

# DIRECTORS' DUTIES: A HARSHER WORLD

## BOARDS FACE A TANGLE OF LEGISLATION



By E.J. NEAL

*Corporate crashes may help rid the business community of unacceptable practices. They also focus a spotlight on the increasingly onerous responsibilities of directors*

For the past few years, the media have been full of stories about alleged unethical behaviour on the part of some of our most visible business people, about serious weaknesses in the economy and, of course, about spectacular company collapses. Australia's international reputation as a secure place in which to invest has been seriously tarnished as a result.

But look behind these headlines and you will find a much more encouraging picture which, I believe, will re-assert itself in the 1990s.

True, some major companies have gone to the wall. Their failures have often been the result of inadequate or reckless leadership, exposed by the high interest rate policies of the past year. Of course, and regrettably, many others have been grievously hurt in the process. The great majority of companies, however, have weathered the storm and are set to enter the 1990s stronger, and more efficient, as a result of the recent testing times.

What we are seeing in Australia, and also in the UK and the US, is a recognition and reaffirmation of the need for economic and commercial responsibility. We have seen how basically flawed commercial practices can survive in a booming economy but have immediate and serious results when slowdowns occur. On the other hand, we have seen how well-managed companies, run on sound, honest lines, can continue to

perform reasonably well, even in difficult times.

Some of us continue to have to relearn the lessons of history. Our major corporations, which were pushed out of the limelight by the dramas associated with our so-called high-fliers, have been generally consolidating their positions and expanding their activities both here and overseas. Inefficiencies in the economy and in work practices in industry are being tackled and we are beginning to see the benefits in our mining, manufacturing and services industries.

We are, therefore, gradually improving our economy's ability to respond quickly, flexibly and imaginatively to challenges that may confront us. But there is still a lot more to be done and we need to accelerate the speed with which this is being undertaken. It is imperative for the new government to commit itself to urgent change.

Despite the uncertainties, I believe that we as a nation possess the determination and the capacity to ride out this period of change in the confident expectation that the future will be better as a result of all of our efforts. And I believe that directors of companies have a crucial role to play in Australia's efforts to make the most of the opportunities that

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will come our way. It is the directors who must endorse or provide the strategic direction for our companies and, by example, encourage management in developing proper principles of business and corporate behaviour.

That also means looking beyond the narrow goal of what is good for the company and the shareholders and accepting that the health of the economy as a whole is of direct interest to us all, including the shareholders we serve. Company directors must help instil both in their companies and in the community a commitment to achieving a level of productivity, quality and service that can compete with rivals both at home and overseas.

We must encourage the formulation of long-term plans to develop, maintain and expand markets in other countries. The need for Australia to devote greater attention to exports is increasingly being recognised but we have to translate that recognition into reality.

Directors must support and encourage management to develop a more entrepreneurial outlook and to seek aggressively the opportunities that their greater exposure to the outside world brings. Management must also be encouraged to attach greater importance to communications, to the development of skills and to the fostering of a solid commitment by its workforce to the firm.

The public image of company directors and our role in the revitalisation of the economy is, however, clouded by the various regulatory measures being considered throughout the community. Because of the importance of the modern corporation to almost the whole of the community, more and more is being asked of directors in terms of their stated responsibilities to shareholders and the public.

The Senate committee report on company directors' duties, a similar inquiry by the House of Representatives, the moves towards uniform national companies legislation, a more active approach by the Australian Securities Commission and recent moves in some of the States to advance the war against pollution all contain the potential to add greatly to the obligations, duties and risks that company directors will have to deal with in the next decade.

## *There must be a self-imposed requirement on directors to become better-educated about their directorial role*

The variety of new and proposed measures are part of a changing attitude on the part of the Australian public, including shareholders, towards company directors. The activities of some high-risk entrepreneurs, the losses suffered since the stockmarket crash in October 1987, and a growing scepticism about the reliability of some people in public life have combined to create pressures for greater public accountability, a higher level of information disclosure and a more effective range of enforcement and penal measures to protect the interests of the public.

The legislative environment in which directors operate is likely, therefore, to change over the next few years under the influence of pressure from the public. To be able both to satisfy and contain these pressures, some company directors will need a higher level of training, information and commitment than may sometimes have been necessary in the past.

Directors today cannot be satisfied with the degree of remoteness and neutrality which may previously have been the preferred method of operation of some boards. There must be a self-imposed requirement on directors to become better-educated about their directorial role and about the company which they help to direct.

Directors will need to be extensively informed about most of the workings of their companies, without intruding on the proper responsibilities of management — a task which will require great tact.

For this level of involvement to be achieved, a co-operative relationship must exist with management. The boards and management of most of our successful companies have already achieved this relationship, which is probably a key factor in their success.

