The Future of Banking in America

The Changing Corporate Governance Environment: Implications for the Banking Industry

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Introduction and Legal Underpinnings

Failures of corporate governance can cause enormous financial losses, not only to individual corporations and their stockholders but also to society as a whole. One widely quoted estimate of the cost of U.S. corporate governance failures is $40 billion a year, or the equivalent of a $10 a barrel increase in the price of oil.[1] Enron shareholders alone lost $63 billion in Enron's failure. Other recent scandals of corporate governance have entailed huge losses as well. These events together have resulted in new legislative, regulatory, and judicial initiatives to counteract perceived failings in corporate governance.

This paper identifies the main developments of the changing environment and illuminates issues of corporate governance that U.S. bankers are likely to face. The paper begins by reviewing the so-called Anglo-Saxon model of corporate governance, which is derived from English common law and based upon extensive legal protections and a large, diffuse ownership of companies.[2] The paper then reviews major academic research on the mechanisms and strategies used to promote good governance in the United States. Next, the paper reviews recent efforts to reform U.S. corporate governance and traces dominant trends. These sections are concerned with corporate governance as it applies to all U.S. businesses. The final section (before a summary and conclusion) focuses specifically on banks and their corporate governance within the broader context.

Corporate governance is defined and practiced differently throughout the world, depending upon the relative power of owners, managers, and providers of capital. Basically, different national systems of corporate governance reflect major differences in the ownership structure of firms in different countries, and particularly differences in ownership concentration.[3]

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[1] Robert Litan, remarks delivered at AEI/Brookings consortium on The Future of Corporate Governance, March 5, 2003.

[2] The Anglo-Saxon approach to corporate governance is also known as the shareholder model. When this paper alludes to "U.S. law" or "U.S. corporate governance" standards, it is not referring to federal law or federal standards but (generally) to the Anglo-Saxon approach to corporate governance as practiced in the United States. There is no federal law of corporations per se except the Sarbanes-Oxley Act of 2002; but the combined actions of the SEC, the national stock exchanges, and state courts have resulted in the development of standards of corporate governance that are generally accepted (i.e., accepted to a degree) in the United States.

[3] This discussion draws on Shleifer and Vishny (1997).

In much of the world outside the United States and the United Kingdom, heavily concentrated shareholdings and controlling ownership are the norm. Virtually every country on the European continent has an ownership concentration higher than that in the United States. Single stockholders are not unusual; many European firms, even large ones, are family owned and operated.

Concentration is an outgrowth of the way foreign firms fund their activities. Whereas U.S. firms typically access the capital markets for equity and debt funding, firms in much of the rest of the world (including the advanced economies of Europe and Japan) typically rely much more on bank lending to meet their funding needs. And whether as lenders or as investors, these banks have constituted a controlling presence. For instance, through proxy voting, large banks in Germany typically control more than a quarter of the votes of major companies. In Japan, large cross-holdings and bank ownership result in highly concentrated ownership and control. In the rest of the world, ownership is typically heavily concentrated in families, with a few large outside investors and banks.

Where there is more control, there may be less need for legal protections.[4] In continental Europe and Japan, large investors and the banks rely less on legal protections and more on themselves to protect their interests. Large shareholders, even large minority shareholders, have the financial incentive and power to investigate how their investment is being used and to initiate change if their rights are not respected by the firm's management.

In the United States, in contrast, controlling (or concentrated) ownership is not the typical case.[5] Ownership and control of businesses by banks, mutual funds, insurance companies and other institutions are legally restricted. This has led to U.S. business reliance on the public capital markets for liquidity and on the legal system for monitoring corporate governance. The role of the legal system in U.S. corporate governance is one focus of this paper.

Courts in the United States provide more protections to stockholders than courts anywhere else in the world, yet managers and directors are protected from liability based on mere mistakes in judgment and good faith errors. U.S. courts review the actions of directors according to the "business judgment rule," developed by state common law.[6] The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[7]

Generally, directors of U.S. companies owe shareholders the duty of care and the duty of loyalty. The duty of care requires that they act with the care that a reasonably prudent person in a similar position would exercise under similar circumstances, and that they perform their duties in a manner they reasonably believe to be in the best interests of the corporation. The duty of loyalty requires that they refrain from engaging in personal activities that would injure the corporation and its shareholders. This duty requires their undivided unselfish loyalty to the corporation and its shareholders, and prohibits the use of their personal position of trust and confidence to further their own private interests.

Although the affirmative duty of loyalty by managers and directors to shareholders is accepted throughout the member countries of the Organization for Economic and Cooperative Development, enforcement of this duty differs. In particular, U.S. courts are considered very strict in enforcing the duty of loyalty, whereas courts in much of the world outside the Anglo-Saxon countries review only major violations of investors' rights. U.S. courts have actively pursued cases of corporate theft and the diversion (civil and criminal) of assets, dilution of existing shareholder equity, and other forms of managerial self-dealing. They have enforced legal requirements that managers consult their boards of directors, and have upheld the rights of minority shareholders.

As mentioned, U.S. courts have traditionally respected the discretion and judgment of corporate managers and

[4] In the case of controlling ownership by one or several owners, however, the rights of minority shareholders can be overlooked.
[5] But large minority ownership and even controlling ownership do exist to some degree in the United States. Holderness (2003) reports that 20 percent of exchange-traded stock belongs to insiders. Shleifer and Vishny (1997) find several hundred cases of over 51 percent ownership in the United States. *Business Week* (2003a) reports that in 177 of the S&P 500 companies as of July 2003, founders or their descendants continued to hold positions in senior management, on the board, or among the company's largest shareholders.

