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ABSTRACT

This paper describes and considers explanations for changes in corporate governance and merger activity in the United States since 1980. Corporate governance in the 1980s was dominated by intense merger activity distinguished by the prevalence of leveraged buyouts (LBOs) and hostility. After a brief decline in the early 1990s, substantial merger activity resumed in the second half of the decade, while LBOs and hostility did not. Instead, internal corporate governance mechanisms appear to have played a larger role in the 1990s. We conclude by considering whether these changes and the movement toward shareholder value are likely to be permanent.

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Corporate governance in the U.S. has changed dramatically throughout the 1980s and 1990s. Before 1980, corporate governance – the mechanisms by which corporations and their managers are governed – was relatively inactive. Then, the 1980s ushered in a large wave of takeover[1] and restructuring activity. This activity was distinguished by its use of leverage and hostility. The use of leverage was so great that from 1984 to 1990 more than $500 Billion of equity was retired on net, as corporations repurchased their own shares, borrowed to finance takeovers, and were taken private in leveraged buyouts (LBOs). Corporate leverage increased substantially. Leveraged buyouts were extreme in this respect with debt levels typically exceeding 80% of total capital. The 1980s also saw the emergence of the hostile takeover and the corporate raider. Raiders like Carl Icahn and T. Boone Pickens became household names. Mitchell and Mulherin [1996] report that nearly half of all major US corporations received a takeover offer in the 1980s. In addition, many firms that were not taken over restructured in response to hostile pressure to make themselves less attractive targets.

In the 1990s, the pattern of corporate governance activity changed again. After a steep, but brief, drop in merger activity around 1990, takeovers rebounded to the levels of the1980s. Leverage and hostility, however, declined substantially. At the same time, other corporate governance mechanisms began to play a larger role, particularly executive stock options and the greater involvement of boards of directors and shareholders.

In this article, we describe the changes in corporate governance in the 1980s and 1990s. We then present and evaluate several potential explanations for these patterns. In particular, we consider three questions: First, what factors were responsible for the 1980s takeover wave and the concomitant leverage and hostility?   Second, why have leverage and hostility not returned with the return of substantial takeover activity in the 1990s, and what governance mechanisms, if any, have replaced them? Finally, does the current dominance of shareholder value as a corporate objective reflect temporary changes in the economic environment or permanent improvements in corporate governance?

We will argue that the preponderance of the evidence is consistent with an overall explanation as follows. The real drivers behind the increased dominance of capital markets and the attendant rise of shareholder value can be traced to deregulation, nationally and internationally, and to new information and communication technologies. For many companies these changes, which began before 1980, created a wedge between actual and potential performance. Managers were slow to respond, partly because of misaligned incentives, but likely also because they were confused and couldn't figure out the appropriate response (and didn't believe that the capital markets knew any better.) The fact that family firms didn't seem to respond very differently from the large, publicly owned companies, suggests that it was difficult to know what should be done.

At the same time, capital markets grew more powerful with increased institutional investments. The potential for improved corporate performance paired with empowered investors gave birth to takeovers, junk bonds and LBOs. In some cases, the capital markets reversed ill-advised diversification; in others, the capital markets helped to eliminate excess capacity; in others, the capital markets disciplined managers who had ignored shareholders to benefit other stakeholders. The incentive and governance features of LBOs are particularly representative of the discipline that the capital markets imposed.

Managers initially fought takeovers with legal maneuvers and by enlisting political and popular support. They were successful in that hostile takeovers became more costly in the 1990s. But by that time, managers, boards and institutional shareholders had seen what LBOs and other market driven restructurings could do. Thanks to lucrative stock option plans, managers could share in the market returns from restructured companies. Shareholder value became an ally rather than an enemy. This explains why restructurings continued at a high rate in the 1990s, but for the most part on amicable terms. There was less of a need for high leverage as deals could be paid for with stock with less worry that managers would abuse this privilege.

Will the capital market's influence continue? We do not have a firm opinion. But we will argue that shareholder value became dominant in the 1980s and 1990s in part at least because capital markets have a comparative advantage in undertaking the kind of structural reforms that deregulation and technological change necessitated. It is possible, therefore, that shareholder value and market dominance will subside as the need for corporate restructurings declines.

1. Corporate Governance in the 1980s: The Rise of Leveraged Takeovers

1.1 The Managerial Climate of the Early 1980s

Many authors have pointed out that the corporate governance structures in place before the 1980s, gave the managers of the large public corporations little reason to focus on shareholder concerns. Donaldson and Lorsch (1983), Donaldson (1994), and Jensen (1988, 1993) all argue that before 1980, management was loyal to the corporation, not to the shareholder. The external governance mechanisms that were formally available to shareholders were little used. External threats from raiders and takeovers were relatively few. Proxy fights were rare and didn't have much chance to succeed. Boards tended to be cozy with management, making board oversight weak. Internal incentives from management ownership of stock and options were also modest; in 1980, only 20 percent of the compensation of chief executive officers was tied to stock market performance (Hall and Liebman, 1998). Long-term performance plans were widely used, but they were based on accounting measures that tied managerial incentives much less directly to shareholder value.

1.2 The Takeover Boom of the 1980s

Takeover activity began to accelerate in the early 1980s and boomed throughout much of the decade. Although the main focus of this section is the 1980s, the discussion also carries into the 1990s, establishing the basis for later comparisons. (The figures and the analysis below are generally consistent with the results in Andrade, Mitchell and Stafford in this symposium.)

Figures 1 and 2 illustrate the extent of the merger boom by presenting measures of merger activity in recent decades. Figure 1 reports takeover activity as a percentage of U.S. GDP from 1968 to 1999. For a longer historical perspective, Golbe and White (1988) present time series evidence of U.S. takeover activity from the late 1800s to the mid-1980s. Their findings suggest that takeover activity above 2 to 3 percent of GDP is unusual. The greatest level of merger activity occurred around 1900 with activity at roughly 10 percent of GNP for a couple of years. By those measures, takeover activity in the 1980s is historically high and the activity in the late 1990s is extraordinary. Figure 2 offers another perspective by measuring acquisition volume as a fraction of stock market capitalization. By this measure, takeover activity was substantial in the 1980s and in the second half of the 1990s, reaching roughly 10 percent of the stock market in two years in each decade.

Takeovers in the 1980s were characterized by heavy use of leverage. Firms purchased other firms in leveraged takeovers by borrowing rather than by issuing new stock or using solely cash on hand. Other firms restructured themselves, borrowing to repurchase their own shares. Finally, some firms were taken private in leveraged buyouts or LBO's. In an LBO, an investor group, often allied with incumbent management, borrows money to repurchase all of a company's publicly owned shares and takes the company private. Kohlberg, Kravis & Roberts (KKR) was one of the earliest and most prominent LBO investors.

This pattern of additional debt is clearly illustrated in Figure 3, which reports the net issuance or retirement of equity by U.S. non-financial corporations as a percent age of total stock market capitalization from 1973 to 1999. From 1984 to 1990, U.S. non-financial corporations were net retirers of equity with annual net retirements running at roughly 3 percent of the total stock market value ($ 532 Billion in total over the six years). From 1991 to 1994, those same corporations became net issuers of equity. Since 1994, U.S. non-financial corporations have again retired equity on net, but at a lower rate than in the 1980s (roughly 1 per cent per year).

Figure 4 shows the volume of "going private" transactions. Most of these transactions were leveraged buyouts. These transactions increased sharply in the 1980s, but virtually disappeared in the

1990s.

Finally, Figure 5 reports the rate of issuance for non-investment grade or "junk" bonds, expressed as a percentage of total stock market capitalization. Junk bonds are bonds that are rated below investment grade by the top bond rating agencies. As such, they have higher yields and higher risks than investment grade bonds. The use of junk bonds increased substantially throughout the 1980s together with LBOs. In the mid- to late 1980s, more than 50% of the issues were takeover related. Drexel Burnham and Michael Milken, who originated this novel use of non-investment grade debt, underwrote or sold a large fraction of the junk bond issues in the 1980s. The use of junk bonds declined in the early 1990s with the credit crunch, and returned to 1980s levels in the late 1990s. The fraction used for takeovers, however, dropped to below 30%.

