

# WHY ALL DIRECTORS SHOULD BE SHAREHOLDERS IN THE COMPANY: THE CASE AGAINST 'INDEPENDENCE'

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## **Abstract:**

*One common theme among the recent string of corporate collapses world-wide (exemplified by the collapse of Enron in 2001) was the close association between members on the board of directors and their external advisers. As a result of this, the centrepiece of recent corporate governance reform programs in jurisdictions across the world has been that directors satisfy the requirement of 'independence'. While the meaning of 'independence' has been the subject of confusion, one thing that is clear is that underlying the requirement for 'independence' is a view that a close connection between the director's self-interest and the interests of the company is a necessarily bad corporate governance practice. Accordingly, a common theme in the various reform programs is a restriction on directors holding shares in the company for which they are on the board. In this article, the authors challenge this position. It is argued that the shift towards more 'independent' directors is a fundamentally bad move, which undermines the rights and powers of minority shareholders and entrenches a second-rate corporate governance model - the separation of ownership and control - in our company law. Rather than suggest cosmetic reform to existing shareholder rights and remedies in an attempt to address the problem, the authors propose that all directors must have a significant interest in the company they serve so that the directors' self-interests and the best interests of the company become inextricably intertwined. It is argued that this is an effective way to tackle the problem of separation of ownership and control head on.*

## **The Shift towards Independence of Directors - Australia and internationally**

### *Background and the Rush for Corporate Governance Reform*

In the past few years there has been a string of corporate collapses. Notable instances are the plight of Enron, HIH and Onetel.<sup>1</sup> This is nothing new. It seems to be an almost cyclical event. In the Australian context, about a decade ago even

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1 See, for example, Henry Bosch, 'The Changing Face of Corporate Governance' (2002) 25 *University of New South Wales Law Journal* 270.

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middle Australia was taken aback by the collapse of the Quintex group and the Pyramid Building society. As was the case then, corporate governance is the 'flavour of the month'.<sup>2</sup> The acuteness of the problem in corporate governance is not only reflected by corporate collapses but also corporate salaries. The last decade has seen an explosion in corporate salaries. The sums have been so offensive that even the Prime Minister, John Howard, has commented that 'golden parachute' amounts of up to \$30 million paid to executives are outrageous. This is no minor matter given that he is the liberal leader of a market economy nation.

There is an enormous amount of commentary concerning the causes of recent corporate collapses; about what went wrong and how to fix it.<sup>3</sup> Indeed tens of millions of dollars have been spent investigating the HIH collapse and how to minimise the likelihood of such collapses, which result in the impoverishment of shareholders to the tune of hundreds of millions of dollars, recurring. A common theme following such reviews is that the 'cosy' relationships between board members and their external advisers is considered to be one of the main reasons for the collapses.

Although many companies that collapse have effective corporate governance structures in place, the close relationship between their board and their advisers is often perceived as a problem that needs to be addressed. 'Independence' of directors is considered a priority. A common feature of corporate governance reform packages in Australia (ASX Corporate Governance Recommendations),<sup>4</sup>

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2 Various reports on corporate governance (particularly in Australia and UK) which expressly state that one of the key objectives of corporate governance regulation is protecting and promoting the interests of shareholders. For example, the Bosch Committee Report in Australia, the Cadbury Committee Report in the UK and the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations* (1992). See generally, Helen Bird, 'The Rise and Fall of the Independent Director' (1995) 5 *Australian Journal of Corporate Law* 235. Also Harold Ford, R P Austin and Ian M Ramsay, *Ford's Principles of Corporations Law* (11th ed, 2003) 296-304; Robert Baxt, Keith Fletcher and Saul Fridman, *Corporations and Associations: Cases and Materials* (9th ed, 2003) 263-268. More recently, see, for example, the introduction to the ASX Corporate Governance Council's 'Principles of Good Corporate Governance and Best Practice Recommendations', March 2003 ('ASX Recommendation's):

The Best Practice Recommendations are not prescriptions. They are guidelines, designed to produce an efficiency, quality or integrity outcome. [They do] not require a 'one size fits all' approach to corporate governance. *Instead [they state] aspirations of best practice for optimising corporate performance and accountability in the interests of shareholders and the broader economy.* If a company considers that a recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it – a flexibility tempered by the requirement to explain why [except for audit committee requirements which are mandatory]. [Emphasis added.]

3 See, for example, the thematic edition (corporate governance) of the *University of New South Wales Law Journal* in Volume 2 of 2002.

4 Available on-line at <[http://www.asx.com.au/about/CorporateGovernance\\_AA2.shtm](http://www.asx.com.au/about/CorporateGovernance_AA2.shtm)>.

the United Kingdom (Higgs Report- 'Review of the Role and Effectiveness of Non-Executive Directors')<sup>5</sup> and the United States (through the *Sarbanes-Oxley Act* 2002) and other common law jurisdictions is a move towards 'independent' directors. A common test of 'independence' is that directors must not be substantial shareholders of the company.<sup>6</sup> While various corporate governance reform measures do not rule out having shares in the company according to the test of independence, they do significantly curtail the opportunity for this. For example, ASX Corporate Governance Council Recommendations state that in order for directors to be considered independent they must not be substantial shareholders in the company.<sup>7</sup> What is meant by substantial is not discussed in the guidelines but is rather a judgment left to the board. Moreover, it is assumed that lack of such independence is undesirable. This is reflected by the fact that directors must establish and justify in the annual report and to shareholders that holding beyond a certain amount of shares does not jeopardise the characterisation of directors as being independent and does not (at least doctrinally) place a barrier between shareholding and directorship.

### **Purpose of Article**

#### *The luxury of spending someone else's money*

The collapse of insurance giant HIH in particular has had the expected outcome. Many thousands of shareholders lost sizeable sums of money due to the mismanagement of the directors of HIH. This led to predictable calls for an investigation into what went wrong. Faced with this pressure, the Australian government established a royal commission and undertook to implement *every* recommendation in the report of the royal commissioner.<sup>8</sup> This will lead to several more pages being added to the thousands that already comprise the *Corporations Act*. Whether these several pages will make a meaningful change to the frequency of corporate mismanagement is unknown. To this end, only time will tell; but we think not. Directors already have a statutory duty to act and make decisions in good faith and for a proper purpose.<sup>9</sup> It is both a statutory and common law duty that directors must always resolve any conflict of interest from outside influences

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5 Available on-line at <[http://www.dti.gov.uk/cld/non\\_exec\\_review/pdfs/higgsreport.pdf](http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf)>.

6 See April 2003 Corporate Governance Report of law firm Mallesons Stephen Jaques for comparative list of corporate governance reforms in Australia, the UK and the US. Available on-line at <[http://www.mallesons.com/publications/alerts/Corporate\\_Governance\\_Alert\\_April\\_2003.pdf](http://www.mallesons.com/publications/alerts/Corporate_Governance_Alert_April_2003.pdf)>.

7 See Recommendation 2.1 and Box 2.1 of the ASX Corporate Governance Council recommendations.

8 See the Final Report of the HIH Royal Commission ('HIH Report'), available on-line at <<http://www.hihroyalcom.gov.au/finalreport/Front%20Matter,%20critical%20assessment%20and%20summary.HTML>>.

9 See *Corporations Act 2001* (Cth) ss 180 (duty of due care and diligence) and 181 (duty to act in good faith and for a proper purpose).