[6] The business judgment rule applies to both managers and directors, but the paper will address the protections it offers to directors.
[7] *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984), *rev'd on other grounds, Brehm v. Eisner,* 746 A.2d 244 (Del. 2000).

directors in the performance of their duties. As discussed below, however, there is some indication that courts are beginning to reexamine their position and stance toward the business judgment rule.

Finally, it is very important that the United States allows those who feel they have been wronged to bring class-action suits. Most other countries do not permit class-action suits, and prohibit contingent fees. The legal remedy of a class-action suit is powerful, and it permits U.S. investors to sue corporate managers for violation of the duty of loyalty.

Strategies for Ensuring Sound Corporate Governance: A Review of the Literature

Shleifer and Vishny (1997) provide a comprehensive overview of the literature on corporate governance. Their study portrays corporate governance as a solution to a principal-agency problem: corporate governance mechanisms are necessary because conflicts of interest are inherent between principals (owners) and agents (management) when the ownership and control of a firm are separate. Corporate governance mechanisms are the economic and legal means created by the firm to mitigate this inherent problem of ownership-control, or principal-agency. The corporate governance structure therefore provides a framework within which corporate objectives are set and performance is monitored, and it provides assurance to investors that they will receive a return on their investment.

Demski (2003) is concerned with corporate conflicts of interest and examines how the multiple players in a business' governance—auditors, boards, analysts, regulators, management and others—manage these conflicts. He argues that conflicts are widespread, and if not managed properly, can grow into financial fraud. Society tends to rely on a combination of prohibition, disclosure and legal remedies to manage conflicts and to apply specific controls to specific problems; instead, he argues that we need to recognize the existence of multiple conflicts and multiple players, which requires an "enlarged interactive web of controls."

Other corporate governance research focuses more narrowly on specific strategies used by U.S. firms to ensure sound corporate governance. One major area of study is the role of the board of directors in protecting shareholder interests—a responsibility with which boards of directors are specifically charged. Another subject of research is the efficacy of large stockholders (blockholders) in corporate governance. Researchers have also evaluated the effectiveness of tailored executive compensation schemes to align the interests of managers with the interests of owners so that managers act in the owners' interests. The final major area of corporate governance reviewed by researchers is the value of corporate information provided to owners through third parties—independent auditors and investment analysts—or corporate information supplied directly from the firm to its owners so that the owners are in a position to act in their own best interests.

The Role of the Board of Directors

Boards of directors are responsible for overseeing management activities and protecting stockholders' interests. They are not always successful. Several studies examine this issue and conclude that the major problems with unsuccessful boards are the board's dependence on management and the board's own lethargy. Hermalin and Weisbach (2003) survey the research on boards and report a number of conclusions common to these studies. The board's composition (i.e., insider vs. outsider) does not seem to predict corporate performance, while the board's size appears to be negatively related to performance. Boards with more outside directors, and smaller boards, tend to make arguably better decisions about acquisitions, poison pills,[8] executive compensation, and CEO replacement. There are some problems with these studies, however. Hermalin and Weisbach caution that these studies are hard to perform and hard to interpret, for factors beyond the composition of the board affect independence—factors such as the degree of the interlock among directors, the extent to which CEOs participate in the process of nominating and selecting board members, the CEO's voting stake, and the unique unobservable personal dynamics of each individual board. Furthermore, for the most part these studies define an outsider very narrowly as someone who is not a current high-level executive of the firm or a relative.

Adams and Mehran (2003) examine corporate governance in bank holding companies (BHCs). They find that boards of BHCs are typically much larger (1.5 times on average) than boards of manufacturing firms; the percentage of outside directors is higher (however,

[8] "Poison pill" is the term used to describe tactics adopted by a company to make itself unattractive to potential buyers in order to prevent a hostile takeover. Such tactics are often viewed as protecting management at the expense of shareholders.

as in other studies of independence, inside directors are narrowly defined as those working for the firm, and outsiders are defined as "not a top executive, a retired executive, a former executive, a relative of the CEO or chairperson, or an outsider lawyer employed by the firm" during the sample period); BHC boards have more committees; and the boards meet more frequently. Contrary to the studies of nonbanking businesses, the study by Adams and Mehran finds that large BHC boards on average are not value-decreasing. They also find that board composition (insider or outsider) is unrelated to BHC performance.

The Role of Blockholders

Holderness (2003) surveys the empirical literature on large shareholders, focusing on four areas: the prevalence of blockholders; the motivation for blockownership; its effect on executive compensation, leverage, takeovers and other corporate decisions; and its effect on firm value.[9] The survey finds that insiders (officers and directors) on average own approximately 20 percent of exchange-listed corporations, and that this concentration has increased over time. It also finds wide variation in the degree of blockownership among companies. The motivation for blockownership is to increase returns through the shared benefits (with all stockholders) of control or the private benefits (not shared with small stockholders) of control. The survey finds that few major corporate decisions are different because of the presence of large blockholders except that blockholders do appear to monitor executive compensation better. Holderness does not find that ownership concentration affects firm value. One of his major conclusions is that the existence of blockholders is not a problem, especially when blockholders are active in the management of the firm.

