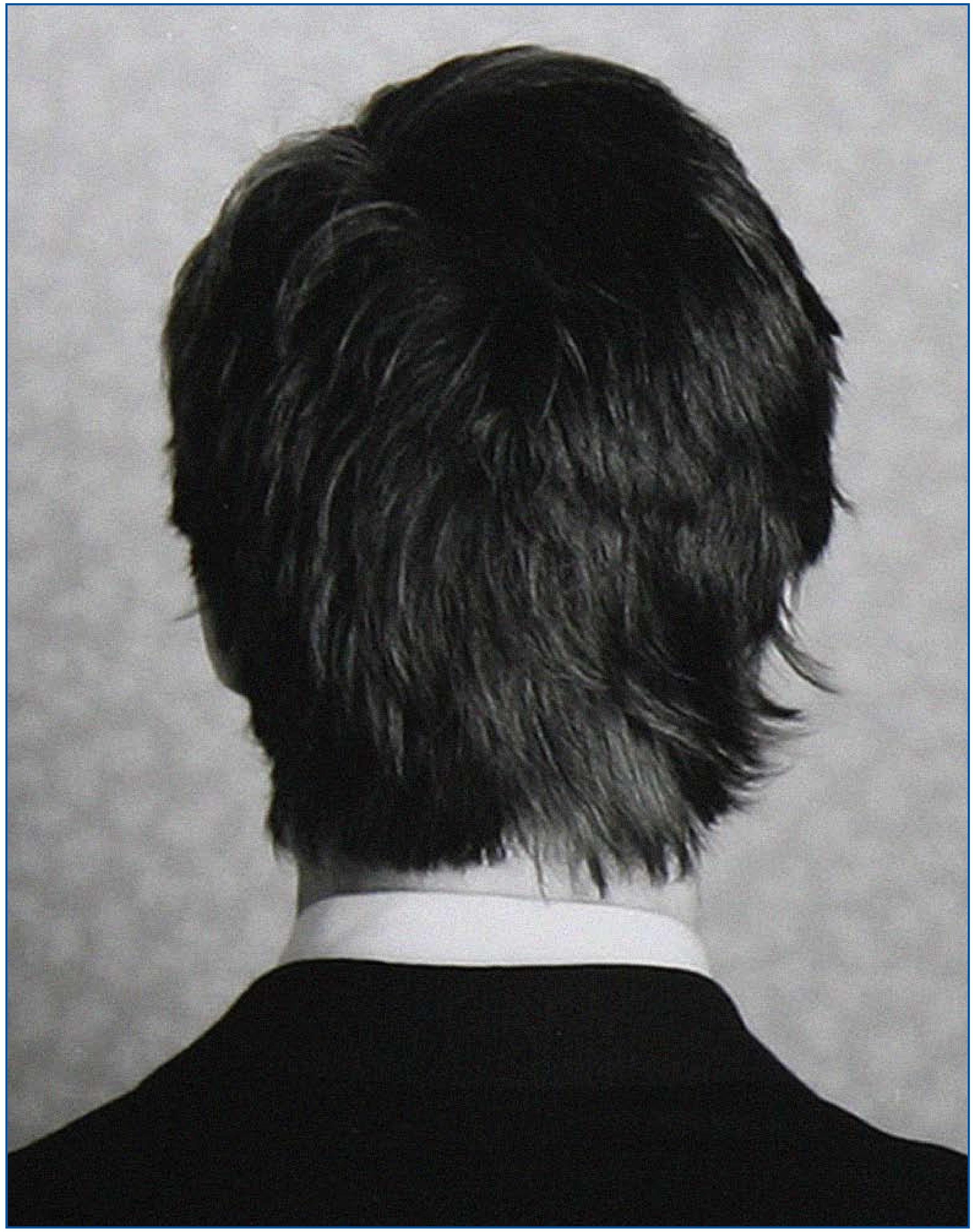


THE TENSION IN CORPORATE GOVERNANCE

Keeping tabs on company health

Susan Watson

Why shareholders are not best-placed to reign in wayward management

LENGTH : **9 min** (2090 words)

GOOD CORPORATE governance is rather like good health: we may all be guilty of neglecting it until its absence causes us actual harm and then it starts to matter to us rather a lot. During the economic boom over the past decade, corporate governance was treated by some as the compliance tick-the-box aspect of running a company. Others saw it as window dressing, with the most egregiously rapacious entities trumpeting their compliance with codes of good governance, along with socially responsible practices that often allowed iron fists to be concealed in green velvet gloves.

