Positions vacant

Wanted: corporate whistle-blowers

Company directors, shareholders and investors would all benefit if corporate senates were established with a power of veto over board actions involving conflict of interest, writes ***Shann Turnbull.***

Most corporations in the English-speaking world are inherently corrupt because their unitary board structures concentrate conflicts of interest and concentrate corporate power. Power corrupts and absolute power corrupts absolutely. Absolute corruption can be avoided by a division of power and the creation of checks and balances. A binary board structure is a step in this direction.

Directors who are appointed to a unitary board to add value for shareholders also obtain the power to use their positions to extract value *from* shareholders. Only rogue directors would argue against a separation of these corporate powers into two boards. It is in the self-interest of all honest directors to avoid becoming tainted, severely embarrassed — and even sued — as a result of the imbalances of the current unethical system of corporate governance.

The division of corporate power into two boards can reduce substantially the weight of complex obligations and skills demanded of company directors. Separation of roles also provides a basis for achieving competitive advantages as well as encouraging simpler and more effective corporate laws and regulations.

The structure of a court of law provides an example of how directors' conflicts of interest might be managed. Two fundamental principles of the judicial system are that the accused should have no say in determining the law under which he or she is to be judged, and that the accused should not be able to influence the remuneration paid to the judge or jury. The independence of the accused from law-makers, judge, jury and witnesses is illustrated in Figure 1.

Company directors have no need to prove their innocence if they are not exposed to a conflict of interest. However, when a conflict of interest exists, they have to be able to show that they did not use their position to further their own interests ahead of the shareholders'. Justice must not only be done, but be seen to be done. Directors who are exposed to a conflict of interest are placed in the position of the accused. To avoid any taint to their reputations they must be perceived as acting properly.

However, with a unitary board structure of corporate governance, this is not possible. Consider Figure 2, where the directors take the role of the accused, accounting standards become the law, the auditor becomes the judge, independent experts become witnesses and the investors who make the decision to invest or not in the company become the jury.

The hindrances to showing that justice is done are that:

- the accused (the board) can get the judge/auditor hired and fired;
- the accused pays the judge/auditor

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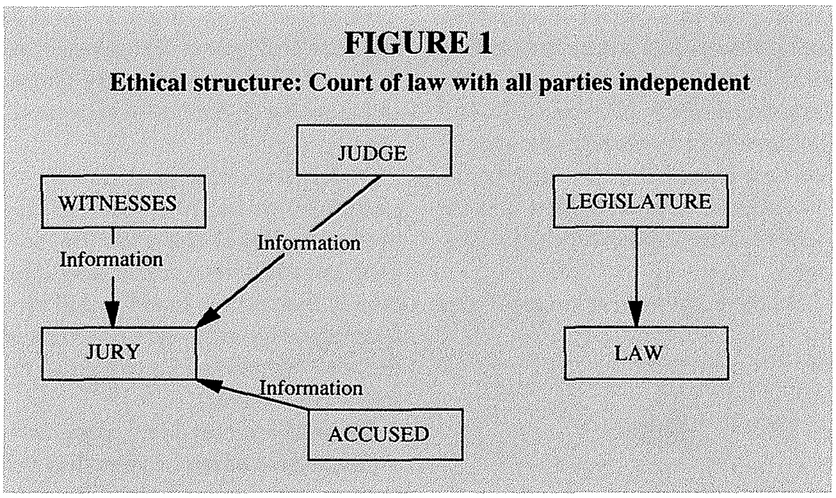


and provides additional remuneration for additional services;

- the accused can hire, fire, brief and pay any "independent witnesses" such as real-estate valuers and other valuers, merchant banks, geological experts, etc;
- the accused can select the law/accounting policies under which their performance is to be assessed by the judge/auditor and jury/investors.

The conflicts of interest listed above would be totally unacceptable in any court of law yet they are accepted with little question in corporations. The law-court example demonstrates why the structure of corporations governed by unitary boards must be intrinsically unsound.

Examples of powers which can be used to further the self-interest of directors on unitary boards are:

- power to nominate how the constitution of the company should be changed to suit their own interests;
- power to recommend to shareholders what benefits directors should receive and to allocate their own remuneration between themselves as they think fit;
- power to control the procedures for holding shareholder meetings and their conduct so as to ensure their own re-election;
- power to frustrate and even deny shareholders the chance to nominate others to be elected as directors;
- power to nominate themselves for elections and deny nomination for board colleagues who may wish to blow the whistle on corruption;
- power to fill casual vacancies on the board;
- power to determine the accounting policies under which their performance will be assessed by the shareholders and the public;
- power to manage the relationship with the auditors and to recommend their appointment or dismissal;
- power to decide how conflicts of interest should be managed and whether they should be reported to shareholders;
- power to deny any board minority the ability to advise shareholders against re-electing directors who lack competence or who have placed their own interests ahead of those of the shareholders.

