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HUFF POST BOOKS

Stephen Bainbridge's *Corporate Governance After the Financial Crisis*

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The new *Economist* has a leader that decries the surfeit of "excessive and badly written regulation" swamping the U.S. The magazine tries to be mature about all this. But on the subject of Dodd-Frank, it can't contain itself.

"Its aim was noble: to prevent another financial crisis. Its strategy was sensible, too: improve transparency, stop banks from taking excessive risks, prevent abusive financial practices and end 'too big to fail' by authorizing regulators to seize any big, tottering financial firm and wind it down. This newspaper supported these goals at the time, and we still do. But Dodd-Frank is far too complex, and becoming more so. At 848 pages, it is 23 times longer than Glass-Steagall, the reform that followed the Wall Street crash of 1929. Worse, every other page demands that regulators fill in further detail. Some of these clarifications are hundreds of pages long. Just one bit, the 'Volcker rule,' which aims to curb risky proprietary trading by banks, includes 383 questions that break down into 1,420 subquestions."

The *Economist*, quaintly familiar to those in the know as "this newspaper," then goes on to ask how this occurs in the land of laissez faire. It offers several answers. First, for all the political blathering, the blame seems to fall on both sides of the aisle. Second, the rules proliferate because of political hubris, notably in Congress, which thinks it can come up with a rule for every contingency. Then there's lobbying. "The government's drive to micromanage so many activities creates a huge incentive for interest groups to push for special favors." It's difficult to deny this reality, although for anyone who's not been paying close attention, it is counter-intuitive: After all, wasn't the financial crisis of 2008 the result of a broad deregulatory push? Well, in part, yes, certainly in practice. But that doesn't mean that the sheer jungle of rules necessarily got much smaller. Over time, it simply layered on more new rules on top of old rules; as the magazine says, such complexity tends to spawn loopholes that facilitate bad or risky behavior. Such complexity also makes regulation to the letter of the law impossible; it actually creates space for regulatory maneuvering (for good or bad) while giving Congress the freedom to blame regulators when things, as they have a tendency to do, go awry. This is a profound dysfunction. Such complexity may serve to create more complexity, as practitioners innovate to either avoid the rules or exploit them. This is a cycle that is clearly a race to the bottom.

But there is more to it than just that. In his new book, *Corporate Governance after the Financial Crisis*, UCLA law professor and popular blogger Stephen Bainbridge provides a longer historical perspective on one aspect of this choking proliferation of rulemaking. (The book doesn't mention his blog, ProfessorBainbridge.com, in his bio, which is interesting.) The title of the book is mildly misleading. While Bainbridge is describing how we got to what he calls "quack corporate governance" after the financial crisis, he is really dealing with the post-2000 period, when Congress reflexively reacted to the Enron and WorldCom scandals with Sarbanes-Oxley, a significant increase in micro-managing boards and managers, and, after 2008, with Dodd-Frank. Bainbridge is pursuing several important themes here. He is skeptical of the so-called monitoring model of governance's ability to function effectively and argues that the model's inherent limitations have created a frenzy of federal rulemaking that attempts to "fix" it. He identifies "quack" corporate governance by several tendencies: lobbying by special interest, usually activist investors, or "policy entrepreneurs pursuing an agenda unrelated to the financial crisis"; very little empirical support as to effectiveness; and a strong impulse toward federalization through specific rulemaking, which has tended over time to expand the power of the federal government in corporate law over state courts, meaning mostly Delaware.

Bainbridge writes clearly, but this is not a book for non-lawyers or for those who (happily, perhaps) haven't spent much time mired in the governance wars. Although this "quack" label does add a polemical edge, he also provides a considerable amount of fairly straight discussion of the details of Sarbanes-Oxley and Dodd-Frank, on say-on-pay, proxy access and compensation, not to say the rise of the shareholder-monitoring model. He has read much of the literature pumped out by the law and business schools on the topic, which is fine by me, since so much of it is tedious, tendentious and dreadfully written. He is polemical; he candidly favors the more traditional board-centric model of governance. But beyond that, Bainbridge, like The Economist, seems to be viscerally angry at this vast expenditure of effort, much of which seems to be a waste, even counterproductive. Simply on the face of it, the increasing prevalence of crisis and meltdown over the past decade would suggest that many rules are not working. One can certainly argue with Bainbridge on specifics -- that the decline of U.S. market share in initial public offerings was a result of Sarbanes-Oxley, for instance, as opposed to more fundamental economic reasons -- but not on the larger trend: that a plethora of rules has not been able to guarantee effective and rational governance in corporations. In fact, the inescapable reality is that this rulemaking tendency when faced with downturns only makes corporations increasingly resemble the bureaucracies designed to watch over them.