Almost half of all major U.S. companies received "hostile" takeover bids in the 1980s, where hostility is defined as bids pursued without the acquiescence of target management (Mitchell and Mulherin, 1996). Even those firms that were not actually taken over often decided to restructure in response to hostile pressure, particularly when corporate raiders had purchased large blocks of shares.

Figure 6 provides evidence of the high level of hostility in the 1980s, especially as compared to the 1990s. In the 1980s, between 20 percent and 40 percent of tender offers were contested by incumbent management.[2] In the 1990s, 15 percent or fewer have been contested. In this symposium, Andrade, Mitchell and Stafford report a similar decline of hostility in the 1990s for mergers overall. Again, this understates the difference between the 1980s and 1990s because it does not include hostile pressure from investors with large blocks of shares.

1.3 Do LBOs and Leveraged Takeovers Provide Productivity Gains?

When large-scale hostile takeovers appeared in the 1980s, many voiced the opinion that they were driven by investor greed; the robber barons of Wall Street had returned to raid innocent corporations. Today, it is widely accepted that the takeovers of the 1980s had a beneficial effect on the corporate sector and that efficiency gains, rather than redistributions from stakeholders to shareholders, explain why they appeared.[3]

The overall effect of takeovers on the economy is hard to pin down, because so many factors are involved. For example, the mild resurgence in productivity levels in the 1980s and greater boost in the second half of the 1990s is consistent with corporate governance boosting productivity – but it is consistent with other explanations as well.

One can try to assess whether the combination of takeovers, debt, and hostility is likely to have improved efficiency, by looking at the evidence on leveraged buyouts. With the use of high leverage and strong incentive mechanisms (described below), LBOs can be viewed as an extreme manifestation of the changes reshaping the corporate sector in the 1980s. If LBOs increased value, it seems likely that the shift in corporate governance increased value in other areas of the economy, too.

LBOs were associated with three large changes in corporate governance. First, LBOs changed the incentives of managers by providing them with substantial equity stakes in the buyout company. Because of high leverage, it was cheaper to give managers a high ownership stake. The purpose was to give managers the incentive to undertake the buyout, to work hard to pay off the debt, and to increase shareholder value. If successful, buyout company managers could expect to make a great deal of money. Kaplan (1989) reports that the chief executive officers of the leveraged buyouts increased their ownership stake by more than a factor of four, from 1.4 percent pre-leveraged buyout to 6.4 percent post-leveraged buyout. Management teams, overall, experienced a similar increase. In the early 1980s, this approach to management compensation was fundamentally different from the prevailing practice.

Second, the high amount of debt incurred in the leveraged buyout transaction imposed strong financial discipline on company management. It was no longer possible for managers to treat capital as costless. On the contrary, failure to generate a sufficient return on capital meant default. This contrasts sharply with the perceived cost of capital in firms with a conservative capital structure. Because dividends are discretionary, and often determined by management, the price of equity is much less tangible than the price of debt.

Third, leveraged buyout sponsors or investors closely monitored and governed the companies they purchased. The boards of the LBO companies were small and dominated by investors with substantial equity stakes.

The empirical evidence supports the view that leveraged buyouts improved efficiency. In the first half of the 1980s, buyout companies experienced improved operating profits (both absolutely and relative to their industry) and few defaults (Kaplan, 1989; Kaplan and Stein, 1993; see also Smith, 1990). However, the leveraged buyout experience was different in the latter half of the 1980s. Roughly one-third of the leveraged buyouts completed after 1985 subsequently defaulted on their debt, some spectacularly (Kaplan and Stein, 1993). These defaults led many to question the existence of efficiency gains.

But even for the late 1980s, the evidence is supportive of the efficiency story. The reason for the defaults was not that profits didn't improve, but that they didn't improve by enough to pay off the enormous quantities of debt that had been taken on. For example, Kaplan and Stein (1993) find that, overall, the larger leveraged buyouts of the later 1980s also generated improvements in operating profits despite the relatively large number of defaults. Even for deals that defaulted, Andrade and Kaplan (1998) find that the leveraged buyout companies retained approximately the same value they had attained before the leveraged buyout. In other words, the net effect of the leveraged buyout and default on capital value was slightly positive.

The case of Federated Department Stores illustrates this effect (Kaplan, 1994a). The leveraged buyout firm Campeau acquired Federated in 1988, in what is sometimes considered in the popular press to be the nadir of leveraged buyouts and the 1980s (Loomis, 1990; Rothchild, 1991). On January 1, 1988, Federated's debt and equity traded at $4.25 billion. From that point until it emerged from bankruptcy in February 1992, Federated returned roughly $5.85 billion in value (adjusted for changes in the S&P 500). In other words, Federated was worth $1.6 billion more after being purchased by Campeau than it would have been if it had matched the S&P 500. But unfortunately for him, Campeau paid $7.67 billion for Federated, and so went bust.

The logical question is, if LBOs increased value, why did so many companies default? The likely answer is that the success of the LBOs of the early 1980s attracted entrants and capital. Those entrants understood the basic LBO insights. The entrants bid up the prices of the leveraged buyouts.

As a result, much of the benefit of the improved discipline, incentives, and governance accrued to the selling shareholders rather than to the post-buyout leveraged buyout investors. The combined gains remained positive, but the distribution changed.

1.4 Why Did Financial Markets Become More Active in the 1980s?

The evidence in the previous section points to efficiency gains as the driving force behind the 1980s takeover wave. What was the underlying source of these efficiencies and why did corporate governance capitalize on them in the 1980s and not earlier?

Jensen (1986, 1988, 1989, 1993) takes the view that the 1980s takeovers were ultimately caused by a failure in the internal governance mechanisms of US corporations. The problems were long in coming. Ever since the 1930s, management incentives had become weaker as corporations had become larger, management ownership had shrunk and shareholders had become more widely dispersed. No one watched management the way J.P. Morgan and other large investors did in the early part of the 20th century. Boards, which were supposed to be the guardians of shareholder rights, mostly sided with management and were ineffective in carrying out their duties. One of the big drawbacks of the corporation, according to Jensen, was that it could and did subsidize poorly performing divisions using the cash generated from successful ones instead of returning the "free cash flow" to the investors.

According to Jensen (1993), corporate mismanagement in the 1970s finally caused capital markets to react. The large windfall gains from the oil crisis that were spent on excessive oil exploration and diversification were a concrete trigger. But changes in technology and regulation more broadly had led to a large amount of excess capacity in many U.S. industries. Managers were unwilling to pair down their operations or simply exit as long as they had the financial resources to continue. In the early and mid 1980s, the capital markets finally found the instruments to reduce excess capacity. Leveraged acquisitions, leveraged buyouts, hostile takeovers, and stock buybacks were successful in eliminating free cash flow, because the debt service requirements that usually accompanied them prodded managers to find ways to generate cash to make interest payments.

Impressed by the performance of the LBOs in the early 1980s, Jensen (1989) went so far as to forecast that in most cases these new organizational forms would soon eclipse the corporation. Among the main benefits of LBO associations run by buyout firms like Kravis, Kohlberg and Roberts, was that they didn't permit cross-subsidization.

There is little doubt that the elimination of excess capacity played an important role in the takeovers of the 1980s, particularly in industries like oil. It is less clear, however, that excess capacity was the primary driver of the takeover wave in the way Jensen suggests. The excess capacity explanation makes some strong predictions about investment. Specifically, if firms involved in takeovers and buyouts were spending too much money on capital expenditures, then after the corporate control transaction, these companies should spend less. The evidence for this is mixed. Kaplan (1989) and Kaplan and Stein (1993) find that management buyout firms do make large cuts in capital expenditures. However, Servaes (1994) finds no evidence that targets of all takeovers, of hostile takeovers, and of going private transactions were overinvesting in capital expenditures before the takeover. Furthermore, there do not appear to be significant changes in the ratio of capital expenditures to sales for firms that went through takeovers in the 1980s (Healy, Palepu and Ruback, 1992; Bhagat, Shleifer, and Vishny, 1990).

Also, it is not obvious that self-interest alone was the reason why managers didn't exit industries with excess capacity or didn't return free cash flow. Free cash flow is not an accounting number and how much cash should be returned to investors depends on the estimated returns from internal investments. It is plausible that some management and board decisions stemmed from uncertainty about returns and competitive position in a changed market environment. Moreover, returning cash to investors was not part of the prevailing management culture at the beginning of the 1980s. Managers were supposed to have a surplus, not a shortage of investment ideas. (Witness the difficulties that today's fund managers have with this same issue.)

