

THE MISAPPLICATION OF MR. MICHAEL JENSEN: HOW AGENCY THEORY BROUGHT DOWN THE ECONOMY AND WHY IT MIGHT AGAIN

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ABSTRACT

Agency theorists diagnosed the economic malaise of the 1970s as the result of executive obsession with corporate stability over profitability. Management swallowed many of the pills agency theorists prescribed to increase entrepreneurialism and risk-taking; stock options, dediversification, debt financing, and outsider board members. Management did not swallow the pills prescribed to moderate risk: executive equity holding and independent boards. Thus, in practice, the remedy heightened corporate risk-taking without imposing constraints. Both recessions of the new millennium can be traced directly to these changes in strategy. To date, regulators have proposed nothing to undo the perverse incentives of the new "shareholder value" system.

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The stagflation of the 1970s, a decade of lackluster stock market performance, and the specter of Japanese domination of auto and high technology manufacturing had sent America's Fortune 500 companies on a spiritual quest by 1980. What was wrong with the model of management? Answers came from all quarters, pointing to everything from human resources policies (Ouchi, 1981) to rigid Fordist production techniques (Piore & Sabel, 1984). When it came to corporate governance and business strategy, agency theory offered a diagnosis of the problem and a ready remedy. Spelled out in an article by Michael Jensen and William Meckling in the *Journal of Financial Economics* in 1976, the theory challenged the way that firms were being run, suggesting that the interests of principals (shareholders) and their agents (executives) were out of synch (Whitley, 1986; Hirsch, 1986; Useem, 1984). Executives were serving their own interests rather than those of owners. They had been building large diversified empires that could shield them from downturns in any particular industry, but which maximized corporate size rather than profitability. Profits went to buy new businesses to expand the pyramids executives sat atop. Meanwhile they rebuffed monitoring efforts that might bring their behavior into line with principals' goal, of maximizing profits, by dominating the boards that were charged with overseeing them (Jensen & Meckling, 1976; Fama, 1980; Fama & Jensen, 1983, 1985). The result was that Fortune 500 companies became unmanageable multi-industry behemoths that did not live up to their potential. So went the diagnosis.

Agency theorists prescribed revolutionary changes in corporate governance and strategy. Three changes were designed to increase corporate profitability by changing incentives to managers, reinforcing industrial focus, and altering financing of new endeavors. First was the prescription to alter incentives to executives, using stock options to guarantee they would focus on increasing the value of the firm, and designing compensation to ensure they held equity in the firms they ran. Second was the prescription to focus the firm on the management team's industry of expertise and leave portfolio diversification to investors. Third was the prescription to use debt financing for new endeavors, leveraging equity, and putting an end to the executive practice of spending profits to buy new businesses just to expand their empires. These three changes would focus management on excelling in a single sector and improving the bottom line. They would encourage entrepreneurial, risk-taking strategies that promised great reward. A fourth prescription was designed to discipline executives and monitor risk. Firms should expand board oversight by making boards more independent of top management teams – through outside directors, smaller and more

accountable boards, and appointment of an independent board chair. Independent, agile boards could end executive feathering-the-nest and prevent undue risk-taking. Executive equity stakes would also dampen risk, by ensuring that the CEO had skin in the long-term game.

After some prodding from institutional investors, in the 1980s America's biggest firms embraced agency theory prescriptions enthusiastically, if selectively. They pursued pay for performance with stock options and bonuses that tied executive compensation to shareholder returns, but did not require executives to hold equity. They deliberately dediversified, spinning off business units in disparate industries (Davis, Diekmann, & Tinsley, 1994; Fligstein & Markowitz, 1993). They used debt to finance new activities, and returned profits to shareholders through share buybacks. They restructured boards, making them smaller and appointing more outsiders, but did not actually make boards more independent; instead they gave more CEOs the title of chairman.

The parts of the formula that firms embraced heightened risk. Stock options were structured to reward executives for short-term share price gains without punishing them for losses, so executives placed bets on business strategies with strong upside and downside possibilities. Dediversification left companies susceptible to the vicissitudes of the market for a single product, and those in cyclical industries susceptible to failure in the trough of the business cycle. Debt made companies vulnerable when the economy soured and income dropped, and when the economy soared and interest rates rose. These risks might have been moderated had firms swallowed the pills designed to moderate risk and increase monitoring, but those are the pills they spit out. On the one hand, new compensation schemes did not force executives to increase their equity stakes, which could have caused them to self-monitor and be wary of high-risk endeavors. On the other hand, boards gained symbolic independence, with more outside members, and became more responsive, with smaller rosters, but they did not begin to monitor or discipline management because they remained under the thumb of the CEO. The result of the changes promoted by agency theory was that by the late 1990s America's corporate leaders were drag racing without brakes. We argue that neither the Sarbanes-Oxley Act nor the post-sub-prime-crisis regulatory proposals address these failures in implementation of agency theory. Chalk one up for Hegel; a theory brought down the economy.

By increasing risk without increasing monitoring, these changes set the stage for both the corporate failures behind the 2001 recession and the bank failures behind the Great Recession at the end of the decade. While managerialism and mindless diversification may have contributed to the poor

financial results of America's leading firms in the 1970s, the strategy was predicated on executive efforts to minimize risk to their firms. Every firm tried to become too big to fail; too large and diversified to go down even if a major business unit crashed. Thus firms in industries at risk (the R.J. Reynolds tobacco empire) went to the altar with firms that could weather any storm (the Nabisco packaged foods Empire). Perhaps CEOs just created industrial cornucopias to secure their own sinecures, and perhaps that strategy undermined profits, but the strategy surely dampened corporate risk.

In the pages that follow, we discuss each of the four main agency theory prescriptions for corporate behavior. We examine longitudinal data on large U.S. firms to show which prescriptions firms have taken up, and which they have left on the table. We chronicle how pay-for-performance, dediversification, and debt-financing exposed firms to risk, while board governance reforms failed to improve monitoring.

A word about methodology before we turn to the story. In the following text, we present evidence from a representative sample of 783 major American firms to track the move toward agency theory prescriptions between 1980 and 2005. We chose a representative group of firms from Fortune lists of industry leaders, selecting equal numbers of firms from aerospace, apparel, building materials, chemicals, communications, computers, electrical machinery, entertainment, food, health care, machinery, metals, oil, paper, pharmaceuticals, publishing, retail, textiles, transportation, transportation equipment, utilities, and wholesale. We sampled from Fortune lists every year between 1965 and 2005 so as to achieve a sample that represents both rising and declining firms. In the following text, we use these data to show that American business did buy certain agency theory prescriptions, and to show which elements they failed to implement or misapplied.

THE MISAPPLICATION OF AGENCY THEORY

The story of the popularization and partial institutionalization of agency theory principles in the corporate world offers lessons for theories of corporate evolution and change. Agency theory has been wildly influential, considering that it was cooked up by a couple of business school professors at the University of Rochester and not by a titan of industry. There are two prevailing approaches to understanding the kind of broad change in business strategy that agency theory brought about. On the one hand, the evolutionary model favored by business historians suggests that corporate

dilemmas posed by technological innovation and industrial expansion are solved by management pioneers, and the best solutions spread across industry and dominate inferior solutions (Chandler, 1977). On the other hand, the institutional model favored by organizational sociologists suggests that perceived economic crises offer innovators with new management prescriptions the chance to compete for a hold over the inter-organizational field. The models that win are not necessarily the best, and they are not necessarily better than those they replace. But a crisis offers the chance for entrepreneurs of management theories to try to win over the corporate world. While we cannot fully test these models in the allotted space, we suggest that as time goes on, the broadly functionalist stories favored by business historians have become more difficult to support, largely because so many lousy approaches have won wide followings and because innovations that do not improve upon the status quo frequently succeed.

Organizational institutionalists have long argued that new management practices diffuse through networks of firms like fads spread through high schools (Meyer & Rowan, 1977; DiMaggio & Powell, 1983). In their models, new paradigms are socially constructed as appropriate solutions to perceived problems or crises. Economic crises often punctuate the equilibrium of existing institutional arrangements (Krasner, 1984), leading to a search for new strategies. Expert groups that stand to gain from having their preferred strategies adopted by firms then enter the void, competing to have their own models adopted (Fligstein, 1990). As we noted at the outset, the economic crisis of the 1970s, fueled by the oil crisis early in the decade and then by economic stagnation coupled with inflation, palpably disrupted the management equilibrium of the 1950s and 1960s. Some called for us to follow Japan. Others called for us to mimic Italian small-firm networks. Others still pointed to France's industrial coordination. Professional theorization of new management models is key to their success (Strang & Meyer, 1994), and Jensen and Meckling faced a number of competing experts with their own theories of the malaise, but they clearly won out in the corporate world. William Ouchi's (1981) Japanese-inspired prescription had a short shelf life, but agency theory has colored the air we breathe. Organizations that conform to emerging management norms are thought to win access to both legitimacy and resources (Meyer & Rowan, 1977), and firms that followed agency theory certainly won out.

