CHAPTER 2

The changing nature of corporate governance

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Introduction

[2.1] Corporate governance in context

The objectives of this chapter are to provide a contextual backdrop and to examine the continuing evolution of the subject of corporate governance. An understanding of the forces that have shaped modern

corporate governance is important, as it helps to explain the evolution of many of the roles, activities and practices of the modern Australian board. The recommendations for leading practice in corporate governance contained in the Corporate Governance Practice Framework are frequently the direct result of the forces outlined in this chapter. Among other roles, corporate governance addresses the concerns of capital providers:

- how to assess the risk associated with their capital investment in a firm's resources;
- how to achieve maximum returns on their investment; and
- how to monitor the administration of their capital on an ongoing basis.[1]

Corporate governance practices have evolved with the growth of the capitalist system and in parallel with the unprecedented expansion and development of the world's economies.

Economic expansion has both accompanied and led to massive social change. The industrial revolution, the growth of managerial capitalism, the new knowledge economy, the shifting composition of the workforce, and changes in the very nature of work itself, represent a complex intertwining of economic and social forces. The complex interplay between social, legal and economic change is one of the major themes running through this book, because ongoing change at both domestic and international levels continues to shape the corporate governance landscape.

Arguably, the most important influence driving these changes has been the advent of the modern limited liability company. The growth of the modern corporation has led to a fundamental change in how economies function internationally. As the power of the corporation has expanded, corporate governance systems have also evolved and adapted to reflect this complex interplay between economic and social change, including changes in the law.

With the advent of the limited liability company, two fundamental changes in business operations took place. First, business owners were able to separate the inherent risk of an entrepreneurial business venture from their more traditional and stable wealth-generating activities. The ability to undertake projects with an increased risk profile enabled the exploitation of many lucrative (though risky) enterprises, including: trade ventures, international commodity operations as well as mineral exploration and extraction.

Secondly, the limiting of liability also encouraged people to amalgamate their resources to pursue enterprises that required a large

capital investment. This ability to consolidate wealth bore fruit in the industrial revolution of the 19th century and the information revolution of the 20th century.

However, as the modern corporation developed, the source of ultimate corporate control and responsibility was often overlooked. Given the general fragmentation of ownership and limitation of responsibility (ie liability), who was ultimately responsible for the actions of a firm? It is the relationship between owners, directors, managers and society that is fundamental to corporate governance.

Corporate governance itself can be defined as "the relationship among various participants in determining the direction and performance of corporations"[2] or as "an umbrella term that includes specific issues arising from interactions among senior management, shareholders, boards of directors, and other corporate stakeholders".[3] While these definitions may differ slightly, it is clear that corporate governance concerns the relationship between corporate stakeholders. In particular, it emphasises the relationship between the owners and the managers of the corporation in setting the purpose and defining the direction of a company. But corporate governance goes beyond this, to the board's roles and processes, which are at the heart of this book. This point is emphasised in the following statement from international governance expert Mervyn King:

> The standard definition of corporate governance is *the way in which companies are directed and controlled*. A more informed definition would be *processes to help directors discharge and be seen to be discharging their responsibilities created by their duties*. This definition applies equally to all entities which are governed.[4] [Emphasis added.]

[2.2] Chapter overview

To review the role of corporate governance in modern society, this chapter begins with a discussion of the historical development of the limited liability company. The growth of the modern corporation is considered in relation to the economic and social changes that occurred between the 18th and 21st centuries. The chapter then examines how these changes interacted with the legal system and how corporate governance systems developed. Next, we look at the four main theories of corporate governance that attempt to link governance practices with corporate performance. We then summarise the changes in corporate governance practices over time and consider the impact of these changes in terms of the performance expectations of directors. Finally, the chapter ends with an overview of the one of the most fundamental questions in relation to corporate governance – what is

board effectiveness? – and outlines a model that seeks to answer that question, the intellectual capital framework.[5]

Evolution of corporations and corporate governance

[2.3] Origin of corporations

While records of companies date back to Phoenician sailing ventures (about 2000 BCE), the modern corporation has its roots in the Middle Ages. During this time monasteries and local government boroughs were granted ownership rights as legal entities. For the first time, corporate ownership was differentiated from personal ownership. This dispensation, given by Royal Charter, was subsequently extended to guilds and other organisations to allow individuals to pool their resources for the common good. In the 18th century, this privilege was extended to a select group of trading companies. Accompanied by national monopoly trading powers, this dispensation enabled a small group of traders to become enormously powerful. As a result, the 18th century was an era when major trading companies, such as the East India Company and the Hudson Bay Company, drove Europe's economies.

Other high-risk international trade ventures outside these particular trading companies were (except in the rare cases that had parliamentary dispensation) operated by sole traders, partnerships or unlimited companies operating under a deed of trust. In each case, the owners of the firm were personally liable for all debts should the business fail. This personal liability for high-risk ventures acted as a brake on the willingness of investors to take part in potentially lucrative trading opportunities. Britain was the first country to recognise this impediment to future economic development and in response devised the concept of limited liability.[6] Thus, in the mid-1800s Britain enacted a series of laws that facilitated high-risk ventures such as trade, and so encouraged the continued expansion of this unpredictable yet profitable area of business.

A need for venture capital and limited risk was not the only reason that the corporate structure proved so positive a force in global development. The need for citizens to pool resources in profit-seeking enterprises grew with the advent of the industrial revolution and the necessity to tap into large sums of capital to fund the industrialisation of Britain and other Western nations. In much the same way as the early boroughs and guilds of the Middle Ages banded together to develop common interests, ordinary people with the means could

come together to finance new business ventures arising from the opportunities created by the industrial revolution.

Factories and huge iron-based manufacturing industries formed the basis of British economic expansion at home and abroad. Within Britain, infrastructure items such as railways, port facilities and town utilities were required to support the increasing urbanisation of the population. Abroad, the mighty steamships that were also a product of the industrial age opened up new trading opportunities. In a self-reinforcing cycle, industrial expansion, initially encouraged by changes in corporate structure, fuelled the expansion of international trade and spurred the success of the limited liability company. As British power expanded globally during the 19th century, British business systems were exported throughout the Empire. British law came to form the basis of company law throughout much of the world including the US, Hong Kong, Singapore, South Africa, New Zealand and Australia.[7]

[2.4] Concerns with growing corporate power

The first check to the growing power of corporations came at the end of the 19th century. In response to a number of anticompetitive practices (particularly the activities of the railroads) the US began to enact the first antitrust (or trade practices) laws. The American *Sherman Act 1890* (US) (Sherman Act) was a response to the concentration of economic power in large corporations and associated anticompetitive business practices. The Sherman Act declared illegal any business collusion that sought to restrain trade or commerce. Specifically, it prohibited a firm from attaining or preserving monopoly power through anticompetitive acts. The Sherman Act was a response to the development of the number of "trusts" that had been established in many industries, particularly agriculture, to prevent price competition. The Sherman Act was influential in many parts of the world, including Australia. After Federation, Australia's legislators looked to the Sherman model when framing the nation's first anticompetitive legislation (the precursor of modern trade practices law, discussed in more detail in Chapter 3).[8] While the first brake on the power and governance practices of limited liability companies had been applied, it was largely ineffectual and the expansion of the modern corporation continued.

[2.5] The managerial revolution

From the turn of the 20th century, the expansion of the corporate system was fuelled by the increasingly successful nature of capital-intensive endeavours. As a result, the number of limited liability corporations expanded. At the same time as the number of companies

was increasing, the founders of early companies were passing their shareholdings on to family members. Often, a single shareholder (founder) would pass the shares on to a number of heirs. This resulting division of shareholdings led to a general trend towards fragmentation or dilution in ownership concentration. At the same time, many of these firms needed to raise additional capital to fund continuing growth. Consequently, there was a general trend of ownership and control passing from a single individual or family to a wider body of shareholders.

Professional managers who held little or no equity in the companies they managed, now increasingly controlled firms. This shift from "proprietorial capitalism" to "managerial capitalism" has been termed the "managerial revolution"[9] and is detailed in the seminal work of Berle and Means, *The Modern Corporation and Private Property*.[10] The greatest concern that accompanied this change in control was the fear that professional managers would defraud their external owners. As a result, there was a significant increase in emphasis on the board's role as a watchdog on the actions of management.

If there was a concern as to the trustworthiness of managers, why did owners not reassert direct control over their companies? The answer lies in the continued growth in the size and complexity of firms as well as the increased spread of ownership which now comprised of many companies, institutions and individuals. This complexity meant owners became increasingly reliant on professional managers, especially in the large corporations that developed following the unprecedented economic expansion in Western nations after World War II. This growth was sustained throughout the 1950s and 1960s, and managerial capitalism reached its zenith during this period as the "company man" was sent forth (especially from the US) to conquer foreign markets. During this period, corporate control (including responsibility for functions now seen as the proper domain of directors) rested largely with professional managers. Boards were seen as "rubber stamps" for management activities.[11]

[2.6] Interruption to economic expansion

The second check to the seemingly unlimited expansion in the role and power of corporations and their managers occurred in the 1970s. During this turbulent period several significant economic changes had major impacts on Western economies. The most important of these was stagflation caused largely by the oil crises and increased international competition from Asian nations (particularly Japan). Large corporations became subject to increasing criticism as economic growth slowed and they began looking for new opportunities. This

was a period of widespread diversification that reached its peak in the mid-1970s as large companies increasingly sought new ways to expand their business empires.