Other sources suggest that ownership concentration is a definite advantage. A recent special report by *Business Week* (2003a, p.100) reports that one-third of S&P firms have significant founding-family representation in management (as senior managers, as directors, or as the largest stockholders), and, in "what may be Corporate America's biggest and best-kept secret, [they are] . . . beating the pants off their nonfamily-run rivals." Interesting in this regard are the views of legendary investor Warren Buffett on this subject. In his most recent annual letter to shareholders of Berkshire Hathaway, he equated true board independence with the board's personal financial stake in the company. Each of Berkshire Hathaway's 11 directors holds more than $4 million in Berkshire Hathaway stock.[10]

The Role of Executive Compensation

Executive compensation is a subject of immense and growing public concern. In 1980, executive compensation was 40 times the compensation of the average employee; in 2000, it was 400 times. William McDonough, chairman of the Public Company Accounting Oversight Board, reported in 2003 that executive compensation was the biggest issue that members of Congress heard about from their constituents—bigger than the war in Iraq and bigger than recent job losses. He believed that extraordinary executive compensation had encouraged companies to "cook the books" to maintain their upward earnings trend, and that although initially this fiddling with the books was perhaps unconscious and minor, over time it became necessary and cumulative.[11]

A number of studies on executive compensation focus on the use of stock and stock options as an incentive tool, and find a large increase in the use of stock options for CEO compensation over the last two decades. Core, Guay, and Larcker (2003) synthesize research of the past decade on stock-based compensation and incentives. Their review finds no theoretical or empirical consensus on the effect of stock options and management ownership on the performance of the firm. In fact, they find that research results are often contradictory and raise more questions than answers. The authors conclude that despite considerable prior research, "the performance consequences of equity ownership remain open to question."[12] A key finding of their survey is that simple normative prescriptions concerning equity based incentive plans are inappropriate, and that one must understand the characteristics of each firm, its shareholders, and its management before drawing conclusions. They caution that activist shareholders can cause damage to the firm by pressuring directors to institute inappropriate executive compensation plans based on normative prescriptions.

[9] While blockholders often serve as directors or officers of the corporations in which they own a major stake, this is not always the case. There are three types of blockholders—individuals who are insiders, individuals who are outsiders, and corporations. Holderness suggests that the incentive structure for all three is different and presents an interesting future area of study.

[10] *Washington Post* (2004b).

[11] Speaking at the U.S. Chamber of Commerce Conference on Strengthening Our Capital Markets, November 12, 2003.

[12] Core, Guay and Larcker (2003), pg. 35.

Another major area of research on executive compensation is on the relationship between compensation and earnings manipulation. Lev (2003) reviews the literature on this aspect of executive compensation. He reports that both aggregate data and cross-sectional research confirm increasing divergence between reported and actual earnings during the 1990s. There has been a dramatic increase in the restatement of earnings by public companies in the last several years, and an increased frequency of firms beating their earnings estimates. (Analysts view restatement of earnings and the beating of earnings estimates as suggestive of earnings manipulation.) The review of the literature shows that manipulation is done for a variety of reasons: for personal gain, to maintain investor or supplier support, or to satisfy contractual agreements.

John and Qian (2003) examine the incentive features of top-management compensation in the banking industry. Their study finds that pay-performance sensitivity is lower for bank CEOs than for CEOs of manufacturing firms and that it declines with bank size. Adams and Mehran (2003) find that compared with other industries, BHC CEOs on average have a smaller percentage of their total compensation in stock, their equity holdings are smaller, and institutional ownership of BHC stock is less.

The Role of Auditors

Demski (2003) argues that conflict of interest is inherent in the auditor's role due to management's hiring of auditors; the typical long-term nature of the auditor/client relationship; the provision of nonaudit services by the auditor; and personnel moves from auditing firms to client firms. There is little evidence on how well these conflicts are managed, for the relationships are not readily observable and there have been few Securities and Exchange Commission (SEC) actions or lawsuits. Bazerman, Loewenstein, and Moore (2002) argue that due to the subjective nature of accounting and the close relationship between auditors and clients true auditor independence is impossible. Unconscious bias, rather than criminal intent, is the major problem with bad audits. They argue that true auditor independence will not occur until companies acknowledge the existence of this unconscious bias and deal with it.

The Role of Investment Analysts

Demski's (2003) review of the research on conflict of interest suggests that similar problems exist with the independence of analysts, brokers, and investment bankers. Studies he reviews find that analysts' forecasts are upwardly biased (though still more accurate than simple time series); recommendations are skewed upward to "strong buy" and "buy"; there is censorship; analysts appear to follow firms with which their own firms have underwriting relationships, and these recommendations tend to be favorable. Other studies he reviews show that firms switch underwriters to acquire access to star analysts and that there is conflict of interest in the advancement of analysts.

The Role of Transparent Disclosure

Bushman and Smith (2003) survey the economics-based research on the role of financial accounting in corporate governance and find a positive relationship between the quality of financial accounting information and economic performance. Studies they review suggest that problems occur when owners lack the necessary power or information to monitor and control management and when the interests of owners and management are out of alignment. They find that financial accounting information is one element of a complex information infrastructure that helps the firm identify investment opportunities and reduces information asymmetries between large and small investors.

Recent Reforms and Trends in Corporate Governance

This section examines recent events and trends in corporate governance and finds a growing movement toward greater independence of boards of directors, greater control by shareholders, and greater accountability of boards, as well as increasing concern over excessive executive compensation. The section begins with summaries of several important provisions of the Sarbanes-Oxley Act of 2002 (SOX) as well as summaries of the new corporate governance rules of the New York Stock Exchange (NYSE) and the NASD. Then the section looks at the recent agreement between the SEC and MCI, recent SEC activities regarding shareholder access, recent court decisions in Delaware on the business judgment rule, and recent efforts by different constituencies to restrict excessive executive compensation.

