PART ONE
BASIC CONCEPTS, BOARD STRUCTURES AND COMPANY OFFICERS

1

The concept 'corporate governance' and 'essential' principles of corporate governance

It is necessary only for the good man to do nothing for evil to triumph.
– Attributed to Edmund Burke (18th-century English political philosopher)
– The *Australian*, Monday 6 December 2004, 4, reporting on the most favoured phrase of quotation-lovers, as determined by an Oxford University Press poll

1.1 The meaning of corporate governance

1.1.1 Generally

Corporate governance is as old as the corporate form itself,[1] although Tricker correctly points out that the phrase 'corporate governance' was scarcely used until the 1980s.[2] In the first edition (2005) of this book we pointed out that there is no set definition for the concept of corporate governance. This has not changed. Commentators still speak of corporate governance as an indefinable term, something – like love and happiness – of which we know the essential nature, but for which words do not provide an accurate description. Many have attempted to lay down a general working definition of corporate governance, yet one definition varies from another, and this often leads to confusion. Early attempts to define the concept of corporate governance appear in the United Kingdom Cadbury Report (1992) and the South African King Report (1994), defining corporate governance as 'the system by which companies are directed and controlled'. That seems not particularly helpful in clarifying the meaning of corporate governance. Over the past decade or so, there have been further attempts at a definition, bringing in additional aspects or elements under the term 'corporate governance'.

1 J J du Plessis, 'Corporate law and corporate governance lessons from the past: Ebbs and flows, but far from "The end of History . . . : Part 1" ' (2009) 30 *Company Lawyer* 43 at 44.
2 Bob Tricker, *Corporate Governance: Principles, Policies and Practices*, Oxford, Oxford University Press, (2009) 7.

In a background paper published prior to the Report of the HIH Royal Commission (the Owen report) on the collapse of HIH Insurance Ltd – one of Australia's largest corporate collapses – a clearer definition began to emerge:

> Corporate governance refers generally to the legal and organisational framework within which, and the principles and processes by which, corporations are governed. It refers in particular to the powers, accountability and relationships of those who participate in the direction and control of a company. Chief among these participants are the board of directors, and management. There are aspects of the corporate governance regime that have an impact on the relationship between shareholders and the company.[3]

In this report, Justice Owen considered the meaning of the term 'corporate governance' in two instances. In the introductory part of the Report, under the heading, 'Corporate governance: A poor role model', he reflected that the term 'corporate governance' was used so widely and so generally that the term 'corporate governance' was potentially meaningless. Justice Owen then provided some substance to the concept:

> Corporate governance – as properly understood – describes the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. Understood in this way, the expression 'corporate governance' embraces not only the models or systems themselves but also the practices by which that exercise and control of authority is in fact effected.[4]

This description of corporate governance focused on specific elements or aspects of corporate governance.

The trend to define corporate governance more precisely continued in 2003 with the appearance of the Australian Securities Exchange's (ASX) *Principles of Good Corporate Governance and Best Practice Recommendations*.[5] The description used in 2003 was slightly different from the description of corporate governance contained in the 2007 ASX's *Principles of Good Corporate Governance and Best Practice Recommendations*:

> Corporate governance is 'the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations'. It encompasses the mechanisms by which companies, and those in control, are held to account. Corporate governance influences how the objectives of the company are

3 Background Paper 11 (HIH Royal Commission) *Directors' Duties and Other Obligations under the Corporations Act* (November 2001) 27 para 76.
4 Report of the HIH Royal Commission (Owen Report), *The Failure of HIH Insurance – Volume I: A Corporate Collapse and its Lessons*, Canberra, Commonwealth of Australia (2003) xxxiii.
5 ASX, *Principles of Good Corporate Governance and Best Practice Recommendations* (March 2003) 3, available at <http://203.15.147.66/about/corporate_governance/principles_good_corporate_governance.htm>. 'What is corporate governance? Corporate governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised. Good corporate governance structures encourage companies to create value (through entrepreneurism, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved.'