As corporations expanded beyond traditional business lines, they experienced limited success. Coupled with general inertia due to size and the first real economic turbulence in more than thirty years, listed companies found their shares were often valued at less than their asset backing. Additionally, investors and entrepreneurs came to believe that they could make greater returns from these businesses than the current management. As a result, there was a sharp increase in the number of hostile takeover bids during the 1980s. New words such as "management buyouts", "junk bonds", "poison pill", "greenmail" and "white knight" entered the corporate vocabulary.[12] These were the terms used to describe the way in which certain takeover deals were financed, and the tactics adopted by target companies as they attempted to defend themselves. Many commentators saw these takeovers as the market disciplining the inefficiencies and managerial incompetence of the 1970s. As well as external pressure from investors, the 1970s and 1980s saw a general rise in company debt and a greater discipline enforced on managers.[13] The leveraged buyouts of the 1980s saw professional managers replaced with owner-managers backed by debt financing, causing some respected academics to proclaim the death of the public corporation.[14] These owner-managers, by their actions, signalled that they believed they could run the business more profitably as owners.

Until the 1960s, as long as corporations were successful, their motives and methods of doing business remained largely unchallenged. The general and sustained decline in profitability for the major corporations during the 1970s and 1980s, however, saw the activities of large corporations increasingly scrutinised by the investment community and the public as companies restructured and staff were retrenched. After two decades of unchecked expansion, economic growth had stagnated and unemployment was rising. In this environment, the increasingly generous remuneration and benefit packages for directors and managers became the subject of public criticism. These practices, combined with the evidence of fraud and mismanagement, led to calls for reform of the corporate governance system, and of the law, to make directors more accountable for the activities of their companies.

Following this initial surge of market discipline, the 1980s and 1990s saw calls for increased investor activism. Rather than wait until significant shareholder value was destroyed, shareholders were increasingly exhorted to make known their views on corporate

performance and use their voting power to express disapproval rather than passively accepting board and management decisions.[15]

Economic uncertainty came to a head in the market crash of 1987. Issues of high leverage and fraud were clearly responsible for both the well-publicised corporate failures of the late 1980s (eg Bond Corporation, Rothwells, Pyramid, Qintex) and the exposure of poor board and executive performance (eg Westpac, Coles Myer). These economic factors precipitated the calls for corporate governance reform but they were not the only forces driving the reform agenda. Social change also had played an important role.

[2.7] The impact of social change

The economic upheavals at the end of the 20th century coincided with several major social changes, in particular, the growth of community or stakeholder activism. As a result of the wealth created by the corporate system, citizens now had the resources and the time to question and protest the activities of the companies that they perceived were affecting them (or even more broadly, humanity) adversely.

As the information age blossomed, activists were better informed than ever before. Mass media coverage of important social issues encouraged the formation of coalitions of activists such as the antidiscrimination movement, the environmental movement and the anti-globalisation movement. Social activists gained a great deal of publicity for their causes and much of it reflected badly on the large corporations. Consumer activists such as Ralph Nader with his exposé of the Ford Pinto debacle, where the company was shown to put profit ahead of human safety by deciding not to recall the car, even when its defects were known, succeeded in arousing public outrage. The Exxon-Valdez disaster, where the actions of a corporation threatened an entire ecosystem, and accusations about Nike's use of child labour are further examples of social concerns that raised serious questions about the integrity of the major corporations.[16] Similarly, bribery allegations such as Lockheed's bid for Japanese orders have generally brought into question the ethical standards, management decisions and corporate governance practices of large corporations.

Clearly, the age where a company could make decisions isolated from community concerns has passed (if indeed it ever existed). As investors and the business community have pressured company leaders for better economic performance, community expectations for better corporate social performance have risen as well. It is with these rising expectations in mind that we examine the most topical trend affecting the modern corporation – globalisation.

[2.8] Globalisation

As discussed, social trends such as the environmental and antidiscrimination movements are inextricably linked with the major economic changes that have occurred over the last thirty years. Perhaps the most prevalent of these changes has been the internationalisation of business. During the last twenty years competition between firms has become increasingly internationalised, resulting in a more competitive business environment that has placed added pressures on the modern corporation. There have been a number of reasons for this.

First, international trade of goods and services takes place more intensively and in a wider range of industries than ever before. For example, the ratio of international trade to gross domestic product (GDP) more than doubled in most advanced countries between 1960 and 1990.[17] One of the main drivers of this trend has been the gradual reduction in trade barriers throughout the world – for example, the General Agreement on Tariffs and Trade (GATT) talks, the Single European Market (SEM) agreement in Europe, the North American Free Trade Agreement (NAFTA) and, of particular importance in the Australian context, the Association of South-East Asian Nations (ASEAN) agreement. The aim of all these agreements has been to reduce or abolish important tariffs and quotas globally.

Secondly, for most of the post-war period the dominant manufacturing nations had been in Western Europe and North America, there has and continues to be a growing competitiveness of newly emerging Asian economies. Thirdly, multinational companies have increased their share of output, employment and investment in almost all nations. With this rise in cross-border investment, domestic producers face the dual pressures of increased overseas competition through international trade and increased competition from overseas competitors setting up trade in their own countries. This has resulted in an increasing proportion of national output being controlled by foreign-owned companies.[18] Finally, advances in technology (noticeably in information technology, communication and transport) have enabled the almost seamless operation of global firms, which has further fuelled this trend.

The trend towards globalisation has affected the operating environment of the modern corporation in a number of ways. First, the balance between public and private sector organisations has changed. An overall push for greater public sector efficiency and the related trend towards privatisation of certain government activities has led to a shrinking of the public sector. Secondly, there was a growing sense throughout the 1980s that in order to compete globally,

companies needed to operate in a free market. This meant reducing the power of unions and building a more flexible work force based around contract and part-time labour – a major change in the labour market.

The globalisation trend has not only affected direct competition for business inputs (eg labour and resources) and finished product markets. Importantly, it has also driven significant changes in the world's capital market. As global investment opportunities become accessible to investors, companies need to compete for the limited capital available. In the Australian context, it has resulted in a substantial deregulation of the financial markets, in which the Australian Securities Exchange (ASX) plays a pivotal role. This is discussed in more detail in Chapter 3.

The globalisation of capital has had profound implications for corporate governance when coupled with the move towards increased institutional investment in the share market. The increasing concentration of ownership brought about by institutional investing has led to what Hilmer and Donaldson term "a resurgence of proprietorial capitalism".[19] As managers and boards are called to account by fund managers the "sovereign power of the owners is being asserted over that of managers, who are to be reduced to their supposedly rightful place as company servants".[20] This reassertion of ownership control pointed to continuing changes in governance practice and the need for boards to focus on accountability for firm performance.

[2.9] Technology boom and bust

The late 1990s was a time of "irrational exuberance" in the US, as the then Federal Reserve Chairman Alan Greenspan famously put it.[21] During the second half of the decade, the US had experienced the continuation of one of its longest periods of economic expansions.[22] Under the leadership of Greenspan at the Federal Reserve, US banking and securities markets were deregulated allowing for growth in capital markets and the proliferation of complex financial instruments known as derivatives including collateralised debt obligations (CDOs), which are essentially a pool of debt by a group of borrowers added together and sold as a set of bonds paying a range of different interest rates. At the same time, the emergence of the internet and the ever increasing use of computer technology saw the stock market soar on technology stocks, initial public offerings (IPOs) were eagerly snapped up, and commentators predicted ongoing high returns.[23]

But the "money machine"[24] began unravelling in March 2000, which saw the bursting of the tech bubble as share values were written

down and many shareholders suffered for failing to recognise the downside to investments with a high risk/reward profile. Such was the enthusiasm for internet companies that Boo.com, a clothing website founded by three twenty-something Swedes, gained the backing of JP Morgan after faxing a five-page business plan to the major Wall Street banks. Boo.com lasted 18 months (closing in May 2000) and lost US$135 million.[25] Other backers included Goldman Sachs, the Benetton family and Bernard Arnault, chairman of LVMH (Louis Vuitton Moet Hennessy).

Another victim of the dot.com bubble was UK corporation Marconi plc, which was formed in 1999 out of the IT and communications businesses of the General Electric Company (GEC). The board allowed its new managing director to use the company's accumulated capital and then begun borrowing in a bid to transform the conservative GEC into a cutting edge technology firm. GEC had been one of Britain's largest companies in 1999 with a market capitalisation of £35 billion. By August 2002, it was struggling to survive and its market capitalisation had fallen to £100.5 million.

During this bull market, companies such as Enron, WorldCom and Adelphia Communications had been pursuing their own interests by inflating company share prices in an effort to continually meet or exceed Wall Street expectations and disguise their true operating performance from investors. Indeed, accounting scandals were reaching epic proportions. For example, Xerox admitted to improperly inflating its revenues by $6.4 billion, while Bristol-Myers-Squibb inflated its 2001 revenue by $1.5 billion.[26]

But it was the Enron bankruptcy – then the largest in history[27] – that would have the most far reaching consequences for corporate governance. Enron's stock had risen in the 1990s from a low of $7 to a high of $90 in 2000, but declined to under $1 by the end of 2001 in the wake of two restatements of net income, which reduced its shareholder's equity by $17 billion. Enron's problems arose from its use of accounting loopholes, special purpose entities, and poor financial reporting to hide billions in debt from failed deals and projects. The Enron Board, its Audit and Compliance Committee and auditors were all criticised for their lack of oversight of Enron's financial dealings and the activities of management. The provision of generous stock option schemes and executive remuneration packages provided to senior executives at Enron and other US corporations also come under fire.