If you read Bainbridge's blog, he makes his political leanings pretty clear: He's a Republican. In this book he's a bit more circumspect. Like the *Economist*, he clearly recognizes that the rulemaking tendency, the drive to federal over state purview of the corporate law, is not about Democrats and Republicans. His book thus raises a fascinating question: How do you map the politics of governance onto a "conventional" political landscape. For a number of decades now, arguably back to the New Deal, shareholders have been viewed as a proxy for the people. This was particularly the case as middle-class retirement plans got pumped through institutional investors, like Fidelity, or through corporate or union pension plans. The Ur problem here in corporate governance, of course, is that these institutions, with their widely diversified portfolios, generally had no particular interest or ability to closely monitor all their holdings. Like so much else in this world, ideas and circumstances had to coincide. Activist investors, which grew dramatically as hedge funds exploded (many of them swollen with institutional money), arose and embraced two separate, if related set of ideas, both propounded in 1976: the legal notion, articulated by University of California, Berkeley law professor Melvin Eisenberg in "The Structure of the Corporation" of the monitoring model and the theory of agency costs from financial economists Michael Jensen and William Meckling.

Here's where we begin to get strange political paradoxes and unintended consequences. Jensen and Meckling are usually viewed as proponents of allowing markets, particularly for change of control, to operate freely. But the combination of Eisenberg's notion of shareholder monitoring and Jensen and Meckling's ideas of agency costs (broadly suggesting that management and boards are almost inevitably entrenched) produced, after the dot-com crisis, an increasingly prevalent federal rulemaking response in Congress: Sarbanes-Oxley. In short, an attempt to clear the market produced ever-greater rulemaking. (Bainbridge doesn't deal with this, but the fact is that even earlier, around 1990 or so, a state response to the hostile takeovers of the '80s served to strengthen managers and boards for a time. That did not sweep Delaware, which dominated state corporate law, and which, as Bainbridge shows, has incrementally adjusted itself to the shareholder-monitoring model that continued to advance. One way to see this is the rise and gradual decline of Marty Lipton's poison pill.) Thus, what began as an attempt to clear away obstacles to efficient and effective governance has become increasingly buried in almost unfathomable collections of rules and guidelines, some contradictory, some wasteful, some ambiguous or absurd -- effectively obscuring what might be right, proper and efficient, such as greater transparency or rational limits on size or risk.

The result: Advocates of the prevalent shareholder-monitoring model of governance now find themselves arguing for increased federal rulemaking and increased regulatory bureaucracy. Proponents of what Bainbridge calls the board-centric model -- Lipton's Wachtell Lipton is certainly on that side of the field -- would argue for fewer rules and more principles, not unlike Delaware's business judgment and duties of care and loyalty principles, and a somewhat different attitude toward shareholders as owners. This effectively splits both political parties into camps: shareholders and boards. This is similar to the establishment versus populist split that is currently fracturing both parties.

This kind of speculation goes beyond Bainbridge's argument about quack governance. But his book does suggest deeper problems of democracy when trying to cope with a complex, global, extremely innovative corporate and financial sector. The populist response to troubles tends to be inflammatory, emotional and reflexive; the establishment response, granted, may end up buried in studies and committees. There's never enough time, or enough knowledge, to step back and make more calculated, empirically based judgments (if such calculations are even possible), particularly with entrenched interests hammering away. These crisis situations demand new rules, as if they were magical talismans and despite the fact that they're attempting to capture elusive, fast-changing and subtle realities, often anchored in human psychology and behavior. Such crises that demand response are not good moments for a legal system like Delaware's built on precedent and principles. But they are politically popular, indeed satisfying, even if, in the long run, they tend to be both ineffective and destructive of prudent and intelligent regulation itself. It's like the tax code. Complexity begets complexity; dysfunction spawns more dysfunction. And soon you get a proliferating mass that begins to resemble a cancer.

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