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John C. Coffee Jr.
Columbia Law School, jcoffee@law.columbia.edu

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John C. Coffee, Jr.

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By John C. Coffee, Jr.
Adolf A. Berle Professor of Law
Columbia University Law School

Abstract

A wave of financial irregularity broke out in the United States in 2001-2002, culminating in the Sarbanes-Oxley Act of 2002. A worldwide stock market bubble burst over this same period, with the actual market decline on a percentage basis being somewhat more severe in Europe. Yet, no corresponding wave of financial scandals involving a similar level of companies broke out in Europe. Indeed, those scandals that did arise in Europe often had American roots (e.g., Vivendi, Ahold, Adecco, etc.). Given the higher level of public and private enforcement in the United States for securities fraud, this contrast seems perplexing.

What explains this contrast? This paper submits that different kinds of scandals characterize different systems of corporate governance. In particular, dispersed ownership systems of governance are prone to the forms of earnings management that erupted in the United States, but concentrated ownership systems are much less vulnerable. Instead, the characteristic scandal in concentrated ownership economics is the appropriation of private benefits of control. Here, Parmalat is the representative scandal, just as Enron and WorldCom are the iconic examples of fraud in dispersed ownership regimes.

Is this difference meaningful? This article suggests that this difference in the likely source of, and motive for, financial misconduct has implications both for the utility of gatekeepers as reputational intermediaries and for design of legal controls to protect public shareholders. What works in one system will likely not work (at least as well) in the other. The difficulty in achieving auditor independence in a corporation with a controlling shareholder may also imply that minority shareholders in concentrated ownership economies should directly select their own gatekeepers.

A THEORY OF CORPORATE SCANDALS: Why the U.S. and Europe Differ

By John C. Coffee, Jr.*

Corporate scandals, particularly when they occur in concentrated outbursts, raise serious issues that scholars have too long ignored. Two issues stand out: First, why do different types of scandals occur in different economies? Second, why does a wave of scandals occur in one economy, but not in another, even though both economies are closely interconnected in the same global economy and subject to the same macro-economic conditions? This brief essay will seek to relate answers to both questions to the structure of share ownership.

Conventional wisdom explains a sudden concentration of corporate financial scandals as the consequence of a stock market bubble. When the bubble burst, scandals follow, and, eventually, new regulation.[1] Historically, this has been true at least since the South Seas Bubble, and this hypothesis works reasonably well to explain the turn-of-the-millennium experience in the U.S. and Europe. Worldwide, a stock market bubble did burst in 2000, and in percentage terms the decline was greater in many European countries than in the United States.[2] But in Europe, this sudden market decline was not associated with the same pervasive accounting and financial irregularity that shook the U.S. economy and produced the Sarbanes-Oxley Act in 2002. Indeed, financial statement restatements are rare in Europe.[3] In contrast, the U.S. witnessed an accelerating crescendo of financial statement restatements that began in the late 1990s. The United States General Accounting Office ("GAO") has found that over 10% of all listed companies in the United States announced at least one financial statement restatement between 1997

* Adolf A. Berle Professor of Law at Columbia University Law School and Director, Center on Corporate Governance, Columbia University Law School.

and 2002.[4] Later studies have placed the number even higher.[5] Because a financial statement restatement is a serious event in the United States that, depending on its magnitude, often results in a private class action, an SEC enforcement proceeding, a major stock price drop, and/or a management shake-up, one suspects that these announced restatements were but the tip of the proverbial iceberg, with many more companies negotiating changes in their accounting practices with their outside auditors that averted a formal restatement.

While Europe also had financial scandals over this same period (with the Parmalat scandal being the most notorious[6]), most were characteristically different than the U.S. style of earnings manipulation scandal (of which Enron and WorldCom were the iconic examples). Only European firms cross-listed in the United States seem to have encountered similar crises of earnings management.[7] What explains this difference and the difference in frequency? This short essay will advance a simple, almost self-evident thesis: differences in the structure of share ownership account for differences in corporate scandals, both in terms of the nature of the fraud, the identity of the perpetrators, and the seeming disparity in the number of scandals at any given time. In dispersed ownership systems, corporate managers tend to be the rogues of the story, while in concentrated ownership systems, it is controlling shareholders who play the corresponding role. Although this point may seem obvious, its corollary is less so: the modus operandi of fraud is also characteristically different. Corporate managers tend to engage in earnings manipulation, while controlling shareholders tend to exploit the private benefits of control. Finally, and most importantly, given these differences, the role of gatekeepers in these two systems must necessarily also be different.[8] While gatekeepers failed both at

Enron and Parmalat, they failed in characteristically different ways. In turn, different reforms may be justified, and the panoply of reforms adopted in the United States, culminating in the Sarbanes-Oxley Act of 2002, may not be the appropriate remedy in Europe.

Part I will review the recent American scandals to identify common denominators and the underlying motivation that caused the sudden eruption of financial statement restatements. Part II will turn to the evidence on private benefits of control in concentrated ownership systems. Patterns also emerge here in terms of the maturity of the capital market. Part III will advance some tentative conclusions about the differences in monitoring structures that are appropriate under different ownership regimes.

