Corporate Governance

Financial Responsibility, Controls and Ethics

Erik Banks
CORPORATE GOVERNANCE
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Corporate Governance

Financial Responsibility, Controls and Ethics

ERIK BANKS
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The Function of Corporate Governance
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The re-emergence of governance

Corporate governance has re-emerged as one of the most significant business topics of the early twenty-first century. Governance – which we define as the structure and function of a corporation in relation to its stakeholders generally, and its shareholders specifically – is not, of course, new. It has been widely discussed, debated, and analyzed for many decades, ever since joint stock companies moved into the mainstream of the global economy. It has also been the focus of reform proposals over the past three decades, as successive waves of corporate problems – some appearing in isolation, others made obvious by difficult economic times – have yielded a variety of recommendations. With recovery in economic growth and corporate profits, however, reform proposals have often been pushed aside. While certain modest improvements might occur, the commitment to sweeping and sustained reform within the global corporate system has not yet appeared.

Privatizations, pension deregulation, free capital movement, and market integration are creating a greater equity investment culture around the world. This phenomenon, together with an increase in the frequency and severity of corporate problems, has moved governance back into the limelight. Public focus is strong because governance failures can now impact a very large number of stakeholders: institutional and retail shareholders (the original and primary focus of most governance initiatives), retirees and pensioners, employees, bank creditors, clients, suppliers, regulators and broad communities. There is heightened realization that good governance is effective in protecting stakeholders, while poor governance puts all parties at risk. Governance failures can lead to a broad range of problems, from temporary reputational damage to insolvency. Events of recent years have demonstrated that even small governance problems can turn into much larger ones if left
unchecked. They must therefore be resolved forcefully: any delay can damage a firm’s reputation, market share and shareholder value.

Governance issues have an impact on companies and countries throughout the world. The subject is relevant in the United States (with spectacular governance failures such as Enron, Tyco, Andersen, and WorldCom), Switzerland (Swissair), Germany (Kirch Media), Japan (Daiwa Bank, Sumitomo Corporation), and every other national system where shareholder rights have to be protected and stakeholder interests require representation. To illustrate the global nature of governance and governance failures, Table 1.1 highlights a small sampling of difficulties that have appeared since the turn of the millennium (we consider some of these in greater depth in Chapter 7 as they are rich with lessons on failed process and control). It is, unfortunately, just a sample as the actual incidence of problems is much greater.

Table 1.1 A sampling of governance problems

**AOL Time Warner (USA):** The media giant was forced to restate its revenues by US$190 million after improper recognition of advertising revenues in 2000–2.

**Asea Brown Boveri (Sweden/Switzerland):** A deeply flawed expansion strategy created by the CEO and sanctioned by the board put the industrial engineering company in financial jeopardy; problems were compounded by the granting of US$170 million of pension benefits to the CEO and his successor without full and proper board approval.

**Adephia Communications (USA):** The US communications company filed for bankruptcy in 2001 under the weight of financial reporting improprieties and fraud perpetrated by the CEO and his top management team over a period of several years.

**Ahold (Netherlands):** The board dismissed the CEO, CFO, and several other senior executives of the Dutch food retailer after it was forced to restate revenues by US$1 billion as a result of financial improprieties.

**Akai (China):** The diversified conglomerate became Hong Kong’s largest corporate failure when it collapsed in 2000; executive management looted the company by redirecting assets and defrauding investors and creditors.

**Allfirst/Allied Irish (US/Ireland):** The US subsidiary of the largest Irish bank reported losses of US$691 million in 2001 as a result of the fraudulent activities of a foreign exchange trader; inadequate controls allowed the activity to proceed unchecked for several years.

**Arthur Andersen (USA):** The accounting firm filed for bankruptcy under the weight of many flawed auditing/consulting assignments (including Enron, for which it was charged with criminal obstruction of justice).
### Table 1.1 continued

**AstraZeneca (UK/Sweden):** The pharmaceutical company agreed to pay US$355 million in criminal fines related to fraudulent sales practices concluded between 1993 and 2001.

**Bank of China (China):** The top executives of China’s largest commercial bank were dismissed after the 2002 discovery of US$3 billion of fraudulent loans extended by its New York branch and Hong Kong subsidiary.