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in favour of the best interests of the corporation. Our confidence that proposed reforms will fail is based on the lessons of history - high profile large corporate collapses have led to more corporate regulation, leading to more director's duties and reporting requirements, followed by more corporate collapses and so the pattern continues. The recommendations in the HIIH Royal Commission report do nothing to address what we believe is the central failing of corporate governance regulation.

The main problem with corporate governance is not that directors have too few duties (or reporting requirements) or that shareholders have too few remedies. It is unlikely that imposing a handful of extra duties or reporting requirements on directors will cure the endemic problem of corporate mismanagement. Directors can be very creative when it comes to circumventing the law or, on many occasions, simply ignoring it - money is a very strong motivational force. The ethos that prevention is better than cure applies as much to law as medicine. We should be seeking to dismantle the corporate structures that, by their very nature, provide a disincentive to prudent and responsible financial decision making. Perhaps no amount of legal regulation in terms of directors' duties and reporting requirements will instill integrity and diligence into corporate governance. A system of corporate 'box ticking' is not the answer to personal indiscretion.

In our view, the problem with the regulatory scheme under the corporations law is far more fundamental than the nature of the duties imposed on directors - it stems from the division between corporate control and ownership. The fundamental cause for the poor financial decisions of many company directors stems from one main reason: *they are spending somebody else's money*. Human nature being what it is, people care far less, and sometimes not at all, about what is not theirs. In the corporate governance context this is not a revelation, it is technically known as 'agency costs'.<sup>10</sup> Jensen and Meckling discuss the problem of agency costs as follows: 'because managers cannot capture all of the gains if they are successful, and will not suffer all of the losses should the venture flop, they have less incentive to maximize wealth than if they themselves were the principals'.<sup>11</sup> Moreover, as Adam Smith wrote in *The Wealth of Nations*:

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10 See Daniel Cheffins, 'Current Trends in Corporate Governance: Going from London to Milan Via Toronto' (1999) 10 *Duke Journal of Comparative and International Law* 5, 15.

Since corporate executives receive only a tiny fraction of returns derived from the profit-enhancing activities they engage in on behalf of shareholders, they may be tempted to use their control over corporate assets to further their own interests at the expense of those who own equity. To the extent that top managers pursue their own agenda, they impose what economists refer to as 'agency costs' on these investors.

11 Daniel Fischel, 'The Corporate Governance Movement' (1982) 35 *Vanderbilt Law Review* 1259, 1262. See also Michael Jensen and William Meckling, 'The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

The directors of such companies, however, being the managers of other people's money than of their own, it cannot be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. ... Negligence and profusion, therefore, must always prevail more or less, in the management of the affairs of such a company.<sup>12</sup>

Although this proposition is not new, it is one that seems to be all but lost on many of those searching for ways to reform corporate governance.

The purpose of this paper is to build on this fundamental concept and argue that the key to better corporate management lies in a closer alignment between the interests of the shareholders and directors - to the maximum extent possible, their fortunes should rise and fall together. This would reduce the degree of reckless spending decisions by directors, and at the same time guarantee - as a natural cause - a closer relationship between the directors and the interests of shareholders. It is almost inconceivable that a person would give \$30 million of his or her money as a payout to an employee. It is inconceivable that a person would use his or her money to buy \$15,000 gold watches for every person he or she employs.<sup>13</sup> Inconceivable is, we are aware, a strong term. However, we are aware of no sole trader or partnership (even the wealthy partnerships such as the large law firms) that has made such prodigal spending decisions.

We do not propose to discuss in detail the current regime for protecting shareholder interests and catalogue the supposed advantages and shortcomings of the various provisions. This is an exacting task and is well summarised in any number of corporate law books. Moreover, this type of analysis would detract from the main focus of this paper and we believe that changes along the lines of existing directors duties and shareholder remedies would be superfluous. As discussed, no matter how many duties are placed on directors and how clearly shareholder remedies are spelt out, the separation of ownership and control through the widely dispersed nature of ownership will continue to provide an overwhelming obstacle to effective enforcement of directors' duties. The separation of ownership by its nature erects several barriers to enforcing prudent corporate governance practices.

This article is concerned with reforming corporate governance principles with a view to providing greater protection to *shareholders*. We do not focus on the issue of enhancing the protections that are afforded to creditors and other parties, such as employees, that are affected by the activities of companies. However, the proposals that we advance in this article will not, in our view, adversely impact on the existing rights held by corporate creditors and employees. To the extent that such rights are affected, it is likely to be positive as a result of more diligent and

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12 Adam Smith, *The Wealth of Nations* (1937), 699.

13 This was a feature of the HIH company which ultimately collapsed.

responsible corporate governance practices that are likely to flow from the proposed reforms. As will emerge, the model we are proposing will place directors in a similar position to partners in large partnerships, and there is no evidence that creditors or employees of large partnerships are treated worse than their corporate counterparts.

In Part 2 of this article, we provide an overview of what is meant by independence. This is followed by an analysis of the arguments against independence. After rejecting these arguments we set out in Part 3 the principles that we believe are the key to responsible and effective corporate governance. In this regard, we contend that the separation between directors and shareholders should be closed by making it a pre-condition to becoming a director of a public company that the director is a material shareholder in the company.

### **The Meaning of Independence**

In the corporate governance context, the concept of independence most commonly arises in terms of a relationship (for example, family and business connections) between directors and outside parties, and transactions which involve businesses or persons which could reasonably be perceived to interfere materially with the exercise of directors' unfettered and independent judgment. According to the ASX Corporate Governance Council ('CGS') definition, key factors of leading to a judgment that a director is 'independent' include:

- within the past three years the director has not been employed in an executive capacity by the group or been a director after ceasing to hold an executive position of the group;
- within the past three years the director has not been a principal of a material professional advisor or material consultant to the group or an employee materially associated with the service provider;
- the director is not a material supplier or customer of the group or an officer of or otherwise associated directly or indirectly with a material supplier or customer;
- the director has no material contractual relationship with the group other than as a director;
- the director has not served on the board for a period which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company; or
- is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.<sup>14</sup>

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14 ASX Corporate Governance Council, 'Principles of Good Corporate Governance and Best Practice Recommendations' (2003), para 2.1. See further, Editorial: 'Two Major Reports Show the Way in Law Reform ' (2003) 31 *Australian Business Law Review* 141.

On the contentious issue of cross-directorships and family ties, the CGC has gone only so far as suggesting in its Commentary and Guidance that cross-directorships and family ties may be relevant and should be disclosed to the board but they do not form part of the CGC definition, unlike the UK Higgs Report.<sup>15</sup>

We agree with most of the above restrictions. However, to the extent that independence of directors is believed to be compromised by ownership of the company (as is implied by the last restriction), and therefore is in some way adversely affecting a director's judgment, we believe that this is a misuse of the term. Certainly, it has been noted that a shareholding in the company may impact on a director's independence. For example, this is a point not missed (but ultimately not endorsed) by Mr Justice Owen in the recently released HIH Report notes:

I agree that it is appropriate to give guidance as to the circumstances which need to be considered in determining independence ... However, neither the matters raised during the Commission nor my experience generally qualifies me to say whether all of the matters listed would necessarily deprive a person of independence. I am again concerned that an attempt to be unduly prescriptive might impose undesirable rigidity, and distract attention from the critical issue of freedom from possible influences, many of which may be subtle and not susceptible to a 'check-list' approach.