Institutionalists argue that different groups of experts and professionals, inside and outside of firms, typically develop and promote new management models in response to equilibrium-challenging crises. Professional groups push models they have construed as compatible with their own interests,

either because they can gain position and prestige by being the proponents of the leading model of management, or because the new model advances the interests of the group. In the case of agency theory, finance-trained executives within firms became vocal proponents of the model, but only after institutional investors and securities analysts promoted elements of the model from outside of the firm (Zuckerman, 2000; Davis et al., 1994; Dobbin & Zorn, 2005). CEOs, money managers, and securities analysts succeeded in institutionalizing the components of the model that were in their own interests. Short-term pay-for-performance systems advantaged CEOs, by increasing their income, and they aligned CEO interests with fund manager interests, for fund manager bonuses were based on short-term increases in stock value, and mutual funds increasingly followed the New York performance logic of maximizing shareholder value over the Boston trustee logic (Lounsbury, 2007). Dediversification was favored by fund managers, who preferred to diversify portfolios themselves, and was promoted by securities analysts, who preferred to analyze single-industry firms that could be compared in horse races with their competitors. Debt financing was preferred by institutional investors and executives because it could leverage corporate equity. Moreover, by borrowing to finance new endeavors and using profits to buy back stock, companies could raise stock price and boost CEO and fund manager compensation. Companies did not follow the agency theory prescriptions that were not in the perceived interest of any of these constituencies. They did not institutionalize long-term equity holding by CEOs, for CEOs preferred to diversify their personal risk. They did not institutionalize independent board monitoring of CEOs, for independent boards could depose CEOs. What got institutionalized were the agency-theory components that had proponents. In the following pages we focus on components of the agency theory model that won out and why these components also raised corporate risk-taking without increasing pressures for restraint. While we do not focus on why these particular components were chosen, we sketch that story in the process.

Agency Theory

In the 1950s and 1960s, America's leading companies were run by, and for, managers according to agency theorists. Jensen and Meckling (1976) proposed that the managers of firms should rightly be working for shareholders. From the perspective of the early nineteenth century, this view was radical. When governments chartered banks, canals, and railroads

as public corporations early in the 1800s, charters stipulated that the benefits of incorporation (limited liability, the right to issue stock) were granted in return for the performance of a public duty (Roy, 1997). The earliest corporations, and their managers, worked for the public good as well as for the private purposes of their shareholders. Later in the nineteenth century, general laws of incorporation permitted firms with purely private purposes (or the sole public purpose of fueling economic growth) to incorporate. This changed the view of what incorporation meant, and of who the corporation was working for, but publicly chartered firms retained a duty to customers and employees as well as to investors, in the public mind. By the 1970s, management thinkers treated the customer, the workforce, and the shareholder as stakeholders in private purpose corporations, and still debated their relative primacy.

The shareholder primacy norm advocated by agency theorists challenged that view, suggesting that corporations could only rightly be run for the benefit of owners (Whitley, 1986; Fligstein & Markowitz, 1993; Hirsch, 1991; Useem, 1996). According to that norm, the job of the board was to promote the interests of shareholders. Agency theorists proposed that firms should compensate executives based on stock performance, disassemble bloated conglomerates so that investors could make their own diversification decisions, finance new acquisitions with debt to rein in wayward executives on buying binges, and improve executive monitoring and discipline by giving corporate boards more independence.

Michael Jensen, a finance professor at the University of Rochester who took an appointment at Harvard Business School in 1985 and became partner at The Monitor Group consultancy in 2000, preached not only in finance journals, but in practitioner outlets such as *Harvard Business Review* (Jensen, 1984). The popular business press was full of advice about how to implement agency theory prescriptions for pursuit of the shareholder primacy norm (Baker & Smith, 1998; Hammer & Champy, 1993; Walther, 1997; Pralahad & Hamel, 1990). Finance had already become the lead specialization in many MBA programs (Fligstein, 1990), and now financial economics and agency theory came to dominate the curriculum (Fourcade & Khurana, 2008). The theory succeeded largely because it was promoted directly by institutional fund managers, as we argue below, and less directly by securities analysts. Executives mostly opposed agency theory at first, for it blamed poor corporate performance on CEOs, and on their propensity to serve themselves. But with time CEOs joined the bandwagon. They saw that the new compensation formulas could work to their advantage.

Agency theory moved quickly beyond the ivory tower in the context of the economic crisis of the 1970s, which had called into question the conglomerate approach to management. Agency theory had a more rapid, and more thorough, effect on corporate managers than any other theory hatched in academia (Guillén, 1994). Next we take the four main precepts of agency theory that were picked up by managers and discuss how they went wrong in practice.

ALIGNING CEO AND SHAREHOLDER INTERESTS

Part of the agency theory diagnosis of America's malaise was that CEOs were busy fortifying their empires against collapse rather than making money for shareholders. The prescription was to stop paying managers on the basis of the size of the firms they managed, and start paying them on the basis of how much they increased share price. If the old system rewarded expansive acquisitions, the new system was to reward money making (Jensen & Meckling, 1976; Jensen & Murphy, 1990). Agency theorists called for CEOs to hold equity and to be paid for performance through stock options and bonuses. Stock options enabled executives to buy a certain number of shares at a certain future date, typically three years hence, but at the market price of the stock on the date of issue or thereabouts. Executives would thus benefit from increases in stock price between the date of pricing and the date of vesting. Stock options had been around for decades and had won favorable tax treatment, which allowed option recipients to defer taxes and firms to keep options off their expense sheets (although expensing was required as of 2006) (Karmel, 2004).

From the early 1980s, stock options were championed by leading institutional investors such as the California Public Employees' Retirement System (CalPERS) (Useem, 1996; Proffitt, 2001; Gourevitch & Shinn, 2005). Organizations representing institutional investors, such as the Council of Institutional Investors (CII), soon got into the act. Institutional fund managers repeated the mantra that stock options would align executive and shareholder interests, but options even more closely aligned executive and fund manager interests, because fund managers earned bonuses based on increases in the value of the portfolios they managed just as CEOs now made money based on increases in the value of the firms they managed. Executives and fund managers alike were paid when stock price rose, but did not have to pay when it fell. Fund manager bonuses, like stock option rewards, did not have to be returned in bad years. Clawbacks would have

been compatible with agency theory, but perhaps institutional investors did not demand clawbacks because the same principle might have been applied to their own bonuses.

The spread of stock options increased executive compensation sharply after 1980, and caused total compensation to be much more closely aligned with firm performance (Hall & Liebman, 1998). Now executives who could make the stock price rise took home boatloads of cash. Fig. 1 shows that that median CEO compensation in our sample of big American firms rose sevenfold from 1984 to 2004, to over \$3,500,000. Much of the rise came in the form of stock option grants and bonuses.

The new compensation system encouraged executives to take risk, but because the system was implemented to reward executives for increasing stock price in the near term, but not to punish them for declines, it encouraged reckless risk-taking. Because they could only win, executives could afford to do deals that offered huge potential for profits and losses

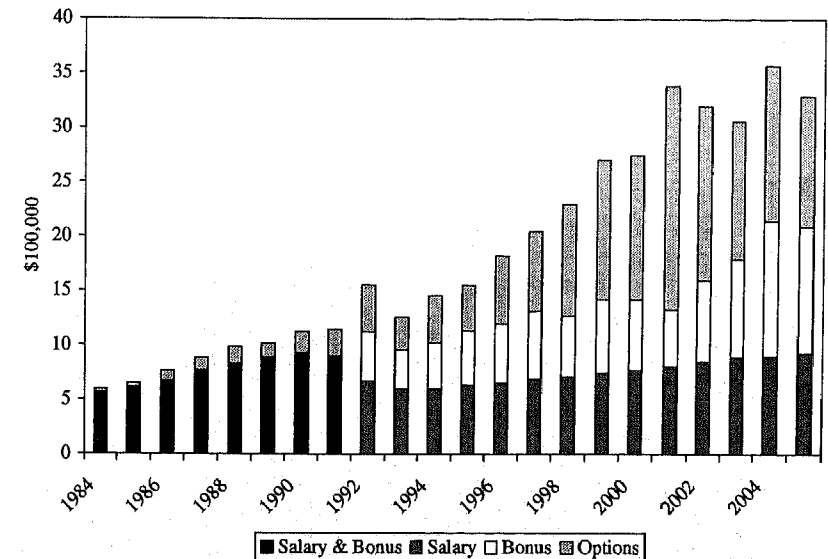


Fig. 1. Median CEO Compensation by Source (1984–2005). Notes: Sample of 783 large U.S. Corporations. Salary and bonus are not reported separately until 1992. The spike in 1992 results from a smaller sample (of larger firms) for that one year. Data on CEO compensation from 1984 to 1991 were provided by David Yermack. CEO compensation data after 1992 are from Standard and Poor's ExecuComp database, available through Compustat.

alike, knowing that for them, there was only an upside. After a few good years, CEOs could walk away if the risk they took soured.

