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The Checks and Balances of Good Corporate Governance

Abstract

Good corporate governance requires a range of regulatory checks and balances - or mechanisms - to be effective. If one mechanism fails, the system will fail like a chain with a weak link. This article provides an overview and brief explanation of the main checks and balances a country needs to have a good corporate governance system. It is of particular relevance to countries with transition economies. However, it is also important in developed countries as recent corporate collapses and failures in the financial system have illustrated.

Keywords

corporate governance, companies, directors' duties, shareholders' remedies, corporate social responsibility, transition economies, ratings agencies, securities regulation

Disciplines

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THE CHECKS AND BALANCES OF GOOD CORPORATE GOVERNANCE

John Lessing*

Good corporate governance requires a range of regulatory checks and balances - or mechanisms - to be effective. If one mechanism fails, the system will fail like a chain with a weak link. This article provides an overview and brief explanation of the main checks and balances a country needs to have a good corporate governance system. It is of particular relevance to countries with transition economies. However, it is also important in developed countries as recent corporate collapses and failures in the financial system have illustrated.

INTRODUCTION

Although corporations are generally recognized as legal entities, they invariably involve relationships between natural persons. A large part of corporations law relates to the regulation of those relationships – particularly the potential conflicts of interest and abuses of power that may arise. There is a fundamental problem with the governance of large companies because of the division between ownership and control. In other words, between the shareholders on the one hand and the directors or managers on the other hand. The danger is that the directors and managers may act in their own interests rather than those of the shareholders. We have a classic conflict of interest situation - and the law has to try and resolve this.

Corporate governance is a broad concept but in essence it has to do with the way in which companies are managed and controlled. The concept has grown in importance recently as companies' *mismanagement* has come into focus and the surrounding issues are addressed more prominently in the news.

Around the world, investment in stock markets has grown in popularity – often with the active encouragement of governments. Sometime these investments have been made directly and sometimes indirectly through managed investment funds. For large companies to grow and invest, they usually need to raise funds on the stock market. It is in the interest of society that they be able to do so because it promotes economic growth and thus employment. Financial markets' development is among

* This article is based on a paper presented by John Lessing, Associate Professor of Law, at the Bond University Centre for Commercial Law Second Annual Corporate Governance Seminar in Vietnam, 4 and 6 September 2009.

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the most important determinants of economic growth.¹ However, investors require confidence in the markets in order to invest.

That confidence has been shattered by the recent global financial crisis but there have, of course, been many crises before this one. Recent examples include the collapse of Enron and other major corporations in the United States and countries around the world.

Various questions arise. How does corporate law deal with these issues? How does it regulate the relationships and potential conflicts of interests between the various stakeholders involved in companies? How can corporate law influence companies to adopt good corporate governance principles? How does corporate law promote the efficient management of companies and confidence in securities markets?

The way in which corporate law deals with these issues is by adopting a range of mechanisms that can be described as a system of checks and balances. The purpose of this paper is to provide an overview of these various mechanisms, to explain what their function is and to ask why they sometimes fail.

DUTIES OF DIRECTORS

As a first line of protection, the law imposes various duties on directors. These duties include fiduciary duties such as the duty to act fairly and honestly. They also include the important duty of care.

The problem with them is enforcement - especially where the wrongdoers control the company.

SHAREHOLDER REMEDIES

Traditionally, the law did not make it easy for shareholders to bring actions on behalf of the company. However, many countries now provide a statutory procedure enabling shareholders to bring an action on behalf of the company (a derivative action) and there is increasing shareholder activism.² Class actions by disappointed shareholders have become more common. When shareholders have a means of protecting their investments, it logically follows that their confidence will

1 Simona Benedettini, 'On Convergence Across Transition Economies' Financial Markets' Development: The Role of Outside Investors' Protection'. (Working paper, Department of Economics, University of Siena, 2009) Downloaded from SSRN on 18 August 2009. <<http://ssrn.com/abstract=1431018>>. The author refers to research showing that more than ten years from the beginning of transition, transition economies still show, on average, underdeveloped stock and credit markets.

2 See, eg, Stephen M Bainbridge, 'Shareholder Activism in the Obama Era' (Working Paper No 09-14), University of California, Los Angeles – School of Law, 2009). <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1437791&rec=1&srcabs=1272234>.

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increase. Shareholder remedies give protection from the wrong-doing of directors or managers.

THE PHILOSOPHY OF DISCLOSURE

Mandatory disclosure has been part of company law since the earliest company statutes. Current examples include annual audits by independent auditors (who then report to shareholders) and other regular reporting requirements – quarterly in the United States. Many countries now have a continuous disclosure requirement for listed companies. Such companies are required to immediately disclose information that may have a material effect on their share price. Mandatory disclosure gives shareholders added confidence that they have all the necessary knowledge to make a sound investment.

