Legitimacy and Corporate Governance

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In my remarks this morning, I want to draw attention to growing parallels between corporate governance and state governance, specifically between institutional features that are now becoming considered for corporate America and institutional features that have long been a mainstay of governmental institutions in the United States. Corporate *governance*, I want to suggest, is becoming structured much more like public *government*. This structure may well be critical for enhancing trust in corporations and capital markets, but it may come at some cost to other important values. Corporate governance is major issue for society and the economy, so we ought at a minimum to be conscious of the direction corporate governance reforms are heading.

I want to begin with the key linkage between power and legitimacy. For most of us, the concept of legitimacy is most deeply and persistently linked with the power of *government* – not of corporations. A *government* like that in the United States or other developed countries possesses enormous powers – powers of violence, powers of compulsion, and powers of conscription. And government possesses its powers in a unified, monopolistic manner. Of course, generally this is a good thing, for no matter what many of us may think about competition in the marketplace, free competition in the

kind of police powers possessed by government would not be a happy state of affairs. Indeed, the monopoly in such powers is precisely the solution to the problems of a Hobbesian world.

power – can be abused. It can be used to satiate the self-interested thirst of greedy CEOS at the expense of shareholders. It can be used to exploit workers, treating them inhumanely and failing to provide safe working conditions or suitable wages. It can be used to make profits at the expense of environmental quality, even putting innocent lives at risk from accidents or toxic pollution.

So the existence of power wielded by corporations means that the question of legitimacy can be applied to the private sector. And in our post-Enron, post-Worldcom, post-Tyco, post-Parmalat, post-corporate-scandal-of-the-week environment, it is precisely the kind of question being asked regularly in board rooms, stock exchanges, the Securities and Exchange Commission, the media, and in the academy. How can integrity and trust – that is, legitimacy – be maintained in the corporate world?

My thesis– and it's a positive or descriptive thesis – is that the prevailing responses to the question of corporate legitimacy have followed many of the forms of political or governmental legitimacy. More than ever before, corporate governance reforms bear a much closer resemblance to institutional mechanisms typically found in government.

Now, with government, legitimacy is usually conceptualized in two main ways: procedural legitimacy and substantive legitimacy. *Procedural legitimacy* is defined in terms of democratic accountability, with elections being the principal defining

otherwise procedurally legitimate legislature. When the US Constitution states that Congress shall make no law abridging freedom of religion, it is saying that even laws that might meet all the tests of procedural legitimacy will still be illegitimate if they restrict people's ability to worship freely.

There is a clear parallel with corporate institutions. What is called *corporate governance* is akin to procedural legitimacy. Corporate governance refers to, among other things, the assignment of separate powers to management, shareholders, and boards of directors, the creation of boards of directors through shareholder voting, and so forth.

What is the substantive legitimacy parallel? It's *corporate regulation*. Regulation imposed by government says that even properly constituted corporations with fully functioning boards of directors (a test of procedural legitimacy) cannot take actions that will pollute the environment or treat their workers badly or take money from investors. Regulation places side constraints on corporate managers in a way conceptually parallel to the side constraints that constitutions place on legislatures.

For the past thirty years or so, corporate regulation has placed many stringent and costly side constraints on how corporations can act. These side constraints are much, much more extensive and detailed than the side constraints the Constitution places on legislatures. But if the substantive constraints on corporations have been strong, until recently at least the forms of procedural legitimacy imposed on corporations have been considerably weaker than those found in government. It is here that I think the potentially most profound changes are taking place.

The major change in recent years in response to Enron, Worldcom and other corporate scandals has been decidedly procedural in nature. Corporate governance

reforms imposed on companies by the Sarbanes Oxley law of 2002, and various rules issued either by the stock exchanges or regulators such as the SEC, have together moved companies closer in the direction of government in terms of their institutional structures. Corporate management has become more procedurally constrained, using institutional features not too dissimilar to those procedural devices imposed on government.

Consider the following four institutional features – separation of powers, transparency, codes of ethics, and elections.

