# The Evolution of U.S. Corporate Governance:

# We Are All Henry Kravis Now

by

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**Abstract**

This paper describes and explains changes in corporate governance in the United States since 1980. The 1980s was a period of unprecedented takeover activity. This activity was distinguished by the prevalence of LBOs and raiders. The paper first considers why LBOs and raiders were prominent in the 1980s and, also, what drove takeover activity in the 1980s. The paper then describes U.S. corporate governance today, and argues why LBOs and raiders have not reappeared despite the recent resurgence of takeovers. A large part of the explanation is that today's shareholders, boards, and managers have applied the insights and strengths of 1980s LBOs. In that sense, we are all Henry Kravis now.

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The 1980s brought a phenomenal dollar volume of corporate takeover and restructuring activity. The annual value of acquisitions exceeded 6.0% of the (end-of-year) market value of U.S. equities in only nine years between 1968 and 1996. Seven of those years were in the 1980s. (see exhibit 1). The annual measures understate the true extent of takeovers and restructurings in the 1980s because many firms substantially restructured without being taken over. According to Mitchell and Mulherin [1996], 57% of large U.S. firms were either takeover targets or restructured on their own between 1982 and 1989.

In addition to the unusual volume of activity, takeovers and restructurings in the 1980s were distinguished by their use of leverage and their hostility. The takeovers and restructurings of the 1980s coincided with and helped to cause an increase in corporate leverage in the U.S. With the increase, leveraged buyouts (LBOs), KKR (Kohlberg Kravis & Roberts), and Michael Milken became household names. The extent of this activity was so great that from 1984 to 1990, net new issues of equity were negative. While acquisition activity has rebounded since 1992, the volume of highly leveraged transactions has not (see exhibit 2)[1].

The 1980s also saw the emergence of the hostile takeover and the corporate raider. Raiders like Carl Icahn and Boone Pickens became household names. Mitchell and Mulherin [1996] find that more than 30% of their sample firms received explicit hostile takeover bids (bids pursued without the acquiescence of target management),or were restructured in response to hostile pressure (particularly the purchases of blocks by corporate raiders). Despite the recent

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[1] Exhibit 2 presents Mergerstat's series of going private transaction volume. While such transactions technically include both leveraged buyouts and non-leveraged buyouts, as a practical matter, they consist almost entirely of LBOs.

upsurge in acquisition activity, raiders have not reappeared and hostile takeovers are less frequent.

This article first considers why LBOs and raiders were prominent in the 1980s and, also, what drove the takeover activity in the 1980s. The article then describes U.S. corporate governance today, and argues why LBOs and raiders have not reappeared despite the recent resurgence of takeovers. A large part of the explanation is that today's shareholders, boards, and managers have applied the insights and strengths of 1980s LBOs. In that sense, we are all Henry Kravis now.

## I. The Takeover And Restructuring Wave Of The 1980s.

### I.1 The Insights Of LBOS.

The LBOs of the early 1980s were based on four insights.[2] First, the high amount of debt incurred in the LBO transaction imposed a strong discipline on buyout company management. With that debt, it was no longer possible for managers to treat capital, particularly equity capital, as costless. On the contrary, failure to generate a sufficient return on capital meant default.

Second, LBOs provided managers with substantial equity stakes in the buyout company. These stakes gave managers the incentives to undertake the buyout, to work hard to pay off the debt, and to increase shareholder value. If successful, buyout company managers could expect to make a great deal of money. Kaplan [1989a] reports that the CEOs of the LBOs increased their ownership stake from 1.4% pre-LBO to 6.4% post-LBO. Management teams, overall, experienced similar increases.

[2] For example, see Jensen (1989) and Kaplan (1989a).

In 1980, this approach to executive compensation was fundamentally different from common practice. Management ownership of stock and option was modest. As discussed in Donaldson and Lorsch [1983], Donaldson [1994], and Jensen [1988 and 1993], management was loyal to the corporation, not to the shareholder. Managers wanted continuity and growth because that was good for employees.

