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Investment Returns

Does Corporate Governance Matter to Investment Returns?

By JAY W. EISENHOFER AND GREGG S. LEVIN

Introduction

Although Conrad Black will tell you that corporate governance is a form of terrorism, an increasing body of evidence suggests that enhanced governance equals enhanced performance. Does this mean there is a perfect correlation between the two? Of course not. However, empirical evidence suggests what common sense tells us is correct—those corporate boards that are more concerned about shareholder rights are also better guardians of shareholder money. Indeed, as one commentator noted in early 2004, “the good news is the discovery of an increasing amount of new evidence suggesting that these links [between returns and governance] do exist.”¹

¹ Nick Bradley, “Corporate Governance Scoring and the Link Between Corporate Governance and Performance Indica-

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As summarized below, the empirical studies conducted to date have generally come in one of two forms. In the first group of studies, researchers have focused on corporate governance practices generally, that is, they examine simultaneously a multitude of variables that relate to “sound” corporate governance. These studies have concluded that the quality of a particular company’s governance practices and procedures positively correlates with both good corporate financial performance and stockholder value. A second group of studies has been more narrowly tailored, concentrating upon some specific aspect of “sound” corporate governance (such as the adoption of anti-takeover provisions or limiting excessive executive compensation). While these studies have employed varying methodologies, they all have tended to reach the same conclusion: those companies that have adopted specific procedures and practices designed to (a) ensure managers’ accountability to owners and (b) align managers’ interests as closely as possible with those of the stockholders perform more strongly than do their counterparts.

This article also addresses the phenomenon known as “socially responsible investing” (or SRI), which involves “the process of integrating values, societal concerns and/or institutional mission into investment

tors: In Search of the Holy Grail,” *Corporate Governance: An International Review*, Vol. 12 at 8 (January 2004).

decision-making.”² As noted below, several recent studies have found that SRI translates into higher returns for investors.

I. The Empirical Link Between Corporate Governance Generally and Firm Performance

One of the primary aims of shareholder activism in recent decades has been the promotion of “sound” corporate governance practices as a means to improve corporate performance and shareholder returns. A pivotal question is whether the hypothesis underlying the movement is valid: *i.e.*, does good corporate governance actually translate into good corporate performance? In recent years, there have been a number of empirical studies, mostly academic journal articles, on the relationship between good corporate governance generally and firm performance. As discussed below, a substantial number of these studies have found that corporations practicing good corporate governance outperform those companies whose processes and procedures are “unsound.”

A. Institutional Shareholder Services Study. In a research study commissioned by Institutional Shareholder Services, Inc. (ISS) and published in 2004, Lawrence D. Brown and Marcus L. Caylor of Georgia State University examined whether firms with “weaker” corporate governance perform “more poorly” than firms with “stronger” corporate governance.³ The criteria Brown and Caylor used to separate “weak” from “strong” corporate governance were derived from ISS’s “CGQ”—the Corporate Governance Quotient utilized in ISS’s proprietary rating system to help institutions evaluate the quality of corporate boards and the impact of their governance practices. Brown and Caylor’s methodology used industry-adjusted CGQ scores to relate to 15 industry-adjusted variables, or performance measures, suggested by ISS and to 20 others that the authors considered of interest. The variables included total returns (one-, three-, five- and 10-year), profitability (ROA, ROE and ROI returns on average equity/average investment), stock price volatility risk (beta), profit margins, market cap, P/E ratios, solvency ratios, interest coverage, ratio of operating cash-flow to total liabilities, dividend payouts, and dividend yields.

Generally, the study found that industry-adjusted CGQ scores reflecting stronger corporate governance were directly correlated to positive performance in four areas—shareholder returns, profitability, risk (measured by stock price volatility), and dividend payouts and yields—while scores reflecting worse corporate governance correlated to worse performance results in those areas. In a second-stage examination, Brown and Caylor related the 35 variables (performance measures) to four “core” factors of the CGQ—board composition, compensation, takeover defenses, and audit—in an effort to determine which were the driving factors behind the results. Brown and Caylor identified board compo-

sition as the most important factor and takeover defenses as the least.

While the study found a direct correlation between corporate governance and three-year, five-year, and 10-year shareholder returns, results for one-year total returns were inconclusive. The study interpreted that result to mean that one-year total return was more of a risk measure (as a proxy for share price momentum) than a true return measure.

B. Lipper/GMI Research on Corporate Governance in Mutual Fund Performance. In a research study conducted jointly by Lipper, Inc., a Reuters company which performs global research on mutual funds, and GovernanceMetrics International (GMI), a corporate governance ratings agency, the two firms paired the stock holdings of 725 large-cap domestic equity mutual funds in Lipper’s database with the governance ratings calculated by GMI for more than 1,000 publicly traded firms, including all of the companies covered in the S&P 500 Index and the S&P Midcap 400, plus other widely held stocks. GMI’s ratings are on a scale from 1 to 10, with 10 reserved for companies with truly independent boards, audit and compensation committees and other good-governance characteristics. The ratings decline in the event of board structures and company policies that limit the board’s effective oversight of management and actions indicating the board has not been effective.

The study results, released in January 2004,⁴ found that managers of large-cap mutual funds tend to overweight their portfolios with companies that have above-average corporate governance profiles. Funds that are heavily overweighted in well-governed companies were found to outperform the average fund in both three- and five-year holding periods and, over the same periods, tended to perform better than funds with a large number of poorly governed companies in their portfolios. The outperformance did not, however, hold true for over just a one-year holding period, perhaps for the same reason observed earlier in relation to the ISS-commissioned study.

In September 2004, GMI announced new ratings on 2,588 global companies, of which only 26 (20 American, five Canadian, and one Australian) received GMI’s highest rating of 10.0. GMI reported that as of August 31, 2004, as a group, these 26 companies outperformed the S&P 500 Index as measured by total returns for each of the last one-, three- and five-year periods by 4.9 percent, 8.3 percent, and 10 percent, respectively.⁵

C. The Governance Index of Gompers, Ishii, and Metrick. In a 2003 article published in the *Quarterly Journal of Economics*,⁶ Paul A. Gompers (Harvard Business School and National Bureau of Economic Research (NBER)), Joy L. Ishii (Department of Economics, Harvard), and Andrew Metrick (Department of Finance, The Wharton School, and NBER) asked the empirical question: Is there a relationship between shareholder rights and corporate performance? Their answer, put simply, was yes.

⁴ *Corporate Governance as a Factor in Mutual Funds Holdings* (2004), available upon request through the GMI Website, at <http://www.gmiratings.com>.