- *Separation of Powers*. Since at least the time of the Federalist Papers, a key structural feature of government has been the separation of powers, with ambition designed to counteract ambition, and a system of checks and balances between different branches of government. In principle, corporations have also long had their own checks and balances, with Boards of Directors responsible both for hiring the CEOs who actually run the company and overseeing their work, and with shareholders retaining the theoretical ability to challenge the slate of directors. While boards in theory provide a check on managerial power, they functioned for many years quite deferentially to the CEO. Indeed, a common cause of corporate scandals and skyrocketing executive compensation has been said to be weaknesses in boards' oversight. Remarkably unlike the kind of strict separation of powers observed in government, boards of directors have never been entirely independent of corporate management. Indeed, corporate managers (in particular, CEOs) themselves sit and vote on boards; in some cases the CEO is also the chair of the board, in many cases the CEO sits on the nominating

committee that selects new board members. Furthermore, even so-called independent board members, that is, those who do not work for the company, not infrequently conducted extensive business with the company.

Such conflicts of interest no doubt can cloud board members' judgment and reduce their incentives to look carefully at how management is running the company with the interests of the shareholders in mind. But the thrust of recent changes to the rules of corporate governance has been to make boards more independent than they have been, strengthening them by moving them a bit closer to the kind of strict separation of powers exhibited in national and state government. For example, Sarbanes Oxley imposed a requirement that the audit committees of the boards of public companies be comprised solely of independent board members, that is, those that neither manage the company nor accept consulting fees or other compensation from the company. New listing standards adopted by the stock exchanges seek to strengthen the independence of boards of publicly traded companies by limiting outside compensation and business dealings for board members. And in the mutual fund industry, the SEC has made dramatic changes to boards of directors, requiring that boards have independent chairs (something that previously only about 20% of the companies in the industry had) and that 75% of the members of the board be independent.

- *Transparency*. A key feature of procedural legitimacy for government has been openness. Laws need to be made in the open and information about most government functions must be made available to the public under laws such as the

Freedom of Information Act. In the business context, publicly traded companies have been, ever since the stock market crash in the early part of the last century, subject to a variety of disclosure requirements that similarly aim to create transparency. But Sarbanes Oxley has taken a series of steps designed to improve the accuracy of financial disclosures and increase transparency in corporations. CEOs and CFOs must now certify the accuracy of key financial statements, and companies now have a duty to update their financials and report material changes in the financial status of the company. New requirements that restrict auditors from performing non-audit services, limit conflicts of interest with auditing companies, and strengthen the regulation of the auditing industry all aim to make investors better aware of the true financial conditions of companies.

- *Codes of Ethics*. The federal government's code

- *Elections*. Elections are a major feature of procedural legitimacy for governments, and we are seeing some movement in the field of corporate governance that may eventually make corporate management more electorally accountable to shareholders. Formally speaking, shareholders do vote on members of the board of directors, but they typically only vote on one slate of candidates – those nominated by the existing board. Rarely are board elections real contests. Indeed, Lucian Bebchuk at the Harvard Law School has documented that for major companies – those with a market cap of over $200 million – meaningful electoral contests occurred in fewer than two companies a year on average during the period 1996-2002. This really isn't too surprising, since the Board, after all, effectively controls the ballot for itself. In response to this state of affairs, the SEC in recent years has proposed a relatively modest change in securities rules that would make it somewhat easier under certain conditions for candidates for a few board seats to be placed on the ballot by shareholders themselves. The rule has not yet been adopted, as it has engendered a firestorm of controversy given its symbolic importance. It is not clear where this modest proposal will end up. But suffice it to say, the fact that such a proposal has been seriously put forward by the SEC indicates yet another possible direction that corporate governance may head in the coming years, taking corporations a small step closer to the kind of electoral legitimacy exhibited by governments.

In these four ways, and in other ways, we see a movement in corporate America toward considering or adopting institutional features that have typically been characteristic of governments. This is not to say that corporate governance is becoming identical to the kind of politics exhibited

giving business managers the discretion they need to innovate and respond quickly to changing economic circumstances, and consider what will be lost if we make corporate governance too constraining. I suspect that few proponents of current corporate governance reforms would advocate making corporations fully as rule-bound and democratically open as government is. But exactly how far should we move in that direction? That is the key policy question that must be confronted. It is squarely on the table since corporate governance, as I have suggested, is increasingly taking on more of the institutional indicia of the governance of nations and states.