Following the collapse of Enron and the end of the tech bubble, public outrage provided the basis for numerous corporate governance reforms including revised listing standards for corporate governance

and disclosure by the New York Stock Exchange (NYSE) and the *Sarbanes-Oxley Act of 2002* (US) (SOX), which sought to strengthen corporate governance and establish greater objectivity and independence amongst auditors.

Australia was not immune from its own high profile corporate failures during this time with HIH Insurance, One.Tel and Ansett Airlines all collapsing in 2001. HIH Insurance, which had losses estimated to be between $3.6 billion and $5.3 billion, was the subject of a Royal Commission which reported its findings in April 2003. The Report of the HIH Royal Commission identified a number of possible breaches of the *Corporations Act 2001* (Cth) (Corporations Act) and the *Crimes Act 1914* (Cth) and made 61 policy recommendations on corporate governance, financial reporting and assurance. These recommendations were considered in the finalisation of the Australian Government's Corporate Law Economic Reform Program (CLERP 9) amendments to the Corporations Act, which dealt with continuous disclosure, including the introduction of personal liability for breach; auditor independence; accounting standards; expensing of options; compliance controls; and encouragement of greater shareholder participation at meetings. The collapse of HIH Insurance as well as telco, One.Tel in 2001 also influenced the introduction of the ASX Principles and Standards Australia's *Good Governance Principles*, which were both released in 2003.

[2.10] Global financial crisis

After the dot.com bubble burst and corporate scandals such as Enron and WorldCom became yesterday's news, global financial wealth moved to the real estate market due to the availability of money and to over-the-counter (OTC) derivatives – a largely unregulated market with respect to the disclosure of information between parties; for example, banks and hedge funds. Millions of home mortgages especially subprime mortgages (that is, a housing loan made to someone with a weak or troubled credit history) were bundled into securities and sold to banks, financial institutions and other investors in the US and globally. Credit rating agencies such as Standard & Poor's, Moody's and Fitch gave most of these mortgage backed securities AAA ratings, which marked them as investment grade.

Until 2006, the US housing market was flourishing. It was easy to get a home loan, so more people wanted to buy a house for their own use or as an investment, which pushed up prices. However, the average income in the US did not keep pace with the housing market.

Mortgage defaults left banks with a liquidity crisis that began a chain reaction causing the world economy to slow down, property prices to fall and credit to tighten.

Governments around the world began propping up troubled financial institutions, such as Northern Rock in the UK, as the fallout from the housing collapse worsened. However, it was the demise of Lehman Brothers in September 2008 that marked the official beginning of what is now termed the "global financial crisis" (GFC). The GFC revealed severe shortcomings in corporate governance, which did not serve its purpose to safeguard companies against "excessive risk taking" in financial institutions as well as board approved remuneration systems that were not "closely related to the strategy and risk appetite of the company and its longer term interests".[28]

The GFC led to changes to governance rules, regulations and reporting requirements internationally, including reforms to enhance global financial stability from various organisations such as the Group of Twenty (G20) countries, the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and the Bank for International Settlement (BIS). For example, the global regulatory standard (BASEL III) on bank capital adequacy, stress testing and market liquidity risk, which was agreed upon by the members of the Basel Committee on Banking Supervision in 2010-11.

Among the US responses to the collapse of Lehman Brothers and other financial institutions in 2008 such as Bear Stearns, Fannie Mae, Freddie Mac and American International Group (AIG), was the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (US) (Dodd-Frank Act). The Act was signed into law by President Obama on 21 July 2010. It spans over 2,300 pages and affects almost every aspect of the US financial services industry. The objectives ascribed to the Act by its proponents include restoring public confidence in the financial system, preventing another financial crisis, and allowing any future asset bubble to be detected and deflated before another financial crisis ensues. Specifically, the Act aimed to:

1. promote US financial stability by "improving accountability and transparency in the financial system";
2. put an end to the notion of "too big to fail";
3. "protect the American taxpayer by ending bailouts"; and
4. "protect consumers from abusive financial services practices".

While Australian institutions were not as exposed to the same degree as other countries to securitisation products such as CDOs, there were corporate collapses; for example ABC Learning Centres,

Allco, Opes Prime and Storm Financial. Among the reasons for Australia's strength during this crisis was the financial regulatory regime and oversight role played by both the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA). However, in accordance with the acknowledged link between incentive-based executive pay, increased risk taking and the global financial crisis, the Australian Government introduced amendments to the Corporations Act with respect to executive remuneration, which are discussed further in this chapter. Similarly, in accordance with the Financial Stability Board's *Principles for Sound Compensation Practices*, which were endorsed by the leaders of the G20 in April 2009, APRA introduced a requirement that regulated entities have a remuneration policy that aligns remuneration and risk management as well as a board remuneration committee comprising at least three independent directors.

It has also been recognised that such regulation alone is not sufficient to avert future financial crises without attention also being paid to the social norms that surround financial markets.[29] For example, Nicholson, Kiel and Kiel-Chisholm have argued for the re-establishment of professional responsibility within the financial sector noting that the norm of caveat emptor (buyer beware) is problematic when the complexity of financial products becomes too great to readily assess.[30] Similarly, the norm of self-interested behaviour needs to be challenged when the entire financial system is put at risk.

The advent of a "Stewardship Code" for institutional investors in the UK is an example of the recognition that governance responsibilities extend beyond companies and their boards. Published in July 2010, the *UK Stewardship Code* aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities by setting out good practice on engagement with investee companies.[31] The European Commission is also considering action at the European Union (EU) level on the use of stewardship codes and other measures intended to motivate shareholders to engage with and monitor the financial institutions in which they invest. Thus, we will continue to see efforts being made on how boards, management, shareholders and stakeholders can create long-term corporate and shareholder value while at the same time meeting societal expectations.

So far, we have focused on the historical development of the general limited liability company. In particular, we traced the major social and economic changes that shape the corporate governance

landscape in which firms operate. Any historical review of the corporate governance system, however, would be incomplete without a review of the legal environment.

The emerging legal framework for corporations

[2.11] Development of the legal framework

Changes in the business environment both reflect and influence the evolution of the legal framework covering companies and directors. As outlined, the limited liability corporation is a legal fiction created to facilitate two purposes – the pooling of resources and encouraging sensible commercial risk taking. Since corporations are a legal fiction, it was necessary for legislation to be invoked to bring them into being. Consequently, in the mid-1800s, three Acts were passed in the British Parliament that moved Britain from a tightly regulated nation to one of the most permissive corporate environments in the world.[32] The first of these Acts was the *Joint-Stock Companies Act 1844* (UK) that required all unincorporated companies to be registered; the second in 1855 allowed for the limitation of debts for an investor in a limited liability company; and the third in 1862 was a consolidating Act.

These early forms of corporate legislation established the limited liability company as a separate legal entity by interposing a corporate veil between the corporation and its owner(s). This early legislation also created the position of directors and the concept of the board. However, this corporate veil led to a justifiable concern that the corporation could evade legal obligations unless a series of appropriate legal relationships to ensure ultimate responsibility for corporate actions was established. In Australia, early corporate law adopted the English model for defining these relationships.

As each of the colonies modified the original English legislation, a lack of uniformity emerged in the laws between the Australian colonies (and later the states). This problem persisted even after Federation. Due to the High Court's narrow interpretation of s 41(xx) of the Australian Constitution, which concerns the Commonwealth's power to make laws with regard to the creation of companies, the Australian Government was precluded from developing a unified legal companies code.[33]

However, the need for a national approach to corporations law became evident as Australia grew. The *Uniform Companies Act* was introduced in 1961 and enacted by each state in an attempt to address

the discrepancies between the laws in each state.[34] While this was a step forward, it did not solve the conflicts between the laws in different states. However, the momentum for a truly uniform system of legislation did not develop until the 1970s and 1980s as a result of two factors:

1. community outcry regarding the company failures and the endemic problems of the 1970s and 1980s; and
2. the increasing complexity of the modern business environment.[35]

While the general need for a national system to promote efficiency was recognised, such as in the recommendations of the Senate Standing Committee on Constitutional and Legal Affairs in a 1987 report,[36] it was really the economic crisis of the stock market crash in 1987 and growing public disquiet that finally convinced the government to pursue uniform federal corporations legislation. In 1989, the federal government introduced a legislative package that would give it complete responsibility for the regulation of companies and securities law. The three Acts that formed this package were the *Corporations Act 1989* (Cth), the *Australian Securities Commission Act 1989* (Cth) and the *Close Corporations Act 1989* (Cth). Before the *Corporations Act 1989* (Cth) came into operation, its constitutional validity was challenged in the High Court by New South Wales, South Australia and Western Australia. The High Court held, by a majority of six to one, that the Commonwealth had no power to make laws for the incorporation of companies.[37]

Following this decision, ministers of the Commonwealth, state and territory governments responsible for companies and securities met in order to discuss a compromise scheme. As a result of these discussions, the original *Corporations Act 1989* and the *Australian Securities Commission Act 1989* were substantially amended by the *Corporations Legislation Amendment Act 1990*. The effect of these amendments was to "federalise" existing state companies legislation,[38] and to create a national scheme that made both the legislation and administration of companies and securities uniform across Australia.