Part I. Fraud in Dispersed Ownership Systems

While studies differ, all show a rapid acceleration in financial statement restatements in the United States during the 1990s. The earliest of these studies finds that the number of earnings restatements by publicly held U.S. corporations averaged roughly forty-nine per year from 1990 to 1997, then increased to ninety-one in 1998, and then soared to 150 and 156 in 1999 and 2000, respectively.[9] A later study by the United States General Accounting Office shows an even more dramatic acceleration, as set forth in Figure I:[10]

[Insert Figure I]

Even this study understated the severity of this sudden spike in accounting irregularity. Because companies do not uniformly report a restatement in the same fashion, the GAO was not able to catch all restatements in its study. A more recent, fuller study in 2003 by Huron Consulting Group shows the following results: in 1990, there were 33 earnings restatements; in 1995, there were fifty;[11] then, the rate truly accelerated to 216 in 1999; to 233 in 2000; to 270 in 2001; and then in 2002, the number peaked at 330 (ten times the 1990 level).[12] On this basis, roughly one in eight listed companies restated over this period. An update this year by Huron Consulting shows that the number of restatements fell to 323 in 2003 and then rose again to 414 in 2004.[13]

Nor were these restatements merely technical adjustments. Although some actually increased earnings, the GAO study found that the typical restating firm lost an average 10% of its market capitalization over a three day trading period surrounding the date of the announcement.[14] All told, the GAO estimated the total market losses (unadjusted for other market movements) at $100 billion for restating firms in its incomplete sample for 1997-2002.[15]

Other studies have reached similar results. Studying a comprehensive sample of firms that restated annual earnings from 1971 to 2000, Richardson, Tuna and Wu reported a negative market reaction to the announcement of the restatement of 11% over a three-day window surrounding the announcement.[16] Moreover, using a wider window that measured firm value over a period beginning 120 days prior to the announcement to 120 days after the announcement, they found that restating "firms lose on average 25 percent of market value over the period examined and this is concentrated in a narrow window surrounding the announcement of the restatement."[17] 25% of market value represents an extraordinary market penalty. It shows the market not simply to have been surprised, but to have taken the restatement as a signal of fraud. For example, in the cases of Cendant, MicroStrategy, and Sunbeam, three major U.S. corporate scandals in the late

1990s, they found that "these three firms lost more than $23 billion in the week surrounding their respective restatement announcements."[18]

The intensity of the market's negative reaction to an earnings restatement appears to be greatest when the restatement involved revenue recognition issues.[19] One study examining just the period from 1997 to 1999 found that firms in which revenue recognition issues caused the restatement experienced a market adjusted loss of -13.38% over a window period beginning three days before the announcement and continuing until three days after the announcement.[20] Yet, despite the market's fear of such practices, revenue recognition errors became the dominant cause of restatements in the period from 1997 to 2002. The GAO Report found that revenue recognition issues accounted for almost 38 percent of the restatements it identified over that period,[21] and the Huron Consulting Group study also found it to be the leading accounting issue underlying an earnings restatement between 1999 and 2003.[22]

The prevalence of revenue recognition problems, even in the face of the market's sensitivity to them, shows a significant change in managerial behavior in the United States. During earlier periods, U.S. managements famously employed "rainy day reserves" to hold back the recognition of income that was in excess of the market's expectation in order to defer its recognition until some later quarter when there had been a shortfall in expected earnings. In effect, managers engage in income-smoothing, rolling the peaks in one period over into the valley of the next period. This traditional form of earnings management was intended to mask the volatility of earnings and reassure investors who might have been alarmed by rapid fluctuations in earnings. In contrast, managers in the late 1990s appear to have characteristically "stolen" earnings from future periods in order to create an earnings spike that potentially could not be sustained. Why? Although it had long been known that restating firms were typically firms with high market expectations for future growth, the pressure on these firms to show a high rate of earnings growth appears to have increased during the 1990s.

What, in turn, caused this increased pressure? To a considerable extent, it appears to have been self-induced – that is, the product of increasingly optimistic predictions by managements to financial analysts as to future earnings. But this answer just translates the prior question into a different format: Why did managements become more optimistic about earnings growth over this period? Here, one explanation does distinguish the U.S. from Europe, and it has increasingly been viewed as the best explanation for the sudden spike in financial irregularity in the U.S.[23] Put simply, executive compensation abruptly shifted in the United States during the 1990s, moving from a cash-based system to an equity based system. More importantly, this shift was not accompanied by any compensating change in corporate governance to control the predictably perverse incentives that reliance on stock options can create.

One measure of the suddenness of this shift is the change over the decade in the median compensation of a CEO of an S&P 500 Industrial company. As of 1990, the median such CEO made $1.25 million with 92% of that amount paid in cash and 8% in equity.[24] But during the 1990s, both the scale and composition of executive compensation changed. By 2001, the median CEO of an S&P industrial company was earning over $6 million, of which 66% was in equity.[25] Figure II shows the swiftness of this transition:[26]

[Insert Figure II]

To illustrate the impact of this change, assume a CEO holds options on two million shares of his company's stock and that the company is trading at a price to earnings ratio of 30 to 1 (both reasonable assumptions for this era). On this basis, if the CEO can cause the "premature" recognition of revenues that result in an increase in annual earnings by simply $1 per share, the CEO has caused a $30 price increase that should make him $60 million richer. Not a small incentive!

Obviously, when one pays the CEO with stock options, one creates incentives for short-term financial manipulation and accounting gamesmanship. Financial economists have found a strong statistical correlation between higher levels of equity compensation and both earnings management and financial restatements. One recent study by Efendi, Srivastava and Swanson utilized a control group methodology and constructed two groups of companies, each composed of 100 listed public companies.[27] The first group's members had restated their financial statements in 2001 or 2002, while the control group was composed of otherwise similar firms that had not restated. What characteristic most distinguished the two groups? The leading factor that proved most to influence the likelihood of a restatement was the presence of a substantial amount of "in the money" stock options in the hands of the firm's CEO. The CEOs of the firms in the restating group held on average "in the money" options of $30.9 million, while CEOs in the non-restating control group averaged only $2.3 million – a nearly 14 to 1 difference.[28] Further, if a CEO held options equaling or exceeding 20 times his or her annual salary (and this was the 80th percentile in their study – meaning that a substantial number of CEOs did exceed this level), the likelihood of a restatement increased by 55%.