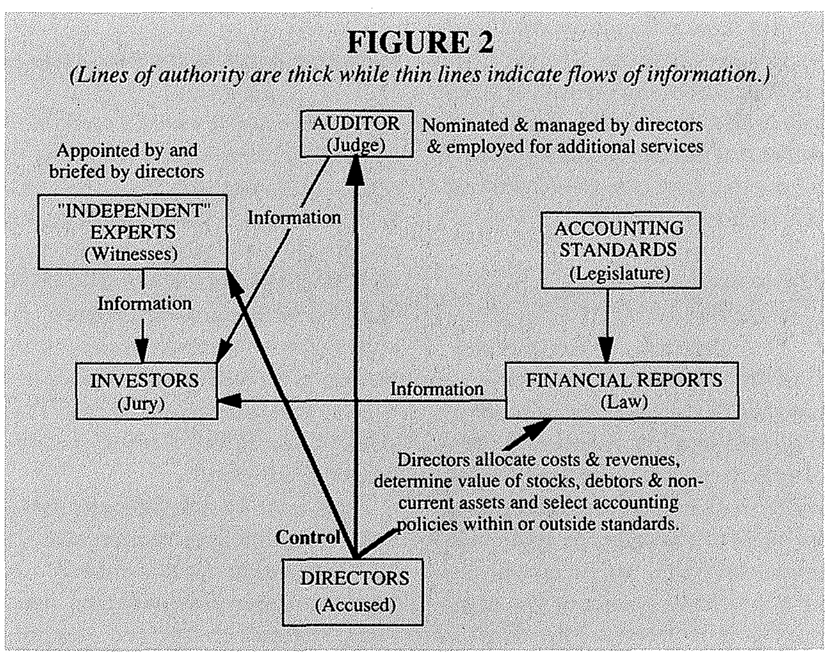
Binary boards could be established in many ways. Ideally, the approach selected should also improve the competitive advantages of the business, such as enhancing the availability of equity investment and minimising its cost.

The institution of a "corporate senate" is one such approach. The senate would attract new equity funds and reduce their cost by taking responsibility for the "extractive" powers vested in directors of a company with a unitary board. I used this approach to raise funds through a rights issue for an unlisted public company registered in Australia which had a majority of shareholders in the United States.

A binary board structure was set up by resolutions passed at an extraordinary general meeting of shareholders in February 1988 to amend the articles of association. As well as establishing a corporate senate to take over the powers listed above, the company introduced a preferential voting system for the election of directors. This eliminated the ability of 51 per cent voters to appoint 100 per cent of the directors (to create what Lord Hailsham described as a "dictatorship of the majority").

This corporate senate has only three members. One member has always been a resident of the US and so the senate has never had a face-to-face meeting. All resolutions are passed by senators returning a "flying minute" by fax after telephone briefings. The constitution of the company gives senators the right of access to all corporate information, as for any director, and obliges each director to report any conflict of interest to the senate.

The basis for electing senators is



not the same as for directors. While directors are elected on the basis of one vote *per share*, senators are elected on the basis of one vote *per shareholder*. Small shareholders obtain the same vote as the large shareholders. However, this does not abrogate the property rights of large shareholders, for two reasons:

- the senate has power over the actions of the board only where a conflict of interest exists, and then its power is only that of a veto;
- the senate veto can be over-ridden by 75 per cent of *shares* voted in a general meeting.

[In the German binary board system, the property rights of investors are subjugated because 50 per cent of the members of the supervisory board are appointed by the employees. As a result, the German approach increases, rather than reducing, the cost of equity funds.]

The potential to improve competitive advantage by establishing a governance system with a division of power and checks and balances is most forcefully demonstrated by the worker cooperatives established around the Spanish town of Mondragon during the past 40 years. The establishment of a *Consejo de Vigilencia* — "watchdog council" — is mandated by Spanish cooperative law. (The watchdog council provided the inspiration for the concept of a corporate senate.)

Hundreds of these cooperatives have now been established with power divided into a number of centres. Not one has failed within five years of start-up, whereas between 80 and 90 per cent of conventional firms fail during this period. In addition, studies have shown that these cooperatives are more productive than enterprises with unitary boards.

Directors' dilemma

The corporate senate provides a confidential body with which any member of the board can discuss any suspected improper behaviour by other directors or their associates. In the absence of a corporate senate, the only way a director can try to avoid being implicated by the appearance or reality of improper actions of board colleagues is to resign. This does not protect the interests of shareholders and investors and it may not, in fact, avoid a taint on the reputation of the resigning director. In contrast, the senate provides a mechanism for a director to protect his or her reputation, the interests of shareholders and the performance of the company (see figure 3).

