CORPORATE GOVERNANCE AND THE SURROGATES OF MANAGERIAL PERFORMANCE

RAZEEN SAPPIDEEN*

This paper examines the theorised approaches to the corporate governance of listed companies in the US-UK-Australian jurisdictions, and the surrogates of corporate governance that have emerged as a consequence. It looks at the ascendancy of finance over accounting data as the driving force in corporate governance, and in this context the symbiotic nature of the relationship between takeovers, executive compensation, share price, and corporate governance. While differences in the system of corporate governance in these three jurisdictions exist at the operational level, the structural similarities of the governance system in these jurisdictions make such differences as may exist in relation to the former to be of little relevance. To further illustrate the point of convergence in these three jurisdictions, and at the same time stress their divergence in relation to some other highly developed economies, the study also makes incidental comparisons with the Japanese and German experiences where necessary. Moreover, while the paper does not claim that the changes in the US-UK-Australian governance are a simultaneously occurring event, it does claim that the trends set by the shifts in paradigm in US corporate governance flow through readily into the Australian and UK corporate governance systems by reason of their being stock market capital based finance systems as against the bank capital based finance systems of Germany and Japan.

The discussion in the paper is structured as follows: Part I discusses the theorised approaches to corporate governance in the US-UK-Australian tradition; Part II examines the emergence of the new market driven surrogates of corporate governance since Berle and Means' *The Modern Corporation and Private Property*[1]; and Part III concludes. The paper highlights how the hierarchy of corporate governance has been inverted: from the board dictating the agenda and direction of the corporation, to share price driving the actions of managers (CEO and team) and the board, and consequently how integrated and sensitive listed corporations and their managers are to market demands and responses. It argues that this shift in paradigm requires a reorientating of the study of corporate governance: from its present preoccupation with finding ways and means of

* Foundation Professor of Law, University of Western Sydney School of Law.

1 Adolf A Berle Jr and Gardiner C Means, *The Modern Corporation and Private Property* (Harcourt, Brace and World, 1932).

making managers more accountable to corporate boards, to ensuring managerial accountability in a context where share price dominates the focus of interest of the board, managers, and shareholders.

I APPROACHES TO CORPORATE GOVERNANCE

Corporate governance is about the process of ensuring that corporate managers fulfil their expectations as envisaged under their employment contracts and in accordance with the tenets of the relevant nation's corporations law.[2] Just to whom these obligations are owed and how these obligations are to be fulfilled depends on two matters: whether the economic measuring rod is efficiency (return on investment) or power (market share),[3] and the legal and societal framework of reference of the particular jurisdiction. Jurisdictions such as the US, UK and Australia emphasise a limited tripartite form of relationship between the board as representing the corporation, managers, and shareholders, with wealth maximisation as the objective. In these jurisdictions, finance has, in the name of shareholder welfare, become the driving force of corporate performance and accountability. In countries such as Japan and Germany on the other hand, a much more inclusive stakeholder form of relationship between the board, managers, capital providers (shareholders and creditors), employees, and even of

2 See, eg, the following definitions of corporate governance: 'the system by which companies are directed and controlled': Committee on the Financial Aspects of Corporate Governance, United Kingdom, *Financial Aspects of Corporate Governance* (1992) 15 ('Cadbury Report'); also adopted in Derek Higgs, Department for Business, Enterprise and Regulatory Reform (UK), *Review of the Role and Effectiveness of Non-executive Directors* (2003) ('Higgs Review'); and the Organisation for Economic Co-operation and Development ('OECD'), which defines corporate governance as 'the system by which business corporations are directed and controlled': OECD, *Corporate Governance* (13 July 2005) <http://stats.oecd.org/glossary/detail.asp?ID=6778>.

3 In other words, corporate efficiency is balance sheet driven and is concerned with the profitability of the firm; corporate power is market share and size-of-firm driven, and not necessarily balance sheet driven: see Julie A Caswell and Ronald W Cotterill, 'Two New Theoretical Approaches to Measuring Industry and Firm Performance' (1988) 4 *Agribusiness* 511.

the community seems to exist in varying degrees.[4] Nevertheless, it can be said that in all of these jurisdictions, boards have both compliance and strategic functions to perform. The compliance function, based on law, seeks to prevent fraud and self-dealing, prevent insider trading and market manipulation of financial information and trading in the company's shares, with prescribed disclosure of price sensitive information intended to monitor and provide a level playing field for investors. The strategic aspect is, of course, concerned with responding to competition in the goods and services markets, as well as protecting the corporation from unwelcome raiders.

In the US-UK-Australian tradition, the relationship between the board as the corporation and managers is contractual, with the corporations law merely ensuring that these contractual obligations assumed by managers are discharged in good faith, with loyalty, and without conflict of interest. Stated differently, the contractual obligation between managers and the corporation assumes a fiduciary tone by reason of the corporations law in its common law and equity setting. Equally, corporations are required to be ethical and socially responsible for their

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4 In the framework of analysis of finance theory, there are two systems of corporate governance: a bank finance based insider system as practised in Japan and Germany, and a stock market based outsider system as practised in the US, UK, and Australia. Underlying the outsider model is the separation thesis: in Adolf A Berle and Gardiner C Means, above n 1; and shareholder welfare, whereas associated with the insider model are broader stakeholder concerns which include shareholders, creditors, and employees. Under the outsider model, shareholders nominally appoint managers, with managerial accountability thereafter being limited to the shareholder meeting and the marketplace, namely, the market for corporate control and share price. Neither employees nor creditors have a say in the affairs of a going concern corporation where managers, provided they observe the requirements of due diligence, can hide behind the business judgment rule. Given this, the outsider model is considered as being riddled with the agency problem between managers, shareholders, creditors, and employees, though adversity might bring about shifting coalitions: see John C Coffee, 'Unstable Coalitions: Corporate Governance as a Multi-Player Game' (1990) 78 *Georgetown Law Journal* 1495, 1495, which points out to the unstable coalitions that circumstances force on the members of these groups. By contrast, under the insider model, employees (whether as members of the Supervisory Board under the two-tier German Board model, or through Worker Councils under the single-tier Japanese model), and banks (as both shareholders and financiers of the corporation – in Germany the Hausbank, and in Japan the Main Bank) have a much closer unity of purpose with that of the corporation, and consequently, reduced concern about the agency problem. The point here is that management under the outsider model has much greater freedom of action with respect to the investment, financing, and dividend decision of the corporation, including the acquisition of other corporations, and with it the displacement of employees and managers. By contrast, such adventures are less likely events under the insider model, as corporations under this model are believed to commit their free cash flow to diversify their operations, and to invest in research and development. In the event that such a corporation is faced with a hostile bid, the close-knit relationship between managers, employees, and banks (in their capacity as both lender and shareholder) in the target, will act as an impediment to the raiders' ability to acquire a controlling shareholder interest. More importantly, given the close knit relationships between banks and businesses, bank based corporations reputedly are able to access funds at lower cost than corporations that do not have such a relationship. Another way of looking at this state of affairs is that, eg, US-UK-Australian *investors* are far less committed to their corporations than are the bank *shareholders* in Germany and Japan. In the former, even institutional *investors* show a preference for exit over loyalty when faced with a badly managed company. In other words, in an outsider financing model society such as the US, there is no natural coalition of interests between managers, shareholders, creditors, and employees, though it is possible that exigencies may draw some members of the group together into temporary coalitions. These differences in approaches to corporate governance are of course the result of their different historical trajectories.

actions. The task of ensuring that managerial behaviour is in keeping within the norms of the contractual, the fiduciary, and the ethical is the problem of corporate governance. The tools relied on to achieve these objectives are the traditional mechanisms of responsibility (under the contractual agreement and the corporations law), accountability (of managers for performance and compliance of the corporation's and individual manager's obligations under the corporations law), and transparency of the decision-making process (through a system of prescribed disclosure). The usefulness and effectiveness of these mechanisms in achieving their desired objectives have been subject to constant challenge. In the UK, for example, following the Cadbury Committee reform proposals (and those of successor Committees),[5] these primary level coordinates have been reinforced by four sub-committees of the board of directors, namely: the Appointments (board appointments), Audit (assisting in the carrying out of the firm's audit by the external auditors), Risk Management (such as hedging and swap transactions in relation to interest and currency exposures), and the Remuneration (on executive compensation) committees. Such committees have also been recommended for adoption in Australia by the ASX Listing Rules.[6]

