Does Corporate Governance Matter to Investment Returns?

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Introduction

Although Conrad Black will tell you that corporate governance is a form of terrorism, an increasing body of evidence suggests that enhanced governance equals enhanced performance. Does this mean there is a perfect correlation between the two? Of course not. However, empirical evidence suggests what common sense tells us is correct — those corporate boards that are more concerned about shareholder rights are also better guardians of shareholder money. Indeed, as one commentator noted in early 2004, "the good news is the discovery of an increasing amount of new evidence suggesting that these links [between returns and governance] do exist."[2]

As summarized below, the empirical studies conducted to date have generally come in one of two forms. In the first group of studies, researchers have focused on corporate governance practices generally, that is, they examine simultaneously a multitude of variables that relate to "sound" corporate governance. These studies have concluded that the quality of a particular company's governance practices and procedures positively correlates with both good corporate financial performance and stockholder value. A second group of studies has been more narrowly tailored, concentrating upon some specific aspect of "sound" corporate governance (such as the adoption of anti-takeover provisions or limiting excessive executive compensation). While these studies have employed varying methodologies, they all have tended to reach the same conclusion: those companies that have adopted specific procedures and practices designed to (a) ensure managers' accountability to owners and (b) align managers' interests as closely as possible with those of the stockholders perform more strongly than do their counterparts.

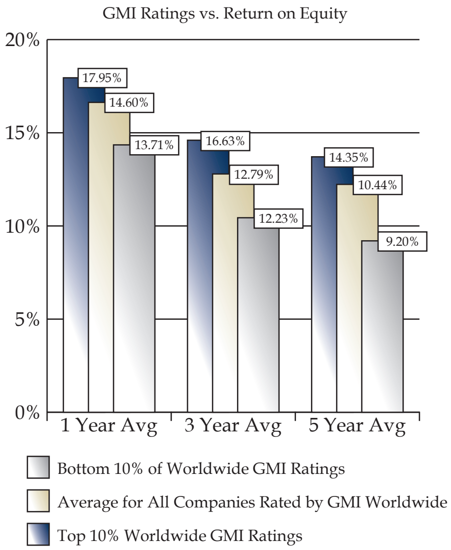
This article also addresses the phenomenon known as "socially responsible investing" (or "SRI"), which involves integrating values, environmental concerns, or institutional mission into investment decision-making. With consumer anxiety over global warming, shareholder activism increasingly will take an environmental focus. As noted below, several studies have found that SRI translates into higherreturns for investors.

Critics of investor activism argue that such activism distracts management from business opportunities and wastes corporate resources. They argue that directors' efforts would be better focused on profit-making than addressing shareholder activism. Yet this analysis misses the point. Rather than balancing the utility of addressing shareholder demands against profit-making endeavors, the relevant inquiry is the relationship between the time devoted to addressing and implementing sound governance practices against a worse alternative, which is time spent correcting mismanagement. Because today's sophisticated investors can serve as an important check on entrenchment of poor or even illegal practices, increased transparency and accountability to shareholders can obviate the need to correct mismanagement, and can lead to improved competitiveness. Other critics question the accuracy of measurement in various studies that have found sound governance practices to be favorable to the corporate enterprise, or whether the studies claim a causal link between good governance and better corporate performance. These studies, however, do not rebut or offer an alternative explanation for corporate performance, and at best can read to show that best practices are neutral and not detrimental to corporate performance. Further, a close reading of the relevant studies on causation reveals that they have consistently shown that improvements in good governance are related to financial returns.

I. The Empirical Link Between Corporate Governance Generally and Firm Performance.

One of the primary aims of shareholder activism is the promotion of "sound" corporate governance practices as a means to improve corporate performance and shareholder returns. A pivotal question is whether the hypothesis underlying the movement is valid: *i.e.*, does good corporate governance actually translate into good corporate performance? In recent years, there have been a number of empirical studies, mostly academic journal articles, on the relationship between good corporate governance generally and firm performance. As discussed below, a substantial number of these studies have found that corporations practicing good corporate governance outperform those companies whose processes and procedures are "unsound."

Table 1. Governance Does Improve Performance



From data published in *Governance and Performance: Recent Evidence*, GMI, September 2006.

A. GMI Research on Corporate Governance Effects on Financial Performance, and GMI/Lipper Research on Mutual Fund Performance.

In September 2006, GMI announced new ratings on 3,800 global companies, of which only 38 received GMI's highest rating of 10.0. GMI reported that since June 2003, as a group, "companies whose GMI rating improved by three points or more over the period both outperformed the [S&P 500] index as a whole and had total shareholder return out-performance of 13.54% over those whose ratings declined by 3 points or more over the period."[3] As shown in Table 1, companies ranked in the top 10% worldwide of GMI ratings had a higher return on equity than companies in the bottom 10%.[4]

The findings were consistent with an earlier research study conducted jointly by GMI and Lipper, Inc., a Reuters company which performs global research on mutual funds. The two firms paired the stock holdings of 725 large-cap domestic equity mutual funds in Lipper's database with the governance ratings calculated by GMI for more than 1,000 publicly traded firms, including all of the companies covered in the S&P 500 Index and the S&P Midcap 400, plus other widely held stocks. GMI's ratings are on a scale from 1 to 10, with 10 reserved for companies with truly independent boards, audit and compensation committees and other good-governance characteristics. The ratings decline in the event of board structures and company policies that limit the board's effective oversight of management and actions indicating the board has not been effective.

The study results, released in January 2004,[5] found that managers of large-cap mutual funds tend to overweigh their portfolios with companies that have above average corporate governance profiles. Funds that are heavily overweighted in well-governed companies were found to outperform the average fund in both three and five-year holding periods and, over the same periods, tended to perform better than funds with a large number of poorly governed companies in their portfolios. The outperformance did not, however, hold true for over just a one-year holding period, perhaps for the same reason observed in relation to the study commissioned by Institutional Shareholder Services, Inc. ("ISS"), discussed below.

B. The Governance Index of Gompers, Ishii, and Metrick.

In a 2003 article published in the *Quarterly Journal of Economics*,[6] Paul A. Gompers (Harvard Business School and National Bureau of Economic Research (NBER)), Joy L. Ishii (Department of Economics, Harvard), and Andrew Metrick (Department of Finance, The Wharton School, and NBER) asked the empirical question: Is there a relationship between shareholder rights and corporate performance? Their answer, put simply, was yes.

In the context of this study, "shareholder rights" referred to a set of unique "provisions," many of them at the firm level, and some embodied in state law, which affect the balance of power between shareholders and corporate management.[7] These provisions were those that have been tracked since 1990 in the database of the Investor Responsibility Research Center ("IRRC"), covering a universe of firms representing 93 percent of the total capitalization of the NYSE, AMEX and NASDAQ markets. The study divided the provisions into five groups: *Delay* (tactics for delaying hostile bidders); *Voting* (voting rights); *Protection* (director/officer protection); *Other* (other takeover defenses); and *State* (state laws).

The authors then devised their Governance Index ("G") which considered only the impact of each provision on the balance of power in the corporation. When the thrust of a "provision" was to increase the power of managers within a firm, a point was scored toward a "Dictatorship" model of the corporation, while the absence of that provision (or the presence of a provision that cut the other way, in favor of shareholders) tilted the balance of power toward shareholders (in the direction of a "Democracy" model). G was the sum of one point for the existence (or absence) of each provision. Thus, the higher a firm's score on the index, the stronger its management control (and the weaker its "shareholder rights").