For example, *it is not immediately clear to me why a substantial shareholding in the company should be regarded as compromising independence. Such a shareholding may provide greater incentive to bring the interests of the company to bear.* On the other hand, the fact that a director has a close personal association with the chief executive may be destructive of independence, but is very difficult to assess objectively or on a 'check-list' basis. The critical question, it seems to me, is not so much whether, on objective criteria, the individual is 'independent' but rather whether he or she is subjectively capable of exercising independent judgment.<sup>16</sup>

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15 The meaning of materiality in the Corporate Governance Council definition of independence is left by the Recommendations to a determination by the Board. Accordingly, the question for the board becomes what if a director is connected with an advisor, supplier or other entity with a business relationship? What is the threshold for it to be material?

Accounting Standard AASB 1031 provides guidance in relation to a quantitative assessment of materiality. There is a presumption of immateriality if the transaction is equal or less than 5% of base amount, and presumed to be material (unless evidenced to the contrary) if equal to or greater than 10% of appropriate base amount. If revenue derived from the advisor, supplier or other contracting party is less than 5% of its total revenue, then the director connected with that party is deemed to be independent unless there are other convincing reasons. Other qualitative factors may determine whether or not a relationship is considered material.

16 HIH Report, above n 8, 6.2 (emphasis added).

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Of course, the ground breaking discussion and analysis of the separation of ownership and control and its implications was by Berle and Means in *The Modern Corporation and Private Property*.<sup>17</sup> This has since been refined, and indeed criticised, in commentaries and texts on corporate governance across the globe. According to Berle and Means, separation of ownership and control means that shareholding (including shares owned by directors) is widely dispersed, thus denying shareholders the capacity to properly scrutinise managerial decision-making.<sup>18</sup> Prentice has provided what we believe is the most succinct and accurate overview of the thesis of Berle and Means. He notes:

The Berle and Means argument has now become part of our intellectual luggage. The argument has an elegant simplicity. Because shareholders in the large listed company are dispersed, relatively ignorant, and individually hold a small percentage of the total issued shares of a company, they exercise little control over corporate management. There was a divergence between ownership and control - ownership being vested in the shareholders and control in the directors, with the latter being for all intents and purposes a self-perpetuating oligarchy. This separation of ownership and control had a potential, according to Berle and Means, for causing a divergence between the interests of the owners and managers without there being any effective check on the power of the latter. ... The intellectual insights of Berle and Means have provided the point of departure for most contemporary writing on the corporate governance debate.<sup>19</sup>

Despite the rise in institutional investment over the last decade or so, shareholding in public companies remains widely dispersed (aided by increasing retail investment in shares), and hence the separation of ownership and control continues to be a live issue. Swept up in this is the increasingly common argument that directors should not have (at least substantial) holdings in the company. This trend towards more widely dispersed companies has been followed in Australia and the UK, with the effect being shareholder apathy and disenfranchisement (demonstrated particularly recently) as shareholders (we refer here to individual shareholders, not institutional shareholders who do have the ear of management) remain distanced from the day to day affairs of the company. Shareholders are less able to exercise control over corporate management - the ultimate effect of separation as recognised by Berle and Means.<sup>20</sup>

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17 Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (1932).

18 See generally Brian Cheffins, 'Comparative Corporate Governance and the Australian Experience' in Ian Ramsay (ed), *Key Developments in Corporate Law and Trusts Law: Essays in Honour of Professor Harold Ford* (2002) 13.

19 'Some Aspects of the Corporate Governance Debate' in D D Prentice and P R J Holland, *Contemporary Issues in Corporate Governance* (1993) 27. See further Cheffins, *ibid.* (cannot find their full names).

20 Berle and Means, above n 17.



The point we wish to make here is simply that there is a widely held sentiment that company directors should be 'independent'. The meaning of independence is unclear.<sup>21</sup> However, it usually extends to directors not having a financial stake in the company. If the independence concept does extend this far we believe it is wrong. Where it does not, it is important that the uncertainty concerning the scope of the concept does not extend to block such connections. Moreover, irrespective of how one chooses to define independence, we believe it is important to argue the merits of an idea, not the terminology. It is to this issue that we now turn.

### **Economic 'Arguments' in Favour of the Separation of Ownership and Control**

The following are the main arguments commonly raised in favour of the traditional separation of ownership and control model of governance. Although they are often raised as strong reasons for maintaining the status quo, as will be discussed, they are really nothing more than unsupportable assumptions lacking empirical evidence, and where empirical evidence has been undertaken (albeit limited), the assumptions have been proven simply incorrect and contrary to reality.

#### **The risk aversion argument**

There is an argument that under the model of separation of ownership and control, directors are less likely to be risk averse as through the company it is the shareholders', rather than the directors' money, that is on the line.<sup>22</sup> It is argued that in closely-held corporations there is a 'powerful incentive to preserve wealth rather than create it'.<sup>23</sup> This suggests that if directors had a financial stake in the company, this would in some way stifle effective entrepreneurialism.

This argument is only true to an extent - and to that extent it supports the thesis offered suggested in this article. We do not disagree that people are more cautious spending their own money than that of other people. This means that necessarily they are less likely to be entrepreneurial, but only to the extent that this involves uninformed and speculative spending decisions.

Psychological studies have shown that people have a strong materialistic drive. They want money and resources. What is more there is a very strong motivation

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21 See Bird, above n 2.

22 Michael Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301, 306 - where it is argued that separation is conducive to risk-taking.

23 Brian Cheffins, 'Corporate Law and Ownership Structure - A Darwinian Link?' (2002) 25 *UNSWLJ* 346, 357.

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to make more and more money.<sup>24</sup> By and large, people do not stop at their first \$100,000 or with the acquisition of the first house or sports car - people have an unseemingly insatiable appetite for more resources. Thus, individuals at a personal level apply their skills and resources to deriving more resources; they are not preoccupied with simply holding the ground they have already acquired. This being the case, it is simply wrong to 'assert' that if directors have a financial stake in the company they will not strive to make more money. Given that people do want to make more money, it obviously follows that they want to preserve their existing asset base. Yet, these are hardly aspects of human nature that we ought to be seeking to disabuse from the make-up of directors. In fact the opposite.

The overriding duty of directors is their fiduciary duty to act in the best interests of the company. Risk necessarily involves the possibility of financial ruin. This cannot be in a company's interests. Companies are not set up for the purpose of engaging in risky investments - casinos adequately fill that void. They are established, in nearly all cases, with a view to enabling private individuals to increase their resource base. In order to do this, some level of financial outlay is necessary. This will entail some risk - even if it is no more than placing money in a term deposit. However, because some risk is required, it is a quantum leap to assume that one of the distinctive features of company trading is to participate in highly risky ventures. Economic principles governing the creation of wealth are not sensitive to the identity of the investor. If a private individual will make money buying stocks or houses, so too will a company and vice versa. It is where the money is put that determines the outcome of an investment, not its source. Prudent investment dictates a balance between risk and safe investments. Certainly in some cases an argument may be mounted that more weight should be given to one variable than another. This, however, applies equally to corporations as it does to real people.

A company with ample cash reserves may be advised to 'punt' on funding a new invention, but so too would an individual who has already put away enough money for his or her retirement. The sentiment that companies *should* by their very nature engage in more risky investments than individuals evinces a misunderstanding of the purpose for which companies operate. Moreover, it is a descriptive observation of what companies actually often do (punt other peoples' money); as opposed to a normative assessment of what they ought to be doing - spending more money wisely. Thus, if directors had a financial stake in the company, it is likely that they would be more prudent with company assets: no more \$30 million retirement pay outs, no more gold watches for employees and no spending money on speculative ventures. This is hardly a criticism of our proposed reform.