**Bristol Myers (USA):** The pharmaceutical firm admitted to improper accounting practices between 1999 and 2002 which resulted in a US$2.75 billion overstatement of revenues; the improprieties were centered on manipulation of inventories and sales incentives.

**Citibank (USA):** The US banking concern was implicated in various scandals including Enron (where it helped arrange transactions that the energy company used to hide leverage), and Wall Street research conflicts (where it produced false/conflicted research in order to win corporate business). The bank was forced to pay regulators hundreds of millions of dollars in fines.

**CMS Energy (USA):** The energy concern inflated its revenues by US$5.2 billion through false “round trip” gas and power trades with others in the marketplace.

**Daewoo (Korea):** The Korean conglomerate collapsed under the weight of massive debts accumulated in the pursuit of an expensive and misguided diversification strategy. The CEO, charged with fraud and looting of company assets, fled the country; other top executives were imprisoned.

**Enron (USA):** The US energy company filed for bankruptcy in late 2001 after suffering a liquidity crisis stemming from the disclosure of fraud, financial improprieties, and accounting irregularities, which significantly inflated revenues and understated its level of debt.

**E-Trade Group (USA):** The CEO of the Internet trading platform and broker returned US$21 million in pay after shareholders discovered he had been given an US$80 million package approved by the head of the board’s compensation committee, who was a personal friend. The CEO ultimately resigned his post under pressure.

**Freddie Mac (USA):** The US mortgage agency ousted the CEO and other top executives after it was revealed that they sanctioned policies that allowed understatement of earnings by US$6.9 billion pretax over a multi-year period. The company consistently misvalued and misreported earnings related to derivative contracts and securities held as investments in order to smooth future earnings volatility.
Table 1.1 continued

**Gateway (USA):** The computer firm became the subject of regulatory investigations based on financial irregularities in its disclosures. The company dismissed its top executives and restated net income down by US$78 million in early 2001 as a result of accounting discrepancies emanating from a foreign subsidiary.

**Global Crossing (USA):** The fiber optic networking company filed for bankruptcy under the weight of US$12 billion of debt used to fund acquisitions and capital investments. Flawed demand projections and financial irregularities associated with false capacity swaps compounded its problems.

**HealthSouth (USA):** The healthcare services provider, under the instructions of its founder/CEO and senior financial officials, engaged in a multi-year pattern of earnings inflation that eventually topped US$2.5 billion. Others in the company aided and abetted the fiction.

**Kirch Media (Germany):** The media company filed for bankruptcy as a result of excessive loans used to pay for an ill-advised expansion into digital television. The loans were provided by banks who appear to have been influenced by political forces.

**Kmart (USA):** After years of misguided strategy and earnings restatements, the discount retail firm filed for bankruptcy in 2002. Internal investigations subsequently revealed widespread abuse of corporate resources by top executives, conflicts of interest, falsification of internal documents, and failure of duties to adequately supervise.

**KPMG (USA):** The accounting firm became the subject of lawsuits and high profile regulatory investigations over accounting scandals at Lernout and Hauspie, Rite Aid, Oxford Health Plans, Xerox, and others.

**Lernout and Hauspie (Belgium):** A multi-year pattern of internal fraud guided by the CEO, founders, and top managers, including the fabrication of a majority of its sales revenue in some subsidiaries, pushed the company into bankruptcy.

**Mannesman (Germany):** The board of the German conglomerate was sued by shareholders following its takeover by the UK’s Vodafone after it became known that large golden parachutes had been given to former executives, without full and proper approval.

**Merck (USA):** The US pharmaceutical company falsely recorded billions in consumer-to-pharmacy copayments that it never collected. It was forced to restate earnings, pay fines, and postpone a public offering for a subsidiary.
Table 1.1 continued

**Peregrine Systems (USA):** The computer firm overstated its revenues by US$100 million through improper recognition of revenue from third-party resellers. The ensuing financial pressure forced the company to reduce its employee headcount by 50 percent.