The Sarbanes-Oxley Act of 2002

Congress passed the Sarbanes-Oxley Act of 2002 (SOX) in response to the very visible and widespread corporate governance failures of the past few years.[13] These failures

[13] Pub. L. No. 107–204. For more information on SOX, see Zinski and Pacioni (2003).

resulted from poor corporate behavior characterized by conflicts of interest, self-dealing, deceptive financial reporting, inadequate disclosure, and weak oversight by boards of directors. A major focus of SOX is to prevent conflicts of interest that might jeopardize the firm. SOX is particularly concerned with ensuring the independence of the audit committee, auditors, and securities analysts so that conflicts of interest do not arise.[14] SOX applies to publicly held businesses.[15]

SOX requires that audit committees of corporations that issue securities registered with the SEC (or with the federal financial regulatory agencies) be composed solely of independent board members.[16] "Independent" means the member is not affiliated with the issuer or with any of its subsidiaries *and* is not receiving consulting, advisory, or other compensatory fees from the issuer.[17] The issuer is to disclose annually whether it has at least one "financial expert" (as defined by SEC regulations) on the audit committee, and if not, why not.[18] The audit committee is required to set up a whistleblower mechanism to protect employees who report accounting, internal control, and auditing problems.[19] SOX also prohibits issuers from extending certain credit in the form of personal loans to or for any director or executive officer.[20] This credit restriction provision does not apply to insured depository institutions that are already subject to the insider lending restrictions of the Federal Reserve Act.[21]

To ensure the independence and objectivity of auditors, auditors are forbidden to provide to the issuer, contemporaneously with the audit, any of the nonaudit services listed in the statute or in the SEC's regulations.[22] The issuer's audit committee must give prior approval for any nonaudit services not expressly forbidden by the Public Company Accounting Oversight Board.[23] Rotation of the audit partners is required, subject to exceptions for firm size.[24] And SOX establishes a one-year cooling-off period before a member of the audit team may accept employment in certain positions with an issuer.[25] To further ensure the independence of the auditor, the audit committee—rather than management—is required to preapprove, hire, and oversee the auditor.[26]

To encourage corporate accountability, SOX requires the issuer's principal executive officer(s) and principal financial officer(s) to certify those items specifically listed in the statute, including the accuracy and materiality of the quarterly and annual reports and the adequacy of internal controls.[27] SOX also mandates additional financial disclosures. All material off-balance-sheet transactions, arrangements, obligations, and relationships must be disclosed in each quarterly and annual report, prepared in accordance with generally accepted accounting principles.[28] The issuer must also disclose whether it has adopted a code of ethics for its senior financial officers, and if not, why not.[29]

New Stock Exchange Regulations

The NYSE submitted its amended recommendations to the SEC on June 20, 2003.[30] The SEC accepted these new rules on November 4, 2003. The standards, which go further than SOX, apply to all companies listed on the NYSE.

The NYSE standards require NYSE-listed companies to have boards composed of a majority of independent

[14] This summary of the law is not meant to be exhaustive. It ignores several aspects of the new law, including provisions on SEC funding and responsibilities.

[15] SOX applies only to institutions that issue securities registered with the SEC or with a federal financial regulatory agency—in other words, publicly held businesses. In regard to financial institutions, there are approximately 700 bank and thrift holding companies registered with the SEC, and approximately 200 banks and thrifts registered with the banking agencies. Additionally, nonpublic banking institutions with more than $500 million in assets are required to comply with the SEC's definition of auditor independence. There are approximately 1,100 banking organizations with more than $500 million in assets. (Many of these are publicly held and are therefore included in the previous figures.)

[16] § 301.

[17] Ibid.

[18] § 407.

[19] § 301.

[20] § 402.

[21] Regulation O, which implements sections 22(g) and 22(h) of the Federal Reserve Act, already restricts loans from banks to their executive officers, directors, and principal shareholders.

[22] § 201.

[23] § 202.

[24] § 203.

[25] § 206.

[26] §§ 202, 204.

[27] § 302.

[28] § 401.

[29] § 406.

[30] The NYSE is the private nonprofit regulator (commonly referred to as an SRO, or self-regulatory organization) for the firms whose securities are listed with it (approximately 2,800 such firms at year-end 2002). The member firms constitute a cross-section of large, midsize, and small-cap U.S. companies and include approximately 470 non-U.S. companies. Although a nonprofit itself, the NYSE is owned by its 1,366 for-profit members, which include traders on the floor as well as large Wall Street brokerage firms, all of whose interests it represents.

directors; and the boards' audit, compensation, and nominating committees are required to be composed solely of independent directors. (These independence requirements are waived for controlled companies—companies in which more than 50 percent of the voting power is held by an individual, a group, or another company. Only the audit committees of controlled companies are required to be wholly independent.)

The criteria for independence are stricter under the NYSE standards than under SOX. Former employees of the company or of the independent auditor of the company, and their family members, are not considered independent until five years after their employment ends. Furthermore, for a director to be deemed independent, the board must affirmatively determine that the director has no material relationship with the listed company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company. Companies must disclose these determinations.

Sitting on a client's or customer's board is discouraged, although not prohibited. The standards state that there is a potential conflict of interest in sitting on a customer's board, particularly if the customer's business is responsible for a significant portion of the income of the director's firm ("significant portion" is defined as the higher of 2 percent of revenues or $1 million). The NYSE standards also require that

- Nonmanagement directors meet regularly without management;
- Directors' fees be the sole compensation for audit committee members;
- The audit committee have sole authority to hire and fire independent auditors and to approve any significant nonaudit relationship with the auditors;
- Shareholders vote on equity compensation plans, including stock option plans (with some exceptions in routine matters);
- Listed companies adopt and disclose corporate governance guidelines and a code of ethics; and
- CEOs certify to the NYSE each year that they are not aware of any violation of NYSE corporate governance standards.

The NASD fashioned similarly focused corporate governance standards, which were also approved by the SEC on November 4, 2003.[31] The NASD, too, is concerned with ensuring the independence of the board, the independence of and a heightened role for the audit committee, and a stronger role for independent directors on compensation and nomination committees. Like the NYSE standards, those of the NASD require listed members to have a majority of independent directors, a code of conduct for all directors and employees, and the approval of stockholders for the adoption of all stock option plans and of any material modification of such plans. Independence is defined in terms of a three-year period rather than the five-year period of the NYSE. As with the NYSE standards, audit committee members may receive no compensation other than their board compensation. Other board members may receive additional compensation of not more than $60,000.

