity of a single Code for companies,"[134] reflecting the desire for a single core conception of relations among stakeholders in the corporation, whether it be a manufacturer or a bank.

The Walker Review itself reflects this fundamental tension. Walker observes that, unlike in other types of companies, corporate governance in banks must balance the shareholder-centrism of the Companies Act, on the one hand, with legitimate public concerns for protecting the financial system from the fallout of bank failures, on the

129. *See* John Armour & Jeffrey N. Gordon, The Berle-Means Corporation in the 21st Century 5, 38 (U. Penn. Law School Seminar 2008), *available at* http://www.law.upenn.edu/currently/seminars/businesslawscholarship/papers/Gordon.pdf (unpublished manuscript); Brian R. Cheffins, *The Stewardship Code's Achilles' Heel*, 73 MOD. L. REV. 1004, 1017-20 (2010); CHEFFINS, *supra* note 100, at 390–91; Gordon, *supra* note 1, at 349; WALKER, *supra* note 1, at 27, 79, 84–85, 148–49. *See also* Institutional Shareholders' Committee, *Improving Institutional Investors' Role in Governance*, *supra* note 75 (suggesting a "broader network" including "foreign investors and sovereign wealth funds with an interest in long-term value").

130. Cheffins, *supra* note 129, at 1020.

131. *See* Financial Reporting Council, *supra* note 61, at 6.

132. *See* Cheffins, *supra* note 129, at 1020-21.

133. Financial Reporting Council, *supra* note 54, at 2, 6. *See also* WALKER, *supra* note 1, at 11 ("[B]oth the UK unitary board structure and the Combined Code of the FRC remain fit for purpose.").

134. Financial Reporting Council, *supra* note 54, at 2. *See also* Org. for Econ. Co-Operation & Dev., *supra* note 1, at 12 (asserting that "banks are not fundamentally different from other companies with respect to corporate governance").

other. Yet he rejects outright the notion of broadening bank directors' duties to extend beyond shareholders.[135] Walker calls for a single corporate governance code "with some additional [bank]-specific elements to be taken forward through the FSA," offering various recommendations including board risk committees and executive pay reforms such as deferrals and clawbacks.[136] That the short-term focus of shareholders "led to both encouragement and greater acceptance of increased leverage" is acknowledged, and yet it is asserted—without explanation—that shareholder-stewards could be expected to provide active "guidance" and "pressure" to focus management's attention on a bank's long-term interests.[137] The reality, however, as John Plender of the *Financial Times* observes, is that "most institutions on both sides of the Atlantic were relaxed about the banks' pursuit of high returns on equity regardless of the resulting dramatic reduction in the capital base of the banking system." They were "as much part of the problem as the solution because they are as prone to faddish thinking and bubble euphoria as are corporate or financial managers."[138]

At the end of the day, the crisis has dealt a body blow to shareholder-centric corporate governance in the financial sector. And yet to recognize and respond directly to that reality would, in the United Kingdom, effectively mean re-visiting long-standing assumptions and beliefs about the appropriate roles of various stakeholders in corporations.[139] It could even potentially require developing a new corporate governance paradigm for banks. This represents a truly fundamental regulatory challenge that the U.K. authorities are deeply, and understandably, reluctant to undertake if it can be avoided.

B. Shareholders as Spectators

The United States, like the United Kingdom, has seized upon shareholder empowerment as the cure to what ails it—at least so far as corporate governance is concerned. In fact, U.S. reform proposals have been considerably more wide-ranging. TARP recipients, for their part, have already been subjected to pay restrictions, regulatory oversight of compensation, and "say on pay" votes.[140] Broader reforms have included "say on pay" votes, enhanced compensation disclosures, clawbacks, and proxy access, among other things.[141] It must be emphasized that such reforms have not been limited to financial firms, notwithstanding the lack of evidence of substantial governance failures outside the financial sector.[142] It should also be noted that features such as

135. *See* WALKER, *supra* note 1, at 23, 29, Annex 3.

136. *Id.* at 11, 19–22.

137. *Id.* at 23–27. Lord Turner, for his part, expresses less faith in the capacity of shareholders to police risk-taking, questions the rationality of markets, and specifically asks "whether the governance arrangements appropriate for banks are different from those which apply to the generality of companies." TURNER, *supra* note 1, at 39–49, 81, 93.

138. John Plender, *Banking: Rarely Pointed Finger*, FIN. TIMES, Jan. 17, 2010.

139. The *Financial Times*, for example, has observed that "while the theory of shareholder value is down, it is not out"—but only, it claims, for lack of any clear "intellectually coherent alternative." *See* Lex Column, *Shareholder Value*, FIN. TIMES, Feb. 4, 2009, at 14.