Other studies have reached similar results. Denis, Hanouna, and Sarin find a significant positive relationship between a firm's use of option-based compensation and securities fraud allegations being leveled against the firm.[29] Further, they find in their study of 358 companies charged with fraud between 1993 and 2002 that the likelihood of a fraud charge is positively related to "option intensity" – i.e. the greater the amount of the options, the higher the likelihood.[30] Similarly, Cheng and Warfield have documented that corporate managers with high equity incentives sell more shares in subsequent periods, are more likely to report earnings that just meet or exceed analysts' forecasts, and more frequently engage in other forms of earnings management.[31] As stock options increase the managers' equity ownership, they also increase their need to diversify the high risk associated with such ownership, and this produces both more efforts to inflate earnings to prevent a stock price decline and increased sales by managers in advance of any earnings decline. In short, there is a "dark side" to option-based compensation for senior executives: absent special controls, more options means more fraud.

At this point, the contrast between managerial incentives in the U.S. and Europe comes into clearer focus. These differences involve both the scale of compensation and its composition. In 2004, CEO compensation as a multiple of average employee compensation was estimated to be 531:1 in the U.S., but only 16:1 in France, 11:1 in Germany, 10:1 in Japan, and 21:1 in nearby Canada. Even Great Britain, with the most closely similar system of corporate governance to the U.S., had only a 25:1 ratio.[32] But even more important is the shift towards compensating the chief executive primarily with stock options. While stock options have come to be widely used in recent years in Europe, equity compensation constitutes a much lower percentage of total CEO compensation (even in the U.K., it was only 24% in 2002).[33] European CEOs not only make much less, but their total compensation is also much less performance related.[34]

What explains these differences? Compensation experts in the U.S. usually emphasize the tax laws in the United States, which were amended in the early 1990s to restrict the corporate deductibility of high cash compensation and thus induced corporations to use equity in preference to cash.[35] But this is only part of the fuller story. Much of the explanation is that institutional investors in the U.S. pressured companies for a shift towards equity compensation. Why? Institutional investors, who hold the majority of the stock in publicly held companies in the U.S., understand that, in a system of dispersed ownership, executive compensation is probably their most important tool by which to align managerial incentives with shareholder incentives. Throughout the 1960s and 1970s, they had seen senior managements of large corporations manage their firms in a risk-averse and growth-maximizing fashion, retaining "free cash flow" to the maximum extent possible. Such a style of management produced the bloated, and inefficient conglomerates of that era (for example, Gulf & Western and IT&T). Put simply, a system of exclusively cash compensation creates incentives to avoid risk and bankruptcy and to maximize the size of the firm, regardless of profitability, because a larger firm size generally implies higher cash compensation for its senior managers.

Once the U.S. tax laws and institutional pressure together produced a shift to equity compensation in the 1990s, managers' incentives changed, and managers sought to maximize share value (as the institutions had wanted). But what the institutions failed to anticipate was that there can be too much of a good thing. Aggressive use of these incentives in turn encouraged the use of manipulative techniques to maximize stock price over the short-run. Although such spikes may not be sustainable, corporate managers possess asymmetric information, and anticipating their inability to maintain earnings growth, they can exercise their options and bail out.

One measure of this transition is the changing nature of financial irregularities. The Sarbanes-Oxley Act required the SEC to study all its enforcement proceedings over the prior five years (i.e., 1997-2002) to ascertain what kinds of financial and accounting irregularities were the most common. Out of the 227 "enforcement matters" pursued by the SEC over this period, the SEC has reported that 126 (or 55%) alleged "improper revenue recognition."[36] Similarly, the earlier noted GAO Study found that 38% of all restatements in its survey were for revenue recognition timing errors. Either managers were recognizing the next period's revenues prematurely – or managers were simply inventing revenues that did not exist. Both forms of errors suggest that managers were striving to manufacture an artificial (and possibly unsustainable) spike in corporate income.

That managers were able to optimistically predict and prematurely recognize revenues in ways that ultimately compelled earnings restatements shows a market failure – particularly when the market penalty for premature revenue recognition was, as earlier noted, so Draconian as to result in a 25% decline in market price on average.[37] Why did securities analysts accept such optimistic predictions and not discount them? Here, the evidence is that very few analysts downgraded public companies in the months prior to earnings restatements – even though short sellers and insiders had recognized the likelihood of an earnings restatement.[38] Yet, while analysts and auditors may have been slow to recognize premature revenue recognition, considerable evidence suggests that short sellers were able to recognize the signals and profit handsomely by anticipating earnings restatements.[39] The implications of this point are that smart traders could and did do what professional gatekeepers were insufficiently motivated to do: recognize the approach of major market collapses. In short, this is a story of "gatekeeper failure" in that the professional agents of corporate governance did not adequately serve investors. In consequence, the Sarbanes-Oxley Act of 2002 understandably focused on gatekeepers and contained provisions regulating auditors, securities analysts and credit-rating agencies.

Part II. Fraud in Concentrated Ownership Regimes.

The pattern in concentrated ownership systems is very different, but not necessarily better. In the case of most European corporations, there is a controlling shareholder or shareholder group. Why is this important? A controlling shareholder does not need to rely on indirect mechanisms of control, such as equity compensation or stock options, in order to incentivize management. Rather, it can rely on a "command and control" system because, unlike the dispersed shareholders in the U.S., it can directly monitor and replace management. Hence, corporate managers have both less discretion to engage in opportunistic earnings management and less motivation to create an earnings spike (because it will not benefit a management not compensated with stock options).

Equally important, the controlling shareholder also has much less interest in the day-to-day stock price of its company. Why? Because the controlling shareholder seldom, if ever, sells its control block into the public market. Rather, if it sells at all, it will make a privately negotiated sale at a substantial premium over the market price to an incoming, new controlling shareholder. Such control premiums are characteristically much higher in

Europe than in the United States. As a result, controlling shareholders in Europe do not obsess over the day-to-day market price and rationally do not engage in tactics to prematurely recognize revenues to spike their stock price. These two explanations – lesser use of equity compensation and lesser interest in the short-term stock price – explain at least in part why there were less accounting irregularities in Europe than in the U.S. during the late 1990s.