> set and achieved, how risk is monitored and assessed, and how performance is optimised. Effective corporate governance structures encourage companies to create value, through entrepreneurialism, innovation, development and exploration, and provide accountability and control systems commensurate with the risks involved.[6]

It is useful to quote another, realistic and open-ended description of corporate governance from a United States perspective, but the absence of a reference to stakeholders as part of this definition and the focus on shareholder primacy (see below), is conspicuous:

> Simply defined, corporate governance consists of all people, processes, and activities in place to help ensure the proper stewardship over a company's assets. Corporate governance is the implementation and execution of processes to ensure that those managing a company properly utilize the time, talents, and available resources in the best interests of absentee owners. These processes include all aspects of a company's performance including risk management, operational and marketing strategies, internal control, conformance with applicable laws and regulation, public relations, communication, and financial reporting.[7]

While a closer description of corporate governance was required, the concept 'corporate governance' remains one that does not lend itself to a single, specific or narrow definition. Several differences remain, sometimes only subtle ones, but in other instances they are more fundamental. In 2008, Justice Owen made the following comments in *The Bell Group Ltd v Westpac Banking Corporation* (No 9):[8]

> [D]irectors are in control of the assets of a corporation but they do not own those assets. They control the assets on behalf of the corporation and, through the corporation, others having an interest in the wellbeing of the entity. There are no hard and fast rules that constitute 'corporate governance'. But there are some basic underlying principles that help to explain the guidelines and legal principles that have developed over time and now dictate how a director is expected to carry out her or his responsibilities.

Before we attempt to give our own definition, it is important to consider the origins of both the corporate governance and the stakeholder debates.

1.1.2 Origins of the corporate governance debate and the stakeholder debate

It is difficult to determine exactly when the corporate governance debate started.[9] However, there is little doubt that there were many factors that brought the corporate governance debate to prominence: the separation of ownership and control

6 ASX, *Principles of Good Corporate Governance and Best Practice* (2nd edn, August 2007) 3, available at <http://203.15.147.66/about/corporate_governance/revised_corporate_governance_principles_recommendations.htm>.
7 K Fred Skousen, Steven M Glover and Douglas F Prawitt, *An Introduction to Corporate Governance and the SEC*, Mason, Thomson South-Western, (2005) 7.
8 [2008] WASC 239 (28 October 2008) [4362].
9 See John Farrar, *Corporate Governance: Theories, Principles and Practice*, Melbourne, Oxford University Press (3rd edn, 2008) 8–120.

(so pertinently illustrated in 1932 by Berle and Means in their book, *The Modern Corporation and Private Property*), which resulted in the so-called 'managerial revolution'[10] or 'managerialism';[11] the pivotal role of the corporate form in generating wealth for nations; the huge powers of corporations, and the effects of these on our daily lives; the enormous consequences that flow from collapses of large public corporations;[12] and what we would like to call the 'boardtorial revolution' or 'directorial revolution', based on what Stephen Bainbridge recently identified as 'the director primacy model of corporate governance' (see discussion below and Chapter 3). We are, indeed, as Allan Hutchinson describes it so appropriately, living in an age of *corpocracy*.[13]

It is also beyond dispute that the corporate governance debate became particularly prominent when the basic perception of the company changed. At first the only real concern for a company was the maximisation of profits.[14] Profits for whom? – the shareholders.[15] This was confirmed in 1919 in the case of *Dodge v Ford Motor*[16] and is a view many commentators adhered to for a considerable period of time, with a further confirmation of the Dodge theory in 1986 in the case of *Katz v Oak Industries*[17]. According to this view, the shareholders are the 'owners of the company', the primary stakeholders and most important providers of capital to enable the company to conduct business. Gradually this perception changed, and the company, especially the large public company, came to be seen in a different light. People realised that there were other stakeholders in a company, too; that if the only purpose of a company was 'the maximisation of profits for the shareholders', the society as such could suffer tremendously – poor working conditions for workers, exploitation of the environment, pollution and so on. Then came the realisation that:

