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# Governance in the Ruins

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# BOOK REVIEW

# GOVERNANCE IN THE RUINS

LAW AND CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD. By Curtis J. Milhaupt & Katharina Pistor. Chicago and London: The University of Chicago Press. 2008. Pp. x, 269. $39.00.

*Reviewed by David A. Skeel, Jr.*[*]

Why do some countries enjoy vibrant markets and steady growth while others seem to stagnate? What gets an economy up and running after a catastrophic war or a period of oppressive rule? While there are nearly as many answers to these questions as experts, one of the most prominent for the past century has been law. Good laws might not be sufficient by themselves, but they are widely viewed as an essential first step. After World War II, the American occupation brought not just troops, but also American-style law, to Japan. When the Berlin Wall came down in 1989, the watchwords for the newly democratic countries of Eastern Europe were privatization and the rule of law. The development efforts of the World Bank and International Monetary Fund around the world have often centered on legal reform. Put the right laws in place, the reasoning goes, and robust economic development will follow.

The title of *Law and Capitalism*, a remarkable new book by Curtis Milhaupt and Katharina Pistor, might seem to suggest that Milhaupt and Pistor are adding their voices to the choir. If this is what one were expecting, however, that expectation would quickly be dashed. Nearly every page of *Law and Capitalism* stands in implicit or explicit dissent from the prevailing view. "In our more cynical moments," they write, "we caricature the canonical view that has taken hold in the economics literature and policy world with the following simple equation:

good law + good enforcement = good economic outcomes" (p. 5).

[*] S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania. I am grateful to Kelli Alces, Aditi Bagchi, Martin Bienenstock, William Cohan, Steven Davidoff, Bill Draper, Giacomo Rojas Elgueta, Luca Enriques, Paolo Giudici, Mitu Gulati, Henry Hansmann, Curtis Milhaupt, Harvey Miller, Eric Orts, Katharina Pistor, Dan Raff, Ed Rock, and Lorenzo Stanghellini; and to participants at faculty workshops at Duke University School of Law, the University of Connecticut School of Law, and the University of Pennsylvania Law School for helpful comments and conversations on earlier drafts; and to David Gunther for research assistance. The University of Pennsylvania Law School provided generous summer funding.

This view, which they call the "endowment perspective" (p. 17), "depicts law as a kind of technology that can be inserted in the proper places — and imported from abroad when necessary — to accomplish an important task" (p. 5). Even in the abstract, they suggest, the assumption that a single law will produce the same results in any context is rigid and simplistic. In practice, the endowment perspective cannot explain why some countries have experienced dramatic growth and others have not. Japan and Korea in the 1980s, and China more recently, to give three obvious examples, became economic powerhouses while flouting the traditional playbook. In each of these countries, law seems to have contributed very little to economic growth.

The key to a more plausible account, according to Milhaupt and Pistor, is a more dynamic conception of law. Rather than taking law as a given and assuming it is politically neutral, scholars should consider how and why it is produced and how the relevant parties respond to it. What they will find is that law is part of a "highly iterative process of action and strategic reaction" (p. 6). This insight, which Milhaupt and Pistor call the "rolling relationship between law and markets,"[1] is the guiding theme of *Law and Capitalism* (*id.*).

Although the initial analysis is framed in general terms, as an inquiry into law and development, the authors quickly shift to corporate governance, their focus for the rest of the book. As they acknowledge, the emphasis on corporate governance is to some extent simply a reflection of their own expertise: both Milhaupt and Pistor are among the world's leading comparative corporate law scholars. But they also point out that corporations are "the most important private actors in a market economy," and that "corporate governance is linked to every facet of a country's economic, political, and legal structures" (p. 4).

Milhaupt and Pistor's foil throughout the book is a team of scholars — La Porta et al., as they are affectionately known by the field — who revolutionized the corporate finance literature starting in the mid-1990s.[2] In classic endowment perspective fashion, La Porta et al. devised an index of corporate governance variables, focusing principally on shareholder and creditor rights, which they measured in each of forty-nine different countries. They also categorized the countries in terms of the origins of their legal systems, distinguishing between English common law systems and three different civil law approaches (French, German, and Scandinavian). Employing standard regression

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[1] Internal quotation marks have been omitted.

[2] The initial articles, which have been followed by many others, include Raphael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter La Porta et al., *Legal Determinants*]; and Raphael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

analysis, La Porta et al. then compared levels of protection and legal origin to economic performance. Their conclusions were striking and apparently robust: shareholder and creditor protection was strongly correlated with larger, more vibrant markets, and countries with common law systems experienced significantly greater economic growth than their civil law counterparts.[3] The La Porta et al. findings have been controversial, but they quickly became the scholarly standard (p. 20).

*Law and Capitalism* abandons the La Porta et al. model in almost every conceivable respect. Gone are the governance variables and anything remotely approximating a regression analysis. Rather than ascribing a single role to law — protecting property rights — Milhaupt and Pistor identify four ways that law influences economic development, the others being coordination of interest group bargaining, signaling, and "credibility enhancement" (p. 7). Rather than large numbers and statistical significance, Milhaupt and Pistor emphasize individual cases. And they concern themselves not with ordinary cases but with the most extraordinary ones: companies that face a crisis so dramatic it may alter the underlying governance system. Theirs is a study of governance in and from the ruins.

Milhaupt and Pistor's countermodel proceeds in two steps. They begin by developing a general framework — a matrix consisting of two axes. The first axis contrasts a purely protective regime on one end, with a pervasively "coordinative" approach on the other. By protective, Milhaupt and Pistor mean a regime that protects basic property and contract rights, thus reducing the risk that value will be expropriated from shareholders or other stakeholders, whereas a coordinative regime is one in which the government and major interest groups negotiate over the organization of the market. The second axis ranges from decentralized governance at one end to centralized governance at the other.

Using the matrix as an organizing framework, the authors then conduct detailed case studies of six high profile corporate crises in a total of seven countries,[4] each from the opening years of the new century. In each of the case studies, which they call "institutional autopsies" (p. 45), Milhaupt and Pistor find evidence of both transition and

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[3] *See, e.g.*, La Porta et al., *Law and Finance*, *supra* note 2 (using the described data to conclude that countries' economic growth is highly correlated with legal origins and the level of law enforcement, and that rich countries with poor investment protection measures have had to develop substitutes that allow the economy to grow); La Porta et al., *Legal Determinants*, *supra* note 2 (using the same data to conclude that common law countries with stronger investment protection measures have the most developed capital markets).

[4] The featured countries, in order of appearance, are the United States, Germany, Japan, South Korea, China and Singapore, and Russia.

of retrenchment — and of the rolling relations between markets and law. Enron prompted an increased centralization of U.S. governance, for instance, but there has already been a backlash against the perceived intrusiveness of the Sarbanes-Oxley Act (SOX) and against the government's stepped-up criminal enforcement. Similarly, after a takeover attempt by a company called Livedoor, Japan adopted principles for corporate takeovers that seem to reflect a much greater openness to takeovers, but which also could foster more managerial entrenchment.

Both parts of the authors' approach are radically innovative. The brilliance of the matrix is that it fully incorporates both interest groups (the demand side) and political actors (a supply side factor) into the analysis. To determine whether a nation's governance is coordinative, for instance, scholars must identify the principal interest groups and assess the nature of their interaction with the government. The institutional autopsies give a unique window into each country's governance at a time of potential transition. "[B]y carefully examining an extraordinary firm-level event and the response it generated among key actors," as Milhaupt and Pistor put it, "one can gain a much deeper understanding of the system's structure, its strengths and weaknesses, and the likely direction of future institutional developments" (pp. 8–9).

A great deal of recent governance reform has involved the transplantation of laws either from one nation — often the United States — or from principles developed by the World Bank and other international organizations. The final chapters of *Law and Capitalism* address the likely efficacy of these legal transplants. In keeping with their hostility to "endowment" approaches, Milhaupt and Pistor question the assumption that rules that are effective in one country will work equally well in another. Internally generated changes will prove more successful than pure transplants, they argue, and the effectiveness of transplants will vary depending on how well the local interests adapt them to local circumstances.

The first two parts of this Review describe Milhaupt and Pistor's matrix-and-autopsy approach in more detail. Part I provides a guided tour of the book, including summaries of each of the six institutional autopsies, while Part II considers both the limitations of the authors' approach and its relationship to existing theories in corporate law and corporate finance. Although *Law and Capitalism* is a book-long refutation of the endowment perspective, Part II concludes that the matrix, the authors' first innovation, can be used even by scholars who remain wedded to the standard approach.

While the authors' institutional autopsies include most of the key corporate crises of the early twenty-first century, there are two obvious omissions: WorldCom in the United States and Parmalat in Italy. Parts III and IV provide brief institutional autopsies of the two missing scandals. Under the prodding of the Securities and Exchange

Commission (SEC), both companies sought to remake themselves as paragons of corporate governance as they emerged from their insolvency proceedings. The new governance of these companies, which featured directorial and shareholder voting rules that went well beyond existing law, was in effect a firm-specific legal transplant, a regulatory strategy that has gone unnoticed in the scholarly literature. In addition to defending the new approach, the autopsies show that the litigation process is often used to coordinate and at times centralize the response to systemwide crises in the United States. The SEC's intervention in Parmalat also underscores the influence of outside regulators on domestic corporate governance.

Part V considers a crisis that occurred after *Law and Capitalism* went to print: the collapse of Bear Stearns. Fearing that Bear Stearns's failure could jeopardize the entire financial system, the Federal Reserve and Treasury bailed Bear out and forced its sale to JPMorgan Chase over a two-day period in March 2008. In the past, the Fed had intervened in this fashion only with commercial banks, since their failure could have broader, systemic effects on the financial market. Its intervention vividly illustrates the most important recent development in corporate governance and finance: the transformation of financial intermediation. The centralized, coordinated resolution of bank crises also shows that different industries may be subject to different kinds of regulatory regimes, even within a single country. This raises the question whether a country's governance can be adequately represented as a single point on a matrix. In addition to developing each of these points, Part V also explores the relationship between regulatory and political responses to a crisis. Ironically, the Part concludes, by preventing Bear from collapsing, the Fed diminished the likelihood that Congress would enact the reforms the Fed itself proposed for modernizing financial services regulation.

While the three autopsies in this Review seek to develop new insights, they are, as the conclusion points out, a tribute to Milhaupt and Pistor's matrix-and-autopsy approach. Rather than a burial, they should be seen as pure praise.

## I. *LAW AND CAPITALISM*: A BRIEF OVERVIEW

According to the prevailing view in corporate finance, the countries with the best markets and economic growth are the ones that supply the best laws. Scholars who hold this view, which Milhaupt and Pistor call the "endowment perspective," "treat[] a legal system as if it were like a highway or a dam — a fixed investment that must be built before economic development can take off but that once in place determines the path of development without itself being subject to change" (pp. 17–18).

In their first chapter, Milhaupt and Pistor trace the endowment perspective back to Max Weber, who argued that a country must establish a "rational legal system" before capitalism can emerge (p. 18).[5] Legal infrastructure and the Protestant work ethic were, in his famous account, the preconditions for robust markets and a vibrant economy. Milhaupt and Pistor detect similar assumptions in Douglass North's Nobel Prize winning work (*id.*). Milhaupt and Pistor's real target, however, and the principal foil for *Law and Capitalism*, is a hugely influential series of articles by Professors Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and several co-authors. In the mid-1990s, La Porta et al. devised a simple governance index consisting of a dozen or so measures of shareholder and creditor protection.[6] La Porta et al. applied their simple index to forty-nine countries, characterizing each country as protecting or not protecting minority shareholders in a variety of ways, then ranking the country on a scale of zero (no protection) to five (high protection).[7] Based on their index, La Porta et al. concluded that common law systems generally provide better corporate regulation than their civil law counterparts, and that countries whose regulation protects minority shareholders have better markets and governance than those whose regulation does not.[8] The authors have fanned out since the initial work, producing a flurry of subsequent articles, but in broad outline the song remains the same: the common law system and shareholder protection bring success, while civil law and the absence of these protections are a recipe for stagnation.[9]

Critiques of the La Porta et al. work have highlighted four general shortcomings. First, the factors they use tend to vary significantly in importance; as a result, adding up the scores for the factors could, and often did, give a very misleading perspective on the overall governance of a particular country.[10] Second, the La Porta et al. coding is based

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[5] The authors quote MAX WEBER, GENERAL ECONOMIC HISTORY (Transaction Books 1981) (1927).

[6] *See, e.g.*, La Porta et al., *Law and Finance*, *supra* note 2; La Porta et al., *Legal Determinants*, *supra* note 2; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *The Quality of Government*, 15 J.L. ECON. & ORG. 222 (1999).

[7] *See, e.g.*, La Porta et al., *Law and Finance*, *supra* note 2, at 1128.

[8] La Porta et al., *Legal Determinants*, supra note 2, at 1149–50.

[9] Examples of these more recent articles include Raphael La Porta, Florencio Lopez-de-Silanes, Cristian Pop-Eleches & Andrei Shleifer, *Judicial Checks and Balances*, 112 J. POL. ECON. 445 (2004) (concluding that judicial independence within a legal system allows for greater economic freedom); Raphael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1 (2006) (finding that securities laws that provide greater stockholder protection lead to larger stock markets).

[10] *See, e.g.*, Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 805 n.39 (2002) (noting that preemptive rights, though listed as a minority protection, can also benefit controlling shareholders).

on a country's formal laws, the "law on the books." But the law on the books can be quite misleading. If a very strong law is rarely enforced in one country, while a weak law is actively enforced in another, the country with ostensibly weaker law may actually provide more protection for shareholders.[11]

The third critique is much broader, questioning the direction of causation. Even if the La Porta et al. indices are roughly accurate, the argument goes, and even if strong shareholder protection correlates with more fully developed financial markets, shareholder protection may be a product, rather than a cause, of a flourishing market.[12] As markets developed in the late nineteenth and early twentieth centuries, investors may have devised ways of protecting their interests and only later sought to reify these protections in formal law. In England, for instance, shareholder-protective laws were not enacted until well after World War II, long after the ownership of family-controlled companies had begun to disperse.[13]

Fourth, the original La Porta et al. work looked entirely at the present (it was cross-sectional rather than time series, in the finance jargon). In historical perspective, however, the La Porta et al. findings are less robust. If the frame of reference is extended back as far as the late nineteenth century, civil law countries often have grown faster than their common law counterparts (pp. 23–25).