⁵ See “Improvements Seen Following Enactment of SOX, But Risks Remain,” GMI Press Release, September 7, 2004.

⁶ Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. Journ. of Economics 107 (2003).

² Steven J. Schueth, “SRI in the U.S.,” available at <http://www.firstaffirmative.com/news/sriArticle.html> (emphasis in original deleted) (“Schueth”).

³ Lawrence D. Brown and Marcus L. Caylor, *The Correlation Between Corporate Governance and Company Performance* (2004) (available at <http://www.bermanesq.com/pdf/ISSGovernanceStudy04.pdf>).

In the context of this study, “shareholder rights” referred to a set of unique “provisions,” many of them at the firm level, and some embodied in state law, which affect the balance of power between shareholders and corporate management.⁷ These provisions were those that have been tracked since 1990 in the database of the Investor Responsibility Research Center (IRRC), covering a universe of firms representing 93 percent of the total capitalization of the NYSE, AMEX and NASDAQ markets. The study divided the provisions into five groups: *Delay* (tactics for delaying hostile bidders); *Voting* (voting rights); *Protection* (director/officer protection); *Other* (other takeover defenses); and *State* (state laws).

The authors then devised their Governance Index (“G”) which considered only the impact of each provision on the balance of power in the corporation. When the thrust of a “provision” was to increase the power of managers within a firm, a point was scored toward a “Dictatorship” model of the corporation, while the absence of that provision (or the presence of a provision that cut the other way, in favor of shareholders) tilted the balance of power toward shareholders (in the direction of a “Democracy” model). G was the sum of one point for the existence (or absence) of each provision. Thus, the higher a firm’s score on the index, the stronger its management control (and the weaker its “shareholder rights”).

In the remainder of the paper, special attention was paid to two extreme portfolios: the “Dictatorship Portfolio” of the firms with the weakest shareholder rights (G 14) and the “Democracy Portfolio” of the firms with the strongest shareholder rights (G 5). The portfolios were updated at the same frequency as G (which changes over time, along with changes or deletions of firms in the sample), so as to create a proxy for the level of shareholder rights at about 1,500 large firms—those tracked by IRRC—during the 1990s. The authors compared those firms and their scores to share price data maintained by the Center for Research in Security Prices (CRSP) and, where necessary, to Standard & Poor’s Compustat database. They concluded from the data that an investment strategy that *bought* firms in the *lowest* decile of the index (*strongest* shareholder rights) and *sold* firms in the *highest* decile (*weakest* shareholder rights) of the index would have earned abnormal returns of 8.5 percent per year during the sample period. Other findings also emerged, among them that firms with stronger shareholder rights had higher firm value, higher profits and higher sales growth.

D. The Entrenchment Index of Bebchuk, Cohen, and Ferrell. Researchers have utilized G, or a variation of this index, in a number of studies published since 2003.⁸ In one such study, Harvard Law School profes-

sors Lucian A. Bebchuk, Alma Cohen and Allen Ferrell, posited that of the 24 IRRC provisions that comprised the G, certain provisions influenced shareholder value more than others. Specifically, Bebchuk, Cohen and Ferrell hypothesized that during two time periods: (1) 1990-1999 and (2) 1990-2003, the corporate governance provisions relating to entrenchment (six of the 24 IRRC provisions studied by Gompers, Ishii and Metrick) impacted firm value and stock returns more than the other 18 IRRC provisions combined.⁹

Accordingly, instead of using the G, which was a composite index that gave equal weight to all 24 IRRC provisions, the authors divided the IRRC provisions into two indices: an “entrenchment” index and an “other provisions” index. The entrenchment index was comprised of six provisions the authors claimed would best measure entrenchment based on personal experience and knowledge, interviews with six “prominent” corporate attorneys and “[e]vidence about the provisions attracting the most widespread opposition from institutional investors voting on precatory shareholder resolutions.”¹⁰ The IRRC provisions in the entrenchment index were staggered boards, limits to shareholder by-law amendments, supermajority requirements for (a) mergers and (b) charter amendments, poison pills and golden parachutes.¹¹ The “other provisions” index was comprised of the remaining 18 IRRC provisions.¹² In this study, each firm received a score based on the same Dictatorship/Democracy guidelines described above in connection with the Gompers, Ishii and Metrick study. The indices represented the sum of one point for the existence (or absence) of each provision.

Upon analyzing the scores of approximately 90 percent of all U.S. public companies during the two time periods, the authors found that the higher the firm’s entrenchment score, the lower the firm’s value.¹³ In addition, the authors found “no evidence” between the 18 other IRRC governance provisions (either individually or in the aggregate) and firm valuation.¹⁴ As to the issue of stock value, the authors concluded that firms with higher entrenchment scores had lower stock returns.¹⁵ Bebchuk, *et al* further found that the six entrenchment provisions were the driving force behind a correlation identified by Gompers, Ishii, and Metrick

ember 7, 2004) (creating a new index, called Gov-Score, and finding evidence that good corporate governance practices lead to better firm performance) (*available at* <http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf>). The *Corporate Governance and Firm Performance* study is discussed later in this article.

⁹ Lucien Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?* (September 2004), Harvard Law School John M. Olin Center Discussion Paper No. 491, *available at* <http://ssrn.com/abstract=593423> (“Bebchuk, *et al.*”).

¹⁰ *Id.* at 7.

¹¹ *Id.* at 7-11.

¹² The remaining 18 IRRC factors are generally set forth as: Blank Check, Limits to Special Meetings, Limits to Written Consent, Compensation Plans, Director Indemnification Contracts, Director Indemnification, No Secret Ballot, Unequal Vote, Anti-Greenmail, Director Duties, Fair Price, Pension Parachutes, No Cumulative Vote, Director Liability, Business Combination Law, Silver Parachutes, Cash-Out Law, and Severance Agreements. *Id.* at 39.

¹³ *Id.* at 3, 39.

¹⁴ *Id.* at 3.

¹⁵ *Id.* at 40.

⁷ The term “corporate management” refers to both directors and officers.