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24 David G Meyers, *The Pursuit of Happiness* (1990) Tim Kasser, *The High Price of Materialism* (2002).

### The managerial quality argument

It has been argued that the separation of ownership and control model ensures high quality directors are appointed to run the companies, as separating management from shareholding ensures that managers/directors are appointed on merit. American Henry N Butler, for example, has written that an advantage of separation of ownership and control is that executives are hired on the basis of their managerial credentials, rather than their ability to finance the firm.<sup>25</sup>

We accept that directors should be chosen on the basis of their business acumen and their inability to buy a substantial stake in the company should not be a consideration which acts as a veto to assuming a position on the board. However, this does not detract from our proposal.

First, it should be noted that the problem may not be as acute in reality as is inferred by Butler. Professional management is not necessarily removed in closely-held corporations. This is demonstrated by experiences of many large European companies.<sup>26</sup> Secondly, as is discussed below, changes can be made to remove the separation of ownership and control by mandating that directors buy a material stake in the company when they enter the board. Thirdly, the overwhelming evidence is that the imposition of a stakeholder requirement as a pre-condition to managing an entity does not deter high quality people from assuming managing roles. In this regard an analogy can be drawn with law firms. Law firms are perhaps the largest non-corporate business structures in the country. This is not by choice, but rather due to the traditional legal requirement that has prevented them operating under a corporate structure. The partnership structure that law firms have been coerced into adopting provides an excellent natural social experiment concerning the impact of making shareholding a pre-condition to assuming a management role.<sup>27</sup> In this regard the evidence is unequivocal. Partnerships in law firms, which can carry a price tag into the millions, are (with the possible exception of judicial appointment) the most coveted legal appointments. It is hardly the case that there is a shortage of high quality lawyers that are willing to buy a stake in the law firm (even if this is a significant financial sacrifice for them) to become partners.

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25 Henry N Butler, 'The Contractual Theory of the Corporation' (1989) 11 *George Mason University Law Review* 99.

26 See Cheffins, above n 23; Prentice, above n 19.

27 We also note that companies, most notably Westpac, have in place a requirement that directors own a certain number of shares in the company. Moreover, under the old Table A of the Corporations Law (which many companies still have in place as their constitution), there is a requirement that each director hold one share until such other arrangement is established by the general meeting. See Jonathan Farrer and Ian Ramsay, 'Director Share Ownership and Corporate Performance- Evidence from Australia' (1998) 6 *Corporate Governance: An International Review* 233, 233.

### The economic performance argument

The above arguments are theoretical in nature and therefore involve matters of judgment and speculation. Astute readers will recognise that what is missing is empirical evidence. The answer to the simple question: 'Do companies with independent directors out-perform companies with non-independent directors?' would weigh extremely heavily in the debate.

It has been argued that companies with disparate shareholdings perform better. For example, in a recent work, 'Back to the Drawing Board', Colin Carter and Jay Larsch note:

Aligning director interest with those of shareholders, by making them shareholders, can erode the directors' independence and even act as a catalyst for actions that are not in the interests of all shareholders. Directors who own stock could think about what is in their personal interests as shareholders and not think broadly about all the shareholders.<sup>28</sup>

However, the empirical evidence raises doubt about this claim. For example, Cambridge professor Brian Cheffins has observed:

There is no meaningful correlation between ownership structure and corporate performance. ... [I]t cannot be taken for granted that the widely held professionally managed firm will yield superior economic outcomes.<sup>29</sup>

Similarly, Australian governance experts Fred Hilmer and Lex Donaldson, in a excerpt reproduced in the second edition of the much-cited work, *Strictly Boardroom: Improving Governance to Enhance Company Performance*, noted:

The first assumption of the independent director dogma is that boards made up predominantly of independent outside directors produce better results than boards made up predominantly of managers. Researchers have examined companies to see whether this is true. The results are fascinating. Most studies fail to find that outsider-dominated boards are associated with more profitable companies. On the contrary, most studies find that outsider-dominated boards produce poorer company performance

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28 Colin B Carter and Jay W Larsch, *Back to the Drawing Board* (2004), 43. They refer to the Enron collapse to demonstrate the potential for directors to manipulate financial numbers to paint an 'unrealistic picture' of a company's financial standing and suggest that this raises issues as to the utility of alignment (p48). This argument, however, is not persuasive. Legal norms of general application cannot be guided by a desire to deter fraud. There are already criminal laws prohibiting such behavior. Moreover, the empirical evidence does not support the view that independent directors on the board leads to fewer illegal acts by the corporation: see, Fred Hilmer, *Strictly Boardroom: Improving Corporate Governance to Enhance Company Performance* (2nd ed, 1998).

29 Cheffins, above n 23, 356.

and that insider-dominated boards are superior. These results are meaningful because most researchers start out expecting to prove that outside boards are superior.

A majority of managers on a board may reduce its independence. However, this is offset by the insider board's far greater expertise in the company's business, leading to higher performance than under the outside board.<sup>30</sup>

It has been pointed out by commentators like Cheffins that while many large US companies that are structured according to the Berle-Means model separating ownership and control have been tremendously successful, large companies in European countries where ownership is more closely-held (indeed, ownership commonly remains in the family) have been just as successful, if not more successful, than their US counterparts over the years.<sup>31</sup> According to Cheffins:

The Berle-Means model needs to offer intrinsic economic advantages to ensure that it is driven to the forefront. Research demonstrates that companies with widely held shares have not moved to the forefront. Indeed, they are very much the exception in the vast majority of industrialised countries.<sup>32</sup>

Further, the fact that some companies structured according to the Berle-Means model are economically successful, does not necessarily mean that they would not be equally successful with a more closely-held ownership structure, or that companies (particularly in European countries such as Germany and Belgium) that have an ownership structure whereby shareholding is more closely-held are any less successful.

Additionally, recent corporate collapses cast further doubt on the economic performance argument. The last two years has seen many large companies in the US and Australia (namely Enron and HIH), structured on the Berle-Means model, collapse or come close to collapse. It seems that the success or failure of a company is predominantly determined according to the vagaries of the market and the nature of the industry that a company is competing in, rather than whether a company's shareholding is widely dispersed or, conversely, remains closely held.<sup>33</sup> The distinction between substance and form is certainly applicable here.

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30 Fred Hilmer and Lex Donaldson, *Management Redeemed* (1996), reproduced as Appendix 1 in Fred Hilmer, *Strictly Boardroom: Improving Governance to Enhance Company Performance*, above n 28.

31 See Cheffins, *ibid.* Also Cheffins, 'Current Trends in Corporate Governance', above n 10. For counter arguments, John Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control' (2001) 11 *Yale Law Review* 1.

32 Cheffins, above n 23, 354.

33 *Ibid.*, 369.

Ultimately, there is no clear empirical evidence establishing a necessary and clear link between ownership concentration and corporate performance.<sup>34</sup> The results of Australian and US studies on this issue are collated in a series of excellent papers by Baxt, Ramsay, Stapledon and Farrer.<sup>35</sup> The upshot of the studies is that there is no evidence to suggest that companies with independent directors perform better than other companies. The reason for is that there are simply too many variables that play a role in the fortunes of a company, such as the general economic climate and the nature of the particular business and finance sector under consideration, making a controlled study impossible.