Agreement between the SEC and WorldCom (now MCI)

The August 26, 2003, settlement between the SEC and MCI is a potentially significant development. In particular, the provisions governing board independence and shareholder control have been described as groundbreaking, and the agreement as a whole has been touted as a possible model for evolving U.S. corporate governance standards.[32] Negotiated by former SEC chairman Richard Breeden, MCI agreed to 78 separate corporate governance reforms.

The agreement requires that MCI's board be wholly independent; most particularly, it calls for an independent chairman. It also prohibits the CEO from sitting on other boards. It calls for an increase in board qualifications and commensurate pay; MCI board members will be paid $150,000, rather than the $35,000 that WorldCom paid its directors. The agreement places constraints on both the board and

[31] The NASD is the private nonprofit regulator for the securities industry and virtually all U.S. stockbrokers and brokerage firms. It oversees approximately 5,500 securities firms and more than 650,000 registered securities professionals. It also oversees and regulates all trading on the NASDAQ stock market (which it sold in 2000) and on the over-the-counter market, as well as transactions in securities listed on the NYSE and the American Stock Exchange that are executed and reported to NASDAQ by NASD member firms. It regulates members' market-making activities and trading practices; their municipal securities activities; their underwriting arrangements in connection with the public distribution of securities; and mutual funds. And it monitors all securities firms' advertising.

[32] *The Economist* (2003).

management: it requires an explicit dividend policy (suggesting 25 percent of net profits, to ensure that reported profits are real) and limits the board on how much it may pay the chief executive. Shareholder approval is required to change these conditions.

Recent SEC Actions regarding Shareholder Access

On July 15, 2003, the SEC, against significant opposition, proposed amendments to its proxy rules, which if enacted would make it easier and less expensive for dissident shareholders to be heard. The proposed amendments, known as "shareholder access," contain several triggers that, if reached, would permit dissident shareholders to propose nominees for directors on the company's own proxy. This proposed rule is highly controversial, with consumer groups generally favoring it and groups representing businesses generally opposing it. James Heard, CEO of Institutional Shareholder Services, is encouraged that institutional investors are beginning to assert themselves but believes that the trigger thresholds are hard to achieve.[33] Martin Lipton, a frequent spokesman on corporate governance, believes that the triggers are very easy to attain and will result in the balkanization of boards.[34]

The SEC also recently adopted a rule requiring companies to disclose how they select directors and how shareholders can participate in this process. This rule, the recently adopted NYSE and NASD rules removing the CEO from the formal nomination process, and the proposed shareholder access rule are all important indications of the movement in corporate governance toward greater board independence and greater shareholder control.

Recent Judicial Actions

Courts in the United States have traditionally been reluctant to question management decisions in the absence of evidence showing a lack of good faith. There is some indication, however, that courts may be willing to reexamine the question of whether they have become too lax in applying the business judgment rule.[35] In particular, two recent cases decided in Delaware seem to suggest this willingness to reexamine.

In the *Walt Disney Company Derivative Litigation*, Walt Disney shareholders alleged that the CEO had hired a friend as president without a final employment agreement reviewed by the board and with minimal board input; that the CEO had given the president an accelerated nonfault termination without board approval after he had served less than one year with questionable performance; and that demanding that the board remedy the situation before filing the litigation would be futile.

The Delaware Supreme Court found that shareholders had raised sufficient doubt about whether the employment contract should be protected under the business judgment rule, and the court sent the case forward to trial.[36] The court ruled that if board members had reviewed and approved the employment agreement, the business judgment rule might have protected them.[37] However, the board had refused to evaluate the agreement, "blindly allowing" the CEO to pursue the interests of a friend. "Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not . . . advance the best interests of the company."[38]

Subsequent to the *Disney* case, shareholders in another case asked the Delaware courts to address compensation paid to the president and CEO of Martha Stewart Living Omnimedia. In this case,[39] the court ruled that the shareholders had not pleaded their case with sufficient particularity to continue the litigation. Although the court did not break any new ground, it expressed its concern generally that litigants' ineptitude (and implicitly not the legal standards) had prevented judicial review and allowed directors to escape justice.

These recent cases suggest that Delaware courts are willing to examine corporate decisions, but shareholders must make a case that the board has violated its duties of loyalty and care and is not entitled to the protection of the business judgment rule. With more than half of all corporations in the United States incorporated in Delaware and subject to its law, Delaware is a leading jurisdiction in the development of corporate gover-

[33] Speaking at the U.S. Chamber of Commerce Conference on Strengthening Our Capital Markets, November 12, 2003.
[34] Ibid.
[35] Hamilton (2003) concludes that the recent spate of corporate governance scandals raises "the legitimate question whether the fundamental assumption that shareholder primacy exists in modern publicly held corporations should be routinely accepted."

[36] The court ruled that the case was de novo and plenary (in other words, the court would look at the case afresh, as if it had not been heard before, rather than deferring to the trial court's findings and conclusions, as case precedent required).
[37] *Walt Disney Company Derivative Litigation,* 825 A.2d 275 (Del. Ch. 2003).
[38] *Id.* at 289.
[39] *Martha Stewart Living Omnimedia Derivative Litigation,* 833 A.2d 961 (Del. Ch. 2003).

nance law. As such, the rulings by its courts may signal that broader changes are forthcoming. At a minimum, the *Disney* court's expansion of the standard of review should mean that more derivative actions go to trial, thereby creating opportunities to change corporate governance law.