140. *See supra* note 62 and accompanying text.

141. *See supra* notes 65–69 and accompanying text.

142. *See supra* notes 79–81 and accompanying text.

independent board chairs and "say on pay" votes have been available to U.K. shareholders for years, yet evidently did little to prevent the crisis or mitigate its effects on the U.K. financial system.[143]

In light of the comparative discussion provided above, it appears that the political dynamics underlying these reform proposals differ fundamentally from those at work in the United Kingdom. Recall that U.S. shareholders historically have been relegated to the sidelines. Their role certainly has not been to act as "stewards" in any meaningful sense, but rather to trust their managers ex ante, and to sue them ex post if things go wrong.[144] Unlike in the United Kingdom—where shareholder empowerment amounts to shoring up the shareholder-centric status quo—shareholder empowerment in the United States represents a dramatic departure from the past. This Article argues that the emergence of so thoroughly shareholder-centric a set of proposals in the wake of the crisis is best understood as one reflection of a much broader populist backlash against managers—a backlash reinforced by both the fragmentation of the U.S. federal system and the relative weakness of public social welfare protections.

Under the "internal affairs doctrine," the internal affairs of a U.S. corporation have traditionally been governed by the law of the state of incorporation—for large public companies, typically Delaware.[145] Critics of the doctrine have vigorously challenged the democratic legitimacy of one (small) state effectively determining the laws governing most of corporate America.[146] In times of perceived crisis, however, Congress can—and will—federalize substantial swathes of the corporate governance terrain pursuant to its broad constitutional authority to regulate interstate commerce.[147] Marcel Kahan and Edward Rock observe that "the biggest threat facing Delaware is the emergence of some major crisis that focuses public attention on the peculiar mode of U.S. corporate lawmaking . . . and undermines the public faith in Delaware's ability to handle the

143. *See* Cheffins, *supra* note 79, at 54–60 (observing that independent board chairs, "say on pay" votes, and greater governance power for U.K. shareholders appear not to have mitigated the crisis). *See also* Gordon, *supra* note 1, at 343–44 (observing of "say on pay" in the United Kingdom that "rejections of remuneration reports have been rare," and that "U.K. CEO salaries and bonus payouts have increased at a double-digit rate in recent years"); Plender, *supra* note 138 (observing that, notwithstanding "say on pay," U.K. "boardroom pay continues to rise remorselessly").

144. *See* Bruner, *supra* note 82, at 593–603. Armour and Gordon argue that U.S. bias against institutional investors resulted in use of the "retail investor as its regulatory heuristic," placing emphasis on disclosure coupled with "aggressive enforcement." The U.K. facilitation of institutional investment, by contrast, led to stronger governance powers but less reliance on disclosure. *See* Armour & Gordon, *supra* note 129, at 3–4.

145. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971).

146. *See, e.g.*, Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, 67 LAW & CONTEMP. PROBS. 101 (2004); Daniel J.H. Greenwood, *Markets and Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41 (2005); Renee M. Jones, *Legitimacy and Corporate Law: The Case For Regulatory Redundancy*, 86 WASH. U. L. REV. 1273 (2009). Skeel suggests that legitimacy concerns may explain the high degree of unanimity among the Delaware Supreme Court. David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 171 (1997).

147. *See* U.S. CONST. art. I, § 8, cl. 3 (giving Congress authority to "regulate Commerce . . . among the several States"). *See also* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1574–90 (2005); Mark J. Roe, *Delaware and Washington As Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 6–12 (2009); Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1084–85 (2008).

job."[148] Notable examples of federal corporate lawmaking following perceived state-level regulatory failures have included the creation of the federal securities regime in the 1930s and the passage of the Sarbanes–Oxley Act in 2002.[149]