> enterprise, private as well as public, because it both contributes to and benefits from society (local, national and larger), can be said to have rights and duties vis-à-vis that society in somewhat the same way as has an individual;[18]

10 See, for example, Klaus J Hopt, 'Preface' in *Institutional Investors and Corporate Governance*. Theodor Baums, Richard M Buxbaum and Klaus J Hopt (eds), Berlin, W de Gruyter (1994) I; and *OECD Principles of Corporate Governance* (April 2004) <http://www.oecd.org/dataoecd/32/18/31557724.pdf> 12.
11 Stephen M Bainbridge, *The New Corporate Governance in Theory and Practice*, Oxford, Oxford University Press (2008) 9, 19–20 and 155 *et seq*.
12 See generally Roberta Romano, *The Genius of American Corporate Law*, Washington, DC, AEI Press (1993); and David S R Leighton and Donald H Thain, *Making Boards Work*, Whitby, Ontario, McGraw-Hill Ryerson (1997) 9–10.
13 Allan C Hutchinson, *The Companies We Keep*, Toronto, Irwin Law (2005) 8.
14 Adolf A Berle, 'The Impact of the Corporation on Classical Theory' in Thomas Clarke (ed.), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, London, Routledge (2004) 45, 49 *et seq*.
15 Margaret M Blair, 'Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century' in Thomas Clarke (ed.), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, London, Routledge (2004) 175, 181. See also Bainbridge, above n 11, 53.
16 *Dodge v Ford Motor* 170 N.W. 668 (Mich. 1919) at 684; (1919) 204 Mich. 459 at 507: 'A business corporation is organized and carried on primarily for the profit of the stockholders The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to the change of the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.'
17 *Katz v Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).
18 Charles de Hoghton (ed.), *The Company: Law, Structure and Reform in Eleven Countries*, London, Allen & Unwin (1970) 7.

and

> [t]he limited liability company does not simply represent one interest. It represents an arena in which there is a potential clash of many interests. We may identify the interests underlying it as: (1) investors – share capital/loan capital; (2) outside creditors – commercial finance/trade creditors; (3) employees; (4) consumers; (5) the public.[19]

The concept of 'managing the corporation' then came to be expressed in terms of these other interests:

> The balancing of the company's responsibilities – to workers as members of the company, to consumers of the goods and services it provides, and to the community of which it is a citizen – with its primary one of operating at maximum efficiency and lowest cost, so as to make profits and discharge its obligations to its shareholders, represents the full scope of management.[20]

Thus, the concept of 'corporate governance' began to adopt this new articulation of 'managing the corporation', with a central focus on the interrelationship between internal groups and individuals such as the board of directors, the shareholders in general meeting, employees, managing directors, executive directors, non-executive directors, managers, audit committees and other committees of the board. However, outside interests are also at stake; for example, those of creditors, potential investors, consumers and the public or community at large (so-called stakeholders). Traditional wisdom regarding shareholder primacy[21] versus other stakeholders began to be challenged with statements like 'managerial accountability to shareholders is corporate law's central problem',[22] 'corporate law is currently in the midst of crisis, because of the exhaustion of the shareholder primacy model'[23] and '[s]hareholder dominance should be questioned'.[24] Nowadays, it is fairly generally accepted that 'in future the development of loyal, inclusive stakeholder relationships will become one of the most important determinants of commercial viability and business success';[25] that 'recognition of stakeholder concern is not only good business, but politically expedient and morally and ethically just, even if in the strict legal sense [corporations] remain directly accountable only to shareholders';[26] and that '[t]he corporation as a legal entity grew out of its ability to protect not only the shareholders but also other