This changing legal environment has brought an element of uncertainty to boards regarding current and future accountability standards. This changed environment also has time and cost implications. Thirty-seven percent of public-company directors reported spending more than 150 hours on board work in 2003, up from 26 percent the previous year.[40] And, IAG/National Fire Insurance, a provider of directors and officers insurance (d&o), reports that class-action lawsuits against directors and officers of corporations increased 137 percent from 1997 to 2003, necessitating large increases in the price, and limitations in coverage, of d&o insurance.[41]

Executive Compensation Activities

The manner and amount of executive compensation is a growing public concern—as the two aforementioned Delaware cases suggest. The public has expressed dismay at what it considers the outrageous executive salaries of the CEOs of Tyco, the New York Stock Exchange, and other companies. The Corporate Library, an independent research organization concerned with issues of corporate governance, cites CEO compensation as one of the most important indications of board effectiveness and is urging boards to better align management compensation with shareholder returns. Berkshire Hathaway chairman Warren Buffett has publicly asked boards to rethink their compensation policies, concerned that confidence in U.S. business will not be restored until executive compensation is controlled. And, as mentioned above, members of Congress reported that excessive executive compensation was the major subject raised by their constituents in 2003.

Some labor unions and large stockholders have become very active in maintaining public interest in this issue. For instance, the AFL-CIO has created a website that provides the amount of compensation to senior executives, which can be accessed by company name, industry or total compensation level. The California Public Employees' Retirement System (CALPERS), the nation's largest public pension fund, has developed a list of companies in its portfolio with the worst executive compensation packages. CALPERS' goal, like the Corporate Library's, is to better align the interests of management with shareholders.[42]

Of particular significance, a coalition of labor unions was successful in getting a resolution included on the proxies of 40 large companies this year—a resolution that, if adopted, would limit CEO pay to $1 million in salary, $1 million in bonuses, and $1 million in stock and stock options. Attempts by targeted companies to keep the resolution off their proxies were disallowed by the SEC.[43]

Some boards have also shown increased sensitivity to the executive compensation issue. The *New York Times* reports that the CEO of MBNA recently resigned because of irresolvable conflicts with his board over his compensation.[44] The CEO earned more than $50 million a year over the past two years, an amount that made him one of the most highly paid executives in the United States. That fact reportedly discomfited his board.

In March 2004, the Financial Accounting Standards Board (FASB) proposed the mandatory expensing of employee-stock option compensation beginning the first quarter of 2005. The expensing of stock options—which are a major source of senior executive compensation in the technology industry, investment banking industry and others—has been a very contentious issue over the years. Although FASB recently voted to delay the deadline for this change by six months, this action represents a significant development in executive compensation.

Despite the furor over executive compensation, two years (2001 and 2002) of overall decreases in management compensation levels were followed by a year in which total executive compensation rose to record levels. Much of the lower executive compensation reported in 2001 and 2002 reflected the fact that executive stock options lost value in a depressed stock market. With a revived market in 2003, options again regained value, and executive compensation rose

[40] *Washington Post* (2004a).

[41] John Keogh, president and CEO of AIG speaking at the U.S. Chamber of Commerce Conference on Strengthening our Capital Market, November 12, 2003.

[42] Dow Jones Newswires (2004).

[43] *Washington Post* (2004c).

[44] *New York Times* (2004).

overall. Increased corporate earnings in 2003 also explain higher 2003 executive compensation.

Issues of Governance for Banks

Banks are different from other types of businesses due to their public purpose. They are therefore subject to corporate governance rules, regulations, and policies issued by the bank regulatory agencies and subject to regular supervisory review of their corporate governance practices and procedures. In fact, many of the SOX provisions are derived from similar standards for bank corporate governance that were enacted in the 1980s and early 1990s in response to bank insider abuses. Nevertheless, the current climate for corporate governance will affect banks.

Differences between Banks and Other Businesses

There are more stakeholders in the governance of banks than other businesses due to the banks' liquidity function and role in promoting the health and stability of the economy.[45] Accordingly, a loss of confidence in banks has the potential to create severe economic dysfunction, adversely affecting the general welfare. A systemic banking crisis caused by bank malfeasance (or the appearance of it) has the potential to shift bank losses to the deposit insurance funds or to the taxpayer.

The banks' corporate governance focus is also different due to the source of their financing. Banks typically receive approximately 90 percent of their financing through debt, which tends to be in the form of deposits from multiple unsophisticated depositors rather than from the more typically sophisticated debtholders of nonfinancial businesses. Banks are also different due to deposit insurance, which largely removes the incentive for depositors (the debtholders of the bank) to monitor the bank's activities—and which can also lead to risky behavior on the part of bank management, for losses from bank failures flow through to the deposit insurance fund.[46]

For all these reasons, banks are subject to regulatory oversight and bank directors are held to the highest fiduciary standards. They are responsible not only to the stockholders who elected them "but [also for] the safety of depositors' funds and the pervasive influence the bank exercises on the community it serves."[47] The public accountability implicit in the bank director's role distinguishes this position from directorships in most other corporate enterprises.

Current Standards for Bank Governance

In the late 1980s and early 1990s, irresponsible and, in some cases, criminal behavior of a number of banks and savings and loans produced significant losses to the deposit insurance funds. Insider abuse was a particular problem. A study by the Office of the Comptroller of the Currency (OCC) (1988) found that insider abuse contributed to approximately one-third of national bank failures between 1979 and 1987. A U.S. General Accounting Office study (1989) of this same period showed insider abuse present in over 50 percent of the banks that failed.

In response to these problems of corporate governance, Congress enacted standards for heightened oversight of and compliance by the industry. In particular, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) enhanced enforcement and regulatory oversight.[48] These laws, as well as state laws regarding management responsibility, were used by regulators to improve financial industry governance in general and to ensure independent audits, minimize conflicts of interest, and enforce fiduciary responsibilities for boards and management in particular.