Both Milhaupt and Pistor have made noteworthy contributions to these critiques prior to writing this book. Pistor was one of the first to point out the arbitrariness of the La Porta et al. indices and the often dramatic differences between a nation's formal corporate governance rules and the law as actually applied.[14] *Law and Capitalism* reports the results of recent historical analysis by Milhaupt that shows civil law countries have often enjoyed faster economic growth than their ostensibly superior common law peers (*id.*), and Milhaupt has previously

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[11] *See, e.g.*, Luca Enriques, *The Comparative Anatomy of Corporate Law*, 114 AM. J. COMP. L. 1011, 1019–24 (2004) (book review) (arguing that a comparative analysis of corporate law is flawed if it takes into account only the official laws and fails to examine how the laws are enforced).

[12] The most prominent exemplar of this critique is a lovely article by John Coffee. *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 64–71 (2001) (noting that market changes often come before changes in the law and arguing that this means La Porta et al. are wrong about the direction of causation).

[13] *See* Julian Franks, Colin Mayer & Stefano Rossi, *Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 581 (Randall K. Morck ed., 2005) (describing the decline of family ownership of British companies before laws were passed to protect shareholders).

[14] *See* Pistor et al., *supra* note 10; Katharina Pistor, Martin Raiser & Stanislaw Gelfer, *Law and Finance in Transition Economies*, 8 ECON. TRANSITION 325 (2000).

critiqued the implications of the endowment perspective for Japan.[15] But *Law and Capitalism* is not designed simply to repeat and further develop these critiques. Nor do Milhaupt and Pistor ask for a more careful application of the La Porta et al. indices, or a more nuanced interpretation of the findings. With *Law and Capitalism*, they say, in effect: it is time to develop an altogether new model.

### *A. The Milhaupt-Pistor Framework*

In the book's second chapter, Milhaupt and Pistor develop a framework for analyzing corporate governance within any given country that is so simple, and in retrospect seems so obvious, that it will surely become a new scholarly paradigm. Their framework, which they call a "legal systems matrix" (p. 37 fig.2.1),[16] includes only a handful of moving parts, but it is flexible enough to address each of the shortcomings of the standard approach.

The matrix consists of two axes. The first, horizontal axis contrasts a "coordinative" approach on one end, with pure shareholder protection (the sole consideration in much current analysis) on the other (*id.*).[17] In a coordinative regime the government organizes the market directly, bargaining with major interest groups, whereas in a protective regime the government's role is less direct: it protects basic property and contract rights, to reduce the risk that value will be expropriated from shareholders or creditors (pp. 31–34). The second, vertical axis ranges from centralized governance at one end to decentralized governance at the other (p. 37 fig.2.1). In a centralized regime, lawmaking and law enforcement power is vested in a central government and private individuals have relatively little ability directly to make or enforce the laws, whereas a decentralized system is more open, often permitting private parties to litigate if they have been adversely affected by public or private action (p. 6).[18]

Simple as it is, the matrix fully resolves the most serious shortcoming of the endowment perspective: its tendency to take law as a given.

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[15] *See, e.g.*, Hideki Kanda & Curtis J. Milhaupt, *Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Governance*, 51 AM. J. COMP. L. 887 (2003).

[16] The "legal systems matrix" is reproduced *infra* p. 711.

[17] Coordination and protection are two of the four roles that law plays, according to Milhaupt and Pistor. They explore the other two roles, signaling and credibility enhancement, in several of the institutional autopsies but do not include them in the matrix. The four uses of law are described on pp. 6–7.

[18] As discussed *infra* in section II.A, the two axes often overlap. They also parallel the distinction often made in the comparative corporate governance literature between market-centered and bank-centered governance systems. *See, e.g.*, Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 328 (1996) (making the distinction). Market (or diffuse equity) systems are usually decentralized and protective, bank-centered (or concentrated equity) systems centralized and coordinative.

To determine how coordinative a country's governance is, a scholar must identify the key interest groups and assess their interaction with the lawmaking process. Similarly, the centralization-decentralization axis requires her to consider the extent to which lawmaking and law enforcement can be contested by private parties. The matrix thus directs attention not just to outputs, as with La Porta et al., but also to the inputs of law. Almost the only thing it lacks is a clever name. Milhaupt and Pistor saved the clever name for their second innovation, the method they use to apply their framework.

### *B. The Heart of the Matter: Institutional Autopsies*

The heart (and soul, one is tempted to say) of *Law and Capitalism* comes in the next six chapters, which consist of a series of detailed case studies. For each of the studies — the "institutional autopsies" (p. 9) — Milhaupt and Pistor focus on a particular company. The companies they choose are not necessarily the most prominent or even the most representative; what each has in common is that it is in extremis, subject to a corporate crisis that could alter the entire country's corporate governance system.

Why do they refer to these studies as "autopsies"? By way of explanation, they write:

> In medicine, an autopsy is an important strategy for learning about the operation of a complex system in the hope of gaining deeper insights into its strengths and vulnerabilities. Like the human body, economic and legal institutions are complex systems that defy simple mechanical analysis. The process of a differential diagnosis is therefore a useful metaphor with which to capture the kind of analysis that is required for understanding the operation of these systems.[19] (p. 46)

The companies to which Milhaupt and Pistor take their invisible scalpel come from the United States, Germany, Japan, Korea, China and Singapore, and Russia, in this order. Each of the autopsies follows roughly the same pattern, though with some variation in the number and focus of the sections. Milhaupt and Pistor begin, in a section labeled "The Story," by recounting the crisis and its apparent causes; next they consider what the crisis suggests about the larger system of corporate governance in the country involved; they then evaluate the responses and aftereffects; finally, they wrap up each study with a brief conclusion.

"It seems appropriate to begin our institutional autopsies with the collapse of Enron and its aftermath," they write (p. 47).[20] "Enron's breathtakingly rapid unraveling in 2001 threw a good deal of cold wa-

[19] A citation has been omitted.

[20] Milhaupt and Pistor discuss Enron on pp. 47–67.

ter on the perception that the United States had reached the zenith of legal and corporate governance" (*id.*). The Enron collapse has been endlessly recounted in the scholarly literature and the popular media; Milhaupt and Pistor do not break new ground in their overview of the collapse. Enron is explained in their account, as in most others, as evidence of the pernicious effect of stock-option-based compensation and of a systemic failure of auditors, securities analysts, and other corporate gatekeepers. More novel are their insights into the aftermath of the scandal. The 2002 Sarbanes-Oxley Act, the principal legislative response to Enron, signaled a shift, they argue, from decentralized to more centralized enforcement of corporate and securities law (pp. 56–57). Taking the cue, the Justice Department stepped up its criminal enforcement of corporate misbehavior and began using hardball tactics to bring wayward corporations to heel. The shift toward centralized enforcement has itself prompted a backlash, however, with critics questioning the fairness of the new prosecutorial tactics and business leaders issuing a report warning that the post-Enron regulatory environment threatened the competitiveness of the United States in world markets (p. 65).[21] "We cannot predict," Milhaupt and Pistor conclude, "whether future reforms will be enacted or precisely how the pendulum will continue to swing in the debates about U.S. regulatory policy" (*id.*).

The German crisis — which arose after Mannesmann, a major German corporation, was acquired by Vodafone, a British telecommunications firm — is, in their telling, a similarly halting shift away from a country's traditional governance patterns.[22] After the acquisition was finalized, an executive committee of Mannesmann's supervisory board resolved to pay £10 million to the head of its management board for "enhanc[ing] shareholder value" in the transaction (p. 70). Although the "appreciation award" was proposed and approved by Vodafone — which at the time of payment owned 98% of Mannesmann's shares — the members of Mannesmann's supervisory board were criminally prosecuted for approving it (*id.*). The prosecution, though later abandoned, accorded with widespread German sentiment that Mannesmann's top managers had sold out a major German company and grabbed a nice side payment for themselves in the process.[23] The one puzzle was the failure of the employee and bank representatives on the supervisory board to protest the payment. Milhaupt and Pistor

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[21] *See* COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[22] Milhaupt and Pistor dissect Mannesmann on pp. 69–86.

[23] "In pictures appearing on Web pages and in journals," as Milhaupt and Pistor put it, "men in dark suits were depicted stuffing cash into their pockets" (p. 71).

conclude that the employee representatives did not intervene because the steel operations that employed the company's blue collar workers were going to be sold, and the banks approved because their representative stood outside German corporate culture and the banks themselves have an increasingly global outlook. This may suggest that the coordinative approach that has characterized German corporate governance since World War II, with firms, employees, and the government bargaining over corporate policy among themselves, is breaking down. But it is still too early to give last rites to the traditional approach: after Mannesmann, Germany spearheaded opposition to the European Takeover Directive, which was designed to require countries to lower the barriers to takeovers, and adopted its own, much weaker takeover law.

With the third crisis, the scene shifts to Japan for another takeover battle that could augur a shift away from a centralized, coordinative corporate governance regime.[24] In early 2005, an Internet company called Livedoor (previously known as Livin' on the Edge) announced that it had accumulated 38% of the stock of Nippon Broadcasting, a subsidiary of Fuji TV, the largest media company in Japan, and that it intended to acquire all of Nippon's outstanding shares. Livedoor's vision, according to its thirty-two-year-old college-dropout CEO, was to "turn[] Nippon Broadcasting's Web site into a portal site and . . . enter into a business cooperation agreement with . . . Fuji" (p. 88). The ensuing battle over Nippon ended peacefully — with Livedoor agreeing to sell its shares to Fuji and Fuji to invest $440 million in Livedoor — but not before Nippon tried to neutralize Livedoor's bid by issuing enough stock warrants to give Fuji majority control and Livedoor successfully challenged the warrant issuance in the courts as "grossly unfair" (p. 94).[25] The apparently tranquil ending was upended by one last dramatic twist: Livedoor's CEO was arrested for misdisclosure and illegal stock trades; by the time he was sentenced to two and a half years in prison, Livedoor itself had been delisted.

"[I]t would be difficult to overstate the controversy Livedoor's bid stirred in Japan," Milhaupt and Pistor write (p. 89). The Livedoor CEO "was telegenic, brash, and blunt — in stark contrast to the geriatric blandness of most corporate executives in Japan" (*id.*).[26] The as-

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[24] Milhaupt and Pistor discuss the Japanese takeover battle on pp. 87–107.

[25] The authors quote *Nippon Hoso K.K. v. Livedoor K.K.*, 1173 HANREI TAIMUZU 125 (High Ct., Mar. 23, 2005).

[26] The Livedoor battle is similar in interesting ways to the takeover battle over Revlon in the U.S. in the 1980s, which also pitted a brash upstart (Ronald Perelman) against a representative of managerial establishment (Michel Bergerac). The battle, and this contrast, is chronicled in CONNIE BRUCK, THE PREDATORS' BALL: THE JUNK-BOND RAIDERS AND THE MAN WHO STAKED THEM 193–240 (1988).

sault on Nippon seemed to repudiate the entire post–World War II governance order, which relied on a company's main bank and the mutual shareholding arrangements known as *keiretsu*,[27] rather than takeovers, to monitor corporate managers. Although Livedoor never fulfilled its original vision, two potentially momentous shifts in Japanese corporate governance can be attributed to its bid: the increased use of litigation to resolve corporate disputes, and the issuance of a set of nonbinding guidelines for takeovers by Japan's Ministry of Justice. As with each of their case studies, the authors find ambiguity rather than a decisive shift in governance. True, Japan did incorporate Delaware takeover doctrine into the guidelines, which suggests a new openness to takeovers. But the endorsement of poison pills "may simply lock insular boards in place and provide a perfect substitute for the disappearing institutions of stable shareholding and cross-shareholding" (p. 102).

During this same period, a somewhat similar battle shook the foundations of Korean corporate governance. As with Livedoor, the catalyst was an unwanted intruder.[28] Chey Tae-Won, the chairman of the board of directors of SK Group, the third largest of Korea's enormous corporate conglomerates (*chaebols*), was convicted of accounting fraud. Afterward, a pair of New Zealand brothers used the Dubai-based investment vehicle Sovereign Asset Management Limited to buy 14.9% of SK's common stock. The accounting fraud had involved SK Global, a trading company affiliated with SK that was bailed out by SK and a group of Korean banks shortly after Sovereign acquired its equity stake. After Sovereign announced its intention to oust Chey from the board and to operate SK independently from its sibling firms, the managers of SK took a series of steps to insulate the conglomerate from Sovereign's challenge, first issuing treasury shares to the same Korean banks that had funded the earlier bailout and then preventing Sovereign from calling an extraordinary shareholders' meeting to vote on removing Chey. Each maneuver was upheld by the Korean courts. Once again, the authors find evidence of conflicting responses to the SK crisis. Korea introduced a variety of reforms inspired by the Sarbanes-Oxley Act, such as a requirement that CEOs and CFOs certify financial statements, and SK itself increased the number of independent directors on its board and created a "transparent management committee" (p. 121). Yet the scandal also stirred a backlash, effectively stoked by SK throughout the crisis, against foreign interference with traditional Korean governance arrangements.

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[27] Milhaupt and Pistor describe *keiretsu* as "historically derived clusters of affiliated firms held together by . . . interlocking directorates, [and] product-market linkages" (p. 90).

[28] Milhaupt and Pistor discuss SK and Korea on pp. 109–24.

The Chinese governance scandal — the implosion of Chinese Aviation Oil (CAO) due to derivative bets gone awry — is the first involving a developing economy.[29] Established in 1993, CAO, which was controlled by a Chinese state-owned corporation, sold 25% of its stock to the public in 2001 and listed these shares on the Singapore stock exchange. The downfall came from a now-familiar pattern in international finance (think Joseph Jett at Kidder, Peabody or Nick Leeson at Barings):[30] CAO lost huge amounts of money (in the end, $381 million) gambling on oil derivatives, repeatedly doubling down after an initially successful strategy of betting on price declines turned sour. When CAO Holding Company (CAOHC), CAO's government-controlled parent, learned of this crisis, it did not shut CAO down, as might have been done with a European or American company. Instead, CAOHC orchestrated a bailout by selling 15% of its CAO shares to the market and using the proceeds to fund a loan to CAO. Unfortunately, no one told the investors who purchased the CAO shares — including Temasek, a company owned by Singapore's Ministry of Finance — that the company was in financial crisis. After CAO filed for bankruptcy a few weeks later, Singaporean regulators charged CAOHC with insider trading in connection with the sale of its stock, and Chen Jiulin, the CEO of CAO, and three CAO directors were arrested. Chen was subsequently sentenced to over four years in prison and the three CAO directors were each fined.