⁸ See, e.g., Belen Villalonga and Raphael H. Amit, *How Do Family Ownership, Control, and Management Affect Firm Value?* (June 7, 2004), AFA 2005 Philadelphia Meetings, EFA 2004 Maastricht Meetings Paper No. 3620, *available at* <http://ssrn.com/abstract=556032>; Hollis S. Ashbaugh, Daniel W. Collins and Ryan LaFond, *The Effects of Corporate Governance on Firms’ Credit Ratings* (June 2004), *available at* <http://ssrn.com/abstract=511902>; Lawrence D. Brown and Marcus L. Caylor, *Corporate Governance and Firm Performance* (De-

between the 24 IRRC provisions on the one hand and reduced firm value and lower share returns during the 1990s on the other.¹⁶

E. Corporate Governance and Firm Performance. In December 2004, Lawrence Brown and Marcus Caylor published another study in which they again opined that good corporate governance correlates positively with firm value.¹⁷ After creating “a broad measure of corporate governance, Gov-Score, based on a new dataset” supplied by ISS, the authors “relate[d] Gov-Score to operating performance, valuation, and shareholder payout for 2,237 firms.”¹⁸ As noted by the authors, “Gov-Score” was intended to be “a broad measure of corporate governance comprised of both external and internal governance mechanisms”¹⁹ which encompassed “51 factors that span eight categories.”²⁰ Those eight categories were “audit, board of directors, charter/bylaws, director education, executive and director compensation, ownership, progressive practices, and state of incorporation.”²¹ The authors suggested that their 51-factor metric was “more highly associated with expected firm performance than is the oft-used 24-factor G-Index derived by Gompers, Ishii and Metrick”²² (which is discussed earlier in this article).

Brown and Caylor concluded that “better-governed firms are relatively more profitable, more valuable, and pay out more cash to their shareholders,”²³ stating that “[w]ith the exception of sales growth, all of our firm performance measures have their expected positive relation with Gov-Score and are significant in our correlation analysis . . . decile analysis . . . , or both, suggesting that firms with relatively poor governance are relatively less profitable (lower return on equity and profit margin), less valuable (smaller Tobin’s Q), and pay out less cash to their shareholders (lower dividend yield and smaller stock repurchases).”²⁴

The authors noted further that “the 13 factors associated most often with good performance are [that] all directors attended at least 75% of board meetings or had a valid excuse for non-attendance, board is controlled by more than 50% independent outside directors, nominating committee is independent, governance committee meets once a year, board guidelines are in each proxy statement, option re-pricing did not occur in the last three years, option burn rate is not excessive, option re-pricing is prohibited, executives are subject to stock ownership guidelines, directors are subject to stock ownership guidelines, mandatory retirement age for directors exists, performance of the board is reviewed regularly, and board has outside advisors.”²⁵ Brown and Caylor also suggested that government officials consider supplementing existing regulations by mandating “the presence of a separate corporate gover-

nance committee that meets at least once a year and a provision limiting a firm’s option burn rate, two governance factors [the authors found] to be highly related to good performance.”²⁶

While the authors stated that generally speaking, the corporate governance reforms required by Sarbanes-Oxley Act of 2002 (“SOX”) and the listing exchanges “facilitate good performance,” they also posited that one such reform (“auditors not providing most non-audit services to clients”) in fact may be detrimental to corporate performance.²⁷

II. Studies Focusing Upon Specific Aspects of Sound Corporate Governance

While the construct of “sound” corporate governance practices cannot be reduced to a dogmatic “one-size-fits-all” approach, a convergence has developed in recent years as to what core structures constitute “best” corporate governance practices. These “best” practices include, for example: (a) the elimination of takeover defenses such as the poison pill or the staggered board (viewed by many as entrenchment devices which permanently impair long-term shareholder value); (b) linking executive compensation to a corporation’s underlying financial performance (so-called “pay for performance”) and (c) curbing excessive grants of stock options to senior management. It is objectives such as these that form the frontiers of modern shareholder activism and serve as the basis for a second group of empirical studies. As summarized below, those studies that have focused upon a specific “best” governance practice have concluded that there is a direct empirical link between (a) particular processes or procedures which promote managerial accountability and align the interests of management and stockholders and (b) higher firm values.

A. The Correlation Between Staggered Boards and Investment Returns. In 2002, Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian published a working paper on staggered boards. The paper’s central thesis maintained that this model of board structure represented a truly massive deterrence to unwanted corporate takeovers—perhaps the mightiest of all takeover defenses.²⁸ *Staggered Boards* recognizes a subspecies of the classified board—the effective staggered board (or ESB)—which, coupled with a poison pill, can prevent circumvention by a hostile bidder, essentially forcing such a party to wage concurrently a proxy contest for board control. Due to the prototypical ESB, which is comprised of three classes each of approximately the same number of director seats, board control cannot be achieved in a single annual meeting election. The ESB will severely try both the staying power and the finances of a dissident group to wage a contest extending over two annual meeting cycles. An ESB clearly increases an incumbent management’s protection

¹⁶ *Id.*

¹⁷ Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Performance*, December 7, 2004 (available at <http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf>).

¹⁸ *Id.* (quotes located in Abstract).

¹⁹ *Id.* at 24.

²⁰ *Id.* at 3.

²¹ *Id.* at 28.

²² *Id.* at 3-4.

²³ *Id.* (quote located in abstract).

²⁴ *Id.* at 29.

²⁵ *Id.*

²⁶ *Id.* at 31.

²⁷ *Id.*

²⁸ Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, National Bureau of Economic Research, NBER Working Paper 8974 (June 2002), available at <http://www.nber.org/papers/w8974> (hereinafter “*Staggered Boards*”).

against takeovers, and, most of the time, the ESB succeeds in maintaining the company's independence. However, as to the effect of the ESB on investment returns, the empirical evidence supported the proposition that the stockholders are worse off with the corporation remaining independent than they would be if the hostile bid were accepted.²⁹

Staggered Boards also cites Robert Daines' finding³⁰ that Delaware corporations have higher values than non-Delaware firms, which translates to the conclusion that Delaware incorporation correlates to higher shareholder returns. While DGCL § 141(d) permits classified boards in accordance with formal requirements, including stockholder approval via the corporation's certificate or its initial by-laws, Delaware does not *require* board classification and maintains only one real anti-takeover provision, DGCL § 302, which nevertheless allows for corporate opt-outs. Bebchuk, Daines and others believe that Delaware law therefore maintains the mildest antitakeover regime in the nation.