Accordingly, until July 2001, Australian corporate conduct was primarily regulated by the following Acts:

- the *Corporations Act 1989* (Cth);
- the *Australian Securities and Investments Commission Act 1989* (Cth);
- the *Corporations ([State]) Act 1990* of each jurisdiction;
- the *Corporations Law* of each jurisdiction; and

- the Australian Securities Commission Law (the ASC law) of each jurisdiction.[39]

However, a number of legal judgments during the late 1990s called into question the validity of this federal structure. One of the most significant of these was the *Wakim*[40] case in which the High Court held that the cross-vesting arrangement was unconstitutional because it conferred jurisdiction on federal courts in relation to matters that were basically state concerns. The effect of the decision in the *Wakim case*was that federal courts could no longer hear matters arising under state legislation. In particular, the Federal Court of Australia could not hear matters arising under the corporations law of the states.[41]

The second major challenge to the federal structure of Australia's corporate law was the case of *R v Hughes*[42], heard by the High Court in March 2000.[43] The case turned on the validity of s 45 of the *Corporations (Western Australia) Act 1989* (WA). Section 45 stated that an offence against the state Act was taken to be an offence against the laws of the Commonwealth. This was an important provision because it was the basis for the Commonwealth Director of Public Prosecutions' power to prosecute offences arising under the state corporations Acts. The challenge in the High Court went to the constitutional validity of s 45.

The High Court's decision in *R v Hughes* added to uncertainty concerning the national enforcement of the *Corporations Law*. Although the court upheld the power of the Commonwealth Director of Public Prosecutions in this particular case, it raised serious doubts for the future about the Director of Public Prosecutions' power in a range of other cases.[44] This decision had major ramifications for Australia's legal and judicial systems because doubt was cast on the validity of the states conferring power on Commonwealth officers.

As a result of the constitutional challenges in the *Wakim* and *Hughes* cases, and because further challenges were pending, the Commonwealth Parliament made the decision to re-enact corporations legislation on the firmer constitutional footing of powers conferred by the states.[45] Under this confirming of power, each state and territory agreed to cede its powers with respect to corporations to the Commonwealth. The result being that, since 15 July 2001, corporate regulation in Australia has been governed primarily by the following Commonwealth Acts:

- the *Corporations Act 2001* (Cth); and
- the *Australian Securities and Investment Commission Act 2001* (Cth).

In summary, instead of separate (but uniform) law in each of the states and territories, there is now one law for one jurisdiction, namely

all of Australia. ASIC and all Commonwealth officers now derive full powers from the Commonwealth legislation alone and this has served to resolve the difficulties raised by the *Wakim*and *Hughes* cases.

This legislation is now the foundation of a uniform corporations law in Australia, even though a legislative approach to conferring power on the Commonwealth to regulate corporate conduct still does not have the same effect as explicit Constitutional powers. For example, under current legislation a state can still terminate a reference of power. However, there are two safeguards that should prevent this happening. First, the disruption to business would be so extreme that it is hoped no government would consider it.[46] Secondly, the power of termination is regulated by an intergovernmental agreement between the Commonwealth and each state and territory. Under this agreement, four states have to vote to terminate the reference of powers before the Commonwealth loses its authority.[47]

The objective of these laws was to restore the regulatory environment that existed before the High Court's decision in the *Hughes* and *Wakim* cases.[48] It did not involve any substantive policy changes. This means, for example, that the personal liability of directors encoded in the *Corporations Law* remained unchanged. Directors and managers are answerable personally for breaches of the Corporations Act. The impact of corporations law and other significant legislation on the role and responsibilities of individual directors is discussed in detail in Chapter 3.

Australian corporate law continues to evolve. For example, the *Corporations Amendment (Repayment of Directors' Bonuses) Act 2003* (Cth) introduced provisions to assist recovery of assets to companies in liquidation where payments or transfers to directors were unreasonable. There were further significant amendments to the Corporations Act in mid-2004, which took into account the results of the Royal Commission into the collapse of HIH Insurance.[49] The *Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004* (Cth) (CLERP[50] 9) was aimed at aligning the financial reporting framework with a focus on the quality, integrity and transparency of financial reporting. Important reforms to the existing corporate governance provisions in the Corporations Act, included:

- changes to continuous disclosure offence provisions;
- changes to financial reporting, including the CEO/CFO sign-off, and management discussion and analysis disclosure in the annual report;
- the introduction of a non-binding vote on remuneration reports and expanded executive and director remuneration reporting;

- improved mechanisms for shareholders to participate and vote in general meetings (eg s 249L of the Corporations Act on notices for general meetings and s 250T of the Corporations Act on the chair allowing members as a whole, a reasonable opportunity to ask questions of the auditor; and
- provisions pertaining to auditor independence and amendments affecting the audit function and oversight.

More recent changes to the Corporations Act relate to executive remuneration, which remains a significant area for reform. For example, following the global financial crisis there were calls for increased regulation of "golden hand-shakes" and other excessive executive pay outs. In March 2009, the Australian Government commissioned an inquiry to assess the need for reform.[51] As a result, legislation was passed to amend the Corporations Act. The first of the executive remuneration reforms came into effect on 24 November 2009, in the form of the *Corporations Amendment (Improving Accountability on Termination Payments) Act 2009* (Cth). Under this Act:

- Termination benefits for directors and executives exceeding one year's base salary are subject to shareholder approval;
- The provisions were extended to apply to senior executives and "key management personnel";
- The definition of benefit was been broadened; and
- The penalties for breach substantially increased.

The second tranche of legislation, the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011* (Cth), introduced further reforms including:

- The opportunity for a board to be spilled if the remuneration report receives "no" votes of 25% or more at two successive AGMs (the "two-strikes rule");[52]
- Strict rules about ASX companies engaging remuneration consultants, performance of their role and disclosure;
- Prohibitions on key management personnel (and closely related parties) hedging their incentive remuneration (such as shares and options);
- Prohibitions on key management personnel and their closely related parties voting on remuneration matters and any board spill motion;
- Confining remuneration disclosures in the remuneration report to key management personnel (by removing the requirement to disclose details of the five highest paid company or group executives);

- A requirement that shareholder approval be obtained for board "no vacancy" declarations; and
- Measures designed to prevent proxy holders from "cherry picking" the proxies they exercise (directed proxies not voted will now default to the chair who must exercise those proxies as directed).

The objective of this discussion of the development of corporations and the legal framework (which is the topic of Chapter 3) in which they operate has been to provide a contextual backdrop to the subject of modern governance. It does not explain the other key concern of governance, namely the relationship between corporate governance practices and firm performance. To examine this important area, we will look at governance as it is now before turning to the theory of corporate governance that forms the basis governance in the 21st century.

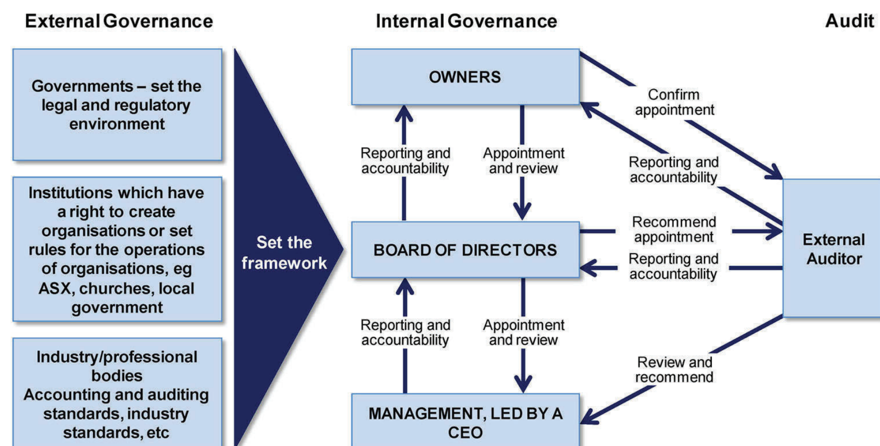
Governance in the 21st century

[2.12] Governance today

The way in which our companies are governed in the 21st century is the result of both external and internal factors. As Figure 2.1 illustrates, there are three major external factors that establish the framework for an organisation's governance:

1. governments;
2. other institutions which have the right to set rules for certain classes of organisations, eg stock exchanges, churches, local governments; and
3. industry and professional bodies.

FIGURE 2.1 Governance in the 21st century



The government is responsible for legislation that establishes corporate organisation such as the Corporations Act and the state-based association's incorporation Acts. These Acts set out the basic rights of owners/members, the duties of directors and other matters including a company's financial reporting requirements. Further, there is a plethora of related legislation such as work health and safety, taxation and competition and consumer protection, which sets in place the regulatory environment with bodies such as ASIC, APRA and the Australian Accounting Standards Board (AASB) that set governance standards for organisations to follow.

Federal, state and territory legislation also empowers other institutions such as churches and local governments to establish incorporated entities and/or set rules for their operation. In Queensland, for example, the *Roman Catholic Church (Incorporation of Church Entities) Act 1994* (Qld) provides a mechanism for incorporating Catholic Church entities.

For listed companies, stock exchanges establish codes of practice for market participants such as the ASX Listing Rules, which have the force of law and the ASX Principles, which operates on a voluntary "if not, why not" basis.