The crisis demonstrates, according to Milhaupt and Pistor, that neither China's regional regulatory apparatus nor state-linked parent companies like CAOHC are capable of monitoring a company like CAO, whose "younger, more aggressive, and financially minded — if ultimately misguided — management team outran the monitoring capacities of bureaucrats at the parent company" (p. 140). While Singapore's unprecedented criminal prosecution of state-linked Chinese directors might seem to demonstrate that CAO's governance was outsourced to Singapore when the company listed on the exchange, Milhaupt and Pistor identify several countervailing factors and point out that in order to attract Chinese companies, Singapore has an incentive to accommodate the concerns of the companies' government sponsors (p. 146).[31]

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[29] The authors discuss CAO and China on pp. 125–48.

[30] These and other rogue traders are analyzed in Kimberly D. Krawiec, *Accounting for Greed: Unraveling the Rogue Trader Mystery*, 79 OR. L. REV. 301 (2000).

[31] Milhaupt and Pistor note, in this regard, that Chinese officials seem to have approved the prosecutions, that the fines imposed on the three directors were small, that Temasek acted more like a "guardian angel" than an abused investor (p. 138), and that none of the Singaporean lenders pursued litigation against CAO.

Milhaupt and Pistor conclude their institutional autopsies with the privatization and renationalization of Yukos, Russia's most successful oil company.[32] The Yukos saga pitted Mikhail Khodorkovsky, one of the Russian oligarchs who acquired huge fortunes in the early post–Soviet era, against Vladimir Putin, who viewed the oligarchs as potential threats as the former KGB official consolidated his power. After Yukos, which had pledged its stock to foreign lenders, was crippled by the 1998 Russian default, Khodorkovsky bought up much of its stock, taking advantage of an auction process that he and other Russian bankers designed to discourage foreign bidders. Shortly after his election in 2000, however, Putin served warning on the oligarchs, comparing them "to shoe sellers and bakers, indicating their new lowly status as simple peddlers of products" (p. 156). Employing the same strategy that was used to strip many Russian companies, Russian tax authorities claimed that Yukos owed staggering amounts of back taxes — $17 billion in all — then forced Yukos into bankruptcy, where its principal production unit was auctioned off to a mysterious company called Baikal Finans Group and quickly resold for the same price to Rosneft, a state-owned oil company.

Yukos is the most spectacular example of Milhaupt and Pistor's repeated claim that law is not simply a neutral endowment. Law was used in a purely instrumental way by both sides in the Yukos drama: Khodorkovsky as he secured control during the oligarchs' moment of glory, and Putin when he sought to neutralize their power.

### *C. Morals of the Stories: Governance Patterns and Legal Transplantation*

In the two chapters that comprise the third and final part of *Law and Capitalism*, Milhaupt and Pistor generalize about their framework and the institutional autopsies.

In the ninth chapter, "Understanding Legal Systems," Milhaupt and Pistor draw three general conclusions from the autopsies. The first, which is nicely illustrated by the contrast between Russia and China, is that the form of a country's government does not matter nearly so much as whether power is centralized or decentralized. Although Russia is nominally federal, authority is highly centralized — more so than in China, a country with an avowedly unitary government (p. 178).[33] Second, although the La Porta et al. literature can be read as suggesting that a country's governance is dictated by its legal origin and is unlikely to change, Milhaupt and Pistor's approach and their findings

[32] The authors discuss Yukos on pp. 149–69.

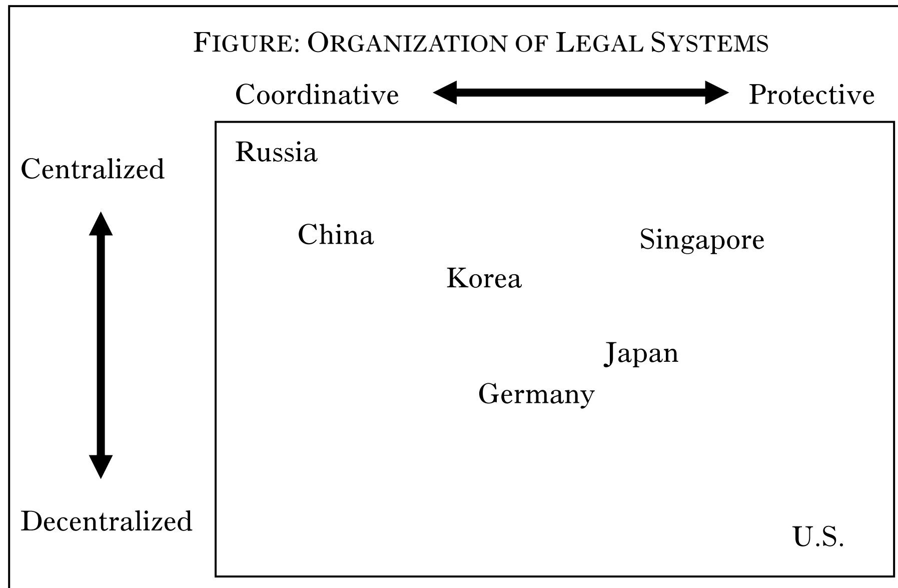
[33] Milhaupt and Pistor are careful to use the terms "unitary" and "federal" (p. 177), rather than "autocratic" and "democratic," presumably because the latter are even more malleable.

show that governance systems can and do change through the constant interaction — the "rolling relation" (p. 28),[34] as they like to put it — between the economy and the legal infrastructure (pp. 179–80). Finally, contrary to the well-known "end of history" prediction that corporate governance is in the process of converging on the U.S. model of shareholder primacy, Milhaupt and Pistor argue that globalization does not mean that decentralized, protective governance will become the norm throughout the world (pp. 192–94).[35] Even if countries adopt similar laws, laws can be used in a variety of different ways — in Korea they were used to protect the status quo, and in the U.S. to signal more centralized governance — and in each country they will be adapted to local norms.

In addition to developing these general arguments about corporate governance, Milhaupt and Pistor revisit their governance matrix, locating each of the seven countries on the centralized-decentralized and coordinative-protective axes (pp. 182–92). As reflected on the figure below, they place Russia and the United States at the extremes of centralized-coordinative and decentralized-protective, respectively. China is centralized and coordinative, although not as extreme in either regard as Russia; Singapore is something of an odd bird, qualifying as centralized but protective; and the remaining three countries cluster in the middle of the matrix. According to Milhaupt and Pistor, "[t]his reflects the postwar role of major organized interest groups in the production and enforcement of law in these countries" (p. 188), which has made each more coordinative than the United States, although all three appear to be "incorporating more protective features into their legal systems" (p. 189).

[34] Emphasis has been removed.

[35] Milhaupt and Pistor's foil in this regard is a much-debated article by Professors Henry Hansmann and Reinier Kraakman. *See* Henry Hansmann & Reinier Kraakman, Essay, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001). Although Milhaupt and Pistor see the rolling relation between law and markets as calling the thesis into question, Hansmann and Kraakman might well detect at least a halting movement toward more decentralized and protective governance in the autopsies as a whole.




In the final chapter, Milhaupt and Pistor address in systematic fashion an issue that percolates just below the surface throughout the book: legal transplants.[36] Legal change depends, they argue, on both "micro-fit" (p. 210) — whether a transplant is compatible with the judiciary, regulators, and interest groups; and "macro-fit" (*id.*) — whether the change fills a gap in the legal system in response to economic pressure.[37] Based on these general observations, Milhaupt and Pistor venture two predictions: internally generated changes work better than transplants and (somewhat tautologically) the effectiveness of transplants will vary depending on how well locals adapt the transplants to local circumstances. More interestingly, they speculate, as they did in their analysis of Livedoor in Japan, that the large number of foreign lawyers who receive some of their training in the United States could increase the attractiveness of U.S. laws (pp. 214–15).

## II. PROBING THE CORONERS' WORK

It bears reemphasizing just how far removed the Milhaupt and Pistor approach is from standard operating procedure in financial economics. Financial economists look for a representative sample of

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[36] The authors discuss legal transplants on pp. 207–12.
[37] The authors attribute the terms to Kanda & Milhaupt, *supra* note 15.

companies, a sample that can be defended as statistically significant.[38] Milhaupt and Pistor flip this approach on its head. They look for the extraordinary — the extreme case — in the expectation that the extraordinary will illuminate the ordinary. How well does the strategy work? The stress test that follows considers four distinct concerns.

### *A. How Effective Is the Matrix-and-Autopsy Strategy?*

To assess the overall effectiveness of the Milhaupt and Pistor framework, start with their first innovation, the matrix. One concern is the absence of variables that might take into account the form of a country's government. Milhaupt and Pistor anticipate this objection and offer a compelling response: form-of-government coordinates would add confusion rather than clarity (pp. 177–79). For instance, as noted earlier, Russia's government theoretically is federal, but its governance is much more centralized than China's.[39] Similarly, although Germany and the United States are both federal, German governance is substantially more centralized and coordinated than U.S. governance (p. 178). The way a country's markets are organized is illuminating, the form of government much less so.

A second objection is more subtle but has more force. Although the two axes of the matrix have different objectives — centralization/decentralization refers to legal organization and coordinative/protective to how a legal system functions — they overlap significantly.[40] If a nation has centralized markets, its governance will almost always be coordinative; and decentralized governance is closely correlated with property rights protection (p. 44). Although one of the seven countries featured in *Law and Capitalism*, Singapore, breaks the pattern, even Singapore does not consistently figure as an exception. The authors characterize Singapore as centralized and protective, but they also emphasize the substantial degree of coordination of its markets.[41]

To say that the two axes are quite similar does not mean it is useless to distinguish them, however. Countries that are centralized and

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[38] *See, e.g.*, La Porta et al., *Legal Determinants*, *supra* note 2, at 1133–37 (describing data used in study).

[39] *See supra* note 33 and accompanying text. Milhaupt and Pistor also discuss the Russia-China example in this context (p. 178).

[40] The similarity of the two axes is reflected in the fact that Milhaupt and Pistor, each of whom is an extremely careful scholar, occasionally seem to conflate the variables. For example, they describe the "spectrum of governance" as ranging from coordination to decentralization, rather than from coordination to protection (p. 37). They also suggest that the coordinated resolution of the China Aviation Oil crisis was "made possible by the Singapore legal system — highly centralized [rather than coordinative] in its own right" (p. 188).

[41] For example, the authors refer to "Singapore's model of market coordination and limited private enforcement" (p. 147).

coordinative, or decentralized and protective, may differ in the relative emphasis of each characteristic in ways that are important to understanding the corporate governance of each. Although China is nearly as coordinative as Russia, for instance, recent reforms have devolved authority to the regional and local levels, making its governance appreciably less centralized (p. 178). The United States and the United Kingdom[42] both qualify as decentralized and protective, but U.K. governance has traditionally been much more coordinative.[43] Distilling the matrix to a single pair of coordinates would make it difficult to capture these nuances.

To be sure, the matrix is not perfect. It is not entirely clear that coordinative and protective are always opposing sides of a single axis, for instance. In the example just mentioned, the U.K., governance is both coordinative and protective. But the matrix brilliantly reconceptualizes the determinants of corporate governance.

With the institutional autopsies, the key question is, as Milhaupt and Pistor themselves acknowledge, whether the single, company-specific crises are adequately representative — whether one case can tell us enough about a particular system of corporate governance (pp. 10–11). The representativeness of the autopsies can be questioned in three ways.

First, in selecting a single, company-specific crisis in each country under investigation, Milhaupt and Pistor are, as economists like to say, looking where the light is. Crises provide valuable information, but a single crisis may not always give a complete picture of a country's overall governance system. China Aviation Oil, the authors' institutional autopsy for China, illustrates this concern (p. 125). Although CAO was listed on the Singapore Exchange, substantially more of China's large corporations are listed in Hong Kong, which suggests that the interaction between Hong Kong regulators and Chinese officials may have more substantial implications for understanding the direction of Chinese corporate governance. Similarly, the CAO case itself implicates only a few of the developments underway in China's rapidly changing corporate governance landscape. Milhaupt and Pistor correct for the limitations of the CAO autopsy by discussing other important developments, such as the increasing use of litigation by

[42] While the United Kingdom is not one of the authors' seven featured countries, they do discuss the organization of its legal system and corporate governance structure (pp. 28–33).

[43] Perhaps the most striking illustration is the divergence in the two countries' regulation of hostile takeovers. The United States relies on litigation (a protective approach), while the United Kingdom has created a Takeover Panel, a form of (coordinated) self-regulation by the London Stock Exchange, investment banks and institutional shareholders (p. 33). The contrast is explored in detail in John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? — The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727 (2007).

private parties, in their overview of the Chinese corporate governance system (pp. 142–45). However, the discussion is only loosely related to the autopsy itself since private litigation was not a salient feature of the CAO crisis.

Second, the search for a company-specific crisis could have caused the authors to miss important developments that take a different form. Indonesia, a country that the authors do not include in their study, may illustrate this possibility — call it omitted country syndrome. Indonesia arguably was hit harder by the Asian financial crisis of the late 1990s than was any other single country.[44] After a period of strong growth fueled in part by heavy borrowing, Indonesia descended into political and economic chaos when the currency depreciated precipitously and borrowers began to default.[45] The World Bank and International Monetary Fund rushed onto the scene, pressuring Indonesia to radically reform its bankruptcy laws, and to establish both a Commercial Court to handle bankruptcies and a separate agency for out-of-court restructurings.[46] The rocky transition that followed soured many observers on the so-called Washington Consensus promoted by the IMF and World Bank,[47] which would make Indonesia a useful case study for one of the key points of *Law and Capitalism*, the dangers of legal transplants that do not fit local conditions (pp. 207–12). The omission of Indonesia from the autopsies may simply reflect the authors' own expertise or the limits of space, but it may also reflect the absence of a single, cathartic, company-specific crisis on which to focus. If a crisis is truly systemic, as in Indonesia, it may not lend itself well to the autopsy approach.

If a period of systemic turbulence may fail to produce an obvious, company-specific crisis to study, so too may periods of calm. It may be — and this is the last representativeness concern — that 2000 to 2005, the period from which each of Milhaupt and Pistor's case studies comes, was historically uncharacteristic. The outset of the twenty-first century has been a period of great transition, which has made it a gold mine — perhaps epidemic would be a better metaphor — of corporate governance crises. If they were writing in another era, such as the

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[44] For a succinct overview of the Indonesian crisis, see Terence C. Halliday, Susan Block-Lieb, & Bruce G. Carruthers, Missing Debtors: National Law-Making and Global Norm-Making of Corporate Bankruptcy Regimes 19–23 (May 2, 2008) (unpublished manuscript, on file with the Harvard Law School Library) [hereinafter Halliday et al.].

[45] LEX RIEFFEL, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 204–05 (2003).

[46] *See* Halliday et al., *supra* note 44, at 19–23.

[47] The Washington Consensus called for reforms with an emphasis on creating free markets through trade and capital market liberalization and tight monetary policies. For a description and fiery critique, see JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 16 (2002).