B. The Relationship Between CEO Compensation and Credit Risk. In July 2005, Moody's Investor Service ("Moody's"), which provides ratings on over 85,000 corporate and government securities, published a study which investigated "the empirical relationship between executive compensation and credit risk."³¹ Studying "non-financial corporations in the United States with senior unsecured bond ratings of B3 or higher, from 1993 through 2003,"³² Moody's found a link between the compensation paid to Chief Executive Officers on the one hand and "overall credit risk" on the other.³³ Specifically, Moody's found that firms in the top 10 percent with respect to "high unexplained bonuses" and "high unexplained option grants" experienced "dramatically higher default rates and dramatically higher downgrade rates than did the middle 70% of the distribution."³⁴ For example, in the case of "high unexplained bonuses," the default rate for the top 10 percent of companies was 1.8 percent, compared to only 0.1

²⁹ See also Lucien Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 853 (January 2005) ("There is evidence that having a staggered board greatly increases the likelihood that targets of hostile bids remain independent, and that it considerably reduces the returns to the target's shareholders both in the short-run and in the long-run. There is also evidence that staggered boards are correlated with lower firm value.") (*Increasing Shareholder Power*); Lucian Bebchuk and Alma Cohen, *The Costs of Entrenched Boards*, June 2004; rev. Sept. 2004 ("We find that staggered boards are associated with a lower firm value (as measured by Tobin's Q). We also find some suggestive evidence consistent with the possibility that staggered boards bring about, and not merely reflect, an economically significant reduction in firm value. Finally, the correlation with reduced firm value is stronger for staggered boards that are established in the corporate charter (which shareholders cannot amend) than for staggered boards established in the company's bylaws (which can be amended by shareholders.") (quote found in Abstract) (*available through* http://www.law.harvard.edu/programs/olin_center/).

³⁰ See Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. Fin. Econ. 525 (2001).

³¹ "Special Comment—CEO Compensation and Credit Risk," *Moody's Investor Service*, July 2005 at 1 (copy on file with the authors).

³² *Id.* at 3.

³³ *Id.* at 1, 8.

³⁴ *Id.* at 6.

percent for corporations which fell in the middle 20 percent.³⁵

The term "unexplained bonuses" (or "unexplained option grants"), as used in this study, refers to bonuses (or option grants) that "deviate[] substantially" from what might be expected "based on firm size, past performance, and other variables."³⁶ Stated more specifically, "[t]o determine unexplained compensation," Moody's developed "a model that predict[ed] expected salary, expected bonus, and expected option grants based on firm size, past operating performance, CEO tenure, and industry—variables selected from the academic literature on CEO compensation."³⁷

In its study, Moody's offered "three possible explanations" for this empirical link that "could be inferred from the [academic] literature."³⁸ As an initial matter, Moody's noted that "excessive compensation may be indicative of weak management oversight."³⁹ In addition, Moody's posited that "large pay packages that are highly sensitive to stock price and/or operating performance may induce greater risk taking by managers, perhaps consistent with stockholders' objectives, but not necessarily bondholders' objectives."⁴⁰ Finally, Moody's stated that "large incentive-pay packages may lead managers to focus on accounting results, which may, at best, divert management attention from the underlying business or, at worst, create an environment that ultimately leads to fraud."⁴¹

C. Takeover Defenses and Credit Risk. In a prior study, published in December 2004, Moody's found a "albeit weak" between takeover defenses and corporate credit risk.⁴² Specifically, Moody's concluded that:

Credit risk is found to have been positively related to the number of takeover defenses. Having more takeover defenses led to more defaults and more large downgrades for both investment-grade and speculative-grade firms. Further, more defenses led to fewer large upgrades. These effects are present, even after controlling for credit ratings.⁴³

This study analyzed data for 1,058 companies from 1990 to 2003,⁴⁴ and focused on the number of takeover defenses a firm had in place (such as poison pills, staggered boards, and golden parachute payments to executives upon a change in control), as well as on information regarding credit upgrades and downgrades and incidents of credit default. Moody's analysis of the data led it to conclude that:

■ "[t]he association of takeover defenses with downgrade rates appears fairly strong;"⁴⁵

■ "[t]he probability of a downgrade increases as the number of takeover defenses increases for all categories" of issuers;⁴⁶

³⁵ *Id.* at 5.

³⁶ *Id.* at 1.

³⁷ *Id.* at 3.

³⁸ *Id.* at 8.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² "Special Comment—Takeover Defenses and Credit Risk," *Moody's Investor Service*, December 2004 at 1 (copy on file with the authors).

⁴³ *Id.* at 8.

⁴⁴ *Id.* at 5.

⁴⁵ *Id.* at 6.

⁴⁶ *Id.*

■ the adoption of “[m]ore takeover defenses” correlated to lower credit “upgrade rates” (although these results were “not as statistically significant” as those pertaining to credit downgrades);⁴⁷ and

■ the risk of credit default seemed to be “higher for firms with greater numbers of takeover defense” (although Moody’s stated that the relationship was “much weaker than that observed for downgrades”).⁴⁸

Moody’s also found that so-called “democrats” (defined as corporations with five or fewer take over defenses) “earned 8.9% greater annual stock returns” than those companies defined as “dictators” (those corporations that had 14 or more takeover defenses in place) during the period beginning in 1990 and ending in 1999.⁴⁹ Moody’s noted that the foregoing finding was “consistent” with prior literature on the subject.⁵⁰ Interestingly, however, Moody’s also discovered that “firms with the fewest defenses earned 14.7% lower annual returns for the period 2000 to 2003.”⁵¹

Although this study concluded that a positive correlation existed between credit risk and the number of takeover defenses enacted by a corporation, Moody’s cautioned that the magnitude of the link was “modest.”⁵² Moody’s further noted that since corporations’ use of takeover defenses “continues to change,” the results seen for the period studied “might not hold in the future.”⁵³ In addition, Moody’s posited that “the effect and meaning of takeover defenses depends highly on the specific circumstances of each firm as well as the firm’s overall corporate governance structure” and that, as such, the effect of such defenses are “highly contingent on specific context.”⁵⁴ In Moody’s view, this indicated that “a case-by-case approach” might be more valuable than making “broad assumptions” regarding the influence of such defenses “on credit quality.”⁵⁵

D. Related Party Transactions: Harmful or Efficient? In the wake of the corporate scandals of recent years, which focused attention on related party transactions between companies and members of their senior management team, Rutgers Business School Professors Elizabeth Gordon, Elaine Henry and Darius Palia conducted a study to test whether a relationship existed between such transactions and firm value.⁵⁶ The authors presented two hypotheses as to how related party transactions might affect the performance of a company. The first hypothesis, which can be traced to Berle and Means’ famous treatise on the “modern corporation,” was that related party transactions “represent a conflict of interest” between managers and shareholders that harm firm value.⁵⁷ In their seminal work first published in the 1930s, Berle and Means posited that the separa-

tion of ownership from control “posed a fundamental threat to the public shareholder” since “[m]anagement groups might pursue their personal interest in higher salaries, favorable stock options, or other conflicts of interest at the expense of the majority of public shareholders.”⁵⁸

The second hypothesis proposed that “related party transactions are efficient transactions” that benefit the corporation.⁵⁹ Under this second hypothesis, these transactions are viewed as a means for corporations to retain skilled executives which, in turn, improves firm value.