The Failure to Induce Executives to Hold Equity

While boards compensated executives for increasing share price, they did not follow the agency theory dictum of requiring executives to hold more equity, perhaps because institutional investors did not push that point as their own bonuses were based on short-term results. Fund managers controlled over 60% of the shares in the average firm in our sample by 2005, up from 20% in 1970, and so they increasingly determined stock price. Executive interests were thus not aligned with the long-term interests of shareholders so much as with the short-term interests of institutional fund managers. Fig. 2 shows equity ownership by executives in our sample of 783 firms between 1992 and 2005, excluding unexercised options. Data on earlier years are not available. We can see from Fig. 1 that executives had much greater resources to invest after 1992, because their compensation

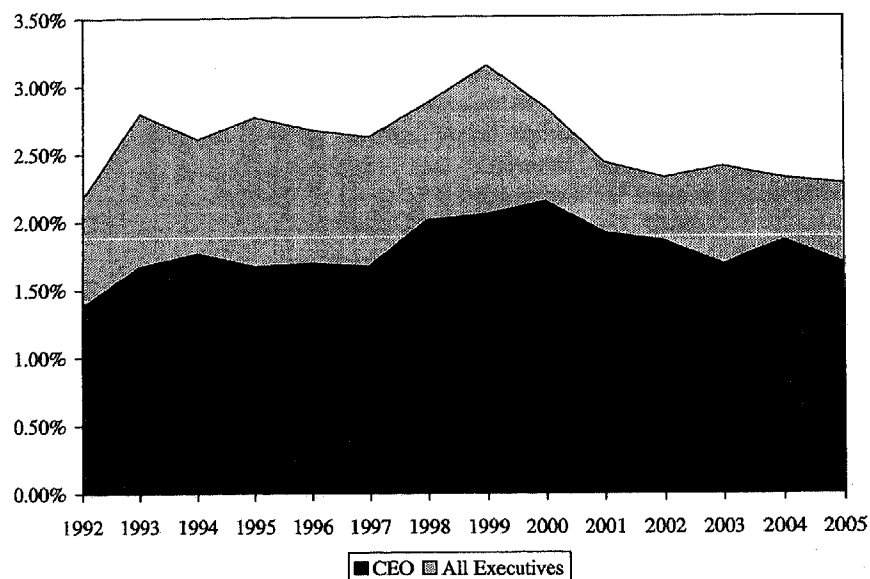


Fig. 2. Average Executive Equity Holdings. Notes: Sample of 783 large U.S. Companies. Unexercised options excluded. Data on executive equity holding are from the ExecuComp database.

skyrocketed. But equity ownership by CEOs, and by all executives, scarcely changes over the period. While investors favored long-term incentive plans for executives, such as plans that required equity ownership, they did not hold boards' feet to the fire. Westphal and Zajac (1998) find that investors bid up the price of firms that announce such plans, particularly when they use agency language. But they do not punish firms that fail to follow through on implementing those plans. Perhaps, again, because their bonuses depend on short-term rises in stock price. Moreover, Westphal and Zajac find, announcing a long-term incentive plan can forestall the implementation of board governance oversight mechanisms.

It is clear that agency theory was misapplied, to the extent that boards did not tie executive rewards to the long-term interests of shareholders. Would requiring executives to increase their equity holdings improve stock performance, as agency theory suggests it should? Hundreds of studies say no. In a meta-analysis of evidence from more than 200 studies, Dalton and colleagues (2003) found that firms whose executives held substantial equity performed no better than firms whose CEOs held little equity. If stock options infused executives with avarice, equity unfortunately did not make them better managers.

Short-Termism and Earnings Management

A new dynamic emerged among market makers in the 1980s. Fund managers looked to quarterly profit reports to value firms, and came to rely heavily on securities analysts to assess which firms were good values. Profits alone had become a poor metric of corporate value in new sectors of the economy, for Amazon could lose money every quarter on its way to dominating Internet commerce. Fund managers came to base their valuations of firms on whether they met analysts' quarterly profit projections. They did this in part because the efficient markets hypothesis, which had been taken up by the finance community, suggested that the present stock value of a firm represents all public knowledge of the firm. When a firm reports earnings lower than analysts project, it signals that experts had overvalued the firm. So a poor earnings report that was expected by securities analysts often has no effect on stock price, on the theory that the poor performance is already built in to the stock's price. But a poor earnings report that is unexpected often leads to a decline in stock price.

This produced a form of short-termism much more acute than one might expect, given the typical three-year period of option vesting. CEOs focused on quarterly profit projections, and seeking to meet or beat analysts'

expectations every three months so as to be able to sustain stock price. As Justin Fox wrote in *Fortune* in 1997:

This is what chief executives and chief financial officers dream of: quarter after quarter after blessed quarter of not disappointing Wall Street. Sure, they dream about other things too—megamergers, blockbuster new products, global domination. But the simplest, most visible, most merciless measure of corporate success in the 1990s has become this one: Did you make your earnings last quarter? (Fox, 1997).

To make the numbers, CEOs and CFOs held conference calls with analysts and updated sales and cost figures regularly, trying to ensure accurate analyst forecasts. They also began to issue earnings preannouncements, to bring analysts' forecasts into line with their own forecasts. Among the firms we studied, the first did this in the early 1990s, and by 2002, 42% were doing it. The quarterly profit report, and its relationship to analyst projections, became the focus of CEO attention. Michael Jensen (Jensen & Murphy, 1990) himself argued that his theory had been misapplied, and that stock option grants were encouraging short-termism.

Options created an incentive for executives to “manage” earnings statements, inflating earnings when they were depressed and deflating when they were above expectations, so as to have something for a rainy day. Firms increasingly used aggressive accounting techniques that allowed them to report sales in advance, move profits forward in time, manipulate the bottom line in other ways so as to be able to meet analyst expectations. Some of these techniques amounted to little more than fraud. Some studies showed that earnings restatements among Fortune 500 companies increased significantly over time, and were driven by stock option grants (Burns & Kedia, 2006; Efendi, Srivastava, & Swanson, 2007). One study suggested that the sharp rise in restatements over three decades was driven by highly leveraged firms in pursuit of favorable loan terms (Richardson, Tuna, & Wu, 2002). Earnings management can also be seen in the increasing likelihood a firm will meet, or beat, analyst estimates (Dobbin & Zorn, 2005).

INDUSTRIAL FOCUS TO HARNESS MANAGERIAL COMPETENCE

The portfolio theory of investment offered a logic to back up the corporate diversification fad of the 1950s through the 1970s. According to that theory, the modern firm should run an internal capital market, investing in promising sectors and spreading risk across different sorts of industries.

The idea was promoted by finance-trained executives at the top of firms and by business educators (Fligstein, 1990). The institutional economist Oliver Williamson (1975) argued that conglomerates could acquire poorly performing firms and improve their profitability by managing them under financial accounting methods. The major consulting firms – McKinsey, Arthur D. Little, the Boston Consulting Group – had developed accounting technologies to facilitate management of diversified conglomerates, which they proffered in the process of promoting diversification. By the end of the 1970s, 45% of the Fortune 500 had adopted these portfolio management techniques (Davis et al., 1994, p. 554).

In the midst of the stagflation of the 1970s, agency theorists argued that managers had pursued diversification as a hedge against the collapse of a particular enterprise or industry and that diversification was not in the interest of shareholders. Managers alone stood to gain by acquiring businesses of questionable value that would stay corporate collapse (Jensen & Meckling, 1976). Financial economists argued that shareholders should shy away from ponderous conglomerates that held poorly performing enterprises in industries little understood by their executives (Shleifer & Vishny, 1989, 1997). They suggested that the investor, not the firm, should assemble portfolios to spread risk (Amihud & Lev, 1981; Teece, 1982; Bettis, 1983).