In the remainder of the paper, special attention was paid to two extreme portfolios: the "Dictatorship Portfolio" of the firms with the weakest shareholder rights (G >14) and the "Democracy Portfolio" of the firms with the strongest shareholder rights (G < 5). The portfolios were updated at the same frequency as G (which changes over time, along with changes or deletions of firms in the sample), so as to create a proxy for the level of shareholder rights at about 1,500 large firms--those tracked by IRRC--during the 1990s. The authors compared those firms and their scores to share price data maintained by the Center for Research in Security Prices and, where necessary, to Standard & Poor's Compustat database. They concluded from the data that an investment strategy that *bought* firms in the *lowest* decile of the index (*strongest* shareholder rights) and *sold* firms in the *highest* decile (*weakest* shareholder rights) of the index would have earned abnormal returns of 8.5 percent per year during the sample period. Other findings also emerged, among them that firms with stronger shareholder rights had higher firm value, higher profits and higher sales growth.

C. The Entrenchment Index of Bebchuck, Cohen and Ferrell.

Researchers have utilized G, or a variation of this index, in a number of studies published since 2003.[8]

In one such study, Harvard Law School professors Lucian Bebchuk, Alma Cohen and Allen Ferrell, posited that of the 24 IRRC provisions that comprised the G, certain provisions influenced shareholder value more than others. Specifically, Bebchuck, Cohen and Ferrell hypothesized that during two time periods: (1) 1990-1999 and (2) 1990-2003, the corporate governance provisions relating to entrenchment (six of the 24 IRRC provisions studied by Gompers, Ishii and Metrick) impacted firm value and stock returns more than the other 18 IRRC provisions combined.[9]

Accordingly, instead of using the G, which was a composite index that gave equal weight to all 24 IRRC provisions, the authors divided the IRRC provisions into two indices: an "entrenchment" index and an "other provisions" index. The entrenchment index was comprised of six provisions the authors claimed would best measure entrenchment based on personal experience and knowledge, interviews with six "prominent" corporate attorneys and "[e]vidence about the provisions attracting the most widespread opposition from institutional investors voting on predatory shareholder resolutions."[10] The IRRC provisions in the entrenchment index were staggered boards, limits to shareholder bylaw amendments, supermajority requirements for (a) mergers and (b) charter amendments, poison pills and golden parachutes.[11] The "other provisions" index was comprised of the remaining 18 IRRC provisions.[12] In this study, each firm received a score based on the same Dictatorship/Democracy guidelines described above in connection with the Gompers, Ishii and Metrick study. The indices represented the sum of one point for the existence (or absence) of each provision.

Upon analyzing the scores of approximately 90 percent of all U.S. public companies during the two time periods, the authors found that the higher the firm's entrenchment score, the lower the firm's value.[13] In addition, the authors found "no evidence" between the 18 other IRRC governance provisions (either individually or in the aggregate) and firm valuation.[14] As to the issue of stock value, the authors concluded that firms with higher entrenchment scores had lower stock returns.[15] Bebchuk, *et al.*, further found that the six entrenchment provisions were the driving force behind a correlation identified by Gompers, Ishii and Metrick between the 24 IRRC provisions on the one hand and reduced firm value and lower share returns during the 1990s on the other.[16]

D. Institutional Shareholder Services Study.

A 2004 research study commissioned by Institutional Shareholder Services by Lawrence Brown and Marcus Caylor of Georgia State University examined whether firms with "weaker" corporate governance perform "more poorly" than firms with "stronger" corporate governance.[17] The criteria Brown and Caylor used to separate "weak" from "strong" corporate governance were derived from ISS's "CGQ" — the Corporate Governance Quotient utilized in ISS's proprietary rating system to help institutions evaluate the quality of corporate boards and the impact of their governance practices. Brown and Caylor's methodology used industry-adjusted CGQ scores to relate to 15 industry-adjusted variables, or performance measures, suggested by ISS and to 20 others that the authors considered of interest. The variables included total returns (one-, three-, five- and 10-year), profitability (ROA, ROE and ROI returns on average equity/average investment), stock price volatility risk (beta), profit margins, market cap, P/E ratios, solvency ratios, interest coverage, ratio of operating cash-flow to total liabilities, dividend payouts, and dividend yields.

Generally, the study found that industry-adjusted CGQ scores reflecting stronger corporate governance were directly correlated to positive performance in four areas--shareholder returns, profitability, risk (measured by stock price volatility), and dividend payouts and yields--while scores reflecting worse corporate governance correlated to worse performance results in those areas. In a second-stage examination, Brown and Caylor related the 35 variables (performance measures) to four "core" factors of the CGQ--board composition, compensation, takeover defenses, and audit — in an effort to determine which were the driving factors behind the results. Brown and Caylor identified board composition as the most important factor and takeover defenses as the least. While the study found a direct correlation between corporate governance and three-year, five-year, and 10- year shareholder returns, results for one-year total returns were inconclusive. The study interpreted that result to mean that one-year total return was more of a risk measure (as a proxy for share price momentum) than a true return measure.

E. Corporate Governance and Firm Performance.

In July 2006, Brown and Caylor published another study in which they again opined that good corporate governance correlates positively with firm value.[18] After creating "a broad measure of corporate governance, Gov-Score, based on a new dataset" supplied by ISS, the authors "relate[d] Gov-Score to operating performance, valuation, and shareholder payout for 2,237 firms."[19] As noted by the authors, Gov- Score was intended to be "a broad measure of corporate governance comprised of both external and internal governance mechanisms"[20] which encompassed "51 factors that span eight categories."[21] Those eight categories were "audit, board of directors, charter/bylaws, director education, executive and director compensation, ownership, progressive practices, and state of incorporation."[22] The authors suggested that their 51-factor metric was "more highly associated with expected firm performance than is the oft-used 24-factor G-Index derived by Gompers, Ishii and Metrick"[23] (which is discussed earlier in this article).

Brown and Caylor concluded that "better-governed firms are relatively more profitable, more valuable, and pay out more cash to their shareholders,"[24] stating that "[w]ith the exception of sales growth, all of our firm performance measures have their expected positive relation with Gov-Score and are significant in our correlation analysis…, decile analysis … or both, suggesting that firms with relatively poor governance are relatively less profitable (lower return on equity and profit margin), less valuable (smaller Tobin's Q), and pay out less cash to their shareholders (lower dividend yield and smaller stock repurchases)."[25]

The authors noted further that "the 13 factors associated most often with good performance are [that] all directors attended at least 75% of board meetings or had a valid excuse for non-attendance, board is controlled by more than 50% independent outside directors, nominating committee is independent, governance committee meets once a year, board guidelines are in each proxy statement, option re-pricing did not occur in the last three years, option burn rate is not excessive, option re-pricing is prohibited, executives are subject to stock ownership guidelines, directors are subject to stock ownership guidelines, mandatory retirement age for directors exists, performance of the board is reviewed regularly, and board has outside advisors."[26] Brown and Caylor also suggested that government officials consider supplementing existing regulations by mandating "the presence of a separate corporate governance committee that meets at least once a year and a provision limiting a firm's option burn rate, two governance factors [the authors found] to be highly related to good performance."[27]

F. The CalPERS Effect.

As investors seek the financial advantages of good governance, their focus naturally turns to the mechanisms to achieve reform. The practical strategies of activist investors are to identify governance issues across global markets, engage a company in dialogue to influence policies directly, or band together with like-minded investors to bring a proxy contest. Large funds often employ in-house analysts to implement a governance improvement campaign, while others hire proxy advisory firms and independent research analysts to assist them.