The authors concluded that, as an overall matter, related party transactions were not beneficial and negatively affected firm value:

the evidence indicates that shareholders do not benefit from, and in fact are harmed by some related party transactions. Our investigation of the corporate mechanisms associated with related party transactions and their impact on firm value supports the hypothesis that they are conflicts of interest between managers/board members and their shareholders. We find that this effect is especially strong for loans and the number of transactions (other than loans) with non-executive directors. . . . Therefore, it appears that concerns among regulators and stock market participants about related party transactions are warranted.⁶⁰

The issue of related-party transactions (“RP transactions”) was also at the heart of a September 2004 study published by University of Wisconsin Professors Mark J. Kohlbeck and Brian W. Mayhew.⁶¹ There, the authors examined the RP transactions of 1,261 of the S&P 1500 companies. Kohlbeck and Mayhew found that one of the most common forms of RP transaction were loans to related parties.⁶² They further concluded, *inter alia*, that “board of director independence (stronger corporate governance) is associated with a lower probability of RP transactions, and when there were RP transactions, the transactions [were] more likely to be disclosed”⁶³ The authors also opined that the evidence suggested that “board monitoring plays a role in mitigating the occurrence of RP transactions and helps to discipline disclosure of the transactions when they do occur.”⁶⁴

E. The Relationship Between Earnings Manipulation and Stock Option Timing. Several studies have focused on the troubling relationship between the timing of the release of a corporation’s earnings results and an award of stock options to senior executives. In a 2000 study titled

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 3, 4.

⁵⁰ *Id.* at 4.

⁵¹ *Id.* (emphasis in original deleted).

⁵² *Id.* at 8.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ Elizabeth A. Gordon, Elaine Henry and Darius Palia, *Related Party Transactions: Associations with Corporate Governance and Firm Value* (August 2004), EFA 2004 Maastricht Meetings Paper No. 4377, available at <http://ssrn.com/abstract=558983> (“Gordon, *et al.*”).

⁵⁷ *Id.* at 8.

⁵⁸ Joel Seligman, “A Modest Revolution in Corporate Governance,” 80 *Notre Dame L. Rev.* 1159, 1162 and n.16 (March 2005) (discussing Berle and Means).

⁵⁹ Gordon, *et al.*, *supra* at note 56, at 8.

⁶⁰ *Id.* at 37-38.

⁶¹ Mark J. Kohlbeck and Brian W. Mayhew, *Related Party Transactions* (September 15, 2004), AAA 2005 FARS Meeting Paper, available at <http://ssrn.com/abstract=591285> (“Kohlbeck”).

⁶² *Id.* at 4, 11-12. Of course, SOX now prohibits a public corporation from making “personal loans to a director or executive officer, except for home improvement loans, manufactured home loans or loans made or maintained by an insured depository institution if the loan is subject to the insider lending restrictions of the Federal Reserve Act.” William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* § 1245; see also 15 U.S.C. § 78m(k).

⁶³ Kohlbeck, *supra* at note 61, at 23.

⁶⁴ *Id.*

CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures, two business professors, David Aboody of UCLA and Ron Kasznick of Stanford University, found that chief executives engage in a kind of self-interested behavior “around [option] award dates by delaying good news and rushing forward bad news.”⁶⁵ Specifically, Aboody and Kasznick discovered that “CEOs who receive their options before the earnings announcement are significantly more likely to issue bad news forecasts, and less likely to issue good news forecasts, than are CEOs who receive their awards after the earnings announcement.”⁶⁶ In their study, the authors also cited to an earlier study by New York University Professor David Yermack, who had concluded that “CEO option awards are preceded, on average, by insignificantly negative abnormal returns, and are followed by significantly positive abnormal returns.”⁶⁷

While the authors did not mean to “necessarily imply that this activity adversely affects shareholder wealth,”⁶⁸ the results of the study do suggest that chief executives are engaging in opportunistic behavior which could be mitigated through better governance practices. Indeed, as Aboody and Kasznick specifically stated, their “findings suggest[ed] that CEOs’ incentives to manage investors’ expectations around scheduled awards could be mitigated by setting award dates immediately after earnings announcements.”⁶⁹

That corporate management engages in self-interested behavior vis-à-vis option grants also was the subject of a January 2005 study published by Professors M.P. Narayanan and H. Nejat Seyhun of the University of Michigan Business School.⁷⁰ In that study, the authors examined “a database of 605,106 option grant filings by insiders between 1992 and 2002” and discovered “significant abnormal stock return reversals around the grant date.”⁷¹ More specifically, the authors found that the:

overall evidence is consistent with substantial managerial influence on their compensation. Stock price [sic] fall significantly prior to option grant dates and rise significantly following option grant dates, thereby producing sharp reversals of abnormal returns. The market-adjusted return for the 90 days preceding the grant date is about -3.6% and the return for the 90 days following the grant date is about 9.4%. In small firms, the 90-day post-grant date average abnormal rise in stock price is about 17%. *These patterns are significantly larger than any that has been documented in previous literature.*⁷²

The authors also concluded that these “abnormal stock return reversals are more pronounced on average when the grants involve top executives such as CEOs, Chairmen of the Board, Presidents, and CFOs, who possess more company specific information, have the abil-

ity to manage information disclosure, and wield greater influence with the board.”⁷³

The Narayanan/Seyhun analysis appears to go one step further than prior studies. According to the authors, while senior management does control the public disclosure of good and bad information, the evidence also suggests that “some firms are setting the [option] grant date on a back-date basis, i.e., picking a date in the past with a lower stock price compared to that on the decision date.”⁷⁴ In this regard, the authors stated that:

while the stock return reversals are consistent with both opportunistic timing of information releases by firms and opportunistic timing of grant dates, these two methods of influencing do not completely explain the observed stock return reversals. In particular . . . the correlation between post-grant and pre-grant abnormal returns cannot be easily explained by these two methods of influencing alone. We propose that some firms may be setting the grant date on a back-date basis, i.e., choosing a grant date in the recent past with a lower stock price than the price on the day of the grant decision is made. If back-date method is employed by some firms, the stock return reversals should be positively related to the reporting lag (the time interval between the grant date and the date on which the SEC receives the grant disclosure forms from the executive). *We find this is indeed the case.*