19 John J Farrar et al., *Farrar's Company Law*, London, Butterworths (1991) 13.
20 George Goyder, *The Responsible Company*, Oxford, Blackwell (1961) 45.
21 See generally on the theory of 'shareholder primacy' Irene-Marié Esser, *Recognition of Various Stakeholder Interests in the Company Management: Corporate Social Responsibility and Directors' Duties*, Saarbrüken, VDM Verlag Dr Müller, (2009) 19–23.
22 David Millon, 'New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law' 1993 (50) *Washington & Lee Law Review* 1373, 1374.
23 Ibid, 1390.
24 Morten Huse, *Boards, Governance and Value Creation: The Human Side of Corporate Governance*, Cambridge, Cambridge University Press (2007) 29.
25 David Wheeler and Maria Sillanpää, *The Stakeholder Corporation*, London, Pitmann (1997) ix. See further James E Post, Lee E Preston and Sybille Sach, *Redefining the Corporation: Stakeholder Management and Organizational Wealth*, Stanford, Stanford Business Books (2002), 1–3; and Mark J Roe, 'Preface' in Margaret M Blair and Mark J Roe (eds), *Employees & Corporate Governance*, Washington, DC, Brookings Institute (1999) v.
26 Leighton and Thain, above n 12, 23.

stakeholders'.[27] This, in turn, made the concepts of 'corporate social responsibility' (the CSR debate) and 'corporate citizenship' highly prominent. Entire books are dedicated to discussion of corporate citizenship and the importance of companies being good corporate citizens. Examples include Mervyn King's *The Corporate Citizen*[28] and *Corporate Citizenship, Contractarianism and Ethical Theory*, edited by Jesús Conill, Christoph Luetge and Tantjana Schönwälder-Kuntze.[29] Also, a spate of books have been published recently on the CSR debate.[30] It seems as though we have truly and inevitably moved away from the view that the primary aim of corporations is 'to make a profit', towards a view that corporations, especially large public corporations, should primarily strive 'to build a better society'.[31]

The stakeholder debate, the CSR debate and 'corporate citizenship', therefore, are integral and prominent in most of the recent corporate governance discussions and reports. We consider stakeholders in greater detail in Chapter 2, but it is useful to refer at an early stage to some of the most prominent statements on the role and importance of stakeholders. The importance of stakeholders was clearly illustrated in the European Union Report, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Members* (January 2002),[32] the South African *King Report on Corporate Governance* (March 2002)[33] and the ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations* (March 2003)[34].

27 Huse, above n 24, 29.
28 Mervyn King, *The Corporate Citizen: Governance for All Entities*, Johannesburg, Penguin Books (2006).
29 Jesús Conaill, Christoph Luetge and Tanjanna Schönwälder-Kuntze (eds), *Corporate Citizenship, Contractarianism and Ethical Theory: On Philosophical Foundations of Business Ethics*, Burlington, Ashgate (2008).
30 Güler Aras and David Crowther (eds), *Global Perspectives on Corporate Governance and CSR*, Farnham, Gower Publishing Ltd (2009); Frank den Hond, Frank G A de Bakker and Peter Neergaard, *Managing Corporate Social Responsibility in Action: Talking, Doing and Measuring*, Aldershot, Ashgate Publishing Ltd (2007); Ana Maria Dávila Gómez and David Crowther (eds), *Ethics, Psyche and Social Responsibility*, Aldershot, Ashgate Publishing Ltd (2007); Wim Vandekerckhove, *Whistleblowing and Organizational Social Responsibility: A Global Assessment*, Aldershot, Ashgate Publishing Ltd (2006); David Crowther and Lez Rayman-Bacchus (eds), *Perspectives on Corporate Social Responsibility*, Aldershot, Ashgate Publishing Ltd (2004).
31 Hutchinson, above n 13, 326.
32 *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Members* (hereafter referred to as European Commission Comparative Study) (January 2002) <http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf> 4: 'Although the comparative corporate governance literature and popular discussion tend to emphasise "fundamental" differences between stakeholder and shareholder interests, the extent to which these interests are different can be debated. The majority of corporate governance codes expressly recognise that corporate success, shareholder profit, employee security and well being, and the interests of other stakeholders are intertwined and co-dependent. This co-dependency is emphasised even in codes issued by the investor community.'
33 *Executive Summary – King Report on Corporate Governance* (King Report (2002)), Parktown, South Africa, Institute of Directors in Southern Africa (March 2002) para 5.3: 'The inclusive approach recognises that stakeholders such as the community in which the company operates, its customers, its employees and its suppliers need to be considered when developing the strategy of a company. The relationship between a company and these stakeholders is either contractual or non-contractual.'
34 *Principles of Good Corporate Governance and Best Practice Recommendations* (2003), above n 5, 59: 'There is growing acceptance of the view that organisations can create value by better managing natural, human, social and other forms of capital. Increasingly the performance of companies is being scrutinised from a perspective that recognises these other forms of capital. That being the case, it is important for companies to demonstrate their commitment to appropriate corporate practices.'