This generalization may seem subject to counter-examples. For example, some well-known European companies – e.g., Vivendi Universal, Royal Ahold, Skandia Insurance or Adecco[40] – did experience accounting irregularities. But these are exceptions that prove the rule. All were U.S. listed companies whose accounting problems emanated from U.S. based subsidiaries or that had transformed themselves into American-style conglomerates (the leading example being Vivendi) that either awarded stock options or needed to maximize their short-term stock price in order to make multiple acquisitions.

Does this analysis imply that European managers are more ethical or that European shareholders are better off than their American counterparts? By no means! Concentrated ownership encourages a different type of financial overreaching: the extraction of private benefits of control. Dyck and Zingales have shown that the private benefits of control vary significantly across jurisdictions, ranging from -4% to +65%, depending in significant part on the legal protections given minority shareholders.[41] While there is evidence that the market cares about the level of private benefits that controlling shareholders will extract,[42] the market has a relatively weak capacity to discern on a real time basis what benefits are in fact being expropriated.

In emerging markets, the expropriation of private benefits typically occurs through financial transactions. Ownership may be diluted through public offerings, and then a coercive tender offer or squeeze-out merger is used to force minority shareholders to tender at a price below fair market value. These techniques have been discussed in detail elsewhere and in their crudest forms have been given the epithet "tunneling" to describe them.[43] A classic example was the Bulgarian experience between 1999 and 2002, when roughly two-thirds of the 1,040 firms on the Bulgarian stock exchange were delisted, following freeze-out tender offers for the minority shares at below market, but still coercive, prices.[44]

In more developed economies, such financial transactions may be precluded. Instead, "operational" mechanisms can be used: for example, controlling shareholders can compel the company to sell its output to, or buy its raw materials from, a corporation that they independently own. In emerging markets, growing evidence suggests that firms within corporate groups engage in more related party transactions that firms that are not members of a controlled group.[45] In essence, these transactions permit controlling shareholders to transfer resources from companies in which they have lesser cash flow rights to ones in which they have greater cash flow rights.[46]

Although it may be tempting to deem "tunneling" and related opportunistic practices as characteristic only of emerging markets where legal protections are still evolving, considerable evidence suggests that such practices are also prevalent in more "mature" European economies.[47] Indeed, some students of European corporate governance claim that the dominant form of concentrated ownership (i.e., absolute majority ownership) is simply inefficient because it permits too much predatory misbehavior.[48]

This provocative question need not here be resolved, but the nature of the scandals that characterize concentrated ownership systems does merit our attention because they show a distinct and different type of gatekeeper failure. Two recent scandals typify this pattern: Parmalat and Hollinger. Parmalat is the paradigmatic fraud for Europe (just as Enron and WorldCom are the representative frauds in the United States). Parmalat's fraud essentially involved the balance sheet, not the income statement. It failed when a 3.9 billion euros account with Bank of America proved to be fictitious.[49] At least, $17.4 billion in assets seemed to vanish from its balance sheet. Efforts by its trustee to track down these missing funds appear to have found that at least 2.3 billion euros were paid to affiliated persons and shareholders.[50] In short, private benefits appear to have siphoned off to controlling shareholders through related party transactions. Unlike the short-term stock manipulations that occur in the U.S., this was a scandal that had continued for many years, probably for over a decade.

At the heart of the Parmalat fraud, there was also a failure by its gatekeepers. Parmalat's auditors for many years had been an American-based firm, Grant Thornton, whose personnel had audited Parmalat and its subsidiaries since the 1980s.[51] Although Italian law uniquely mandated the rotation of audit firms, Grant, Thornton found an easy evasion. It gave up the role of being auditor to the parent company in the Parmalat family, but continued to audit its subsidiaries.[52] Among these subsidiaries was the Caymans Islands based subsidiary, Boulat Financing Corporation, whose books showed the fictitious Bank of America account whose discovery triggered Parmalat's insolvency.[53]

The recent Hollinger scandal also involved overreaching by controlling shareholders. Although Hollinger International is a Delaware corporation, its controlling shareholders were Canadian, as were most of its shareholders. According to the report prepared by counsel to its independent directors, former SEC Chairman Richard Breeden, Hollinger was a "kleptocracy".[54] Its controlling shareholders allegedly siphoned off more than $400 million from Hollinger – or more than 95% of the company's adjusted net income from 1997 to 2003.[55] On sales of assets by Hollinger, its controlling shareholders secretly took large side payments, which they directed be paid to themselves out of the sales proceeds.[56] But bad as the Hollinger case may be, little evidence suggest that Lord Black and his cronies manipulated earnings through premature revenue recognition. What this contrast shows is that controlling shareholders may misappropriate assets, but have much less reason to fabricate earnings. This does not mean that business ethics are better (or worse) within a concentrated ownership regime, but only that the modus operandi for fraud is different. The real conclusion is that different systems of ownership encourage characteristically different styles of fraud.

Part III. <u>Gatekeeper Failure Across Ownership Regimes</u>

Both ownership regimes – dispersed and concentrated – show evidence of gatekeeper failure. The U.S./U.K. system of dispersed ownership is vulnerable to gatekeepers not detecting inflated earnings, and concentrated ownership systems fail to the extent that gatekeepers miss (or at least fail to report) the expropriation of private benefits. A key difference, of course, is that in dispersed ownership systems the villains are managers and the victims are shareholders, while, in concentrated ownership systems, the controlling shareholders overreach minority shareholders.