Corporate governance is also influenced by professional and industry bodies. For example, governance guidelines are issued by organisations such as the Australian Council of Super Investors (ACSI), the Australian Shareholders' Association (ASA) and the Investment and Financial Services Association (IFSA), which cover a variety of key stakeholders including both institutional investors and retail investors. While their guidelines are directed at boards, they also give their

members a point of reference when engaging with companies and voting on corporate governance matters. Similarly, accounting bodies such as Institute of Chartered Accountants in Australia (CA) and Accounting Professional and Ethical Standards Board Limited (APESB) and organisations specifically centred on governance such as the Australian Institute of Company Directors (AICD) and Chartered Secretaries Australia (CSA), provide codes of practice, standards and guidance to their members and influence the legislative and regulatory environment through their advocacy and policy development roles. Bodies such as Standards Australia, which develops internationally-aligned Australian Standards to ensure products, services and systems are safe, reliable and consistently perform the way they were intended, has also developed a set of corporate governance standards, which establish generic guidelines that organisations can tailor to suit their own circumstances, as well as widely followed standards for risk and compliance.

As we have already discussed in this chapter, the external drivers of corporate governance are ever changing. For example, the legal and regulatory environment undergoes constant change in line with community expectations and has led, for example, to ever more onerous legal obligations for directors. Such change means that the organisation's "internal" governance will constantly evolve too, and as we recommend throughout this book, it must be continually reviewed to keep pace with such change.

For most organisations, the "internal" governance relationship outlined in Figure 2.1 is about the respective roles and responsibilities of the shareholders or members as owners, directors as the representatives of the owners and the managers of the corporation. Internal governance is concerned with setting rules and procedures concerning the respective rights and responsibilities of those three key positions in the governance framework as to how the company is run. As represented by the arrows, there are appointment and review responsibilities for the owners and boards, as well as reporting and accountability requirements from management to the board and from the board to the owners. Internal governance is also about putting checks and balances (again represented by arrows) in place to prevent abuses of authority and ensure the integrity of financial results, which is the role of the internal and external auditors, but especially the external auditor.

External auditors are appointed by the shareholders upon the recommendation of the board to provide assurance as to the veracity of the company's financial reports. As such, external auditors are expected to be independent of the company and report their findings objectively. Auditors can only play their role effectively if they are

independent. The external auditors are responsible for removing any possible management bias regarding the presentation of the company's financial information. They can also report to what extent the company practices good corporate governance. As guardians of a company's financial integrity, external auditors are expected to play a significant role in maintaining good governance and must be prepared to comment on the organisation's governance practices.

As Figure 2.1 reveals, robust governance requires effective interaction and communication among the board, management, the external auditor and the owners/members. For the remainder of this chapter, we explore the theoretical underpinnings of corporate governance as it now operates and discuss how the current legislative and regulatory regimes, along with leading practice guidance, have evolved into the model of governance set out this section.

Theoretical underpinnings of corporate governance

[2.13] Major governance theories

Our historical review to date has traced the evolution of the modern corporation, the social and economic forces prompting its development and the legal framework in which it operates. Along with this evolution, a number of theories have developed, which attempt to link corporate governance mechanisms with corporate performance. Understanding these theories is important because they have helped to define the role of the modern Australian board. The most influential of these theories to date has been agency theory.

[2.14] Agency theory

The fundamental building blocks of corporate governance are concerned with what has been labelled the "Berle-Means hypothesis".[53] The central argument of the Berle-Means hypothesis is that, between the 1850s and the 1930s, a fundamental separation of ownership and management took place in large corporations. Driven by a dilution of ownership concentration, this separation led to the emergence of a professional managerial class and the maturation of equity markets (to trade newly developed stocks). As previously outlined, the entrepreneurial or proprietorial capitalism of the 19th century gave way to managerial capitalism. However, Berle and Means contended that there was more than a mere separation of ownership and management taking place. Those who owned the company no longer controlled its actions (that was the place of the professional

manager), and so there was a fundamental separation of ownership and control. This view of the corporation remained unchallenged until the 1970s.

The period from 1970 to 1990 saw a refining of the role of the board (as owner representatives) in academic circles. While Berle and Means had identified the separation of ownership and control, the 1970s saw increasing attention paid to the effects of this separation. Jensen and Meckling's formal exposition of the concept of agency costs provided a theory for understanding the implications of separating ownership from control and continues to be influential.[54] Their "agency theory" provides the theoretical underpinning for the majority of recent changes in corporate governance law and practice.

Agency theory suggests that professional managers can, by virtue of their superior knowledge and expertise, gain advantage over the firm's owners. Since they control (though do not own) the firm, managers are relatively free to pursue their own interests by a number of means. They might obtain so-called perquisites (eg large offices), pursue pet projects at the expense of shareholder value (eg pursuing firm growth at the expense of profitability) or by increasing the percentage of revenue they extract from the company through remuneration or through increasing their ownership of the company while not paying market rates for such ownership by virtue of option schemes and share placements. By viewing the firm as a nexus of contracts, Jensen and Meckling developed formal economic proofs to show that the effect of separating management from control is to diminish the value of the corporation. Under this thesis, the purpose of corporate governance is to minimise company losses that result from this separation. In order to protect shareholders from management's potential conflict of interest (ie their personal interest in maximising perquisites versus their role in maximising shareholder value), adequate monitoring mechanisms need to be established.[55]

Agency theory's development coincided historically with both the "failure" of corporate governance mechanisms in the 1970s and the observed excesses of the 1980s. The extravagances of the 1980s, ranging from unwise diversification into non-core activities through to outright fraud, were precisely the types of behaviour that agency theory saw as resulting from the separation of ownership and control. As a result, regulators, academics and practitioners alike embraced agency theory and advocated the widespread adoption of an independent board mechanism to monitor a corporation's management. This agency role of boards, as expressed in legislation, is sometimes referred to as the legalistic view of the board.

In Australia and in many other countries, a board is a legal requirement.[56] Legislation also specifies certain powers and responsibilities for a board. Specifically, directors are responsible for the overall operations of the company and owe three broad types of duties. These are:

1. the fiduciary duty to the shareholders/owners;
2. a duty to exercise due care and diligence; and
3. other statutory duties prescribed by legislation (eg work health and safety, equal opportunity, environment).

Thus, the legalistic view of corporate governance is concerned with the legal requirements of the board and its directors, because there are significant legal sanctions for companies and individuals that do not comply.

A concern with the legalistic view is that it concentrates on the behaviours and actions of individual directors rather than on the impact of the board as a whole.[57] The duties specified in the Corporations Act, for example, are the duties of directors and officers, not of the board as a whole. Further, the emphasis under the legalistic view is on shareholders' interests, whereas in reality directors owe duties to many other stakeholders including employees, customers and the general community.

In summary, the legalistic view of corporate governance arises from agency theory and focuses on the board's roles in mitigating agency problems and monitoring management. As such, it is not so much concerned with adding value to the organisation, but of ensuring that shareholders are protected against malfeasance.

[2.15] Stewardship theory

Yet agency theory has not remained unchallenged. During the 1990s, an alternative "stewardship theory" of corporate governance was advanced.[58] In essence, stewardship theory proposes that managers are essentially trustworthy individuals or good stewards of the resources entrusted to them. Stewardship proponents maintain that managers naturally work to maximise profit and shareholder returns. Stewardship theory is, therefore, diametrically opposed to agency theory because of the emphasis it places on the trustworthiness of managers. Not surprisingly, it proposes that corporate control be centralised with management and that the role of independent directors should be limited. Proponents of stewardship theory point to the superior amount and quality of information possessed by "inside" (ie executive) directors,[59] the positive relationship noted between research and development spending and the presence of inside

directors,[60] and a more balanced approach to CEO compensation[61] to support this argument. Which theory is borne out by empirical evidence? The only clear statement that can be made is that there is conflicting empirical evidence that both supports and disputes stewardship and agency theories.[62]

[2.16] Resource dependence theory

In contrast to both stewardship and agency theories and their focus on management oversight, resource dependence theory attempts to explain how companies use their boards to further their interests with external parties such as customers, financiers, governments, key suppliers and so on.[63] Resource dependence theory has its roots in sociological research seeking to understand how directors are selected and the effect of board interlocks (ie where a director or executive from one organisation joins the board of another organisation) on competitive rivalry and organisation performance.[64]

The four areas where directors can bring advantages to the organisation through external links are:

1. information in the form of advice and counsel – for example, a director who is a partner in a law firm might provide legal advice either in board meetings or in private communication with the CEO that may otherwise be more costly for the firm to secure;
2. information sharing and collaborative communication – research has found that valuable information is disseminated between firms through boards;[65] for example, communication enabling the effective coordination of transactions and joint activities between companies;
3. preferential access to resources such as funding and customers; and
4. legitimacy – hiring reputable directors allows an organisation to gain prestige and legitimacy in the eyes of key stakeholders and the community at large.

As Pfeffer concluded, "board size and composition are not random or independent factors, but are, rather, rational organizational responses to the conditions of the external environment".[66] But, "it is not just the number, but the type of directors on the board that matters";[67] for example, research has found that firms with poor financial or stock market performance will appoint directors from financial institutions to their boards' companies.[68] Moreover, much will depend on the willingness of directors to share their "outside"

experience in the boardroom.[69] We discuss the resource dependence role of directors further in Chapter 4 in relation to the skills directors need.

In essence, resource dependence theory maintains that the board is the critical link between a firm and the essential resources it needs to maximise its performance, such as access to capital, suppliers, key customers, government, information and power that might otherwise be beyond an organisation's reach.[70] For example, a study by Daily has shown that companies with a greater proportion of "outside" (ie non-executive) directors were more likely to successfully re-emerge from bankruptcy.[71]

A key criticism of resource dependence theory is that empirical findings can be interpreted according to the researcher's own field of study[72] and it fails to consider an organisation's internal resources, which it can use to create value.[73] Its strengths are that it focuses on the presence of power, which is the control over vital resources, and the dependence on relationships to provide a greater insight to corporate governance theory.