The magnitude of the gains for large grants from back-dating can be significant. Our results show that if grant date is back-dated by 20 days, executives receiving large grants (500,000 shares or greater) increase the value their option compensation by about 10%. By conservative estimates, this is equivalent to a windfall of \$0.7 million per grant.⁷⁵

As one recent press report noted, the Narayanan/Seyhun study “suggests one easy litmus test of a company’s corporate governance: Check the company’s filings for the timing of recent option grants. If they occur with an eerie regularity at prices close to the company’s trailing 52-week lows, then you should become suspicious of its internal corporate culture.”⁷⁶

F. The Correlation Between Executive Compensation and Accounting Fraud. In a study published in February 2004, Merle Erickson (Graduate School of Business, University of Chicago), Michelle Hanlon (University of Michigan Business School), and Edward Maydew (Kenan-Flagler Business School, University of North Carolina) set out to determine if a relationship existed between the structure of executive compensation and accounting fraud. The authors used a sample of 50 firms that had been accused of such fraud by the SEC from January 1996 to November 2003.⁷⁷ Erickson, *et al.* tested two opposing views on the impact of stock-based compensation on executive incentive.⁷⁸ One view is that option-based compensation aligns manager and shareholder interests and is consistent with the maximization of firm value.⁷⁹ The opposing view is that option-based

⁶⁵ David Aboody and Ron Kasznick, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. Acct. & Econ. 73 (2000).

⁶⁶ *Id.* at 75.

⁶⁷ *Id.* at 76.

⁶⁸ *Id.* at 98.

⁶⁹ *Id.*

⁷⁰ M.P. Narayanan and H. Nejat Seyhun, “Do Managers Influence their Pay? Evidence from stock price reversals around executive option grants,” January 2005 (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649804).

⁷¹ *Id.* (quotes found in Abstract).

⁷² *Id.* at 30 (emphasis added).

⁷³ *Id.*

⁷⁴ *Id.* (quote found in Abstract).

⁷⁵ *Id.* at 31 (emphasis added).

⁷⁶ Mark Hulbert, “Does corporate governance matter?” *Marketwatch*, February 18, 2005.

⁷⁷ Merle Erickson, Michelle Hanlon and Edward L. Maydew, *Is There a Link Between Executive Compensation and Accounting Fraud?* (February 24, 2004), available at <http://ssrn.com/abstract=509505> (“Erickson, *et al.*”).

⁷⁸ *Id.* at 2-4.

⁷⁹ *Id.* at 2.

compensation poorly aligns the long-term interests of shareholders and managers, provides ineffective incentive for managers, and leads to misleading corporate reporting on executive compensation.⁸⁰ The authors concluded that a positive correlation existed between accounting fraud and equity-based executive compensation, noting that “[t]he results are consistent with the likelihood of accounting fraud increasing in the percent of total executive compensation that is stock based.”⁸¹

A 2003 study published by Louisiana State University Professors Shane A. Johnson, Harley E. Ryan and Yisong S. Tian reached a similar conclusion.⁸² After studying 43 firms accused of accounting fraud by the SEC from 1992 to 2001, the authors found that “executives who commit fraud face greater financial incentive to do so” and that these incentives “stem from significantly larger stock and option holdings.”⁸³ The authors further noted that the “level of equity-based compensation [has] trended upward in recent years” and that, as a result, anti-fraud measures (including such measures at the investor level) “should increase commensurately.”⁸⁴

In a recent study presented to the Academy of Management in Honolulu, Jared Harris and Professor Philip Bromiley of the Carlson School of Management at the University of Minnesota, concluded that when a chief executive receives a large stock option package, there is a much greater likelihood that the company in question will “misrepresent their financial position.”⁸⁵ The Harris/Bromiley study analyzed companies that had restated their financial results over a five and one-half year period (January 1, 1997 to June 30, 2002) because of “accounting ‘irregularities’”⁸⁶ and found that within those companies, stock options comprised one-half of a chief executive’s total compensation (this stood in stark contrast to CEO compensation at comparable companies that did not experience such a restatement—where options comprised only 39 percent of remuneration).⁸⁷ The authors also concluded that probability of financial misrepresentation increased “rapidly” when stock options constituted “more than 76% of compensation.”⁸⁸ Moreover, “while [t]he analyzed sample reveal[ed] that a publicly traded company has approximately an 8.77% probability of having a financial misrepresentation discovered during a given five-year time period,”⁸⁹ the authors noted that among those companies that paid their chief executives over 92 percent of compensation as

stock options, the probability of misrepresentation was 21 percent⁹⁰

III. Other Studies on the Relationship Between Sound Corporate Governance and Firm Performance

There are, of course, numerous other recent studies not specifically cited above which also have concluded that sound corporate governance is directly correlated with firm performance. By way of example, on its website, ISS states that “[t]aken as a whole, the empirical evidence shows that governance matters—in terms of firm value for large firms, reducing earnings management, reducing the risk of fraud, and restoring trust if fraud is discovered.”⁹¹ Among the studies cited by ISS in this regard were *Restoring Trust After Fraud: Does Corporate Governance Matter?* authored in January 2004 by David B. Farber of the Eli Broad Graduate School of Management at Michigan State University.⁹² Farber’s study “focused on firms that had been cited by the SEC for financial fraud” and concluded that “fraud detection consistently led to improvements in the quality of the board of directors and increases in audit committee activity.”⁹³ Significantly, the study also found a “positive and economically significant relation between increases in board independence and long-run buy-and-hold abnormal returns over the three-year period following fraud detection.”⁹⁴

In late 2004, a study by Richard Bernstein, chief U.S. strategist at Merrill Lynch, received a great deal of attention in the media.⁹⁵ As noted in those media accounts, Mr. Bernstein concluded that companies which have “split” the roles of Chairman and CEO perform better than those companies which have the same individual in both positions.⁹⁶ In this regard, ISS reported that “[i]n the past decade, companies with different people serving as chairman and CEO have outperformed those that combine the roles, according to Richard Bernstein, chief U.S. strategist at Merrill Lynch & Co. Of the 100 largest companies in the S&P 500 Index, corporations that split the roles have posted a 22 percent annual return since 1994, outpacing the 18 percent return earned by firms that did not”⁹⁷

⁹⁰ *Id.* at 31.

⁹¹ ISS Governance Center, *Governance Weekly – Studies Show Governance Refroms Matter* (available at <http://www.issproxy.com/governance/publications/2004archived/105.jsp>) (“Governance Weekly”).