It follows that any claim of a connection between ownership concentration and corporate performance is nothing more than assumption. Indeed, according to Cheffins, the evidence is to the contrary, that manager-controlled firms have been less profitable due to the problem of agency costs, that is, directors detracting from the performance of the firm by acting in their own self-interest rather than being focused on pursuing the best interests of the corporation.<sup>36</sup> Cheffins considers agency costs to be the major problem with the Berle-Means model, with directors naturally inclined to act in their own self-interest. At the same time, there is practical evidence of a relationship between ownership concentration and (i) the rights/powers of shareholders, and (ii) the exercise/enforcement of such rights/powers (eg minority shareholder apathy). In Australia, this is seen with shareholder apathy in attending meetings, voting and exercising other functions, and through under-utilisation of shareholder powers (eg the oppression remedy

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34 Harold Demsetz, 'The Structure of Ownership and Control and the Theory of the Firm' (1983) 26 *Journal of Law and Economics* 375; Harold Demsetz and Kenneth Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' (1985) 93 *Journal of Political Economy* 1155; Jeffrey Lawrence and Geof Stapledon, 'Do Independent Directors Add Value?', Research Report, 1999, Centre for Corporate Law and Securities Regulation, executive summary:

US and UK studies have produced mixed results on whether independent directors add value. Those studies that have sought to find a relationship (direct or indirect) between board composition and corporate performance have, overall, not produced convincing evidence that independent directors enhance corporate performance. ... (In relation to Australian studies) two groups of studies were carried out. The first group of studies searched for a direct relationship between board composition and corporate performance. The second group of studies focused on whether independent directors had a positive influence in the area of executive remuneration. On the whole, the studies produced no solid evidence that the proportion of independent directors influences corporate performance (whether measured as share price returns or accounting performance).

35 See Robert Baxt, Ian Ramsay and Geof Stapledon, 'Corporate Governance in Australia: The Evolving Legal Framework and Empirical Evidence' in Low Chee Keong, *Corporate Governance: An Asia-Pacific Critique* (2002) 175-176; Geof Stapledon, *Institutional Shareholders and Corporate Governance* (1996); Farrer and Ramsay, above n 27.

36 See generally Cheffins, above n 23.

and derivative actions under Part 2F.1A of the *Corporations Act*), even though such powers are structurally and technically sound in comparative terms.

### **Law Reform in a Climate where Relevant Empirical Evidence is Lacking**

In the absence of empirical evidence one way or another, it is logical that legal reform should be driven by assumptions concerning human nature. The enthusiasm for the proposal in question should be roughly commensurate with the degree of confidence that the assumption is valid. This is certainly the approach that has been taken in the development of other areas of the law. For example, in the criminal law a common form of punishment is the imposition of a fine. This assumes that people dislike having part of their wealth being taken from them.<sup>37</sup> Another assumption, in the field of sentencing law, is that rehabilitation works. Therefore sentences are often justified or modified in order to rehabilitate an offender. This assumes that it is possible to engender internal attitudinal reform in a person while at the same time harming (punishing) the person. There is always the possibility that future empirical studies will rebut such assumptions. And indeed, the weight of available evidence suggests that the goals of punishment and rehabilitation may be inconsistent due to the apparent inherent contradiction between punishing a person while simultaneously attempting to promote his or her internal reform.<sup>38</sup> In circumstances where empirical evidence rebuts assumptions that underpin legal principle, the law ought to be changed to accommodate the new findings.

However, in the absence of relevant probative empirical evidence bearing on the persuasiveness of a reform proposal, the best that we as a community can do in reforming is to (i) ground such decisions in fundamental aspects of human nature; and (ii) lay down the nature of these assumptions. The first step is forced upon us due to the absence of deeper knowledge. The second is optional, but is critical if the law is to develop in a coherent manner. Making clear the assumptions that underpin legal principle identifies for both advocates and critics the area in which further research should be undertaken to ensure that the law continues to be developed in a reasoned and logical fashion.

To this end, the assumptions that our reform proposal rests upon are (i) people care more about what is theirs; and (ii) people make more prudent and thoughtful decisions regarding matters that directly affect them. Applied in a corporate setting this means that if the people who control the company also have a meaningful ownership stake in the company, they are more likely to make better informed and more prudent financial decisions.

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37 For a general discussion regarding the assumptions underpinning criminal sanctions, see Mirko Bagaric, 'New Criminal Sanctions: Inflicting Pain Through the Denial of Employment and Education' [2001] *Criminal Law Review* (UK) 184.

38 See Mirko Bagaric, *Punishment and Sentencing: A Rational Approach* (2001), ch 6.

## CORPORATE GOVERNANCE REFORM - A TALE OF CONTRADICTION

### The need for fundamental reform

Prior to outlining our reform proposal we first discuss the broad merits of connecting ownership and control in the context of corporations. There is a contradiction in saying that the interests of shareholders are a central concern in reforming corporate governance practices (as, discussed above, a number of recent corporate governance reports have suggested),<sup>39</sup> while going about implementing changes to further separate ownership and control through ensuring that directors are independent by not having a substantial/material shareholding in the company. A relationship between directorship and shareholding should be encouraged and fostered, rather than discouraged. This contradiction needs to be emphasised. To repeat what Justice Owen stated in his report following the HIH Commission, *'it is not immediately clear to me why a substantial shareholding in the company should be regarded as compromising independence. Such a shareholding may provide greater incentive to bring the interests of the company to bear'*.<sup>40</sup>

Considering the problem of agency costs and an unfortunate disinclination by some directors properly to apply company funds to the on-going affairs of the company, independence is not the way to go about ensuring directors adhere to the overriding fiduciary obligation of acting in the best interests of the company. Indeed, it is our view that the most realistic and effective way to ensure directors act in good faith and in the best interests of the company is to establish an interconnectedness between the director's self-interest (which they will naturally, as human beings, endeavour to satisfy) and the best interests of the company by making directors shareholders in the company.

Management within companies is highly structured and professional, with the consequence being that shareholders feel more and more distanced from the company and its affairs, and have less agency with the company. Shareholders are more likely to be oppressed by an increasingly powerful board of directors and feel that they are incapable of doing anything about it, thus explaining how the phenomenon of shareholder disenfranchisement and apathy, and the growing issue of under-utilisation of shareholder rights/powers is very much connected with the entrenchment of separation of ownership and control.

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39 See also, for an international perspective, the older article of M Lipton and S A Rosenblum, 'A New System of Corporate Governance: The Quinquennial Election of Directors' (1991) 58 *University of Chicago Law Review* 187 in which it is discussed that corporate governance structures are designed with a view to reflecting the wishes of shareholders, who naturally want their rights protected and to receive an adequate share of company profits.

40 Refer to HIH Report, above n 8.



Rather than tinkering with the rights and powers of minority shareholders to overcome what is called the 'tyranny of the majority' (in reference to minority shareholders) and the emerging issue of shareholder apathy and under-utilisation of shareholder rights/powers, it must be recognised that in reality any legislatively-enshrined shareholder rights/powers are not a significant cause of shareholder apathy/feelings of disenfranchisement. What is, rather, is the underlying problem of separation of ownership and control. Technical legislative reform to existing minority shareholder remedies to address outstanding problems would thus amount to no more than cosmetic reform.

It is time that the separation of ownership and control is tackled head on. If enhancing the interests of shareholders is genuinely considered the central objective of corporate governance reform, and the Berle-Means model of separation of ownership and control is disenfranchising shareholders and undermining the effectiveness of shareholder powers, then rather than move towards independence of directors as a key objective, the main focus of corporate governance reform needs to focus on shareholder's place in the corporation and the implementation of changes to the underlying foundation of corporate governance to address this. This makes complete sense given that shareholder interests are the key concern of corporate governance reform.