At such times, Delaware recognizes that it is in the backseat, and that the strategy minimizing damage to its long-term influence becomes to lay low and ride it out—an approach embraced following the current crisis.[150] J.P. Morgan's acquisition of Bear Stearns—orchestrated by the Federal Reserve and the Treasury—included extraordinary deal protection measures that were very likely invalid under well-established Delaware precedents. Yet Vice Chancellor Parsons uncharacteristically agreed to stay a Delaware action challenging them, permitting the litigation to proceed in New York instead—notwithstanding Delaware's strong interest in "maintaining the integrity of the fabric of Delaware corporate law."[151] The reason, Kahan and Rock argue, was simply to avoid provoking uncomfortable questions regarding Delaware's political legitimacy as a national corporate lawmaker—or worse, outright conflict with the federal government. As they put it, "how could Delaware even contemplate enjoining a transaction that was supported, indeed, arguably driven and financed by the Federal Reserve with the full support of the Treasury—a transaction that may have been necessary to prevent the collapse of the international financial system?"[152] Notwithstanding Delaware's strong interest in the case, it was politically impossible for Delaware to hear it—in large part because the only interest at stake for Delaware was the integrity of its own corporate law jurisprudence. Critically, as Kahan and Rock rightly point out, Delaware's courts possess no coherent legal basis upon which to address issues of broader national interest reaching beyond the narrow confines of corporate law.[153]

In the United States, matters affecting numerous constituencies—and implicating numerous modes of regulation—can be more comprehensively addressed at the federal level. As Mark Roe observes, "when Washington acts on corporate law, it brings with it

148. Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware and the Strategic Use of Comity*, 58 EMORY L.J. 713, 715 (2009).

149. *See, e.g.*, CHOI & PRITCHARD, *supra* note 9, at 89; Roe, *supra* note 147, at 7. *See also* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 872–86, 906–07 (2003) (discussing the expansion of federal corporate governance regulation).

150. In some cases Delaware may act preemptively to stave off federal intrusion in a given area, as some speculate it aimed to do by adopting proxy access provisions in the face of the federal move in this direction. *See, e.g.*, J. Robert Brown, *The SEC, Access and the Need to Preempt Delaware Law*, THERACETOTHEBOTTOM.ORG (Apr. 23, 2009) *available at* http://www.theracetothebottom.org/preemption-of-delaware-law/the-sec-access-and-the-need-to-preempt-delaware-law.html. However, Delaware's alternatives in the face of imminent federal action are in any case limited given Congress' authority to regulate interstate commerce. *See supra* note 147 and accompanying text.

151. *See* Kahan & Rock, *supra* note 148, at 714–16; *In re* The Bear Stearns Companies, Inc. Shareholder Litigation, C.A. No. 3643-VCP, 2008 Del. Ch. LEXIS 46 (Del. Ch. 2008).

152. Kahan & Rock, *supra* note 148, at 744.

153. *See id.* at 738, 744. *See also* Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1752, 1770–71 (2006) (endorsing their approach to issues of corporate federalism); Jones, *supra* note 146, at 1275–77 (arguing that "regulation at the federal level shores up the legitimacy of the overarching structure"). For an argument that Delaware nevertheless remains better positioned than Congress or the SEC to tackle fundamental issues of corporate law, see Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. (forthcoming 2010), *available at* http://ssrn.com/abstract=1669282.

another strain of public policy: American populist sentiment and national public opinion."[154] Unlike Delaware, focusing primarily on shareholders and managers, in Washington there are "more interest groups, and broader ideas of efficiency, fairness, and sometimes power leveling are in play."[155] This is readily observable both in the terms of proposed corporate governance reforms, as well as in their relation to other regulatory domains. Commentators have identified in these shareholder-centric proposals a "populist" backlash against the all-powerful corporate manager,[156] reflecting a number of the broader social issues implicated by U.S. corporate governance. First and most obviously, as discussed above, there really were corporate governance failures in financial firms for which management must bear substantial responsibility,[157] and policymakers tapping into populist anger stand to gain little from careful differentiation between financial firms and non-financial firms in fashioning responses. Again, given the binary structure of our corporate governance system, the simplistic logic appears to be that if management was the problem, shareholders must be the solution—an approach in evidence both in SEC and congressional reform initiatives,[158] notwithstanding the illogic of empowering risk-preferring shareholders in banks, the lack of evidence of corporate governance failures in non-financial firms, and the substantial heterogeneity of U.S. shareholders' interests.[159] There is surely also at work here a substantial degree of opportunism by activist institutional shareholders themselves, long hungry for the kind of raw governance power their U.K. counterparts possess—and perfectly willing to capitalize on faulty reform initiatives that happen to advance their interests.[160]

154. Roe, *supra* note 147, at 17. While Roe elsewhere emphasizes populist backlash against concentrated ownership, he does observe that managers were principal beneficiaries of the fragmentation of American finance. *See* ROE, *supra* note 99, at 42–43.

155. Roe, *supra* note 147, at 33. *See also* Jones, *supra* note 146, at 1298 ("Federal legislators must . . . balance the interests of competing constituencies in ways that legislators in Delaware and other states can avoid."); Strine, *supra* note 147, at 1080–81 (observing that Congress is subject to "multi-constituency pressures").