In turn, this raises the critical issue: can gatekeepers in concentrated ownership systems monitor the controlling shareholder who hires (and potentially can fire) them? Although there clearly have been numerous failures by gatekeepers in dispersed ownership systems, the answer for these systems probably lies in principle in redesigning the governance circuitry within the public corporation so that the gatekeeper does not report to those that it is expected to monitor. Thus, the auditor or attorney can be required to report to an independent audit committee rather than corporate managers. But this same answer does not work as well in a concentrated ownership system. In such a system, even an independent audit committee may serve at the pleasure of a controlling shareholder.

Indeed, some forms of gatekeepers common in dispersed ownership systems seem inherently less likely to be effective in a system of concentrated ownership. For example, the securities analyst is inherently a gatekeeper for dispersed ownership regimes. In concentrated ownership regimes, the volume of stock trading in its thinner capital markets is likely to be insufficient to generate brokerage commissions sufficient to support a profession of analysts covering all publicly held companies. But even if analyst coverage in concentrated ownership regimes were equivalent to that in dispersed ownership systems, the analyst's predictions of the firm's future earnings or value would still mean less to public shareholders if the controlling shareholder remained in a position to squeeze-out the minority shareholders.

Even the role of the auditor differs in a concentrated ownership system. The existence of a controlling shareholder necessarily affects auditor independence. In a dispersed ownership system, corporate managers might sometimes "capture" the audit partner of their auditor (as seemingly happened at Enron). But the policy answer was obvious (and Sarbanes-Oxley quickly adopted it): rewire the internal circuitry so that the auditor reported to an independent audit committee. However, in a concentrated ownership system, this answer works less well because the auditor is still reporting to a board that is, itself, potentially subservient to the controlling shareholder. Thus, the auditor in this system is a monitor who cannot effectively escape the control of the party that it is expected to monitor. Although diligent auditors could have presumably detected the fraud at Parmalat (at least to the extent of detecting the fictitious bank account at the Cayman Islands subsidiary), one suspects that they would have likely been dismissed at the point at which they began to monitor earnestly. More generally, auditors can do little to stop squeeze-out mergers, coercive tender offers, or even unfair related party transactions. These require statutory protections if the minority's rights are to be protected. In fairness, shareholders in a concentrated ownership system may receive some protection from other gatekeepers, including the large banks that typically monitor the corporation.

There is an important historical dimension to this point. The independent auditor arose in Britain in the middle 19th Century, just as industrialization and the growth of railroads was compelling corporations to market their shares to a broader audience of investors.[57] Amendments in 1844 and 1845 to the British Companies Act required an annual statutory audit with the auditor being selected by the shareholders.[58] This made sense, because the auditor was thus placed in a true principal/agent relationship with the shareholders who relied on it. But this same relationship does not exist when the auditor reports to shareholders in a system in which there is a controlling shareholder. Finally, even if the auditor is asked to report on the fairness of inter-corporate dealings or related party transactions, this is not its core competence. Other protections – such as supermajority votes, mandatory bid requirements, or prophylactic rules – may be far more valuable in protecting minority shareholders when there is a controlling shareholder. This may explain the slower development of auditing procedures and internal controls in Europe.

Potentially, there is a further implication for the use of gatekeepers in concentrated ownership economies. If the controlling shareholder can potentially dominate the selection of the auditor or other gatekeepers, then it becomes at least arguable that if the auditor is to serve as an effective reputational intermediary, it should be selected by the minority shareholders and report to them. This article will not attempt to design such an unprecedented system, but will smugly content itself with pointing out the likely inadequacy of alternative systems. The second-best alternative would appear to be according the auditor's selection, retention and compensation to the independent directors.

Conclusion

This article's generalizations are not presented as iron laws. "Private benefits of control" can be misappropriated in a U.S. public company, and recent illustrations include the Tyco and Adelphia scandals. Similarly, companies with dispersed ownership are now common (but still the minority) in Europe. Public policy needs, however, to start from the recognition that dispersed ownership creates managerial incentives to manipulate income, while concentrated ownership invites the low-visibility extraction of private benefits. As a result, governance protections that work in one system may fail in the other. Even more importantly, different gatekeepers need to be designed into different governance systems to monitor for different abuses.

Endnotes

[1] For a pre-Sarbanes-Oxley review of the last three hundred years of this pattern, see Stuart Banner, What Causes New Securities Regulation? 300 Years of Evidence, 75 Wash. U. L. Q. 849 (1997).

[2] See Bengt Holmstrom and Steven Kaplan, The State of U.S. Corporate Governance: What's Right and What's Wrong, 15 Accenture J. of App. Corp. Fin. 8, 9 (2003) (showing that from 2001 through December 31, 2002, the U.S. stock market returns were negative 32%, while France was negative 45% and Germany negative 53%).

[3] Although they have been rare in the past, FitchRatings, the credit ratings agency, predicts that they will become common in Europe in 2005, as thousands of European companies switch from local accounting standards to International Financial Reporting Standards, which are more demanding. See FitchRatings, "Accounting and Financial Reporting Risk: 2005 Global Outlook," March 14, 2005.

[4] See U.S. Gen. Accounting Office, Pub. No. 03-138, FINANCIAL STATEMENT RESTATEMENTS: Trends, Market Impacts, Regulatory Responses and Remaining Challenges (2002) at 4.

[5] See Huron Consulting Group, An Analysis of Restatement Matters: Rules, Errors, Ethics, for the Five Years Ended December 31, 2002 (Jan. 2003) (discussed in text at notes 11 to 13).

[6] For a detailed review of the Parmalat scandal, see Andrea Melis, Corporate Governance Failures. To What Extent is Parmalat a Particularly Italian Case? (September 30, 2004) (http://ssrn.com/abstract=563223).

[7] See text and notes infra at note 34.

[8] The term "gatekeeper" will not be elaborately defined for purposes of this short essay, but means a reputational intermediary who pledges its considerable reputational capital to give credibility to its statements or forecasts. Auditors, securities analysts, and credit ratings agencies are the most obvious examples. See John Coffee, Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, 84 B.U.L. Rev. 301, 308-311 (2004).