[2.17] Stakeholder theory

Another important perspective on corporate governance, stakeholder theory, had its origins in R Edward Freeman's 1984 publication, *Strategic Management: A Stakeholder Approach*,[74] and developed as a theory of corporate governance in the 1990s. It also attempts to explain corporate performance, but takes quite a different approach from both agency and stewardship theories. While agency and stewardship theories differ in their view as to whether managers or owners should exert ultimate control in the management of companies, they both rest on the central assumption that the role of the company is to maximise shareholder wealth.[75] These theories are clear as to whose interests they believe the firm should serve, but divided as to whether it is owners or managers who can be trusted to achieve this goal. In contrast, stakeholder theory starts from the premise that the creation of shareholder wealth is not the only reason for corporations to exist. Stakeholder theory is based on the view that companies and society are interdependent and therefore the corporation serves a broader social purpose than its responsibilities to shareholders. Stakeholder theorists conceptualise the corporation as representing a complex web of relationships, extending beyond the traditional shareholder-management relationship. Donaldson and Preston define the stakeholder corporation as "a network involving

multiple participants and interests, each of which may make contributions and receive rewards as a result of corporate activity".[76]

Stakeholder theorists argue that each company has its own unique set of stakeholder groups that both have an impact on corporate activities and are themselves affected by a company's actions. Under this definition a large number of interest groups can be considered stakeholders: customers, suppliers, communities, employees, investors, political groups, unions, governments and trade associations. These stakeholders can be further divided into primary and secondary stakeholders.[77] Primary stakeholders are those whose interests are directly aligned with the success of the company – shareholders, employees, investors, customers, suppliers and residents of communities in which the company operates. Secondary stakeholders are those whose influence on the company is more indirect or who are less directly affected by its operations, such as governments or the nation at large.

Most business leaders today accept that companies have stakeholders and that there is a dynamic and interdependent relationship between the two. For the proponents of stakeholder theory, this dynamic relationship between companies and their stakeholders can be a source of opportunity and competitive advantage.[78] According to the stakeholder view of the corporation, the focus of managerial activity should be on the development and maintenance of stakeholder relationships. Stakeholder interests, however, will not necessarily coincide. Accordingly, managing competing stakeholder interests becomes a primary management function.[79] The relative importance of stakeholder groups to managers is determined by their legitimacy, their power and the urgency of their claims.[80]

The implication of stakeholder theory for corporate governance is that the board should be able to judge whether the interests of all stakeholders are being justly balanced.[81] Some commentators have even suggested that representatives of primary stakeholder groups should be on the board,[82] in particular employee representatives.[83] Others have introduced balancing stakeholder interests as a new role of the board.[84] Clearly, stakeholder theory has significant implications for corporate governance research because it calls for different ways of evaluating firm performance and corporate social responsibility (CSR); ethical considerations and valuing human capital have now become measures of success, not just shareholder wealth. Thus, stakeholder

theory offers a different perspective from governance that continues to provide useful insights for research and practice.[85]

The growing focus on the responsibility companies have to their stakeholders is seen in the major reports by the Parliamentary Joint Committee on Corporations and Financial Services (PJC)[86] and the Corporations and Markets Advisory Committee (CAMAC)[87] commissioned by the Australian Government. Institutional investors, such as superannuation funds and insurance companies, and other shareholders are also increasingly interested in corporate social and environmental performance. The World Economic Forum lists the general areas in which companies can be socially responsible as: climate change, managing social and environmental risks down the supply chain, product distribution and use, increasing access and affordability of essential products and services and tackling bribery and corruption.[88]

When a company embraces CSR, the board of directors has an important role to play, as it must oversee the articulation of core company values and principles and how they underpin business goals. It is the board's responsibility to lead by example in setting the company's standards as well as overseeing the implementation and adherence to these standards throughout the organisation. Guidance on integrating CSR into the company can be found in Standards Australia's *Corporate Governance – Corporate Social Responsibility (AS 8003-2003)*. Further, ASX Principle 3 asks companies to consider the "reasonable expectations of their stakeholders".[89] These reasonable expectations include that corporations behave responsibly and act ethically.

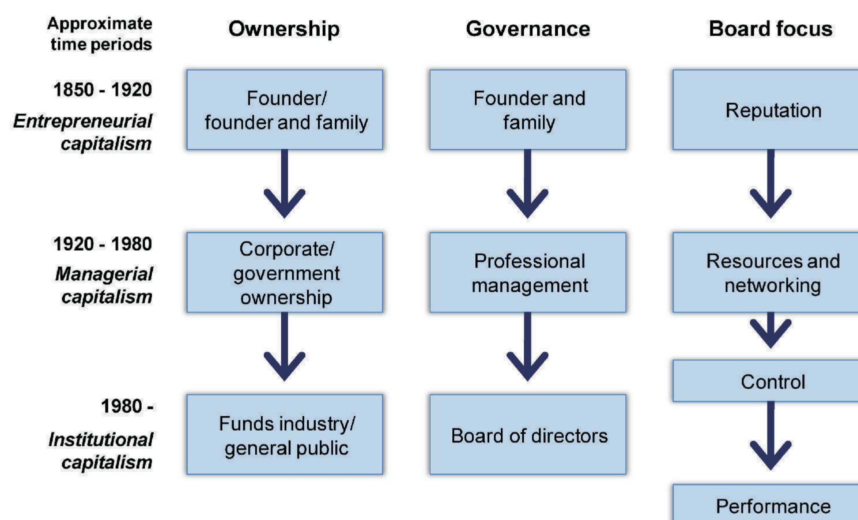
In conclusion, while research is developing in a number of directions, the major focus in corporate governance research to date has been on agency theory. The lack of any clear alternative theoretical approach until the 1990s, combined with the historical events of the 1970s and 1980s, has meant that agency theory has dominated the corporate governance landscape. This explains the current widespread support for boards that are independent of management, answerable to shareholders, and that perform a strong monitoring role. In particular, it is the underlying rationale behind calls to move to a majority of independent directors on each board and to a separation of the CEO and chair roles.[90] As this brief review of the dominant theories of corporate governance has shown, there are many approaches and each has its strengths and weaknesses. When thinking about boards, we believe a synthesis of these perspectives provides a sound understanding of how boards work.

Ownership and control: a system in transition

[2.18] Corporate governance today

As can be seen from the preceding discussions, Australia's corporate governance system has developed in response to a complex interweaving of social, legal and economic forces. A summary of the discussion is shown in Figure 2.2, which depicts the changes in ownership structure and corporate governance practice over time.

FIGURE 2.2 Governance in transition



As the ownership structure of companies has changed over time, so too have corporate governance practices and the role of the board adapted to align themselves with these changes. When the founder was the owner of the company, governance matters were relatively uncomplicated and remained in the hands of the founders. Boards merely had to ensure compliance with a few basic legal requirements and directors were often appointed because of their reputation and status. With the growth of the modern corporation and a mix of corporate, government and individual ownership of major enterprises, professional managers assumed control for the management and direction of the company, while the board's role was to aid corporate expansion via networking and providing the company with access to the resources it needed in order to achieve its business goals.

After the corporate scandals of the 1980s, the board rather than the company's managers became increasingly responsible for corporate governance matters. Directors were now held to be accountable for the success or failure of the firm and were expected to monitor closely the actions of management. This expectation was created by a hardening of community attitudes towards management failure. Moreover, this sentiment was reflected in legal decisions that stated explicitly that directors should be more responsible in their monitoring role.

Today, the growth in the power of institutional investors and their focus on performance has led to another shift in the board's role. The emphasis is very much on the board adding value by contributing to firm performance. Remuneration packages for senior management are commonly based on bonuses and share option schemes, thereby linking compensation to company performance. Thus, the interests of owners and managers are more closely aligned because the risks are shared more equally. Moreover, there is growing debate regarding the advantages and disadvantages of the use of similar remuneration schemes as the primary compensation tool for board members themselves, reflecting the perceived need for directors to be more directly accountable for company performance.

Practical interest in corporate governance has been demonstrated via several inquiries and commissions held into corporate governance matters in many countries during the 1990s and 2000s. In the 1990s, reports such as the Cadbury Report[91] and Hampel Report[92] in the UK and the NACD Blue Ribbon Commission in the US were influential in shaping normative views of good governance. In Australia, the Bosch Report[93] was a major influence in the area of corporate governance reform. Mirroring the concerns of the major UK and US reports, its emphasis was on accountability and transparency in board practices and on the board's role in improving corporate performance. As stated in the Bosch Report: "directors should ensure the company is properly managed to protect and enhance shareholder value and to meet the company's obligations to shareholders, to the industry and the law".[94] In order to achieve these goals, the chief recommendations of the report were that the chair and CEO roles should be separated, that the majority of a board should be non-executive directors and that at least one-third of the board should be independent. It also recommended that a statement of the company's main corporate governance practices be presented in each annual report.