A second explanation of why takeovers appeared in the 1980s, offered by Shleifer and Vishny (1990), is that "the takeover wave of the 1980s was to a large extent a response to the disappointment with conglomerates" that had been assembled in the previous merger and acquisition wave in the 1960s. In their view, corporate America in the 1980s "returned to specialization." Companies sold unrelated businesses and expanded into related businesses. "To a significant extent the 1980s reflect the deconglomeration of American business. Hostile takeovers and leveraged buyouts ... facilitated this process." In other words, the 1960s conglomeration wave was a mistake, at least in hindsight, something managers were slow or unwilling to recognize until capital markets began to exert pressure on them.

Again, this argument has strong implications. If mergers were about deconglomeration, then it should be true that corporate diversification was value decreasing and deconglomeration value increasing in the 1980s, and that U.S. business became substantially less diversified in the 1980s after the wave of deconglomeration. The evidence on these implications is mixed.

In influential pieces, Lang and Stulz (1994) and Berger and Ofek (1995) find that diversified firms in the U.S. trade at a discount to single-segment firms in the 1980s and early 1990s. These pieces suggest that diversification destroys value. Berger and Ofek (1996) find that for diversified firms the likelihood of a takeover increases with the size of the diversification discount.

More recent evidence, however, suggests that at least half of the diversification discount (and potentially a good deal more of it) can be attributed to the fact that diversifying firms are different. Many of the targets were discounted before they were acquired and became part of a diversified firm (Graham, Lemmon and Wolf, 2000). Similarly, acquirers apparently trade at a discount before making diversifying acquisitions (Campa and Kedia, 1999).[4] But the most difficult finding to explain is that the combined gain to bidder and target shareholders at an acquisition announcement even in diversifying acquisitions is always positive on average in every study we have seen.

While U.S. businesses did become less diversified during the 1980s, the extent of the decrease remains unclear. Montgomery (1994) points out that, in 1991, the typical firm in the S&P 500 had the same number of industry segments as the typical firm in the S&P 500 in 1981. Comment and Jarrell (1995), on the other hand, report bigger declines in diversification over the 1980s. Among firms covered by Compustat, the percentage of firms with a single business segment went up from 36.2 percent in 1978 to 63.9 percent in 1989. Finally, Mitchell and Mulherin (1996) find that takeover activity in the 1980s clustered in particular industries at particular points in time. In contrast, takeover activity in the 1960s and 1970s exhibited no such clustering. To them, the 1980s seem less about breaking up conglomerates than about restructuring certain industries.

Stein (2001) summarizes the large and conflicting body of evidence on diversification and its value implications. One of the main observations is that it was primarily the poorly performing conglomerates that were taken over and restructured (Berger and Ofek, 1996). In that respect, conglomerates may not be any different from other firms that perform poorly (Morck, Shleifer, and Vishny, 1989). Overall, these empirical results suggest that deconglomeration played a role in the 1980s takeovers, but was probably not the primary driver.

Donaldson (1994) provides yet another perspective on the 1980s takeover wave. He argues that in the 1980s the balance of power shifted from corporate stakeholders to shareholders, because of a rise in the number of institutional shareholders. From 1980 to 1996, large institutional investors nearly doubled their share of ownership of U.S. corporations from under 30% to over 50% (Gompers and Metrick, 2000), while individual ownership declined from 70% in 1970, to 60% in 1980, to 48% in 1994 (Poterba and Samwick, 1996). The shift towards institutional ownership and the resulting shift in power are keys for understanding why the takeovers appeared in the 1980s. Donaldson calls the 1980s the "decade of confrontation."

One of the important effects of greater institutional ownership was on takeovers. Fund managers were more interested in squeezing out higher returns and less loyal to incumbent management than individual investors. Institutional investors were often the key sellers of larger blocks of shares in takeovers. This made takeovers easier. Institutional investors also supported takeovers by being large investors in the buyout funds and in the market for high-yield bonds.

In summary, we believe the 1980s takeover wave was caused by a complex combination of the factors mentioned above. Without a large increase in pension assets, which concentrated financial power, it is less likely that there would have been a willingness and ability to support large multi-billion dollar takeovers. The scale and scope of the 1980s takeover wave was a product of the increased size of the financial markets. On the other hand, there must also have been significant inefficiencies in the way corporations were run. Without inefficiencies, the purpose of takeovers would have been missing.

The source of the inefficiencies remains open to debate. Jensen (1986, 1988) thinks the problem is a poorly designed governance system, but his endorsement of the LBO association has not had material following. In the 1990s, the largest public corporations have become even larger and many of them have been exceptionally successful. The privatization movement has stopped as seen in Figure 4. In Section 3 we suggest that the efficiencies provided by market intervention and shareholder value may partly reflect a temporary comparative advantage of these forms of governance.

2. Why Did Corporate Governance and Mergers in the 1990s Look So Different?

At the end of the 1980s, the takeover wave ended. As the previous figures show, takeover volume, going private volume, and the use of leverage declined substantially in 1990. At the time, anti-takeover legislation and jurisprudence, overt political pressure against leverage[5], the collapse of the high yield bond market, and a credit crunch were among the explanations proffered for the decline (Jensen, 1991; Comment and Schwert, 1995). Since then, both the political pressure against leverage and the credit crunch have abated and the non-investment grade bond market has recovered (see figure 6). Yet, neither the use of extreme leverage nor hostility have come close to their 1980s levels, suggesting that anti-takeover legislation has had an effect.

In this section, we document that corporations in the 1990s began to emulate many of the beneficial attributes of LBOs. This could explain why hostility declined: hostile takeovers were no longer needed, as companies voluntarily restructured and adopted a shareholder value perspective with the prodding from time to time of institutional shareholders. The fear of the 1980s hostile takeovers likely played a part in this development. Also important (and perhaps more so), is that managers became aware of the potential benefits of pursuing shareholder value by observing the success of LBOs and takeovers in the 1980s. Helped along by generous stock option programs, management came to endorse shareholder value in the 1990s and pursue it with vigor.

2.1 The Rise of Incentive-based Compensation

Hall and Liebman (1998) find a remarkable increase in equity-based compensation for U.S. CEOs. From 1980 to 1994, the average annual CEO option grant (valued at issuance) increased almost seven-fold. As a result, equity-based compensation made up almost 50% of total CEO compensation in 1994, compared to less than 20% in 1980. The effect of the increase in equity-based compensation has been to increase CEO pay-to-performance sensitivities by a factor of ten times from 1980 to 1998 (Hall and Liebman, 2000).[6] The increase in pay-for-performance sensitivity over this period is of the same order of magnitude as the increase for CEOs in LBOs found in Kaplan (1989).

The results in Hall and Liebman combined with those in Holderness, Kroszner and Sheehan (1999) suggest that managerial equity ownership is very high today relative to most of the last century (and perhaps all of it). Holderness et al. compare equity ownership by officers and directors in 1935 and 1995 and find that equity ownership was substantially greater in 1995 than in 1935.

It is arguably the case that the large payoffs earned by LBO sponsors and, more importantly, by the top executives of LBO companies made it more acceptable for top executives of public companies to become wealthy through equity-based compensation.

2.2 Forcing a Recognition of the Cost of Capital

The second distinguishing characteristic of LBOs is to incur enough leverage to force management to view capital as costly, because LBOs have to earn a return on capital sufficient to repay the interest and principal on the debt. Corporations (and consulting firms) now increasingly try to create a parallel effect through new performance measurement and compensation programs. For example, Stern Stewart markets Economic Value Added (EVA) and the Boston Consulting Group markets Total Business Return (TBR). These programs compare a measure of return on capital – usually the after-tax profit earned by a company or division – to a measure of the cost of capital – the after-tax profit required by the capital invested, i.e., the product of capital employed and the weighted average cost of capital.[7] Managers are then monitored and compensated on the extent to which the return on capital exceeds the cost of capital. This allows boards and CEOs to make sure that managers view capital as costly.

While it is reasonable to argue that these programs do not impose as much discipline as the debt in an LBO would, there is evidence that these programs have LBO-like effects.[8] Biddle, Bowen and Wallace (1999) find that firms that implement EVA, improve operating efficiency, dispose of assets, reduce investment, and repurchase stock to a greater extent than a control sample of non-implementers.