AUDITORS

Auditors operate as ‘gatekeepers’. In other words, they provide independent verification of a company’s financial position. However, recent collapses such as Enron have shown us that auditors do not always act with sufficient independence. Some of them encouraged ‘creative accounting’ to influence share prices artificially. Their reward for this was huge fees for consulting work. There was a lack of professional accountability.

These failures led to more regulation of auditors – for example, compulsory rotation of auditors, limits on consulting, etc.

INDEPENDENT DIRECTORS

Independent directors are today regarded as an important mechanism of good corporate governance. Their role is to act as an independent monitor of management and to look after the interests of shareholders. The problem in the past has been that many of them were not really independent. Often they had links with management and allowed these to compromise their independence.

There have been calls for these directors to be truly independent and provisions have been introduced in various countries to exclude those who even indirectly receive any benefit from the company beyond their director’s fee. It is particularly important that the chairman should be independent and that the roles of the chairman and chief executive officer be separated. There have also been calls for more diversity on corporate boards – for example, representatives of employees and consumers – but most countries have not attempted to achieve this by regulation.

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SECURITIES LAWS

Securities laws 'facilitate contracting among entrepreneurs, managers, shareholders, and financial intermediaries by providing a standardized set of rights and obligations'.³ The advantage is to reduce transacting costs but they may also limit the legally available terms or conduct.

This includes rules against insider trading - persons should not use information to their benefit when that information is not available to market participants generally, such as knowledge of a large upcoming profit or loss, major discovery or pending takeover, that may impact positively or negatively on the share price of a company.

The downside of these laws is that they may be introduced in haste to combat the perceived causes of the most recent crises to satisfy the public demands that something be done - without sufficient consideration. Often the real causes are not deficiencies in the law but rather in its enforcement.

SHARE OPTIONS

Options give directors the right to buy shares in the future at a price fixed now. They are meant to encourage directors to act in the interest of shareholders by increasing the value of the company and thus its shares. Unfortunately, some directors and executives effectively gave themselves millions of dollars – even in badly performing companies - by manipulating the share price and backdating options. Options are also criticised because they can lead to short-term cost cutting that leaves the corporation ill prepared for the future. Such conduct may well amount to a breach of directors' duties but, as mentioned earlier, these duties are not always enforced.

Banning the use of options would be an overreaction. The preferred approach is to have options accounted for as a cost in the financial statements of companies - plus to be approved by shareholders. Rules are being introduced to ensure that options are properly accounted for, have appropriate performance hurdles, and are issued in reasonable amounts. These safeguards would give investor the confidence, knowing that it would be harder for directors to breach their duties and to benefit from shareholder investments.

INVESTMENT BANKS

Investment banks are also supposed to be gatekeepers on the assumption that they would not sacrifice their reputations by providing false information. However, research analysts at these banks have given misleading advice – sometimes advising clients to buy shares in companies they knew were not doing well because they were hoping to earn large fees from those same companies. Some of these banks have now

3 Paul G Mahoney, 'The Development of Securities Laws in the United States' (2009), 47(2) Journal of Accounting Research 325 <<http://ssrn.com/abstract=1394636>> 22 August 2009.

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had to pay large amounts in compensation and we can expect stricter scrutiny of analysts in future. Again, these measures should increase shareholder confidence.

CREDIT RATING AGENCIES

Credit rating agencies have allegedly been the culprits in the most recent global financial crisis. The rating agencies in the United States 'exploited their regulatory status to profit from the booming sub-prime mortgage market at the expense of homeowners'.⁴ Consequently, various countries are now introducing rules regulating credit rating agencies, for example, the SEC has proposed that rating agencies be required to disclose 100% of their ratings actions in a publicly accessible format.⁵ There have also been suggestions that the rating companies should be held liable to the investors in residential mortgage backed securities who have lost large amounts in the recent financial crisis.⁶

THE LAWYERS

The question arises: if lawyers assist in concealing the true financial position of a company – by for example advising on ways to hide debt (as in Enron with its off-balance sheet partnerships) – aren't they misleading shareholders?

Shouldn't the lawyers have some obligations towards the shareholders of the companies for which they work? If they did, perhaps investors would gain confidence knowing that the best legal minds were not working against them.

THE REGULATORS

Regulators have an important role to play in the administration and enforcement of corporations law.

As regards corporate governance, the main regulators in Australia are ASIC (Australian Securities and Investment Commission) as well as APRA (Australian Prudential Regulatory Authority – which is responsible for banks and insurance companies).

4 David J Reiss, 'Rating Agencies: Facilitators of Predatory Lending in the Subprime Market' in RW Kolb (ed), *Lessons from the Financial Crisis: Insights and Analysis from Today's Leading Minds* (2010). <<http://ssrn.com/abstract=1439748>> 22 August 2009.