The California Public Employees Retirement System ("CalPERS") has long used the clout of its large fund to improve the performance of its investments.[28] The so-called "CalPERS Effect" is the measure of increase in stock price when the state fund announces a slate of desired governance improvements for a target corporation.

Several studies have examined the movement of stock prices from CalPERS' corporate governance program. Some studies have found that the CalPERS governance work has added significant value, while others have found a less powerful effect. A 1995 study by Steven Nesbitt examined the performance of 42 companies targeted by CalPERS.[29] Nesbitt found that while the stock price of focus list companies trailed the S&P 500 Index by 66% in the five-year period before CalPERS acted to achieve governance reforms, the same firms outperformed the Index by 52.5% in the following five years. Nesbitt dubbed it the "CalPERS Effect." A follow on study by Michael Smith, with the Economic Analysis Corporation, concluded that corporate governance activism had increased the value of CalPERS' holdings in 34 firms over the 1987-93 period by $19 million at a monitoring cost of $3.5 million.[30]

A January 2006 study by James Nelson questioned whether there is a CalPERS Effect at all.[31] Nelson concludes the results reported in studies finding a positive effect are driven by the inclusion of irrelevant data from 1992-1993, and from bias in choosing periods of known under-performance. Nelson also argued the studies finding a CalPERS Effect fail to control for contaminating events and apply unnecessarily long event windows. After correcting the previous studies' methodology, Nelson found no evidence to support a CalPERS Effect.

However, a more recent November 2006 study by Brad Barber of the University of California, Davis, found a positive CalPERS Effect.[32] Based on short-term announcement responses, Barber showed CalPERS activism has resulted in total wealth creation of $3.1 billion between 1992 and 2005.[33] Barber's data identified a seemingly modest 23 basis point positive benefit. But the size of the CalPERS fund is so large that even the small percentage improvement translates to significant dollar improvement. Barber maintains that the benefits of activism derive from institutional reforms, stating: "corporate managers may pursue projects that benefit themselves, but not shareholders.

Effective monitoring by institutions can reduce these…costs — benefiting not only their investors, but raising the value of stocks for all investors."[34] Barber refers to this type of institutional activism as "shareholder activism." However, Barber warns that activism aimed at moral or social issues, so called "social activism," may reduce profitability.[35]

G. Corporate Governance and the Cost of Capital.

Two recent studies have used the cost of capital as an alternative to share price to measure value. In a 2006 paper, economists Ryan La Fond of MIT and Holly Ashaugh-Skaife of the University of Wisconsin determined there was a correlation between GMI ratings and a corporation's cost of equity capital.[36] They utilized GMI data on nearly 2,000 U.S., European and Asia-Pacific firms to correlate specific attributes of corporate governance with cost of capital. The economic principle is simple: the less the market knows about a company, the greater the risk of an unpleasant financial surprise, and the higher the risk premium the market will impose on corporate borrowers. On the flip side, financial transparency achieved through good governance means the market is fully apprised on accounting issues and will charge a lower risk cost on capital formation. The data studied by Ashbaugh-Skaife and LaFond demonstrate that specific attributes of governance (for example, board independence) are correlated with companies' systematic risk, idiosyncratic risk, and the cost of equity capital. The authors conclude that firms with strong governance have lower systematic risk, idiosyncratic risk, and cost of equity capital relative to firms with weak governance.[37]

A 2007 study by Jeroen Derwall and Patrick Verwijmeren followed and extended the inquiry started by Ashbaugh-Skaife and LaFond.[38] Evidence from the study by Ashbaugh-Skaife and LaFond "suggests that several corporate governance constructs are associated with a lower cost of equity, consistent with the idea that better governance reduces the agency and information risks against which investors price protect."[39] Derwall and Verwijmeren used GMI's overall corporate governance rating and compared that to a cost of equity measure. In the study, the authors make three findings. First, they conclude that firms with better overall corporate governance enjoy a lower cost of equity capital. Second, they find that better governance is associated with lower systematic risk, as measured by a firm's beta. Finally, Derwall and Verwijmeren relate corporate governance to firm-specific risk.

The findings of Derwall and Verwijmeren in 2007 are consistent with the conclusions of Ashbaugh-Skaife and LaFond in 2006 that good corporate governance reduces the cost of capital by better informing market participants of financial risks.

H. Corporate Governance and Performance in Britain.

A February 2008 study conducted by the

Association of British Insurers ("ABI") found a strong correlation between good governance and financial returns. Examining the five year period of December 2002 to November 2007, the authors found that "well-governed companies deliver higher risk-adjusted returns."[40] Specifically, the study discovered that well-governed companies deliver "18% and 13% higher average returns to investors than the portfolios of poorly-governed companies after underlying risk is accounted for."[41]

The methodology of the ABI study was similar to Gompers, Ishii and Metrick.[42] The study examined 361 companies with Institutional Voting Information Service data over four years. The companies were separated into three portfolios based on the quality of governance (good governance, neutral and poor governance) and share price returns were analyzed. Measure of performance in the ABI study rested on commonly used metrics, namely return on assets, Tobin's Q and returns to shareholders. Finally, the ABI study found "a strong indication that corporate governance leads to better performance, rather than vice versa."[43] In Britain, the data supported causation between governance and value.

II. Studies Focusing Upon Specific Aspects of Sound Corporate Governance.

While the construct of "sound" corporate governance practices cannot be reduced to a dogmatic, one-size-fits-all approach, agreement has emerged as to what core structures constitute "best" corporate governance practices. These best practices include, for example: (a) the elimination of takeover defenses such as the poison pill or the staggered board (viewed by many as entrenchment devices which permanently impair long-tem shareholder value); (b) linking executive compensation to a corporation's underlying financial performance (so-called "pay for performance"); and (c) curbing excessive grants of stock options to senior management. It is objectives such as these that form the frontiers of modern shareholder activism and serve as the basis for a second group of empirical studies. As summarized below, those studies that have focused upon a specific best governance practice have concluded that there is a direct empirical link between (a) particular processes or procedures which promote managerial accountability and align the interests of management and stockholders, and (b) higher firm values.

A. The Correlation Between Staggered Boards and Investment Returns.

In a 2007 study, Bebchuk concluded that procedures for replacing directors were a key to improving shareholder value.[44] Bebchuk relied, in part, on a 2007 study by Ronald Masulis, Cong Wang and Feng Xie that found "acquisitions made by companies with stronger antitakeover protection are more likely to be value decreasing."[45] He cites a 2007 study by Olubunmi Faleye that "antitakeover protection is associated with lower compensation incentives in the CEO's compensation as well as with lower sensitivity of CEO turnover in firm performance."[46] Bebchuk observes that "there is evidence of a correlation between antitakeover protections and lower firm value."[47]

Bebchuk found shareholders faced substantial hurdles in voting out poorly performing directors. He details several impediments to reform, including the existence of staggered boards.[48] For the study, Bebchuk examined proxy fights occurring in the 1996-2005 decade, and found the incidence of challenges "seeking to manage the company better as a stand-alone entity is negligible."[49] The problems of board entrenchment are so great, in practice, the ability of shareholders to force increases in company value by the voting of shares is largely a myth. Given the hurdles to voting, investors often seek to leverage the sway of their block of shares by employing analytical tools offered by The Corporate Library, or by engaging the proxy advisory services of Glass, Lewis & Co., or Egan-Jones Proxy Advisors, to band together sympathetic shareholders.