Third, LBO sponsors or associations closely monitored and governed the companies they leveraged. Unlike public company boards that were large and dominated by distant outsiders with small ownership stakes, LBO company boards were small and dominated by LBO sponsors with substantial equity stakes in the companies (and the companies' successes).

Finally, the LBOs of the early 1980s also benefited to some extent from favorable tax treatment (see Kaplan [1989b]). These tax laws were made less favorable in 1986 by the Tax Reform Act of 1986.

What did these insights lead to? In the first half of the 1980s, the LBO insights led to great success. As documented in Kaplan [1989a] and Kaplan and Stein [1993], buyout companies experienced improved operating profits and few defaults. Adjusting for the overall stock market or industry, these early buyouts generated abnormally positive returns. Because the overall stock market increased over this period, buyout sponsors earned substantial nominal returns. These results led Jensen [1989] to predict that the value of the first three insights was so great that publicly-held corporations would soon disappear.

The LBO experience was substantially different in the latter half of the 1980s. Many LBOs defaulted, some spectacularly. As Kaplan and Stein [1993] document, roughly one-third of the LBOs completed after 1985 subsequently defaulted on their debt. This default experience led many to criticize LBOs and, in fact, the entire 1980s. But did this default experience mean that the LBO insights were wrong?

The evidence, even for the late 1980s, indicates that the LBO insights hold. Kaplan and Stein [1993] find that, overall, the larger LBOs of the later 1980s also generated improvements in operating profits despite the relatively large number of defaults.

Even for deals that defaulted, Andrade and Kaplan [1997] find that the LBO companies retained approximately the same value they had attained before the LBO. In other words, the net effect of the LBO and default on capital value was slightly positive. The case of Federated Department Stores (described in Kaplan [1994a]) illustrates this effect.

Campeau's 1988 acquisition of Federated is still widely considered the nadir of LBOs and the 1980s (see Loomis [1990] and Rothchild [1991]). Yet the facts say otherwise. On January 1, 1988, Federated's debt and equity traded at $4.25 billion. From that point until Federated emerged from bankruptcy in February 1992, Federated returned roughly $5.85 billion in value (adjusted for changes in the S&P 500). In other words, Federated was worth $1.6 billion more because of Campeau than it would have been if it had matched the S&P 500. Unfortunately for him, Campeau paid $7.67 billion (again, adjusted for the S&P 500).

Combining the marginally positive results for LBOs that defaulted with the largely positive results for LBOs that did not default leads to the conclusion that LBOs, even in the late 1980s, increased value substantially on average.

The logical question is, if LBOs increased value, why did so many default? The answer is straightforward. The success of the LBOs of the early 1980s attracted entrants and capital to the LBO market. Those entrants understood the basic LBO insights. Because so many understood the insights, the purchase prices for the LBOs began to reflect the insights. As a result, much of the benefit of the improved discipline, incentives, and governance accrued to the selling shareholders rather than to the post-buyout LBO investors. The key point is that the combination of gains to pre- and post-buyout investors was positive overall. The LBO insights and benefits were real.

### I.2 Why The Takeover And Restructuring Wave Of The 1980s?

More generally, the takeover wave of the 1980s appears to have been a capital market response to corporate governance deficiencies. This is the only explanation that satisfactorily explains the takeover wave.

Jensen [1986, 1988, 1989 and 1993] argues that changes in technology, regulation, competition, and capital markets led to a large amount of excess capacity in U.S. corporations. According to Jensen, the capital markets in the 1980s provided the necessary catalyst to eliminate that excess capacity because internal control systems -- i.e., incumbent management and boards of directors -- largely failed to bring about timely exit. Leveraged acquisitions, leveraged buyouts, hostile takeovers, and stock buybacks were particularly successful in eliminating excess capacity, because the debt service requirements that usually accompanied them prodded managers to find ways to generate cash and prevented them from wasting it. Jensen also places emphasis on the improved management incentives associated with LBOs and raiders who pursue hostile takeovers.

A second major explanation is articulated by Shleifer and Vishny [1990], who argue that, "the takeover wave of the 1980s was to a large extent a response to the disappointment with conglomerates" that had been assembled in the conglomerate acquisitions of the 1960s.