⁹² Study available at <http://ssrn.com/abstract=485403>.

⁹³ *Governance Weekly*, *supra*, at note 91.

⁹⁴ *Id.*

⁹⁵ See, e.g., “Study Says Two Chiefs Not Too Many, Firms Which Divvy Up The Power Outperform Those With One Leader,” *Columbia State (SC)*, November 8, 2004 (available at 2004 WLNR 6690167); “The division of corporate powers pays,” *New Jersey Record*, October 20, 2004 (available at 2004 WLNR 3246145).

⁹⁶ See, e.g., “Companies with split officials best for stockholders,” *Belleville News Democrat (IL)*, October 24, 2004 (available at 2004 WLNR 4285085) (“It turns out that those companies with different people at the helm tend to see their stock outperform those that don’t, at least according to new research tracking returns over the last decade.”).

⁹⁷ Ted Allen, “Independent Board Chairs Remain a ‘Priority,’” *ISS Governance Weekly*, November 12, 2004 (available

⁸⁰ *Id.* at 3-4, citing, *inter alia*, to various studies.

⁸¹ *Id.* at 32. See also *id.* at 33 (“We consistently find that a higher stock-based mix of pay is positively associated with a likelihood of fraud.”).

⁸² Shane A. Johnson, Harley E. Ryan, and Yisong S. Tian, *Executive Compensation and Corporate Fraud* (July 2003), available at http://www.nd.edu/~finance/020601/news/Johnson_paper.pdf and version available at <http://ssrn.com/abstract=395960>.

⁸³ *Id.* at 30.

⁸⁴ *Id.* at 31.

⁸⁵ Jared Harris & Philip Bromiley, “Incentives to Cheat: The Influence of Executive Compensation and Firm Performance on Financial Misrepresentation,” March 2005 at 1 (copy on file with the authors).

⁸⁶ *Id.* at 8.

⁸⁷ *Id.* at 43 (table 1).

⁸⁸ *Id.* at 31.

⁸⁹ *Id.* at 35.

In March 2005, ameinfo.com posted an article titled “Corporate responsibility and corporate governance,” which discussed “two major new studies” on the relationship between “corporate responsibility” on the one hand and “financial performance” on the other.⁹⁸ The first such study, authored by Marc Orlitzky (University of Sydney) and by Frank Schmidt and Sara Rynes (University of Iowa), concluded that there was “a statistically significant association between corporate social performance and financial performance . . . varying ‘from highly positive to modestly positive.’”⁹⁹ The second such study, titled “Corporate Environmental Governance,” was “commissioned by the UK Environment Agency” and reviewed “60 research studies over the last six years.”¹⁰⁰ The author found that 85 percent of those research studies “showed a positive correlation between environmental management and financial performance,” leading to a conclusion that “companies with sound environmental policies and practices are highly likely to see improved financial performance.”¹⁰¹

IV. The Benefits of Socially Responsible Investing

“Socially Responsible Investing . . . is a general term used to describe investments that reflect good values, morals, and ethics.”¹⁰² As a general matter, SRI involves the process of assessing “the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis.”¹⁰³

SRI has increased dramatically in recent years. Indeed, a recent press report noted that “approximately \$2.16 trillion was invested using a socially responsible strategy as of December 2003.”¹⁰⁴ Along these same lines, a growing number of companies also now make “social responsibility” an important part of their corporate culture.¹⁰⁵ As noted in a recent article in *Business Week*, “managers from all parts of American business are increasingly seeing social responsibility as a strategic imperative.”¹⁰⁶ In the view of Home Depot’s CEO, Robert L. Nardelli, this thought-process reflects:

a growing embrace of so-called stakeholder theory, which posits that companies are beholden not just to stockholders — but also to suppliers, customers, employees, community members, even social activists. That’s quite a departure from the long-dominant notion that corporations’ only duty is to increase profits for shareholders. ‘Things have become a lot more interdependent,’ says Nardelli. ‘There are a broader range of constituents.’¹⁰⁷

at <http://www.issproxy.com/governance/publications/2004archived/150.jsp>).

⁹⁸ See AME Info – Middle East Finance and Economy, “Corporate responsibility and corporate governance,” March 16, 2005 (available at <http://ameinfo.com/55905.html>).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² “Socially Responsible Investing,” available at <http://www.investorhome.com/sri.htm>.

¹⁰³ Schueth, *supra*, at note 2.

¹⁰⁴ Eddie Roodveldt, “Smart Investing,” *Contra Costa Times*, July 15, 2005 (available at 2005 WLNR 11103597).

¹⁰⁵ See Brian Grow, *et al.*, “The Debate Over Doing Good,” *Business Week*, August 15, 2005.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

Of course, the recognition that corporations should embrace public service and philanthropic causes also may be viewed as a “gussied-up bid for good favor.”¹⁰⁸ In that regard, *Business Week* noted that:

[t]arred by a raft of corporate scandals from Enron to WorldCom, social outreach can be a way to regain the high ground. That’s probably one reason corporate giving hit \$3.6 billion last year, an all-time high, up from \$3.5 billion in 2003, according to philanthropy research group the Foundation Center.¹⁰⁹

Some academics have deduced that “socially responsible investing results in a less profitable portfolio.”¹¹⁰ However, as noted below, several recent studies have cast doubt on that conclusion.

A. The Study Conducted by Derwall, Günster, Bauer, and Koedijk. In a 2004 study authored by Erasmus University professors, Jeroen Derwall, Nadja Günster, and Kees Koedijk, in conjunction with Rob Bauer of ABP Investments and Maastricht University,¹¹¹ the authors hypothesized that eco-efficiency (“the ratio of the value a company adds (e.g. by producing products) and the waste a company generates from the creation of that value”)¹¹² related to better portfolio performance. Five criteria were used to analyze the eco-efficiency of a number of U.S. companies, “historical liabilities” (i.e., “risks resulting from preceding actions”); “operating risk” (i.e., “risk exposure from recent events”); “sustainability and eco-efficiency risk” (i.e., “future risks initiated by the weakening of the company’s material sources of long-term profitability and competitiveness”); “managerial risk efficiency” (i.e., management’s “ability to handle environmental risk successfully”); and “environmentally-related strategic profit opportunities” (i.e., available business opportunities that result in a competitive advantage over other “industry peers”).¹¹³ The authors then constructed “two mutually exclusive stock portfolios,” each of which had “distinctive eco-efficiency characteristics.”¹¹⁴ Upon conducting various analyses on the performance of each portfolio, the authors concluded that SRI adds value to an investor’s portfolio:

In spite of the widespread skeptical attitude towards SRI, we present evidence that a stock portfolio consisting of companies labeled ‘most ecoefficient’ sizably outperformed its ‘less eco-efficient’ counterpart over the period 1995-2003. Using several enhanced performance attribution models to overcome methodological concerns, we show that the observed performance difference cannot be explained by differences in market sensitivity, investment style, or extreme industry tilts. Even in the presence of transaction costs, a simple best in-class stock selection strategy historically earned a higher risk-adjusted return of 6% compared to a worst-in-class portfolio. Overall, our find-

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ Anupam Chander, “Diaspora Bonds,” 76 N.Y.U. L. Rev. 1005, 1071 (October 2001).