The purpose of improving the efficacy of shareholder voting is to drive increased value in the corporation.[50] Bebchuk reviews the scholarship on corporate governance, and notes that "empirical studies consistently found that proxy fights are associated with accompanying increase in shareholder wealth."[51] He points out that "there is substantial evidence that the general direction in which the proposed reform would go — reducing incumbents' insulation from removal — has an overall beneficial ex ante effect on the management of public companies."[52]

Bebchuk comments that "there is also evidence that insulation from removal results in greater consumption of private benefits by executives."[53] In sum, not only does good corporate governance improve shareholder value, the corollary holds true that specific areas of poor governance, such as entrenched boards, reduce firm value.

In 2002, an article in Stanford Law Review by Bebchuk, John Coates IV and Guhan Subramanian discussed the issue of staggered boards. The article's central thesis maintained that this model of board structure represented a truly massive deterrence to unwanted corporate takeovers — perhaps the mightiest of all takeover defenses.[54] *Staggered Boards* recognizes a subspecies of the classified board — the effective staggered board (or "ESB") — which, coupled with a poison pill, can prevent circumvention by a hostile bidder, essentially forcing such a party to wage concurrently a proxy contest for board control. Due to the prototypical ESB, which is comprised of three classes, each of approximately the same number of director seats, board control cannot be achieved in a single annual meeting election. The ESB will severely try both the staying power and the finances of a dissident group to wage a contest extending over two annual meeting cycles. An ESB clearly increases an incumbent management's protection against takeovers and, most of the time, the ESB succeeds in maintaining the company's independence. However, as to the effect of the ESB on investment returns, the empirical evidence supported the proposition that the stockholders are worse off with the corporation remaining independent than they would be if the hostile bid were accepted.[55]

Staggered Boards also cites Robert Daines' finding[56] that Delaware corporations have higher values than non-Delaware firms, which translates to the conclusion that Delaware incorporation correlates to higher shareholder returns. While DGCL § 141(d) permits classified boards in accordance with formal requirements, including stockholder approval via the corporation's certificate or its initial by-laws, Delaware does not *require* board classification and maintains only one real antitakeover provision, DGCL § 203, which nevertheless allows for corporate opt-outs.[57] Bebchuk, Daines and others believe that Delaware law therefore maintains the mildest antitakeover regime in the nation.

B. The Relationship Between CEO Compensation and Credit Risk.

In July 2005, Moody's Investor Service ("Moody's"), which provides ratings on over 85,000 corporate and government securities, published a study which investigated "the empirical relationship between executive compensation and credit risk."[58] Studying "non-financial corporations in the United States with senior unsecured bond ratings of B3 or higher, from 1993 through 2003,"[59] Moody's found a link between the compensation paid to Chief Executive Officers on the one hand and "overall credit risk" on the other.[60] Specifically, Moody's found that firms in the top 10 percent with respect to "high unexplained bonuses" and "high unexplained option grants" experienced "dramatically higher default rates and dramatically higher downgrade rates than did the middle 70% of the distribution."[61] For example, in the case of "high unexplained bonuses," the default rate for the top 10 percent of companies was 1.8 percent, compared to only 0.1% for corporations which fell in the middle 20%.[62]

The term "unexplained bonuses" (or "unexplained option grants"), as used in this study, refers to bonuses (or option grants) that "deviate[] substantially" from what might be expected "based on firm size, past performance, and other variables."[63] Stated more specifically, "[t]o determine unexplained compensation," Moody's developed "a model that predict[ed] expected salary, expected bonus, and expected option grants based on firm size, past operating performance, CEO tenure, and industry — variables selected from the academic literature on CEO compensation."[64] In its study, Moody's offered "three possible explanations" for this empirical link that "could be inferred from the [academic] literature."[65] As an initial matter, Moody's noted that "excessive compensation may be indicative of weak management oversight."[66] In addition, Moody's posited that "large pay packages that are highly sensitive to stock price and/or operating performance may induce greater risk taking by managers, perhaps consistent with stockholders' objectives, but not necessarily bondholders' objectives."[67] Finally, Moody's stated that "large incentive-pay packages may lead managers to focus on accounting results, which may, at best, divert management attention from the underlying business or, at worst, create an environment that ultimately leads to fraud."[68]

The 2007-2008 collapse of the subprime mortgage markets underscores the importance of good governance and offers new opportunities to improve policies. While scholars are still studying the root causes of the subprime collapse, it is readily apparent that a contributing factor lies with companies that took on too much risk in an effort to meet short term goals (and maximize executive compensation) at the expense of long-term stockholder value.

Recognizing this, the Emergency Economic Stabilization Act of 2008 ("EESA" or the "Act") includes specific limits on excessive executive compensation and directed the Department of the Treasury to implement rules establishing greater controls over the compensation practices of companies that sought distribution of government funds authorized by the Act.[69] For covered financial firms, the EESA amends Section 162(m) of the Internal Revenue Service code to limit the deductibility of compensation earned by the top three executives to $500,000 per year per executive (reduced from $1 million), without exception for performance-based compensation. Indeed, I during n floor debate on the Act, Senator John Kerry of Massachusetts stated that in recent years CEOs "have increased their pay by increasing the risks their companies take."[70] The EESA, he argued, includes "meaningful limits on both executive compensation and 'golden parachutes.' This will help insure that not one dime of taxpayer funds will be used to pay the salary of CEOs who have abused the public trust and played a role in developing the economic crisis we face."[71] The purpose of the EESA's compensation limits is to ensure that short term interests of executives do not diminish long term performance at the expense of shareholders. In October of 2008 the Treasury Department announced the Troubled Asset Relief Program ("TARP") to implement the EESA.[72]**{CITE}** TARP mandates specific governance policies, particularly with respect to compensation practices, to which companies seeking government funds must comply. Among other things, TARP requires increased director oversight on compensation practicesby review of compensation practices that could lead to excessive risk within 90 days of receiving funds, annual meetings of the board's compensation committee to discuss and review compensation and risk, and certification by the compensation committee of completion of such reviews. [73] A clawback for bonuses is provided in Section 111(b)(2)(B) of the EESA, which requires "a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate."[74] These provisions evidence a recognition that sound governance and oversight on compensation issues are widely regarded as essential to long-term positive financial performance.

