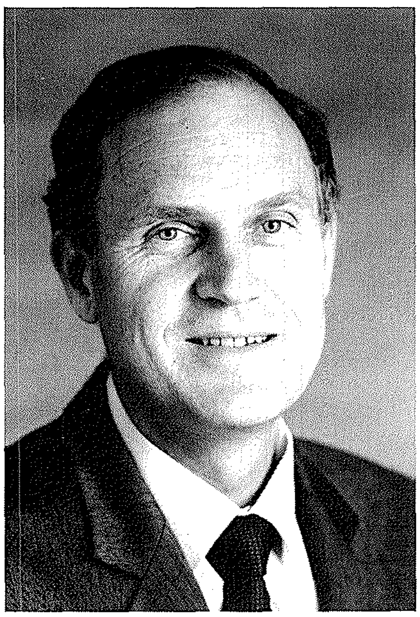
HOW THE ROGUES CAN HIJACK COMPANIES

INVESTORS' KEY ROLE IN KEEPING THEM HONEST



By LEIGH HALL

Shareholders, including institutions, have sometimes been kept in the dark about the activities of the companies in which they have invested. There is plenty they can do to improve their monitoring of managements.

I would like to be able to say that as an institutional investment professional I have always been able to avoid becoming involved with dodgy companies and therefore have had no dealings whatever with wayward directors. However, I cannot claim to have exercised such perfect judgment. Fortunately, the number of encounters which could have turned into occasions for regret is relatively small. But it is still worth explaining why we institutions do get caught in these situations.

Sometimes it is just bad judgment. Sometimes, when we have been introduced to a company by respectable professionals, including brokers, merchant bankers or other reputable directors, we develop a false sense of security. Sometimes the reason is the insistence of clients and their consultants that we perform as well as the latest market hotshot.

Consider the halcyon days before October 1987 when entrepreneurial stocks, widely defined, accounted for one-fifth of stockmarket capitalisation; when entrepreneurial stocks had outperformed the stockmarket index several times over; and when the media and most of the population, with the notable exception of potential takeover targets, were in adulation of the entrepreneurs' achievements in and outside the corporate field.

At that time, my analysts were able to explain to me the misleading way some of these companies' accounts were presented and show that much of their proclaimed success was illusory. But the market was not interested in hearing or believing anything adverse about these companies, so the institutional investor, to be competitive, had to join the game of pass-the-parcel and hope that it would not be left holding a booby-prize when the music stopped.

Prevention is better than cure. If one were able, one would avoid making such investments. If the investment has to be made and there are doubts about the integrity of the direction and management of a company, it will be with a view to flicking it on as soon as possible. This is the typical boom-market scenario when the fastest-running companies tend to be those with spivvy managements. Everyone is confident of getting out in time, but I think the experience of most investors is that they get caught with their share in the end, and it serves them right.

Where the incumbent board and management are inappropriate for a company, it seems logical that existing and prospective shareholders should enhance the value of the

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company by removing them. In practice, though, this is very difficult except in the case of a takeover. Existing shareholders tend to be loyal to their board no matter how dismal its performance. It is also usual for the existing board to stick together to protect its members, each of them unwilling to admit having tolerated less-than-deserving colleagues. The outside shareholder also faces the problem that a public statement alleging directorial and management shortcomings could spark defamation proceedings.

Shareholders typically take little interest in the activities of a corporation until it is too late. If a new director is appointed between annual meetings, any opposition to the appointment at the next annual meeting would be tantamount to opposition to an incumbent, with all that entails.

Shareholders may not only be unaware of the appointment; they may also know little or nothing about the new director's reputation or background. In such cases, they would see little reason to take an interest in the appointment, let alone oppose it.

If you are not a significant shareholder in a company and you have cause for feeling uncomfortable, the usual course is to quit your shareholding. If an institution has a large shareholding this may be difficult and, in fact, can count against the institution's interests by forcing the value of the company down further. Where a number of institutions collectively own a major part of the capital, then the sale by any one of them because of dissatisfaction is probably going to result in other institutions, as the buyers, inheriting the problem.

