■ CORPORATE REFORM

Balance the powers

By Richard L. Wise & John J. Whyte SPECIAL TO THE NATIONAL LAW JOURNAL

THE CURRENT CRISIS in investor confidence is destabilizing international financial markets and creating a paradigm for insolvency not seen since the bank runs of the Great Depression. While some public action is appropriate, the private sector should demonstrate that it can put its own house in order—or the public sector will do it for us.

This crisis is the direct result of an imbalance of power in the corporate governance structure. None of the New York Stock Exchange's (NYSE) proposed standards from June for listing companies, the Nasdaq's proposed standards this month or the recently enacted corporate oversight bill, adequately address this imbalance.

Many of the changes proposed by President Bush and Congress are reasonable and warranted. But they focus on punishment rather than constructive corporate change. By analogy, if there were a crime wave, it might be helpful to impose stiffer penalties on thieves, but it might be more effective to have citizens lock their doors.

Let's alter the basic framework.

While the NYSE's and the Nasdaq's proposed new listing standards go a long way toward strengthening corporate governance systemically, they do not fully address the power imbalance in the corporate-governance structure. For example, while it is appropriate to assign more responsibilities to audit committees, unless they are given a meaningful power base from which to exercise those powers, they cannot effectively carry out their charge.

The multinational corporations whose shares are traded on the NYSE have the economic power of many large countries. Given the social and economic influence exerted by them, it is appropriate to examine the lessons to be learned from the balancing of power demonstrated by our constitutional democracy.

The imbalance of power in American corporate governance plays on two fundamental weaknesses: the unitary board and the incomplete contract between stockholders and management. There is a gross disparity in power between management and the board as represented by its audit committee. Changing these power dynamics can rebalance the process to establish accountability through oversight and protect the integrity of the oversight process. This can be accomplished by making six changes in addition to those proposed by the NYSE and Nasdaq:

- The chairman of the board and the chief executive officer of all listed companies should be two unrelated individuals. The chairman should also be a nonmanagement director.
- Directors' compensation should minimize the number of shares that nonmanagement directors have compared to their net worth. This would likely mean limiting or eliminating stock options for directors.
- Each corporation's audit committee should have on retainer its own independent counsel and independent auditing consultant (parties lacking any significant relationship with the company). They should be available for consultation and attend all audit committee meetings.
- Audit committee meetings must not be attended by any other management director or representative absent an invitation. Nor should they be held on the same days as board meetings.
- All changes in audit committee composition should be treated as would a change in outside auditor: with prompt public reporting and a detailed explanation for the change.
- Audit committee members should have three-year terms to ensure a reasonable period of tenure, staggered to provide continuity.

These proposals would fundamentally alter the framework of corporate governance, reducing the power of the CEO and the board chair over the oversight process and almost establishing a secondary board in the audit committee, albeit solely for oversight purposes. The proposals if implemented may be unpopular with CEOs and board chairs, but they enable the private sector to assure the investing public that an internally consistent methodology has been adopted that will prevent the majority of the sort of abuses that have recently provoked public outrage.

If management consists of men and women of principle, they will recognize that these steps can not interfere with their authority to manage their companies' day-to-day business. They should welcome the opportunity to have the propriety of their conduct certified. On the other hand, if management is unscrupulous, all the more reason that these recommendations need to be implemented. NLJ

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