FIRREA significantly expanded the enforcement authority of banking regulators. It gave the FDIC the authority to suspend temporarily the deposit insurance of a bank that had no tangible capital, and it extended the cease-and-desist (C&D) authority of regulators to cover specific bank activities. Temporary C&Ds could be issued to restrict an insured bank's growth; they could also be issued if regulators concluded that an activity would result in significant damage to bank assets or earnings, or if bank records were too incomplete for regulators to determine the bank's financial condition. FIRREA also greatly increased the civil money penalties that could be imposed on federally insured banks, and it required banks that could not meet capital adequacy requirements to obtain FDIC approval before accepting brokered deposits.

[45] This argument is developed fully in Macey and O'Hara (2003).
[46] See Hanc (1999) for a discussion of deposit insurance and moral hazard.
[47] FDIC (2002), Section 4.4-1 (Management/Administration), Subsection II (Directors).
[48] FDIC (1997), 101–3.

FDICIA was above all a supervisory law, enacted in response to the belief that regulators had not acted quickly enough during the savings and loan crisis. This statute initiated the system of "prompt corrective action," which required regulators to institute increasingly severe actions—ranging from restricting certain activities to closing institutions—on the basis of an insured institution's capital adequacy. As implemented through Part 364 of FDIC regulations, FDICIA also prohibited, as an unsafe and unsound practice, the payment of excessive compensation as well as compensation that could lead to material financial loss to an institution.

In addition, FDICIA amended the Federal Deposit Insurance Act (FDI Act) to require increased reporting by larger banks. As implemented by Part 363, banks with more than $500 million in assets were required to have annual audits by licensed and registered auditors in good standing who met the independence requirements of the SEC.[49] They are required to submit annual reports that contain a statement of management's responsibility for preparing financial statements, for establishing and maintaining an internal control structure and procedures for financial reporting, and for complying with laws and regulations related to insiders and dividend restrictions. The report also must contain an evaluation of the effectiveness of the internal control structure. For banks of this size, FDIC regulations now require that audit committees be composed entirely of independent directors and that the bank's public accountants meet with the audit committee.

For banks with more than $3 billion in assets, the audit committee must also include at least two directors with banking and related financial expertise and must not include any large customers of the bank.

Institutions with less than $500 million in assets are not subject to Part 363 but are nonetheless encouraged to comply with its provisions. If such an institution's securities are registered with the SEC or with one of the federal banking agencies, the institution is subject to SOX.

[49] From time to time, the FDIC may amend Part 363 to improve the regulation of auditor independence. Any amendments to Part 363 would be developed in consultation with the other federal banking agencies and would generally be published in proposed form for public comment in the *Federal Register.*

Issues Arising from New Initiatives in Governance

As mentioned above, banks and bank holding companies are already accustomed to corporate governance regulation, examination, and enforcement and are therefore in a better position than nonbanks to adjust to the new initiatives that have been instituted. That is not to say that compliance is free of problems.

The SEC reported in early 2003 that approximately a dozen community banks had filed notice of their intention to withdraw the registration of their securities. The main reason given for delisting was the additional cost of registration resulting from the bookkeeping and accounting mandates of SOX.[50] Smaller, less actively traded institutions are balancing the benefits and costs of having publicly traded securities, and some have decided that the benefits do not outweigh the costs.

Some banks have also expressed difficulty in meeting SOX's new definition of independence for audit committee members. Recent corporate governance events presage an even greater move toward board independence as well as a stricter definition of what constitutes it. Many banks may experience some difficulty, at least initially, in complying with these evolving standards. In particular, interlocking directorships may become an issue.

Banking rules and regulations permit interlocking directorships between a bank and its major customers; in fact, interlocking directorships were encouraged by the National Bank Act, which required directors to reside within a 100-mile radius of the bank or within its home state. Directors are also permitted to serve both on the board of the holding company and on the board of its bank. For the most part, the FDIC has not found these interlocking directorships a serious governance problem. When interlocking directorships threaten to compromise or have compromised the safety and soundness of the institution, the FDIC has used its regulatory authority to protect depositors and the deposit insurance funds.[51] Nonetheless, breach of duty by officers and directors—across the corporate spectrum—and issues of board independence are attracting the attention of public interest groups, Congress, and the press. As a recent example, the board of J. P. Morgan Chase was included on the Corporate Library's top ten list of worst boards in

[50] *American Banker* (2003c).
[51] FDIC (2003).

2003 primarily because of the board's large number of interlocking board members.[52] Although regulators have not identified board interlocks as an issue, banks should be aware that the public's views on this issue are evolving and that the status quo could change. This paper contends that banks would be well advised to plan for more change in the standards of board independence.

As also discussed above, the excessive compensation of employees of publicly held companies is an issue of increasing power. FDICIA prohibits excessive employee compensation, which it defines as "amounts [that] are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder."[53] Regulatory standards on executive compensation, however, leave significant discretion to boards (and shareholders) to determine appropriate executive compensation. Publicly held banks are advised to be sensitive to this issue and to recognize that federal regulators are not their only audience. New NYSE and NASD rules on the independence of compensation committee members, a new activism by stockholders, a generally more favorable environment for dissatisfied stockholders, and the public embarrassment of many boards over recent executive compensation decisions have worked to change the environment for this issue.

As mentioned, FASB has announced plans to require companies to treat employee stock-option compensation as an expense against earnings beginning the third quarter of 2005. While this represents significant change for many industries, banks should be relatively less affected by the expensing of options as stock options do not represent a significant portion of compensation for bank executives—even at very large banks—relative to executives of other companies.[54]

Banks are among the many businesses that have also complained of difficulty in recruiting directors. Increased board time commitments, increased issues of liability, increased emphasis on financial expertise, and the movement toward independent boards are likely to exacerbate this problem. In addition, many companies have begun to restrict their CEOs to a maximum of two or three outside boards because of the increased time demanded for board service.