In the case of those few that have

not, I consider it vital to the relationship between directors and their management, with management developing a systematic approach both to the process of keeping their directors informed about a broad range of issues and to accepting an expanded "auditing" role on the part of their boards.

In turn, some boards may need to develop a more professional approach to their responsibilities. More attention may need to be paid to the structural aspects of boards' work. In larger organisations, greater use should be made of committee systems, such as Audit committees, finance committees and the like.

I have spoken at some length on other occasions about the need for boards of listed public companies to have a majority of non-executive directors and the desirability of not combining the roles of chairman and chief executive officer. I believe that these are important factors in maintaining boards' objectivity and effectiveness.

Directors must continue to develop a broader view of their responsibilities and devote adequate time to issues such as the environment, health and safety, and equal opportunities, for the modern corporation is an integral part of our society. Companies have many intangible responsibilities which extend beyond their customers, shareholders and staff.

In the light of this, I believe that we need to ensure that our boards increasingly reflect the diversity of our constituency and of our responsibilities. There should be a greater emphasis on a broad range of expertise and experience among board members.

Directors will have to continue to maintain both high ethical standards and a high degree of self-regulation. In this context, I believe that a few directors are to blame for many of the problems that now confront us

all. They have let themselves and us all down through their lack of discipline.

It seems to me that there is little point in trying to roll back the wave of regulation that is threatening directors unless, as a group, we can demonstrate our ability to regulate ourselves effectively and to restore the faith of the public in our propriety.

The Senate committee which looked at directors' duties has urged the Institute of Company Directors to develop and promote a code of ethics. This is an important goal, and is compatible with our concept of self-regulation. As part of that code directors must ensure that they insist on the highest standards of honesty in their dealings with their companies.

The independence of directors may be another important feature of a code of ethics. It is not proper for any director to be someone else's cipher — to occupy a seat at the board table to carry out someone else's bidding.

Decisions made at the board table are joint decisions but the responsibility for integrity and due care and diligence lies squarely and equally on each individual director.

Executive directors in Australia should examine their consciences from time to time to assess whether, in fact, they are independent or merely ciphers for the chief executive.

Attention to all of these matters cannot, of course, ensure that corporations will not occasionally fail. The mere fact that commerce and industry depend on enterprise and calculated risk-taking almost guarantees that some mistakes will be made: anticipated markets might not eventuate, a product might outlive its usefulness or be supplanted by an unexpected rival, government policies may change, pilots' disputes may decimate bookings at a tourist hotel, and so on. These are risks which industry must take and they have nothing to do with dishonesty.

Unfortunately, when companies, especially big companies, crash, it is sometimes found that directors have in various ways failed to exercise a reasonable degree of skill, care and diligence. The vague dividing line between acceptable and unacceptable behaviour has been crossed.

Directors need to encourage our

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law-makers to avoid the temptation to try to cover all aspects of our activities in their legislation and to concentrate on the principal measures of directors' performance — honesty and reasonable skill, care and diligence.

What directors should be working towards is the goal of having governments tidy up the law relating to companies and the way those companies and their industries are run.

I am particularly concerned by suggestions that our leading business people could become reluctant to accept positions on company boards because of the growing complexity of the regulatory environment affecting company directors and their personal vulnerability to severe legal penalties.

I believe that, because of their roles and our experience, company directors must continue to make a major contribution to the achievement of a competitive economic performance in Australia.

The response to concerns about the behaviour of a small number of people must not be allowed to undermine that contribution.

At present, however, the extent of legislative supervision of directors has reached the point where it may deter qualified people from accepting invitations to become directors.

In a report to the Business Council of Australia in 1988, Dr Timothy Pascoe cited the chairman of a company who had provided him with a list of 13 Acts, including a list of about 400 specific provisions, with which his company has to comply in the operation of a mine. I have no doubt that many directors could tell similar stories.

It is probable that each of those 13 Acts, like the companies Act, would have a plethora of clauses which create offences for directors — all too often offences which carry both civil and criminal penalties.

Some of the principal problems facing directors now and in the years ahead arise from the lack of definition. In the eyes and minds of many, a definition must be found so that directors can be controlled better. What such people fail to understand is the simple fact that governments cannot legislate for honesty. They can legislate to punish dishonesty and that is all.

No matter what legislation is in place, a dishonest man or woman will flout the law if that suits his or her purpose. In those circumstances, they should be dealt with according to the law.

Politicians should be encouraged to recognise what lawyers have known for centuries, that every time you introduce further specifics into the law, you provide fertile ground for the unscrupulous to seek loopholes. The introduction of further restrictions and penalties could make it harder to attract good directors or to retain existing ones.