It may be that the major shareholders in a corporation will need to take action to preserve their position. In the first instance, an analyst or portfolio manager from the institution will contact the corporation's chief executive and advise him of the concerns. If this does not result in remedial action the institution might call on the chairman. If there is still an inadequate response the institution must then consider the options.

Is the register such that influence can be exerted? If the company is locked up under the control of a group with more than half of the capital, those people might simply thumb their noses at the minority. If those in control are in a minority position, you then have to determine whether there are enough like-minded shareholders to take collective action. Is there a director who might see justice in the institution's complaint? If the company is not doing anything explicitly dishonest then the various sections of the Companies Act regarding directors' duties and the protection of the minority may not be relevant. Sometimes it might be necessary to encourage some external publicity. The media are interested in corporate misdeeds and, given the right information, will often give them suitable publicity.

If shareholders decide to take collective action they must be careful about the legal provisions relating to takeovers. The difficulty when shareholders get together is that the law may deem them to be "associates" of each other. The legal definition of "associate" is extremely wide and includes persons who propose to enter into "an agreement, arrangement, understanding or undertaking, whether formal or informal and whether expressed or implied" concerning control or influence over voting rights or the composition of a board or the conduct of a company's affairs. The group could find themselves in immediate breach of the Takeovers Code if their aggregated holdings exceeded 20 per cent.

Therefore, in any meeting of concerned shareholders, there can be no understanding or arrangements between them on such things as how they will vote their shares. However, it is quite legitimate for shareholders to express their views and to ascertain how other shareholders are thinking so that they can make independent decisions on how to proceed. Such a meeting can be described as no more than an expression of views.

However, shareholders could still be challenged over the mere fact that a meeting was held. Even though a meeting can be shown to be legitimate, the threat of legal proceedings can act as a strong disincentive for shareholders to meet and exchange views, particularly in a hostile environment.

Last year a number of institutional and corporate shareholders were concerned about the direction a particular company was taking. In this instance, it was not a case of there being rogues on the board, but rather that certain actions of the board, in the view of a majority of shareholders, were not adding value. A group of shareholders representing more than 50 per cent of the capital met and expressed their disquiet. This was a sufficient show of force to cause the board to take heed of those shareholders' views.

In a number of recent instances, institutional shareholders have taken collective action to bring about changes for the benefit of all shareholders. The actions are not always well publicised. Often it is preferable for the negotiations to be conducted in private without the risk of their being blown up into unproductive public debate. Let me emphasise that these actions are taken to preserve and promote shareholder value and are not cosy insider deals or ones to give particular privileges to the institutions.

Australia does not have an institutional shareholder body which can be used as a vehicle for taking such action. So far, action has been taken on an ad hoc basis according to the circumstances. Some institutions have considered whether there is a need for such a body. The Australian Shareholders' Association does a good job in promoting shareholders' interests in a variety of fields; apart from promoting sound and more effective legislation, it has been very active in a large number of situations in which shareholder interests have been prejudiced. However, not all institutional shareholders believe that they would have interests in common with small shareholders who are often troubled by the antics of small fringe companies.

Investors can be faced with a range of unsatisfactory corporate behaviour. Boards that are found wanting might be classified in the following categories:

- could do better;
- generally incompetent;
- tendency to sail close to the wind;
- definitely suspect behaviour;
- outright thieves.

The first two categories do not involve dishonesty, but they are still issues which the investor needs to resolve. The latter three categories go from roguish to rogue to thief. It is probably just as important for the institutions to be taking action in the milder categories as in the latter.

Not only does the proper and efficient working of the private enterprise system demand it, but it will be far more difficult for the rogues to get control of companies if the management is being closely scrutinised.

Properly managed companies will perform well and will be attractive to investors; there will be less temptation to chase corporations whose accounts might give the illusion of business success. In addition, the example is important. If the rogues see strong action being taken against those who are doing an inadequate job, they will learn that they cannot get away with dishonest behaviour.