Despite the growing recognition of the need to protect shareholder rights (and in particular minority shareholder rights given the increasingly dominant role of institutional investors in Australia and elsewhere)<sup>41</sup> as a key plank of corporate law objectives, we continue to implement initiatives which further entrench the separation of ownership and control. The push for more independent directors - thereby further dismantling the link between directorship and shareholding, is the clearest example of this. If we are truly concerned with ensuring that directors are effective in monitoring and supervising management with a view to the company's affairs being managed in the best interests of the company, then independence of directors is the last thing we should be striving for. Indeed, Professor Nicholas Wolfson has written of the reform agenda of installing more independent directors on boards of companies as follows:

The fundamental design of the reform is to place control over the corporation in the hands of people whose major interests are elsewhere. Stated so accurately and baldly the proposition sounds fairly idiotic but it

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41 See, for example, Ian Ramsay and Mark Blair, 'Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies' (1993) 19 *Melbourne University Law Review* 153, 176-186; Baxt, Ramsay and Stapledon, 'Corporate Governance in Australia: The Evolving Legal Framework and Empirical Evidence' in Keong, above n 33, 175-176; G P Stapledon, *Institutional Shareholders and Corporate Governance* (1996).

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is ... the most widely accepted reform effort of the past decade.<sup>42</sup>

Similarly, Carter and Lorsch recently argued:

Today, having as many truly independent directors as feasible has become a synonym for effective corporate governance ... [t]his creates a difficulty that is rarely discussed. Having an overwhelming majority of independent directors means having a board that is likely to know little about the business or its industry. This lack of knowledge is particularly worrisome, since a good understanding of the business is something we've already flagged as critical to the effectiveness of a board.<sup>43</sup>

Cheffins has said that 'when shareholder protection is in place, the best arrangement is a widely-held professionally-managed firm'.<sup>44</sup> This statement raises the crux of the current corporate governance contradiction. The statement of Cheffins suggests that effective shareholder protection mechanisms (in the form of rights and remedies) and the separation of ownership and control can happily co-exist. It is our view, however, that this is contrary to the position in reality. The separation of ownership and control *inherently* undermines shareholder protection mechanisms as shareholders either become so apathetic that they do not use them, or are so distanced from the company and its affairs that they do not know or apprehend that such remedies are available. Therefore, even if separation of ownership and control produces economic benefits (which, as is argued above, has not been substantiated), a choice needs to be made between shareholder protection and economic performance as the overriding objective when implementing corporate governance reforms. If the interests of shareholders are designated as the overriding objective, which the recent wave of corporate governance reform programs expressly suggest, then the underlying structure of separation of ownership and control needs to be directly targeted and fundamentally reconsidered.

**How can this Contradiction be addressed?**

The contradiction between expressing as a priority the protection and enhancement of shareholder interests, and further entrenching the Berle-Means model of corporate governance which undermines these interests, can be addressed in various ways. We stress that cosmetic reform will not be enough. The separation of ownership and control needs to be tackled head on. This is not the first time that this has been considered, although usually the response among legal academics is to strengthen the rights and remedies of shareholders as an attempt to protect them from the tyranny of the board and majority shareholders,

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42 Nicholas Wolfson, *The Modern Corporation – Free Markets Versus Regulation* (1984) 83, cited in John Farrar, *Corporate Governance in Australia and New Zealand* (2001) 346.

43 Carter and Lorsch, above n 28, 44.

44 See Cheffins, above n 23, 355.

rather than embracing the idea of shareholder and director 'alignment', by way of directors also being shareholders, which financial economists (particularly in the US)<sup>45</sup> and management experts<sup>46</sup> have written about for years.

One American legal commentator who *has* proposed linking ownership and control through director share ownership was Elson, but this was designed to overcome the explosion in director remuneration in the US, rather than set in place a corporate governance regime where shareholder interests are the key priority for directors (which will, we submit, also rein in directors' salaries). Further, rather than setting in place a regime of threshold levels of share ownership as a prerequisite to becoming a director as we are proposing, Elson suggested that directors' would acquire their share ownership by receiving their annual fees in the form of company stock.<sup>47</sup>

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45 According to Carter and Lorsch, above n 28, 47, the alignment argument was introduced in the 1980's, and is that the director's job is to provide the best possible return to shareholders, and will do a better job if they think and act like shareholders. Therefore, directors should own stock, and non-executive directors should be paid wholly or partially in stock and/or options. Carter and Lorsch go on to discuss that whilst the 'alignment' concept was initially met with resistance in countries outside the US, due to the stock options becoming an integral part of corporate governance practices, things are changing. The main US academic articles on the 'alignment' concept, are George P Baker, Michael C Jensen and Kevin J Murphy, 'Compensation and Incentives: Practice versus Theory' (1988) 43(3) *Journal of Finance* 593; Michael C Jensen and Kevin J Murphy, 'Performance Pay and Top Management Incentives' (1990) 98(2) *Journal of Political Economy* 225.

46 See, for example, Hilmer and Donaldson, above n 30, 62: 'A preferable way [to create a financial incentive] may be an arrangement which gives the manager bonuses either annually or on a deferred basis in step with increases in share value'. For US analysis, see M C Jensen, 'The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems' (1994) 6(4) *Journal of Applied Corporate Governance* 4, 19 ('much of America's governance problems arise from the fact that neither management nor board members typically own substantial fractions of their firm's equity'), and J K Kerr and L Kren, 'The Effect of Outside Directors and Board Shareholdings on the Relation between Chief Executive Compensation and Firm Performance' (1997) 27(4) *Accounting and Business Research* 297 (which argues that executive director shareholdings act as an incentive that aligns managers and shareholders interests, and thus reduces the need for alternative governance controls such as board monitoring).

47 Charles M Elson, 'Duty of Care, Compensation, and Stock Ownership' (1995) 63 *University of Cincinnati Law Review* 649. See also Demsetz, above n 32, 387 who suggests that due to the 'diluting' effect of the separation of ownership and control on shareholders and their interests vis-à-vis the company, 'there would seem to be a demand for an ongoing supervision of management or for a linking of the interests of management to those of shareholders.' Also Brian Cheffins, above n 10, who proposes linking executive remuneration with shareholder return. 'The theory is that executives need to be motivated to think like shareholders: if those who run companies face the same risks and opportunities as those who invest, they will have a direct incentive to do what is best for investors.'