156. *See, e.g.*, Bhagat & Romano, *supra* note 41, at 359–63 (observing of the "political backlash" following the crisis that "executive compensation has a long history of being targeted by populist attacks following market declines and scandals"); Gordon, *supra* note 1, at 338, 355–56 (suggesting that "expansion of shareholder rights in the executive compensation area has a legislative momentum that responds to the political moment"); Cheryl Bolen et al., *White House Seeks Tough Limits on Size, Trading Activities of Large Financial Firms*, 42 SEC. REG. & L. REP. 117 (BNA), Jan. 25, 2010 (suggesting that President Obama's proposal to limit the size and scope of financial firms "taps into widespread populist discontent with the financial services sector").

157. *See* Bratton & Wachter, *supra* note 9, at 657.

158. *See* notes 62–75 and accompanying text.

159. *See* Gordon, *supra* note 1, at 350, 362–63 (observing the greater heterogeneity of U.S. shareholders relative to their U.K. counterparts); Bruner, *supra* note 70, at 1439–42 (discussing the differing incentives of various types of U.S. institutional shareholders); ASPEN INSTITUTE, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (Sept. 9, 2009), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/overcome_short_state0909_0.pdf (discussing problems arising from the influence of institutions "who focus on short-term stock price performance, and/or favor high-leverage and high-risk corporate strategies designed to produce high short-term returns"); Mary Williams Walsh, *Public Pension Funds Are Adding Risk to Raise Returns*, N.Y. TIMES, Mar. 8, 2010, *available at* http://www.nytimes.com/2010/03/09/business/09pension.html (reporting that "states and other bodies of government are seeking higher returns for their pension funds, to make up for ground lost in the last couple of years and to pay all the benefits promised to present and future retirees," leading them to take on "more risk").

160. *See* Bratton & Wachter, *supra* note 9, at 656 (observing that proponents of greater shareholder power

Least obviously, yet just as critically, anti-manager sentiment has been fueled by—and in turn has fueled—a powerful coalition of shareholders and employees brought together under the unifying banner of American "middle class" interests. Though the term is notoriously difficult to define, the "middle class" concept is increasingly used to invoke a broadly held set of aspirations that, to our purposes, effectively bridge the investment-related and social welfare-related goals and concerns of the average working family in the United States.[161] In this light, growing fears regarding the availability of healthcare due to job loss, as well as the safety of savings for education and retirement, have become highly politically salient issues—and all the more so in combination.[162]

"have shifted their emphasis in the wake of the financial crisis" away from "market control," which "resonates equivocally in light of recent market failures," and toward restoration of "trust"); *28 Business, Investment, Academic & Labor Leaders Join Aspen Institute in Bold Call to Overcome Short-Termism*, ASPEN INSTITUTE, http://www.aspeninstitute.org/news/2009/09/09/28-business-investment-academic-labor-leaders-join-aspen-institute-bold-call-overcom (last visited Oct. 11, 2010) (quoting John F. Olson, remarking, "I see real danger in our settling for cosmetic reforms that don't address the critical problem: failure to aim for long term sustainable value"). *See also* Carl C. Icahn, *The Economy Needs Corporate Governance Reform*, WALL ST. J., Jan. 23, 2009, at A13 ("Lax and ineffective boards, self-serving managements, and failed short-term strategies all contributed to the entirely preventable financial meltdown. It is time for battered shareholders to fight back."); Crafter, *supra* note 1 (advocating shareholder empowerment initiatives and stating that the "time to restore investor trust in the integrity of America's capital markets and public corporations is long overdue"); Mahoney, *supra* note 74, at 2 (arguing that "investor oversight of management and boards" will "address many of the problems that led to the current crisis"); Press Release, Cal. Pub. Emps' Retirement Sys. et al., *Principles of Financial Regulation Reform: A Model for Change* (Mar. 10, 2009), at 2, *available at* http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2009/mar/regulation-reform-principles.xml (arguing that institutional shareholders could serve as "an 'early warning' system on market developments that raise systemic risk"); Erik Krusch, *Proxy Disclosures: More Say and Less Pay*, WESTLAW BUS. CURRENTS, Jan. 26, 2010 (observing that, by January 2010, "activist shareholders [were] already demanding a variety of changes to executive compensation disclosure and practices").