The last four decades, however, has seen the emergence of the takeovers market, executive compensation strategies, and share price as substantial forces in their own right and as surrogates of corporate performance in the US, UK, and Australia. These new surrogates complement, compete, and continue to exist alongside the old disciplinary forms of competition in the goods and services markets. By contrast in Germany and Japan, the takeovers market, share price,

5 See, eg, Cadbury Report, above n 2 (comply or explain requirement directed to listed companies); Confederation of Business and Industry (UK) *Study Group on Directors' Remuneration: Final Report* (1995) ('Greenbury Report') (remuneration code directed primarily at managers of government privatised entities); Financial Reporting Council (UK), *Committee on Corporate Governance: Financial Report* (1998) ('Hampel Report') (more meaningful disclosure than box ticking); Financial Reporting Council, United Kingdom, *Internal Control: Guidance for Directors on the Combined Code* (1999) ('Turnbull Report') (Combined Code guidance on internal controls); Paul Myners (UK), *Institutional Investment in the UK: A Review* (2000) ('Myners Report') (on the need for activism by institutional shareholders); Higgs Report, above n 1 (on the role of non executive director activism); Financial Reporting Council, United Kingdom, *Guidance on Audit Committees* (2003) ('Smith Report') (on the role of audit committee and other committees); Financial Reporting Council (UK), *Internal Control: Revised Guidance for Directors on the Combined Code* (2005) ('Revised Turnbull Report') (revised Combined Codes). The most talked about legislative change in the area of corporate governance in the US has been the *Sarbanes-Oxley Act of 2002,* Pub L No 107-204, § 201, 116 Stat 745 (2002); in the EU, High Level Group of Company Law Experts, European Commission, *Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (2002) ('Winter Report') and its action plan for the modernisation of company law and corporate governance in the EU: European Commission, *Modernisation of Company Law and Enhancement of Corporate Governance* (5 April 2011) <http://ec.europa.eu/internal_market/company/modern/index_en.htm>; and in Australia, the continuing revisions under the Corporate Law Economic Reform Program ('CLERP') which has released reports since 1997, and the Corporations and Markets Advisory Committee ('CAMAC') which has released reports since 1991.

6 See ASX Corporate Governance Council, *Revised Corporate Governance Principles and Recommendations: Guidance Note 9A* (2007) 51–5: '2.4 The board should establish a nomination Committee. ... 4.2 ... an audit committee. ... 9.2 ... a remuneration committee' ... 7.1 The board or appropriate board committee should establish policies on risk oversight and management.'

and executive compensation strategies are not regarded as alternative disciplinary forces in their own right. Profitability of the entities measured by competition in the product and services market, as well as market share, alongside monitoring by bank lenders remain the yardstick of measurement. In this sense, the German and Japanese corporate governance scenes are yet to be exposed to the vagaries of the capital markets and its consequences. The impact of these surrogates on corporate governance, especially their influence on who determines and how the corporate agenda is driven, is discussed in Part II of this paper. The remainder of the discussion in this Part of the paper sets the contextual background to these changes and the role played by finance theory in this regard.

A Narratives of the US-UK-Australian Governance Model

There are four narratives of the US model of corporate governance, which have reverberated into the UK and Australian models. The first is the separation thesis of Berle and Means, which takes the form of an intra-firm narrative, and implicit in which is the need to devise strategies to ensure the accountability of corporate managers to the shareholder body.[7] The second is the market for corporate control thesis of Manne. It is an inter-firm narrative that emphasises the disciplinary force of the mergers and acquisitions market in keeping errant managers in check. It argues that efficiently run entities will take over inefficient entities and weed out non-performing managers, and that this will force managers to deliver their best.[8] The third narrative is that of Jensen and Meckling, whose agency theory, like Manne's market for corporate control theory, sees efficiencies being introduced into the firm through greater accountability of management beyond that demanded by the external product and services market and the internal fiduciary obligation restraints imposed by corporations law.[9] Jensen and Meckling's agency theory strategy sought to achieve these greater efficiencies through individually tailored compensation packages for managers as a means of inducing them to take risky business decisions in the interests of the corporation, even if such actions did not accord with the individual preferences of the managers. Individual shareholders for their part were expected to diversify their share portfolios and thus protect themselves against the downside of such corporate risk taking. Here it must be noted that unlike Berle, who saw managers becoming independent of shareholders and consequently unaccountable to anybody, Manne as well as Jensen and Meckling saw the disjunction between expectation and performance of managerial obligations lying in the depths of managerial discretion and malaise – a feature, though difficult to gauge, nevertheless needed to be addressed. The most recent narrative is that of Bebchuk

7 Their concern was that managers in the large modern corporation would, unless made accountable to the shareholder body, end up not being accountable to anybody: see also A A Berle, 'Corporate Powers as Powers in Trust' (1931) 44 *Harvard Law Review* 1049.

8 Henry Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110.

9 Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

and Fried,[10] who attempt to overcome the downside that has resulted from the adoption of agency theory compensation strategy solutions. They suggest a governance structure, which on the one hand ensures that directors are independent of managers, while on the other ensures their dependence on shareholders – a suggestion which has its origins in the Berle and Means separation thesis.[11]

In response to Berle and Means' unanswered question as to how managers could be made accountable to shareholders,[12] regulatory measures following the New Deal era in the US in 1933 included increased disclosure requirements and the provision of continuous and timely information, as well as increased shareholder activism and greater access to the proxy machinery and the like, with an eye to boosting investments in capital markets following the crash of 1929.[13] It was this regulatory climate which enabled neoclassical economists in the 1970s to make inroads into theorising as to what took place inside the black box of corporate decision-making. Neoclassical economic theorists had by this time come around to recognising that managers did not necessarily engage in relentless wealth maximisation as had been assumed, and that beyond certain minimum profit constraints required for their successful continuation, engaged in utility maximisation.[14] In response, Jensen and Meckling articulated what they saw as the agency problem between corporate managers and outside equity and debt holders, and of ways of overcoming it through incentive based remuneration schemes.[15] In three famous articles, the first co-authored with Meckling, the

10 Lucian A Bebchuk and Jesse M Fried, 'Pay Without Performance: Overview of the Issues' (2005) 30 *Journal of Corporation Law* 647, 659–60.

11 Berle and Means, above n 1. While these narratives have a US flavour to them, they are nonetheless reflective also of the UK scene: see, eg, Brian R Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press, 2008).

12 Berle, above n 7.

13 Prime examples were the *Securities Act 1933,* 15 USC § 77a (1933), and the *Securities Exchange Act of 1934,* 15 USC §§ 78a–78jj (1934).

14 See, eg, William J Baumol, *Business Behaviour, Value and Growth* (MacMillan, 1967) (firms act to maximise sales); Robin Marris, *The Economic Theory of Managerial Capitalism* (MacMillan, 1967) (managers will maximise the rate of growth within a secure framework), Oliver E Williamson, *The Economics of Discretionary Behaviour: Managerial Objectives in a Theory of the Firm* (Prentice-Hall, 1967) (personal gains are important motivators within organisations). Each of these theories viewed the firm as a production unit and addressed the problem accordingly.

