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Law in Society: The Corporate Governance Debate

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Introduction

Corporate governance has to do with the way in which companies are managed and controlled. It has become a major issue during the last two years. It has moved from the business pages of the newspapers to the front pages. We have had President Bush speaking about it - as well as our Prime Minister, John Howard, and the leader of the Federal opposition. They have been promising a much tougher approach to corporate abuses and crime. (Though John Howard has also said that he does not want to unnecessarily burden business)

Why has this happened?

The greater part of the population these days has an interest in shares and the stock market. About half the adult population in Australia have investments in the stock market - either directly or through an intermediary, for example a superannuation fund or other managed investment. Many young people these days invest in shares as a means of saving and building up some capital.

As such, they need to understand their basic legal rights as shareholders. For example, do they have a role in monitoring the company? And, if so, what assistance does the law provide them?

But there is also a broader interest to society. 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. But investors will only invest if they have confidence in the market.

Not so long ago, the economy in the United States was being held up as a model to all. In contrast to the so-called 'crony capitalism' which was blamed for the problems in many of the Asian economies. Academic writers on corporate law were even writing about the 'End of History for Corporate Law' - meaning that the system of corporate regulation in the United States was so good that everyone would follow it, as there really was no successful alternative.

And then suddenly it all changed...and with shock serious flaws in the system were exposed. It all really started with the collapse of Enron - this was one of the largest companies in the United States. It collapsed owing millions of dollars. Some people state that this had a greater effect on the US economy than September 11.

This was followed by the collapse of other big companies - or the 'restatement' of their profits by huge amounts. It became apparent that the management of these companies had been misleading investors in those companies with the result that those investors lost millions of dollars. The revelation of these abuses lead to the phrase 'cowboy capitalism'.

Then we saw similar collapses in Australia - HIH, One.Tel, Harris Scarfe, Ansett and others.

What went wrong?

There is of course an awful lot that one could say about this - but it is also possible to extract the main points. 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. So, we have a classical conflict of interest situation - and the law has to try and resolve this.

It is the regulation of this conflict that we need to critically analyse. Does the law achieve a just, fair and equitable solution to this conflict? What are the ethical, social and economic implications of this problem?

There are various mechanisms - checks and balances - that are designed to ensure that the mangers of companies don't act in their own interests and that shareholders are kept informed about their company. For example:

- Fiduciary duties of directors (ie to act fairly and honestly)
- Annual audits by independent auditors (who then report to shareholders).
- Regular reporting - quarterly in the United States.
- Independent directors.
- Rules against insider trading (ie someone should not use information to their benefit when that information is not available to all the market such as knowledge of a large upcoming profit or loss or major discovery that may impact positively or negatively on the share price of a company)..
- Independent analysts who advise investors.

Why didn't the safeguards work? And how do we fix them?

1 Auditors were not sufficiently independent

Some of them encouraged 'creative accounting' - cooking the books - to influence share prices artificially. Their reward for this was huge fees for consulting work. So there was a lack of professional accountability here. One of the largest accounting firms in the world, Arthur Anderson, has had to close down because of its involvement with some of these corporate collapses.

This failure will lead to more regulation of auditors - as self-regulation has clearly not worked - for example, we may see compulsory rotation of auditors, limits on consulting, etc.

2 Share options

These 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. But they were abused.

Some directors and executives effectively gave themselves millions of dollars - even in badly performing companies by manipulating the share price. Options are also criticised because they can lead to short-term cost cutting that leaves the corporation ill prepared for the future.

There are now calls for options to be accounted for as a cost in the financial statements of companies - plus approved by shareholders. Some companies have even announced that they will no longer use them - for example, Commonwealth Bank (though its chief executive is reported to have made $80 million out of his options). This is probably an overreaction. But we can expect to see rules to ensure that options are properly accounted for, have appropriate performance hurdles, and are issued in reasonable amounts.

3 Independent directors

They are supposed to look after the interests of shareholders by keeping an eye on management. The problem is that many of them weren't really independent. Often they had links with management and were mates who gave in to pressure

So there are calls for these directors to be truly independent and to exclude those who even indirectly receive any benefit from the company beyond their director's fee. There are also calls for more diversity on corporate boards - for example, representatives of employees and consumers.

4 Investment banks

Research analysts at these banks gave misleading advice - sometimes advising clients to buy shares in companies they knew were not doing well. Why? Because they were hoping to earn large fees from those same companies. Some of these banks have now had to pay large amounts in compensation and we can expect stricter scrutiny of analysts in future.

5 The lawyers

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

Long after the Enron debacle, its law firm was still touting its skill in off-the-books financing advice - on its website. No wonder some say that 99% of lawyers give the rest a bad name.

Shouldn't the lawyers have some obligations towards the shareholders of the companies for which they work?

Closer to home - HIH

If we take the example of HIH: we saw a failure across various levels: The company's management, its boards of directors and its auditors (Arthur Andersen). And also failure by the regulators - ASIC (Australian Securities and Investment Commission) as well as APRA (Australian Prudential Regulatory Authority - which is responsible for insurance companies).

Some also blame the ASX (Australian Stock Exchange) but that is probably not justified. The ASX's function is really only 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' to draw up a set of the best corporate governance principles. Other organisations in Australia are also working on formulating best practice guidelines. A Royal Commission has been investigating the collapse of HIH and we await its report.

Political implications

There is a further dimension to all of this - that has arisen particularly in the United States context but may also have relevance here. It goes to the essence of our democracy and the issue of who really has power in our society.

Enron had close links with both the Clinton and the Bush administrations - It made huge financial contributions to their political campaigns - and of course many other large companies make similar contributions. So there is some scepticism about whether any really effective reforms will be introduced. As one commentator in the Unites States put it: 'In a bloodless coup, our government by, for and of the people has been replaced by the dictatorship of the corporate dollar.'

On the other hand, the use of companies to commit fraud is nothing new. The Times of 30 October 1929 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.