Corporate America "returned to specialization." Companies sold unrelated businesses and expanded into related businesses. "To a significant extent the 1980s reflect the deconglomeration of American business. Hostile takeovers and leveraged buyouts ... facilitated this process."

While there is a great deal of truth to both the excess capacity and specialization explanations, they each only partially explain the 1980s. Jensen's notion of excess capacity makes strong predictions about investment. He argues that firms involved in takeovers and buyouts were spending too much money on capital expenditures. If Jensen is right, after the corporate control transaction, these companies should spend less. The evidence for this is mixed. Kaplan [1989a] and Kaplan and Stein [1993] find strong evidence that management buyout firms make large cuts in capital expenditures. Servaes [1994], however, finds no evidence that targets of all takeovers, of hostile takeovers, and of going private transactions overinvest in capital expenditures before the takeover. Furthermore, Healy, Palepu, and Ruback [1992] find no evidence of significant changes in capital expenditures to sales for a sample of large takeovers in the early 1980s. Using qualitative data, Bhagat, Shleifer, and Vishny [1990] find no evidence of this either.

Shleifer and Vishny make the strong prediction that U.S. business became less diversified in the 1980s and that the deconglomeration was value increasing. Again the evidence in support of these arguments is less strong than is commonly believed.

While U.S. business did become less diversified during the 1980s, the decrease was not large. For example, Montgomery [1994] finds that the typical S&P 500 firm in 1991 had the same number of industry segments as the typical S&P 500 firm in 1981. Similarly, Liebeskind and Opler [1994] and Comment and Jarrell [1995] find only modest declines in diversification over the

1980s.  Finally, Mitchell and Mulherin [1996] find that takeover activity in the 1980s clustered in particular industries at particular points in time.  In contrast, takeover activity in the 1960s and 1970s exhibited no such clustering.  These results seem less about breaking up conglomerates than about restructuring industries.

The most convincing explanation for the 1980s, articulated by Donaldson [1994], argues that the rise of institutional shareholders and the greater availability of information to the capital markets placed more pressure on corporate managements to maximize shareholder value.  He calls the 1980s the decade of confrontation.   The governance and ownership structures of the 1960s and early 1970s were not sufficiently efficient for the financial markets of the 1980s.  As of 1980, management was loyal to the corporation, not to the shareholder.  This loyalty led to underutilised resources -- organizational slack, operational slack, and mismatched product lines. The 1980s brought mechanisms for shareholders to rebel that had not existed before.  The results in Morck, Shleifer, and Vishny [1989] and Berger and Ofek [1996] that takeovers are more likely for firms with relatively low valuations is consistent with this explanation.

In sum, the takeover and restructuring wave of the 1980s is best explained by an ascendancy of the capital markets over corporate managers.  In some cases, the capital markets reversed ill-advised diversification; in others, the capital markets helped to eliminate excess capacity; in others, the capital markets disciplined managers who had ignored shareholders to benefit other stakeholders.  LBOs and the insights behind them are particularly representative of the changes that the capital markets imposed.

## II. Corporate Governance In The 1990s.

At the end of the 1980s, the takeover wave ended.  As exhibits 1 and 2 show, both takeover and LBO volume declined substantially in 1990. At the time, anti-takeover legislation and jurisprudence, overt political pressure against leverage, the collapse of the high yield bond market, and a credit crunch were among the explanations proffered for the decline. (See Jensen [1991] and Comment and Schwert [1995] for a discussion of these explanations.) Since then, both the political pressure against leverage and the credit crunch have both abated, and the high yield bond market has recovered (see Exhibit 3). Yet LBO volume and raiders have not reappeared. Furthermore, the resurgence of takeover activity in general suggests that anti-takeover laws and amendments are not terribly effective.

The most compelling explanation for the rise and fall of LBOs and raiders is that shareholders and corporations increasingly obtain the benefits of LBOs and raiders on their own. In other words, we are all Henry Kravis now (or at least, like Henry Kravis was in the early 1980s).