15 Agency theory assumes that everyone is motivated by self-interest, and that conflicts of interest between principal and agent abound: see Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 308. Given that premise, an agent will always be tempted to engage in self-serving behaviour and to put his own interests ahead of the interests of his principal, eg, managers as wanting to consume excess leisure perquisites and in general be less dedicated to the goal of wealth maximisation than they would if they were not simply agents: see Herbert G Hunt, 'The Separation of Corporate Ownership and Control: Theory, Evidence and Implications' (1986) 5 *Journal of Accounting Literature* 85. However, they also assume that 'individuals are rational and capable of forming unbiased expectations regarding the impact of agency problems and the associated future value of their wealth.' Rationality, according to this view, 'implies that every individual recognises the self interest motivations of all others so that future decisions by agents based on their own interests are anticipated and taken into account by principals': see Amir Barnea, Robert A Haugen, and Lemma W Senbet, *Agency Problems and Financial Contracting* (Prentice-Hall, 1985) 26.

second with Fama,[16] and the third with Murphy,[17] Jensen laid out the structure of the argument of agency theory and its corollary stock based compensation by linking his agency theory of the firm with governance of the firm itself, and sought to provide a comprehensive solution to the problem, which has since been described by Bebchuk and Fried as the optimal contracting theory model.[18]

Agency costs have been defined by Jensen et al as the costs associated with cooperative effort by human beings, namely, the sum of the contracting, monitoring and bonding costs undertaken to reduce the costs arising from conflicts of interest plus the 'residual loss' that occurs because it is generally impossible to perfectly align the agent's interests with those of the principal, namely, shareholders as owners of the corporation. Within this framework of analysis, agency theory aims at overcoming managerial slack by creating the right market based incentives for managers to perform and to thereby align their interest with those of shareholders.[19] With these in mind, compensation packages were to be designed with three key parts: salary to recruit talent, bonus to reward performance, and incentive plans to ensure managers continue to perform.[20] As stated by Jensen and Murphy, '[i]t is appropriate ... to pay CEOs on the basis of shareholder wealth since that is the objective of shareholders'.[21] As stock based compensation formed a significant part of these incentive plans, directors have an incentive to increase share price, as their own personal wealth is directly related to the price of shares. However, following the blowout in executive compensation packages, and Bebchuk and Fried's attribution of the problem to management control of the board, the need for corrective action through greater board independence and oversight over managerial decision-making has once again taken centre stage. Their recommendations go beyond agency theory contracting and incorporate a range of prescriptive rules as a means of reining in managerial power.[22] At present, all four strategies to improve internal efficiencies of the firm subsist alongside each other:

16 Eugene F Fama and Michael C Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301.

17 Michael C Jensen and Kevin J Murphy, 'Performance Pay and Top-management Incentives' (1990) 98 *Journal of Political Economy* 225.

18 See ibid.

19 Ibid.

20 Alistair Bruce and Trevor Buck, 'Executive Pay and UK Corporate Governance' in Kevin Keasey, Steve Thompson and Mike Wright (eds), *Corporate Governance: Accountability, Enterprise and International Comparisons* (Wiley, 2005) 117.

21 See, Jensen and Murphy, above n 17, 226.

22 Bebchuk and Fried see the solution as lying in reducing board dependence on directors, while increasing board dependence on shareholders: see Lucian A Bebchuk and Jesse M Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004).

(i) regulatory measures to overcome the separation problem;[23]

(ii) balancing efficiency with fairness in the takeovers market;[24]

(iii) ensuring that executive compensation achieves alignment;[25] and

(iv) balancing the dependence and independence of the board;[26]

with the task of corporate governance being to handle their cumulative impact.

B The Ascendancy of Finance Based Estimates

There are four landmarks in the evolution of modern finance theory and its ascendancy over accounting theory based valuation of corporate performance. Its starting point is perhaps the 1958 Modigliani and Miller theorem, which demonstrated that in perfect markets, and absent transaction costs such as taxation, the decision whether to finance with debt or equity capital did not matter; and secondly, that the dividend decision and financing decision were independent of each other, meaning that the company's decision whether to pay out dividends and replace it with outside capital or employ retained earnings for that purpose made no difference to the value of the firm.[27] 1959 also saw the publication of Markowitz's portfolio selection theory,[28] which heralded the benefits of portfolio diversification. This was followed in 1964 by Sharpe's beta factor (diversifiable and undiversifiable risk) and the capital asset pricing model ('CAPM') developed by Sharpe and Lintner,[29] that is to say that the value of a company is dependent on its cash flows and level of risk – the greater the cash flows and the lower the risk, the more the company was worth. This was

23 These include the increased accountability of managers by requiring the tabling of the annual report and director's report each financial year under s 292 of the *Corporations Act 2001* (Cth) ('*Corporations Act*'), questioning the Chair and the Auditor at the Annual General Meeting under ss250S and 250T respectively of the Corporation Act, as well as the ultimate threat of Board discipline by the 'two strike rule' under s 250U, whereby the rejection of a proposal on executive compensation by at least 25 per cent of shareholders at two successive AGMs can lead to a board spill.

24 Thus Chapter 6 of the *Corporations Act* provides on the one hand information as to the identity of the bidder and reasonable information to decide on the merits of the bid, as well as a reasonable and equal opportunity to participate in a takeover under s 602, while on the other it permits the compulsory acquisition of remaining shares following a bid, as well as the right to a declaration of 'unacceptable circumstances' under s 657A upon an application by the bidder, target, ASIC or a person whose interests have been affected in these circumstances.

25 See the discussion below at Part IIB below.

26 See, eg, the 'two strike' rule discussed above n 23.

27 See Franco Modigliani and Merton H Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48 *American Economic Review* 261; Franco Modigliani and Merton H Miller, 'Corporate Income Taxes and the Cost of Capital: A Correction' (1963) 53 *American Economic Review* 433.

28 Harry Markowitz, 'Portfolio Selection' (1952) 7 *Journal of Finance* 77; Harry Markowitz, *Portfolio Selection: Efficient Diversification of Investments* (Wiley, 1959).

29 William F Sharpe, 'Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk' (1964) 19 *Journal of Finance* 425; John Lintner, 'Security Prices, Risk and Maximal Gains from Diversification' (1965) 20 Journal of Finance 587.

followed in 1970 by Fama's efficient markets theory.[30] In other words, accounting was seen as being more of historical relevance only,[31] whereas the more relevant value of a firm at any point of time was seen as being reflected in the price of shares in an efficient market that incorporated the market's expectations of managerial performance. It was in this background in 1976 that Jensen and Meckling advanced their notion of agency theory and alignment of the interest of managers with shareholders.

Until this point of time, both accounting and finance theory seem to have coexisted in their respective universe: accounting information taken as representing transactions that had taken place or would take place (given accruals accounting conventions), while finance specialists made investment decisions based on expectations of corporate performance. However, two developments of the late 1990s in the US led to the ascendancy of finance theory over accounting practice. These were first, the rise in power of the Chief Financial Officer within the firm alongside the growing power of analysts' earnings forecast reports specifying expectations; and secondly, the rise in importance of corporate pro forma figures expressing hopes.[32] Consequently, earnings forecasts and share valuations based on these forward-looking estimates came to rule the day.[33] Moreover, devotees of forward looking disclosure redefined the target audience for financial disclosure from the average investor to the sophisticated investor, helping thereby pave the way for more and more forward looking disclosure with the Securities and Exchange Commission ('SEC') releases in 1979, 1982, and 1989 as well as increasing their orientation toward this. In the words of a commentator:

> While [forward-looking disclosure aided by efficiency market hypothesis] dominated for two decades, the SEC reversed course in the late 1990s by adopting Regulation FD to require that guidance provided to one investor must be provided simultaneously to the public at large. This step completed the circle that the

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30 Eugene F Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383.

31 That is, of providing a view of the value of the company as a going concern at a particular moment in time through the balance sheet providing a snapshot of the entity's financial position at a particular date, supplemented by the income statement or profit and loss statement, which provides updates of the cash flow position.

32 As observed by one commentator:

> Wall Street analysts are steeped in the finance school, not the accounting school. … many – during the late 1990s at least – pressured managers into making elaborate forecasts of future performance. This was delicately called 'guidance' and led analysts to define and disseminate 'expectations'. Many of these analysts, moreover, worked for securities firms whose investment banking department sought underwriting business from the companies that analysts followed. … These futuristic explanations pressured management to recast actual historical experience, to conform to and facilitate prognostications. … This involved presenting financial data forms that deliberately varied from GAAP.