1950s or 1960s, the coroners might not have enough work to assess the governance systems of the time.

Although the representativeness of the autopsies is indeed imperfect, corporate crises are nevertheless a good proxy for stress points in a nation's governance. China Aviation Oil is not perfectly representative of developments in Chinese governance, for instance, but the issues it raises are systemwide concerns. This may in fact be inevitable: corporate travails are most likely to become crises when they resonate with existing concerns about the governance system. Nor is an absence of crises likely to be a serious threat. The current era has been unusually tumultuous, but even the most placid periods tend to be punctuated by representative, company-specific crises.[48]

### *B. Are the Autopsies Complete in Themselves?*

If one is persuaded that the Milhaupt-Pistor approach is more useful than the standard measures of corporate governance, what are the implications for the existing approaches? Are the matrix and autopsies a substitute for the alternative approaches, or are they complementary?

Start with the authors' principal foil throughout the book, the endowment perspective as exemplified by the La Porta et al. governance indices. Although *Law and Capitalism*'s dynamic perspective on governance change provides a much more nuanced perspective, governance metrics still have a role to play. While a simple index like those produced by La Porta et al. is unlikely to provide a complete picture of a nation's governance, it may isolate important details — such as the extent to which investors are protected. This information may be useful in constructing a matrix; it also could provide context for an institutional autopsy, much as transparency or corruption indices can serve as the starting point for a careful analysis of political governance.[49] The decisiveness of their dismissal of La Porta et al. suggests that Milhaupt and Pistor may reject the project of measuring corporate governance variables for the purpose of quantitative comparisons alto-

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[48] Even in the 1950s, for instance, which is often recalled as a period of quiescence in U.S. governance, Americans experienced a tumultuous proxy contest for New York Central Railroad and the advent of hostile tender offers, each of which would be well-suited for institutional autopsies. *See* RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 507–10 (1990) (describing successful contest by Robert Young for control of New York Central Railroad in 1954).

[49] For a nice example, see Curtis J. Milhaupt, Essay, *Property Rights in Firms*, 84 VA. L. REV. 1145, 1149 (1998), which uses "economic freedom, corruption, and political risk" indices as a basis for analysis of the "property rights theory of governance diversity."

gether. But *Law and Capitalism* can also be viewed as providing a richer context for their use.[50]

Milhaupt and Pistor describe the other major scholarly approach as the use of an "evolutionary theory" (p. 199). The most important exemplar is a book by Reinier Kraakman and six co-authors called *The Anatomy of Corporate Law*.[51] Kraakman et al. contend that a central objective of corporate law is to constrain agency costs caused by three kinds of conflicts of interest: between managers and shareholders, between controlling and minority shareholders, and between the firm and third parties such as creditors.[52] Because the challenge is the same in every jurisdiction, Kraakman et al. argue, lawmakers will develop loosely analogous solutions.[53] To demonstrate this, Kraakman et al. construct an elaborate typology of legal regulatory strategies, and explore which are favored in particular settings, such as self-dealing and takeovers.[54]

Those who are literarily inclined might detect an anxiety of influence in Milhaupt and Pistor's relationship to *The Anatomy of Corporate Law*, given the nearly identical medical metaphors the authors use to frame their analyses.[55] Kraakman et al. do not make a sustained appearance in *Law and Capitalism* until late in the book (pp. 198–99), and Milhaupt and Pistor's autopsies seldom speak explicitly of managerial agency costs, which are the dominant theme in *The Anatomy of Corporate Law* and several decades of American corporate law scholarship. Why sidestep the lingua franca of the corporate law literature? Perhaps agency costs–based analysis, especially as the infrastructure for an evolutionary theory, provides too thin an account of corporate law. "The problem with the evolutionary approach," as Milhaupt and Pistor put it, "is that once one moves beyond simple abstractions, it does not tell us very much" (p. 200). Although every nation's corporate law must respond to agency costs, "the location and severity of agency problems in firms, as well as what might be called the institu-

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[50] For an analysis of the difficulties of developing quantifiable variables and argument as to the importance of the effort in another context, judicial decisionmaking, see David F. Levi & Mitu Gulati, Judging Measures (Oct. 14, 2008) (unpublished manuscript, on file with the Harvard Law School Library).

[51] REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW (2004). The book is summarized and critiqued in much more detail in David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 YALE L.J. 1519 (2004) (book review).

[52] KRAAKMAN ET AL., *supra* note 51, at 21.

[53] *See id.* at 1.

[54] *See id.* at 23–28 (summarizing typologies).

[55] In Harold Bloom's classic account, poets adopt one or more of a handful of strategies to negotiate the influence of their great predecessors. HAROLD BLOOM, THE ANXIETY OF INFLUENCE (1973).

tional inclination to use law (corporate or otherwise) to address these problems, differ widely from system to system" (*id.*).[56]

If they were asked whether evolutionary theories like *The Anatomy of Corporate Law* should be tossed in the dustbin (and given a suitable truth serum to prevent modesty from interfering with their answer), Milhaupt and Pistor surely would say yes. Their emphasis on the rolling relationship between law and markets is designed to discourage generalization about the commonalities between different systems. Yet the Kraakman et al. strategy may complement Milhaupt and Pistor's approach in at least one respect. Given that corporate governance systems do confront analogous problems, as Milhaupt and Pistor concede,[57] appreciation of the different strategies that have been used for addressing them could inform a discussion of which options are more or less likely to be effective in a given corporate governance system. More generally, if one is cautious about the claims one makes for an evolutionary theory, it provides a framework for thinking about the changes one observes at a particular moment in time.[58]

In other words, Milhaupt and Pistor's resistance to generalization is a powerful corrective to context-insensitive theories, but the authors risk erring in the opposite direction. Insisting that each system is unique and unpredictable would prevent us from learning either from history or from the experience of other systems. "Thinking means connecting things," as G.K. Chesterton once said in another context, "and stops if they cannot be connected."[59] The resistance to generalization also can become its own generalization, as in the authors' recurrent finding that crisis has prompted reforms that could change a nation's overall governance system, but that the reforms then spurred a backlash that could stymie change.[60]

### *C. Do the Matrix and Autopsies Belong Together?*

A third general issue is whether the matrix and autopsies are a single, unified approach to corporate governance. That is, do they belong

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[56] Emphasis has been removed.

[57] They note that "[a]t the stratospheric level of abstraction at which it is typically presented," the evolutionary approach does identify genuine similarities among systems (p.199).

[58] In an extremely influential body of work that appears mostly in passing in *Law and Capitalism*, for instance, Professor Mark Roe has developed a theory of the relationship between politics and corporate governance arguing, among other things, that labor governments tend to focus on protections for employees, whereas conservative governments are more shareholder-oriented. *See, e.g.*, MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE FINANCE (2003). In my own work, I have argued that different approaches to corporate governance are associated with complementary forms of bankruptcy regulation. *See, e.g.*, David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1327–28 (1998).

[59] G.K. CHESTERTON, ORTHODOXY 30 (Hendrickson Publishers 2006) (1908).

[60] The authors point to signs of backlash in the United States (p. 66), Japan (p. 107), and Korea (p. 124).

together? Whereas the autopsies illustrate the rolling relation between law and markets that is central to the Milhaupt and Pistor approach, the matrix is static. Might the two parts of the framework be severed, perhaps by removing the matrix and the theoretical discussion that accompanies it at the beginning and end of the book?

In a sense they could. From this perspective, *Law and Capitalism* would reflect a plea for case studies rather than the stylized governance indices that dominate the current literature.[61] The matrix, on the other hand, might prove useful for scholars committed to the traditional approach by providing a richer set of variables to examine. But removing either component would significantly diminish the richness of Milhaupt and Pistor's analysis. The matrix provides essential context for the autopsies by framing their analysis of the underlying governance system, interest groups, and government actors implicated by a particular corporate crisis. The matrix also provides the basis for making comparisons between one system and another, and between historical periods in a single country. Each of the parts can be used independently of the other, but together they are the best — and for a scholar, most exciting — strategy yet devised for doing comparative corporate governance work.

### *D. Could the Authors Do More with the Autopsies?*

In extolling Milhaupt and Pistor's matrix-and-autopsy approach, I do not mean to suggest that the authors' own institutional autopsies are perfect. The autopsies could benefit both from more details and, as we have seen, from more theory.

First, the details. One of the most important contributions of the authors' new approach is its focus on both the demand for and supply of law within a legal system (pp. 40–44). Having invented a new diagnostic tool with this profound virtue, Milhaupt and Pistor might be expected to offer a detailed analysis of the interest groups in each of these systems, and of the interactions between the private and political sector that affect the demand for and supply of law. But Milhaupt and Pistor's analysis often relies on shorthand rather than specific detail. Although the Mannesmann autopsy provides a helpful overview of the evolution of German codetermination, which gives employees representation on the supervisory boards of large corporations (pp. 75–77), in many of the other autopsies the authors do not explain the mechanisms through which each interest group operates. Similarly, the authors provide a good general overview of the governance breakdowns that made the Enron collapse possible (pp. 48–51), but they do

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[61] The authors summarize both the empirical claims made by such scholarship and the problems with its approach (pp. 18–25).

not fully explain the norms and regulations that contributed to the collapse.[62]

The institutional autopsies also would benefit from additional theoretical context. One of the most striking attributes of the completed matrix, for instance, is that six of the seven observations fall on the diagonal between the two axes (p. 183 fig.9.1). This provides visual confirmation that the variables on each axis are complementary,[63] and could be used to develop predictions about the likely direction of change. If centralization and coordination are complements, as are decentralization and protection, one might expect developments that mix the orientations (and thus are "off the diagonal" on the matrix) to be unstable. The increased centralization augured by the responses to Enron[64] thus will only endure if it is accompanied by increased coordination, perhaps reflected in more active political involvement of organizations representing institutional shareholders. By more fully developing the theoretical underpinnings of the matrix, Milhaupt and Pistor could enhance its explanatory power and generate empirically testable predictions.

The model could be further enriched by an analysis of the different ways crises are likely to play out in different regimes. In the United States, with its decentralized, protective governance system, corporate scandals galvanize public opinion and prompt reform that would not be possible under ordinary circumstances.[65] In a centralized, coordinative regime, by contrast, one would not expect change to come through the same channels, because legal change is a product of bargains between interest groups and the government, without widespread participation by ordinary citizens.

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[62] Several of the practices that contributed to Enron and the other U.S. corporate scandals can be traced to regulation. For example, the heavy use of option-based pay was fueled in part by a 1993 tax change that was intended, ironically enough, to discourage excessive compensation. DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 153 (2005). In addition, the Delaware Supreme Court's decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), gave a boost to accountants' and investment banks' consulting practices, which contributed in turn to the conflicts of interest that undermined the performance of auditors and securities analysts as gatekeepers. SKEEL, *supra*, at 129–30.

[63] *See supra* notes 40–43 and accompanying text (discussing the overlap between the two axes).

[64] The authors describe the effect of the 2002 Sarbanes-Oxley Act as centralizing corporate governance regulation (pp. 56–57).

[65] This pattern is discussed in more detail *infra* pp. 741–42.

## III. WORLDCOM: THE SHORT, HAPPY (?) LIFE OF A GOVERNANCE EXPERIMENT

Some of the benefits of additional theory and detail perhaps can be illustrated by considering several of the key early twenty-first-century crises that do not appear in *Law and Capitalism*.[66] There are two obvious omissions from Milhaupt and Pistor's institutional autopsies of early twenty-first-century corporate crises: the failures of WorldCom in the United States in 2002, and of Parmalat, the giant Italian dairy conglomerate, the following year. The scandals were strikingly similar. The companies had similar pathologies, and each committed blatant accounting fraud. But the most noteworthy similarity came in the aftermath of the scandals. Regulators sought to remake the two companies, turning each into a corporate governance paragon.

The usual shorthand account of the government's response to the U.S. corporate scandals goes something like this. Enron and WorldCom were the most spectacular examples of a wave of corporate failures that reflected a breakdown in American corporate governance. Its eyes squarely on Enron, Congress enacted the Sarbanes-Oxley Act, which is so packed with provisions that were directly inspired by Enron's misdeeds that it can be characterized as a "future Enron" prevention act, or less charitably as shutting the barn door after the horse has escaped.[67]

While accurate so far as it goes, this account is incomplete and a trifle misleading. Although Enron was indeed the principal inspiration for Sarbanes-Oxley, the legislation never would have been enacted if it were not for the WorldCom collapse.[68] After Enron and several other major companies failed in late 2001 and early 2002, Congress held hearings and pieced together potential legislation. But the Bush Administration made clear that it was not especially interested in new regulation, and by late spring the excitement had begun to quiet down. The likelihood of substantial reform dwindled markedly. Then the WorldCom scandal hit. WorldCom reignited the crisis, making it impossible for the Bush Administration to resist reform. After an emergency speech by President Bush failed to calm the markets, the administration dropped its resistance, Congress rushed legislation to the President's desk, and the President signed it.

WorldCom was far more than simply the proximate cause of the Sarbanes-Oxley Act, however. Unlike Enron, it had so substantial a

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[66] Given the constraints of the essay review form, the autopsies that follow will be necessarily truncated. But they will seek to incorporate some of the suggestions of this section into the Milhaupt and Pistor model.

[67] *See* Stuart L. Gillan & John D. Martin, *Corporate Governance Post-Enron: Effective Reforms, or Closing the Stable Door?*, 13 J. CORP. FIN. 929 (2007) (using this metaphor).

[68] The details in this paragraph can be found in SKEEL, *supra* note 62, at 175–77.

core business that it was destined to outlive its misdeeds. It was in the restructuring phase, as regulators tried to convert the governance villain into a governance paragon in Chapter 11, that WorldCom most influenced U.S. corporate governance.

WorldCom was a child of the deregulation of the telecom industry after the breakup of AT&T.[69] When Bernie Ebbers, a former college basketball player with no telecommunications experience, assumed control, the company, then known as LDDS, was a financially shaky reseller of long distance services. Ebbers seems to have made one contribution to the company's business plan: acquisitions. "With Mr. Ebbers at the helm," as a bankruptcy report put it, "the Company quickly began acquiring resellers of telecommunication services in other states."[70] It first went public through one of its acquisitions — a business that was listed on NASDAQ. The company changed its name to WorldCom in 1995 and soon extended its tentacles into local markets and the Internet. WorldCom's high point came when it swallowed MCI in 1998, a merger then said to be the largest in history. In 1999, WorldCom was poised to acquire Sprint, one of its largest competitors, but the merger was derailed by the U.S. Department of Justice.

