Expert: Flawed corporate watchdog methods helped fuel economic crisis

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Archaic corporate governing systems that failed to ferret out risky business deals helped stoke the nation's deepest financial meltdown since the Great Depression, a University of Illinois business law expert says.

Law professor Larry E. Ribstein argues the traditional, corporate-run firms that dominate the nation's Fortune 500 are ill equipped to prevent dicey management decisions that have choked credit markets, sparking a massive, taxpayer-financed Wall Street bailout.

But he says those problems could be averted by shifting to the partnership-style structure of hedge funds, private equity firms and other "uncorporate" businesses, which have better weathered the crisis through controls that include more closely tying managers' compensation to company financial fortunes.

"There's nothing like the fear that you yourself are going to lose money," said Ribstein, an authority on corporate and partnership law. "With corporations, everyone has long known that the oversight of managers is imperfect and it's always going to be."

Shareholders in traditional corporations have limited options to monitor powerful managers, said Ribstein, who wrote an article titled "Partnership Governance of Large Firms" that will appear in the University of Chicago Law Review. Even those scant alternatives, such as electing directors to oversee company operations, offer little direct control, he says.

"In corporations, boards of directors are supposed to be independent, which means that they don't really have strong incentives to pay a lot of attention to what's going on," Ribstein said. "They worry more about making some embarrassing mistake than trying to identify the fundamental problems that need to be fixed."

In contrast, he says, hedge funds and other "uncorporations" rely on incentives and discipline that essentially make managers partners in the operation and less likely to take needless risks that could ultimately cost both them and owners.

As a result, those partnership-based firms ducked miscalculations about the real estate market that sank traditional corporations such as Lehman Brothers and forced a $700 billion government bailout of others, Ribstein said.

He says the relative success of "uncorporate" firms during the nation's financial crisis earned a de facto government endorsement recently when the Federal Reserve relaxed restrictions prohibiting private equity firms from investing in banks.

"It was a desperation move by the Fed that was consistent with current economics, where the better governed firms are the ones with money," Ribstein said. "Whatever prejudice there was against private equity firms is diminishing. We can't afford to have prejudice against anyone who has money today."

Ribstein hopes the recent failure of corporate governing systems resurrects a
wake-up call for corporate America that was overlooked when the aftermath of Enron's collapse veered toward criminal charges rather than an investigation of internal problems.

"The Enron board was actually very sophisticated, but it turns out they didn't really understand what was happening in the company," Ribstein said. "And I think that we'll find that's true with the boards of the companies that are going bust today."

"There are now governance mechanisms demonstrated by hedge funds, private equity firms and others that are actually superior to the corporate form," he said. "And it's not just a matter of superiority. It's apparent that traditional corporate governance mechanisms just can't keep up with the modern world of finance."

Source: University of Illinois at Urbana-Champaign

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