Lawrence A Cunningham, 'Finance Theory and Accounting Fraud: Fantastic Futures versus Conservative Histories' (2006) 53 *Buffalo Law Review* 789, 799.

33 Ibid 800. Cunningham states that '[i]n an era of market bubbles such as the late 1990s, people wanted to believe these giddy pictures of the future. [Securities markets] efficiency theory reinforced the fantasies since participants were able to conclude that the market must be right – a whole new economy must have been born.'

> forward-looking disclosure regime inaugurated: (1) managers were redirected from accounting to finance and (2) all investors were functionally brought inside the enterprise by mandates that managers supply finance-oriented information.[34]

The consequence of this move to forward-looking estimates was one short step from accounting fraud to securities market valuation estimates fraud. As Jensen describes:

> almost all organisations of any size punish their managers for telling the truth, and pay them for lying, in a very important and critical business process, namely the budgeting process. ... Of course higher level managers know this is going on so they lie about what their subordinates can do. All this is considered proper behaviour and simply part of the negotiation process. But the result of this system is that no one has the incentive to provide unbiased data to the critical process by which firms coordinate disparate parts of complex organisations.[35]

In the context of this evolving scenario of corporate governance, Part II examines the impact of the new surrogates that have emerged.

II THE IMPACT OF THE NEW SURROGATES OF CORPORATE GOVERNANCE

The unleashing by finance theory of share price, the corporate control market, and executive compensation schemes as the surrogates of corporate performance has led to the functional role of the board as an intermediary between managers and shareholders, and its role in directing the corporate agenda in its competitive setting to come under siege. In other words, corporate governance has undergone a Kuhnian paradigm shift:[36] from boards sitting at the apex, managers carrying out their directives, and shareholders judging the response of the marketplace and determining share price, to share price driving the agenda of all of these corporate players. This change in the dynamics of managerial accountability has resulted from the emergence of share price as the prime surrogate of corporate governance. Stated differently, instead of the board deciding on what is best in the long run based on accounting notions of earnings and provision for the future, the focus now is on share price based on cash flow estimates, and the drive toward higher share price. Consequently, given that managers are in the best position to influence the upward determination of share price, they are also able to influence the financial strategy of the corporation and, with it, to leverage their

34 Ibid 802–3. Cunningham also states that critics of forward-looking disclosure opposed it on three key grounds. First, such estimates were inherently unreliable and misleading per se, in that no one is clairvoyant and that management can be no more clairvoyant than investors or other users of financial reports. Secondly, that it would result in investors assigning greater credence to formal managerial disclosure of forward-looking information, despite this inherent unreliability. Thirdly, that forward-looking information is more susceptible to managerial manipulation than hard historical fact. He concludes that in the light of the accounting frauds that occurred in the late 1990s and early 2000s, all of these objections to forward estimates have proved to be valid: at 801–2.

35 Michael C Jensen, 'The Agency Costs of Overvalued Equity and the Current State of Corporate Finance' (2004) 10 *European Financial Management* 549, 550.

36 Thomas Kuhn, *The Structure of Scientific Revolutions* (University of Chicago Press, 1962).

position of power within the organisation. More importantly, the drive to high share price seems to have succeeded in resolving the separation problem, the hostile takeover threat, aligning managerial and shareholder interests in respect of stock based compensation, as well as aligning the interests of the board with those of managers and shareholders.[37] The following sections examine the interrelationship between takeovers, executive remuneration and share price, and the unifying role of high share price in relation to all of them.

A Takeovers and Corporate Governance

There are two main theorised approaches on corporate takeovers.[38] The first is the management theory based managerial power explanation; the second is the finance theory based market efficiency argument. According to the former, a target company may be taken over not because it is inherently inefficient, but because the bidder company wants to eliminate or limit the competition, or increase its market share as distinct from any efficiency concerns. According to the finance theory based argument, good corporate governance adds value to the firm, increases the price of its shares, makes existing shareholders reluctant to sell their shares, and more importantly, makes it very expensive for a potential raider to take over the company.[39] Share price, takeovers, and corporate governance are linked according to this view from the need for an offeror to entice shareholders to sell at a price higher than the prevailing market price. In other words, financial economists see takeovers as a device to keep managerial autonomy under check and to impose discipline by enabling the acquirer to reallocate the target's resources more profitably. While the management power[40] explanation argues that takeovers may be instituted with a variety of purposes in mind and cite the lack of consistent evidence to support the theory that pre-takeover targets perform poorly in comparison to non-targets,[41] the fact remains that takeovers threaten the target directors' employment, and this in itself is sufficient inducement for managers to ensure that share prices remain high and the company consequently an unattractive target. In other words, takeovers, or its threat thereof, keep managers and boards on their toes, and this has a positive impact on governance. Studies show, for example, that top management turnover is more prevalent in companies that have been taken over than in companies not targeted for takeovers, and that even failed takeovers may prompt a re-evaluation

37 Given that managers have all their eggs in the basket of their employment contract, whereas shareholders generally hold diversified portfolios, it will be the case that managers will manipulate financials to suit their timing preferences. Yet shareholders with diversified portfolios will benefit from an averaging out of the results.

38 See Caswell and Cotterill, above n 3.

39 See Manne, above n 8.

40 See Caswell and Cotterill, above n 10.

41 See Noel O'Sullivan and Pauline Wong, 'The Governance Role of Takeovers' in Kevin Keasey, Steve Thompson, and Mike Wright (eds), *Corporate Governance: Accountability, Enterprise and International Comparisons* (Wiley, 2005) 155.

of the performance of the company by investors because of newly revealed information and managerial turnover still occurs when a takeover fails.[42]

Takeovers do not feature as prominently in the Japanese and German insider financing based corporate governance systems. In both Germany and Japan, the concentration of ownership is thought to be the reason for the limited number of hostile takeover attempts.[43] While some have argued that a market for corporate control in Germany exists though in a form different to the markets in the UK and the US, others point only to its rarity of occurrence and limited impact.[44] In the Japanese bank network system the banks see their role as helping keep the company out of financial difficulties, and as such, struggling companies are assisted, not taken over.[45] Added to this, current Japanese law gives incumbents protection against hostile takeovers.[46] While this may warrant the conclusion that the German and Japanese systems are still very much top down (meaning that boards remain in control), this may also be because of the substantial stakeholder

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42 Ibid 172.

43 Diane K Denis and John J McConnell, 'International Corporate Governance' (Working Paper No 5, European Corporate Governance Institute, 2003).

44 Marc Goergen, Miguel C Manjon Antolin, and Luc Renneboog, 'Recent Developments in German Corporate Governance' (Finance Working Paper No 41/2004 (Revised), European Corporate Governance Institute ('ECGI') May 2004) 15–7 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=539383##>. In this respect, the Mannesmann–Vodafone takeover battle proved to be a watershed in German takeover history, with an international marauder introducing a competitive alternative within Germany's stakeholder-based governance system as against its established system of stakeholder prioritisation. The interests of Vodafone won out through the questioned ability of incumbents to defend a company contrary to the interests of shareholders. The decision caused much discomfort in Germany. However, following a lengthy process of negotiation, an EU Directive in the form of Article 9 (based on Principle 7 of the City Code) was agreed upon. Article 9 was made optional, meaning that members could choose whether or not to permit takeover defences: see Guido Ferrarini, 'Share Ownership, Takeover Law and the Contestability of Corporate Control' (Paper presented at the Conference on Company Law Reform in OECD Countries – A Comparative Outlook of Current Trends, Stockholm, 7–8 December 2000) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265429>; Guido Ferrarini and Geoffrey P Miller, 'A Simple Theory of Takeover Regulation in the United States and Europe' (Law Working Paper No 139, European Corporate Governance Institute, 2010) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1497083>.

45 Christine A Mallin, *Corporate Governance* (Oxford, 2004) 174; Kenneth A Kim and John R Nofsinger, *Corporate Governance* (Pearson, 2007).