The legal powers of shareholders are limited, in part by the ruling (established in Foss v. Harbottle) that in most cases directors can only be sued by the company itself. And companies do not tend to launch actions against the boards which control them.

Some exceptions to the ruling do appear to give powers to the shareholder. For example, Section 320 of the Companies Code (the Oppression Remedy) allows a shareholder (or the NCSC) to apply for an order regulating the affairs of a company where the company's affairs are being conducted in an oppressive manner. However, cases which have been brought show that courts require the clearest of evidence of oppressive conduct before exercising their powers.

Another exception is Section 574, which allows a shareholder to seek an injunction to restrain directors from engaging in conduct in contravention of companies legislation. Only a few cases brought under this section have been decided—none dealing specifically with breaches of directors' duties—so it is probably too early to judge its effectiveness. A recent discussion paper draws attention to the law of Ontario, where a shareholder can apply to the court to take legal proceedings on behalf of the company against rogue directors. I would be interested to learn how effective this mechanism has been in Ontario. If it has been successful, then it should be introduced in Australia.

Even when circumstances suggest that legal action would be successful, the shareholder faces the prospect of having to bear substantial legal expenses. Having already seen the value of the investment decrease as a result of mismanagement, the shareholder must wonder whether there is enough left to make an action worthwhile. The greater the perceived misdeeds in the company, the more likely it is that the company will fight your action with your money. Even if you do succeed, it may only be after all of the company's financial resources have been exhausted by legal expenses.

Sometimes it might be possible to gather sufficient information to pass on to the regulatory authorities in the hope that they can act. Regrettably, the regulators have had their own problems in terms of financial and physical resources too limited to enable them to undertake the necessary investigations and prosecutions. There is a widespread hope that the new Australian Securities Commission will be able to perform a proper policing role when the aggrieved public seeks assistance.

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If there is an independent director of competence and integrity on the board of a troublesome company, the shareholders might be able to enlist him in the pursuit of a remedy. That director may well need help in the collection and analysis of evidence and the analysing of material. It might also be possible to help with the payment of consultants' fees that the director may incur. Of course, it is necessary to be careful that the director is not providing you with insider information which could create problems if you wished to deal in the company's securities.

I would like directors to be able to "dob in" fellow directors for breach of their duties. At present, this is difficult because of a director's duty to keep confidential non-public information concerning a company. Would a director be in danger of prosecution for defamation or breach of confidentiality if he dobbed in his fellow directors to the ASC and a successful prosecution followed? While legal defences may be available, their outcome is not certain. We should consider the "whistle-blower" legislation which exists in the US.

A particular problem when there is trouble is ensuring that the good directors will remain at their posts. This is not easy; a good man will not wish to have his name associated with the activities being complained about. However, if the independent directors resign, no-one is left to protect the shareholders, although the act of resignation may itself be a sufficient signal to shareholders and regulators that things are amiss.

At times, the most desirable course of action is to attempt to change the composition of the board to ensure that good directors are in a majority and therefore in a position to give proper direction to the company. But it is often not easy to get good, honest men to stand. There is little glory in taking on the task of cleaning a company up, and it is often not easy to find good, honest, willing men—those with the right attributes and the tenacity to pursue the task with vigour. I recall an occasion a couple of years ago when I was seeking a worthy resident in Perth who would be willing to be nominated as a director of a well-known but controversial company. The task gave me some appreciation of how Diogenes felt, walking the streets of Athens with his lamp, searching for an honest man.

In the US in 1985, a group of 20 public and private pension funds organised the Council of Institutional Investors. It has since tripled its membership, which has assets of more than $US300 billion. The council and, in particular, its larger public pension funds are taking a very active approach to corporate governance. It has proposed a continuous review of the governing structure of companies to determine whether the system minimises conflicts of interest and maximises the capacity and motivation of boards to oversee corporations in a way that protects shareholder interests.