### II.1 The Application Of LBO Insights.

Corporations have applied the three primary LBO insights without actually doing LBOs. Recall that the first LBO insight is to impose a cost of capital on management so that management does not view (equity) capital as costless. Corporations (and consulting firms) now implement this insight through innovative performance measurement and compensation programs. The best-known of these programs are marketed by consulting firms. For example, Stern Stewart markets Economic Value Added (EVA) and the Boston Consulting Group (and its Holt Value Associates subsidiary) markets Cash Flow Return on Investment (CFROI). EVA, CFROI, and their analogs compare the after-tax profit earned by a company or division to the after-tax profit required by the capital invested (the product of capital employed and the weighted average cost of capital).[3]

While it is reasonable to argue that these programs do not impose as much discipline as the debt in an LBO would, it is unreasonable to argue that these programs do not impose any discipline at all. (These programs also avoid financial distress costs that are sometimes associated with LBO debt.)

There is also anecdotal evidence that companies increasingly approach decisions with the goal of maximizing shareholder value. For example, consulting firms like McKinsey & Co. routinely measure the effects of their consulting assignments on shareholder value.[4]

Compensation committees and consultants increasingly apply the second LBO insight -- providing more high-powered incentives to top executives. In a widely cited article, Jensen and Murphy [1990] find that the compensation of top executives in the U.S. is relatively insensitive to the performance of their companies' stock. This appears to be changing. The use of stock options, restricted stock grants, and other forms of equity-based compensation have increased substantially in the last several years. In fact, there is some evidence that equity incentives are greater today than they have been since before the Depression and, possibly, ever.

A recent paper by Hall and Liebman [1997] finds a remarkable increase in equity-based compensation for U.S. CEOs. From 1980 to 1994, the average annual CEO option grant (valued

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

[4] For McKinsey's approach, see Copeland et al. [1994].

at issuance) increased more than seven-fold from $145 thousand to just under $1.2 million. As a result, equity-based compensation made up almost 50% of total CEO compensation in 1994, compared to less than 20% in 1980. Hall and Liebman estimate that the effect of this trend has been to increase CEO pay-to-performance sensitivities by a factor of three to seven times since 1980. (This increase in equity-based compensation combined with the strong performance of the stock market is partially responsible for the even larger realized increases in top executive compensation.)

Intriguingly, the Hall and Liebman results combined with those in Holderness et al. (1997) suggest that managerial equity ownership today may be at a historical high. Holderness et al. compare equity ownership by officers and directors in 1935 and 1995 and find that equity ownership is substantially greater today.

Again, the increased emphasis on equity-based compensation among corporations in general has as its direct antecedent the emphasis by LBO sponsors on such compensation. Indeed, it is arguably the case that the large payoffs earned by LBO sponsors and, more importantly, by the top executives of LBO companies made it more acceptable for top executives of public companies to become wealthy through equity-based compensation. Coca-Cola's $100 million-plus restricted stock grant to Roberto Goizueta and Scott Paper's compensation contract for Al Dunlap are two of the more prominent examples.

Finally, public companies appear to be increasingly applying the third LBO insight -- closer and more active monitoring by boards and shareholders. There is increasing pressure on boards to become more active and more shareholder-oriented.

For example, the National Association of Corporate Directors [1995] calls for a substantial increase in equity-based compensation for directors. Millstein [1993] has called for boards to become more active, and has helped implement that recommendation in a number of situations. In a survey of institutional investors, Felton et al. [1997] find that many institutional investors will pay a premium of approximately 10% for companies with good corporate governance.

Additional evidence that boards have become more shareholder-oriented comes from the recent statement on corporate governance by the Business Roundtable, a group of 200 CEOs of the largest U.S. companies.[5] Historically, the Business Roundtable has consistently opposed hostile takeovers and raiders as well as substantial changes in corporate governance practices. Among other recommendations, the Business Roundtable announced that "the paramount duty of management and the board is to the shareholder and not to ... other stakeholders." A prominent shareholder activist (Nell Minow) reacted to the statement by commenting that "I'm not on the fringe anymore."