46 It is widely believed that following the Asian financial crisis of the 1990s there has been an erosion of cross-shareholdings, in particular, between creditor banks and corporate borrowers. The foreign ownership of Japanese companies, which used to account for only a few percent of all shares outstanding, has now risen to some 20 per cent. Banks, formerly the bedrock amongst Japanese institutional shareholders have been found unable or unwilling to cushion any share price plunges. Pressure on incumbent boards to deliver profits for shareholders has increased, especially where shareholdings are more international. Japan's corporate law is also being reformed with a deliberate eye on US concepts, laying the groundwork for the introduction of 'poison pill' type defences. The Ministry of Justice issued 'Guidelines' in 1995 aimed at creating rules for takeover defences. These guidelines give specific examples of defences, along with conditions governing their use. However, as to whether these changes alone expose Japanese corporations to the vagaries of hostile takeovers is yet to be seen. See Kotaro Tsuru, *How to Cope with the Threat of Hostile Takeovers: Japanese Corporate Governance at a Crossroads* (13 April 2011) Research Institute of Economy, Trade and Industry, IAA <www.rieti.go.jp/en/papers/contribution/tsuru/02.html>.

input into the corporate entity in these jurisdictions, and the perception that the role of the corporation is to also further overall societal interests.

B Executive Compensation and Corporate Governance

Executive remuneration comprises of a basic fixed salary, annual bonus (tied to accounting performance), long term incentive plans (restricted stock options tied to multi-year accounting based performance plans and retirement programs), and stock compensation (based on the appreciation of the firm's stock). It is this last element of the package, stock options, which has been held out as linking pay to performance. Prior to the 1980s there was little evidence of the use of stock based compensation schemes even in the US. So influential was Jensen and Meckling's seminal 1976 paper[47] that greater efficiencies within the firm could be achieved by aligning managerial and corporate interests through stock based compensation schemes for executives that it has since become the staple of executive compensation. However, not all has worked out as expected, with much discontent expressed over the current state of executive pay in terms of its amount and its determination:[48] that the amounts received have been excessive,[49] and the process of compensation determination as having been taken over by

47 Jensen and Meckling, above n 9, 305.

48 See Kevin Rudd, *Press Conference at the G20 Leaders' Summit, Washington* (15 Novmeber 2008) <http://canberra.usembassy.gov/irc/us-oz/2008/11/15/pm1.html>; Wayne Swan and Chris Bowen, 'Productivity Commission and Allan Fels to Examine Executive Remuneration' (Media Release, No 25, 18 March 2009) <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/025.htm&pageID=&min=wms&Year=&DocType=O>.

49 See, eg, Productivity Commission, 'Executive Remuneration in Australia' (Productivity Commission Inquiry Report, No 49, 19 December 2009) xiv, which makes the following observations: (1) incentive pay 'imported' from the US and introduced without appropriate hurdles spurred pay rises in the 1990s, and that more recent complex incentive pay may have delivered unanticipated 'upside'; (2) some termination payments look excessive and could indicate compliant boards; (3) instances of 'excessive' payments and perceived inappropriate behaviour could also reduce investor and community trust in the corporate sector more broadly, with adverse ramifications for equity markets. It concludes, however, that (1) capping pay or introducing a binding shareholder vote would be impractical and costly; (2) the way forward was not to bypass the central role of the board, but rather by strengthening the corporate governance framework by (a) removing conflicts of interest through independent remuneration committees and improved processes for use of remuneration consultants, and (3) promoting board accountability and shareholder engagement through enhanced pay disclosure and strengthening the consequences for those boards that are unresponsive to shareholders' 'say on pay'. The construct of the investigation in the Commission Report is on ways of containing excessive payouts through improved and transparent governance mechanisms. For the US, the United States House of Representatives Committee on Oversight and Government Reform, 'Executive Pay: Conflicts of Interest Among Compensation Consultants' (Majority Staff Report, December 2007) ('Waxman Committee Report') 1 shows for example, that in 2006 the Chief Executive Officers ('CEOs') of the 250 largest US companies, as identified by Fortune magazine, received an average of $18.8 million each, an increase of just 38 per cent from the previous year. They also show that while the aggregate pay of the top five executives at large US companies in the late 1990s amounted to about five per cent of corporate profits, the share of corporate earnings paid to top executives had doubled to ten per cent by 2003. Moreover, the Report cites company directors as admitting that executive compensation practices are problematic. For example, in a recent survey of over 1000 directors at large US companies, 67 per cent said that they believe boards are having difficulty controlling the size of CEO pay packages: 3.

managers.[50] In this environment of perceived lack of accountability and control of managerial compensation packages, some commentators see public outrage as being the only effective antidote to rein in these excesses. The global financial crisis ('GFC') of 2008 has helped further reinforce this view: it saw on the one hand the bailout of financial institutions particularly in the US and the UK through use of public funds, while on the other it saw key managers of these institutions continue to receive lavish bonuses and termination payments. While Australia was spared the downside of the GFC, the need for executive compensation to be more accountable has nevertheless taken firm root. The result has been the demand for a 'say on pay vote' for shareholders on the remuneration received by managers,[51] greater disclosure of remuneration policy and directors remuneration packages and explanations of the relationship of these packages to company and individual manager performance, and of other measures to limit the overall amount of compensation paid.[52]

Bebchuk and Fried attribute the failure of agency theory contracting to the emergence of managerial power independent of the board of directors and unaccountable to shareholders. They view executive compensation as being a double-edged sword, having both the potential to solve as well as to generate agency problems of its own. In their managerial power theory model, they argue that in the absence of arms-length bargaining, compensation arrangements will result in a systematic favouring of the interests of managers, as managers will seek to have their pay structured in ways that are unrelated to performance, and lead to an overall failure in the alignment of pay, incentives, and performance.[53]

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50 See, eg, Frank Dobbin and Dirk Zorn, 'Corporate Malfeasance and the Myth of Shareholder Value' (2005) 17 *Political Power and Social Theory* 179, 180 who observed that

> Corporate malfeasance took a new form in the 1990s. Executives no longer looted company coffers and fled to sunny isles without extradition treaties. They lied about how much money their firms made. This practice was not new, but the peculiar form it took was new. They lied to make corporate earnings appear to rise at a constant rate toward an infinite horizon, and to conform to the projections of securities analysts. They cooked the books in both directions, withholding news of exceptional earnings as insurance against a rainy day. Five executives at Freddie Mac, the semi-public mortgage company, were deposed after famously under-reporting earnings by 5 billion dollars between 2000 and 2002.

51 The UK was the first to introduce such a requirement in the *Companies Act 2006* (UK) c 49, s 217. This has now been followed in Australia and in the US (*Dodd–Frank Wall Street Reform and Consumer Protection Act 2010,* Pub L No 111-203, § 951, 124 Stat 1376, 1899 (2010). While shareholder resolutions on the issue are not binding, company boards are required to stand for nomination if the resolution is passed over two consecutive years. In Australia, company boards are required to stand for nomination if more than 25 per cent of the shareholders voted as such over two consecutive years, whereas the UK Corporate Governance Code 2010 requires all directors of FTSE 350 companies be subject to annual election by shareholders (Financial Reporting Council, *The UK Corporate Governance Code* (June 2010) 3.

52 Examples include the US 2009 Troubled Asset Relief Program ('TARP') which limits executive salaries to a maximum of $500 000 to companies that were bailed out with taxpayer funds (*Emergency Economic Stabilization Act of 2008* Pub L No 110-343 § 11, 122 Stat 3765, 3776), and the earlier *Internal Revenue Code of 1986*, 26 USC § 162(m) which prohibits deductibility to the corporation of amounts of compensation paid in excess of $1 000 000 dollars, unless it was performance based pay. The latter led to the paying out of massive amounts of stock based compensation to managers.