Golden Fleece

Those who actively set out to fleece the public ...eventually find a way around the law.

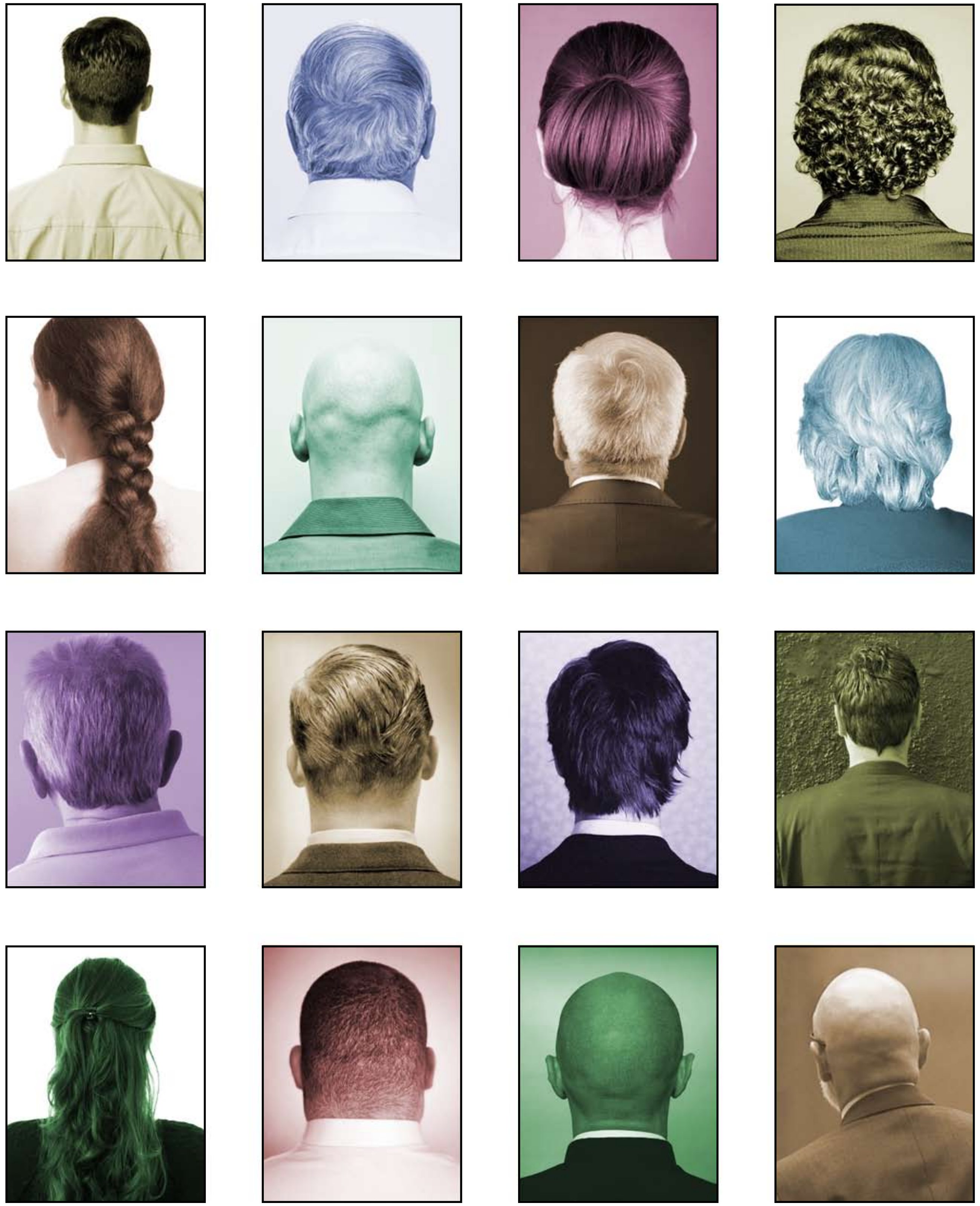
THE THING about cycles is that they revolve, and the Global Financial Crisis—and New Zealand's related, but unique, crisis in the finance sector—have highlighted grievous governance failures.