161. *See, e.g.*, WHITE HOUSE MIDDLE CLASS TASK FORCE, FINANCING THE DREAM: SECURING COLLEGE AFFORDABILITY FOR THE MIDDLE CLASS 1, 4 (2009), http://www.whitehouse.gov/assets/documents/staff_report_college_affordability1.pdf (describing the availability of a college education for one's children as a "middle-class" aspiration) [hereinafter FINANCING THE DREAM]; WHITE HOUSE MIDDLE CLASS TASK FORCE, THE AMERICAN RECOVERY AND REINVESTMENT ACT: HELPING MIDDLE-CLASS FAMILIES 3 (2009), http://www.whitehouse.gov/assets/documents/staff_report_ARRA-FINAL.pdf (describing "the challenge we face" as being "to reconnect the living standards of middle-class families to the economic growth they themselves are creating") [hereinafter ARRA]; Ann Belser, *Middle Class Finding It's Harder to Make Ends Meet*, PITTSBURGH POST-GAZETTE, Jan. 31, 2010, *available at* http://drummajorinstitute.org/library/article_print.php?ID=7276 (observing that the "middle class" might be defined by reference to income or, alternatively, by reference to "a set of aspirations," including buying a home, good schools, retirement savings, college for one's children, access to healthcare, and "a modest summer vacation"); Claire Suddath, *Obama's Middle-Class Task Force Has No Middle Class*, TIME, Mar. 4, 2009, http://www.time.com/time/printout/0,8816,1882913,00.html ("[M]ost academics agree that the term refers to anyone earning between $30,000 and $100,000 a year."); Claire Suddath, *The Middle Class*, TIME, Feb. 27, 2009, http://www.time.com/time/printout/0,8816,1882147,00.html (observing that the U.S. government "does not define what it means to be middle class"). *See also* Strine, *supra* note 147, at 1081–82 ("[M]ost Americans have become what I call forced capitalists, people who earn most of their wealth through their labor, but who are required to provide for their retirement by giving substantial portions of their income to financial intermediaries for investment in the stock market.").

162. *See, e.g.*, DRUM MAJOR INSTITUTE, MIDDLE CLASS HOUSEHOLDS ARE FEARFUL FAMILIES 1–2, 9–10 (2008) (finding that three-quarters of those who identify as "middle-class" support creation of "a national health insurance plan"); David U. Himmelstein et al., *Medical Bankruptcy in the United States, 2007: Results of a National Study*, 122 AM. J. MED. 741 (2009) (finding that "62.1% of all bankruptcies in 2007 were medical");

These are long-standing constellations of middle class social concerns[163] that, as discussed above, are deeply intertwined with corporate governance through the "employee welfare state"[164] approach to social welfare protections historically pursued in the United States.

As Theda Skocpol has explored, the limited state-based social welfare benefits historically made available in the United States have tended to be conceptualized as a form of reward for service, as with Social Security (a reward for a lifetime of work) and the G.I. Bill (a reward for military service in World War II).[165] This reward-for-service rhetoric has, in turn, been deployed in characterizing middle class vulnerability following the crisis as a symptom of an unraveling "social contract."[166] Senator Schumer's proposed Shareholder Bill of Rights Act gestures in this direction by noting that investment losses "have been borne by millions of Americans who are shareholders through their pension plans, 401(k) plans, and direct investments."[167] The Obama Administration, for its part, has paid close attention to middle class issues following the crisis, even establishing a "Middle Class Task Force" led by Vice President Biden,[168] and various reform initiatives have been styled as means of reconnecting middle class rewards with service to the country. A Task Force report on the American Recovery and Reinvestment Act describes "the challenge we face" as devising policies "to reconnect the living standards of middle-class families to the economic growth they themselves are

Michael Luo & Megan Thee-Brenan, *Poll Reveals Trauma of Joblessness in U.S.*, N.Y. TIMES, Dec. 14, 2009, http://www.nytimes.com/2009/12/15/us/15poll.html?_r=1&pagewanted=print (finding that over half of the unemployed have "cut back on doctor visits or medical treatments because they are out of work," and that "[n]early half of those polled said they felt in danger of falling out of their social class"); *About the Task Force*, WHITE HOUSE MIDDLE CLASS TASK FORCE, http://www.whitehouse.gov/StrongMiddleClass/about (Oct. 21, 2009) (including among its goals "[e]xpanding education" and "retirement security") [hereinafter *About the Task Force*]; FINANCING THE DREAM, *supra* note 161, at 6 ("[C]ollege tuition growth vastly outpacing family income has become a major part of the middle-class squeeze."); WHITE HOUSE MIDDLE CLASS TASK FORCE, WHY MIDDLE CLASS AMERICANS NEED HEALTH REFORM 1 (2009), http://www.whitehouse.gov/assets/documents/071009_FINAL_Middle_Class_Task_Force_report2.pdf ("Middle class Americans across the country are demanding health reform."); Richard Morin, *America's Four Middle Classes*, PEW RES. CENTER (July 29, 2008), http://pewresearch.org/pubs/911/Americas-four-middle-classes (surveying concerns across various demographic groups who self-identify as "middle class"); Andrea Batista Schlesinger & Amy Traub, *A Strengthened Middle Class* (Drum Major Institute, 2009) ("Over the longer term, costs for health care, housing, and higher education – the very goods that define a middle-class standard of living – have skyrocketed.").