Based on these developments, I would confidently predict that boards will continue to evolve to be more like LBO boards -- more equity ownership, more independence from the CEO, and smaller boards. (See Gertner and Kaplan [1996] for a description of LBO boards.)

Shareholders also have increased the pressure they place on corporate boards and corporate management. CALPERS, USA, and the Council of Institutional Investors have

[5] See The Business Roundtable, "Statement on Corporate Governance," September, 1997, and John Byrne," CEOs Catch Up With Shareholder Activist," *Business Week*, September 22, 1997, p. 36.

mounted active and public campaigns against a selected group of underperforming and undergoverned public companies. Other investors -- the most prominent of whom include LENS and Michael Price's Mutual Shares -- appear to target underperforming, undergoverned companies one at a time and attempt to change governance (and performance) at those companies. In other words, today's institutional shareholders are the raiders and LBO sponsors of the 1990s.

Although the academic literature indicates that these campaigns have met with mixed success,[6] it seems likely that the pressure -- overt, covert, and implied -- from shareholders has increased. This is important because it means that companies and their boards are likely to initiate LBO-type responses without overt or even covert pressure. In other words, the "handwriting is on the wall," and companies are responding to it.

## II.2 Why Is All This Happening Now?

While it is clear that public companies increasingly apply the insights emphasized by the LBOs of the early 1980s, it may be less clear whether this will continue. To answer that question, it is important to understand why all this is happening now. There are at least three interrelated reasons.

First, the shareholdings of professional, institutional investors continue to increase. For example, Poterba and Samwick [1996] show that individual ownership of corporations in the U.S. declined from 70% in 1970, to 60% in 1980, to 48% in 1994. Those figures include the

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[6] For example, see Gillan and Starks [1995], Opler and Sokobin [1996], and Smith [1995].

ownership of private companies. Individual ownership of public companies is even lower. This means that sophisticated shareholders -- who have strong incentives to generate greater stock returns -- own an increasingly large fraction of U.S. corporations.

Second, in 1992, the SEC substantially reduced the costs to shareholders of coordinating challenges against underperforming management teams by relaxing the proxy rules regarding shareholder communications. Under the old rules, any time a shareholder wanted to talk to ten other shareholders, the shareholder had to file a detailed proxy statement with the SEC before talking to others. Under the new rules, shareholders can essentially communicate at any time in any way as long as they send a copy of the substance of the communication to the SEC afterward. The rule change has lowered the cost of coordinating shareholders and challenging management teams because it has reduced the money and time that has to be spent obtaining SEC approval. It is telling that the Business Roundtable and other management organizations were extremely hostile to this rule change when it was proposed.

Combined with the increased concentration of institutional holdings, it is now substantially less expensive for several large shareholders to confront managers and boards of underperforming companies.

The third reason for the corporate governance changes we see today is the SEC's requirement, also in 1992, that public companies provide more detailed disclosure of top executive compensation and its relation to firm performance, particularly stock performance. This requirement had two effects. First, it focused boards of directors on stock performance. Companies now routinely report firm, industry, and market stock performance in their proxy statements. This represents a substantial shift from the pre-1980s when companies were more likely to focus on earnings per share, growth, and other measures that might or might not affect company stock performance.

Second, the requirement makes large equity-based compensation packages defensible, if not desirable. Boards of directors are unlikely to be criticized by shareholders or by the press if company executives are compensated based on stock performance. Executive compensation will be high only if the company has performed well.

### II.2 Is There Any Evidence That Corporate Performance Has Improved?

If corporate governance has improved since 1980, first through the takeover and restructuring wave, and then through pressure from institutional investors, corporate profitability should have improved as well. Of course, many other factors are involved, so this comparison can only be suggestive rather than definitive. Nevertheless, Poterba [1997] finds that U.S. corporate profitability has rebounded significantly since the early 1980s. Exhibit 4 shows Poterba's data, which measure the sum of corporate profits and interest relative to tangible assets. This series bottoms out in the early 1980s.