53 According to Bebchuk and Fried, above n 22, 15–61, CEOs have been able to get away with this because of the strategic advantages they enjoy in the pay setting process, including:

The crisis in executive compensation highlights also the almost complete failure of the gatekeeper system. Gatekeepers exist to ensure compliance and conformance with prescribed standards, which in the context of executive compensation is assigned to the firm's compensation or remuneration committee. Compensation committees for their part absolve themselves of this responsibility by relegating the task to the 'independent outside remuneration consultants' they hire and relying on their recommendations.[54] Evidence abounds, however, of gatekeeper conflicts of interest in the formulation and resolution of these compensation packages.[55] It is of no surprise then that the solutions advanced by Bebchuk and Fried, and Jensen and Murphy, all seem to require fixing the gatekeeper system – the monitoring of monitors. By contrast, in the Japanese and German systems, where the insider system is self-monitoring, executive compensation is not such a big problem. In these jurisdictions, banks have representatives on the board and feel less of a need to utilise compensation schemes for corporate governance.[56] Consequently, executives receive much lower remuneration than their counterparts in the UK, US, and Australia.[57] In Germany, there is also the fact that more than half the companies are controlled by family owners, with companies whose major shareholders are banks paying managers less than companies with widely dispersed ownership.[58] To the extent that managers in Japan and Germany are remunerated less than their UK-US-Australian counterparts,[59] while their corporate entities remain internationally

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i. CEO influence over the director nomination process;
ii. CEO ability to direct economic benefits to causes favoured by board members;
iii. desirability of directors to get along with, and therefore go along with, management;
iv. the small personal costs to directors to get along with the CEO; and
v. pressures of time and informational limits on directors.

54 See John C Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

55 For instance, in the US, the Waxman Committee Report found that consultants who did other work for the company while helping devise executive pay recommended significantly higher pay packages than consultants who had no such additional relationships: Waxman Committee Report, above n 49, ii.

56 Perhaps for this reason, stock option valuation has not proved to be possible at current levels of executive pay disclosure in Germany. As at 2005, only nine of the top 30 DAX firms disclosed executive pay data for the board as a whole with no data on individual directors, and another three identified only CEO pay individually: see generally Gregory Jackson and Hideaki Miyajima, 'A Comparison of Mergers and Acquisitions in Japan, Europe and the United States' in Roger Strange and Gregory Jackson (eds), *Corporate Governance and International Business: Strategy, Performance and Institutional Change* (Palgrave Macmillan, 2008) 186.

57 See Lawrence Mishel, Jared Bernstein, and Sylvia Allegretto, *The State of Working America 2004/2005* (Cornell University Press, 2005), cited in Mark Kroll, *CEO Pay Rates: US vs Foreign Nations* (2005) <http://www.cab.latech.edu/~mkroll/510_papers/fall_05/group6.pdf>.

58 Goergen et al, above n 44, 10. The example of Japan and Germany above must not be taken to suggest that that strengthening of boards as prescribed by Bebchuk and Fried will result in the problem of excessive compensation being brought under control. This is because in Japan and Germany, shareholders are in for the long haul and the board representatives of major shareholders, such as banks in these two countries, are nominees of and report directly to their principals. Additionally, in the absence of extensive stock based compensation in these two countries, there is less opportunity for managers to game their compensation.

59 See Mishel, Bernstein, and Allegretto, above n 57.

competitive means that managers, shareholders, or both in the UK, US, and Australia receive excessive rents by comparison to their Japanese and German counterparts. It may also mean that in at least some respects, product and services markets are not as internationally competitive as they should be. What flows from this, is that in the UK, US, and Australia the efficiency-based claims of agency theory has been used inadvertently or otherwise to lend an air of legitimacy and respectability for excessive managerial and shareholder rent seeking practices.

C Share Price and Corporate Governance

Two key issues are how share prices are formed, and what share price stands for. Explanations on this[60] include the efficient markets hypothesis ('EMH')[61] behavioural theory,[62] entrepreneurship,[63] and shareholder market value.[64] What is relevant is how these positions inform the role of share price on corporate governance, and in this whether share price is reflective of market efficiency or the role of market players. This is examined below.

According to EMH, in efficient securities markets, all of the market inputs and outputs that are of a price sensitive nature, as discussed above, will be reflected in share price.[65]

Implied in this is the claim that stock markets readily capture price sensitive information. It also assumes that since individuals behave in an economically rational manner, markets – securities markets in particular – are, therefore, per se perfectly competitive, that securities prices reflect their fundamental value, are rightly priced, and securities markets are therefore efficient both in an individual as well as an aggregate market sense. However, these claims have been refuted.[66]

Additionally, behavioural theorists show, for example, that individuals do not and often cannot, behave in an economically rational manner for any number of reasons, especially in relation to securities markets.[67] Behavioural theory

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60 See, Razeen Sappideen 'The Paradox of Securities Markets Efficiency: Where to Next?' [2009] *Singapore Journal of Legal Studies* 80.

61 This sees share price as representing the price determined by the objectively determined profit maximising actions of investors.

62 This sees share price as being the product of investment decisions by individual investors based on their own frames of risk preferences.

63 This sees share price as the product of the actions of individuals striving to improve their position.

64 This sees share price as the product of 'guidance' by forces within and outside the entity.

65 EMH rests on three assumptions:
   i. economically rational behaviour by market participants (utility maximisation behaviour),
   ii. homogeneous expectations of participants in the marketplace, and
   iii. price movements based on the instantaneous transfer of information by arbitrageurs: Sappideeen, above n 60, 80.

66 See Sappideen, above n 60.

67 While the wealth of behavioural theory scholarship is enormous, its outer boundaries roughly consist of the following:

identifies significant deviations in individual investor behaviour from the profit maximisation models assumed by EMH and entrepreneurship. These studies show that individuals, far from maximising their utility through use of complex statistical analysis, act in a very subjective way, use simple rules of thumb to make decisions, and are swayed by herd behaviour.[68]

What the above explanations demonstrate is that while market movements generate profits (or losses) to participants, they may have little or no relevance to any notion of fundamental value. Moreover, they highlight the important role played by actors within and without the firm in shaping share price, notably institutional shareholders and analysts, and more importantly of managers as navigators of the corporation.[69] For sure, these actions of managers benefit not only themselves, but also shareholders (institutional or otherwise), and the board; and it is this latter result that provides legitimacy and lends credibility to managerial actions in pursuit of high share price under the new paradigm.

III CONCLUSION

Corporate governance in the US-UK-Australian tradition has come to be dominated by modern finance theory, particularly agency theory and its notion of unifying ownership and control. By contrast, the Japanese and German systems continue in the main, to focus on product and services markets competition, and the continuation of corporatist strategy and ideals. When Berle and Means pointed to the existence of the severance, their concern was the lack of accountability of this new force of corporate mandarins through the corporate process, given their obvious lack of accountability through the democratic

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(i) perception bias (eg, on selection, confirmation, matters hindsight, and mind suppression of contrary data); (ii) prediction bias (arising from undue optimism, overconfidence, self-serving, and regret); (iii) probabilities bias (inability to estimate probabilities caused by eg, bounded rationality, anchoring and adjustment, sunk cost effect – throwing good money after bad – and time delay trap); and (iv) Prospect theory's view of how individuals go about making decisions (framing, mental accounting, risk aversion and loss rescuing, ie, preference for avoiding losses than making gains): Sappideen, above n 60, 87.

68 See Daniel Kahneman and Amos Tversky, 'On the Psychology of Prediction' (1973) 80 *Psychological Review* 237, which uses the notion of 'subjective probability heuristics' to explain what individuals rely on when assessing the likelihood of alternative events. Overall, behavioural theory makes three fundamental points:

i. investors rather than engaging in utility/profit maximisation, rely on heuristics to make sense of complexity;
ii. these heuristics are conditioned by their individual frames of reference and have a preference for avoiding losses than making gains; and
iii. consequently, stock prices are subjective preferences of individual participants based on their particular frames of risk preference.

69 On a lighter note, the inputs and influences that go into share price may not be different to how laws and sausages are made! Otto von Bismarck was once supposed to have said: 'Laws are like sausages: it's better not to see them being made.' However, while one may choose not to know the inputs and influences that went into the making sausages and of particular laws, it is imperative to know why and what (if not also who) influences share prices in order to ensure the integrity of stock markets.

electoral process.[70] In line with the shareholder as owner thesis, Manne argued that a surrogate for achieving accountability had already evolved in the marketplace in the form of the market for corporate control; Jensen and Meckling sought to restore the now established shareholder as owner catena through rigorous contractual arrangements; and Bebchuk and Fried have suggested increasing the powers of the board as intermediary as the solution.