[9] See George B. Moriarty & Philip B. Livingston, Quantitative Measures of the Quality of Financial Reporting, Fin. Executive (July/August 2001) at 53, 54.

[10] See U.S. Gen. Accounting Office, supra note 4.

[11] See Huron Consulting Group, supra note 5.

[12] See Huron Consulting Group, 2003 Annual Review of Financial Reporting Matters, at 4. The number of restatements fell (slightly) to 323 in 2003. Id. Not all these restatements involved overstatements of earnings (and some involved understatements). Still, the rising rate of restatements seems a good proxy for financial irregularity.

[13] See Press Release Huron Consulting Group, "New Report by Huron Consulting Group Reveals Financial Restatements Increased at a Record Level in 2004" (January 19, 2005). If one wishes to focus only on restatements of the annual audited financial statements, excluding restatements of quarterly earnings, the numbers were: 2000: 98; 2001: 140; 2002: 183; 2003: 2006; 2004: 253.

[14] See GAO Report, supra note 4, at 5.

[15] Id. at 34.

[16] See Scott Richardson, Irem Tuna, and Min Wu, Predicting Earnings Management: The case of earnings restatements, (October 2002) (http://ssrn.com/abstract=338681) at p. 4.

[17] Id. at 16.

[18] Id.

[19] See Kirsten L. Anderson and Teri Lumbardi Yohn, The Effect of 10K Restatements on Firm Value, Information Asymmetries, and Investors' Reliance on Earnings (September, 2002) (http://ssrn.com/abstract = 332380).

[20] Id. at p. 13. This loss was measured in terms of cumulative abnormal returns ("CAR"). Where the cause of the restatement was reported as "fraud," the CAR rose to negative 19%, but there were only a handful of such cases.

[21] See GAO Report, supra note 4, at 28.

[22] See Huron Consulting Group, supra note 5, at 4.

[23] For a fuller account of these various explanations, see John Coffee, What Caused Enron?: A Capsule Social and Economic History of the 1990s, 89 Cornell L. Rev. 269 (2004).

[24] See Brian J. Hall, Six Challenges in Designing Equity-Based Pay, 15 Accenture J. of App. Corp. Fin. 21, at 23 (2003).

[25] Id.

[26] Id.

[27] Jap Efendi, Anup Srivastava, and Ed Swanson, Why Do Corporate Managers Misstate Financial Statements: The Role of Option Compensation, Corporate Governance and

Other Factors, (August 2004) (http://ssrn.com/abstract=547920). For an earlier similar study, see Shane A. Johnson, Harley E. Ryan Jr., and Yisong S. Tian, Executive Compensation and Corporate Fraud, (April 2003) (http://ssrn.com/abstract=395960).

[28] Efendi, Srivastava, and Swanson, supra note 27, at 2.

[29] See David J. Denis, Paul Hanouna and Atulya Sarin, Is There a Dark Side to Incentive Compensation?, (March 2005) (http://ssrn.com/abstract=__). For an earlier study finding that the greater use of option-related compensation results in greater private securities litigation, see Lin Peng and Ailsa Roell, Executive Pay, Earnings Manipulation and Shareholder Litigation, (December 2004), AFA Philadelphia Meetings (http://ssrn.com/abstract=488148).

[30] Denis, Hanouna and Sarin, supra note 29, at 4.

[31] See Qiang Cheng and Terry Warfield, Equity Incentives and Earnings Management, (November, 2004) (http://ssrn.com/abstract=457840).

[32] See Gretchen Morgenson, "Explaining (Or Not) Why the Boss Is Paid So Much," N.Y. Times, Jan. 25, 2004, §3, at 1.

[33] See Guido Ferrarini, Niamh Moloney and Cristina Vespro, Executive Remuneration in the EU: Comparative Law and Practice (ECGI Working Paper 2003) at 7 n. 21.

[34] Id. at 6-7 (noting that performance related pay is in wide use only in the U.K. and that controlling shareholders tend to resist significant use of incentive compensation).

[35] In 1993, Congress enacted Section 162(m) of the Internal Revenue Code, which denies a tax deduction for annual compensation in excess of $1 million per year paid to the CEO, or the next four most highly paid officers, unless special tests are satisfied. Its passage

forced a shift in the direction of equity compensation. For a fuller account of this change, see Coffee supra note 23, at 274-275.

[36] See Securities and Exchange Commission, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (2003) at 2.

[37] See text supra at note 17.

[38] See Paul A. Griffin, A League of Their Own? Financial Analysts' Responses to Restatements and Corrective Disclosures (August 15, 2002) (http://ssrn.com/abstract= 326581) (reporting study of 847 companies sued in federal securities class actions between 1994 and 2001).

[39] Hemang Desai, Srinivasan Krishnamurthy, and Kumar Venkataraman, Do Short Sellers Target Firms with Poor Earnings Quality?: Evidence from Earnings Restatements, (Dec. 2004) (http://ssrn.com/abstract=633283). For a similar study, see Jap Efendi, Michael R. Kinney and Edward P. Swanson, Can Short Sellers Predict Accounting Restatements?, AAA 2005 FARS Meeting Paper (March 2005) (http://ssrn.com/abstract= 591361).

[40] Both the financial scandals at Adecco and Royal Ahold originated in the United States and, at least initially, centered around accounting at U.S. subsidiaries. See Haig Simonian, "Europe's First Victim of Sarbanes-Oxley? CORPORATE GOVERNANCE: Adecco was pilloried for its poor handling of U.S. accounting problems," Financial Times, January 29, 2004, at p. 14; Kevin McCoy, "Prosecutors Charge Nine More in Royal Ahold Case," USA Today, January 14, 2005 p. 1B (noting that Royal Ahold's accounting problems began at U.S. Foodservices, Inc., a subsidiary of Royal Ahold, where the U.S. managers were compensated with stock options); Vivendi Universal can be described as a

U.S.-style acquisitions oriented financial conglomerate. See Jo Johnson, "Vivendi Probe Ends With Euro $1 Million Fine for Messier," Financial Times, December 8, 2004 at p. 31.