## IV. How Well Does The U.S. System Work?

The U.S. capital markets and U.S. corporate governance have been successful relative to those of other countries over the last fifteen years. In the 1980s, some observers criticized the U.S. capital markets and governance system, and looked to the German and Japanese systems as being superior, particularly in their ability to manage for the long-term. (For example, see Porter

[1992].)[7]

Kaplan [1994b and 1994c] question this criticism, finding that Japanese and German managers face many of the same incentives faced by those in the U.S.  Executive turnover in all three countries increases significantly with poor stock performance and earnings losses.  Cash compensation for top executives in Japan and the U.S. is also related to stock returns and earnings losses.  The effects in all three countries are generally economically and statistically similar.  The fortunes of German and Japanese top executives, therefore, like those in the U.S., are affected by stock performance and current cash flows.

While Kaplan [1994b] finds that the three systems are similar in many respects, there is one substantial difference -- U.S. managers hold much larger stock and option positions.  Since the period studied in that papers, the differences between the U.S. and other systems almost certainly have increased because the wealth of U.S. CEOs has become increasingly sensitive to the performance of their companies' stock.

[7] For a discussion of different governance systems, see, also, Shleifer and Vishny [1997] and La Porta et al. [1996 and 1997].

If the U.S. corporate governance and incentive system is superior, one would predict that other countries would start to copy the U.S. This appears to be happening. Japan, for example, recently introduced a new law allowing companies to repurchase more of their own shares -- from 3% to 10% -- and eliminated a substantial tax penalty on executive stock options. The effect of these two changes has been to make it substantially easier and less costly for Japanese corporations to issue executive stock options.[8] And in Europe, according to accounts in the popular press, the use of stock options for executives and boards is increasing.

Despite the recent U.S. successes and the ascendancy of shareholder power, some observers still argue that the U.S. system is flawed. Although it is impossible to test this definitively, the fact that takeovers have resurged, but plain vanilla LBOs (particularly of public companies) have not, suggests that U.S. companies are obtaining or being pushed to obtain many of the benefits of LBOs and hostile takeovers. As institutional investors and boards continue to become more sophisticated, I would expect them to become even more proficient at obtaining those benefits.

[8] See "Exercised: Share buybacks in Japan," *The Economist*, August 2, 1997, pp. 59-60.