Others echoed the sentiment that conglomerates were too unwieldy to manage, and that they had been managed to suit executives rather than shareholders. Jack Welch at General Electric argued for hands-on management and corporate focus. Management consultants turned against conglomerates en masse in the wake of publication of the first blockbuster management bible, *In Search of Excellence* (Peters & Waterman, 1982), which admonished executives to “stick to the knitting,” focusing on the core business of the firm. In 1990, the reengineering gurus C.K. Prahalad and Gary Hamel published “The Core Competencies of the Firm” in *Harvard Business Review* arguing that a management team can excel at one or two things, but cannot be good at everything. As Michael Useem (1996, p. 153) argues, “While diversification had been a hallmark of good management during the 1960s, shedding unrelated business had become the measure during the 1980s and 1990s.”

Takeover firms, institutional investors, and securities analysts encouraged the corporate focus trend in their own ways. The threat of hostile takeover fueled dediversification early in the game. In the 1970s and 1980s, hostile takeover firms targeted diversified conglomerates that they could break into pieces to be resold at a profit (Fligstein & Markowitz, 1993; Davis et al.,

1994; Liebeskind, Opler, & Hatfield, 1996; Matsusaka, 1993). While diversification had not depressed stock price in the early 1970s, it did so by the late 1970s and so takeover firms could make money simply by selling business units. Beginning in 1976, Kohlberg Kravis & Roberts (KKR) bought over 40 companies and broke up most, including such behemoths as Beatrice Companies and RJR Nabisco (Useem, 1993, p. 35). KKR often played the role of “white knight,” saving the management team from other takeover firms, but the end result was the sell-off of business units just the same.

Michael Jensen (1984, p. 10) argued that the possibility of hostile takeover disciplined executives, serving a “fundamental economic function” by helping to create an efficient market for corporate control.

In the corporate takeover market, managers compete for the right to control – that is, to manage – corporate resources. Viewed in this way, the market for corporate control is an important part of the managerial labor market ... After all, potential chief executive officers do not simply leave their applications with personnel officers. Their on-the-job performance is subject not only to the normal internal control mechanisms of their organizations but also to the scrutiny of the external market for control.

Jensen described the hostile takeover not as a form of disruptive speculation, but as a restraint on managerial malfeasance (Jacoby, 2006; Securities Regulations and Law Report, 1985). Between 1985 and 1988, more than 6% of Fortune 500 companies received tender offers each year, and in the course of a decade, one-third received hostile takeover bids (Davis & Stout, 1992, p. 622). These activities put the fear of God into executives, for executives typically lost their jobs in takeovers (Davis et al., 1994). Two-thirds of the Fortune 500 instituted takeover defenses such as poison pills and golden parachutes, and so by the 1990s takeover attempts were rare (Useem, 1996, p. 2; Davis, 1991).

Institutional investors had come to favor focused firms because they preferred to choose diversification strategies themselves and to invest in firms with clear profiles (Dobbin & Zorn, 2005). By the 1980s they were pushing firms to dediversify under the flag of agency theory. Where institutional investors held the sway, firms were fast to dediversify. From the 1980s, Fortune-500 companies with concentrated ownership were most likely to spin off unrelated businesses (Useem, 1996, p. 153).

Securities analysts encouraged dediversification through word and deed alike. They argued that focused firms were better performers, and they focused their professional attention on them. Analysts specialized by industry and conglomerates that did not fall into a neat category usually

failed to win coverage. Because coverage was overwhelmingly positive, executives coveted coverage. This led them to dediversify in order to win coverage and boost institutional investor interest (Zuckerman, 1999, 2000).

The preferences of fund managers and analysts for single-industry firms translated into changes in business strategy. Thus diversification continued to decline even after the hostile takeover wave subsided, as executives voluntarily spun off units unrelated to their core businesses. In Fig. 3, we chart the level of diversification among our sample of large American firms. The entropy index, which measures diversification based on the contribution of each industry to the firm’s sales, shows a consistent decline between 1980 and 1998, and then a leveling off. As firms dediversified, they began to hire executives with industry backgrounds and training rather than with backgrounds in general finance and the intricacies of financial management of conglomerates (Ocasio & Kim, 1999). Finance experts fought back by promoting agency theory principles from economics, and not industry expertise, as the key to good management.

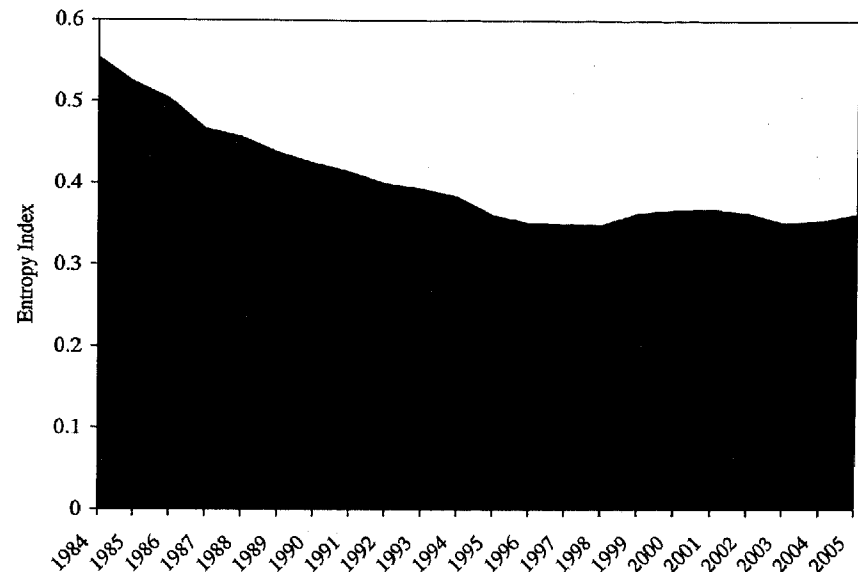


Fig. 3. Average Level of Diversification. Notes: Sample of 783 large U.S. Companies. The trend is adjusted for accounting rule changes in 1997 that caused firms to report operations in more industries. The entropy index of diversification is calculated using data from the Compustat Industry Segment database.

Mixed Evidence on the Efficiency of Dediversification

While it is clear that firms dediversified with the aim of improving profitability and stock returns (Zuckerman, 1999; Campa & Kedia, 2002), the evidence of a link between diversification and performance is weak at best. Some studies find a "conglomeration discount" in stock price in the 1960s and after the mid-1970s, but not in between (Servaes, 1996; Matsusaka, 1993), and others find no discount (Campa & Kedia, 2002; Villalonga, 2004). Alfred Chandler (1977) argued that the conglomerate's components, the multidivisional form pioneered at General Motors by Alfred P. Sloan (1963) and modern financial accounting systems, helped the conglomerate to outcompete the single-industry firm. Glenn Hubbard and Darius Palia (1998) find that investors themselves recognized this source of efficiency in the 1960s. Investors rewarded companies that announced diversifying takeovers in the 1960s, though by the 1990s, by which time agency theory had tarnished diversification, investors were rewarding companies that announced spin-offs. Studies of profitability show inconsistent effects of diversification, and this tends to suggest that the post-1975 conglomerate stock price discount may have been a product of the self-fulfilling prophecy of agency theory (Wernerfelt & Montgomery, 1988; LeBaron & Speidell, 1987). Another chink in the armor of the focused-firm paradigm is that the within-industry mergers that became the alternative to diversifying acquisitions in the 1980s do not appear to have increased profitability, despite the fact that they quelled competition (Jensen & Ruback, 1983). Some suggest that diversification is efficient in some markets but not in others. George Baker and colleagues argue that when capital and management talent are scarce, a large firm can acquire a poorly managed, capital-starved company and manage it efficiently as a subsidiary. When capital and talent markets are strong, these advantages disappear (Baker, 1992; Baker & Smith, 1998; Baker, Gibbons, & Murphy, 2001).

Corporate focus may also have failed to improve performance for another reason. One critique financial economists aimed at the portfolio theory of the firm was that the cost of selling a business can be prohibitive, and potential buyers scarce, and so conglomerates are often stuck with poorly performing acquisitions. Yet when large institutional investors hold blocks of stock, they often face similar constraints, finding it difficult to sell a large block without depressing share price. Thus large institutional investors may face constraints in unloading struggling enterprises similar to those faced by executives at conglomerates.

The evidence that single-industry firms perform better than conglomerates is mixed at best. Evidence that single-industry firms had higher stock prices after 1975 may simply be proof of the growing hegemony of agency theory. When market makers came to believe that focused firms are more valuable than conglomerates, so they were.