The currency for these deals and many others was WorldCom stock, which defied gravity for much of the 1990s.[71] But it began losing steam in 2000, around the time the Internet bubble burst. Faced with deteriorating stock value and the demise of the Sprint merger, WorldCom tried several restructuring gimmicks and, as the world later learned, began falsifying its accounting numbers to create the illusion of profitability.[72] Ebbers resigned at the end of April 2002 and the sky fell two months later.

Few companies have been as closely examined as WorldCom after the scandal broke. In June 2002, the Securities and Exchange Commission sued WorldCom for securities fraud, and shortly thereafter the

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[69] Most of the details in this paragraph can be found in a succinct summary of WorldCom's rise and fall provided by the bankruptcy examiner in the first of three reports. *See* First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner at 9–20, *In re* WorldCom, Inc., No. 02-15533 (Bankr. S.D.N.Y. Nov. 4, 2002) [hereinafter First Thornburgh Report], *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/thornburgh1strpt.pdf.

[70] *Id.* at 13.

[71] The details in this paragraph come from the First Thornburgh Report. *See id.* at 20–32.

[72] Much of the mischaracterization involved treating line costs as if they were contributions to capital, so that they would not figure as expenses on WorldCom's financial statements. For detailed explanations, see, for example, Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner at 271–79, *In re* WorldCom, Inc., No. 02-13533 (Bankr. S.D.N.Y. Jan. 26, 2004) [hereinafter Third Thornburgh Report], *available at* http://www.klgates.com/files/tbl_s48News/PDFUpload307/10129/WorldCom_Report_Final.pdf; DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. 61–129 (2003) [hereinafter DIRECTORS' REPORT], *available at* http://news.lp.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf.

district court appointed Richard Breeden, a former SEC chair, to serve as Corporate Monitor and prepare a report with recommendations.[73] A month later, WorldCom's board of directors established an independent committee of new, post-fraud directors to undertake its own investigation.[74] And the bankruptcy court appointed yet another high-profile chaperone, former Pennsylvania Governor Dick Thornburgh, as Examiner, launching a third investigation.[75]

As documented in the three reports, WorldCom's governance failures were a caricature — an exaggerated but revealing likeness — of the weaknesses of American corporate governance more generally. Bernie Ebbers's compensation was based heavily on stock options, as was the pay of Scott Sullivan, his CFO.[76] Because they pay handsomely if the stock price rises, but they cost nothing to the executive if it falls, stock options create a powerful incentive to push up the stock price in any way possible. The strategy under Ebbers and Sullivan was acquisitions, and in the end creative accounting, to sustain the illusion of profits after they no longer existed.

Although a majority of WorldCom's directors were independent, they served less as checks on Ebbers's influence than as extensions of his reign. The board had a non-CEO chairman and an active Compensation Committee, but both answered to Ebbers. "Mr. Ebbers' recommendations," as the bankruptcy report put it, "were of 'paramount importance in setting base salaries of other executive officers,'" and he also had "significant personal influence" over their bonuses.[77] Other directors were more fully independent, but they never questioned Ebbers until it was too late.

The outside gatekeepers were equally ineffectual. Arthur Andersen, which audited both WorldCom and Enron, identified WorldCom as a high-risk client but failed to pursue a series of "red flags" indicating serious problems.[78] Still more problematic was WorldCom's relationship with Salomon Smith Barney and its star analyst Jack Grubman. Salomon invited Ebbers and other WorldCom directors to

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[73] *See* Restoring Trust: Report to Hon. Jed S. Rakoff, The United States District Court for the Southern District of New York, on Corporate Governance for the Future of MCI, Inc., SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. Aug. 26, 2003) [hereinafter Restoring Trust], *available at* http://www.nysd.uscourts.gov/rulings/02CV4963_082603.pdf.

[74] *See* DIRECTORS' REPORT, *supra* note 72, at 2–3.

[75] *See* First Thornburgh Report, *supra* note 69, at 1–2.

[76] *See id.* at 65 n.7 (Ebbers's stock options and other compensation for 1999, 2000, and 2001); *id.* at 68 n.13 (noting that Sullivan's WorldCom holdings were almost exclusively unexercised stock options).

[77] *Id.* at 66 (quoting WorldCom, Inc., Proxy Statement (Form DEF 14A) (Apr. 22, 2002)). The Compensation Committee chair was given access to a company jet for a token fee, which underscored the absence of independence. *Id.* at 70.

[78] *See* Third Thornburgh Report, *supra* note 72, at 317–41; First Thornburgh Report, *supra* note 69, at 50–51.

participate in valuable IPOs and Grubman touted the WorldCom stock, while WorldCom regularly hired Salomon to advise it on mergers and underwrite stock and bond offerings.[79] "What used to be a conflict is now a synergy," Grubman famously announced, defending a web of interdependence that made objective securities analysis impossible.[80]

In their institutional autopsy of Enron, Milhaupt and Pistor highlight the stepped up criminal enforcement of corporate fraud after the enactment of SOX (p. 60). In addition to contributing to this development,[81] WorldCom inspired two other innovations, each with potentially momentous implications for American corporate governance.

The first was a civil litigation analogue to the newly aggressive prosecution of corporate fraud. Among the many lawsuits filed against WorldCom and related parties was securities fraud litigation against WorldCom and its directors.[82] Ordinarily, if the plaintiffs and their attorneys have a strong case, the lawsuit will be settled and both the attorneys' fees and any recovery will be paid by the company's insurers. The WorldCom litigation initially proceeded along this track, but the head of the New York state public pension fund, which was the lead plaintiff in the case, insisted that WorldCom's directors make contributions out of their own pockets to the settlement fund.[83] In effect, these payments reinforced the shaming sanction of the litigation itself. Because the payments do not seem to have increased the overall amount of the settlement, they served much the same function as criminal enforcement — punishing the defendants without directly compensating the victims. If public pensions continue to play this quasi-regulatory role in other high-profile corporate misbehavior cases, this, like the stepped up criminal enforcement discussed by Milhaupt and Pistor, could edge U.S. corporate governance in a slightly more coordinative direction.

The innovation that will occupy most of our attention is the second: the effort to remake WorldCom as a corporate governance paragon. This project was a collaboration between the SEC and U.S. Dis-

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[79] *See* First Thornburgh Report, *supra* note 69, at 98 (noting that "Mr. Grubman attended the Board's meetings as a 'financial advisor' to the Company and performed roles that seem inconsistent with that of an independent securities analyst").

[80] ANDY KESSLER, WALL STREET MEAT: JACK GRUBMAN, FRANK QUATTRONE, MARY MEEKER, HENRY BLODGET AND ME 193 (2003).

[81] Like the trials of Ken Lay and Jeff Skilling of Enron, the trial of WorldCom's Bernie Ebbers was an early centerpiece of the government's use of criminal prosecution after corporate scandals.

[82] *See, e.g.*, Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1057–58 (2006) (describing the litigation).

[83] *Id.* (discussing the $24.75 million in payments made by the directors, and noting that the Enron directors also made (smaller) out-of-pocket payments).

trict Judge Jed Rakoff, centered on the proposals of Corporate Monitor Richard Breeden, a former chair of the SEC under the first President Bush. In his role as Corporate Monitor, Breeden was far more than simply a representative of WorldCom investors. Framed as a series of recommendations for MCI, Inc., the name WorldCom would take upon exiting bankruptcy, the Monitor's report is a blueprint for corporate best practices, with the renamed WorldCom itself as the model.[84]

Breeden's final report, "Restoring Trust," called for independent directorial oversight, with directors who meet frequently, have relevant expertise, and are well-compensated for the added expectations they have under the new model of board oversight.[85] The report proposed that the board include only one insider, the CEO, and that it establish separate Audit, Governance, Compensation, and Risk Management committees, as well as expanding the use of the existing Ethics Pledge and holding regular ethics training.[86] To give shareholders more say, the report recommended a mandatory turnover of at least one director each year, with shareholder consultation on the company's nominee, and that any proxy proposal supported by at least 1% of the shares be submitted to a shareholder vote via a proposed Internet-based discussion forum.[87]

The report also spoke to the hotly contested issue of hostile takeovers, adopting a moderately pro-takeover stance. The report recommended that the company's certificate of incorporation prohibit the use of staggered boards, based on the view that limiting election of directors to some fraction of the board each year would unduly interfere with a bidder's ability to take control of the board.[88] The Monitor would not forbid altogether the other major antitakeover defense, poison pills. A "chewable pill" that "would exempt a fully financed cash offer to any and all shareholders at a minimum premium," he explained, would give managers the ability to negotiate with a hostile bidder without unduly entrenching themselves.[89]

The Monitor's proposals were a radicalized version of conventional wisdom, going much further than either SOX or the stock exchange reforms. The company and its professionals worried about the costliness of the reforms, and repeatedly prodded Breeden to scale them

[84] *See* Restoring Trust, *supra* note 73.
[85] *See id.* at 50–53, 59–61, 77–78.
[86] *See id.* at 5–9 (summarizing recommendations).
[87] *See id.* at 4–5 (director turnover), 114 (proxy proposals).
[88] *See id.* at 134–35.
[89] *Id.* at 134; *see also id.* at 137. Limited antitakeover defenses might be particularly appropriate in WorldCom's case, according to Breeden, because post-bankruptcy sales of the reorganized company's stock could artificially lower its stock price in the months right after bankruptcy. *Id.* at 135.

back;[90] but most of the major recommendations made it into the charter of MCI. The governance overhaul had an unmistakably centralized and coordinative flavor, despite having taken place in the judicial context: it was brokered by the court-appointed Monitor with MCI's principal constituencies;[91] and while it may have benefited MCI's postbankruptcy shareholders, the elaborate new directorial responsibilities also imposed substantial costs.

As it turned out, the governance experiment came to a premature end. In early 2005, less than a year after emerging from bankruptcy, "MCI became the subject of a torrent of takeover interest among its rivals," as the *New York Times* put it.[92] Verizon and Qwest quickly emerged as the principal bidders. Although Qwest offered substantially more, $7.3 billion as compared to Verizon's $6.6 billion, MCI's managers accepted the lower bid, justifying the Verizon deal as a less risky transaction.[93] Many of MCI's largest shareholders were outraged, but they and Qwest were stymied by a poison pill MCI had put in place the day it emerged from bankruptcy.[94]

Recall that Breeden had blessed the use of a poison pill so long as it was chewable, in part because he worried that MCI might be subject to a lowball takeover bid. The MCI pill met all of Breeden's requirements, and Breeden himself participated in discussions about the two bids, but the pill was used in precisely the opposite way than the report contemplated: to prefer a lower bid over a higher one.[95]

Once it became a wholly owned subsidiary of Verizon, MCI's days as a publicly held corporation, and as a paragon of corporate governance, were over. Like a Mars probe that peters out as soon as it reaches the planet's surface, the MCI governance experiment did not last long enough to provide most of the data for which it was designed.

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[90] Telephone Interview with anonymous bankruptcy attorney (July 21, 2008).

[91] There is an interesting analogy between the Corporate Monitor's role and the SEC's former role in bankruptcy. From 1938 to 1979, the SEC examined proposed reorganization plans and issued a report outlining its views about the plan. *See, e.g.*, DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 169 (2001) (mentioning this role as one the SEC could exercise in Chapter X bankruptcies).

[92] Matt Richtel & Andrew Ross Sorkin, *Verizon Agrees To Acquire MCI for $6.6 Billion, Beating Qwest*, N.Y. TIMES, Feb. 14, 2005, at A1.

[93] *See id.*

[94] *See* Ross Wehner, *MCI Keeps Stock Limit: "Poison Pill" Is On*, DENVER POST, Apr. 12, 2005, at C1.

[95] *See, e.g.*, Yuki Noguchi, *The 'Sheriff' of MCI*, WASH. POST, Apr. 28, 2005, at E1 (describing Breeden's participation in MCI board deliberations on the takeover bids). The pill was effective against Qwest because it was chewable only for a bidder who offered a 25% premium and whose bid was at least $31.25 per share. The latter requirement proved prohibitive. *See* MCI, Inc., Common Stock Purchase Rights (Form 8-A), (Apr. 20, 2004), *available at* http://www.sec.gov/Archives/edgar/data/723527/000095010304000557/apr1904_812g1.htm.

Despite its short life, the SEC intervention could have profound implications for American corporate governance. Although the particular innovation — a governance makeover — was new, innovative judicial responses to a crisis are not. Chapter 11 itself was the product of a remarkable judicial innovation — coordinated with railroad managers, Wall Street investment banks and their lawyers — in the late nineteenth century.[96] Eliot Spitzer's industry-wide settlement with the securities industry, another of the major scandal-inspired reforms, also was achieved through the courts.[97] As these illustrations suggest, American capitalism often seems to become temporarily coordinative and at times more centralized (as with the Spitzer settlement) after a crisis.

The form this coordination took in WorldCom (and, as we shall see, in Parmalat) has received remarkably little scholarly attention. This is unfortunate. The governance makeover was an unusual strategy born of crisis, but it is a strategy worth revisiting. Consider the issue of greater shareholder access to the proxy process in corporate law. At the height of the corporate scandals, the SEC proposed a rule that would make it easier for shareholders to propose their own nominees for the board of directors, and shareholder access has been the single hottest issue in the corporate law literature in the past five years — at least if one judges by the number of pages in leading law reviews.[98] Yet no one really knows how smoothly shareholder access would function and what effect if any it would have on corporate governance. There are no real data. The single-firm transplant strategy would offer a test — just one firm, to be sure, but a firm whose governance stands as a yardstick — and would serve as a laboratory for assessing the proposed governance model.

The best candidates for this governance makeover are companies like WorldCom that have committed fraud and subsequently filed for bankruptcy. The case for single-firm reform is strongest in this context,[99] and the bankruptcy process provides for a reworking of the debtor's charter. Bankruptcy is not a prerequisite, however; similar

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[96] *See* SKEEL, *supra* note 91, at 48–70 (describing the creation of American corporate reorganization through a judicial reshaping of foreclosure and receivership law).

[97] For an overview of the settlement, see, for example, JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 265–70 (2006).

[98] The leading advocate of shareholder access has been Lucian Bebchuk. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005). The issue also figured in the recent presidential campaign, with both Barack Obama and John McCain endorsing a pending Congressional proposal to require nonbinding shareholder votes on executive compensation.

[99] A claim by shareholders or creditors (who are likely to be the new shareholders after bankruptcy) that the company is being treated as a guinea pig at their expense is least compelling if the company has engaged in fraud.

reforms could be implemented through securities litigation outside of bankruptcy.[100] While the strategy may seem heavy-handed to some, serious surgery is appropriate when cancer is discovered in a firm. Moreover, if the reforms impaired the company's governance, the directors and shareholders could subsequently remove them by amending the charter or bylaws. If, on the other hand, the reforms proved successful, they might generate momentum for change at other companies.