**PNC Financial (USA):** The bank holding company misreported the effect of three off-balance sheet special purpose vehicles containing problem loans and bad venture capital investments and was forced by regulators to consolidate them back in and pay fines/restitution of US$115 million.

**Provident Financial Group (USA):** The bank holding company announced that it had overstated earnings by 12 percent over a six-year period as a result of “over-recognition” of income on leases and erroneous booking of off-balance sheet transactions.

**Qwest (USA):** The telecommunications company announced that it had overstated revenues by US$1 billion by booking of false capacity swaps in 2000 and 2001. Following the announcement shareholders filed lawsuits against the company.

**Reliant Energy (USA):** The energy company inflated its revenues by US$6.4 billion through false “round trip” energy trades with others in the marketplace.

**SK Group (Korea):** Prosecutors indicted ten senior executives (including the chairman) of the Korean conglomerate for orchestrating an eight-year scheme of accounting and stock fraud that included inflating profits by US$1.2 billion and hiding US$1 billion of bank debt.

**Swissair (Switzerland):** Switzerland’s main flag carrier collapsed in late 2001 under the weight of excess leverage/lack of liquidity resulting from an ill-advised debt-financed acquisition strategy that was sanctioned by the board.

**Tyco (USA):** The CEO and CFO engaged in a multi-year pattern of revenue overstatement in order to boost the stock price and increase the value of personal holdings; they also defrauded the company and engaged in tax evasion schemes. Certain board directors were also found to have committed fraud and were forced to resign after facts became known.

**Vivendi Universal (France):** The CEO of the company was forced to resign after embarking on a flawed strategy that included massive leverage and ill-advised acquisitions. The firm took the largest writedown in French corporate history and became the subject of investigation on grounds of financial misreporting.
Table 1.1 continued

**Waste Management (USA):** The company engaged in a long history of earnings and accounting manipulations in order to improve its financial profile. Earnings restatements eventually totaled billions of dollars and required sale and restructuring of the company.

**World Online (Netherlands):** The CEO sold her pre-IPO shares in the firm without first making public disclosure, in contravention of securities rules and ethical considerations. The firm ultimately filed for bankruptcy.

**WorldCom (USA):** The US telecom company, which defaulted on US$23 billion of debt in 2002 (the largest default in history) was the scene of massive accounting fraud by senior executives, who together manipulated corporate accounts by more than US$11 billion. Subsequent investigations revealed a host of control and board problems.

**Xerox (USA):** The company misstated its revenues by US$6.4 billion and its pre-tax earnings by US$1.3 billion over a five-year period and was forced to settle charges with regulators.

**Corporate earnings restatements (USA):** 330 US public companies restated their revenues/earnings in 2002, a 22 percent rise over 2001. Seventy-four of those restatements were large (US$1 billion+) and included high profile corporate names such as IBM, Computer Associates, Xerox and Kmart.6

What has caused these governance failures? What aspects of the corporate landscape of the 1980s and 1990s have led to the raft of problems that have become so evident in the millennium?

Although the matter is complex and often company-specific, we can point to various general factors that often appear, including:

- unethical conduct within a company, where directors, executives, and/or employees exhibit poor judgment or behavior
- weak boards that can be influenced and cajoled by powerful (and often charismatic) chief executives, and that lack the expertise to actively manage and challenge
- inattentive directors who fail to focus on issues of importance, and conflicted directors who derive personal gain from their ties to executive management
- ineffective internal controls that cannot detect or prevent problems
- poor external ‘checks and balances’ (for example, regulators, auditors,
capital markets, legal frameworks) that are unable to set or enforce proper standards.

While many of the problems appearing in recent years have been attributable to tactical/strategic mistakes or unethical behavior by executive management, the root causes and issues are often much deeper. For instance, although board directors and regulators often escape scrutiny, criticism, or discipline in the face of problems, they must share responsibility. While a chief executive might lead a company astray, board directors who permit it to occur have failed to discharge their duties properly. Equally, regulators that do not take actions to minimize, *ex ante*, the likelihood of problems appearing are not doing their jobs.