Dediversification and Increased Risk

Financial economists have long argued that investors, not companies, should make portfolio diversification decisions, choosing companies to invest in based on their own preferences for risk versus stability, long-term versus short-term gains, etc. The critique of managerialism was that executives diversified to moderate risk to their own firms and in the process, denied investors the potential for large gains (Amihud & Lev, 1981; Fligstein, 1990). While diversifying mergers tend to water down the profits of the best performers in the conglomerate portfolio, they also tend to moderate risk to individual business units. The internal capital market of the conglomerate can be used to prop up firms that are going through rough spots. Even the utter collapse of one business unit does not usually doom the corporation. Just as diversification reduces the risk of firm failure for managers, it reduces systemic risk across the economy in economic downturns, for each conglomerate is buoyed by its stronger business units. Hence while it is not clear that nondiversified firms earn superior profits, and while it is not clear that they improve stock performance except through the self-fulfilling prophecy of agency theory, it does seem clear that dediversification increases corporate risk.

DEBT FINANCING

Jensen and Meckling (1976) based some of their core arguments about the agency costs associated with equity versus debt financing on the arguments of financial economists (Modigliani & Miller, 1958; Miller & Modigliani, 1961). The agency costs associated with turning over management to nonowners stem from the propensity of management to, first, sacrifice profitability so as to minimize the risk of firm failure; second, over-reward themselves and drain profits; and third, pursue short-term strategies that will benefit management rather than long-term strategies that will benefit shareholders. One way of reducing agency costs is to have managers hold equity. If they hold 100% of equity, agency costs drop to zero. Another way is to force managers to pay dividends, which will lead them to issue

additional stock to fund new endeavors and thereby open themselves up to additional shareholder monitoring. A third way of reducing agency costs, according to Jensen and Meckling (1976) is to take on debt. By reducing total equity financing, debt moderates the conflict of interest between shareholders and managers. According to the theory, managers will take on debt only when they are convinced that they can achieve rates of return, on new endeavors, that exceed the cost of debt. As a CEO, you wouldn't borrow money at 6% for an endeavor that would return 4%, but you might choose to invest profits in the same endeavor.

Under the theory, shareholders came to favor firms that used debt financing, taking debt financing as a signal of management's conviction that a new endeavor will pay off. Debt financing also permitted firms to leverage equity, multiplying the returns to investors. Shareholders should prefer debt financing to the issuance of new stock for that reason, and they should prefer to see profits returned to shareholders through dividends or share buybacks that boost share value (Westphal & Zajac, 1998; Zajac & Westphal, 2004).

In Fig. 4 we see that the firms in our sample of 783 large U.S. corporations indeed took on more debt in the years following the popularization of

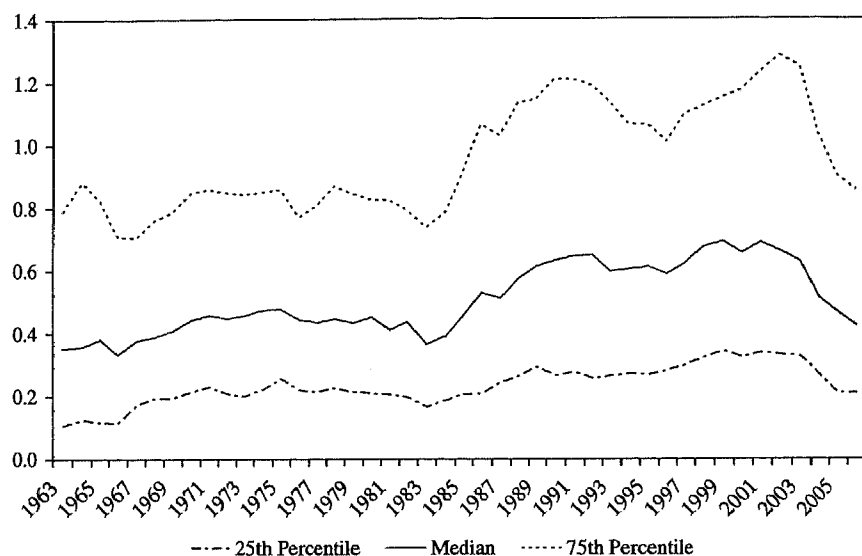


Fig. 4. Debt-to-Equity Ratio. Notes: Sample of 783 large U.S. Companies. Debt-to-equity ratio is calculated as total long-term debt divided by common equity. Data on both items are from Compustat.

agency theory. We report the debt equity ratios by quartiles from 1963 to 2005. Before the mid-1980s, the median firm had about 40 cents of debt for every dollar of equity. This rose to about 60 cents after the mid-1980s. The rise of junk bonds, spearheaded by Michael Milken and Drexel Burnham Lambert, coincided with the new theory and made debt available even to struggling firms.

Debt and Risk

Modigliani and Miller (1958) recognized that relying on debt can increase corporate vulnerability. Recent studies show that firms with heavy debt burdens are especially vulnerable during economic downturns (Campello, 2003, 2006). If returns from a new investment do not exceed interest on the bonds used to finance it, a firm may find itself with debt it cannot pay off. Moreover, debt may encourage managers to undertake high-risk investments to pay bondholders when their initial investments do not pay off (Crutchley & Hansen, 1989, p. 37). Many accounts of the crisis point to excess leverage by mortgage lenders, which put them at risk when mortgage-backed securities and mortgages themselves failed, and encouraged them to try even riskier moves to save themselves (Johnson, 2008; Sorkin, 2009; Posner, 2009). Firms also took on debt to prevent takeover, but we see from Fig. 4 that high debt levels continued after the 1980s, when hostile takeovers subsided.

BOARD INDEPENDENCE TO MONITOR RISK

Agency theorists argued that independent corporate boards could address the more general problem of agency costs – of executives behaving in their own interests (Fama, 1980, p. 293). The thinking was that outside directors, small focused boards, and independent chairmen could help to monitor executive behavior, ensuring that it conformed to investor interests. First, outside directors are better monitors. Insiders (company executives) rarely challenge the CEO either because they depend on him, or because it is in their interest, as in the executive's, to favor strategies that maximize corporate stability over profitability (Byrd & Hickman, 1992; Hermalin & Weisbach, 1988). Insiders are particularly unlikely to vote for CEO ouster and they oppose takeovers that might increase share value,

for fear of losing their jobs, and so they back costly takeover shields such as poison pills and golden parachutes (Weisbach, 1988). Recall that Jensen (1984) argued against such antitakeover measures, defining the takeover as an effective means of replacing ineffective management teams. Second, small boards are more accountable and less unwieldy, and thus more likely to monitor CEO behavior. Third, boards with independent chairmen should better monitor the CEO than those on which the CEO is also chair (Daily, Dalton, & Cannella, 2003; Beatty & Zajac, 1994). Boards chaired by the company CEO are particularly unlikely to call for CEO ouster.

Institutional investors promoted board monitoring under agency theory principles just as they had promoted pay for performance and dediversification. CalPERS was one of the first to advocate board independence (Schwab & Thomas, 1998). CalPERS sponsored more shareholder resolutions to update governance after 1984, when California lifted a restriction limiting its stock holdings to 25% of portfolio value (Blair, 1995). CalPERS officials were instrumental in the creation of the CII in 1985, which brought together 30 funds (29 of them public) controlling assets of \$132 billion, and which now includes a wide range of funds with assets in excess of \$3 trillion (<http://www.cii.org/about>). CII's "Shareholder bill of rights" called for independent oversight of executive compensation and auditing, equal treatment for different categories of shareholders (to prevent a minority of, for instance, shareholders from the founder's lineage dominating a board), and shareholder approval of key strategic decisions (Jacoby, 2006). CalPERS and CII sponsored proposals that boards be composed of a majority of outsiders, and that compensation committees be composed exclusively of outsiders. In many companies they opposed antitakeover strategies, such as the poison pill, designed to keep incumbent executives in place at all costs (Davis & Stout, 1992; Jacoby, 2006).