As mentioned above, a strategy that Richard Breeden at MCI used to recruit board members in this challenging environment was to raise board salaries—from the $35,000 that WorldCom had paid its directors to $150,000 to new MCI directors. There are other strategies. As noted by Spencer Stuart, a major recruiting agency for board members and executives, a large untapped pool of potential directors continues to exist. Board recruiters see not a shortage of capable directors, but a mismatch between the types of individuals currently available for board service and the types of directors businesses are still seeking.[55] Board duties still represent status, are intellectually challenging, and provide good opportunities for networking, but the CEOs that companies used to look to for board service are no longer available. The recruiters suggest that companies look to a different type of board member. They advise them to focus on both younger and older members—for example, on more division directors and fewer sitting CEOs, and on more retired persons, who have the time and expertise to put into board service. They suggest that women are another large untapped potential board resource.[56]

In this demanding and changing corporate governance environment, banks, like other businesses, will need to broaden their horizons to find knowledgeable, independent, and committed directors.

Summary and Conclusions

The paper finds that the environment for corporate governance remains fluid, as standards and norms continue to evolve. It would appear, however, that public and private views on corporate governance have changed dramatically. Specifically, the paper finds evidence of a growing movement in corporate gover-

[52] The Corporate Library (2004).
[53] FDIC (2002).
[54] According to a study by Merrill Lynch (as reported in the *American Banker (2004),* the expensing of options should result in a 3 percent reduction in earnings for the typical large bank, compared with an average 7 percent reduction for companies in the S&P 500. The study expects only one large bank, Northern Trust Corp., would be more affected than the average S&P business, with an estimated 10 percent reduction in earnings.

[55] Julie Daum, North American leader of Spencer Stuart, Inc. speaking at the U. S. Chamber of Commerce Conference on Strengthening Our Capital Markets, November 12, 2003.
[56] *Business Week* (2003b) reports that in 2003 women represented only 14 percent of S&P 500 board members, but the new emphasis on board financial expertise makes women executives more attractive as board members, for they are much more represented in CFO ranks than in CEO ranks. In 2003 over 7 percent of CFOs at S&P 500 companies were women, as opposed to less than 2 percent of CEOs.

nance toward greater board independence, greater shareholder control, and greater board accountability, along with increasing attention to excessive executive compensation and other corporate behaviors viewed as nonresponsive to shareholder concerns.

One must not be naïve, however. Corporate governance reforms have often followed in the wake of corporate scandal. This said, the enactment of SOX, the exchange reforms, recent SEC activities, recent court decisions, and new shareholder activism suggest that changes in standards and norms for corporate governance in the United States are not a passing phenomenon.

Specifically, the Sarbanes-Oxley legislation represents real change. This is the first federal statute ever enacted on the corporate governance of nonregulated businesses[57]—an area traditionally reserved to state law. The new NYSE and NASD rules on board independence and the agreement between MCI and the SEC on board independence and shareholder control also represent significant changes in the way things are done. And the SEC proposal to permit dissident directors on company proxies, if adopted, would promote board independence and cede more control to shareholders.

Recent Delaware court decisions, especially the decision in *The Walt Disney Co. Derivative Litigation,* are significant for suggesting that the courts may be more willing than in years past to review shareholder allegations of breach of fiduciary duty. They may portend a more rigorous review by the courts of the business judgment rule as a protection for boards from shareholder suits. Because Delaware is home to more than half of all U.S. corporations, it is a very important jurisdiction for developments in corporate law, and one that has generally been considered friendly to business.

Finally, recent successful efforts by different constituencies to curtail excessive employee compensation suggest that this matter remains an issue of abiding and growing concern.

What is the likely effect on banks of these reforms? Although for most businesses the Sarbanes-Oxley legislation represents significant change, the act should have little effect on most banks that are subject to it because of the strong standards of governance that were adopted by banks in the 1980s and early 1990s, and even earlier.[58] Many of the provisions of SOX, in fact, are derived from bank governance standards. This is not to say that there is no room for improvement in bank governance, nor that banking organizations are not experiencing and will not experience problems in adjusting.

The paper concludes that meeting the evolving norms of board independence is likely to pose more of a challenge to the banks. In particular, interlocking directorships may become a major problem for the banks in the future. Publicly held banks, like other businesses, must also be prepared for changes in standards of board accountability and for increased involvement of shareholders.

Another issue with which some bank boards will have to contend—perhaps the driving focus in corporate governance for publicly held businesses today—is excessive executive compensation. Major constituencies, including labor unions and pension funds, and boards of some of the highest-paid public businesses, including banks, are currently examining this issue. The use of stock options to motivate executives is an area of particular public interest. Although banks, even large ones, for the most part make less use of stock options in compensating their executives than other businesses do, public focus on executive compensation—in all its forms—is likely to continue.

Because of their important role in society, banks need to be especially careful about their governance so as to maintain public confidence. The paper concludes that the most effective way to avoid corporate governance problems is to select a knowledgeable, engaged, and independent board of directors. But like other businesses, banks may have difficulty recruiting board members in the current environment. The increased commitment of time required of board members, increased issues of liability, an emphasis on financial expertise, and the trend toward more independent boards are likely to exacerbate this problem. The paper suggests that banks—and other businesses—may need to expand their vision of what constitutes a qualified board member in this demanding and changing environment for corporate governance.

[57] FIRREA and FDICIA are, of course, federal statutes concerned with the governance of regulated financial institutions.

[58] Publicly-held banks under $500 million in assets are the major exception.

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