However, compared to Manne's focus on externally generated pressures imposing internal efficiencies, Jensen and Meckling as well as Bebchuk and Fried, like Berle and Means before them, turn the focus of the corporate governance debate back to the internal operations of the firm. In the end, however, Manne's thesis of external forces influencing share price may be right after all, not necessarily because corporate control markets are an accurate representation of value in the EMH sense, but because share price is what drives governance. In other words, the emergence of share price as the surrogate for corporate performance and the benefits flowing from it to shareholders, managers, as well as board members has shifted the focus of corporate governance to a point where separation is no longer the troubling issue. What is of interest is how the search for high share price has now largely united the board, managers, and shareholders (even if their motives differ), and its consequences to corporate governance.

This search for high share price has been primarily a response to agency theory strategy of aligning shareholder-manager interests through the threefold strategy of short-term managerial employment contracts, high remuneration packages consisting mainly of stock based compensation (stock and stock options), and the imprimatur to engage in high-risk, high-return strategies that benefit shareholders at the expense of creditors. Moreover, given that the value of stock based compensation is dependent on share price (both in its determination and in terms of its realisation value), and because managers have a tenuous hold over their employment, high share price offers the best form of reward and protection for managers. Additionally, the search for high share price as the surrogate is greatly strengthened by the fact that shareholder returns and board member compensation packages benefit by high share price.

Overall, the momentum for high share price is generated by the following crucial outcomes which high share price is able to deliver: for the corporation access to cheaper capital from the marketplace, a ready-made defence against hostile bidders, and the corollary of acquiring targets more cheaply; for shareholders, a higher exit price; and for managers (as well as board members) higher remuneration, higher realisation price for the stock based component of their remuneration packages, as well as longer tenures of office where corporate raiders are kept at bay. The result has been an inversion in the hierarchy of corporate governance – from the board as determiners of the dividend, investment, and financing decisions of the corporation, and with it share price – to share price as driver in its own right of the affairs of the corporation. In this

70 See Berle, above n 7.

backdrop, it is in the interest of the triumvirate of board, managers, and shareholders to ensure that share price remains high, whether with or without the help of third parties such as analysts.

The downside associated with high share price is that it induces managers to manipulate share price as both an offensive and defensive strategy. Its use as a defensive strategy is primarily to keep corporate raiders at bay. Its use as an offensive strategy is to enable managers to elicit better remuneration packages, realise their stock based component at a high price, and better secure their tenure of office. While the fundamental prerequisites for high share price are market competitiveness delivered through good management and governance, it has also been facilitated by the manipulation of share price through practices such as target based budgeting, earnings management, and overvalued shares.[71] Such practices have the potential to harm the reputation of and confidence in securities markets, of the stock market as an institution, and with it the long-term financial stability of corporations.[72]

As stock based compensation is now an accepted feature of managerial compensation, and board members, managers, and shareholders all benefit by high share prices, the need is for strategies which help protect the integrity of the stock market while letting it operate freely. While the obvious solution to the problem lies in ensuring that the share price represents the true value of the underlying, how one does this in an open market consisting of many buyers and sellers nobody knows, not even Jensen as he so candidly admits.[73] The difficulty lies in that there is no such thing as an objective share price as the activities of market players cause it to move constantly. In other words, the problem for solution does not fall within the rubric of agency theory and agency problem classification – at least not within the norms of agency theory as articulated by Jensen and Meckling, and solutions for them must be looked for elsewhere. This is so because agency theory is concerned with relationships within the corporate black box – of relations between managers, shareholders, and creditors, where managers (including the board) are agents of shareholders who are the principals (the corporate entity is not the principal). More so, since high share price first, benefits all of shareholders, managers and the board, and secondly, does not come at the expense of one or the other of the members of this triumvirate; it comes at the expense of potential investors (including existing investors acquiring new securities, who in terms of agency theory fall outside the framework of the principal–agency relationship). The problem presented by the pursuit of high share price then must be seen for what it is: as a problem outside of the agency framework and requiring remedies of its own, as it raises concerns on the impact of these managerial strategies on potential investors. It also affirms the point that not all of corporation law problems and managerial behaviour are capable of being formulated and resolved through the principal–agency

71 See Sappideen, above n 60.

72 Michael C Jensen, 'Agency Costs of Overvalued Equity' (2005) 34 *Financial Management* 5.

73 See ibid; Joseph Fuller and Michael C Jensen, 'Just Say No to Wall Street: Putting an End to the Earnings Game' (2002) 14 *Journal of Applied Corporate Finance* 41.

framework. In this sense then, the agency problem as between managers and shareholders may well have reached its end of history,[74] or is now at most a sideshow in the main game of high share price.

Hence resort has been made to second best strategies to contain the fallout from resort to stock based compensation strategy. For example, a recent statement of the European Corporate Governance Forum on Director Remuneration links executive remuneration to share price in two ways: first, to factors that represent real growth of the company and real creation of wealth for the company and its shareholders, thereby requiring pay to reflect the level of benefit a director bestows on the company and the shareholder; and secondly, that the level of remuneration for the director should be open and transparent thus enabling shareholders to review the value of the director against the value they add to the entity.[75] Both aspirations have of course been the holy grail of all advanced economies. Whereas the first aspiration is both relevant to and possibly achievable in the bank or insider capital based systems of Japan and Germany, it is not so in the stock market finance jurisdictions of the UK, US, and Australia, where share price reigns supreme in the face of the ascendancy of finance over accounting based valuation of corporate performance. In other words, in these latter jurisdictions, subject to the constraints of insolvency, share price now acts as the proxy reflecting the level of benefit managers bestow on the company and its shareholders. By contrast, there have been significant developments in Australia, UK, and the US in respect of the second aspiration of open and transparent remuneration disclosure.

For example, Australia has seen a move away from relying primarily on the *Corporations Act* provisions of good faith and related obligations on directors, to focusing on how much compensation was received by managers and the need for greater accountability and transparency of the process. Following developments in the UK in particular, the value of having committees with oversight on appointments, remuneration, audit, and risk management to assist the board in carrying out its functions have come to be recognised. Moreover, following the recommendations of the Productivity Commission Report of 2009 on executive salaries, the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011[76] seeks to better align compensation with performance, and in making directors more responsive to shareholder concerns on these matters by making the threat or their removal real. In all, the changes seek to improve accountability of the process by ensuring the independence of remuneration consultants from executive directors;[77] prohibiting executives and

74 In the sense of Francis Fukuyama, *The End of History and the Last Man* (Avon Books, 1993).

75 European Corporate Governance Forum, 'Statement of the European Corporate Governance Forum on Director Remuneration' (Report, European Commission, 23 March 2009).

76 If successfully passed through both Houses of Parliament, these provisions will become operational from 1 July 2011.

77 The proposed changes to the *Corporations Act* will see s 206K require the remuneration consultant to be initially approved by the directors or the remuneration committee, and s 206L require its recommendation to be submitted to either the remuneration committee and/or the nonexecutive directors (except where all directors are executive directors).

persons related to key management personnel from voting on their compensation packages;[78] prohibiting them from hedging the 'at risk' component of their compensation packages;[79] clawback of remuneration found to have been made on material misstatements;[80] as well as making real the threat of board ouster by the so called 'two strike' rule.[81]

In the UK too, following the adoption of the recommendations of the *Directors' Remuneration Report Regulations 2002* (UK),[82] numerous changes have been made to executive compensation laws. For example, the Combined Code requires a remuneration committee be established made up of non-executives members and that compensation policies be formal and transparent. Since 2002 requirements for disclosure regarding executive compensation have been incorporated into UK company law,[83] and companies are required to conform to Part B of the Combined Code disclosure requirements or explain as to why they have not. As this did not prevent the payment of excessive bonuses following the global financial crisis of 2008, new regulatory measures have been introduced.[84]

More recently, the US has responded to these developments through the *Dodd–Frank Wall Street Reform and Consumer Protection Act 2010,* Pub L No 111-203, § 951, 124 Stat 1376, 1899 (2010) ('*Dodd-Frank Act*'). Of special

78 Subject to few exceptions, key management personnel (KMP) and closely related persons (as well as persons acting for them) will be prohibited by s 250BD and s 250(4)-(10) of the amended *Corporations Act* from voting on the remuneration report or on the "spill" resolution.