163. *See, e.g.*, THEDA SKOCPOL, THE MISSING MIDDLE: WORKING FAMILIES AND THE FUTURE OF AMERICAN SOCIAL POLICY 6–11, 124–41 (2000); ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE 57–63, 78–95 (2003); John M. Broder, *Problem of Lost Health Benefits Is Reaching Into the Middle Class*, N.Y. TIMES, Nov. 25, 2002, http://www.nytimes.com/2002/11/25/us/problem-of-lost-health-benefits-is-reaching-into-the-middle-class.html; Shannon Brownlee & Matthew Miller, *Lies Parents Tell Themselves About Why They Work*, U.S. NEWS & WORLD REP., May 12, 1997, at 58 (estimating, as of 1997, that "4 million to 5 million women [were] locked unhappily in full-time jobs only for the sake of health benefits").

164. *See* Charny, *supra* note 111, at 1601–06.

165. *See* SKOCPOL, *supra* note 163, at 24–29.

166. *See* Schlesinger & Traub, *supra* note 162. *See also* Morin, *supra* note 162, at 7–10 (citing survey data indicating that, among those self-reporting as middle class, those falling near the middle on "key measures of social standing" may "seem to be living the American Dream," yet "say they're not").

167. Shareholder Bill of Rights Act of 2009, S.1074, 111th Cong. pmbl., § 2(3) (2009).

168. *See About the Task Force*, *supra* note 162.

creating."[169] Likewise President Obama himself, shortly after signing the Dodd–Frank Act into law, reiterated this theme in his weekly address, summarizing "an overall economic plan" aimed at making "our middle-class more secure"—an approach in which tax credits for education, health insurance reform, and the effort to counteract "recklessness and irresponsibility" in financial firms are all of a piece.[170] The strong nexus between corporate governance reform efforts and middle class politics reflects the aspect of the U.S. system most starkly differing from the situation in the United Kingdom, where more robust state-based social welfare protections have effectively deflected such pressures from the corporate governance system.[171]

The intrinsic connections among these various issues in U.S. politics and social policy—strongly resonating with middle class families, as shareholders and employees alike—are vividly illustrated by the posture of the California Public Employees' Retirement System (CalPERS).[172] As the name implies, CalPERS manages the public employee pension system in California.[173] With approximately $200 billion under management, it is the largest U.S. public pension fund,[174] and accordingly speaks with a loud voice in corporate governance matters. At the same time, however, as manager of healthcare benefits for its members, CalPERS is also the second largest public purchaser of healthcare benefits in the United States (after the federal government).[175] Managing retirement benefits for about 1.6 million people and health benefits for about 1.3 million people, its dual, integrated mission reflects the confluence of these issues: "to advance the *financial and health* security for all who participate in the System."[176] Accordingly, CalPERS has vigorously pursued both shareholder-centric financial reforms as well as healthcare reforms—the two being intimately connected in the lives of its

169. *See* ARRA, *supra* note 161, at 5. Even the 2011 budget has been defended in these terms. *See* OFFICE OF MGMT. & BUDGET, THE FEDERAL BUDGET FISCAL YEAR 2011: SUPPORTING MIDDLE CLASS FAMILIES, http://www.whitehouse.gov/omb/factsheet_key_middle_class/?print=1 (last visited Feb. 8, 2010) (arguing that various aspects of the federal budget would "support middle class families").

170. *See* Remarks of President of Barack Obama As Prepared for Delivery: Weekly Address (July 24, 2010), http://www.whitehouse.gov/the-press-office/weekly-address-president-obama-praises-new-wall-street-reform-law-says-gop-plan-wil.

171. *See* Bruner, *supra* note 82, at 611–46.

172. Gourevitch and Shinn observe that share ownership by employee pension funds can reinforce coalitions among shareholders and employees. *See* PETER ALEXIS GOUREVITCH & JAMES J. SHINN, POLITICAL POWER AND CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE 205–28 (2005).