Executives and boards followed the dictates of agency theorists when it came to outside directors and board size. Fig. 5 reports the average percentage of outside directors among sampled firms between 1980 and 2005. In the average firm, outside directors held 66% of seats in 1980, and 83% in 2005. Analysts have often questioned whether independent directors are truly independent, and we can see that they had cause for concern. From 1996, when data on outside directors' ties to the firm were first available, the figure shows the percent of directors with no familial ties or employment history with the firm (*independent* directors). In 1996, in the average firm, nearly 80% of directors were outsiders, but less than 60% were independent. Thus while board members were more likely to be outsiders, many of those

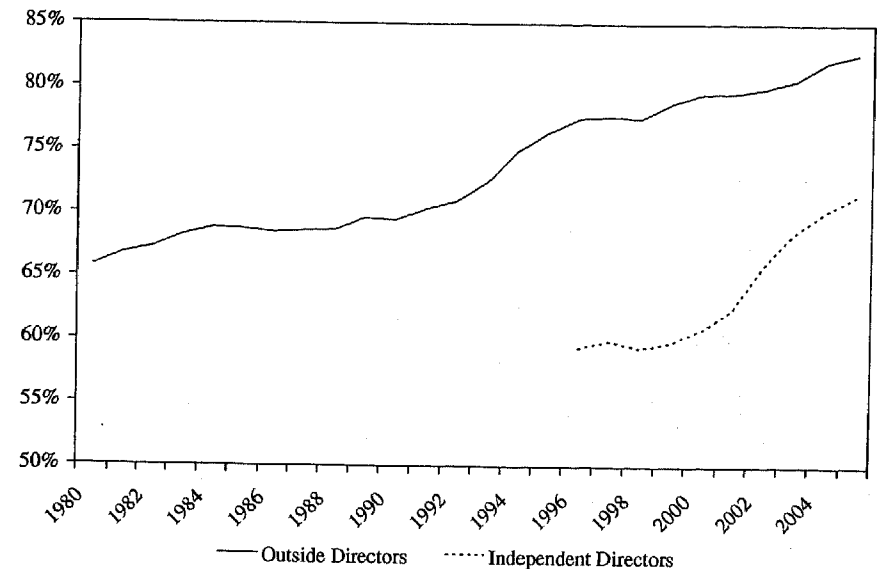


Fig. 5. Average Percent of Outside and Independent Directors. Notes: Sample of 783 large U.S. Companies. Data on outside directors who are *independent* are available only from 1996. Outside directors are defined as any directors not employed by the firm. For this, we referred to *Standard & Poor's Register*. After 1996, we use data from the Investor Responsibility Research Center (IRRC) Directors database to further classify outside directors into affiliated and independent directors.

outsiders had links to management. Moreover, because candidates for board positions are nominated by the board's own nominating committee, boards are often made up of friends of the chair, and friends-of-friends. In theory they represent shareholders, but in fact, they are appointed by a committee that operates under the CEO/Chairman.

Companies reduced the size of their boards on the advice of agency theorists, so they did not achieve a greater proportion of outsiders by adding new members. Fig. 6 shows that the average number of directors declined from 11.7 to 10.2 between 1980 and 2005. A 15% decrease over 25 years may seem meager, but it proved difficult to reduce board size because directors typically hold lifetime appointments, and tend to hang on because the compensation is attractive and the duties are not particularly onerous, although they have expanded since passage of the Sarbanes-Oxley Act.

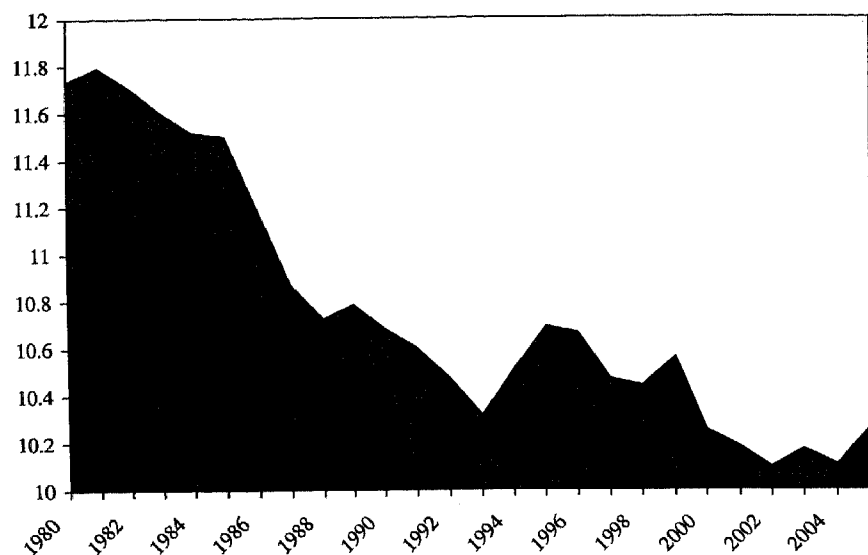


Fig. 6. Average Number of Directors. Notes: Sample of 783 large U.S. Companies. We calculated the average number of directors on the board using information from *Standard & Poor's Register*.

The Failed Mandate of Chair Independence

Boards did not, however, take up the advice to appoint independent chairmen (see Daily et al., 2003). The call for separating the CEO and Chair positions was challenged by a countertrend: firms sought to appoint celebrity CEOs to fuel stock price growth through positive media attention. Boards responded to poor stock performance by hiring well-known CEOs so as to send the message that the firm was now in competent hands (Khurana, 2002). Celebrity CEOs often held the upper hand in negotiations, and agreed to serve only if they were offered the title of chairman. After all, now that agency theory directed boards to oust CEOs who did not return strong results, incoming CEOs had good reason to keep the position of chair out of the hands of a potential critic. Between 1980 and 2000, CEOs in our sample who held the title of chairman of the board rose from 57 to 75%, dropping back to 67% by 2005 (see Fig. 7). Even firms that appointed someone other than the CEO to chair the board often appointed the former CEO, or a chum of the current CEO, and so even non-CEO chairs were often closely allied with management.

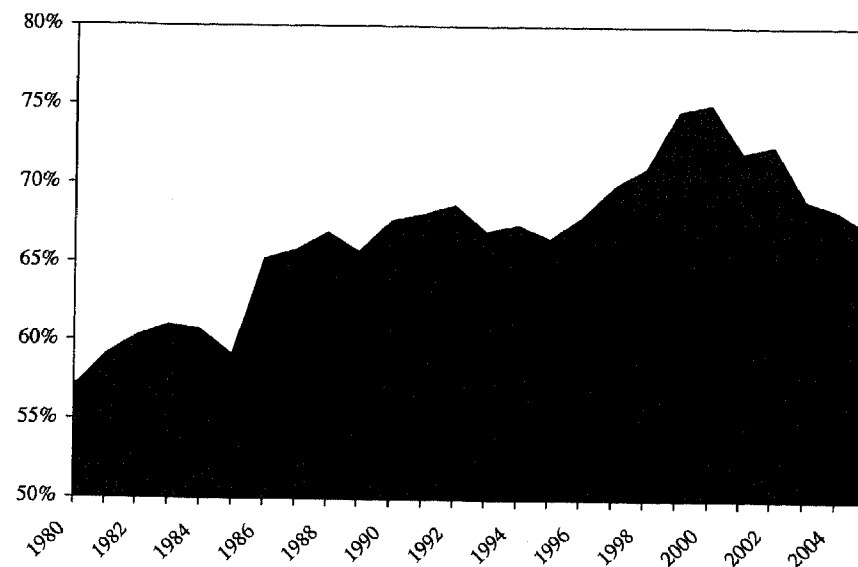


Fig. 7. Percent of Firms in which CEO is Chair. Notes: Sample of 783 large U.S. Companies. To identify CEOs who held the title of chairman of the board, we referred to *Standard & Poor's Register*.

Failure of Board Monitoring: The Difficulty of Ousting CEOs

Agency theorists charged boards with ousting CEOs for poor performance, the ultimate stick to complement the carrot of stock options. CEO turnover did increase across the period, from 9.7% per annum in the 1980s to 11.5% in the 1990s and 12.6% between 2000 and 2006 (see Fig. 8). It is difficult to judge how much of the increase was the result of board ouster, because CEOs who see the writing on the wall often leave quietly to "pursue other interests" or to "spend more time with the family," but even if all of the change over time was a consequence of board ouster, the change accounted for less than a quarter of all CEO turnover in the new millennium. There was hardly an upswell in board ouster of poor performers. There was an increase in the appointment of outside CEOs over this period. Rakesh Khurana (2002) ties this to board efforts to signal a change of course, and bolster lagging stock price.