5 For further proposals, including a regime that holds rating agencies directly accountable for their rating quality, see John P Hunt, 'Comments on Securities and Exchange Commission Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations' (Working Paper, University of California – Davis School of Law and Berkley Centre for Law, Business and the Economy, 2009) <<http://ssrn.com/abstract=1369308>> 13 August 2009.

6 Kristofor William Nelson, 'Rough Waters for the Rating Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007-2008?' (2009) 63(4) *University of Miami Law Review*. <<http://ssrn.com/abstract=1430552>> 22 August 2009.

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The main stock exchange is the ASX (Australian Stock Exchange). The ASX's function is really to regulate the market – to set and enforce the rules for companies to list on the stock exchange, particularly their disclosure obligations. It is responsible to ensure that the market is efficient, fair and transparent. It is not responsible for broader corporate regulation. Nevertheless, the ASX has established a 'Corporate Governance Council' which has drawn up a set of the best corporate governance principles.

All of these bodies have been criticized for not being active enough during recent collapses and crises. Like many other stock exchanges around the world, the ASX converted from a co-operative to a public company listed on its own exchange a few years ago. This placed it in a conflict of interest situation as it then had a responsibility to maximize its profit which means the more listings and trading the better. Some allege that this encouraged it to lower the standards required for a public listing and to relax disclosure requirements, for example regarding stock lending and short selling.

It has recently been announced that ASIC will take over more direct supervision and control of stockbrokers and market conduct such as insider trading. The problem is that ASIC itself has been criticised for not being vigorous enough in its enforcement role in the past. Whilst there may be some truth in this, it should be acknowledged that it is impossible for regulators to pursue every instance of alleged misconduct and that, on the whole, the market in Australia has come through the recent global financial crisis in reasonably good shape.

EFFECTIVE INSOLVENCY PROCEDURES

This is an often forgotten but important monitoring mechanism. If the law empowers liquidators to conduct effective investigations of corporate collapses, this may lead to the uncovering of misconduct and resulting liability. Recent research shows that the legal provisions concerning the creditors' control rights in the insolvency process are a strong predictor of the average growth rate.⁷

In Australia, the effectiveness of this mechanism has increased as litigation funders are now permitted to operate. They have provided the funding required to institute class actions on behalf of investors against companies and directors who have contravened the law. The reward for the litigation funders is a share of the damages if the action is successful.

⁷ Benedettini, above n 1. Interestingly, this author claims that the rule of law negatively affects the growth of the stock market as, in countries where the rule of law is more effective, managers have less incentive to go public given that a stronger enforcement of minority shareholders' rights could limit their ability to perform asset stripping. This seems a rather cynical view as the law should not allow asset stripping in the first place.

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THE MARKET FOR CORPORATE CONTROL

This is, again, a sometimes overlooked but important mechanism for improving corporate governance. The threat of a hostile takeover encourages management to run their company efficiently. If they do not, the share price will decline and potential bidders may decide that they could take over the company and run it more efficiently. Thus, it is important for the legal system to provide a procedure that allows takeovers whilst also ensuring that shareholders in the target company are protected.

INDEPENDENT COURTS OR ARBITRATORS

An effective corporate governance system requires an impartial decision maker to resolve disputes that may arise. The courts are one option but they often involve lengthy delays and high costs. Furthermore, the adversarial nature of court litigation often leads to a worsening of the relationship between the parties.

Seen as an alternative to courts, independent arbitrators are now being considered for resolving a variety of industry specific disputes. Often experts in a field, independent arbitrators offer a neutral decision that the parties contractually agree to be bound by. In this way, the conflict comes to an end quicker, without being bound by legal precedent or convention. Costs are generally lower than if the dispute is handled by courts but, more importantly, business relationships are salvaged as the adversarial method, found in courtrooms, is avoided.

By not following the litigation route, shareholder confidence may be increased knowing that companies would utilise independent arbitrators for speedy dispute resolutions.

CONCLUSION

The use of companies to commit fraud is nothing new. *The Times* of 30 October 1929 in England commented on the 'orgy of speculation' in shares that preceded the subsequent crash and criticised the 'newly invented conceptions of finance' that had been used to artificially inflate share prices. Those comments could just as easily have been written today.

Legal systems have to utilize all of the checks and balances discussed above to promote good corporate governance. Consideration of these various mechanisms in Vietnam to decide which operate efficiently and where there may be room for improvement is already underway. Securities regulation is, for example, one area where it has been suggested that legislative reform may be required. The challenge for governments around the world is to provide the legislative framework for the mechanisms to operate efficiently to promote economic activity whilst also protecting the interests of the various stakeholders involved in that activity.