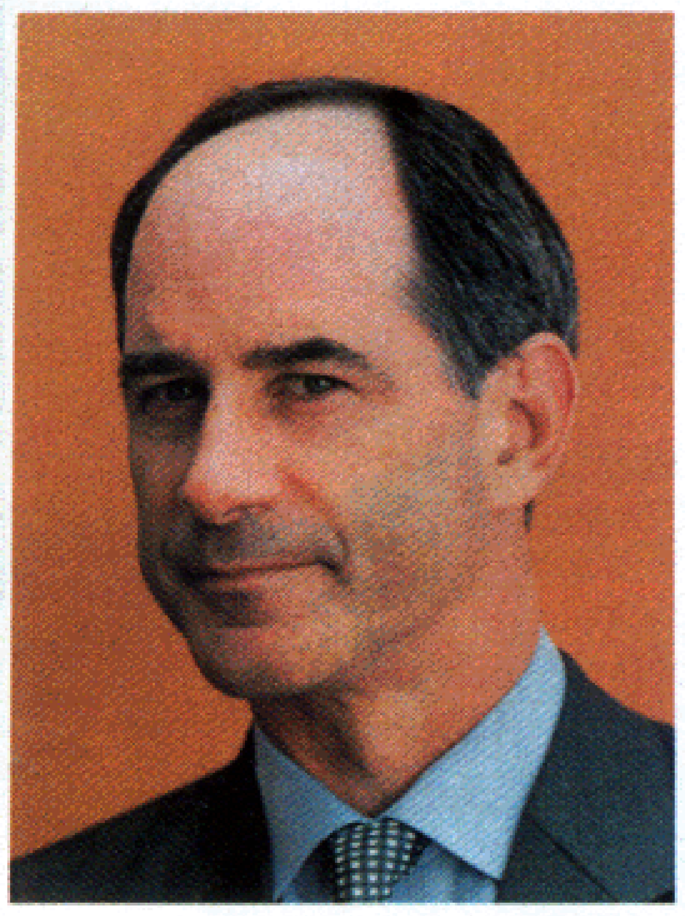
GUEST COLUMN



Commitment phobia

Too many investors are treating share ownership like anonymous sex. No wonder there's a governance crisis

IN BOTH THE UNITED STATES AND Canada, independent directors are the focus of attempts to toughen the governance of publicly traded corporations. More powerful and influential audit and governance committees, made up solely of independent directors, loom large in the proposed or legislated remedies. It would be great if these directors were supermen or superwomen, but they are mere mortals. So we have to ask, a) What is their real job? And b) Are they up to it? The answers are, a) A tougher job than we may think. And b) Probably not.

Independent directors are supposed to protect outside shareholders—the non-managers and non-controlling shareholders who have the least insight into the workings of the company and who, in theory, are the most vulnerable. There is no one else to protect the interests of outside shareholders. These directors are also supposed to give sage advice on things like strategy, but the company can easily hire consultants for that.

It seems to me there are just two possible roles for outside directors. Let's call the first State E—for easy. The company has a CEO like Berkshire Hathaway's Warren Buffett, who is committed to outside shareholders. The directors and the CEO spend their time patting each other on the back. The dark side of State E is that directors are largely redundant—there are nice dinners and off-site meetings, but the CEO et al. are already doing the directors' principal job.

Then there's State H—for hard. Think of YBM Magnex or Enron. The directors have to protect the interests of outside shareholders from a CEO or managers willing to subvert those interests to feather their own nests.

This is where governance reform gets tricky. The focus is on the general case, not where it needs to be—on State H. August bodies such as the 2002 Ontario Securities Commission and Toronto Stock Exchange joint committee on corporate governance, chaired by Guylaine Saucier, argue that if management doesn't want an independent board chair, it's okay to have a "lead director" instead who is sort of like a board chair, but not quite.

But in State E, the CEO won't object to an independent board chair, so there's no need for a lead director. In State H, why would managers allow anything but an easily controlled lead director? Also, who will sign up as an independent director to discipline a CEO who they know is inclined to take advantage of outside shareholders? Is it a well-paying job? No. Is it prestigious? Ask the directors of YBM Magnex, Enron, Bre-X, WorldCom, etc.

Is it fun? Hell, no. I can speak from experience. It's no fun at all confronting a CEO who is not even modestly interested in being governed. It is miserable, lonely, annoying, unrewarding and, most importantly, ineffective. The CEO has a decisive power and an information advantage over any independent director, and in State H, he or she is motivated to use it.

Outside directors won't save you. Confronting renegade CEOs is no fun for them either

So why would reasonably intelligent people sign up for the task? Because they think, hope or pray it is State E. When they get State H, they are usually unprepared to dive into the miserable challenge at hand. This was the case with the highly qualified group of Enron directors, including its audit committee chair, Robert K. Jaedicke, former dean of Stanford Business School and a respected accounting professor. Thanks to a preponderance of CEOs who are also board chairs, along with directors not interested in dirty work, the diving-in doesn't happen consistently.

This is why we have a crisis. Most corporate governance is, in effect, great but unnecessary. In State E when we need it least, we get it most—great directors flock to great firms with great leadership. In State H when we need it most, we get it least—weaker directors gravitate to weak firms with weak leadership.

So what's the answer? Let's think a minute about the outside shareholders who need to be "protected." Directors and management have only a vague notion of who these people might be. They can sell their own shares at the slightest whim without explanation. This is roughly the relationship depth of anonymous sex. Remind me again why these shareholders think they deserve flawless protection by independent directors?

They don't, and that's the root of the problem. Shareholders get the protection they deserve. If they want serious commitment from independent directors, they too have to discover commitment. Unilever shouldn't have to ask why 10 of its large shareholders didn't even vote at its last annual meeting. Institutional investors will have to work a lot harder, and even individual shareholders won't be able to "fire and forget" with their investments. Until then, don't be too surprised by any sequels to YBM Magnex, Enron, Bre-X or WorldCom. R

Roger Martin is dean of the Rotman School of Management at the University of Toronto. **Eric Reguly** returns next month