173. *See* CAL. PUB. EMPS' RETIREMENT SYS., FACTS AT A GLANCE: GENERAL 1 (2010), http://www.calpers.ca.gov/eip-docs/about/facts/general.pdf [hereinafter CALPERS, GENERAL].

174. *See* CAL. PUB. EMPS' RETIREMENT SYS., CALPERS APPLAUDS SENATE ON HEALTH CARE REFORM ACTION (Dec. 24, 2009); CAL. PUB. EMPS' RETIREMENT SYS., FACTS AT A GLANCE: INVESTMENTS 1 (2010), http://calpers.ca.gov/eip-docs/about/facts/investme.pdf.

175. CAL. PUB. EMPS' RETIREMENT SYS., FACTS AT A GLANCE: HEALTH 1 (2010), http://www.calpers.ca.gov/eip-docs/about/facts/health.pdf.

176. CALPERS, GENERAL, *supra* note 173, at 1 (emphasis added).

beneficiaries,[177] reflecting the distinctly American political realities discussed above.

This long-simmering set of social concerns has naturally risen to the surface of U.S. politics in a time of substantial financial and economic uncertainty, and in this light, it is no coincidence that shareholder-centric corporate governance reform efforts have coincided quite closely with substantial social welfare-oriented interventions and reform efforts—notably the bailout of the American auto industry and the U.S. health insurance reforms signed into law by President Obama in March 2010.[178] Just as employees in the 1980s entered a coalition with managers in response to the perceived threat posed by the shareholders' desire to accept premium hostile tender offers,[179] so employees today have entered a coalition with shareholders in response to the perceived threat posed by financial firm managers deemed responsible for all the risk-taking leading up to the crisis.[180] The fundamental political and social dynamics driving each episode are essentially the same, but this shift in prevailing views on the compatibility of the respective power constituencies' incentives and interests with those of the larger public (and particularly the middle class) suggests that an entirely new social welfare equilibrium may be taking shape in the United States—one involving more robust shareholder rights and correlative enhancement of external social welfare protections for non-shareholders.[181] It remains to be seen whether such efforts will prove sufficient to lighten the social and political pressures historically inhibiting U.S. corporate governance from focusing more exclusively on shareholders. But in any event, it is unsurprising in the face of tectonic political forces like these that nuances of corporate governance, findings of the finance literature, and the critical distinction between financial and non-financial firms should so easily be lost in the shuffle.

V. CONCLUSIONS

Both the United States and the United Kingdom have responded to the financial and economic crisis that emerged in 2007 with a range of corporate governance reforms. The U.S. and U.K. proposals similarly tend to empower shareholders, and thus similarly threaten to amplify tendencies in financial firms that already dangerously skew toward excessive leverage and risk. This core problem of short-termism in banks has been recognized by a number of scholars, and grappling with it must be a component of any

177. *See, e.g.*, CAL. PUB. EMPS' RETIREMENT SYS., CALPERS APPLAUDS SENATE ON HEALTH CARE REFORM ACTION, *supra* note 174 (expressing "strong support for . . . Senate action that advanced national health care reform one step closer for all Americans"); CAL. PUB. EMPS' RETIREMENT SYS., *CalPERS Presses for Financial Market Reform*, http://www.calpers-governance.org/marketinitiatives/initiatives/financial-reform (last visited Jan. 26, 2010) ("CalPERS encourages and supports global reform to protect investor interests . . . ."); CAL. PUB. EMPS' RETIREMENT SYS., FACTS AT A GLANCE: CORPORATE GOVERNANCE 3 (2010) (arguing that shareholder proxy access would "ensure a sustainable system of corporate governance that fosters democracy, director accountability and long-term value creation"); Memorandum from Ann Sausboll, Chief Executive Officer, Cal. Pub. Emps' Retirement Sys., to California Congressional Delegation, H.R. 5173 "Wall Street Reform and Consumer Protection Act of 2009" (Dec. 9, 2009) (arguing that shareholder empowerment initiatives would "ensure transparency and accountability in corporate boardrooms and help restore trust and stability" following the crisis).

178. *See* Bruner, *supra* note 82, at 646–53.

179. *See supra* notes 114–115 and accompanying text.

180. *See supra* notes 161–171 and accompanying text.