[41] See Alexander Dyck and Luigi Zingales, Private Benefits of Control: An International Comparison, 59 J. Fin. 537 (2004); see also Tatiana Nenova, The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis, (July, 2000) (http://ssrn.com/abstract=237809).

[42] See Olaf Ehrhardt and Eric Nowak, Private Benefits and Minority Shareholder Expropriation (or What Exactly Are Private Benefits of Control), (June 2003), EFA Annual Conference Paper No. 809, (http://ssrn.com/abstract=423506).

[43] For the article coining this term, see Simon Johnson, Rafael La Porta, Francisco Lopez-de-Silanes, and Andrei Schleifer, Tunneling, 90 Amer. Econ. Rev. 22 (2000).

[44] See Vladimir Atanasov, Conrad S. Ciccotello, and Stanley B. Gyoshev, How Does Law Affect Finance? An Empirical Examination of Tunneling in an Emerging Market, William Davidson Institute Working Paper Number 742 (January 2005) (http://ssrn.com/abstract=423506). These authors estimate that these transactions occurred at about 25% of the shares' intrinsic value.

[45] See Jian Jane Ming and T. J. Wong, Earnings Management and Tunneling through Related Party Transactions: Evidence from Chinese Corporate Groups, EAA 2003 Annual Conference Paper No. 549 (June 2003) (http://ssrn.com/abstract=42488).

[46] See Marianne Bertrand, Paras Mehta and Sendhil Mullainathan, Ferreting Out Tunneling: An Application to Indian Business Groups, MIT Dept. of Econ. Working Paper No. 00-28 (Sept. 2000) (http://ssrn.com/abstract=246001).

[47] See Tom Kirchmaier and Jeremy Grant, Financial Tunneling and the Revenge of the Insider System: How to Circumvent the New European Corporate Governance Legislation, (October 2004) (http://ssrn.com/abstract=613945).

[48] See Tom Kirchmaier and Jeremy Grant, Corporate Ownership Structure and Performance in Europe, CEP Discussion Paper No. 0631 (April 2004) (http://ssrn.com/abstract=616201).

[49] This summary of the Parmalat scandal relies upon the Wall Street Journal's account. See Alessandra Galloni and David Reilly, "How Parmalat Spent and Spent," Wall Street Journal, July 23, 2004.

[50] Id. Parmalat's former CEO, Mr. Tanzi, appears to have acknowledged to Italian prosecutors "that Parmalat funneled about Euro 500 Million to companies controlled by the Tanzi family, especially to Parmatour." See A. Melis, supra note 6, at 6. Prosecutors appear to believe that the total diversions to Tanzi family-owned companies were at least Euros 1,500 million. Id. at 6 n. 2.

[51] Id. at 10.

[52] Id. at 9-10.

[53] Id. at 10.

[54] See "Report of Investigation by the Special Committee of the Board of Directors of Hollinger International Inc" (August 30, 2004) at 4.

[55] Devin Leonard, "More Trials for Lord Black," Fortune, October 4, 2004 at p. 42.

[56] Id.

[57] See A.C. Littleton, ACCOUNTING EVOLUTION TO 1900 (1988) at 260-262.

[58] The 1844 amendment was to the Joint Stock Companies Act, (see 7 & 8 Vict., Ch. 110) (1844), and the 1845 amendment was to the Companies Clauses Consolidation Act (see 8 & 9 Vict., Ch. 16) (1845). For a more detailed review of this legislation, see Sean M. O'Conner, Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence, 45 Boston College L. Rev. 741 (2004).