There is also anecdotal evidence that companies increasingly approach decisions with the goal of maximizing shareholder value. For example, consulting firms like McKinsey & Co. routinely measure the effects of their consulting assignments on shareholder value (Copeland et al., 1994).

2.3 Monitoring

The third distinguishing characteristic of LBOs is closer monitoring by shareholders and the board. There are at least two reasons it is likely that public company shareholders monitor management more closely in the 1990s than in the 1980s. First, as mentioned earlier, the shareholdings of professional, institutional investors increased substantially. From 1980 to 1996, large institutional investors nearly doubled the share of the stock market they owned from under 30% to over 50% (Gompers and Metrick, 2000). This means that professional investors – who have strong incentives to generate greater stock returns – own an increasingly large fraction of U.S. corporations.

Second, in 1992, the SEC substantially reduced the costs to shareholders of mounting proxy contests that challenged management teams. Under the old rules, a shareholder had to file a detailed proxy statement with the SEC before talking to more than ten other shareholders. Under the new rules, shareholders can essentially communicate at any time in any way as long as they send a copy of the substance of the communication to the SEC afterward. The rule change has lowered the cost of coordinating shareholder actions and to block management proposals. Not surprisingly, the Business Roundtable – a group of 200 CEOs of the very largest U.S. companies – and other management organizations were extremely hostile to this rule change when it was proposed.

Shareholder activism has increased in the U.S. since the late 1980s with CALPERS, the Council of Institutional Investors, the LENS Fund, and Michael Price's Mutual Shares among the more prominent activists. Changes in the proxy rules have made this possible. The evidence on the impact of shareholder activism, however, is mixed. Karpoff (1998) summarizes the results of 20 empirical studies on the effects of formal shareholder proposals and private negotiations with firms, and finds evidence of, at best, only small effects on shareholder value.

Unfortunately, it is difficult to measure the extent and effects of shareholder activity because much of it is communicated verbally and not reported (Russell Reynolds Associates, 1995). Interestingly, Gompers and Metrick (2000) find that returns are higher in companies with greater institutional ownership. This is consistent with a monitoring role for large institutions – greater institutional ownership implies more effective monitoring, which is associated with higher stock prices. Furthermore, in a survey of institutional investors, Felton et al. (1997) find that many institutional investors will pay a premium of approximately 10% for companies with good corporate governance.

There also is evidence that boards of public companies have changed in the 1990s and become more active monitors than in the past. Like top management, directors receive an increasing amount of equity-based compensation. Perry (1999) estimates that the fraction of compensation for directors that is incentive-based increased from 25% in 1992 to 39% in 1995. Russell Reynolds Associates (1998) report that the use of incentive-based compensation for directors also increased from 1995 to 1997.

Boards of public companies have become somewhat smaller over time (Hermalin and Wesibach, 2000; Wu, 2000). This is interesting because boards of LBO firms are smaller than otherwise similar firms (Gertner and Kaplan, 1996); and smaller boards are associated with higher valuations (Yermack, 1996).

The CEO turnover process also appears to have changed. Huson, Parrino, and Starks (1999) compare CEO turnover for large companies from 1971 to 1994. They find a marked increase in forced turnovers and hiring of new CEOs from outside the company. The incidence of forced turnovers and outside succession is highest from 1989 to 1994.

The evidence on the relation between turnover and performance is mixed. Huson, Parrino, and Starks (1999) find that CEO turnover is more sensitive to changes in operating income from 1989 to 1994 than in earlier years. On the other hand, Murphy (1999) finds that CEO turnover is less sensitive to industry-adjusted stock performance from 1990 to 1995 than in earlier years.

2.4 Changes in Regulation and Taxation

Two other corporate governance changes in the 1990s – one in regulation and one in taxation – are worth mentioning.

In 1992, the SEC required public companies to provide more detailed disclosure of top executive compensation and its relation to firm performance, particularly stock performance. This requirement arguably had two effects. First, it focused boards of directors on stock performance. Companies now routinely report firm, industry, and market stock performance in their proxy statements. This represents a substantial shift from the pre-1980s when companies were more likely to focus on earnings per share, growth, and other measures that might or might not affect company stock performance. Second, the requirement makes equity-based compensation packages easier to defend. Boards of directors are less likely to be criticized by shareholders or the media if managers are compensated based on stock performance.

In 1993, Congress passed legislation that capped the tax deductibility of top executive compensation at $1 million unless the compensation was performance-based. Hall and Liebman (2000), Perry and Zenner (2000), and Rose and Wolfram (2000) find that this legislation had at most a modest effect on the increased use of performance-based compensation.

2.5 Summing up the Change in Corporate Governance in the 1990s

Taken as a whole, the evidence strongly suggests that U.S. corporations have increasingly pursued shareholder value friendly policies on their own in the 1990s. This also provides the most plausible explanation of why hostile takeovers and LBOs largely disappeared in the 1990s – they were no longer needed. A telling piece of anecdotal evidence on the change in the corporate mindset comes from a 1997 statement on corporate governance by the Business Roundtable(1997). Up until 1995, the Business Roundtable consistently opposed hostile takeovers and raiders as well as substantial changes in corporate governance practices. In 1997 the Business Roundtable changed its position to read "the paramount duty of management and the board is to the shareholder and not to ... other stakeholders." Commenting on this, Nell Minow, a prominent shareholder activist noted: "I'm not on the fringe anymore" (Byrne, 1997).

We believe management's acceptance of the shareholders' perspective was greatly aided by lucrative stock option plans, which allowed executives to reap big financial benefits from increased share prices. As a result, the restructuring of corporate America continued in the 1990s on much more amicable terms than in the 1980s.

Another reason why the 1990s merger wave differed from the 1980s wave likely has to do with different stages of the restructuring process. In the 1980s, restructuring was just beginning. The focus was on forcing corporate assets out of the hands of managers who could not or did not want to use them efficiently. The results included takeovers and restructurings of companies with excess capacity as well as bust-up takeovers of inefficient conglomerates. Hostility and leverage were important accompaniments. The 1990s appear to have been more of a build-up wave with assets reconfigured to take advantage of growth opportunities in new technologies and markets. This logic also fits with the evidence of increased use of equity in place of debt.

The move towards shareholder and market preeminence also is apparent in the way corporations have reorganized themselves. There has been a broad trend towards decentralization. Large companies are trying hard to become more nimble and to find ways to offer employees higher-powered incentives. At the same time, external capital markets have taken on a larger share of the reallocation of capital. The large volume of mergers is evidence in point. Venture capital funding commitments also have increased by an order of magnitude over the 1990s (as discussed in this symposium by Gompers and Lerner). While corporate managers still reallocate vast amounts of resources in the economy through internal capital and labor markets, the boundary between markets and managers appears to have shifted. As managers have ceded authority to the markets, the scope and independence of their decision-making have narrowed.

3. An Alternative View on Changes in Corporate Governance

There are two interpretations of the increased influence of markets on corporate decision-making. One view is that, after a period of corporate mismanagement, including misguided experiments with conglomerates in the 1960s and waste of free cash flow in the late 1970s and early 1980s, we have finally seen a return to healthy market capitalism. Shareholder value is back, because it is the most efficient form of corporate governance.

While such a conclusion is consistent with much of the evidence we have presented, the efficiency hypothesis has its weak spots. Chief among them is the U.S. economic performance of the 1960s. How could productivity and GDP growth be so great at a time when managers supposedly wasted large amounts of money on conglomerates? How could an inefficient governance system produce so much more wealth? And what about all the family firms that became conglomerates in the 1960s? Family firms are subject to fewer agency problems than widely held companies, yet many of them followed the general trend. The 1960s, rightly or wrongly, viewed conglomerates more favorably than we do today. Indeed, stock markets reacted positively to most conglomerates in the 60s (Matsusaka, 1993). If hindsight can condemn this economically successful period as mismanaged, then what guarantees that shareholder value will not suffer the same fate?

As an alternative hypothesis, this section explores the possibility that capital markets have come to play a bigger role not because they have become better at allocating capital and not because managers misbehaved, but rather because the market's comparative advantage has been favored by economy-wide trends in deregulation, globalization, and information technology.[9] If the shifts in corporate governance have been driven by these factors, then the market's strong influence on corporate governance may be more transitory.

