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LEGITIMACY AND CORPORATE GOVERNANCE

BY CARY COGLIANESE

ABSTRACT

Parallels between corporate governance and state governance appear to be growing. This essay focuses on the suggestion that corporate governance is becoming structured much more like public government in certain ways. This shift may well be helpful for enhancing credibility and confidence in capital markets, but it also raises important questions. Will reforms enacted in the post-Enron era limit managers’ discretion to innovate, take risks, and respond quickly to changing economic circumstances? How far should society go in imposing on corporations the kinds of procedures found commonly in democratic governments?

INTRODUCTION

In recent years, the institutional structures of public corporations appear to be converging in notable ways with the institutional structures of public government. Changes to corporate governance may well be crucial for enhancing trust in corporations and capital markets, but they may also come at some cost to other important values. Because corporate governance is a major issue for society and the economy, we ought to take note of the direction corporate governance reforms are heading, if for no other reason than to assess the consequences of such efforts to increase corporate legitimacy.

POWER AND LEGITIMACY

I shall begin with a key linkage between power and legitimacy. For most of us, the concept of legitimacy is deeply and persistently linked with the power of government—not of business. 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, creating a monopoly in such powers is precisely the solution to the core problem of a Hobbesian world.¹

Yet the monopoly of legislative and police power in the government brings with it the potential for its own abuse—and also gives rise to the challenge of legitimacy. Legitimacy is what is needed to justify, in moral terms, the wielding of such enormous, monopolistic power. Of course, compared with the Hobbesian world, any old monopolist might be thought to be better than the brutish state of nature; however, life under an oppressive governmental monopolist can also be quite nasty, brutish, and short. Moreover, because the government wields power monopolistically, people do not have any realistic choice about whether they must submit to it. So, it is proper to demand more of a government than simply that it amounts to being the biggest thug around. We can and should ask whether government possesses legitimacy in addition to whether it has secured de facto monopolistic power.

All of this should be rather familiar. But what about corporations and their managers? They too exert significant power affecting people's lives in important ways.² Their power over employees is easiest to see. But business decisions also have major ramifications for investors, for customers, for those who inhabit the communities where corporations do business, and for the economy overall in cities and regions around the world. Even though corporations are unlike government in that they are voluntary associations, and also unlike government in that they have competitors, we still can and should ask whether corporate power is legitimate. Just as with governmental power, corporate power—more precisely, corporate managerial power—can be abused.³ 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.

²See Robert A. Dahl, A Preface to Economic Democracy 3 (1985) (noting that corporations are large employers and have important economic, social, and educational effects).
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 environment, it is precisely this kind of question that has been raised increasingly 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 is simply a positive or descriptive thesis—is that the prevailing responses to the question of corporate legitimacy have followed certain of the forms of political or governmental legitimacy. Perhaps more than ever before, corporate governance reforms bear a much closer resemblance to institutional mechanisms typically found in government.

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 characteristic, and also in terms of institutional arrangements like separation of powers, transparency, and rule of law principles intended to combat abuses of power.

Substantive legitimacy, in contrast, is usually defined in terms of rights, typically rights enshrined within a constitution that makes certain actions off limits even to an otherwise procedurally legitimate legislature. When the U.S. Constitution states that Congress shall make no law abridging freedom of religion, for example, it is saying that even laws that might meet all the tests of procedural legitimacy will still be illegitimate if they restrict citizens' 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

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5For a summary of the WorldCom scandal, see In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004).
6For a summary of the Tyco scandal, see http://www.tycofraudinfocenter.com (last visited Jan. 30, 2007).
7For a summary of the Parmalat scandal, see Gail Edmondson & Laura Cohn, How Parmalat Went Sour, BUS. WK. ONLINE, Jan. 12, 2004, available at http://www.businessweek.com/magazine/content/04_02/h3865053_mz054.htm.
8For a discussion of rights as side-constraints, see ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 26-53 (1974).
9U.S. CONST. amend I.
procedures for selecting and removing members of boards of directors, and so forth.

What is the substantive legitimacy parallel? It is 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, 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.

A SHIFT IN CORPORATE GOVERNANCE

For the past thirty years or so, government regulation has placed many stringent and costly side constraints on how corporations can act. These side constraints are 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 requirements for procedural legitimacy imposed on corporations have generally been much weaker than those found in government. It is here that I think the potentially most profound changes are taking place.