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Although separation of ownership and control is the root cause of shareholder apathy and disenfranchisement, the existence of such separation remains sacred ground in the arena of corporate governance reform. Indeed, rather than address separation, the current reform agenda seems to be about fostering the separation - in simple terms, separation will be even more distinct if there is a stricter requirement for director 'independence'. If directors are required to have a significant shareholding in the company as we are proposing, then our companies would resemble the closely-held companies in European countries where, interestingly, it is not considered as important to have strong shareholder remedies in place.<sup>48</sup>

Although separation of ownership and control is a problem in terms of shareholders effectively utilising their rights and powers, who is to say that this will change by addressing the separation of ownership and control? How will making directors shareholders improve the lot of existing shareholders? Will directors simply continue to act according to their own self-interest, rather than perform their proper obligation of acting in the best interests of the company- ie what's in it for the minority shareholders? The point is that by making it mandatory for directors to have a material shareholding in the company, the problem of agency costs is resolved because the best interests of the company become the director's own personal interest by way of them having a stake in the company. *The director's self-interest necessarily becomes what is in the best interests of the company. The distinction between the director's personal interests and company's interests is closed.* In addition to this, it would encourage directors to take more interest in the company's affairs. Directors would be moved to find out more information about the company's activities, thereby leading to more informed and balanced decisions. To again quote from Carter and Lorsch's recent work:

The ironic truth is that the more independent directors there are on a board, the more reliant it is on management information. When companies go into decline their boards have generally been slow to respond to warning signs. A common excuse from the board members is that they rely on information from management. Unfortunately, independence can make directors even more captive to management's view of the business - the diametric opposite of what independence is intended to achieve.<sup>49</sup>

### **Tackling the Separation of Ownership and Control Head On - The Authors' Proposed Governance Model**

At the outset it is important to note that the reforms we suggest would be limited to directors, not to all of management. It is unnecessary to extend the proposal beyond directors given that the role of directors is to supervise the activities of

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48 See, for example Cheffins, above n 23; Prentice, above n 19.

49 Carter and Lorsch, above n 28, 46.

management. Our proposal will, in our view, overcome the tyranny to 'small shareholders' caused by the existing separation of ownership and control. If the directors are required to have a similar stake in the company, they are less likely to act oppressively towards other shareholders, and are less likely to be frivolous with the company's funds given that it would then become their money that is being used. As Elson argued in his excellent article in the *University of Cincinnati Law Review*:

The solution to the problem of the passive board lies not in using the threat of legal liability to force compliance with some theoretical standard of care, but in creating an environment where a board finds it in its own self-interest to engage in active oversight.

...

The outside directors must be made to consider management initiatives, not from the perspective of one engaged by and beholden to management, but from the viewpoint of the stockholders to whom they are legally responsible. The best way to create this perspective is to appeal directly to those directors' pecuniary interests. To ensure that they will examine a management proposal in the best interests of the stockholders, we must make them stockholders as well.<sup>50</sup>

In terms of defining the guidelines that should govern eligibility for directorship, directors need to have a sufficient stake in the company to overcome agency costs and similar problems, rather than abusing their position and flitting away company funds. At the same time, the shareholding requirement cannot be too substantial, otherwise the current problem of majority shareholder tyranny will simply exist in a different form, as the board of directors could use their combined shareholding to protect their own agenda, and such a shareholding requirement would thus become a real deterrent to good quality people becoming directors and simply be overly burdensome.<sup>51</sup> As Farrer and Ramsay noted in their study of director share ownership in Australia:

... [H]igh director ownership makes it less likely that (outside) institutions will have a large stake in the company, in which case institutional monitoring of directors and management is reduced. Directors with high share ownership would also wield significant power at company meetings. With immense voting power and minimal market monitoring, these directors effectively become 'entrenched'. As a result, these directors will have secure jobs even if the company's performance is mediocre. They may also be able to divert corporate resources to their own ends in a way that is not consistent with maximizing shareholder wealth.<sup>52</sup>

Given this need for a balancing of considerations, and to address the wide scale of

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50 Elson, above n 42, 652

51 See generally Farrer and Ramsay, above n 27.

52 Ibid, 236 (citations omitted).

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difference in the size of many of Australia's public companies, we propose that a 'materiality' scale of shareholding based on the nominal share capital in the company be used (to be introduced into the *Corporations Act*) to determine the level of shareholding required of directors. We propose that for public companies with nominal share capital of less than \$100m, directors would be required to have a 3% stake in the company. Between \$100m and \$500m, directors would be required to have a 2% stake in the company, and over \$500m, the directors would be required to have at least a 1% stake in the company. These shares would be in the open market, so that the capitalisation of the firm is not affected.<sup>53</sup> Further, the ownership requirement would need to be satisfied within 6 months of taking office as director, rather than 5 years which is common for stock ownership policies in the US. On what basis were these threshold figures derived? First, empirical evidence suggests that the average number of directorships on boards of Australia's top 100 companies is close to 9.<sup>54</sup> This means that even for smaller companies, based on these threshold requirements, the directors (collectively) would usually not have a majority stake, therefore overcoming issues concerning possible 'entrenchment' of power (ie if director share ownership is too high, this could lead to overly cautious investments as directors have too much at stake), and the potential for directors to hold the company to ransom.<sup>55</sup> Secondly, for each

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53 This last point draws on an often-cited incentive structure developed by Salomon Brothers. According to Hilmer and Donaldson, above n 30, 64, under this scheme: Once the individual bonus was determined, a fixed percentage is withheld and used to buy stock in the firm.

This stock is repurchased in the open market, so that the capitalisation of the firm is unchanged. The stock then is held in trust for the employee, who will not be able to withdraw it for five years. In effect, the value of each employee's current bonus is tied to the overall market value of the firm five years in the future. The plan covers all employees, although there are different percentages applied to those at the managing director level and above. ... The explicit aims were to change the culture, to encourage a long-term perspective and co-operation and to align the employee's interests with one another and with those of the stockholder owners.

54 Geof Stapledon and Jeffrey Lawrence, 'Board Composition, Structure and Independence in Australia's Largest Listed Companies' (1997) 21 *Melbourne University Law Review* 150, 172 (study showed an average of 8.89 directors). John Farrar has also conducted a survey of the top 100 listed Australian listed companies, which found that in 1999 there was an average of 9.6 directors, comprising 7.4 non-executive directors and 2.6 executive directors. There was also an average of 0.7 women as directors. See Farrar, above n 42, 347. See also Korn/Ferry International, *Board of Directors in Australia and New Zealand* (2000) 8.

55 See Farrar and Ramsay, above n 27, 235 for a discussion of the entrenchment argument. The study by Farrar and Ramsay also shows a negative correlation between increases in director share ownership and corporate performance. In terms of the study of Tobin's Q measured (defined in the study as the market value of equity divided by the book value of equity), corporate performance fell as the percentage of share ownership increased. While performance progressively improved as director share ownership increased between the 0-5% director share ownership bracket, there was a steady drop in performance in the 5-20% bracket as share ownership increased,

particular director, the level of ownership cannot be too high, otherwise the entry price will be too prohibitive. Importantly, as part of our proposal, directors would not be able to dispose of their shareholding while remaining on the board to prevent them profiteering from more stringent regulation in the area of corporate governance.

A potential problem with this threshold proposal is the argument that (at least in substance) this does not depart in any way from existing practice, given that notwithstanding issues of independence many companies already require directors (under the company's constitution or through company policy) to acquire a certain level of stock ownership in the company.<sup>56</sup> Thus, it could be argued that,

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with performance then stabilising once ownership is beyond the 20% bracket. Overall, however, mean shareholder returns increased as the percentage of director share ownership rose. A similar result was found when measuring the effect of increases in director share ownership on growth in earnings per share in the company (GEPS). While Farrar and Ramsay conclude from their study that significant share ownership should not be encouraged as, based on the results for Tobin's Q, Tobin's Q was highest when ownership is in the 0-5% bracket, we believe that even if our proposal results in directors collectively holding up to 27% (based on 9 directors in a small company each having a 3% stake), this is not a concern as the benefits in terms of reduced agency costs and enhanced shareholder participation outweighs the potential for a minor deterioration in corporate performance (although we do not necessarily think that performance would deteriorate at all). See Farrar and Ramsay, above n 27, 240.