¹¹¹ Jeroen Derwall, Nadja Günster, Rob Bauer, and Kees Koedijk, “The Eco-Efficiency Premium Puzzle,” May 17, 2004 (available at <https://ep.eur.nl/bitstream/1765/1296/1/ERS+2004+043+F%26A.pdf>) (“Derwall, *et al.*”).

¹¹² *Id.* at 7.

¹¹³ *Id.* at 8.

¹¹⁴ *Id.* at 16.

ings suggest that the benefits of considering environmental criteria in the investment process can be substantial.¹¹⁵

B. Other Studies on the Benefits of SRI. The study authored by Derwall, *et al.* is not alone in its conclusion that SRI obtains superior investment returns. As noted in the January 2003 issue of the *Journal of Accountancy*, two other studies also have opined that SRI enhances shareholder returns.¹¹⁶ First, during the period 1990 to 1998, “the Domini 400 Social Index—a benchmark that measures the impact of social screening on financial performance—returned 18.54% vs. 16.95% for the S&P 500.”¹¹⁷ Second, a Spring 2000 article in the *Financial Analysts Journal*, “took a comprehensive look at the risk-and-return characteristics of socially responsible mutual funds” and concluded that “[n]ot only did the screened funds do better, they did so at a modest risk premium—14.19% standard deviation vs. 13.23% for the S&P 500.”¹¹⁸

C. The Impact of ERISA on Socially Responsible Investing. Institutional investors who are subject to the fiduciary requirements imposed by the Employee Retirement Income Security Act (“ERISA”),¹¹⁹ should be mindful of two pronouncements from the Department of Labor (“DOL”) pertaining to socially responsible investing. In an interpretative bulletin issued in June 1994 (so-called Interpretative Bulletin 94-1), the DOL addressed plan investments in so-called “economically targeted investments” (or “ETIs”) which it termed, “investments selected for the economic benefits they create apart from their investment return to the employee.”¹²⁰ The DOL opined that the that “[t]he fiduciary standards applicable to ETIs . . . are no different than the standards applicable to plan investments generally” and that plan fiduciaries must—in making any investment decision—“give[] appropriate consideration to those facts and circumstances that . . . the fiduciary knows or should know are relevant” including “diversification, liquidity and risk/return characteristics.”¹²¹ The DOL further noted that that since “every investment necessarily causes a plan [or a participant] to forgo other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.”¹²²

In an advisory opinion written in May 1998, the DOL reiterated the foregoing principles in connection with an inquiry regarding the application of ERISA’s fiduciary’s responsibilities to a plan’s selection “of a ‘socially-responsible fund’ as a plan investment or a designated

investment alternative.”¹²³ While the DOL stated that ERISA does not “preclude consideration of collateral benefits, such as those offered by a ‘socially-responsible’ fund, in a fiduciary’s evaluation of a particular investment opportunity,” those collateral benefits can be determinative “only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks.”¹²⁴ In the DOL’s view, a fiduciary’s obligation to act in the best interests of plan participants and beneficiaries cannot be subordinated to other social objectives. Accordingly, “in deciding whether and to what extent to invest in a particular investment, or to make a particular fund available as a designated investment alternative, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment, or to designate an investment alternative, may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments.”¹²⁵ As noted by one commentator, “the DOL is of the opinion that, once it is determined that an investment alternative is prudent for participant direction—based on an analysis of only the investment considerations—the fiduciaries can then, and only then, consider the collateral issues, like the socially responsible screen.”¹²⁶

Conclusion

In a *Harvard Law Review* article published in January 2005, Lucian Arye Bebchuk noted that “[t]o students of corporate law, the proposition that corporate governance matters requires little explanation. As the evidence indicates that the quality of governance arrangements affects firm performance and shareholder value.”¹²⁷ Similarly, a April 2004 piece published by Deutsche Bank concluded that “investments in companies with the highest quality of governance structures and behavior have significantly outperformed those with the weakest governance.”¹²⁸ Indeed, Deutsche further found that “companies that have taken action to improve their governance standards have outperformed those that have taken negative actions over the past two years.”¹²⁹

As discussed throughout this article, a substantial number of studies support the notions that investing in companies with sound corporate governance programs

¹²³ See “Calvert Letter,” U.S. Dep’t. of Labor PWBA Advisory Opinion 98-04A (May 28, 1998) (available at <http://www.dol.gov/ebsa/programs/ori/advisory98/98-04a.htm>).

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ Fred Reish, “Doing Well While Doing Good: Doing the Right Thing with Socially Responsible Funds,” May 2003 (available at http://www.reish.com/publications/article_detail.cfm?ARTICLEID=381).

¹²⁷ *Increasing Shareholder Power*, *supra* at note 29, 118 *Harv. L. Rev.* at 850.

¹²⁸ Deutsche Bank “Beyond the Numbers, Corporate Governance: Implications for Investors,” April 2004 (concluding that (available at http://www.unepfi.org/fileadmin/documents/materiality1/cg_deutsche_bank_2004.pdf).

¹²⁹ *Id.*

¹¹⁵ *Id.* at 18; *see also id.* at 15 (“companies performing relatively well along environmental dimensions collectively provided superior returns.”).

¹¹⁶ Cynthia Harrington, “Socially Responsible Investing,” *Journal of Accountancy*, January 2003 (available at http://www.aicpa.org/pubs/jofa/jan2003/spec_har.htm).

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ 29 U.S.C. §§ 1001, *et. seq.*

¹²⁰ 29 C.F.R. § 2509.94-1.

¹²¹ *Id.*

¹²² *Id.*

and practices makes good economic sense and that good corporate governance fosters long-term profitabil-

ity. Simply put, good corporate governance does, in fact, pay.