A particularly good summary of the importance of the stakeholder debate, as an integral part of the corporate governance debate, appears in the *Organisation for Economic Cooperation and Development (OECD) Principles of Corporate Governance* (April 2004):

> A key aspect of corporate governance is concerned with ensuring the flow of external capital to companies both in the form of equity and credit. Corporate governance is also concerned with finding ways to encourage various stakeholders in the firm to undertake economically optimal levels of investment in firm-specific human and physical capital. The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, and suppliers. Corporations should recognise that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies. It is, therefore, in the long-term interest of corporations to foster wealth-creating co-operation among stakeholders. The governance framework should recognise that the interests of the corporation are served by recognising the interests of stakeholders and their contribution to the long-term success of the corporation.[35]

Thus, since 2004, the *OECD Principles of Corporate Governance* has referred to corporate governance as 'a set of relationships between a company's management, its board, its shareholders and other stakeholders'.[36] Also, because of the prominence of the stakeholder debate in recent times and the realisation that stakeholders form an integral part of any corporation's existence and long-term prosperity, some commentators have moved away from the traditional 'ownership-orientated' definition of the corporation to a broader 'stakeholder-orientated' definition. James E Post, Lee E Preston and Sybille Sach offer the following definition of a corporation:

> The corporation is an organisation engaged in mobilising resources for productive users in order to create wealth and other benefits (and not to intentionally destroy wealth, increase risk, or cause harm) for its multiple constituents, or stakeholders.[37]

We deal with this expanded definition in much greater detail in Chapter 2. However, it is worthwhile pointing out that over time these developments have made commentators and researchers pick up some definite trends, and increasingly theories and models of the corporation and of corporate governance have been identified.[38] Until very recently, the 'shareholder primacy model' and 'stakeholder primacy model' of corporate governance have been the most prominent models, but Stephen Bainbridge, in his excellent work, *The New Corporate Governance in Theory and Practice*, analyses these theories and provides some exciting new perspectives on corporate governance models by expanding on the 'director primacy model' that he developed recently. Bainbridge began to develop

35 *OECD Principles of Corporate Governance*, above n 10, 46.
36 Ibid, 11. See also Etsuo Abe, 'What is Corporate Governance? The historical implications' in *The Development of Corporate Governance in Japan and Britain* (edited by Robert Fitzgerald and Etsua Abe), Aldershot, Ashgate Publishing Ltd (2004) 1.
37 Post, Preston and Sach, above n 25, 17.
38 See Esser, above n 21, 19–36 for a useful summary of these theories.

this model with his research paper 'Director Primacy: The Means and Ends of Corporate Governance' in 2002 and in a comprehensive article, titled 'Director Primacy and Shareholder Disempowerment', published in the *Harvard Law Review* in 2006.[39] We discuss the 'director primacy model' in greater detail in Chapter 3, but it can be summarised here: It is boards of directors, and not the shareholders, other stakeholders or managers in large corporations, that actually control the corporation and 'have the ultimate right of fiat'.[40] This, in our view, could be described as the 'boardtorial revolution' or 'directorial revolution', in a similar vein to what has been identified as the 'managerial revolution' (see reference above) several years ago.