IN HINDSIGHT it seems remarkable that those failures went undetected. The legislative response, both internationally and within New Zealand, has been (relatively) swift. In New Zealand, the focus has been on creating a single, well-resourced regulator of the financial markets so that action against transgressors will not continue to fall in the gaps between existing regulators. Also, the Securities Act 1978, which regulates offers of securities to the public, will get an overdue overhaul. And breaches of some directors' duties will become criminal offences.

But, although the Financial Markets Authority intends to improve its market-intelligence capabilities, many of the legislative responses are *ex post* mechanisms—improving the ways in which wrongdoers are held accountable rather than preventing the wrong doing in the first place. For example, no explicit protection exists for corporate whistleblowers who report breaches of directors' duties, (something I have written on elsewhere with Rebecca Hirsch.) Whistleblower protection might at least allow wrongdoing to be detected at an earlier stage.

The legislative responses are also reactive in that they identify existing holes in financial market enforcement and seek to plug them. Reactive legislation in this area is not new. The Securities Markets Act 1988 was a response to the sharemarket crash of 1987 and the resulting exposure of insider breaches; the Securities Act 1978 was a response to the 1977 Securitibank crash. At that time, securities legislation was contained in the Companies Act 1955; those who sought to avoid it needed only to offer securities to the public using entities other than companies. Earlier examples exist. In fact, the first piece of investor-protection legislation in New Zealand—the Promotions and Directors' Liability Act 1891—was a response to an English case, *Derry v Peek* (1889) 14 App Cas 337, where it was held that a plaintiff in an action for deceit based on a false representation in a prospectus must prove actual fraud. What this history tells us is that, whatever the legislative response, determined wrongdoers—those who actively set out to fleece the public—eventually find a way around the law.

What to do? The solution may lie within the companies themselves—by improving corporate governance and board accountability in some fundamental way. One approach, advocated by some North American commentators, is to increase the powers of shareholders. It is assumed that empowered shareholders would be able to monitor management and remove those who were malfeasant or incompetent. If shareholders really could control directors, this approach would be sound. Shareholders would have the opportunity to limit their loss or, at the very least, make such directors responsible for corporate failure. However, I believe that it will become increasingly



accepted that this approach is flawed. The idea that individual shareholders can monitor and control management has existed since the inception of the modern company in the mid-19th century, and it continues to persist despite all evidence to the contrary. In fact it is very rare for diverse groups of shareholders to act to appoint or remove directors or to reign in management abuses. The exception is when shareholders derive power from holding a significant or controlling stake in a company. In closely held companies, for example in many family-controlled European companies, shareholders exercise that power. The classic conception of the company expounded by Berle and Means highlights the separation of ownership (in shareholders) from control (in management) as the defining characteristic of the corporate form. Once that gap is bridged by controlling shareholders, the separation between ownership and control narrows. In the classic conception of the corporation, shareholders acting in that capacity should not instruct and control directors. Separation of ownership and control is one of the fundamental tenets of company law and when it does not exist companies become, in substance but not form, a type of partnerships. Also, if shareholders do bridge the gap between ownership and control to too great an extent, they risk being deemed directors, and therefore subject to many of the obligations of directors. The ability of majority shareholders to control management is not an example of the company model working but rather of it being bypassed.

The 19th-century theory that underpins the long-held belief that shareholders can monitor management and reign in abuses is that shareholders (as principals) appoint directors (as their agents) to operate companies on their behalf. Directors have certain fiduciary obligations of loyalty and care that prevent them from acting in self interest or performing inadequately. Stripped down, modern law and the economic theory of agency, which has dominated thinking about firms in recent decades, mirrors this dominant strand of corporate law theory. Shareholders appoint managers as their agents to run the firm. Agency costs arise through the necessity of monitoring mechanisms to prevent self-interested behavior. Ultimately, under both versions of the theory, shareholders as principals can exercise the ultimate sanction by removing directors or managers from their positions. Thus, it seems logical to empower shareholders.