As the senate has veto power over any board activity where a conflict of interest is involved, it has the power to *prevent* problems, which is always better than a cure. In addition, the senate enables potential problems to be dealt with privately, quickly and without cost. Without a senate structure, directors can only report improper activities to a meeting of shareholders and/or government regulators. This is especially difficult *before* the improper action occurs.

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Even after an unsatisfactory situation has become apparent, any attempt by a director to apply a remedy can involve considerable publicity, time, costs, nervous energy and commitment. The remedy may also result in legal actions against the director, or the loss of his or her board position and standing in the business community.

It is much easier for a director to protect his or her own interests and those of the shareholders and the company by procuring a senate veto. The onus is then on the board to call on a meeting of shareholders to overrule the veto by voting 75 per cent in favour of the board.

Ironically, it may be the large institutional shareholders, rather than the small shareholders, who would seek to have their representatives on a corporate senate. Institutions with an executive on the senate would automatically become insiders and so subject to insider protocols in buying or selling shares in the company. This situation would be preferable to the existing practice of big shareholders using their market power to obtain inside information and selling out or buying before small shareholders.

The senate is required to advise shareholders in the annual report about its activities in managing conflict-of-interest situations. Each senator also has the right to report independently. This allow matters to be raised in the annual report which are not triggered by a conflict of interest, such as the nomination or retirement of directors.

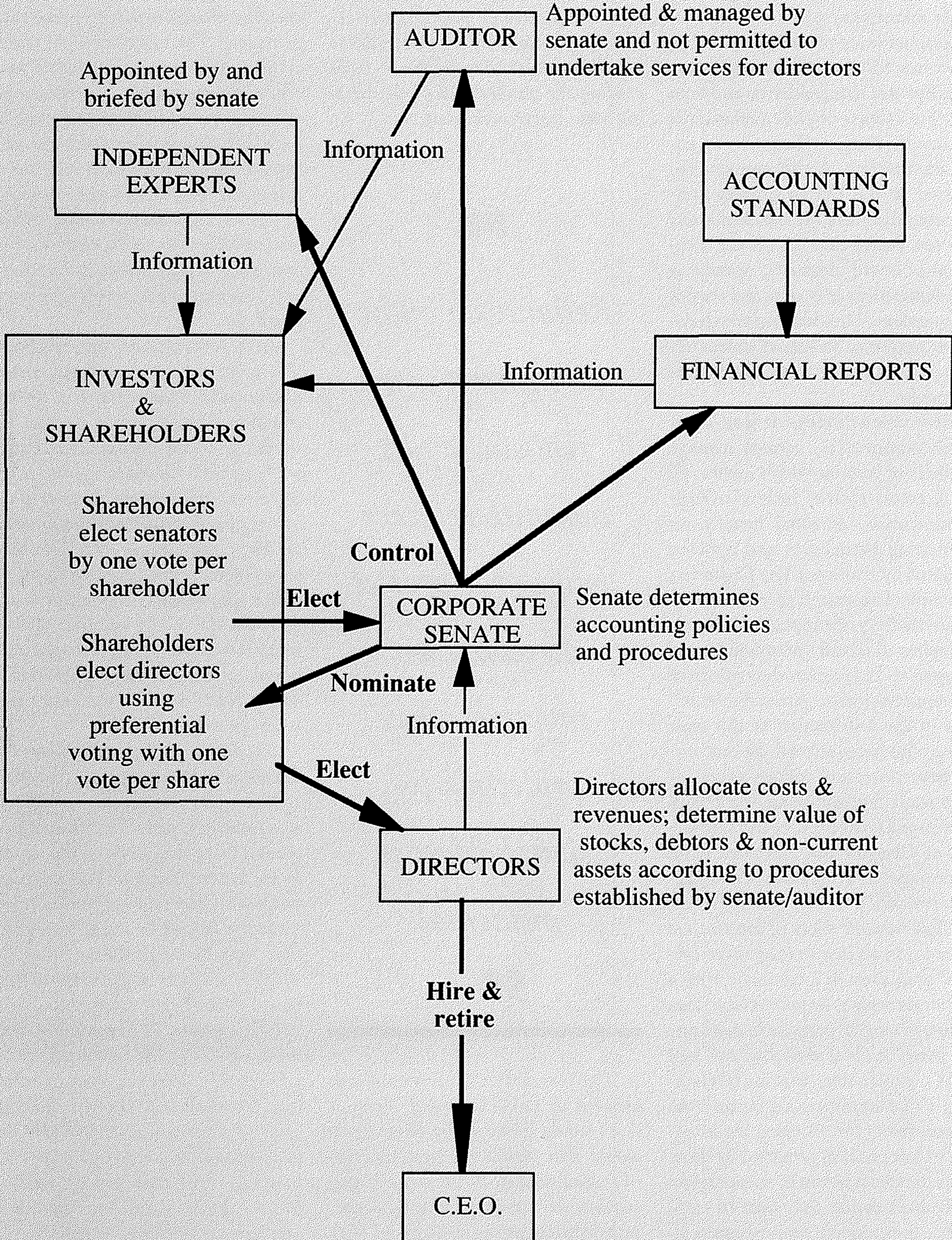
The division of powers and responsibilities between two boards reduces directors' responsibilities, duties and exposure to personal liability. As members of the senate have no operating responsibilities, their exposure to financial or legal action is minimised. The risk for directors would be significantly reduced because conflicts of interest are minimised and a mechanism established for managing any conflicts which remain.