1.1.3 Definition of 'corporate governance'

If one takes into consideration recent developments, corporate governance could be defined as follows:

> The system of regulating and overseeing corporate conduct and of balancing the interests of all internal stakeholders and other parties (external stakeholders, governments and local communities – see Chapter 2) who can be affected by the corporation's conduct, in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation.[41]

Thus, the most important components of this definition are that corporate governance:

- is the system of regulating and overseeing corporate conduct
- takes into consideration the interests of internal stakeholders and other parties who can be affected by the corporation's conduct
- aims at ensuring responsible behaviour by corporations
- has the ultimate goal of achieving the maximum level of efficiency and profitability for a corporation.

A comparison with the definition provided in the first edition of this work will reveal that we have changed the first part of the definition from 'a process of controlling management' to 'the system of regulating and overseeing corporate conduct'. This adjustment was required to reflect a widening of the corporate governance debate and the prominence that regulating and overseeing corporate conduct has gained since 2005. The global financial crisis (GFC) of 2008–9 provided further impetus to view corporate governance in an even wider context. Although views differ on this,[42] it is important to note that the GFC was

39 Stephen M Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119 *Harvard Law Review* 1735.
40 Bainbridge, above n 11, 11.
41 For other useful definitions of corporate governance, see Ken Rushton, 'Introduction' in *The Business Case for Corporate Governance* (Ken Rushton, ed.), Cambridge, Cambridge University Press (2008) 2–3; Huse, above n 24, 15 and 18–24; Bob Garratt, *Thin on Top*, London, Nicholas Brealey Publishing (2003) 12; John Farrar, 'Corporate Governance and the Judges' (2003) *Bond Law Review* 49; and Güler Manisali Darman, *Corporate Governance Worldwide: A Guide to Best Practices and Managers*, Paris, ICC Publishing (2004) 9–11.
42 See Thomas Clarke and Jean-Francois Chanlat, 'Introduction: A new world disorder?' in *European Corporate Governance* (Thomas Clarke and Jean-Francois Chanlat, eds), London, Routledge (2009) 1 and

no indication of a total failure of corporate governance. This is explained in the King Report (2009) from a South African and United Kingdom perspective, but it rings true much wider:

> The credit crunch, and the resulting crisis among leading financial institutions, is increasingly presented as a crisis of corporate governance. However, although current problems are to an extent indicative of shortcomings in the global financial architecture, they should not be interpreted as reflecting dysfunction in the broader South African and UK corporate governance models where values-based principles are followed and governance is applied, not only in form but also in substance.[43]

What we need to establish is how the principles of contemporary corporate governance contribute towards ensuring better governance of large public companies. This will become clear in the following chapters of this book.

1.2 'Essential' principles of corporate governance

In recent years there have been several attempts to identify and explain what are the 'essential' principles of corporate governance. Although there are several examples,[44] it will be seen that different principles are identified as 'essential' and, over time, views have changed on what could be considered as 'essential' corporate governance principles. There is nothing wrong or inconsistent with this evolutionary process. Corporate governance is a subject area that grows and expands, and it adjusts according to new insights and new challenges. As Mervyn King puts it, 'good governance is a journey and not a destination'[45] or, as Bob Tricker puts it:

> Overall, corporate governance continues to evolve. The metamorphosis that will determine the bounds and the structure of the subject has yet to occur. Present practice is still rooted in the 19th century legal concept of the corporation that is totally inadequate in the emerging global business environment.[46]

A good illustration of this is provided by the various South African King Reports. In the King Report (2002), seven 'essential' principles of corporate governance were identified, namely:

1. discipline
2. transparency
3. independence

13–18. See generally, and for a more radical plea for a total overhaul and new perspectives on the state of health of corporate governance, Hutchinson, above n 13, 12–19 and 203 *et seq*.

43 *King Report on Governance for South Africa 2009* (King Report (2009)), Johannesburg, Institute of Directors (2009) 9 <http://african.ipapercms.dk/IOD/KINGIII/kingiiireport/>.

44 See, for example, *OECD Principles of Corporate Governance*, above n 10, and *The Combined Code on Corporate Governance* (UK Combined Code (2008)), available at <www.frc.org.uk/corporate/combinedcode.cfm>.

45 King, above n 28, 4.

46 Tricker, above n 2, 22.