## IV. PARMALAT: THE NEW FACE OF ITALIAN GOVERNANCE?

For decades, the predecessor of Parmalat was a locally important "dynasty of food traders" near Parma in Northern Italy, specializing in prosciutto.[101] In the 1960s, under Calisto Tanzi, the company expanded into the dairy business, using a new packaging technology called Tetra Pak to establish a dominant position in the Italian market. Parmalat was the name Tanzi gave the new dairy enterprise. In the 1980s, Tanzi bought Odeon TV, a disastrous investment he secretly bailed out with Parmalat money, and Parmalat expanded into other food-related businesses such as juices and bakery goods. The conglomerate used sports as a key part of its branding strategy, acquiring the Parma soccer team in the 1990s, as well as teams in Brazil and Chile. As with WorldCom, the pace of expansion accelerated in the 1990s, featuring acquisitions in Latin America and in the tourism industry.

Notoriously stingy with disclosure, Parmalat took an "opaque and arrogant approach towards analysts and investors."[102] But with the company apparently thriving, enthusiastic analysts filled the information gaps with creative theories about what Parmalat was up to. Parmalat's mounting debt was defended by the company's supporters as a clever strategy for minimizing the company's tax burden. "The unconcerned analysts considered the strategy to be theoretically sound," according to two leading commentators, "even though they had no clear picture of how it could work, since Parmalat did not disclose sufficient information and the group structure was terribly complex."[103]

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[100] Outside of bankruptcy, the SEC or shareholder litigants might negotiate for bylaw changes reflecting the reforms, since a charter amendment would require a shareholder vote. Alternatively, the directors might agree in the settlement to hold a shareholder vote on proposed charter amendments. To the extent private plaintiffs pursued governance changes, single-firm reform would be less of a deviation from the traditional decentralized model of U.S. governance.

[101] Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The* Parmalat *Case*, *in* AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE U.S. 159, 162 (John Armour & Joseph A. McCahery eds., 2006). The details that follow can be found in *id.* at 162–65.

[102] *Id.* at 165.

[103] *Id.* at 166.

Although its analysts kept the faith, Parmalat's stock price drifted downward in early 2003 amid rumors that the company had issued debt on unattractive terms.[104] At this point, Consob, the Italian securities regulator, stepped in, pressing Parmalat's internal and external auditors for information.[105] The auditors' response was hardly encouraging. After investigating, Deloitte Touche Tohmatsu, the outside auditor, declared itself unable to give a fairness opinion on the value of a mutual fund controlled by Parmalat.[106] Several unusual transactions (one was with a company known as Buconero, or "Black Hole") were discovered during this period.[107] The collapse came in early December, after Parmalat defaulted on an issuance of bonds; the €3.95 billion it supposedly held in a Cayman Islands subsidiary was found to be a mirage; and a last ditch attempt to arrange a sale fell through. The once mighty conglomerate was declared insolvent on December 27, 2003, and Tanzi, who had resigned two weeks earlier, was thrown in jail the same day.[108]

As with WorldCom, Parmalat's fraud was remarkable more for its audacity and scope than for its complexity. "As far as the technical means," Ferrarini and Giudici write, "they were extremely basic. Parmalat hid losses, overstated assets or recorded non-existent assets, understated its debt, and diverted company cash to Tanzi family members."[109] With at most only three of its directors independent, Parmalat's board provided no oversight.[110] Its auditors were equally ineffectual. Indeed, its original outside accounting firm may have directly aided the fraud. The Cayman Islands subsidiary was set up after Parmalat was forced by Italian law to rotate to a new external auditor; Grant Thornton, the original auditor, stepped down as principal external auditor, but oversaw the subsidiary.[111]

The Parmalat implosion prompted a flurry of responses both in the United States and in Italy. In the United States, the SEC brought suit on December 30, 2003, filing on behalf of American investors who

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[104] *See id.*

[105] Under Italian law, corporations must have an internal "statutory" auditor as well as an external auditor. The statutory auditor is appointed by shareholders, but most Italian companies have a controlling shareholder and the statutory auditor has traditionally been complacent. *Id.* at 186–87. The external auditor can be appointed for up to three three-year terms. After nine years, the auditor must be changed. As discussed below, *see infra* note 111, this requirement was an obstacle to Parmalat's fraud, but an obstacle the company sidestepped.

[106] Ferrarini and Giudici, *supra* note 101, at 167.

[107] *See id.*

[108] *See id.* at 168.

[109] *Id.* at 168–69.

[110] *See id.* at 174.

[111] Although Grant Thornton could not continue as primary auditor to Parmalat once its nine years ended in 1999, it was able to serve as a secondary auditor responsible for Bonlat, the separate Cayman Islands entity. *See id.* at 178.

purchased Parmalat debt issued between August and November 2003.[112] Class action lawyers sued Tanzi, CFO Fausto Tonna, Attorney Gian Paolo Zini, and the auditors several days later, alleging that the company had misdisclosed its finances when it issued debt, much of which was bought by U.S. investors.[113] The U.S. class action litigation would have a major indirect effect on the Parmalat saga, and the SEC would figure quite directly.

By the time Parmalat was declared insolvent, its chief executive was Enrico Bondi, who had been hired initially as a consultant but took over a few days later when Tanzi resigned.[114] Bondi, Italy's leading corporate turnaround specialist, made his name by rescuing the sprawling Ferruzzi conglomerate and had also served briefly as CEO of Telecom Italia.[115]

The first major obstacle to Bondi's restructuring effort was Italian insolvency regulation. Italy's corporate governance has traditionally been both centralized and coordinative, a negotiated bargain between the government and the controlling shareholders that dominate Italy's large corporations.[116] Italian insolvency regulation was even more centralized at the time of the Parmalat crisis: it relied heavily on court oversight, significantly limited the influence of creditors and other private parties, and gave little scope for reworking a company's capital structure. Of particular note were two features of "administration," the procedure used for large companies like Parmalat. First, in an administration, the company's managers would be displaced by a newly appointed administrator, the Extraordinary Commissioner, a step that would bring a quick end to Bondi's tenure.[117] Second, the insolvency provisions did not permit a company to give creditors stock in place of their debt; this limitation would make an ordinary restructuring impossible.

The authority question was resolved first, before Parmalat was declared insolvent. The Italian government issued a decree establishing special rules for the Parmalat administration. Most importantly, the

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[112] *See* SEC Charges Parmalat with Financial Fraud, SEC Litigation Release No. 18,527, 81 SEC Docket 3143 (Dec. 30, 2003) (announcing the litigation).

[113] *See* Ferrarini & Giudici, *supra* note 101, at 170.

[114] *See* Eric Sylvers, *Parmalat Chief Resigns as a Turnaround Specialist Steps In*, N.Y. TIMES, Dec. 16, 2003, at C12.

[115] *See id.*

[116] *See* Marco Ventoruzzo, *Takeover Regulation As a Wolf in Sheep's Clothing: Taking U.K. Rules to Continental Europe*, 11 U. PA. J. BUS. L. (forthcoming 2008) (manuscript at 15–16, on file with the Harvard Law School Library), *available at* http://works.bepress.com/marco_ventoruzzo/1 (describing influence of controlling shareholders in Italy).

[117] The Extraordinary Administration procedure was established by Law No. 95, April 3, 1979, *Gazz. Uff.* No. 94 (Apr. 4, 1979), as an alternative to liquidation. The provisions for large firms were adopted in connection with a reform passed two decades later. *See* Legislative Decree No. 270, July 8, 1999, *Gazz. Uff.* No. 185 (Aug. 9, 1999).

authority to select the Extraordinary Commissioner was given to a governmental minister, rather than to the court, assuring that Bondi would be appointed.[118] Bondi also persuaded the legislature to authorize debt-for-equity swaps, and to give creditors the right to vote on a reorganization plan, thus shifting the balance of power more to the parties themselves.[119] Bondi used these changes as the basis for a sweeping reorganization in which Parmalat's creditors received stock in exchange for their debt.[120]

Much of Bondi's energy, both during and after bankruptcy, has been spent pursuing claims against Parmalat's accountants and banks.[121] Like U.S. securities lawyers and the SEC, Bondi sued the banks and auditors under U.S. securities law, alleging that they contributed to Parmalat's fraud. Bondi also invoked a "clawback" provision in Italian bankruptcy law, under which a company can recover payments made before bankruptcy.[122] This bankruptcy litigation has played a remarkable, unanticipated role in Parmalat's post-bankruptcy governance, much as WorldCom's poison pill did in the United States.

Thanks in part to the governance reforms discussed below, Parmalat emerged from bankruptcy as Italy's only truly widely held corporation, which made it much more susceptible to a takeover than most Italian firms. Almost as soon as Parmalat completed its restructuring, takeover interest did in fact develop, with an Italian food company investigating a possible bid.[123] The difficulty for this bidder and others (especially Italian bidders) was Parmalat's bankruptcy litigation. One issue was valuation: the value of the litigation was extremely uncertain, and it was arguably Parmalat's most important asset. But there was a subtler and far more intractable problem as well: any bidder that bought Parmalat would acquire a hostile relationship with every major Italian bank. Given that Italian companies depend

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[118] Decree-Law No. 347, Dec. 23, 2003, *Gazz. Uff.* No. 298 (Dec. 24, 2003). The decree was approved by then and current Prime Minister Silvio Berlusconi, who had said he would never let Parmalat file for bankruptcy.

[119] *See* Law No. 39, Feb. 18, 2004, *Gazz. Uff.* No. 42 (Feb. 20, 2004) (equity for debt provision).

[120] Each of these developments bears an uncanny resemblance to the creation of corporate reorganization in the United States in the late nineteenth century. *See* SKEEL, *supra* note 91, at 64 (describing Wabash receivership in which representatives of Jay Gould persuaded a judge to allow the existing managers to initiate a receivership voluntarily and retain their control).

[121] Two of the principal bank targets were Bank of America, Parmalat's largest lender, and Citigroup. *See, e.g.*, Eric Dash, *Jury Finds Parmalat Defrauded Citigroup*, N.Y. TIMES, Oct. 21, 2008, at B7 (describing unsuccessful litigation against Citigroup and upcoming trial of Bank of America).

[122] Decree-Law No. 347, Art. 6, Dec. 23, 2003, *Gazz. Uff.* No. 298 (Dec. 24, 2003), *modified by* Law No. 39, Feb. 18, 2004, *Gazz. Uff.* No. 42 (Feb. 20, 2004).

[123] *Bondi Voted In as Parmalat Boss*, BBC NEWS, Nov. 8, 2005, *available at* http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/4417196.stm (noting that two "food companies, Italian firm Granarolo, and France's Lactalis, have been reported to be interested in buying Parmalat").

on banks either as lenders, underwriters of bonds, or both, Parmalat's litigation portfolio had a major downside.[124]

Faced with this dilemma, the bidder's lawyers devised a clever solution. They proposed that Parmalat be divided into two companies, one with its litigation and the other with its operating assets. The bidder would spin off the litigation as a separate, publicly held company and would retain the operating assets. Bondi aggressively resisted both the bid and the proposed split. He contended that Italian law prohibited the formation of a company that had no operating assets, and thus that the contemplated spinoff was illegal. Although the claim was debatable, it was plausible enough to discourage the bidder from pursuing the proposed takeover. Parmalat's litigation has thus served as an embedded takeover defense, but a defense with an intriguing quality: as with MCI, the defense is temporary.[125] Once the litigation is fully settled, the defense will dissolve and control of Parmalat will be (at least in theory) fully contestable.

The Parmalat and WorldCom crises were alike in another way as well. As with WorldCom, the SEC used its securities fraud litigation to extract corporate governance reform from Parmalat. Prior to its collapse, Parmalat had a governance structure characteristic of publicly held Italian companies, with family control and an insider-laden board of directors.[126] Under the consent decree that settled the SEC litigation, Parmalat adopted a series of reforms that reflect the model of widely held Anglo-American companies. Parmalat's new bylaws require that a majority of its directors be independent and that they serve for limited terms, and that the chief executive officer and board chairman be different people. The decree also called for the board to adopt a Code of Conduct and establish an Internal Control and Governance Committee.[127]

The SEC's intervention in Parmalat recalls the regulatory dance between Singaporean regulators and Chinese officials during the CAO

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[124] The details in this paragraph and the next are based on discussions with Lorenzo Stanghellini, Professor of Law, University of Florence, who has been involved in the Parmalat case in a variety of capacities.

[125] Although the defense in Parmalat was accidental, it was better tailored to the period of post-insolvency instability than was the MCI pill, which, as we have seen, gave MCI more protection than intended.

[126] Nine of Parmalat's thirteen directors were insiders, and several of the ostensible outsiders had close ties to Tanzi or Parmalat. *See* Ferrarini & Giudici, *supra* note 101, at 174.

[127] Consent and Undertakings of Defendant Parmalat Finanziaria, S.p.A. ¶¶ 7–8, *incorporated in* SEC v. Parmalat Finanziaria, S.p.A., Civ. No. 03 CV 10266 (S.D.N.Y. July 28, 2004) (Judgment of Permanent Injunction Against Defendant Parmalat Finanziaria, S.p.A.). The reforms are summarized in SIDLEY AUSTIN BROWN & WOOD LLP, SEC UPDATE: SEC SETTLES ENFORCEMENT ACTION AGAINST PARMALAT (2004), *available at* http://www.sidley.com/files/News/5099cd3a-9349-47b2-9a85-309e4bcd87e6/Presentation/NewsAttachment/96de7979-3d94-4a5d-8ee9-33861bec5cb6/SECAlertAug0404.pdf.

crisis,[128] and underscores the increasing importance of foreign regulators to domestic governance as finance has globalized. It also raises the question of how active the SEC will be outside the United States. Although Parmalat surely will not be the last of these interventions, two political factors may constrain the SEC's cross-border activities. First, the SEC has a limited budget, and activities with limited salience in the United States will contribute little to the SEC's case for funds. Second, the widespread foreign criticism of the costs the Sarbanes-Oxley Act threatened to impose on foreign issuers has forced the SEC to tread gingerly with non-U.S. companies.[129]

In Milhaupt and Pistor's terms, the Parmalat governance makeover does not seem especially well-adapted to local conditions.[130] Even now, Parmalat is the only major Italian corporation that does not have controlling shareholders. But Italian governance is very much in flux. In addition to the bankruptcy reforms discussed earlier,[131] Parmalat spurred the enactment of new legislation providing a class action device for the first time.[132] These reforms can be seen as the foundation for a more decentralized, protective governance system. From this perspective, Parmalat could be the leading edge of a shift in Italian governance. It is too early to tell whether the changes will prove to be a mirage. The new class action device has already been criticized as failing to address key issues such as uncertainty about the compensation of attorneys and limited access to discovery.[133] The Italian court system also is notoriously inefficient, which further increases the likelihood of a default back to the current, coordinative approach.