Limits to the Effectiveness of Board Monitoring

Press reports and academic research suggest that boards have not played the monitoring and disciplining role that agency theory suggests they should

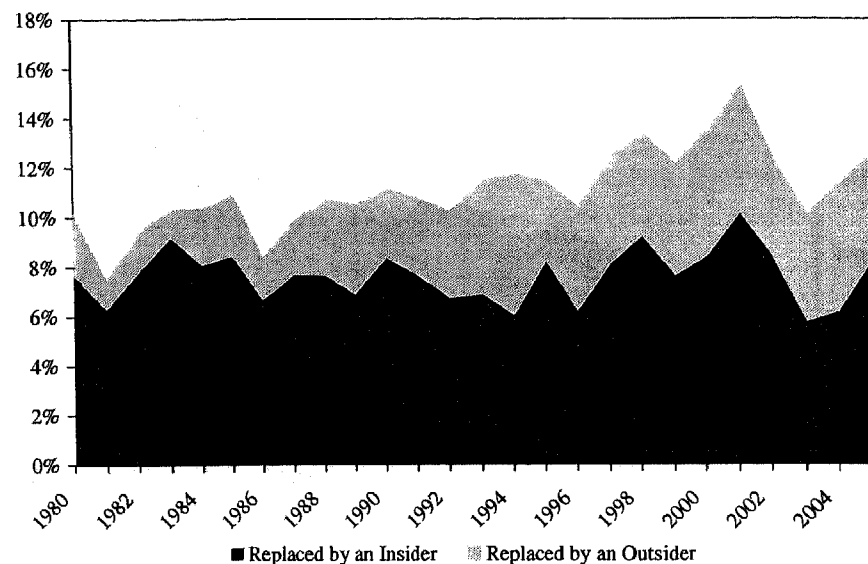


Fig. 8. Annual CEO Turnover. Notes: Sample of 783 large U.S. Companies. CEO replacement events were identified in two steps. First, we noted any changes in the names of CEOs in consecutive volumes of *Standard & Poor's Register of Corporations, Directors, and Executives*. Then, we confirmed that these changes in the names reflected actual CEO succession events, using the *Wall Street Journal Index*, the *New York Times Index*, and the Lexis-Nexis service.

play. One comparative study found that Japanese firms with lackluster performance were much more likely to appoint outside directors than American firms with the same problem, suggesting that in Japan alone boards respond to challenges by seeking outside input. Moreover, outsider appointments in Japan alone presage CEO turnover, suggesting that outsiders there actually monitor executives and encourage replacement of poor performers (Kaplan, 1994; Kaplan & Minton, 1994).

Notwithstanding the leadership of CII in encouraging board activism and monitoring, institutional investors have proven reluctant to hold boards to account and to dictate to top management teams. Shareholder proposals do increase in number over time, but they are disproportionately initiated by public pension funds. One reason for this may be that mutual funds have conflicting interests. They invest in companies with one hand and with the other, market retirement instruments to them. This creates a disincentive to fund managers to fall out of favor with top managers, through challenges to

management decisions or calls for the ouster of top management team members (Gourevitch & Shinn, 2005; Davis & Kim, 2007).

The increase in outside board members has also produced something of a conundrum for monitoring. Directors should ideally know the industry well, to be able to assess the company's business strategy and prospects for growth and profitability. But antitrust provisions, and concerns about trade and strategic secrecy, prevent firms from appointing outside directors who are industry insiders. In consequence, outside directors frequently know little or nothing about the industry in question. Insiders then typically have a significant knowledge advantage over outsiders, and are better positioned to judge corporate strategy. Those on the board who are best able to assess strategy are thus least likely, by dint of their insider status, to challenge the CEO.

To the extent that the corporations wrought by agency theory are more oriented to increasing share value, more lean and industry focused, and more disciplined by the use of debt, they will behave more entrepreneurially, and take more risks that promise great rewards. More risk for more reward is the new mantra of managers. But the failure of corporate board reform has left firms without the discipline and restraint that, according to agency theory, should have had the effect of putting the brakes on risk. Independent boards should be the ones to implement some components of agency theory, such as stock options, and indeed their compensation committees have done that. But they have not generally exercised greater oversight over business strategy or disciplined executives who took undue risks or failed to increase share value. One reason for this pattern, of boards whose compensation committees embrace the generic prescription of stock options but do not monitor fine-grained corporate strategic decisions, may be that board energy is limited and the industry knowledge of outsiders is finite (information asymmetry plays an obvious role). Boards may be better equipped to implement an out-of-the-box compensation system than to roll up their sleeves and question the minutiae of strategy.

CONCLUSION

Since the early 1980s, large American corporations have transformed themselves to conform to the new "shareholder value" model of the firm. That model can be traced to the conflicts agency theorists depicted between interests of managers and shareholders, and the prescriptions they set out for minimizing those conflicts. First, they suggested that firms should align the interests of these two groups by paying managers for increasing stock

price (through stock options) and making sure they hold equity in the firm. Second, firms should focus on one core business, leaving the job of portfolio diversification to investors, because the huge diversified conglomerate did not produce an efficient market for capital. Third, corporations should finance new endeavors and expansion with debt, leveraging the investment of shareholders and at the same time disciplining executives tempted to use profits to expand into low-return ventures. These three changes should make the firm more entrepreneurial and focused, and give managers incentives to take risks that promise strong returns. Fourth, corporate boards should be more independent of management, to increase monitoring of executives and guarantee discipline when management strays off course. Outside directors, small and agile boards, and independent board chairmen were what the doctor ordered. If the first three innovations lead to greater risk-taking, the fourth should restrain executives and help to protect shareholder investment. In fact, both the compensation and governance prescriptions serve the dual functions of encouraging entrepreneurialism and restraining recklessness. In compensation, the executive-equity formula restrains risk-taking and short-termism, while the stock-option formula promotes initiative. In governance, autonomous boards should encourage executive entrepreneurialism yet discourage ill-advised risk.

The data we present on the compensation systems, business strategies, and governance structures of 783 large American corporations suggest that firms have indeed followed certain agency theory prescriptions (see also Zuckerman, 1999; Davis et al., 1994; Fligstein & Markowitz, 1993). They have revolutionized executive compensation, dediversified, financed new endeavors with debt, appointed outside board directors, and reduced board size. Companies followed these strategies largely at the behest of fund managers, who themselves benefitted from the steady increases in stock price that these strategies promised, for fund manager bonuses were tied to improvements in the value of the portfolios they managed. CEOs at first resisted these innovations, but soon realized that they stood to win big by taking stock options and by focusing on increases in stock value rather than on growth for its own sake. They embraced some of the innovations simply to keep fund managers happy.

We argue that while the average firm has assiduously applied the agency theory principles that increase corporate entrepreneurialism and risk, it has not applied the principles that bolster monitoring and foster executive self-restraint. Executives have not been required to hold more equity, and boards have not truly gained independence. These changes encouraged corporations to invest in riskier ventures and to deceive shareholders in the

early years of the first decade of the twenty-first century, producing high-profile failures at Enron, WorldCom, and Tyco and contributing to the recession of 2001. These changes then encouraged banks, insurance companies, and industries to assume speculative risk at the end of that decade, contributing to the Great Recession. There was nothing to prevent firms from pursuing excessive risk, and little to prevent them from committing outright fraud, and there still is little to restrain either pattern of behavior.

First, the CEOs of GM, GE, and IBM were paid salaries of a million dollars or so in 1970. By 2000, the chiefs of these companies were paid with stock options, and those who could raise share value could expect ten, twenty, or a hundred times the old salaries. Tying CEO earnings to stock price seemed like a good idea, but agency theory was misapplied, for firms did not simultaneously require executives to hold more equity. CEOs now gained from short-term increases in stock price but had little invested in the long run. They even benefitted from volatility. CEOs made out when the stock price plummeted in the window of option pricing and then spiked when it was time to exercise options. Because CEOs didn't expand their equity holdings, and didn't have to return money earned through options when stock prices plunged, the new compensation system encouraged CEOs to gamble on short-run endeavors that would increase firm value rather than to look after the long-term vitality of the firm. Not only was the theory misapplied, empirical evidence suggests that it may have been wrong in the first place. Econometric studies raise questions about whether stock options and equity holdings improve corporate performance. Moreover, the literature in behavioral economics and psychology suggests that "extrinsic" systems of motivation such as pay-for-performance may not improve managerial performance (Benabou & Tirole, 2003).

Second, dediversification certainly made America's firms more focused over the period we study. Yet empirical studies question whether focused firms are more efficient than conglomerates. The profits of single-industry firms and conglomerates do not show clear patterns of difference, and single-industry firms show superior *stock* performance only in the heyday of agency theory. We suggested that this pattern may indicate a self-fulfilling prophesy – if investors believe single-industry firms to be better values, their values will indeed rise. Moreover, in the same period, securities analysts preferred to rate focused firms, and institutional investors preferred to create portfolios out of focused firms. Those preferences may well be fleeting, and thus they may not continue to affect value. While it is uncertain whether focused firms earn higher profits, or attain higher market

valuations, than conglomerates, it seems likely that they face greater risk. As we have argued, focused firms do not have the cushion that conglomerates enjoy from operating in industries with different business cycle profiles and at different life-course stages. A cyclical enterprise can be buffered by countercyclical enterprises in a diversified conglomerate, but does not have that buffer if it is on its own. A youthful enterprise in need of capital can be fueled by a sunset enterprise, but not when it is on its own. The dediversified firm almost certainly faced greater risk of failure, and may not have made up for that risk with improved performance.