Of considerable concern to current and potential board members are the implications of the resort to criminal measures in company law. While it is appropriate for directors or officers who engage in conduct of a criminal nature to be dealt with by the criminal law, we should be careful about allowing the criminal law to intrude into matters that are essentially civil or commercial.

Directors and senior executives of companies cannot be expected to make bold and far-sighted decisions for the benefit of their companies and shareholders if they face criminal charges and personal ruin should a perfectly proper and well-considered initiative fail as a result of changed circumstances or unforeseen events.

Moreover, I am concerned when directors face criminal action because of the overturning of the normal basis of the common law. For example, environment protection legislation has recently been enacted in New South Wales which provides for the possibility that senior management may be fined \$150,000 or

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Black-Scholes option pricing model, the resulting option prices will be wrong. The size of these errors may be significant. To overcome this misspecification, quoted interest rates should be converted to continuously compounded rates. This conversion process generally involves an intermediate conversion of quoted market rates or yields into effective interest rates.

The estimate of the future volatility of the underlying share on which the option is written is also crucial in determining the value of an option, particularly since it is the least observable of the factors affecting the option's value.

The use of an outdated last-sale price for the current share price in an option pricing model will also distort the computed option value. When no recent sale has occurred, it is preferable to use the mid-point of the buy-sell quotes.

Option participants should also be aware of whether the option is a listed equity option or a warrant. Given identical terms, warrants are worth less. □

#### NOTES

1. F. Black and M. Scholes, "The Value of Option/Contracts and Corporate Liabilities," *Journal of Political Economy* 1973.

2. The shorter period of compounding for the nominal rate, or the shorter the period of quotation for the yield, the smaller is the difference between the quoted rate and the continuously compounded rate.

3. This is possible even though the shares on which traded options exist have a high trading volume. The problem is more acute for warrants, which are often issued over thinly traded shares.

### Table 1: Example put and call option values

(figures show value in dollars for 20 contracts based on current share price of \$6.50 for a non-dividend-paying stock)

Series	Type	Contract value using		Error in pricing	
		Effective rate	Continuously compounded rate	\$	%
Dec 5.50	Call	25834	25612	222	0.87
	Put	1838	1886	-48	-2.55
SD=.4 Dec 6.50	Call	12632	12464	168	1.35
	Put	7910	8060	-150	-1.86
Dec 7.50	Call	5092	4994	98	-1.96
	Put	19642	19914	-272	-1.37
Dec 5.50	Call	24080	23818	262	-6.52
	SD=.2 Dec 6.50	Call	7762	7564	198
Dec 7.50	Put	3040	30160	-120	-3.80
	Call	994	946	48	5.07
Put	Put	15544	15864	-320	-2.02
	Mar 5.50	Call	31334	30938	396
Put	Put	3488	3612	-124	-3.43
	SD=.4 Mar 6.50	Call	19118	18784	334
Put	Put	9846	10126	-280	-2.77
	Mar 7.50	Call	10840	10594	246
Put	Put	20140	20604	-464	-2.25
	SD=.2 Mar 6.50	Call	28130	27638	492
Put	Put	284	310	-26	-8.39
	Mar 7.50	Call	12606	12194	412
Put	Put	3332	3536	-204	-5.77
	Mar 7.50	Call	3780	3582	198
Put	Put	13082	13592	-510	-3.75

SD = standard deviation (volatility) of the underlying stock.

## DIRECTORS' DUTIES

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jailed for up to seven years unless they can prove that:

- the breach of the legislation took place without their actual or imputed knowledge;
- they were not in a position to influence the company's action; and
- if they were in such a position, they used all due diligence to prevent the breach.

It is a basic feature of Australian law that the onus of proof should be on the prosecution. This new approach to law-making is tantamount to an assumption of guilt. The nature of the activity involved does not warrant such a break with this fea-

ture of our legal system.

I believe directors must obtain adequate insurance cover to protect them and third parties from the results of commercial misjudgment or misfortune. It is appropriate to consider changing the Companies Code to permit premiums to be met by directors' companies. It may even have to become compulsory for directors to be insured, analogous to third party motor vehicle insurance.

The advent of a single body to represent company directors and to support their interests is timely. I would like to set out four specific goals that I believe the Institute of Company Directors and its members should pursue:

- To work towards having company

law simplified to remove the risk of directors inadvertently breaching the law through the sheer complexity and volume of the law with which they have to be familiar.

- To encourage and assist directors to be better educated about their role and their responsibilities.

□ To encourage improved structuring of boards; eg, through use audit and other committees and, if necessary, appointment of more appropriately qualified independent non-executive directors;

- As individuals and through the institute strive to publicise at every opportunity the fact that the vast majority of directors are honest and diligent and their companies efficiently and well run. □