79 (Amended) *Corporations Act* S206J.

80 See Australian Government 'The Clawback of Director and Executive Remuneration in the Event of a Material Misstatement' (Discussion Paper, December 2010).

81 Under the proposed amended section 250U of the *Corporations Act*, where a listed company's remuneration report receives a 'no' vote of at least 25 per cent of shareholders (first strike) at the AGM, the company's subsequent remuneration report must explain whether or not shareholder concerns have been taken into account, and if so how. Where another 'no' vote of at least 25 per cent is recorded at the subsequent AGM, a resolution to 'spill' the board must be put to the AGM, and if passed, a further shareholder meeting must be held within 90 days, with all existing directors ceasing to hold office immediately before the end of the 'spill' meeting (amended section 250V). Shareholders then have the opportunity to either re-elect or replace the board.

82 These regulations amended the *Companies Act 1985* (UK) c 6.

83 For example, ss 420, 421, and 422 of the *Companies Act 2006* (UK), c 49 specify that the directors of a quoted company must provide a directors' remuneration report for each financial year of the company; that regulations under the Act may specify the form and content of information to be provided in the report; and that the report be approved by the board of directors.

84 See Financial Services Authority, *Financial Services Authority Handbook* (2011), Senior Management Arrangements, Systems and Controls, 19A. It is intended to apply to financial services institutions such as banks, building societies, and credit institutions. It contains broad principles of best practice in remuneration. Principle 19A.3.12 refers to the independence of the Remuneration Committee; 19A.3.15 to risk management and compliance; 19A.3.22 that bonuses be based on profits; 19A.3.23 be adjusted for risk; 19A.3.24 to measurement of long term performance by adjusting earnings per share and total shareholder returns measures appropriately; and 19A.3.30 on the need for remuneration to be linked to future performance of the firm. However, these principles fail to come to grips even in the setting of financial services institutions of the problem of moral hazard, of managers benefiting themselves and shareholders at the expense of creditors, of managers gaming the realisation stage of their stock based compensation and the like – problems presented in the post AT era of global financial and securities markets.

importance are the provisions in Title IX of the *Dodd-Frank Act*, entitled the *Investor Protection and Securities Reform Act 2010* establishing new rules relating to executive compensation.[85] It provides for a non-binding shareholder vote on executive compensation;[86] requires Compensation Committee members to be independent directors with the authority to appoint independent Consultants and Advisors;[87] requires disclosure of executive compensation through a proxy statement containing information on the relationship between compensation actually paid and the financial performance of the company taking into account changes in the value of its stock value and dividends paid;[88] the clawback of incentive compensation paid to all executive officers in the event of an accounting restatement being required due to material noncompliance with financial requirements;[89] disclosure of whether employees are permitted to purchase financial instruments hedging against decreases in the market value of any equity security of the company;[90] empowers the SEC to issue rules permitting shareholders to nominate directors within the company's proxy solicitation materials;[91] empowers SEC to adopt rules requiring companies to disclose as to why, if the same person is acting as both Chairman and CEO;[92] and Restrictions on Broker discretionary voting.[93] Of the above, the s 954 clawback provision must be singled out. This follows the SEC rules introduced in 2000 (some of which were amended in 2006) imposing constraints on the

85 This legislation delegates power to the US Securities Exchange Commission to draft rules spelling out the details of the law: s 951. Sections 953 and 954 are of relevance to the discussion on stock based compensation. Section 953(a)(i) requires a clear description of any compensation ... 'actually paid', while s 953(b)(1)(B) requires disclosure of 'the annual total compensation' of the CEO. Section 953(b)(2) provides that the latter is to be determined in accordance with s 229.402(c)(2)(x) of title 17, *Code of Federal Regulations*. While these regulations refer to realised price of stock options, nowhere do they refer to the realised price of shares. Such references as exist refer only to the 'present value' of the grant. (s 229.402(c)(2)).See also s 229.402(a)(2) requiring disclosure of all plan and non-plan compensation 'awarded to, earned by, or paid to' the executives; again there is no reference to realised value.

86 *Dodd-Frank Act* s 951.

87 *Dodd-Frank Act* s 952.

88 Additionally, there must also be disclosed information on internal pay disparity, including (a) the median total compensation paid to all employees excluding the CEO, (b) the total compensation of the CEO, and (c) the ratio of the median employee total compensation to the CEO's total compensation: *Dodd-Frank Act*, s 953.

89 *Dodd-Frank Act* s 954.

90 *Dodd-Frank Act* s 955.

91 *Dodd-Frank Act* s 971. On this a *New York Times* editorial is most instructive. It states:

> In large part, the success of financial reform will depend on regulators writing tough rules and enforcing them, which they have failed to do in the past. An early and important test of such willpower will come soon as the SEC finalises new rules for nominating directors to corporate boards. Currently, it is prohibitively expensive and complex for investors to propose an alternate slate of directors. Boards too often become bastions of cronyism, with directors tied to executives whose practices they are supposed to oversee rather than to shareholders whose interests they are supposed to protect. This dynamic has fostered excessive compensation and other ills.

Editorial, 'Putting Investors First', *The New York Times* (online), 3 August 2010 <http://www.nytimes.com/2010/08/04/opinion/04wed3.html?dbk>.

92 *Dodd-Frank Act* s 972. In the UK and Australia the positions of CEO and Chairman are split, and are held by different individuals.

93 *Dodd-Frank Act* s 957.

communication of soft information on the corporation's future, or alternatively requiring their release to the public generally.[94] Section 954 and the SEC rules will at best catch situations where managers continue to receive lavish bonuses despite the spectacular failure of the business, and would appear not to come anywhere close to addressing the gaming of stock based compensation problem.

In summary, these changes in the Australian-UK-US jurisdictions seek to make the compensation process more accountable to the shareholder in terms of (1) amount and components of the package awarded; (2) clear relationship of components of package to performance; (3) independence of persons determining the compensation process from executive director influence; (4) the clawback of compensation awarded on information later found to be based on misrepresentation; (5) prohibiting the hedging of the 'at risk' component of the compensation package; and (6) in Australia, making Board accountability a reality through Board replacement under the two strike rule.

Finally, in relation to takeovers, the Australian Takeovers Panel,[95] like its UK counterpart the Panel on Takeovers and Mergers,[96] seeks to ensure broad neutrality in the face of a hostile bid by requiring a non-frustration response to such a bid. In this context, the onus is always on managers to tread the delicate balance of ensuring that share price represents the fair value of the firm – whatever that may mean – in the context of revolving managerial doors, the firm has no excess or idle capacity, and is administered with an eye to corporate downturns which might cause the value of its shares to plummet. In all, corporate managers do live in 'interesting times'.

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94 See, eg, *Executive Compensation Disclosure*, 71 Fed Reg 78 338 (29 December 2006); *Selective Disclosure and Insider Trading*, 64 Fed Reg 72590 (28 December 1999) which seeks to prohibit selective disclosure; *Regulation Analyst Certification* 17 CFR § 242 (2003) relating to analyst independence.

95 See Takeover Panel (Cth), *Guidance Note 12 – Frustrating Action* (6 May 2011) 5 in relation to takeovers. It gives as examples of frustrating action the significant issuing of new shares, or issuing of convertible notes; acquiring or disposing of a major asset, including making a takeover bid; undertaking significant liabilities or changing the terms of its debt; declaring a special or abnormally large dividend; as well as significant changes to company share plans.

96 See, eg, The Panel on Takeovers and Mergers, *The Takeover Code (UK)* (9th ed, 2009) General Principles 2.3, rr 3, 21, 37.3. See also *Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids* [2004] OJ L 142, arts 9, 11.