A senate is a valuable reassurance for investors who might find it difficult to believe directors are acting in shareholders' best interests when taking actions which also further the directors' own interests, such as in a takeover.

The takeover may result in key executives giving up control and becoming minority interests. After the "honeymoon" period of a merger, the mi-

FIGURE 3

How a senate remedies corrupt features of a unitary board by enabling conflicts of interest to be separated



(Lines of authority are thick while thin lines indicate flows of information.)

nority shareholders may find that the value of their shares is reduced by the actions of the controlling shareholder. This allows the major shareholder to buy out the minority interests on terms most favourable to those in control. In such a situation, a corporate senate may be able to safeguard the position of the minorities.

In some situations a senate may be powerless to protect minority interests. But the independence and veto power of a senate provide a substantial improvement over reliance on an audit committee. Audit committees evolved in the US to protect non-executive directors, *not shareholders and investors*. Audit committees are composed of board members, operate as sub-committees of boards and are not independent. They have no veto powers or authority to report independently to shareholders and the investing public.

Audit committees, or any other board committees, cannot manage conflicts of interest which involve all the directors, such as the level of their remuneration, personal benefits or accounting procedures and policies. As noted by Professor Ray Chambers of Sydney University, there is an "extensive battery of alternative accounting rules, all equally permissible, and all open to variation at the options of accountants or managers or directors". It is in the self-interest of the most ethical director to select those accounting procedures and policies which reflect most favourably on the board. Professor David Flint of the University of Glasgow has described audit committees as a "misnomer and misconception".

However, conflicts of interest are inherent in all line-management systems and, even in a company with a corporate senate, an audit committee can serve a useful purpose in monitoring these. A chief executive can best build a constructive, trusting relationship with subordinate managers if the responsibility for checking the integrity of information provided by those subordinates is borne by independent individuals *outside* the chain of command. Independent non-executive directors on an audit committee are ideally placed to carry out this role. They can also undertake compliance supervision for regulatory authorities so that the chief executive can focus on activities which add value for shareholders.

However, reliance on audit committees to improve the integrity of corporate reporting and to manage boardroom conflicts of interest is not realistic. Audit committees were designed to protect directors, not investors; any protection for shareholders is incidental, as may be noted from reading the publications of the leading audit firms on this topic.

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The mandating of corporate senates for all publicly traded corporations would be far more effective. It would also permit the simplification of a number of stock-exchange listing requirements and laws relating to corporations engaging in activities with their directors or associates. Changes in the capital structure of corporations and mergers could be expedited by authorising corporate senates to vet and approve some activities which now require special meetings of shareholders.

Corporate senates could have profound implications for the politics of the accounting profession. Senators would become the most valuable audit clients, rather than directors and their managers. The big audit firms would compete to meet the requirements of corporate senates. Members of the big audit firms are heavily represented on the controlling bodies of the accounting profession. A considerable incentive would be created for the adoption of accounting standards and procedures which protected investors rather than those which allowed management and directors to place their own interests first.

A corporation with a unitary board places its directors, auditors, shareholders and regulators in a no-win situation. Regulators can only act "after the horse has bolted". Shareholders have little recourse against rogue directors. Auditors are accused of not protecting shareholders and are sued for large sums of money. The most conscientious and hard-working director can become implicated in unethical activities. In addition, with so many conflicts of interest shared by all board members, the reputations of directors are jeopardised if justice does not appear to be done.

Corporate senates create a win-win situation for regulators, shareholders, auditors and directors. Corporate senates move the onus for investor protection from the public to the private sector to permit simpler laws and regulations. Auditors are not compromised by being placed in a position where they may be required to "blow the whistle" on their clients, as they are now retained by the corporation's own whistle-blower. The reputation of directors is protected, as the senate becomes responsible for vetting contentious conflicts of directors' interests, such as remuneration, benefits and dealings with themselves. Further, the complex duties and call on skills — and so the exposure to financial liabilities — of being a director are reduced. It is in the self-interest of all parties, except rogues, to support the introduction of corporate senates. ■