181. *See* Bruner, *supra* note 82, at 646–53.

effective corporate governance reform package in either country.[182]

The political forces conditioning policymakers' responses in the United States and the United Kingdom have neither been recognized nor reckoned with. Yet it is essential to understand why policymakers in each country have seized on shareholder empowerment in this time of crisis, and to grapple with the underlying political forces driving such efforts, if more effective responses are to have any hope of supplanting them. As the foregoing analysis indicates, this presents very different challenges in each country. In the United Kingdom, shareholder empowerment reflects a reinforcement of deeply entrenched beliefs and cultural understandings regarding the appropriate role of historically dominant shareholders in corporate governance—a role that lies at the very heart of the U.K. conception of the corporation. In the United States, on the other hand, shareholder empowerment reflects a sharp deviation from the substantial autonomy historically possessed by managers—a more sweeping reform agenda fueled by populist anger and a heady mix of "middle class" concerns reflecting the far less stable social welfare environment encountered by American working families in difficult economic times.

Given the skewed risk incentives in banks that lay at the heart of the crisis, policymakers in both countries ought to be working to devise incentive structures divorcing financial firm managers' interests from the short-term orientation of equity holders to the maximum degree possible. One approach would be to retain equity based compensation while seeking to impose a longer-term view through deferral mechanisms.[183] More promising would be a compensation structure severing pay from stock price entirely—or at least substantially diluting the effect of stock price on pay.[184] Such an approach appears all the more attractive in light of recent findings suggesting that "bank CEOs' inside debt holdings preceding the Financial Crisis are significantly positively associated with better stock returns and accounting return on assets"—and significantly negatively associated with risk taking.[185]

At the same time, it must be recognized that there is simply no reason to assume that the appropriate governance structure for non-financial firms will mirror that for financial

182. *See generally* Bebchuk & Spamann, *supra* note 1; Bhagat & Romano, *supra* note 41; Bratton & Wachter, *supra* note 9; Tung, *supra* note 4. *See also* Macey & O'Hara, *supra* note 2, at 97 (discussing excessive risk-taking in banks).

183. *See, e.g.*, Bhagat & Romano, *supra* note 41 (advocating use of restricted stock vesting two to four years after leaving the job); POZEN, *supra* note 13, at 277–81 (advocating, among other things, "a three-year measurement period for cash bonuses," deferral of a portion of bonuses for two to three years, and use of restricted stock vesting over time with performance conditions); WALKER, *supra* note 1, at 21–22 (arguing that "[d]eferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance").

184. *See, e.g.*, Bebchuk & Spamann, *supra* note 1, at 283–85 (advocating replacing equity-based compensation with "compensation based on the value of a broader basket of securities representing a larger part of the corporate pie," including common stock, preferred stock, and bonds); Gordon, *supra* note 5, at 11–14 (advocating the use of "equity that will convert into subordinated debt upon certain external triggering events" indicating financial distress); Tung, *supra* note 4, at 24–53 (advocating replacing equity-based compensation with compensation in the form of the bank's own "publicly traded subordinated debt").

185. *See* Frederick Tung & Xue Wang, *Bank CEOs, Inside Debt Compensation, and the Financial Crisis* (Emory Pub. Law Research Paper No. 10-98, 2010; Emory Law and Econ. Research Paper No. 10-63, 2010), *available at* http://ssrn.com/abstract=1570161. Tung and Wang observe that "firm managers hold significant amounts of inside debt in the form of pensions and deferred compensation." *Id.* at 3.

firms, or vice versa. The analysis of this Article suggests that U.K. policymakers may well be forced to grapple—sooner or later—with the challenge of re-thinking the fundamental structure of the U.K. corporation in the financial setting, where shareholder-centrism has produced some decidedly negative consequences.[186] It likewise suggests that U.S. policymakers ought to scrutinize with a far more skeptical eye the call to empower shareholders further in financial and non-financial settings alike. In the financial sector, such a move not only would fail to remedy the problem, but would likely make matters worse. And in the non-financial sector, where the case for reform remains far from established, the intrinsic relationship of corporate governance to social welfare goals in the United States would render this a considerably more comprehensive and complex regulatory undertaking than is generally recognized.

186. Recall that this challenge may arise in the non-financial setting as well to the extent that diminishing stock ownership among British pension funds and insurers undermines the factors historically encouraging reliance on shareholder-centric self-regulation. *See supra* notes 129–132 and accompanying text. Erosion of social welfare benefits historically facilitating shareholder-centric corporate governance rules could have a similar effect. *See* Sarah Lyall & Alan Cowell, *Britain Plans Deepest Cuts to Spending in 60 Years*, N.Y. TIMES, Oct. 20, 2010 (reporting that post-crisis austerity measures would include "sharply curtailing welfare benefits," though adding that "the National Health Service—one of the most politically delicate institutions in Britain—will be allocated more money, rather than less").