Issues for review would include:

- Before identifying potential board members, does a board or nominating committee identify the kinds of expertise the board should have and the kinds it needs to strengthen?
- What criteria are used to judge the independence of independent directors?
- Do executive directors serve on nomination and compensation committees?
- What information is given to board members, and in what form? How long before a meeting do they receive it? Who prepares it? Who reviews it?
- What staff support is made available to independent directors? Should they, at company expense, be able to seek the advice of attorneys, bankers and auditors?
- Is there a limit on the term an independent director can serve?

Understandably, a number of US corporations believe that the institutions' proposals go too far. However, they need to take these issues far more seriously. In recent times an increasing number of propositions have been put to shareholder meetings by major institutions. Many of these propositions have been passed and others have been withdrawn because of the company's agreement to the proposed course of action.

Typical of these very active institutions is the $US60 billion California Public Employees' Retirement System. Late last year it wrote to General Motors when the company was about to select a new chief executive officer and asked, among other things:

- What performance standards will you develop to evaluate the performance of the new management of General Motors?
- What kind of policies and structure do you contemplate for an ongoing relationship with your shareholders, particularly with large institutional shareholders such as CalPERS who are, because of the nature of their investment horizons, permanent owners and who are convinced that their informed involvement is essential for corporate as well as societal benefit?

It was CalPERS which led the fight against the 91-year-old Armand Hammer at Occidental Petroleum to stop him using company funds to build up his charitable foundation and to maintain a jetsetting lifestyle.

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In the UK, the Association of British Insurers, which has been active in promoting the interests of its members, has recently published a discussion paper on the role and responsibilities of directors. Another group in the UK is the recently revitalised Institutional Shareholders' Committee, which encompasses not only pension funds and insurers but also the merchant banks and investment and unit trusts.

The ISC's membership controls some 60 per cent of the capitalisation of shares listed on the London Stock Exchange, so its collective voice is well heeded. The committee is also active in urging institutional shareholders to exercise their right to vote. The ISC chairman, Donald Brydon, said recently that institution fund managers do not have the ability to manage companies. However, he went on to say: "Our job is to supervise the board, but to do that we have to be able to discuss with the board a framework and a strategy for the company and understand the purpose of it and then make assessments." While the ISC is not envisaged as the mouthpiece for shareholder dissatisfaction, it will be able to support to members who may be concerned about how a company is being managed. Where there is concern, the ISC could supervise a study of the company's long-term future and strategy.

Australian institutional investors will no longer stand by and see value being destroyed by incompetent directors or rogues. On the contrary, they will be consciously trying to try to enhance value by ensuring the very best direction and management in the companies in which they invest. Even those who are responsible for index funds will need to take action to protect their interests; no longer should they leave it to the rest of the market to determine values and to take the actions necessary to protect shareholder interests.

With some minor changes to legislation, and with the new Australian Securities Commission having improved resources, the institutions will in future see more point in seeking remedies.

The institutions' prime concern, in ensuring that the rogues are kept at bay, should be that the boards of the companies in which they invest are composed of directors who are honest and competent. The institutions will insist on a proper balance on the board between management and external directors. The chairman will not be the chief executive and the outside directors will be truly independent.

The worst cases of abuse against the interests of shareholders occur when management does what it likes. However, there must be balance, and we would not wish to see a dead hand of restraint placed on management to the detriment of the company's performance.

When rogues are in evidence in a company, the institutions should deny them capital. They must have the courage to do this even in boom markets, when those companies are often the high-flyers. The institutions will need to educate clients and their consultants to understand why that part of the market has been forsaken. If rogues get into a good company then it is essential that the shareholders do whatever they can to have them removed, even when it will be difficult and expensive.

It is worth recalling the comments made some years ago by the then Governor of the Bank of England in a speech entitled *The Developing Role and Responsibilities of Institutional Investors:*

"In the same way as a board of directors is accountable to shareholders for the discharge of their obligations, the reciprocal of this obligation is the obligation of the shareholders to satisfy themselves about the competence of their boards and the way in which they are functioning. Just as it is the responsibility of the board to satisfy itself as to the competence of the management, so it is that of the shareholders to seek to ensure the quality of the board." □