[required meetings; clawbacks; making sure incentive compensation for senior execs does not encourage excessive short term risks] [CITE]

C. Takeover Defenses and Credit Risk.

In a prior study, published in December 2004, Moody's found a link - "albeit weak" - between takeover defenses and corporate credit risk.[75] Specifically, Moody's concluded that:

> Credit risk is found to have been positively related to the number of takeover defenses. Having more takeover defenses led to more defaults and more large downgrades for both investment-grade and speculative-grade firms. Further, more defenses led to fewer large upgrades. These effects are present, even after controlling for credit ratings.[76]

This study analyzed data for 1,058 companies from 1990 to 2003,[77] and focused on the number of takeover defenses a firm had in place (such as poison pills, staggered boards, and golden parachute payments to executives upon a change in control), as well as on information regarding credit upgrades and downgrades and incidents of credit default. Moody's analysis of the data led it to conclude that:

- "[t]he association of takeover defenses with downgrade rates appears fairly strong;"[78]
- "[t]he probability of a downgrade increases as the number of takeover defenses increases for all categories" of issuers;[79]
- the adoption of "[m]ore takeover defenses" correlated to lower credit "upgrade rates" (although these results were "not as statistically significant" as those pertaining to credit downgrades);[80] and
- the risk of credit default seemed to be "higher for firms with greater numbers of takeover defense" (although Moody's stated that the relationship was "much weaker than that observed for downgrades").[81]

Moody's also found that so-called "democrats" (defined as corporations with five or fewer take over defenses) "earned 8.9% greater annual stock returns" than those companies defined as "dictators" (those corporations that had 14 or more takeover defenses in place) during the period beginning in 1990 and ending in 1999.[82] Moody's noted that the foregoing finding was "consistent with prior literature"[83] on the subject. Interestingly, however, Moody's also discovered that "firms with the fewest defenses earned 14.7% lower annual returns for the period 2000 to 2003."[84]

Although this study concluded that a positive correlation existed between credit risk and the number of takeover defenses enacted by a corporation, Moody's cautioned that the magnitude of the link was "modest."[85] Moody's further noted that since corporations' use of takeover defenses "continues to change," the results seen for the period studied "might not hold in the future."[86] Moody's cautioned that "the effect and meaning of takeover defenses depends highly on the specific circumstances of each firm as well as the firm's overall corporate governance structure" and that, as such, the effect of such defenses are "highly contingent on specific context."[87] In Moody's view, this indicated that "a case-by-case approach" might be more valuable than making "broad assumptions" regarding the influence of such defenses "on credit quality."[88]

D. Related Party Transactions: Harmful or Efficient?

Corporate scandals involving related party transactions between companies and members of their senior management team are all too common. In 2004, Rutgers Business School professors Elizabeth Gordon, Elaine Henry and Darius Palia conducted a study to test whether a relationship existed between such transactions and firm value.[89] The authors presented two hypotheses as to how related party transactions might affect the performance of a company. The first hypothesis, which can be traced to Berle and Means' famous treatise on the "modern corporation," was that related party transactions "represent a conflict of interest" between managers and shareholders that harm firm value.[90] In their seminal work first published in the 1930s, Berle and Means posited that the separation of ownership from control "posed a fundamental threat to the public shareholder" since "[m]anagement groups might pursue their personal interest in higher salaries, favorable stock options, or other conflicts of interest at the expense of the majority of public shareholders."[91] The problem corporations faced, Berle and Means explained, was "managers might enrich themselves at the expense of owners."[92]

The second hypothesis proposed that "related party transactions are efficient transactions" that benefit the corporation.[93] Under this second hypothesis, these transactions are viewed as a means for corporations to retain skilled executives which, in turn, improves firm value.

The authors concluded that, as an overall matter, related party transactions were not beneficial and, instead, negatively affected firm value:

> The evidence indicates that shareholders do not benefit from, and in fact are harmed by some related party transactions. Our investigation of the corporate mechanisms associated with related party transactions and their impact on firm value supports the hypothesis that they are conflicts of interest between managers/board members and their shareholders. We find that this effect is especially strong for loans and the number of transactions (other than loans) with non-executive directors … Therefore, it appears that concerns among regulators and stock market participants about related party transactions are warranted.[94]

The issue of related party transactions ("RP transactions") was also at the heart of a September 2004 study published by University of Wisconsin professors Mark Kohlbeck and Brian Mayhew.[95] There, the authors examined the RP transactions of 1,261 of the S&P 1500 companies. Kohlbeck and Mayhew found that one of the most common forms of RP transaction were loans to related parties.[96] They further concluded, *inter alia*, that "board of director independence (stronger corporate governance) is associated with a lower probability of RP transactions, and when there were RP transactions, the transactions [were] more likely to be disclosed."[97] The authors also opined that the evidence suggested that "board monitoring plays a role in mitigating the occurrence of RP transactions and helps to discipline disclosure of the transactions when they do occur."[98]

E. The Relationship Between Earnings Manipulation and Stock Option Timing.

Press accounts have chronicled the wide-spread manipulation of the timing of stock option grants by executives.[99] The U.S. Securities and Exchange Commission ("SEC"), as well as criminal prosecutors, has alleged illegal options grant practices at a number of prominent companies.[100] For those who would rely on internal compliance in lieu of shareholder activism to check corporate malfeasance, a sobering aspect of the cases is the central role played by lawyers in facilitating the option timing fraud.[101]

In a 2007 study, two economists, Gerard Sanders and Donald Hambrick, reviewed stock options awarded to the executives of 950 American firms from 1993 to 2000.[102] They conclude that options create asymmetric incentives. The options pay out when a company's stock price exceeds the option exercise price, but once they fall below the exercise price then further falls make no difference to the ultimate payout, since the options are worthless. This effect, the authors explain, provides an artificial incentive for executives to pursue a strategy of risky activities with long odds on a high pay-off. They also find that these big bets will produce, on average, more losses than wins.

The data during the 1993-2000 period showed that the larger the percentage of share options in a chief executive's pay package, the more likely firms were to direct investment towards risky activities. The data also revealed that high levels of share options were associated with greater volatility in a firm's share price, and that the large drops significantly exceeded the extreme highs. They conclude: "We find that CEO stock options engender high levels of investment outlays and bring about extreme corporate performance (big gains and big losses), suggesting that stock options prompt CEOs to make high-variance bets, not simply larger bets."[103]

Sanders and Hambrick theorize that "not only does this asymmetry affect the selection of strategic initiatives, as we have discussed, but it may also cause CEOs to be inattuned to early signs of project failure and generally careless about risk mitigation."[104] The study shows that oversight of executive pay packages is a necessary part of a corporate governance plan to protect shareholder value.

In a sense, improper options backdating is an example of risky behavior which scholars predicted. As early as 2000, several studies focused on the troubling relationship between the timing of the release of a corporation's earnings results and an award of stock options to senior executives. In a 2000 study, titled, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, two business professors, David Aboody of UCLA and Ron Kasznick of Stanford University, found that chief executives engage in a kind of self-interested behavior "around [option] award dates by delaying good news and rushing forward bad news."[105] Specifically, Aboody and Kasznick discovered that "CEOs who receive their options before the earnings announcement are significantly more likely to issue bad news forecasts, and less likely to issue good news forecasts, than are CEOs who receive their awards after the earnings announcement."[106] In their study, the authors also cited to an earlier study by New York University professor David Yermack, who had concluded that "CEO option awards are preceded, on average, by insignificantly negative abnormal returns, and are followed by significantly positive abnormal returns."[107]

While the authors did not mean to "necessarily imply that this activity adversely affects shareholder wealth,"[108] the results of the study did foreshadow the now disclosed practice in of a number of companies' that executives engaged in opportunistic behavior which could have been mitigated through better governance practices.[109] As Aboody and Kasznick specifically stated, their "findings suggest[ed] that CEOs' incentives to manage investors' expectations around scheduled awards could be mitigated by setting award dates immediately after earnings announcements."[110]

That corporate management engages in self-interested behavior vis-à-vis option grants also was the subject of a January 2005 study published by Professors M.P. Narayanan and H. Nejat Seyhun of the University of Michigan Business School.[111] In that study, the authors examined "a database of 605,106 option grant filings by insiders between 1992 and 2002" and discovered "significant abnormal stock return reversals around the grant date."[112] More specifically, the authors found that the:

> overall evidence is consistent with substantial managerial influence on their compensation. Stock price [sic] fall significantly prior to option grant dates and rise significantly following option grant dates, thereby producing sharp reversals of abnormal returns. The market-adjusted return for the 90 days preceding the grant date is about -3.6% and the return for the 90 days following the grant date is about 9.4%. In small firms, the 90-day post-grant date average abnormal rise in stock price is about 17%. *These patterns are significantly larger than any that has been documented in previous literature.*[113]

The authors also concluded that these "abnormal stock return reversals are more pronounced on average when the grants involve top executives such as CEOs, Chairmen of the Board, Presidents, and CFOs, who possess more company specific information, have the ability to manage information disclosure, and wield greater influence with the board."[114]

The Narayanan/Seyhun analysis appears to go one step further than prior studies. According to the authors, while senior management does control the public disclosure of good and bad information, the evidence also suggests that "some firms are setting the [option] grant date on a back-date basis, *i.e.*, picking a date in the past with a lower stock price compared to that on the decision date."[115] In this regard, the authors stated that:

> while the stock return reversals are consistent with both opportunistic timing of information releases by firms and opportunistic timing of grant dates, these two methods of influencing do not completely explain the observed stock return reversals. In particular … the correlation between post-grant and pre-grant abnormal returns cannot be easily explained by these two methods of influencing alone. We propose that some firms may be setting the grant date on a back-date basis, i.e., choosing a grant date in the recent past with a lower stock price than the price on the day of the grant decision is made. If back-date method is employed by some firms, the stock return reversals should be positively related to the reporting lag (the time interval between the grant date and the date on which the SEC receives the grant disclosure forms from the executive). *We find this is indeed the case.*
>
> The magnitude of the gains for large grants from backdating can be significant. Our results show that if grant date is back-dated by 20 days, executives receiving large grants (500,000 shares or greater) increase the value their option compensation" by about 10%. By conservative estimates, this is equivalent to a windfall of $0.7 million per grant.[116]

As one press report noted, the Narayanan/Seyhun study "suggests one easy litmus test of a company's corporate governance: check the company's filings for the timing of recent option grants. If they occur with an eerie regularity at prices close to the company's trailing 52-week lows, then you should become suspicious of its internal corporate culture."[117] When the SEC took this approach, it found numerous examples of illegal timing.[118]

F. The Correlation Between Executive Compensation and Accounting Fraud.

In a study published in February 2004, Merle Erickson (Graduate School of Business, University of Chicago), Michelle Hanlon (University of Michigan Business School), and Edward Maydew (Kenan-Flagler Business School, University of North Carolina) set out to determine if a relationship existed between the structure of executive compensation and accounting fraud. The authors used a sample of 50 firms that had been accused of such fraud by the SEC from January 1996 to November 2003.[119] Erickson, *et al.* tested two opposing views on the impact of stock-based compensation on executive incentive.[120] One view is that option-based compensation aligns manager and shareholder interests and is consistent with the maximization of firm value.[121] The opposing view is that option-based compensation poorly aligns the long-term interests of shareholders and managers, provides ineffective incentive for managers, and leads to misleading corporate reporting on executive compensation.[122] The authors concluded that a positive correlation existed between accounting fraud and equity-based executive compensation, noting that "[t]he results are consistent with the likelihood of accounting fraud increasing in the percent of total executive compensation that is stock based."[123]

A 2005 study published by three business school professors, Shane Johnson, Harley Ryan and Yisong Tian, reached a similar conclusion.[124] After studying 43 firms accused of accounting fraud by the SEC from 1992 to 2001, the authors found that executives who commit fraud face greater financial incentive to do so and that these incentives "stem from significantly larger stock and option holdings."[125] The authors further noted that the "level of equity-based compensation [has] trended upward is recent years" and that, as a result, anti-fraud measures (including such measures at the investor level) "should increase commensurately."[126]

In a 2007 study, Jared Harris of the Darden Graduate School of Business Administration, University of Virginia, and Philip Bromiley of the Merage School of Business, University of California, Irvine, concluded that when a chief executive receives a large stock option package, there is a much greater likelihood that the company in question will "misrepresent their financial position."[127] The Harris/Bromiley study analyzed companies that had restated their financial results over a five and one-half year period (January 1, 1997 to June 30, 2002) because of "accounting 'irregularities'"[128] and found that within those companies, stock options comprised one-half of a chief executive's total compensation. This stood in stark contrast to CEO compensation at comparable companies that did not experience such a restatement — where options comprised only 39% of remuneration.[129] The authors also concluded that probability of financial misrepresentation increased "rapidly" when stock options constituted "more than 76% of compensation."[130] Moreover, "while [t]he analyzed sample reveal[ed] that a publicly traded company has approximately an 8.77% probability of having a financial misrepresentation discovered during a given five-year time period,"[131] the authors noted that among those companies that paid their chief executives over 92 percent of compensation as stock options, the probability of misrepresentation was 21 percent.[132]

III. The Benefits of Socially Responsible Investing.

Socially Responsible Investing means "the constructing and managing of investment funds through the use of social, environmental and ethical considerations in addition to conventional financial criteria."133 As a general matter, SRI involves the process of "integrating personal values and societal concerns with investment decisions."134

SRI has increased dramatically in recent years. A 2007 study conducted by the European Social Investment Forum valued the venture capital pool targeted at this market at €1.25 billion.[135] A December 2003 press report noted that "approximately $2.16 trillion was invested using a socially responsible strategy."[136] To take one example, the Calvert Group operates funds that pursue socially responsible investing.[137] The large players are involved, too. ABM Amro offers more than 20 SRI funds. Their SRI investments are well-established in Sweden and Brazil and continue to grow along with the European SRI market.[138] The SRI funds seek to capture value across a spectrum of investments and share a common goal. The ABM Amro Web site explains: "What they have in common is an emphasis on checks and balances within a company, accountability to shareholders and management ethics. International corporate governance best practices now strongly encourage institutional investors, like pension funds and asset managers, to take a more active role in monitoring corporate governance issues, to exercise shareholder rights and report about this to their beneficiaries or clients."[139] Calvert and ABM Amro are simply two examples among a growing industry that is focused on the SRI market from the investment side.

Along these same lines, a growing number of *companies* also now make "social responsibility" an important part of their corporate culture.[140] Of course, the recognition that corporations should embrace public service and philanthropic causes also may be viewed as a "gussied-up bid for good favor."[141] In that regard, *Business Week* noted that: "[t]arred by a raft of corporate scandals from Enron to WorldCom, social outreach can be a way to regain the high ground. That's probably one reason corporate giving hit $3.6 billion last year, an all-time high, up from $3.5 billion in 2003, according to philanthropy research group the Foundation Center."[142]

Some academics have deduced that "socially responsible investing results in a less profitable portfolio."[143] However, as noted below, several recent studies have cast doubt on that conclusion.