3.1 When Markets are Superior Agents of Change

Markets are more effective than managers when it comes to moving capital from declining industries to emerging industries. Firms are experts at particular technologies, products and processes. It would make little sense for shareholders to become directly involved in General Motors's choice of car models, for instance -- though their opinion may be reflected in the subsequent share price. But if resources are to shift from car manufacturing to computer manufacturing, there is little reason to believe that having General Motors start making computers, an area in which the company currently has little expertise, would make economic sense. Instead, the market may have a role to play in funneling capital toward the new companies.

Europe offers a counterexample of where, instead of markets moving capital from sunset industries to sunrise industries, corporations have tried to do so. Mannesmann and Preussag are perhaps the best examples. Both were in the metals business just ten years ago. Before the recent takeover by Vodafone, Mannesmann was well on its way to become a pure wireless operator. In another five years, Preussag will probably be a pure travel business. While both of these transitions appear to have been relatively successful, migration of corporate identity as a mechanism for economic restructuring seems difficult to rely upon. Europe and Japan have clearly had more difficulties transforming their corporations than the United States in the last two decades.

A major problem with asking a corporation to migrate between businesses is that it exacerbates internal conflicts (Milgrom and Roberts, 1988; Meyer, Milgrom and Roberts, 1992). Employees know that their firm-specific knowledge is likely to become less valuable once the firm changes course and starts pursuing new lines of business. A new firm, with a lack of commitments and old baggage, can offer a distinctive competitive advantage in rapidly growing industries such as information technology and telecommunications. From this perspective, forcing older companies to adhere more rigorously to maximization of shareholder value reduces those activities of employee influence that cause costly delays, distorted investment decisions, and misguided efforts to save jobs. If decisions of where to cut and where to expand jobs were left to a democratic body of workers, the heterogeneity in employee preferences would make the process of change slow and costly. When shareholders determine in which direction a company should go, the decision can be made swiftly without favoring any particular group of workers (Hansman, 1996; Hart and Moore, 1996).

Markets also have a distinct advantage over corporations when it comes to evaluating and rewarding future performance. U.S. capital markets have often been accused of short-termism (for example, Porter, 1992), but insofar as these accusations suggest that investments should not be evaluated on an ongoing basis in the light of current events, the accusations are largely misplaced. Especially in a time of technological transition, quick reassessments of where capital should be reallocated are a rational response to greater uncertainty. Large swings in stock prices arise precisely because the market takes a long view of growth expectations. Also, while stock prices are highly imperfect, they have one unmatched virtue: they have integrity, because markets are asking people to put their money where their mouth is.

Without the measuring stick of share prices, the long-term effects of management actions would become much harder to assess. If Netscape, E-Bay or Amazon had been invented inside a big company, their potential value would probably have been overlooked. Even if some degree of value had been seen, it would have been difficult or impossible to give management a strong incentive to maximize the value inherent in these ideas. As independent firms with their own stock prices, management incentives were altogether different. In times of change, when the future takes on exceptional significance, the value of market information and market-based incentives is particularly great.

The hierarchical investment approval process that is characteristic of internal capital markets is another impediment to innovation within firms. Business history is littered with tales of frustrated entrepreneurs, who could not realize their ideas as employees, but managed to establish successful new businesses on their own. Tight screening of projects should not necessarily be seen as a defect of the large corporation. People within the organization do not carry the responsibility that an entrepreneur carries. The freedom to pursue innovation needs to be curbed to avoid excessive experimentation and inattention to the business end of the process. After all, the freedom to pursue innovation with the company's money needs to be monitored, lest easy money foster excessive experimentation and inattention to the business end of the process. (Fairchild Technologies and Xerox PARC are famous examples where the fruits of innovation were reaped by others.) By design, the large corporation is not set up for revolutionary inventions (Holmstrom, 1989; Bhide, 2000).

Today, corporations try to adjust to the increased need for innovation by outsourcing some of it to start-ups. Companies realize that their in-house resources are insufficient to generate the quantity and variety of new ideas they need, and so they must participate in the market-oriented innovation process, whether by forming alliances with promising start-ups, often by using corporate venture capital funds, and sometimes by purchasing firms outright.

3.2 Will the market's influence continue to prevail

The logical next question is whether the capital market's enhanced role will be sustained. One argument is that the pace of economic change has accelerated and that market flexibility will continue to be valuable, if not more valuable, over time. Alternatively, one might appeal to history to argue that this continually faster change is unlikely. Periods of big technological and organizational change are, nearly by definition, followed by less exciting periods. If change itself is the only driver of market influence, won't we eventually see a return to old ways of doing business?

A reversion to the older style of corporate governance in the 1960s and 1970s seems unlikely for two reasons. First, the institutional and organizational knowledge and infrastructure that have been developed to deal with corporate restructuring have changed traditional trade-offs. For instance, financial markets have more timely and better information, many new instruments, and much new expertise available to help managers reallocate capital. This is also a reason why merger and acquisition activity is likely to stay at a higher average level in the future.

The second reason why we will not see a return to the old days is that deregulation and information technology have brought structural changes that have altered the old trade-offs between markets and hierarchies. For instance, deregulation has increased market opportunities and competition, reducing the cost of potential hold-ups in a vertical chain. Improved information technology, including the Internet, have made access to financial capital easier and reduced the power of physical assets relative to human capital (Rajan and Zingales, 2000).

The industrial and organizational implications of these changes have not been easy to predict. In the 1970s, the common belief was that powerful computers would result in more centralization and ever-larger corporate structures, since corporations would become better planners and information processors relative to the market. This matches poorly the growth of networked, market-intermediated forms of organization both in new and traditional industries. While the current number of alliances, joint ventures and related hybrids is likely to decline as the rush into new markets declines, it is also clear that companies have discovered new patterns of cooperation that will have a permanent effect on the organizational landscape. On the other hand, global companies seem to become ever larger, in contrast to those arguing the demise of the corporation (Jensen, 1989). Evidently, hierarchies as well as markets benefit from information technology with the net effects generally ambiguous (Brynjolfson, 1994). As Baker and Hubbard (2000) have nicely demonstrated in the context of trucking, a detailed structural study is required to sort out competing effects.

4. Concluding Remarks

U.S. corporate governance has changed substantially in the last 20 years. The underlying substance of this transformation has been that U.S. managers have become much more focused on stock prices. The corporate governance mechanisms that have driven this focus have evolved over time, from the leveraged hostile takeovers and buyouts of the 1980s to the incentive-based compensation, activist boards of directors and shareholders in the 1990s.

We have argued that at least some of the efficiency gains associated with these changes can be traced to the comparative advantage of markets in undertaking large-scale change. Since, these effects are temporary, it is possible that the current level of market influence on the governance and organization of firms is going to abate. It is not hard to build a scenario in which the pursuit of shareholder value becomes a less important guideline to managers in the next few years. Stock options were popular when the stock market boomed in the 1960s, but disappeared during the flat market in the 1970s. If the stock markets are flat or down for the next few years, then the extensive reliance on stock options may again dissipate, leading managers to have less focus on stock prices.

But even after taking such reservations into account, it seems to us that a more market-oriented style of corporate governance than existed up to the early 1980s is here to stay. The growth of mutual funds and institutional investors seems certain to continue over the next couple of decades. The market-based system of corporate governance also seems to have a potentially powerful role to play as the forces of deregulation, globalization, and information technology continue to sweep across the world economy. It will be revealing to see how market-oriented the corporate governance systems in other countries will become.

Historically, U.S. corporate governance has differed in the use of equity-based compensation, in the ability to repurchase one's own shares, and in allowing a number of takeovers[10]. In recent years, other countries have begun to move toward the U.S. model. In Europe, according to accounts in the popular press, the use of stock options for executives and boards is increasing. Japan has eliminated a substantial tax penalty on executive stock options.[11] In the last several years, France, Germany, and Japan have made it easier for companies to repurchase their shares. Finally, continental Europe has recently experienced a rise in hostile takeovers. Escherich and Gibbs (2000) report that 34 hostile bids with a total value of $406 billion were announced in 1999 in Continental Europe. These included Vodaphones' bid for Mannesmann, TotalFina's bid for Elf Aquitane, and Olivetti's bid for Telecom Italia. This volume compares with 52 bids for $69 billion over the entire 1990 to 1998 period.