Even if the bankruptcy and class action reforms fully take hold, Italian governance will remain appreciably more centralized and coor-

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[128] The intervention also recalls the imposition by the IMF and World Bank of Washington Consensus reforms in many countries during the global financial crises of the 1990s.

[129] Costly provisions such as SOX's requirement that public companies establish and certify a system of internal controls are widely seen as having prompted many companies to do initial public offerings in London rather than the United States. The SEC responded to concerns about SOX by exempting most foreign issuers from its requirements. For analysis of the effects of SOX and the SEC's adjustments for foreign issuers, see Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-U.S. Companies Cross-Listed in the U.S.*, 13 J. CORP. FIN. 195 (2007).

[130] For a general note of caution about adopting U.S.-style reforms in countries like Italy with concentrated ownership, see Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP., Winter 2007, at 117, 138.

[131] *See supra* note 119 and accompanying text. A working group of Italian banks and professionals convened at the University of Florence recently adopted a set of protocols to encourage nonbankruptcy workouts, thus furthering the trend discussed in the text. *See* Editorial, *Arrivano le "linee" per i finanziamenti*, IL SOLE 24 ORE, May 17, 2008, at 35 (describing the new principles).

[132] *See* Law No. 244, Dec. 24, 2007, *Gazz. Uff.* No. 300 (Dec. 28, 2007) (providing for "compensatory collective action" litigation).

[133] *See, e.g.*, PAOLO GIUDICI, LA RESPONSABILITÀ CIVILE NEL DIRITTO DEI MERCATI FINANZIARI 149–56 (2008).

dinated than U.S. governance. Parmalat is thus likely to remain an outlier. But whether or not the governance overhaul has any immediate effect on Italian governance, the strategy itself is quite promising, and the reversibility of the governance changes limits its downside risks, as noted earlier.[134]

Both WorldCom and Parmalat add important features to our understanding of their respective countries' governance. WorldCom illustrates the surprisingly coordinative and at times centralized character the judicial process often takes on in the United States in a time of crisis.[135] Parmalat underscores the stresses in the traditional model of Italian governance, and the growing influence of outside regulators on domestic governance. The most direct link between the two cases — the SEC-prompted effort to turn each into a governance paragon — may be the single most promising regulatory innovation to come out of the early-twenty-first-century corporate scandals.

## V. BEAR STEARNS: THE GOVERNMENT AS INVESTMENT BANKER

Until recently, financial services fit into traditional boxes. A company that wanted a loan went to a commercial bank; to raise money by selling stock or debt to the public, the company paid a call on an investment bank. In the last twenty years, the categories have been scrambled. Not only has investment banking been transformed, but hedge and equity funds increasingly provide the services that were traditionally the domain of banks, sometimes through loans or securities purchases, but also through derivative securities.[136] Yet there is almost no evidence of this transformation in *Law and Capitalism*.[137] Its absence is due not to authorial negligence, but to the nature of institutional autopsies. Because they are somewhat backward looking — coroners cannot get started until a body turns up — institutional autopsies will not always identify emerging trends in their early stages.

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[134] *See supra* pp. 726–27.

[135] Although my particular focus is corporate governance, judges also have assumed a quasi-legislative, centralized role in other contexts, such as structural litigation. The classic scholarly treatment is Abram Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281 (1976).

[136] A good overview of this development and some of its implications is Raghuram G. Rajan, *Has Financial Development Made the World Riskier?*, *in* THE GREENSPAN ERA: LESSONS FOR THE FUTURE — A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY 313 (2005) *available at* http://faculty.chicagogsb.edu/raghuram.rajan/research/finrisk.pdf.

[137] There are tantalizing hints in the authors' comment that German banks now depend more on bond trading than traditional loans (p. 85) and in the role of derivatives trading in the China Aviation Oil crisis (pp. 125–27). But in each case the focus of the autopsy is (appropriately) elsewhere.

While *Law and Capitalism* was at the printers, the body arrived. The shocking collapse of the investment house Bear Stearns, and the upheavals that followed, have brought the transformation of financial services and the gaps in the existing regulatory framework into sharp focus. The rough contours of Bear Stearns's history parallel the trajectory of other major U.S. investment banks. For much of its life, Bear was a partnership, but it converted to a corporation and sold shares to the public in 1985,[138] as investment banking shifted from a business based on information and reputation to one where much of the bank's profits came from proprietary trading.[139] Bear was perhaps best known for its prime brokerage business — that is, for lending money to and conducting trades for hedge funds and other large institutional clients.

Bear's fall was foreshadowed by a more limited collapse that historians will probably identify as the start of the recent subprime crisis. In July 2007, two hedge funds that were run by Bear Stearns and had invested heavily in subprime mortgages through collateralized debt obligations (CDOs)[140] suddenly failed, wiping out the stakes of the hedge funds' investors.[141] The collapse not just of originators of subprime loans,[142] but also of funds that invested in them, signaled that large swaths of the financial system could be at risk.

Over the next eight months, Bear Stearns tried to reassure the market that the bank itself was stable. But in March 2008, as doubts about Bear's liquidity intensified, major clients began moving their business to other banks. By the end of the day on March 13, the *Wall Street Journal* later reported,

> so many clients had pulled their money from Bear Stearns that the firm had run through $15 billion in cash reserves. Lenders such as Fidelity In-

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[138] *See A History of Bear Stearns*, N.Y. TIMES, http://www.nytimes.com/imagepages/2008/03/17/business/20080317_BEAR_STEARNS_GRAPHIC.html (last visited Nov. 8, 2008).

[139] The best explanation of this shift is a recent book by Alan Morrison and Bill Wilhelm. ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW (2007) (explaining investment bank IPOs as fueled by transition to a proprietary trading model of investment banking).

[140] The indictment of the two Bear Stearns executives who ran the funds gives a simple definition of a CDO, characterizing it as "a security that [is] backed by a pool of debt securities, such as mortgages. The debt securities generate[] interest, which belong[s] to the CDO. A CDO [is] typically divided into tranches, and a CDO investor could have owned part or all of one or more tranches." Indictment at 4, *United States v. Cioffi*, Cr. No. 08 CR 415 (E.D.N.Y. June 18, 2008).

[141] *See* Bryan Burrough, *Bringing Down Bear Stearns*, VANITY FAIR, Aug. 2008, at 106, 109.

[142] Several substantial subprime lenders had collapsed during the same period, and Countrywide, the largest subprime lender, was in precarious condition. The largest failure was the bankruptcy of New Century in early 2007. *See, e.g.*, Vikas Bajaj & Julie Creswell, *A Lender Failed. Did Its Auditor?*, N.Y. TIMES, Apr. 13, 2008, § 3, at 1. Countrywide was eventually bought by Bank of America. *See, e.g.*, Gretchen Morgenson & Eric Dash, *Troubled Giant in Home Loans Close to Rescue*, N.Y. TIMES, Jan. 11, 2008, at A1 (reporting that the directors of both companies had agreed to the acquisition).

> vestments were refusing to replenish the financing Bear Stearns needed to open the next morning. Fellow brokerages Deutsche Bank AG, Goldman Sachs Group Inc., and others were being inundated by requests from clients who wanted to get out of trades with Bear Stearns.[143]

Late the night before, CEO Alan Schwartz had called Rodgin Cohen, the chairman of Sullivan & Cromwell, who called Timothy Geithner, the president of the Federal Reserve Bank of New York, alerting him to the growing crisis. After spending the day futilely searching for financing, Schwartz contacted James Dimon, the CEO of JPMorgan Chase, shortly after the close of business on March 13 and said, "Let's do something." With the active involvement of Geithner, they did, arranging a $30 billion loan and then a buyout of Bear Stearns by JPMorgan.

Under the terms of the loan, the Fed would lend the money to JPMorgan, which would then lend it to Bear Stearns, with Bear Stearns putting up $30 billion of securities as collateral and the Fed holding JPMorgan harmless in the event the securities turned out to be worth less.[144] Although Bear Stearns initially had twenty-eight days to arrange for the bank's future, the Fed and Treasury Secretary Henry Paulson decided that Bear could not survive the weekend on its own. The deal needed to be done by Sunday night, they told Schwartz, which effectively meant that it needed to be done with JPMorgan. As if this intervention were not remarkable enough, Paulson even shaped the price of the deal, pressuring JPMorgan to *lower* its offer to a paltry $2 per share from the $4 or $5 Dimon had been contemplating. A higher price, he apparently feared, could invite criticism that the government was "bail[ing] out Wall Street investors at a time when homeowners were losing their houses to foreclosure in record numbers."[145]

The crisis confirmed that the New Deal regulatory framework has become obsolete in key respects. Although the SEC is the principal regulator of investment banks like Bear Stearns, it has no funding capacity and played almost no role in the resolution of Bear Stearns's crisis. Nor was the Fed's traditional authority adequate for the transaction it and the Treasury Department engineered. Fed loans have traditionally been available only to commercial banks.[146] But because

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143 Kate Kelly, *Fear, Rumors Touched Off Fatal Run on Bear Stearns*, WALL ST. J., May 28, 2008, at A1. The details in the text that follows can be found in *id.*

144 JPMorgan later agreed to assume $1 billion of the risk, reducing the Fed's exposure to $29 billion. *See, e.g.*, Kate Kelly, *Bear Stearns Neared Collapse Twice in Frenzied Final Week*, WALL ST. J., May 29, 2008, at A1.

145 *Id.*

146 *See* U.S. DEP'T OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 7 (2008) [hereinafter TREASURY BLUEPRINT] (noting that the Fed "has used its authority for the first time since the 1930s to provide access to the discount window to non-depository institutions").

lending is done by so many other forms of intermediaries, the collapse of which could threaten the financial system, the narrow focus on commercial banks no longer makes sense.

An advocate of decentralized, protective governance might say that the Bear Stearns deal made a mockery of both these attributes of the traditional U.S. approach.[147] Rather than leaving the parties to their own devices, with the backdrop of the courts, the Fed and the Treasury took control of the process. As if to underscore the governmental role, the "shotgun wedding"[148] flouted ordinary Delaware corporate law. Both the original merger agreement — which included a provision prohibiting Bear Stearns from proposing an alternative deal for a year, and others giving JPMorgan options to buy 19.9% of Bear Stearns's stock and its headquarters at a below-market price even if the acquisition fell through — and the revised agreement might well have been struck down if the merger did not have the government's imprimatur.[149]

The deal itself was the opposite of shareholder protective, with Secretary Paulson driving down the deal price to ensure that the pain of the collapse was inflicted on shareholders. Bear Stearns's shareholders did achieve one small victory: they forced a renegotiation of the price to ten dollars per share, but only because the hastily finalized merger agreement included a provision under which JPMorgan agreed to fund all of Bear Stearns's trades for a year even if the merger fell through.[150] They had little other leverage.[151] Although the merger formally required a shareholder vote, the marriage was essentially con-

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[147] For a critique along these lines, though not in these terms, see Jonathan Macey, Op-Ed., *Brave New Fed*, WALL ST. J., Mar. 31, 2008, at A19.

[148] Kelly, *supra* note 144 (quoting James Dimon, CEO of JPMorgan).

[149] *See* AGREEMENT AND PLAN OF MERGER BY AND BETWEEN THE BEAR STEARNS COMPANIES INC. & JPMORGAN CHASE & CO., at § 6.10 (lockup); § 6.11 (headquarters option) (2008), *available at* http://graphics8.nytimes.com/images/blogs/dealbook/BSmerger.pdf; The Bear Stearns Cos. Inc., Current Report (Form 8-K), at exh. 99.2 (Mar. 20, 2008) (19.9% option). Delaware has been hostile to deal protection provisions that make it difficult for a target corporation to enter into alternative deals, which raises serious questions about the one year lockup period. *See, e.g.*, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003). The stock option and option to buy Bear Stearns's headquarters (if it was indeed less than market price) would further interfere with any alternative bids. *See generally* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994). As part of the renegotiation discussed below, the lockup period was removed. A share exchange for 39.5% of Bear's stock was substituted for the 19.9% stock option, and the option to purchase the headquarters remained. *See* AMENDMENT NO. 1 TO THE AGREEMENT AND PLAN OF MERGER BY AND BETWEEN THE BEAR STEARNS COMPANIES INC. & JPMORGAN CHASE & CO., at § 2.8 (removing the lockup); § 2.9 (retaining and modifying headquarters option); § 2.12 (removing stock option) (2008), *available at* http://bearstearns.com/includes/pdfs/investor_relations/amendment_merger.pdf; The Bear Stearns Cos. Inc., Current Report (Form 8-K), at 2 (Mar. 24, 2008) (39.5% option).

[150] *See, e.g.*, Kelly, *supra* note 144.

[151] *See id.*

summated as soon as the revised merger agreement was signed. JPMorgan managers moved in and began taking over Bear Stearns's operations.[152] At this point, the vote was simply a technicality, like Russian voters' decision who to choose for president.

With a commercial bank, the emergency loan and brokered sale would have been dramatic but would not have reflected a shift in U.S. governance. In Milhaupt and Pistor's terms, the governance of commercial banks is already much more centralized and coordinative than the regulation of other corporations. Before Bear Stearns, the regulation of investment banks was more like the regulation of nonfinancial corporations — that is, it was comparatively more decentralized and protective. This suggests a general point about the Milhaupt and Pistor matrix: even within a single country, different industries may be regulated differently. We therefore should be cautious about adopting a single characterization of a country's governance.[153]

Could the Bear Stearns crisis have been handled in a less centralized, coordinative way? The answer to this question is a qualified yes. If Bear Stearns had filed for Chapter 11, the government might not have needed to dictate the terms of its merger, although the benefits of Chapter 11 are undermined by its questionable treatment of derivatives, as we shall see. A second key question is whether the shift in the Fed's treatment of investment banks will be permanent. Here, too, the answer is yes, though once again with qualifications: the contours of financial services and securities regulation will depend on the fate of reforms that were proposed shortly after the crisis.

Take each of these issues in turn, starting with bankruptcy. That the parties were well aware of the bankruptcy option is evident from reports that a swarm of bankruptcy lawyers from a large New York law firm were buzzing around in the Bear Stearns headquarters early in the crisis, and that Bear's directors even authorized a filing.[154] The main players seem to have had an allergic reaction to the thought of bankruptcy, however, and it was treated as a last resort.[155] This skepticism, while a familiar enough reaction in American business, is more

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[152] *See, e.g.*, Landon Thomas Jr. & Eric Dash, *At Bear Stearns, Meet the New Boss*, N.Y. TIMES, Mar. 20, 2008, at C1.