During the early 2000s, there was a flurry of reports in the UK including the Myners Review on institutional investors,[95] the Tyson Report on director recruitment,[96] the Smith Report on audit committees,[97] and the Higgs Review on non-executive director effectiveness,[98] which informed the *Combined Code on Corporate Governance*[99] (renamed *The UK Corporate Governance Code*[100] in May 2010) for listed companies in an effort to improve corporate governance and enhance corporate performance. In Australia, the Ramsay Report (2001) on the independence of company auditors discussed measures to enhance audit independence such as audit committees and auditor attendance at AGMs and recommended amendments to both the Corporations Act and the ASX Listing Rules. The HIH Royal Commission's three volume report, *The Failure of HIH Insurance*, was released in April 2003. The report's policy recommendations on corporate governance and financial reporting and assurance, along with the Ramsey Report, all figured in the finalisation of the Australian Government's amendments to the Corporations Act through CLERP 9.

Australia's best practice code for listed companies was released in 2003. The first edition of the ASX Corporate Governance Council's (ASXCG) *Principles of Good Corporate Governance and Best Practice Recommendations* (ASX Principles) set out 10 "principles" of good governance.[101] It was set up as a guideline, not a prescriptive document. The ASXCG adopted the approach of recommending various corporate governance practices, requiring reporting on these practices as part of the corporate governance report under the ASX Listing Rules, but at the same time giving companies the option to explain why they did not believe that a principle or recommendation is appropriate in their case. The ASX Principles is now in its third iteration after further amendments to the now eight principles in 2010.[102] We discuss the development and application of the ASX Principles in Chapter 3. Also in 2003, Standards Australia released a suite of standards, which includes *AS 8000 Good Governance Principles*, *AS 8001 Fraud and Corruption Control*, *AS 8002 Organizational Codes of Conduct*, *AS 8003 Corporate Social Responsibility* and *AS 8004 Whistleblower Protection Programs for Entities*. Standards Australia's *Good Governance Principles* (AS 8000-2003) were developed to provide "a blueprint for the development and implementation of a generic system of governance suitable for a wide range of entities" including public and private companies, government entities, trustee companies and not-for-profit organisations.[103]

From an international perspective, the principles of modern corporate governance have been enshrined in the *OECD Principles of*

Corporate Governance,[104] which form the base for Standards Australia's *Good Governance Principles*. The OECD recommends six principles of corporate governance that should exist no matter what legal system or governance system currently operates. The core OECD principles are:

- *Chapter I: Ensuring the basis for an effective corporate governance framework*
  - The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
- *Chapter II: Basic rights of shareholders and key ownership functions*
  - The corporate governance framework should protect and facilitate the exercise of shareholders' rights.
- *Chapter III: Equitable treatment of shareholders*
  - The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- *Chapter IV: Role of stakeholders in corporate governance*
  - The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- *Chapter V: Disclosure and transparency*
  - The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- *Chapter VI: Board responsibilities*
  - The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.[105]

Corporate governance codes are not confined to Australia, the US and UK. As the European Corporate Governance Institute's Index of governance codes of practice reveals, the current number of corporate governance codes and guidelines is in the hundreds.[106] There are also numerous codes of practice for industry sectors, most notably the

banking sector. These codes have been developed and issued by various bodies including government agencies, stock exchanges, business groups and professional bodies, and reflect a variety of national legal traditions and national practices. For example, the codes of Germany, France, the Netherlands and Norway focus on the importance of employees and other stakeholders, whereas the approach taken in countries such as the US, UK and Australia seek to maximise shareholder value. Despite such differences, the common theme among the codes is the importance of transparency and upholding shareholder interests, while all corporate governance codes stress the importance of a board comprising independent and competent directors.

Much of the regulation, reports and good practice guidelines we have discussed can be directly linked to corporate collapses and malfeasance. For example, in the US, a slew of corporate scandals including Enron (2001), WorldCom (2002), Global Crossing (2002) and Tyco (2002) led the *Sarbanes-Oxley Act of 2002* (US), which aimed to:

- improve the quality of disclosure and financial reporting;
- strengthen the independence of accounting firms;
- increase the role of audit committees; and
- increase the responsibility of management for corporate disclosures and financial statements in publicly traded companies.

Table 2.1 provides a snapshot of some of the more notable Australian governance failures and the efforts by the Australian Government, regulators and other bodies to prevent such failures happening again.

TABLE 2.1 Examples of Australian responses to governance failures

Corporate failure		Response		
Era	**Company**	**Legislative/ Regulatory**	**Report**	**Guidance**
1980s - 1990s	• Ariadne (1988) • Rothwells Merchant Bank (1989) • Qintex (1989) • Pyramid Building Society (1990) • Bond Corporation (1991) • National Safety Council (Victorian Division) (1991) • State Bank of South Australia (1991) • Tricontinental (1992)	• *Corporations Law 1991* • ASIC commences regulatory role (1991) • WA Royal Commission into Commercial Activities of Government and Other Matters (1992) • APRA commences operations (1998) • *Corporate Law Economic Reform Program (CLERP 3) Act 1999*	• Bosch Report (Corporate Practices and Conduct) (1991; 1993; 1995) • Hilmer Report (1993; 1998) • Audit Office of NSW, Corporate Governance (1997) • Wallis Report (Financial System Inquiry) (1997)	• AIMA Guide & Statement of Recommended Practice (1995) • IFSA† Corporate Governance: A Guide for Investment Managers and Corporations (1999)

Corporate failure		Response		
Era	**Company**	**Legislative/ Regulatory**	**Report**	**Guidance**
2000s	• HIH Insurance (2001) • Harris Scarfe (2001) • One.Tel (2001) • Ansett (2001) • Pasminco (2001) • Sons of Gwalia (2004) • NAB (2004) • James Hardie (2005) • AWB (2005) • Westpoint (2006)	• *Corporations Act 2001* • *Financial Services Reform Act 2001* • ASX Principles (2003; 2007) • *Corporate Law Economic Reform Program (CLERP 9) Act 2004*	• Ramsay Report (2001) • The Failure of HIH Insurance (2003) • CAMAC,* Insider Trading (2003) • Davis Report (Study of Financial System Guarantees) (2004) • CAMAC, The Social Responsibility of Corporations (2006) • CAMAC, Personal Liability for Corporate Fault (2006) • CAMAC, Corporate Duties Below Board Level (2006) • CAMAC, Shareholder Claims Against Insolvent Companies: Implication of Sons of Gwalia (2008)	• IFSA Blue Book (2002) • Standards Australia (2003) • ASCI‡ Corporate Governance Guidelines (2003) • APRA Prudential Standards 510 and 520 (2006)

Corporate failure		**Response**		
Era	**Company**	**Legislative/ Regulatory**	**Report**	**Guidance**
GFC to present	• Opes Prime (2008) • Allco Finance Group (2008) • ABC Learning Centres (2008) • Allco (2008) • Storm Financial (2009) • Babcock & Brown (2009)	• *Corporations Amendment (Termination Payments) Act 2009* • ASX Principles (2010) • *Corporations Amendment (Executive Remuneration) Act 2011*	• CAMAC, Aspects of Market Integrity (2009) • CAMAC, Diversity on Boards (2009) • CAMAC, Guidance for directors (2010) • Productivity Commission, Executive Remuneration (2010) • CAMAC, Executive Remuneration Report (2011)	• ASCI Governance Guidelines (2011)

Corporations and Markets Advisory Committee
† Australian Investment Managers' Association
‡ Investment and Financial Services Association (formerly AIMA)
§ Australian Council of Superannuation Investors

Governance failures of the magnitude of those shown in Table 2.1 are not common and the majority of boards will not be the subject of ASIC investigation or have their names emblazoned in newspaper headlines. However, just staying out of the headlines does not mean a board is effective nor does the fact a company is performing well. Indeed, one of the great challenges for both academics and practitioners lies in defining what constitutes an "effective" board.

Further, the different contexts in which different boards operate (eg for-profit versus non-profit; family owned versus listed; stable versus turbulent industry) and the impact of the particular industry in which the organisation operates, result in boards undertaking different tasks and having different attributes.[107] Thus, board effectiveness will vary with a company's circumstances.

Boards are also social systems, so an understanding of effective boards that contribute to organisational value creation requires an understanding of the "human side" of governance, since board

members approach boards from various perspectives depending on their experiences and backgrounds.[108]

The following model, the intellectual capital framework, helps us understand the components of board effectiveness and the elements of the model that has informed the Corporate Governance Practice Framework.

The intellectual capital framework

[2.19] Introduction to the framework

Organisations face different pressures and threats at different stages of their organisational life cycle and are therefore unlikely to have the same corporate governance requirements throughout these life cycle stages:

> [B]oards are expected to perform qualitatively different roles at various points of the cycle as exemplified by the different way a board performs its control function in an entrepreneurial firm as opposed to a well-established, mature operation.[109]

Building on the work of Zahra and Pearce, Nicholson and Kiel developed a holistic framework for examining how boards of directors affect corporate outcomes.[110] They rejected the view that a board is simply "a mechanism to monitor management and control agency costs",[111] as discussed previously, and concluded that boards can add value to an organisation in a much broader manner including: reviewing key decisions, informing the strategy process, advising management, and providing access to key resources such as information. The authors viewed the construct of "intellectual capital" to be the core of the transformational processes through which a board adds value to an organisation.[112] For example, one component of the framework is the board's human capital – that is, the individual knowledge, skills and abilities possessed by directors.

In addition to the knowledge, skills and abilities of directors (human capital), the intellectual capital framework is concerned with the social ties that directors bring to an organisation – the board's "social capital". Because social structures exist within groups, between groups and between the organisation and the external environment, the social capital of the board will lie at three levels: intra-board relationships, board-management relationships (particularly between the board and the CEO and management) and extra-organisational relationships.