In the 1970s and 1980s, many observers criticized the U.S. capital markets and governance system quite strongly and looked to other systems, particularly the German and Japanese systems, as being superior (for example, Porter, 1992). But since the mid-1980s, the U.S. style of corporate governance has reinvented itself, and the rest of the world seems to be following the same path.

Acknowledgements

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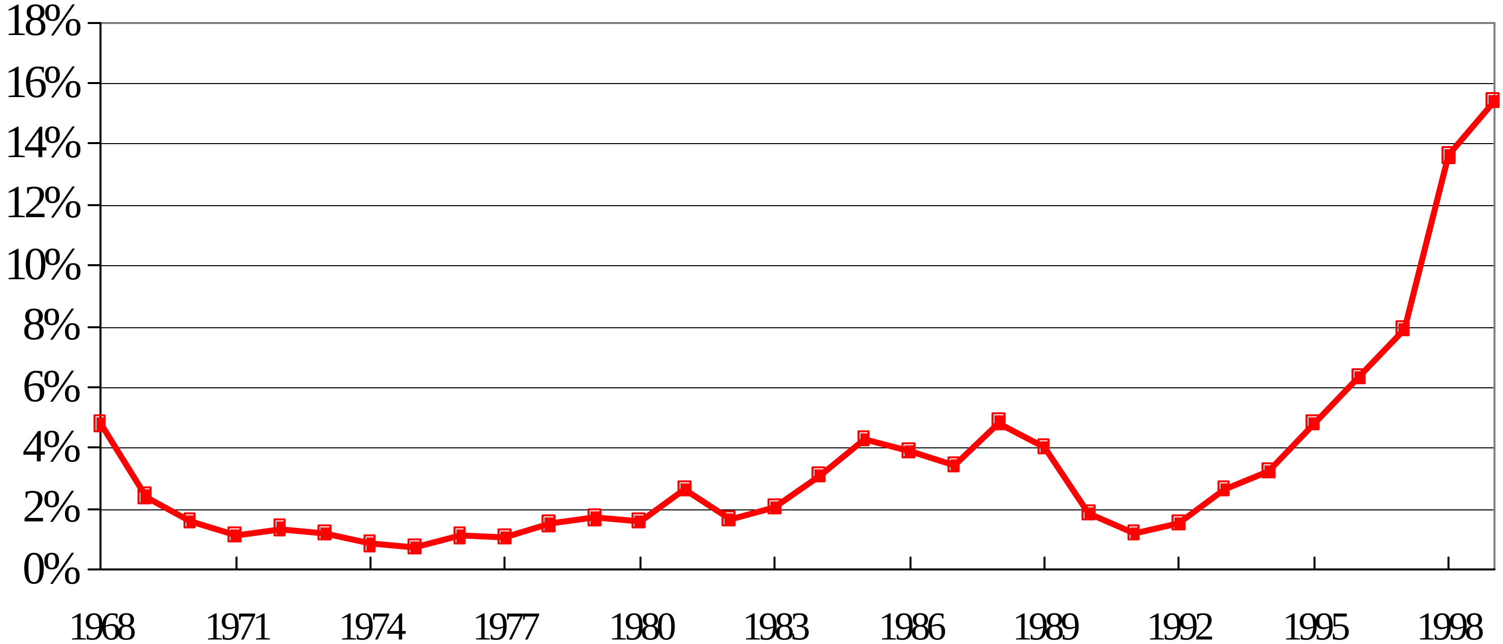
Figure 1

All Acquisition Volume
As % of Average GDP
1968-1999



Source: Mergerstat, Authors' Calculations

Figure 2

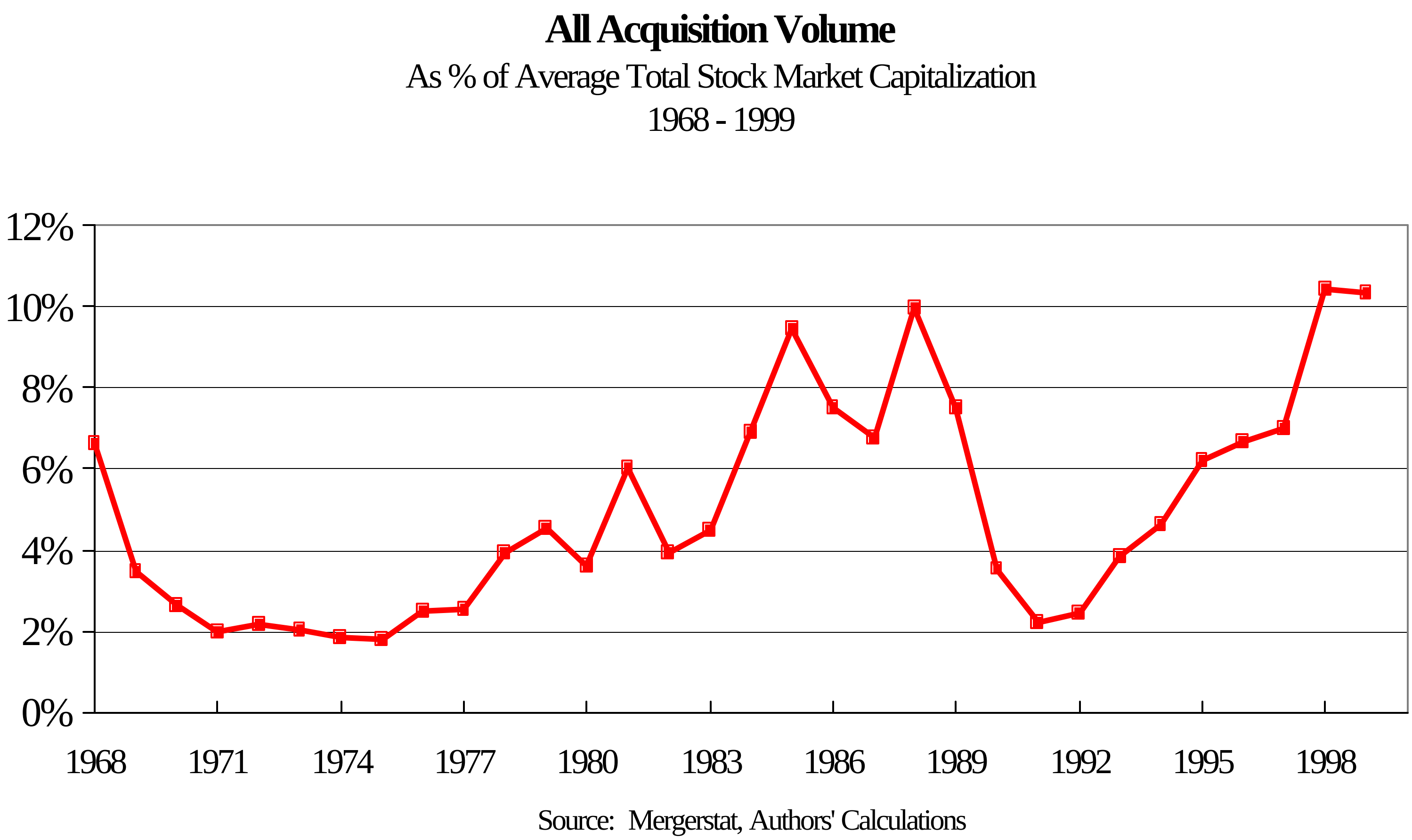

All Acquisition Volume
As % of Average Total Stock Market Capitalization
1968 - 1999
12%
10%
8%
6%
4%
2%
0%
1968
1971
1974
1977
1980
1983
1986
1989
1992
1995
1998
Source: Mergerstat, Authors' Calculations