A. The Study Conducted by Derwall, Gunster, Bauer and Koedijk.

In a 2004 study authored by Erasmos University professors Jeroen Derwall, Nadja Gunster and Kees Koedijk, in conjunction with Rob Bauer of ABP Investments and Maastricht University,[144] focused on eco-efficiency. The authors hypothesized that eco-efficiency ("the economic value a company adds (e.g., by producing products) relative to the waste it generates when creating that value")[145] related to better portfolio performance. The authors used five criteria to find the eco-efficiency of a number of U.S. companies, as follows: "historical liabilities" (*i.e.*, "risks resulting from preceding actions"); "operating risk" (*i.e.*, "risk exposure from recent events"); "sustainability and eco-efficiency risk" (*i.e.*, "future risks initiated by the weakening of the company's material sources of long-term profitability and competitiveness"); "managerial risk efficiency" (*i.e.*, management's "ability to handle environmental risk successfully"); and "environmentally related strategic profit opportunities" (*i.e.*, available business opportunities that result in a competitive advantage over other "industry peers").[146] The authors then constructed "two mutually exclusive stock portfolios," each of which had "distinctive eco-efficiency characteristics."[147] Various analyses on the performance of each portfolio led to the conclusion that SRI adds value to an investor's portfolio:

> Although conventional investment theory predicts that investors should be cautious about adopting SRI, we presented evidence that a stock portfolio consisting of large-cap companies labeled "most eco-efficient" sizably outperformed a less ecoefficient portfolio over the 1995–2003 period. Using several enhanced performance attribution models to overcome methodological concerns, we showed that the observed performance difference cannot be explained by differences in market sensitivity, investment style, or industry bias. Even in the presence of transaction costs, a simple best-inclass stock selection strategy historically earned a higher market risk–adjusted and style-adjusted return of 6 pps than a worst-in-class portfolio. Overall, our findings suggest that the benefits of considering environmental criteria in the investment process can be substantial.[148]

B. Other Studies on the Benefits of SRI.

The study authored by Derwall, *et al.* is not alone in its conclusion that SRI obtains superior investment returns. A June 22, 2007 report by Goldman Sachs found corporate governance and environmental concerns are linked, as follows: "Investors focused on quality of management over the long term cannot separate corporate governance issues from social and environmental issues. Our analysis has shown that, with few exceptions, the two go hand-in-hand."[149] As noted in the January 2003 issue of the *Journal of Accountancy*, two other studies also have opined that SRI enhances shareholder returns.[150] First, during the period 1990 to 1998, "the Domini 400 Social Index — a benchmark that measures the impact of social screening on financial performance — returned 18.54% vs. 16.95% for the S&P 500."[151] Second, a Spring 2000 article in the *Financial Analysts Journal*, "took a comprehensive look at the risk-and-return characteristics of socially responsible mutual funds" and concluded that "[n]ot only did the screened funds do better, they did so at a modest risk premium--14.19% standard deviation vs. 13.23% for the S&P 500."[152]

Another study, titled, *Corporate Environmental Governance*, was commissioned by the U.K. Environment Agency and reviewed 60 research studies over the last six years.[153] The U.K. report found that 85% of research studies reviewed showed a positive correlation between environmental management and financial performance. The report concluded that "companies with sound environmental policies and practices are highly likely to see improved financial performance."[154]

The tangible benefit for business interest in environmental aspects of SRI is customer loyalty.[155] A recent study concluded: "A structured 'green' branding approach, in which global business lines and brands are on one end and local branding strategy are on the other, will play pivotal role in achieving customer loyalty and acquisition, as well as ensure that such products are tailored to the specific needs and demands of local communities."[156]

C. SRI and the Legal Framework for Public Pensions.

In 2005, a study by international law firm Freshfields reviewed the legal limits on SRI for public fiduciaries in nine countries. These included the U.S. and Japan, European countries (France, Germany, Italy and Spain), as well as Commonwealth nations (the U.K., Canada and Australia). A value focus required in the laws could be harmonized with SRI goals, Freshfields wrote: "Conventional investment analysis focuses on value, in the sense of financial performance. As we note above, the links between [environmental, social and governance ("ESG")] factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."[157]

The Freshfields report reasoned that a proper reading of U.K. law "confirms that fiduciary powers must be exercised in the interests of beneficiaries; as such, the interests of beneficiaries beyond financial return should be considered in arriving at investment decisions in certain circumstances."[158] In several countries, investment laws now require fund managers to disclose the extent to which environmental, social and governance issues were taken into account. These include the U.K., Australia, France and Germany.

The U.K. Social Investment Forum Web site characterized Freshfields' findings as failure to assess environmental, social and governance issues, "may well breach a trustee's duty to act in the best interests of scheme beneficiaries."[159] The underlying point is the overall economy will predictably suffer from social unrest and environmental degradation, if investment managers fail to appreciate SRI factors.

A 2006 study found that the Hermes Pensions Management, Ltd., combined SRI goals with positive investment returns, satisfying U.K. fiduciary requirements.[160] Hermes, a fund owned by British Telecom Pension Scheme, has achieved solid returns through activist techniques, such as calling for corporate governance improvements. Having examined data on engagements with management in firms targeted by its U.K. Focus Fund, the study found: "In contrast with most previous studies of activism, we report that the fund substantially outperforms benchmarks and estimate that the abnormal returns are largely associated with engagements rather than stock picking."[161] While the Freshfields study examined the use by public fiduciaries of SRI factors in making an investment, the Hermes study suggests that in the future we may see more interest by managers in the corporate governance tools deployed by activist hedge funds to obtain higher returns.

D. The Impact of ERISA on Socially Responsible Investing.

Institutional investors who are subject to the fiduciary requirements imposed by the Employee Retirement Income Security Act ("ERISA")[162] should be mindful of two pronouncements from the U.S. Department of Labor ("DOL") pertaining to socially responsible investing. In an interpretative bulletin issued in June 1994 (so-called Interpretative Bulletin 94-1), the DOL addressed plan investments in so-called "economically targeted investments" (or "ETIs") which it termed, "investments selected for the economic benefits they create apart from their investment return to the employee."[163] The DOL opined that "[t]he fiduciary standards applicable to ETIs…are no different than the standards applicable to plan investments generally" and that plan fiduciaries must — in making any investment decision — "give[] appropriate consideration to those facts and circumstances that…the fiduciary knows or should know are relevant" including "diversification, liquidity and risk/return characteristics."[164] The DOL further noted that that since "every investment necessarily causes a plan [or a participant] to forgo other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return."[165]

In an advisory opinion written in May 1998, the DOL reiterated the foregoing principles in connection with an inquiry regarding the application of ERISA's fiduciary's responsibilities to a plan's selection "of a 'socially responsible fund' as a plan investment or a designated investment alternative."[166] While the DOL stated that ERISA does not "preclude consideration of collateral benefits, such as those offered by a 'socially responsible' fund, in a fiduciary's evaluation of a particular investment opportunity," those collateral benefits can be determinative "only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks."[167] In the DOL's view, a fiduciary's obligation to act in the best interests of plan participants and beneficiaries cannot be subordinated to other social objectives. Accordingly, "in deciding whether and to what extent to invest in a particular investment, or to make a particular fund available as a designated investment alternative, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment, or to designate an investment alternative, may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments."[168] As noted by one commentator, "the DOL is of the opinion that, once it is determined that an investment alternative is prudent for participant direction-based on an analysis of only the investment considerations —

the fiduciaries can then, and only then, consider the collateral issues, like the socially responsible screen."[169]

IV. Critics of Investor Activism.

Of course, there are critics who contend that corporations do not benefit from investor activism. In a reply article to Bebchuk's *The Myth of the Shareholder Franchise*, attorney Martin Lipton criticizes the notion of benefits from activism in electing directors.[170] Lipton argues that corporations best create value when boards and managers are left alone, as shown by historical performance. Lipton writes that the "electoral system [Bebchuk] seeks to dismantle has enabled U.S. firms to consistently outperform their global peers."[171] Contested director elections will tend to drive out talented candidates, Lipton argues, and not motivate them to higher performance.[172] Lipton's view is that shareholder activism distracts companies from profit seeking, so it follows that it is bad for performance. Any study showing a correlation between better governance and improved shareholder value would be at odds with Lipton's boardroom experience.