[153] Another U.S. industry that was regulated in coordinated, centralized fashion for many years was the utilities industry. *See generally* SKEEL, *supra* note 62, at 98–100 (describing the New Deal restructuring of the utilities industry).

[154] Kelly, *supra* note 143 (Bear Stearns's "usual corporate counsel, Cadwalader, Wickersham & Taft LLP, sent over a large team, and dozens of bankruptcy specialists were also called in.").

[155] According to William Cohan, who has interviewed nearly every major participant in connection with a forthcoming book on the Bear Stearns debacle, the one exception was James Cayne, the former CEO of Bear Stearns. But Cayne pressed for bankruptcy principally to punish the Fed and Treasury for pushing for such a lopsided deal — not because he thought it was a better alternative. Interview with William Cohan in N.Y., N.Y. (July 2, 2008) [hereinafter Cohan Interview].

difficult to justify than one might guess. Bankruptcy would not have interfered with the Fed loan, and the bankruptcy judge could have overseen a prompt auction of Bear Stearns,[156] which in theory could have produced a higher price for Bear (and less intrusive governmental involvement) than the single-bidder, Fed-endorsed sale.[157]

One objection to the bankruptcy option was that the bankruptcy laws preclude broker-dealers from invoking Chapter 11; they are only permitted to use Chapter 7, which provides for a court-appointed trustee to liquidate the business.[158] The appointment of a trustee would have complicated the sale, not least by taking CEO Alan Schwartz out of the picture altogether. Yet it may have been possible for Bear Stearns, and clearly would be for other investment banks, to sidestep Chapter 7. A clever bankruptcy attorney, or swarm of them, would put Bear's nonbrokerage entities in Chapter 11, while keeping the brokerage business outside of bankruptcy.[159] Bear Stearns's attorneys concluded that, because its non-brokerage subsidiaries were so insubstantial, a Chapter 11 filing would be too risky.[160] While this may have been the right decision from Bear Stearns's perspective, the history of bankruptcy court oversight of novel cases suggests a bankruptcy judge could have made the case work.[161]

The other main obstacle was bankruptcy's treatment of derivatives. When a company files for bankruptcy, bankruptcy's automatic stay prevents most creditors from attempting to collect what they are

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[156] For a discussion of the flexibility offered by Chapter 11 for financing arrangements in bankruptcy, see David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905 (2004). Prompt sales are a common feature of recent Chapter 11 practice. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, Reply, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003) (analyzing cases resolved in 2002).

[157] This Review was written before the subsequent failure and bankruptcy filing of Lehman Brothers Holdings Inc. in September 2008. *See* Voluntary Petition, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. Sept. 14, 2008), *available at* http://www.creditslips.org/creditslips/Lehman.pdf. The Lehman Brothers bankruptcy is fully consistent with the analysis that follows, and is discussed further *infra* note 159, and p. 740.

[158] 11 U.S.C. § 109(d) (2006) (excluding stockbrokers and commodity brokers from chapter 11); *id.* §§ 741–753 (provisions for stockbroker liquidation). The traditional rationale for prohibiting reorganization is that it could tie up the securities markets by interfering with the settlement of trades.

[159] This, in fact, is precisely what was later done when Lehman filed for bankruptcy. A variation of this strategy, which is known as "ring fencing," was used in the PG&E bankruptcy in the early 2000s. Tim Reason, *Ring Around the Subsidiary*, CFO MAG., Oct. 1, 2001, *available at* http://www.cfo.com/article.cfm/3001311.

[160] *See, e.g.*, Cohan Interview, *supra* note 155 (noting that several leading bankruptcy lawyers advised against a bankruptcy filing).

[161] Perhaps the best known recent illustration of bankruptcy judges' creative use of their equity powers is their handling of mass tort cases. *See, e.g.*, In the Matter of Johns-Manville Corp., 68 B.R. 618, 624–26 (Bankr. S.D.N.Y. 1986) (using equitable powers to fashion relief for victims of asbestos exposure and enjoining them from suing the reorganized company).

owed.[162] But derivatives have a special dispensation.[163] Based on the contention of the derivatives industry that preventing parties from immediately settling their derivatives could snarl the financial system, Congress has exempted derivatives from the automatic stay.[164] If Bear Stearns had filed for bankruptcy, it therefore would not have been able to prevent the counterparties in its derivatives transactions from terminating their contracts. This is indeed a problem: absent a stay, counterparties may head for the exits when a firm that has entered numerous derivatives contracts files for bankruptcy. Ironically, given that the exemption from the automatic stay is justified as reducing the risk of systemic crisis, the special treatment of derivatives is therefore at least as likely to invite chaos in the financial markets as forestall it. Yet the special rules would not necessarily have prevented an orderly sale of Bear Stearns through the bankruptcy process. The rules would only have affected derivative transactions in which Bear Stearns was a party to the contract.[165] They would not have affected derivatives — such as Bear's large portfolio of subprime-related CDOs — that the bank held as investments, since Bear Stearns was not itself a party to these contracts. Moreover, a commitment by the Fed to support Bear Stearns's trades until the bank was auctioned in bankruptcy would have removed one of the major reasons for counterparties to exit their contracts.

Even under the flawed current rules, which need to be revisited, bankruptcy would have offered a less centralized and coordinative response to the Bear Stearns crisis.[166] The bankruptcy alternative would not have committed the Fed to bailing out the next failing investment bank, as its handling of the sale to JPMorgan seemed to. Although

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[162] 11 U.S.C. § 362(a).

[163] For a more detailed discussion of the relevant provisions and their effect, see Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1048–50 (2007).

[164] The special treatment of derivatives in bankruptcy was significantly expanded in connection with the 2005 amendments to the Bankruptcy Code. The changes are described in detail in Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697 (2005).

[165] Even with these derivatives, some counterparties would have little incentive to exit. If Bear Stearns was the protection buyer in a credit default swap, for instance (that is, it was paying for protection in the event some other firm defaulted), there might not be any reason for the protection seller to terminate the contract.

[166] The larger issue underlying the analysis in the text is whether investment banks are so much like commercial banks that their distress should be resolved by (immediate, secret) government action as with commercial banks. The argument in the text is based on the view that bankruptcy would be a superior mechanism for resolving investment banks' financial distress, and that complete governmental control is not as necessary. Taxpayer money is not at stake with investment banks to the same extent as with depository institutions, most of whose deposits are guaranteed by the government. For an argument defending the current exclusion of commercial banks from bankruptcy, see David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723, 774–76 (1998).

Bear Stearns might initially have had difficulty tapping its usual sources of funding after a bankruptcy filing, the Fed loan would have provided the necessary funds for a transition.[167]

Six months after the Bear Stearns sale, an investment bank did indeed find itself in bankruptcy. After the Treasury Department and Federal Reserve declined to make an emergency loan or guarantee financing by another institution, Lehman Brothers filed for Chapter 11 in September 2008. With Lehman Brothers, bankruptcy was a last resort after the government confounded expectations that it would intervene. It therefore is not a true test of whether Chapter 11 is likely to be effective when it is treated as an option from the outset of financial distress. But the prompt sale of many of Lehman's assets is evidence that bankruptcy is indeed flexible enough to handle investment bank failures.

The decision to treat Bear Stearns as if it were a commercial bank appears to have marked a permanent shift in the governance of financial services firms. The Fed has taken a few related steps already, such as opening its discount window to investment banks for the first time, in recognition of the increasing centrality of investment banks to financial intermediation.[168] But the future of financial services is likely to depend on a package of reforms introduced in the wake of the Bear Stearns collapse.

Less than two weeks after the sale to JPMorgan was announced, the Treasury Department released a blueprint for restructuring financial services regulation.[169] The proposals would radically alter the regulatory framework, shifting to an "objectives"-based approach that would coordinate regulation under three general heads: market stability, prudential regulation, and business conduct.[170] Among its short-term recommendations, the blueprint calls for the establishment of a

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[167] Indeed, emergency loans have been arranged under somewhat similar circumstances in previous cases. In the bankruptcy of Hvide Marine, for instance, which provided transport services to oil rigs, the bankruptcy court approved an emergency loan that provided that the company would be sold if the loan was not refinanced within six months. E-mail from Martin Bienenstock, Partner, Dewey & LeBoeuf LLP, to David A. Skeel, Jr. (July 17, 2008) (on file with the Harvard Law School Library).

[168] *See, e.g.*, Sudeep Reddy, *Overhaul of Financial Regulation Gains Momentum*, WALL ST. J., July 11, 2008, at A3 (noting that the Fed program is set to expire after six months but may be extended). The Fed's role has been further expanded under the foreclosure prevention legislation passed in July 2008. In addition to providing up to $300 billion in federal guaranties for restructured mortgages, the legislation gave the Fed additional lending and oversight authority over Fannie Mae and Freddie Mac, the two government-sponsored mortgage companies. *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654. The $700 billion bailout passed in October 2008 has dramatically expanded the government's direct role in protecting the stability of investment banks.

[169] TREASURY BLUEPRINT, *supra* note 146.

[170] *Id.* at 13–14 (summarizing proposal and contrasting objectives-based regulation to the current, loosely functional approach).

new commission to license state mortgage market participants and for the development of standards for access to the Fed's discount window for non-depository institutions such as investment banks.[171] Intermediate-term reforms include direct federal control over state banks and insurance companies, and merger of the SEC and Commodity Futures Trading Commission (CFTC). Rationalizing financial regulation under the three general heads is a longer-term project.

As with the reforms that became the Sarbanes-Oxley Act, these proposals had been percolating within the Treasury Department even before the subprime crisis began.[172] When Bear Stearns collapsed, they were quickly finalized and rolled out. As the resulting report acknowledges, many of its proposals — including several of the most compelling — face serious political obstacles. State insurance and banking regulators will not gladly cede authority to federal regulators, and the CFTC will resist being absorbed into the SEC. If the entire blueprint were submitted to a vote in Congress, it would be opposed by so many substantial interest groups that it is hard to imagine who would vote yes.

Interestingly, the history of the very regulatory framework the Treasury's blueprint is designed to replace suggests that it is possible to implement reforms as radical as these. During Franklin D. Roosevelt's first two terms, his New Deal reformers completely restructured the banking industry and put the securities laws in place, and in addition reformed the bankruptcy laws, the utilities industry, and the regulation of bonds and investment advisors.[173] Rather than pursuing all of the reforms at once, Roosevelt separated them in order to prevent the interest groups opposed to each from coordinating their opposition.[174] A similar strategy is the most plausible approach to the current package of reforms, and is to some extent implied in the blueprint's distinction among short-, intermediate-, and longer-term objectives.

Ironically, the Fed and the Treasury's own handling of the Bear Stearns crisis significantly complicated the prospects for reform. In the United States, sweeping governance reform usually comes in the wake of corporate collapse. Corporate and financial reform are low-

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[171] These recommendations and the recommendations that follow are summarized in *id.* at 1–22.

[172] *See, e.g.*, *id.* at 1 (noting that the Treasury's study began after a conference held in March 2007); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1568–85 (2005) (describing the Sarbanes-Oxley Act as an example of Congress's tendency to devise legislation from existing proposals).

[173] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 127–32 (1982) (utilities regulation); *id.* at 191–97 (bankruptcy reform and Trust Indenture Act).

[174] *See generally* RALPH F. DEBEDTS, THE NEW DEAL'S SEC: THE FORMATIVE YEARS 81–82 (1964).

salience issues under ordinary circumstances, but widespread failure galvanizes public attention, especially when failure is accompanied by scandal.[175] Congress responds to the demand for reform by quickly passing legislation responding to the crisis, whether it be the securities laws, deposit insurance, or the Sarbanes-Oxley Act.

When the government prevented Bear Stearns from failing, it also short-circuited the political process. This is not the first time this has happened. In the mid-1980s, Continental Illinois, a large midwestern bank, teetered on the edge of failure. The government bailed out the bank and its unprotected large depositors, which may have delayed Congress's response to the S&L and banking crisis.[176] As with the earlier crisis, the Bear Stearns bailout pushed back the timeline of reform.

The key point here is about politics, not wisdom. As bailouts go, the Bear Stearns sale seems to have been handled well. By ensuring that the Bear Stearns shareholders took steep losses, the government reduced the risk that the bailout would lead to moral hazard at other investment banks. But the bailout also complicated the prospects for reform, by dampening the political pressure that would have been created by a failure.

The overall lessons of the Bear Stearns debacle are three. First, the Fed intervention has added a new industry — investment banks — to the financial institutions that are regulated in a significantly coordinated, centralized fashion. Second, rather than engineer bailouts, the Fed should rely on the bankruptcy system to handle investment bank failures, thereby not committing the government to potentially costly interventions. To facilitate this solution, Congress need only reverse the special protections it has given to derivatives. Third, the Bear Stearns bailout delayed and interfered with the Treasury's own efforts to promote a restructuring of the framework for regulating financial services.

The Bear Stearns autopsy also has important implications for Milhaupt and Pistor's governance matrix. In the United States, bank governance is much more centralized and coordinative than the governance of other corporations. The existence of industry-specific variation suggests that it may be misleading to distill a country's governance to a single point on a matrix. This does not mean that the matrix is useless: the regulation of most industries in the United States is consistent with the decentralized, protective label. But it does suggest that we may need separate matrices (or perhaps separate coordinates on the same matrix) for different industries in a single country.

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[175] This dynamic is a central theme of SKEEL, *supra* note 62.

[176] For sharp criticism of the Continental Illinois bailout, see Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1180–87 (1988).

## VI. CONCLUSION

The three new institutional autopsies presented here introduce concerns and developments that are either absent from, or underexplored in, *Law and Capitalism*. The autopsies of WorldCom and Parmalat, both of which occurred during the period covered by the book, highlight a new regulatory strategy — single firm governance transplants. Parmalat also illustrates the influence of outside regulators on domestic governance, and WorldCom shows that litigation, which is ordinarily viewed as decentralized and protective, is often used in the opposite fashion in the United States in a crisis. Bear Stearns demonstrates that different industries are sometimes regulated differently even within the same country, and underscores the relationship between regulatory and political responses: direct governmental intervention both delayed and diminished the likelihood of a substantial political (legislative) response.

If they are useful, these insights are simply an extension of *Law and Capitalism*, since they flow directly from its methods. The matrix developed by Milhaupt and Pistor and the institutional autopsies they use to apply it are revolutionary. Their framework introduces key factors, including interest groups on the demand side and government actors on the supply side, that are neglected in the standard corporate finance framework. Each of the authors' own institutional autopsies generates important and often counterintuitive insights about the governance system under examination.

In the hands of other scholars, the framework will continue to deepen our understanding of governance and governance change. It is a gift that will keep on giving.