Why, then, is the corporate form so easily abused? The answer lies in recognising the flaws in the theories and understanding the pathology of companies. Boards do not actually derive their powers from shareholders, but rather from an enabling statute such as the Companies Act 1993. In a legal sense, directors are not the agents of the shareholders. As a matter of practice, the selection of directors is carried out by, or under the direction of, existing board members. If shareholders are not the principals of directors and are not the source of their powers, the consequence is that it becomes legitimate for boards of directors to consider the interests of other stakeholders when those interests arise. The most obvious instance of this would be the interests of creditors when

Structural Flaws

It is very rare for diverse groups of shareholders to act to appoint or remove directors or to reign in management abuses.

a company nears insolvency. But the inability of shareholders who have not aggregated their shares to exercise control over management means that the opportunities for management abuses are great. Correctly understood, the role of the board is not to 'manage' the company, in the contemporary understanding of the word, but to supervise. It is the board that is the monitor of management, not the shareholders. The use of the term 'manage' in the statutory provisions that empower boards is unfortunate and historical—it had a different meaning until the evolution of management science at the beginning of the 20th century. The tendency of some law and economics theorists to conflate the board with management ignores the fact that the board has an important supervisory and monitoring role to play that is not a management function. The harsh reality is that boards of directors and management control corporations. In a fundamental structural sense, shareholders cannot constrain the exercise of those powers, and attempts to bolster shareholder powers as a mechanism to control management are thus doomed to failure.

Unscrupulous

It is essential that we provide adequate protection against a dominant and powerful institution that is potentially devoid of scruple or conscience.

So, how can corporate management be controlled? The long title to the Companies Act 1993 in part states that the Act is intended to "reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks." The Act is also intended to "encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management powers." And therein lies the tension for future corporate governance regulation. Can we control the beast without destroying it? On one hand we must seek to nurture and incentivise enterprise through a vehicle—the limited liability company—that is so effective as a means of aggregating capital for productive purposes that it has been described as the greatest invention of the modern era. On the other hand it is essential that we provide adequate protection against a dominant and powerful institution that is potentially devoid of scruple or conscience. How do we get rid of the bathwater without the baby going out with it? My argument is that it can only be achieved through boards functioning as monitors of good corporate governance.

As the role of the board of directors in a legal sense is better understood, the importance of good corporate governance will become clearer. Broad consensus exists around practices that determine good governance. The Securities Commission produced guidelines also adopted by the Financial Markets Authority, and codes such as the UK Combined Code and the OECD Principles of Corporate Governance have been adopted in most jurisdictions. Less consensus exists over how important good corporate governance is to a company's financial bottom line. An increasing number of studies show that good governance does in fact have a positive effect on profitability, but to focus on this as the sole arbiter of the importance of good governance is to miss the point. Limited liability companies are not really, or not completely, an example of private ordering. Limited liability and, more significantly, the right to incorporate, are privileges granted by the State. Many of the principles of public law were derived from corporations' law, especially the law of municipal corporations. In corporate law history the public and private are intertwined. Once the public law aspect of corporations is accepted, the idea that corporations can be regulated by the State should become less repugnant. In fact, if it is accepted that incorporation carries with it complete control by management over the assets of the investors of the company, a failure to constrain that power through regulation would be a dereliction of duty by the State. Controls exist, through the imposition of directors' duties, that impose on boards monitoring obligations and accountability. *Ex ante* mechanisms to ensure observance are important. But many of the principles in corporate governance guidelines remain soft law, ultimately able to be rejected by the boards of companies that are probably most in need of them. The advantage of corporate governance principles is that they tend not to constrain management in the advancement of the enterprise. Rather, they clarify the monitoring and oversight role of the board. Implemented correctly, they may allow us to keep the baby and lose the bath water.

Mistakes of the past are often not repeated. Instead, new ones arise that may be manifestations of an underlying systemic problem. The history of corporate and securities law is a record of mistakes and responses; holes exposed and then plugged. But new problems always emerge as the incompetent get it disastrously wrong and as determined wrongdoers find new and more creative ways to fleece the gullible public. The spokes in the wheel of this cycle may be, first, a greater insight into the pathology of companies and, second, a truer understanding by boards of their role, through the imposition of good corporate governance requirements. ■

Susan Watson is Professor of Commercial Law and Associate Dean Academic Faculty at The University of Auckland Business School. She is also Deputy Director of the School's New Zealand Governance Centre. Professor Watson jointly edits the *New Zealand Business Law Quarterly* and is New Zealand editor of the *Journal of Business Law*. She has been published widely in international journals and is a contributor to the second edition of *Company and Securities Law in New Zealand*, which she will jointly edit.

s.watson@auckland.ac.nz

KEY TAKE-OUTS

- **The legislative response to the financial sector crisis has tended to focus on increasing accountability rather than preventing wrongdoing, but improving corporate governance might be a better strategy.**
- **Shareholders should not be relied on to monitor and control management—that is the function of the board of directors.**
- **Implemented correctly, corporate governance principles protect shareholders and creditors while boosting company profitability.**