56 In the US, many companies have adopted so called 'stock ownership guidelines'. These guidelines require (or encourage) senior officers and/or directors within a company to obtain a certain specified level of share ownership (expressed as a multiple of the remuneration amount, within 5 times the annual remuneration amount being common), a defined number of shares or a particular dollar value), within a specific time period (commonly 5 years). Some companies include requirements that directors/executives retain a certain level of equity-based remuneration (eg share options or restricted shares) in excess of the guideline ownership level. See Blake Dawson Waldron, 'Remuneration and Benefits Update', February 2004, available via [www.bdw.com.au](http://www.bdw.com.au). A useful example of company stock ownership guidelines in the US is that for McDonalds. McDonalds in the US has separate guidelines for 'outside directors' and executive officers. McDonalds' encourages both to have a significant stock ownership in the company. In 1997, minimum stock ownership requirements were adopted for all officers. In May 2003, it established a requirement for a certain minimum number of shares to be owned according to the level/band of each officer's position within the organisation. In Australia, stock ownership guidelines are not common, but large public companies (such as Woolworths) do have director share ownership requirements. Note also IFSA (Investment and Financial Services Association, a national not-for-profit organisation representing over 100 members within the retail and wholesale funds management and life insurance industry investing approximately \$685 billion on behalf of over nine million Australians) Guidance Note No 2.00, 'Corporate Governance: A Guide for Investment Managers and Corporations', Guideline 8.2.11 which recommends that a public company should establish and disclose in its annual report a policy to encourage non-executive directors to acquire shares in the company (but not to take part in incentive share or

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particularly in Australia, directors can satisfy the test of 'independence' so long as they do not have a 'substantial' shareholding in the company.<sup>57</sup> Indeed, it may be that directors are already permitted to hold a greater stake in the company than is prescribed under our model. Yet this is a weak argument for two reasons.

One, on a practical level it assumes that all directors already have a considerable stake in the company. While this may be true in some instances, the mean level of share ownership is significantly less than we prescribe. A study reported by Farrer and Ramsay shows that the mean level of director share ownership for all listed public companies was 10.26%. Broken down further, the mean level of ownership for small, medium and large companies was 19.18%, 9% and 2.68% respectively.<sup>58</sup> Accordingly, given the average number of directors in the larger end of Australian public companies highlighted above, directors would have a strong presence (on average approximately 20%) on the board.<sup>59</sup>

One obvious issue with our proposal is the potential problem of talented business people who appear to have the knowledge and skill to be become directors of (even large) companies not having the wealth to buy into the company. Would not our reform proposal effectively exclude a large pool of candidates from such positions, thereby diluting the talent that is available to manage our top companies? How does a person without inherited wealth obtain the \$1 million plus to 'buy' his or her way into a directorship? Ostensibly this argument seems strong, but there are a range of financing options that can be employed to redress the issue. For example, legislative mechanisms (most appropriately through the *Corporations Act*, or regulations to the Act) could be set in place whereby directors who do not have the funds to acquire the required stake of shares in the company, would incur an interest-free debt to the company.

Moreover, as we discussed earlier in this article, industry practice suggests that talented people do not regard buying a stake in a firm/company as being a deterrent to assuming a leading role in an organisation.<sup>60</sup> Law firms are an

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option offers and other programs available to executives). The IFSA Guidelines are used to determine the approach of IFSA members (superannuation funds, financial trustees etc) to corporate governance, voting and other issues proposed by public companies in which members invest their clients' funds.

57 See Recommendation 2.1 and Box 2.1 of the ASX Corporate Governance Council Recommendations.

58 See Farrer and Ramsay, above n 27, 236. For the relevant definitions of 'small', 'medium' and 'large' companies, see 238.

59 Insert reference to empirical evidence that shareholding between 0-5% is positive in terms of the correlation with company performance, then deteriorates somewhat between 5% and 20%, before increasing again over 20%.

60 See also the Investment and Financial Services Association's Guidance Note 2: '*Corporate Governance: A Guide for Investment Managers and Corporations*' in which it is recommended that the board of directors of each publicly listed company should



excellent illustration of this. Forced by legal regulation to adopt a non-corporate structure they are bonded by large - sometimes very large - partnerships. The cost of buying into a partnership (in law firms which impose this requirement to becoming partner) in the case of the top echelon firms runs into the millions of dollars. Yet there is certainly no shortage of talented and capable people willing to take on such a debt to become a partner. While there are manifest structural differences between a partnership and corporation, the analogy is apt.

The final point to note is the enormous difference between the manner in which large partnerships and companies operate. In the case of large partnerships, given that those at the top have a large financial stake in the company and personally depend on the profitability of the firm for their livelihood, there is, relatively speaking, no hint of financial scandal or impropriety. No outlandish spending, no reckless risk taking. There is simply not an issue in relation to agency costs because partners are not agents of the firm- they have a direct stake in the firm and therefore have a real incentive to keep all costs (apart from, perhaps, their salaries) to a minimum.

Some commentators will have reservations concerning the exact manner in which ownership should be tied to control and more generally how the interests of shareholders and directors can be harmonised. For example, another (or additional) alternative is that the remuneration of directors could be directly tied to the performance of the company, as the 'pay for performance' movement in corporate governance demands.<sup>61</sup> While we agree that there is some merit in this proposal, we believe that our proposal is preferable because capital investments are typically less transient and therefore more central to a person's financial well-being than income streams.

## Conclusion

The separation of control from ownership is necessarily inimical to good corporate governance. First, it minimises the information that is available to the owners concerning the affairs of the company. Secondly, the widespread nature of ownership reduces the level of interest that any particular owner has in the affairs of the company. It also leads to co-ordination problems. The more people (or votes) that are required to change the management structure, the more difficult this process becomes. Ultimately, the distinction between ownership and control means that the typical shareholder - who is by definition removed from the board - becomes, more and more distanced from management, leading to growing shareholder disenfranchisement, growing shareholder apathy (both in the sense of

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establish (and disclose) in its annual report an explicit policy encouraging non-executive directors to acquire shares in the particular company.

61 See also Elson, above n 42.

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general participation in the company's affairs, and through under-utilisation of shareholder rights and remedies) and poor corporate performance.<sup>62</sup> Therefore, tinkering with (or even a fundamental overhaul of) shareholder rights and remedies will not help; the underlying problem which is the real cause of shareholder disenfranchisement and apathy is the separation of ownership and control - a position that will become further 'entrenched' with a strict requirement for directors to be independent.

Meaningful corporate reform requires a re-assessment of the fundamental problems associated with corporate management. In our view many of the problems (prevalent particularly in large corporations) stem from the fact that the separation of ownership from control means that directors are placed in a position where they are spending other peoples' money. This is the pure and simple cause of agency costs. Human nature dictates that the financial decisions made in such a context will not be as prudent or informed as is normally the case. Until law reformers wake up to the virtues of an 'alignment' of shareholder and director interests, a concept that other disciplines have wilfully embraced, the exploitation of large numbers of shareholders will continue.

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62 On the point of the positive correlation between director share ownership and corporate performance in Australia, see Farrer and Ramsay, above n 27, 248:

We have empirically examined whether there is a positive relationship between the level of director share ownership and the performance of Australian companies. The results, although to some extent inconclusive, suggest there may be a link between director share ownership and returns to shareholders, which is arguably the best performance measure for companies.'

Also Elson, above n 42, 653 notes that in the US the empirical studies of the relationship between outside director stock ownership and corporate performance showed that 'companies with substantial outside director equity ownership tended to outperform companies whose directors had insubstantial holdings.'