Figure 1: Total Number of Restatement Announcements Identified, 1997-2002

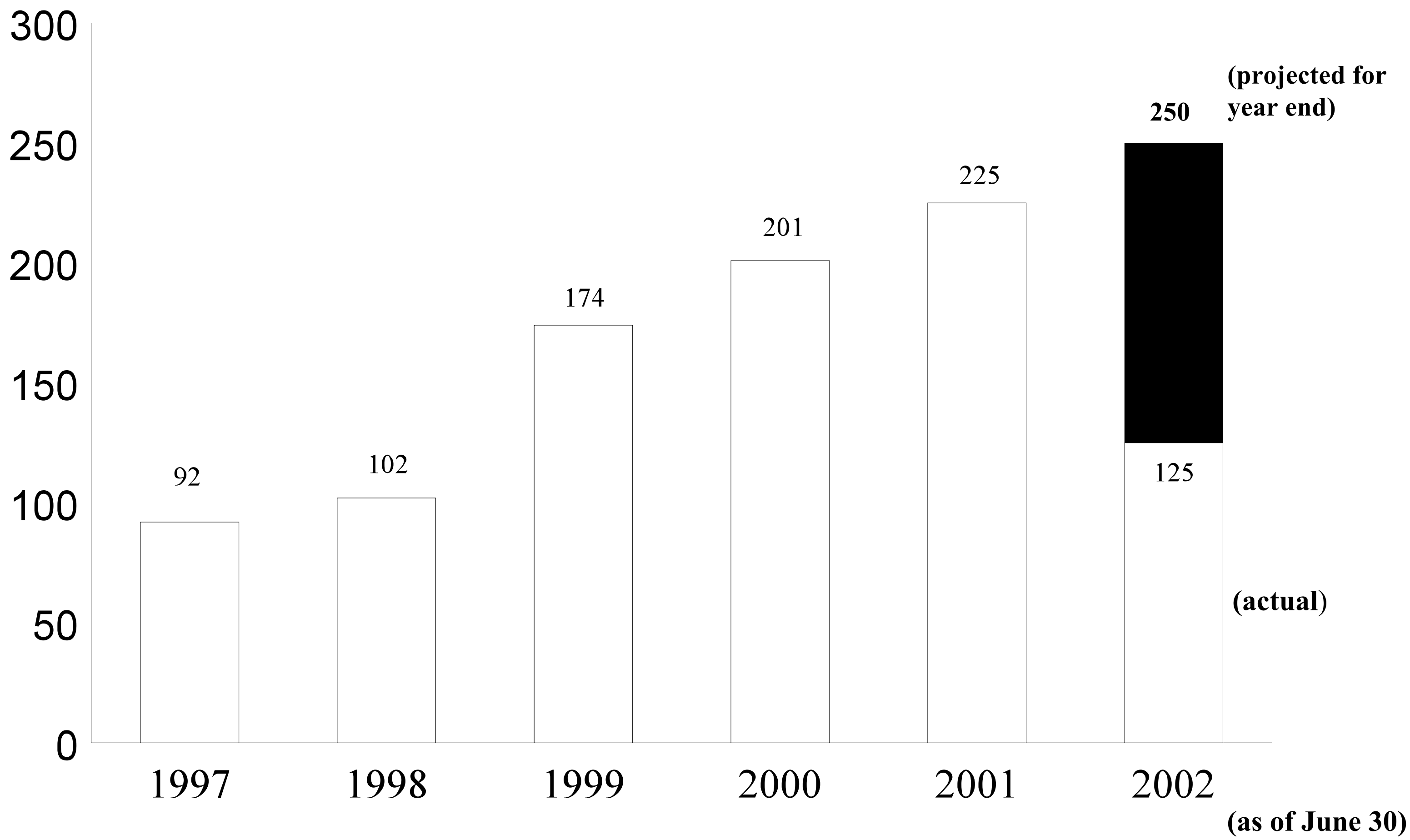
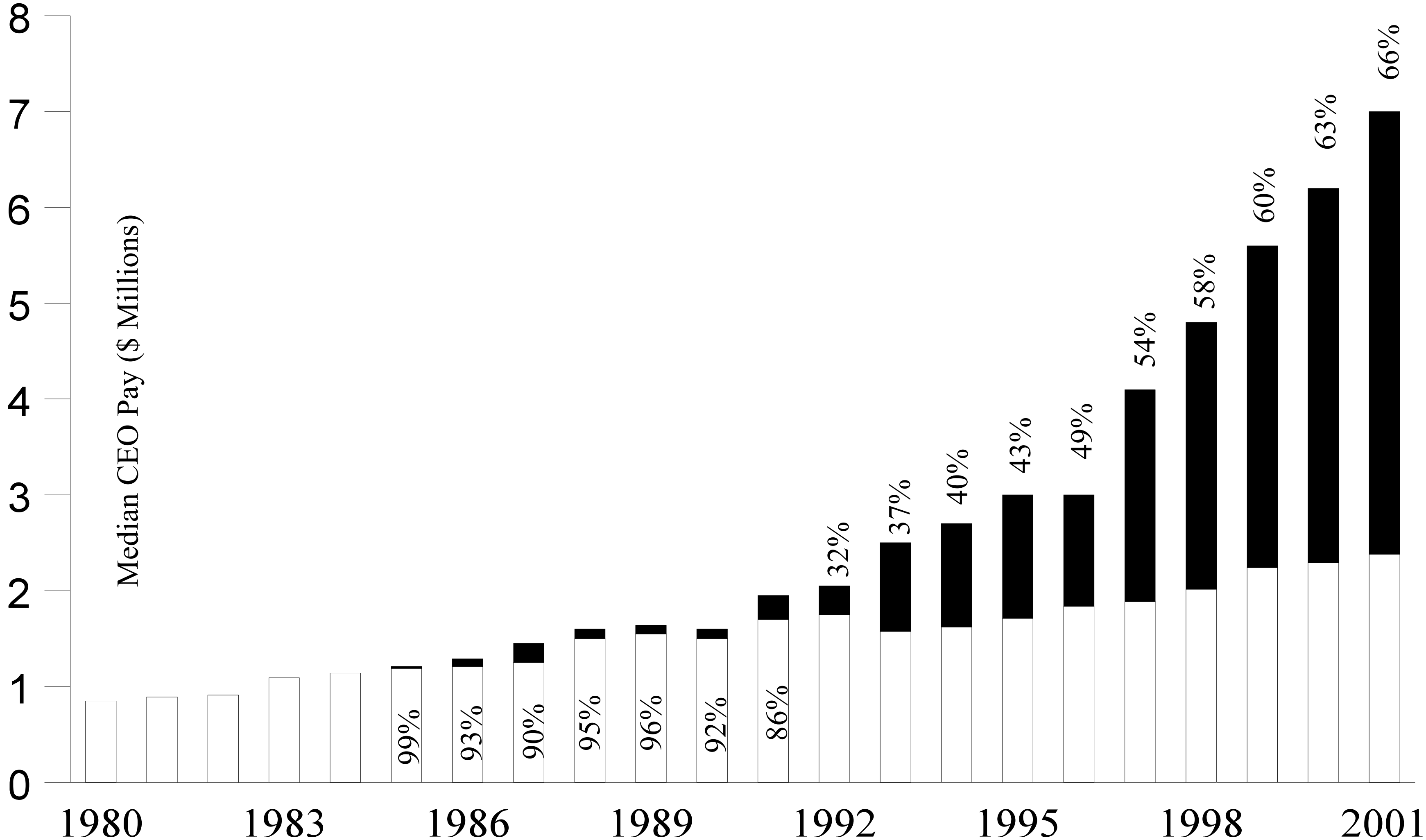


Figure 2



(Source: Brian J. Hall, Harvard Business School)