Some of the most important changes in recent years in response to Enron, WorldCom and other corporate scandals have 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 at least some 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

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12For a review of recent changes in corporate governance post-Sarbanes-Oxley, see Joel Seligman, A Modest Revolution in Corporate Governance, 80 NOTRE DAME L. REV. 1159 (2005).
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 companies and then 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 have 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) have sat and voted themselves on boards; in some cases the CEO has also served as the chair of the board or on the nominating committee that selects new board members. Furthermore, even so-called independent board members, that is, those not employed by the company, would still sometimes conduct 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 a company with the interests of the shareholders in mind. 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

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13The Federalist No. 51 (James Madison).
14For example, the Corporate Monitor's report in the WorldCom bankruptcy proceeding characterized the company's governance failings squarely in terms of a lack of checks and balances. Richard C. Breeden, Restoring Trust 1-2 (2003), available at http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/corpgov82603rpt.pdf (arguing that "the board of directors of the Company consistently ceded power" such that the CEO "was allowed nearly imperial reign over the affairs of the Company" and "there were no checks and balances"); see also Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 23-44, 201-16 (2004) (noting how weaknesses in corporate governance have kept executives from negotiating their compensation packages in an arm's-length manner, leading to excessive compensation).
compensation from the company.\textsuperscript{16} New listing standards adopted by the stock exchanges seek to strengthen the independence of boards of publicly traded companies.\textsuperscript{17} And in the mutual fund industry, the SEC has made dramatic changes to boards of directors, requiring that they have independent chairs (something that previously only about 20\% of the companies in the industry had)\textsuperscript{18} and that 75\% of the members of the board be independent.\textsuperscript{19}

\textit{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.\textsuperscript{20} 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.\textsuperscript{21} 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,\textsuperscript{22} and companies now have a duty to update their financials and report material changes in the financial status of the company.\textsuperscript{23} 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.\textsuperscript{24}

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\textsuperscript{21} See Joel Seligman, \textit{The Historical Need for a Mandatory Corporate Disclosure System}, 9 J. CORP. L. 1 (1983) (discussing the SEC’s mandatory disclosure system and analyzing the historical context which led to the system’s creation).
\textsuperscript{24} See generally id.
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Codes of Ethics. The federal government's code of ethics instructs public officials and public managers to "Put loyalty to the highest moral principles . . . above loyalty to persons, party, or Government department," to "Uphold the Constitution, laws, and legal regulations of the United States and of all governments therein and never be a party to their evasion," and to "Expose corruption wherever discovered." A governmental code of ethics is premised on the belief that inculcating norms of public-regarding behavior can help prevent governmental corruption.

The Sarbanes-Oxley law similarly adopts measures to expand the adoption of codes of ethics within companies. It also calls for the SEC to impose new obligations on corporate lawyers, requiring them to report to the corporate counsel or CEO any evidence of material violations of securities laws or serious breaches of the company's managers' fiduciary duties. Even in business, some protection against abuse may lie in efforts to create a culture of integrity.

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, Professor Lucian Bebchuk has documented that for major companies—those with a market cap of over $200 million—meaningful electoral contests occurred in fewer

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26 Id.
27 Id.
28 Id.
33 Susan A. Rose, Optional Cumulative Voting & Staggered Terms of Directors: Is the California Climate Warming to Corporations?, 27 SAN DIEGO L. REV. 467, 483 n.133 (1990) (noting that corporate boards remain fairly consistent because management's slate is "virtually assured of reelection").
than two companies a year on average during the period 1996-2002. This really is not 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 been adopted, as it has engendered a firestorm of controversy given its symbolic importance. It is not clear where a modest proposal like this will eventually end up in the years ahead. 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.

CONCLUSION

In these four ways, and in others, we see what appears to be 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 has become or ever will become fully identical to the kind of politics exhibited by democratic governments; far from it. Corporations are still much more hierarchical and unitary than government is, and corporate managers still possess a lot of power. But the kinds of responses and proposals adopted in the last few years clearly move corporations and their governance in a direction closer to the kinds of institutional arrangements that we have seen exhibited by liberal, democratic governments.

Recognizing as a descriptive matter that such a movement may be afoot is but the first step in posing the question of whether such a shift
would be a good one. In conclusion, I simply raise—though do not answer—the most important policy or normative question that lies ahead in corporate governance: how much procedural legitimacy should society demand of corporations? The procedural mechanisms that characterize governments often reflect a high level of risk aversion to the worst abuses governments can exhibit. They are conservative in that they make it harder for government to move with a unitary voice in a direction dictated by a single individual or a single faction. One result is that government is often criticized for its sluggishness and for its "gridlock." 39

Maybe sluggishness and gridlock are not necessarily such bad things for governments. How much gridlock and division, though, is tolerable in the corporate setting? Answering this question will depend in part on an assessment of the dangers of corporate power: the greater they loom, the more ambition should be designed to counteract ambition in the corporate world. But we must also consider the benefits that come from 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 if, as I have suggested here, corporate governance is increasingly assuming more of the institutional indicia of the governance of nations and states.

39See, e.g., JONATHAN RAUCH, DEMOSCLEROSIS: THE SILENT KILLER OF AMERICAN GOVERNMENT 10 (1995) (discussing the causes and consequences of governmental "gridlock").