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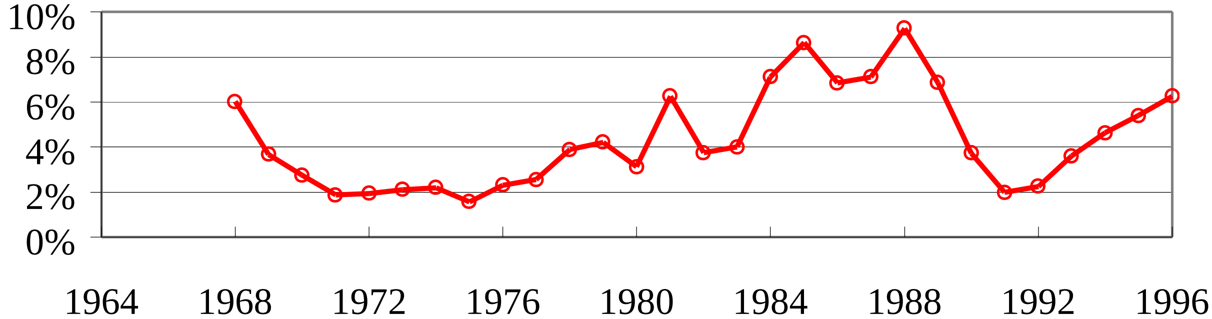
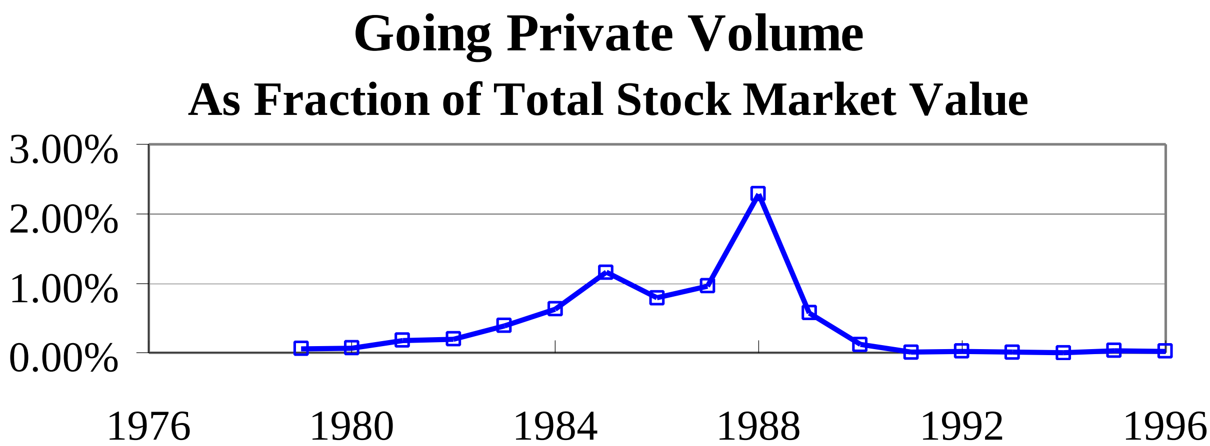
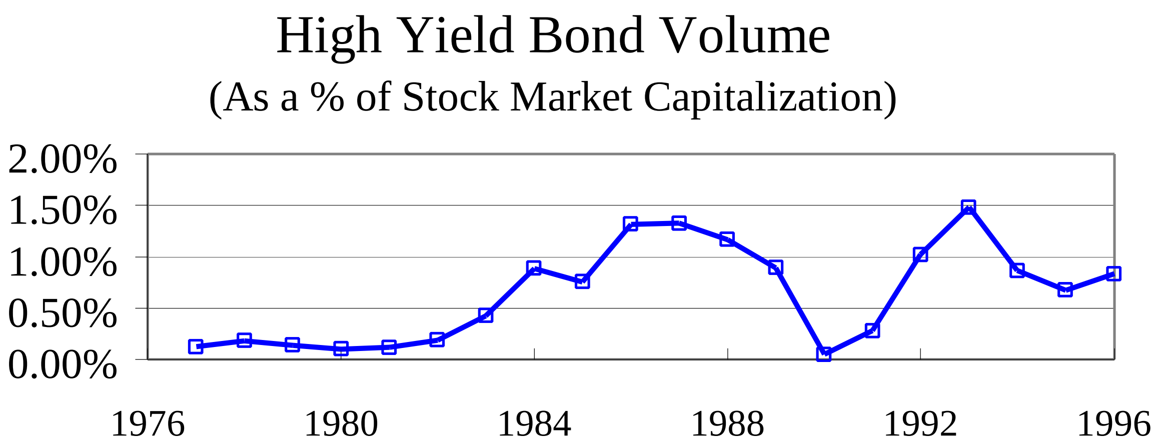
All Acquisition Volume
As % of Total End-of-Year Stock Market Value




Sources: Mergerstat, Author's Calculations.