Figure 3

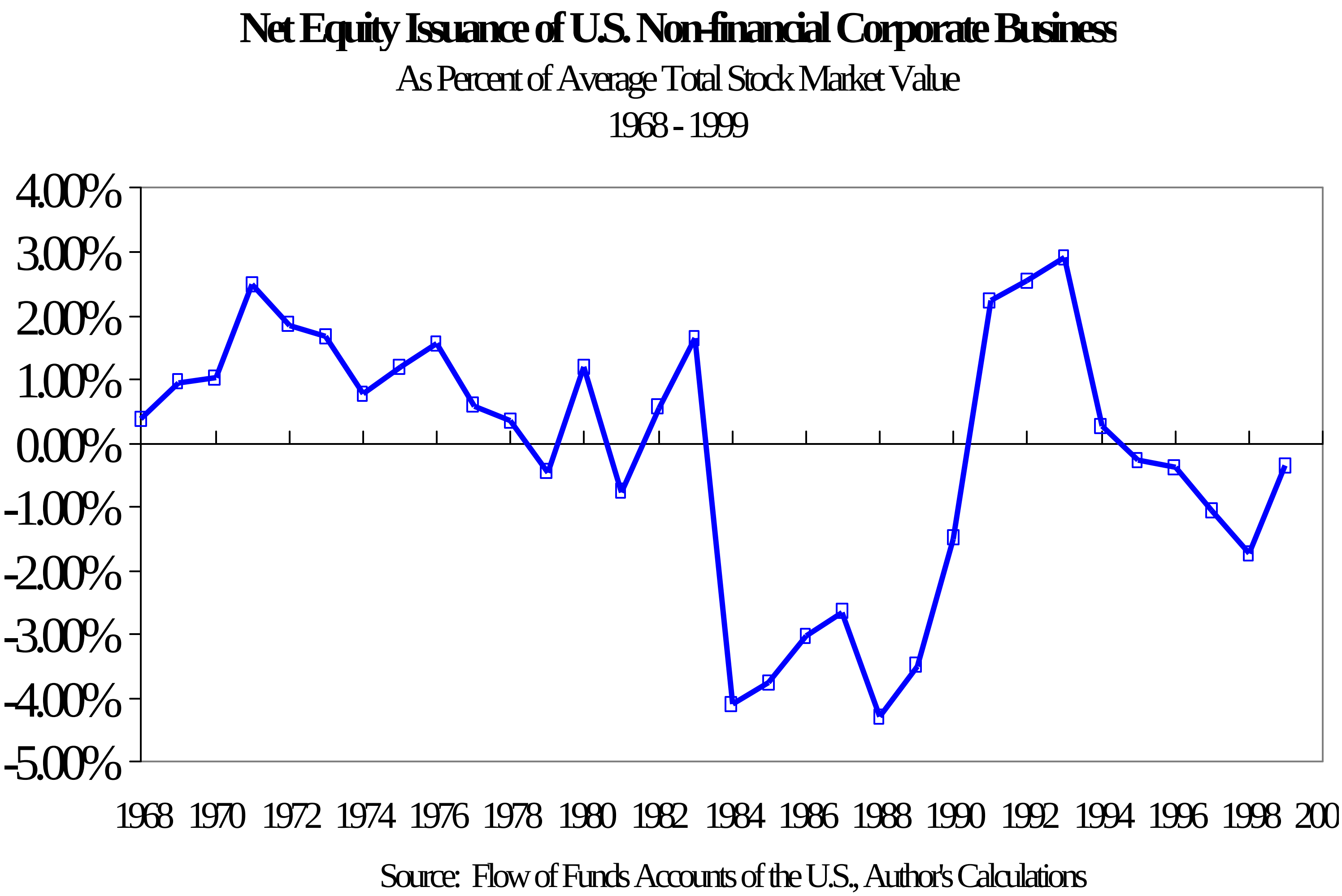

Net Equity Issuance of U.S. Non-financial Corporate Business
As Percent of Average Total Stock Market Value
1968 - 1999
4.00%
3.00%
2.00%
1.00%
0.00%
-1.00%
-2.00%
-3.00%
-4.00%
-5.00%
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
200
Source: Flow of Funds Accounts of the U.S., Author's Calculations

Figure 4

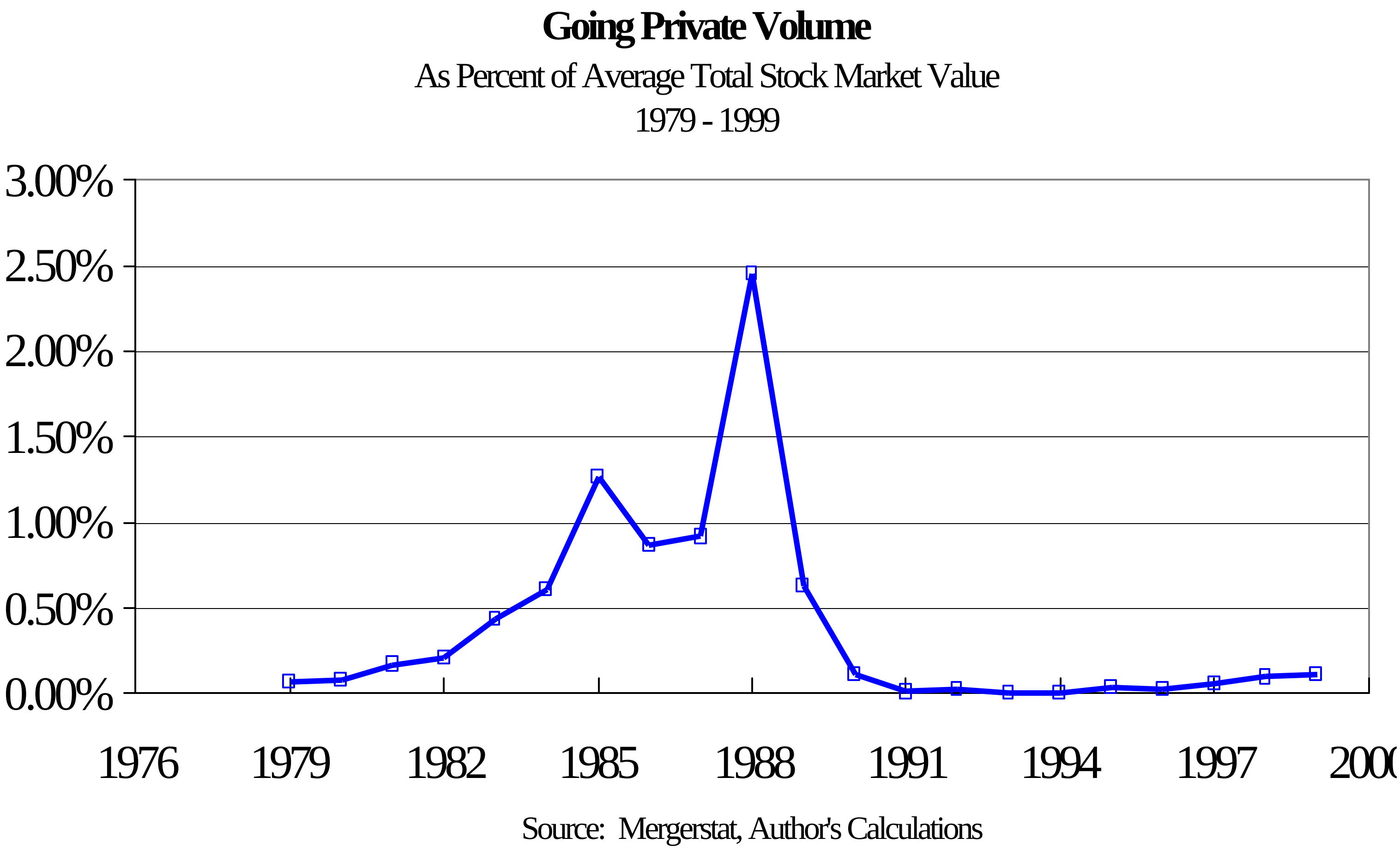

Going Private Volume
As Percent of Average Total Stock Market Value
1979 - 1999
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
1976
1979
1982
1985
1988
1991
1994
1997
Source: Mergerstat, Author's Calculations