Third, the idea that by requiring management to finance expansion with debt, shareholders could discipline CEOs and prevent them from buying low-yield enterprises just to expand their empires, seemed sound. It also made sense that debt could leverage the investment of shareholders, who came to see executive decisions to take on debt as evidence of their confidence in the firm's prospects. But debt clearly increased corporate risk. Meanwhile the rise of junk bonds allowed even struggling firms to take on debt to solve short term problems. But the business cycle could undermine debt-financing strategies, for good times brought higher interest rates that increased the cost of debt and bad times brought reduced demand and lower profits with which to pay off debt. There was a downside to debt, then, but executives came to understand that debt could improve their own compensation. CEOs could use profits for share buybacks, raising the value of their options, and then turn around and leverage option value through debt-financed expansion. Because corporations did not claw back money previously earned from options when stock price sank, executives did not lose their previous winnings when debt-financed expansion did not pay off. This dynamic certainly contributed to the bank defaults of the Great Recession. Shareholders discovered that investment banks were highly leveraged in 2008, and wildly optimistic about their holdings of opaque and volatile investment vehicles such as collateralized debt obligations. Banks failed, but their executives did very well.

If these first three proposals were to encourage managers to behave entrepreneurially, and to make the firm more tractable, the fourth proposal was to exert restraint and monitoring by the delegates of shareholders. Corporate boards should look out for shareholder interests, and to do this they need to be independent of management. If managers were running the firm for their own benefit, boards could discipline them or throw them out. Agency theorists prescribed boards small enough to actually oversee strategy, filled with outsiders rather than inside managers, and headed by independent chairs. It was a good theory, but firms put it into practice very

selectively. They did make their board smaller. They did appoint more outsiders, although many had ties to the chief executives or employment histories with the firm. "Outsiders" weren't exactly shareholder representatives. Where boards did nominate true outsiders, they chose people from outside of the industry to comply with antitrust laws, which often meant that the outsiders were least able to assess firm strategy. Most importantly, CEOs became more, not less, likely to simultaneously hold the position of chairman of the board, and this undermined the core precept of true board independence, for when CEOs chaired boards, boards did not challenge corporate strategy and they rarely ousted the chief.

We have shown that the average company embraced agency theory dictums that served fund managers and CEOs, and that incidentally increased corporate exposure to risk, without embracing the dictums that imposed restraints on corporate behavior. But agency theory had much broader effects on the American economy, for its short-term pay-for-performance prescription won favor in other sectors, and it exposed those sectors as well to new forms of risk-taking.

The Wider Misapplication of Agency Theory's Compensation Formula

The misapplication of agency theory, in the form of short-term incentives for fluctuations in the market value of firms, came to affect pay systems well beyond the world of industrial firms. Investment banks had been organized as partnerships, but now they listed themselves on the stock market, making their partners wealthy through initial public offerings and ensuring that executives no longer faced the downside risk they had faced as partners. Institutional investors too were compensated based on annual performance, earning a proportion of the paper gains in their portfolios. Hedge fund managers and private equity fund managers were likewise paid based on the performance of their portfolios. In short order, key decision makers across the economy were being paid for moving the market value of corporations up, and all of these compensation systems suffered from the same focus on short-term gains and lack of a disincentive for taking risks that caused medium-term share price collapse. In this period as well the focus of the American economy was moving toward finance, and finance workers gained both prestige and income (Lounsbury, 2002; Davis, 2009).

This common approach to compensation encouraged all participants to overvalue firms, since private equity managers, hedge fund managers, institutional investors, and captains of the industry were paid for increases

in value, but not sanctioned for subsequent losses. All benefitted from short-term increases in the book value of firms. Hedge funds, for instance, typically charged investors a flat fee of 2% of funds under management and 20% of gains. They did not pay back 20% of losses. University endowment managers were compensated with bonuses for portfolio gains, and it led them as well to favor high values, especially for illiquid assets where value could be a matter of dispute. As an investment bank reported on Harvard's paper loss on private equity investments in 2008, the cause was "unrealistic pricing levels at which funds continued to hold their investments" and "fantasy valuations." The system encouraged CEOs and fund managers to promote paper gains in value, as a self-appointed oversight committee from Harvard's class of 1969 argued of the Harvard Management Corporation's 2008 losses; "The events of the last year show that the whole procedure of rewarding people so handsomely based on increases on paper value of the endowment was deeply flawed" (Condon & Vardi, 2009).

The partnership offered the ideal compensation system, if you listened to agency theorists, because executives were the shareholders. But partners in investment banks recognized the benefits of public ownership and stock options. Partners in the leading investment banks took their banks public, and became executives paid through stock options and bonuses rather than partners sharing in the profits. Now the heads of investment banks like the heads of industrial firms shared in the gains of their firms, but did not share in the losses. More generally, agency theory did not move industrial firms toward the logic of partnership by increasing equity holding. It moved all of these sectors toward a logic of gambling in increases in equity value. Risk-taking became contagious. Once your competitors, in industrial management, investment banking, institutional investment, hedge funds, or private equity begin engaging in high-risk, high-reward activities, it is difficult to resist. To keep the best talent at your investment bank, the logic goes, you have to offer compensation opportunities that equal those of your competitors. The system encouraged risk at Enron, WorldCom, and Tyco but also at the commercial banks that were issuing subprime mortgages, at the investment banks that were putting those mortgages into collateralized debt obligations and selling the tranches to institutional investors, at mutual funds that bought CDOs, and at insurers such as AIG that insured them. There was no downside risk to anyone in this chain of financial executives. None of these executives stood to lose from the failure of individual enterprises, even of their own enterprises.

Missteps in Regulatory Response

Will regulation remedy these problems? Efforts to regulate corporate malfeasance driven by the perverse incentives stock options created for executives have been meager. The Sarbanes-Oxley Act of July 30, 2002 defined the failures of Enron and WorldCom and Tyco as resulting from accounting fraud. The Senate title of the bill says it all; "Public Company Accounting Reform and Investor Protection Act." The bill made it marginally more difficult for CEOs and CFOs to file fictitious earnings reports and thereby boost stock price. Yet the Act did nothing to alter the stock option compensation system that had encouraged CEOs to delude the public. If Sarbanes-Oxley had outlawed compensation tied to short-term changes in stock price, it might have removed the incentive to "manage" earnings. As it stands, we have seen corporate restatements of earnings, which amount to admissions of earnings management, *increase* after the passage of Sarbanes-Oxley. Some argue that the increase is a good sign, indicating that companies are confessing their transgressions. But transgressions they are.

Regulatory responses to the crisis of 2008 are still in process, but to date, no one has proposed regulations that would rewind corporate strategy and governance to 1970. Aside from policies designed to prevent the failure of mortgage issuers, insurers, automakers, and banks, the main policy responses have been classical Keynesian countercyclical spending and moderate regulatory reform. We have proposals for a consumer finance safety commission that would apprise investors of high-risk investment instruments. We have proposals to limit the size of financial institutions so as to limit the exposure of the economy to the failure of individual institutions. None of these changes will fundamentally alter the incentives to executives.

Globally it looks like agency theory is winning more converts, not facing the sort of challenge one might expect for a theory that contributed importantly to two major recessions within a decade. Japanese firms are increasingly appointing outside directors, reducing board size to make boards more accountable, and expanding investor relations services to boost investor confidence (Kaplan, 1994; Kaplan & Minton, 1994; Dore, 2000; Jacoby, 2005, 2006). The "shareholder value" model of the firm promoted by agency theory appears to be alive and well, and to have been checked very little by the Enron, WorldCom, and Tyco scandals that led to the Sarbanes-Oxley Act, and not at all by the Great Recession that followed.

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NEOLIBERALISM IN CRISIS: REGULATORY ROOTS OF THE U.S. FINANCIAL MELTDOWN

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ABSTRACT

Social scientists have long been interested in how political institutions affect economic performance. Nowhere are these effects more apparent today than in the current U.S. financial meltdown. This article offers an analysis of the meltdown by showing how government regulation among other things helped cause it. Specifically, the article shows how regulatory reforms closely associated with neoliberalism created perverse incentives that contributed significantly to the increased lending in the mortgage market and increased speculation in other financial markets even as such behavior was becoming increasingly risky. The result was the failure of mortgage firms, banks, a major insurance company, and eventually the market for short-term business loans, which triggered a general liquidity crisis thereby thrusting the entire economy into a severe recession. Implications for future research are explored. The article also offers a few policy prescriptions and an assessment of their political viability going forward.

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