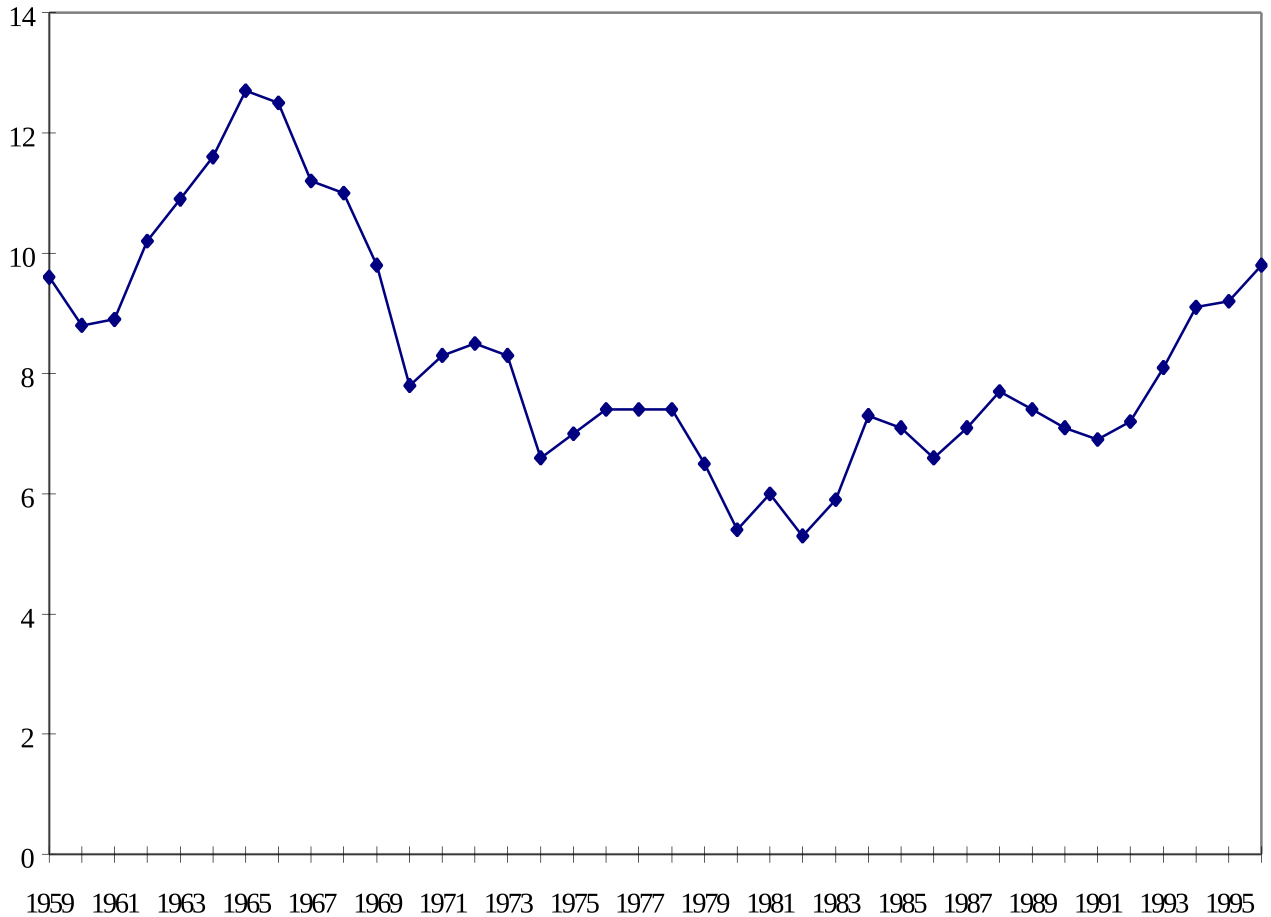

**Source: Mergerstat, Author's Calculations**




Source: Merrill Lynch, Author's Calculations

## Capital Income to Tangible Assets

**1959-1996**




Source: Poterba [1997]

2003. â€œThe state of US corporate governance: whatâ€™s right and whatâ€™s wrongâ€. Journal of Applied Corporate Finance. 15: 8â€“20.Â  Kaplan, S. N. 1997. â€œThe evolution of corporate governance: we are all Henry Kravis nowâ€. Working paper. Kaplan, S. N. and J. Stein. 1993. â€œThe evolution of buy-out pricing and nancial structure in the 1980sâ€. Quarterly Journal of Economics. 108: 313â€“359. In that sense, we are all Henry Kravis now. View. Show abstract.Â  This article describes the evolution of corporate governance in Japan since the Second World War, and surveys the empirical evidence on its performance. Although there is substantial evidence on the effectiveness of the Japanese system, there is also evidence on its significant shortcomings. The article also evaluates the effects of the current macroeconomic and banking crises on corporate governance in Japan, and suggests possible directions for future changes, which are likely to make Japan more similar to the USA in this respect. Copyright 2000 by Oxford University Press. View. The Evolution of U.S. Corporate Governance: We Are All Henry Kravis Now (pp. 7-14). Steven N. Kaplan. https://www.jstor.org/stable/43503175.