Another sort of critic presents an agnostic view that governance features may be good, bad or neutral for corporate performance, but studies have not yet measured the effect so we do not know. In an October 2007 paper, Sanjai Bhagat, Brian Bolton and Roberta Romano argue that the business world is too complex to be summarized in a corporate governance index. The authors caution: "Our core conclusion is that there is no consistent relation between the academic and related commercial governance indices and measures of corporate performance."[173]

Bhagat, *et al.* argue that a close examination of several corporate governance studies reveals there is not a finding of a causal relationship between governance and financial performance. They praise the 2001 study by Gompers, Ishii and Metrick, *Corporate Governance and Equity Prices*, for its careful handling of data, but note the paper, "did not draw causal conclusions about the relation between good governance and superior performance."[174] Likewise, in the 2005 study by Lucian Bebchuk, Alma Cohen and Allen Ferrell, *What Matters in Corporate Governance?*, the authors do not claim the data "demonstrated causation; rather, they state that the evidence is 'suggestive' that the set of entrenching governance provisions that they have identified effect performance."[175] Finally, Bhajat, *et al.* analyze the 2004 study by Lawrence Brown and Marcus Caylor, *Corporate Governance and Firm Performance*, which created a "Gov-Score" measurement. The problem with the study, Bhajat, *et al.* argue, is Brown and Caylor "do not adjust performance by industry, as do [Gompers, Ishii and Metrick] and [Bebchuk, Cohen and Ferrell], nor do they examine stock returns."[176] Thus, Brown and Caylor cannot be cited for improved financial performance from good governance.

In reply, critics such as Lipton do not sufficiently recognize the agency relationship between investors and a corporation. Today, the market power of institutional investors with their portfolio firms is the driving force behind activism. With responsibility for multi-million dollar, international portfolios, institutional investors play a complex role as empowered shareholders and even moral fiduciaries. When critics reexamine the identities and goals of these modern investors, they will see that the purpose of most activism is to increase shareholder value. The sophisticated analytical tools of The Corporate Library, or the services of proxy advisory firms such as Glass, Lewis & Co., or Egan-Jones Proxy Advisors, are employed precisely because activist investors do not seek to distract management or waste the resources of the corporation which they own. Instead, activist investors are a check on entrenchment of poor or even illegal practices, and can offer management the most innovative business ideas of shareholders.

While the studies cited by Bhagat, *et al.* reflect a scholar's caution in drawing causal connections between governance and performance, the studies support causation. Brown and Caylor found "powerful evidence that … two entrenchment measures [no poison pill and no staggered board] are linked to firm valuation,"[177] validating the findings of Bebchuk, Cohen and Ferrell. Brown and Caylor further identified "five internal governance provisions that are linked to firm value."[178] Additionally, a 2006 study by two Georgetown University business professors, Reena Aggarwal and Rohan Williamson, reviewed 5,200 U.S. companies and concluded: "there is a very strong positive relationship between firm value and corporate governance."[179] A skeptic might point out that even a badly run company can achieve an improved stock price in a bull market, so good governance is not an exclusive catalyst for valuation. While the critics are correct to point out that research in the field of investor activism should withstand the highest order of scrutiny, the relevant studies have consistently shown that improvements in good governance are related to financial returns.

Conclusion

In a 2005 *Harvard Law Review* article, Professor Bebchuk noted that "[t]o students of corporate law, the proposition that corporate governance matters requires little explanation. As the evidence indicates that the quality of governance arrangements affects firm performance and shareholder value."[180] Similarly, Goldman Sachs analysts have concluded that "investments in companies with the highest quality of governance structures and behavior have significantly outperformed those with the weakest governances."[181] An April 2004 study by Deutsche Bank further found that "companies that have taken action to improve their governance standards have outperformed those that have taken negative actions over the past two years."[182]

The shift in recent years in shareholder activism lies in finding common ground with boards to increase corporate value. The view that boards and managers are best left alone to pursue profit opportunities held sway for a time. The lessons of options back-dating scandals, or simply fatigue at criminal prosecutions to halt bad management, mark a change in season from rhetoric to reason in corporate governance. Looking to the future, the pursuit of investment returns, more than pondering past problems, provide fresh impetus to commentators considering changes in corporate governance models. The growth in socially responsible investing, activism of hedge funds, and cross-border issues raised by globalization are new elements.

Previously, in studies from 1991 and 2002, Judge Frank Easterbrook argued that capital markets impose sufficient discipline and make governance better.[183] But the experience of the past year is a lesson that transparency is needed for *laissez faire* lighthouses to warn of shoals ahead. The current financial crisis shows that corporate governance is a necessary precursor to enable markets to accurately evaluate risk. Further, as the billion dollar figures for bank bailouts rises each month, it has become clear that capital markets are not a replacement for good governance when the problems end up in the public's lap.

As discussed throughout this article, a substantial number of studies support the notions that investing in companies with sound corporate governance programs and practices makes good economic sense and that good corporate governance fosters long-term profitability. Simply put, good corporate governance does, in fact, pay.

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7 The term "corporate management" refers to both directors and officers.

8 *See, e.g.*, Belen Villalonga & Raphael H. Amit, *How Do Family Ownership, Control, and Management Affect Firm Value?* (June 7, 2004), AFA 2005 Philadelphia Mtgs., EFA 2004 Maastricht Mtgs. Paper No. 3620 (*available at* http://ssrn.com/abstract=556032); Hollis S. Ashbaugh, Daniel W. Collins & Ryan LaFond, *The Effects of Corporate Governance on Firms' Credit Ratings* (June 2004) (*available at* http:// ssrn.com/abstract=511902); Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Valuation*, J. Accounting Public Policy 25(4), 409-434 (July-Aug. 2006) (creating a new index, called Gov-Score, and finding evidence that good corporate governance practices lead to better firm performance) (*available at* http://www2.gsu.edu/~wwwacc/Faculty/lbrown/Corporate_Governance_and_Firm_Valuation.pdf)("Brown & Caylor"). The *Corporate Governance and Firm Valuation* study is discussed later in this article.

9 Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?* (Sept. 2004), Harvard Law School John M. Olin Center Discussion Paper No. 491 (*available at* http://ssrn.com/abstract=593423)("Bebchuk, et al.")

10 *Id.* at 7.

11 *Id.* at 7-11.

12 The remaining 18 IRRC factors are generally set forth as: Blank Check, Limits to Special Meetings, Limits to Written Consent, Compensation Plans, Director Indemnification Contracts, Director Indemnification, No Secret Ballot, Unequal Vote, Anti-Greenmail, Director Duties, Fair Price, Pension Parachutes, No Cumulative Vote, Director Liability, Business Combination Law, Silver Parachutes, Cash-Out Law, and Severance Agreements. *Id.* at 39.

13 *Id.* at 3, 39.

14 *Id.* at 3.

15 *Id.* at 40.

16 *Id.*

17 Lawrence D. Brown & Marcus L. Caylor, *The Correlation Between Corporate Governance and Company Performance* (2004). A research study prepared for Institutional Shareholder Services.

18 Brown & Caylor, *supra*, at note 7.

19 *Id.* (quotes located in Abstract).

20 *Id.* at 24.

21 *Id.* at 3.

22 *Id.* at 28.

23 *Id.* at 3-4.

24 *Id.* (quote located in Abstract).

25 *Id.* at 29.

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Id.

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