As well as the board attributes captured by the two constructs of human and social capital, the board's internal processes will differ

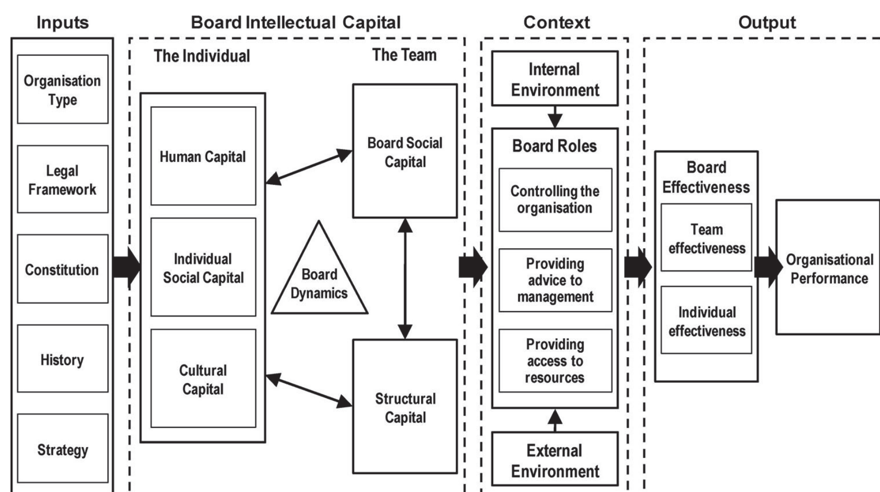
between organisations.[113] It is the board's structural capital, its routines, processes, procedures and policies that facilitate the board's use of its human and social capital.

Recognition of the potential importance of structural capital to board effectiveness has a long history. For example, significant research effort has focused on the impact of committees, most notably the audit committee, remuneration committee and nomination committee, with findings that there is a link between the presence of board committees and board effectiveness.[114] Additionally, several other key elements of board structural capital have been examined. For instance, the board agenda has been shown to focus the work of the board and that the operating performance of a corporation improves following years of abnormal board activity.[115] Finally, the decision-making style of the board has been linked to corporate performance.[116]

The academic investigation of the structural capital of boards is supplemented by normative interest in the topic. The emergence of "codes of best practice" such as the ASX Principles highlight the importance placed on attributes of the board by practitioners. Likewise, advice from governance handbooks stresses the importance of policies, procedures and processes.[117]

A system is commonly defined as a group of interacting units or elements that have a common purpose; the intellectual capital framework, shown in Figure 2.3, provides a general model that conceptualises the board as part of a "governance system". Further, it recognises that this system is complex and constantly evolving due to an array of internal and external factors.

FIGURE 2.3 The intellectual capital framework



Adapted from GJ Nicholson & GC Kiel 2004b, "A framework for diagnosing board effectiveness", *Corporate Governance: An International Review*, vol 12, no 4, 442-460, at p 456.

Among the insights from the intellectual capital model is that "an effective corporate governance system requires a series of components to be in a state of congruence or alignment".[118] The dynamics of the board reveals the degree of alignment or fit between the various elements of board intellectual capital, which are elaborated in Table 2.2. For example, while directors with extensive experience and skills and a high degree of credibility with key stakeholders may be appointed to a board, and that board may have in place leading practice policies and procedures, it is not this human, social and structural capital alone that will determine the effectiveness of the board. It is the dynamics of the system as revealed by the behaviours of individual directors that will determine whether that capital can be used in a way that adds value to the organisation.

TABLE 2.2 Key components of board intellectual capital

Compo-nent	Human capital	Social capital	Structural capital	Cultural capital
Definition	Innate and learned abilities, expertise and knowledge	Implicit and tangible set of resources available by virtue of relevant social relation-ships	Explicit and implicit codified knowledge (eg routines, policies and procedures)	The values, norms and rules sanctioned by the dominant group (eg honesty)
Resides in	Individual directors	Individual directors Board	Board	Individual directors
Key dimensions	• General knowledge • Board experience • Industry experience • Company specific knowledge and experience • Functional experience and knowledge • General business knowledge and experience	• Network of extra organisational contacts • Relationship(s) with CEO, both as a board and as individuals • Relationship(s) with management, both as a board and as individuals • Relationships between board members	• Documented board policies including charters and guidelines • Board culture • Implicit board procedures and norms	• Individual work • Individual morals • Individual motivations

Adapted from GJ Nicholson & GC Kiel 2004b, "A framework for diagnosing board effectiveness", *Corporate Governance: An International Review*, vol 12, no 4, pp 442-460, at p 450.

A graphic example of the failure of the social capital embedded in the relationships between directors occurred in 2004 when the board of the National Australia Bank (NAB) imploded publicly after one director questioned the integrity of a PricewaterhouseCoopers (PwC) report into a $360 million foreign exchange loss at the bank after the revelation that four foreign exchange dealers had concealed actual results by using incorrectly recorded or false trades for three years.[119] The dissident director and seven other non-executive directors all stepped down as a result of the squabble. This issue of board behavioural dynamics is discussed more fully in Chapter 8.

Zahra and Pearce's integrative model and Nicholson and Kiel's intellectual capital framework are by no means the only "models" of board effectiveness developed through empirical research and normative practices. For example, Carter and Lorsch's model of board effectiveness, which recognises the contingency of the relationship between board roles and the company's situation, proposes that it is

often not so much how individual directors perform, but how they function together that is critical to board effectiveness.[120] Similar to the other models, Huse also sees the board as a system and concentrates on how the board's composition and routines, processes and policies allow it to execute the role set required by its context.[121]

Conclusion

[2.20] Changing nature of corporate governance

A series of fundamental economic and social changes has resulted in directors' duties becoming more complex and onerous. As the trend towards globalisation continues and businesses become more complex, it is unlikely that expectations placed on directors and managers will decline. Instead, the legal framework in which directors operate will continue to change in response to these pressures, placing further demands on directors. As we have indicated, there is a clear link between changes in community expectations and more onerous legal obligations. The next chapter discusses in detail the legal duties of directors in terms of corporate governance.

Over the past two decades in particular, the Australian business environment has continued to exert increased performance and compliance pressures on directors and managers of Australian companies. A number of judicial decisions has created uncertainty about the extent of directorial duties (eg the *AWA cases*,[122] James Hardie case,[123] Centro case[124]) and a rise in the quantum of damages for which directors are liable (eg Chair Max Eise held liable for $97 million in the *National Safety Council case*).[125]

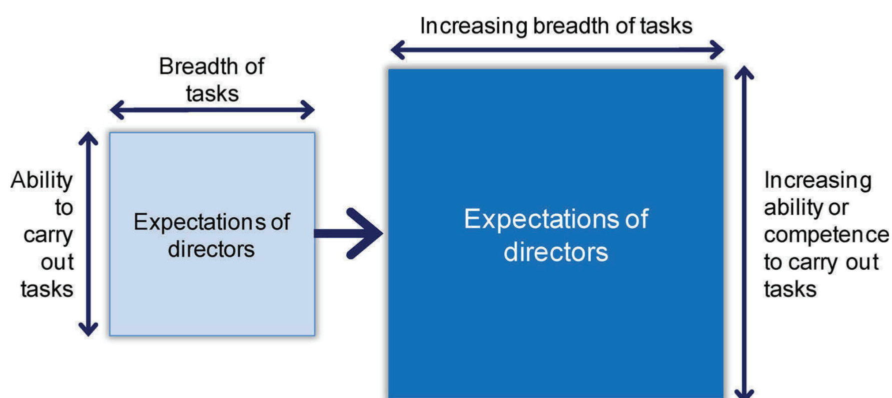
Corporate governance remains a "hot topic" as the directorial community struggles to come to terms with the increasingly onerous duties placed upon it. Until relatively recently, the board was considered as little more than a "rubber stamp" for management activities.[126] Boards must now respond to the changes outlined above and redefine their role in the modern corporation and in society as a whole.

We will most likely continue to move away from a caveat emptor position where shareholders and other stakeholders are seen as responsible for their own actions and only protected by the law in clear cases of fraud and deceit on the part of directors or managers. Instead, companies and their directors will increasingly be held directly accountable for their actions. This movement is not only discernible in the more onerous legal duties (or conformance role) placed on corporate directors and officers, but also in the increased performance expectations of all parties. At the same time as directors

are being burdened with increasing duties and obligations, their competence in carrying out these duties is also being scrutinised.

The effect of this dual increase in both task breadth (or number of tasks) and depth (or degree of competence in carrying out tasks) is highlighted in Figure 2.4. As the diagram shows, rather than a simple increase in director responsibilities (eg a doubling), the effect of the two pressures causes a multiple increase (eg a quadrupling) in what is expected of the modern director. These expectations create many challenges for boards of the 21st century.

FIGURE 2.4 Expectations of directors



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123 *ASIC v Macdonald* (No 11) (2009) 230 FLR 1; 256 ALR 199; [2009] NSWSC 287; *ASIC v Macdonald* (No 12) (2009) 259 ALR 116; [2009] NSWSC 714; *Morley v ASIC* (2010) 247 FLR 140; 274 ALR 205; [2010] NSWCA 331.

124 *ASIC v Healey* (2011) 196 FCR 291; [2011] FCA 717; *ASIC v Healey* (No 2) (2011) 196 FCR 430; [2011] FCA 1003.

125 *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115.

126 For example, see Mace, op cit.