Figure 5

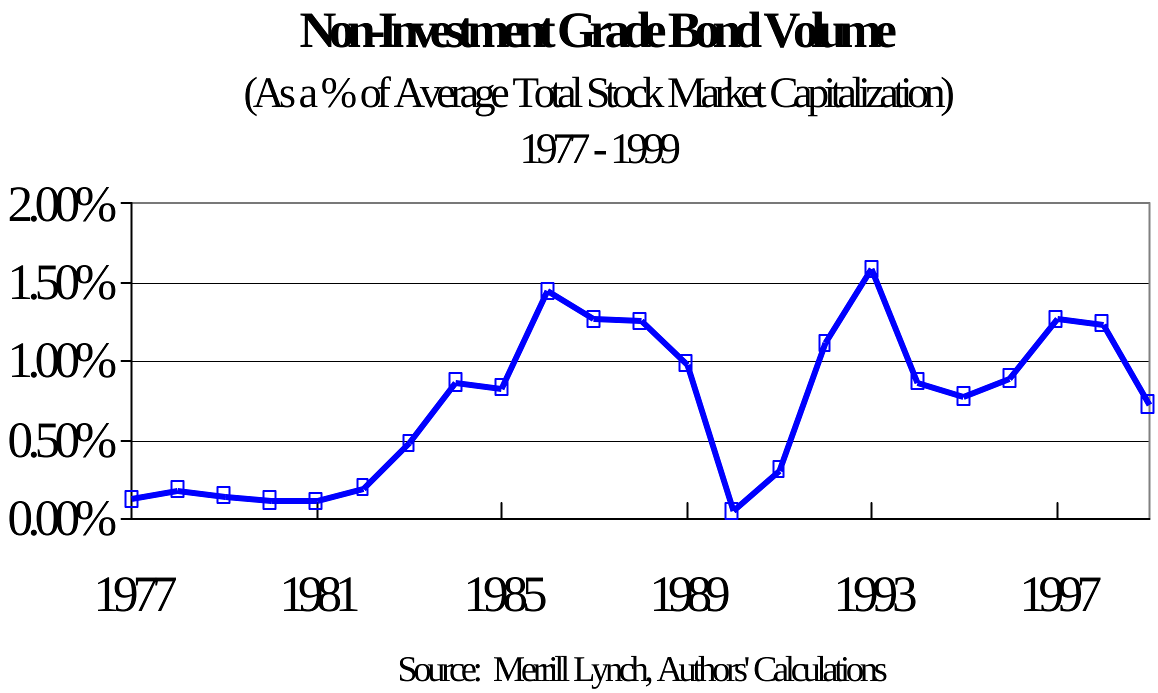
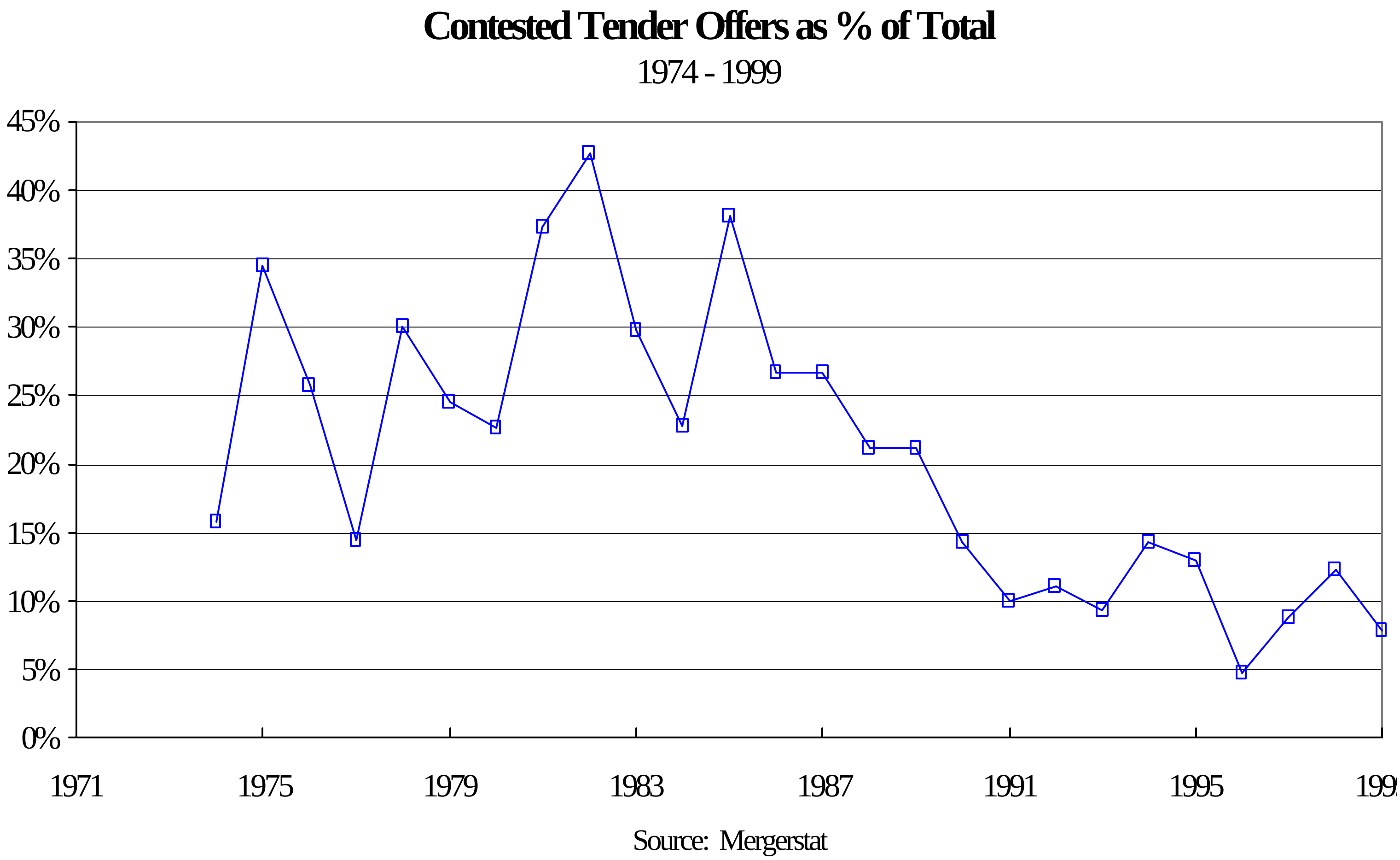

Non-Investment Grade Bond Volume
(As a % of Average Total Stock Market Capitalization)
1977 - 1999
2.00%
1.50%
1.00%
0.50%
0.00%
1977
1981
1985
1989
1993
1997
Source: Merill Lynch, Authors' Calculations

Figure 6


Contested Tender Offers as % of Total
1974 - 1999
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
1971
1975
1979
1983
1987
1991
1995
199
Source: Mergerstat

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Endnotes

[1] We use merger activity and takeover activity interchangeably.

[2] Tender offers are formal offers to purchase a company's shares for cash. By SEC regulations, a tender offer must stay open for 20 business days. A tender offer is not necessary for a takeover. Many takeovers are accomplished by, first, the agreement of the boards of the buyer and seller to an acquisition, and, second, a subsequent vote of the seller's (and, in some cases, buyer's) shareholders. Mergers that use equity are typically accomplished using the second method rather than through a tender offer.

[3] For evidence on this, see Jarrell, Brickley and Netter (1988), Bhagat, Shleifer and Vishny (1990) Kaplan (1989), Marais, Schipper and Smith (1989), Rosett (1988) and Jensen (1993). Shleifer and Summers (1988) argue the reverse, using the hostile takeover of TWA as evidence.

[4] The results in Chevalier (1999), Hyland (1999), Lamont and Polk (1999) also suggest that the diversification discount can only partially be attributed to diversification destroying value.

[5] Regulatory restrictions were placed on insurance company and savings & loan investments in junk bonds and on commercial bank loans to LBOs. In addition, the U.S. government prosecuted Michael Milken and others involved in takeover financing.

[6] This increase in equity-based compensation combined with the strong performance of the stock market is partially responsible for the even larger realized increases in top executive compensation.

[7] The after-tax profit used in this calculation is not the company's actual net income, but a construction, referred to as NOPAT (net operating profit after-tax), which measures the after-tax profit that the company would have earned if it did not have any debt. For a more detailed description of one of these programs, EVA, see Stewart (1990).

[8] These programs also avoid any financial distress costs that might be associated with LBO debt.

[9] Historically, the two big drivers of organizational change have been changes in regulation (Shleifer and Vishny, 1990) and technological innovations (Chandler, 1962, 1977; Yates, 1991).

[10] For example, see Kaplan (1994b), Shleifer and Vishny (1997) and La Porta et al. (1997, 1998).

[11] See "Exercised: Share buybacks in Japan," *The Economist*, August 2, 1997, pp. 59-60 and "Buyback fever hits Europe," *Business Week*, May 11, 1998, p.46.