If companies as large and well known as Enron, WorldCom, Daewoo, and Swissair can fail, investors must wonder what other potential problems exist in the corporate world – particularly in systems that do not feature the same supposed control rigor. Indeed there has been, and remains, a widespread perception in the Americas, Europe, and Asia that many public companies have committed financial or corporate “improprieties,” executives have enriched themselves at the expense of investors and other stakeholders, and directors and regulators have failed to provide proper protections. Investors have witnessed many cases where directors have become passive or conflicted (or both), and executives earn handsome paychecks, regardless of what happens to the company, its earnings or share price. Not surprisingly, they have lost confidence in the corporate world, and that loss of confidence ultimately impacts companies in the form of more expensive capital. A slowdown in corporate expansion and economic growth can ultimately follow. The actions of a few taint the image of many others. Although it may be unfair, bad practices at a few firms mean many others are “tarred with the same brush,” and become subject to the same doubts and concerns.

Given the renewed global focus on governance, the fresh examples of failures and the legislative/best practice reforms that are (re)appearing, it is important to explore the issues so that problems and causes can be understood and realistic solutions considered. In this book we seek to understand how, in a practical sense, governance can be strengthened. In its broadest interpretation, governance might be said to include performance – maximizing enterprise value and conformance – ensuring proper accountability and responsibility. Any governance process based on performance and conformance must be flexible across time, location, and industry so that it can adapt, but not so flexible that proper standards and metrics fail to be applied or followed. Effective governance, as we shall discover, is often a balancing act, and we are interested in understanding
how a strong, yet flexible, framework can actually be created and enforced.

In Part I of the text we explore the theoretical framework of governance. We focus on understanding internal governance mechanisms, which are generally centered on the board of directors, executive management, internal controls, and ethical conduct, as well as external mechanisms, which are based on regulation, legal and bankruptcy systems, corporate control (for example, takeover) activities, investor activism, and external audits/ratings. We also consider the protections demanded by, and afforded to, a range of stakeholders. While much of our focus is on the role and rights of shareholders, we cannot ignore the requirements of the broader group of stakeholders; indeed, in some systems these other stakeholders “outrank” shareholders in the eyes of management and directors, and so deserve proper review.

In Part II we examine failures in the governance process. Here we focus on the reasons governance problems occur and the form they can take. We also consider, from a theoretical perspective, the different stages of “financial damage” a company might travel through as a result of failures in governance mechanisms. In order to ground the theoretical discussion in the realities of the modern corporate world, we develop a series of case studies drawn from corporate and industry events of the past few years.

In Part III we move from theory and failure to reform, exploring micro and macro changes that are intended to improve corporate behavior and protect stakeholders. Some of these reforms are internal to individual companies, guided by the actions of board directors, executives, and controllers; others are macro in nature, intended to be driven by regulators, auditors, legislators, and market conduits and intermediaries. In addition, some of the reforms we consider are ethical: we take a step back from policy and control mechanisms to consider broader issues related to corporate behavior and codes of conduct. The focus of all of these reforms, as we shall discuss, is on substance. Reforms must serve a sufficiently useful purpose, and be easy enough to implement and follow, that they become second nature. Indeed, the idea of substantive governance is so vital that we shall stress it with frequency, because only through truly substantive measures can shareholders and other stakeholders be protected properly.

In the balance of this chapter we introduce several key concepts regarding corporate structure, rights, and control. By examining these issues we begin to understand why a governance framework is necessary and how internal and external governance mechanisms factor into the process. We also consider different theoretical models of governance and the benefits that can be obtained through a proper process.
BASIC CORPORATE STRUCTURE

Limited liability, equity investors, and debt holders

Every company requires capital in order to operate. Capital funds the purchase of assets that are used to generate the products or services that form the core of a company’s business. The products and services are then sold to generate revenues, a portion of the revenues is returned to the suppliers of capital, and the balance is reinvested in the company (which can be used to expand production further, and so forth). A limited liability company (LLC), a standard legal structure in many countries, draws its capital from two sources: equity and debt.9

Through an LLC equity investors (or shareholders; we use the terms interchangeably) contribute risk equity to the operation in exchange for certain rights. These rights, based on the concept of private ownership of property, are defined by the LLC’s corporate charter and are conveyed in marketable form through a share of stock.10 That share is a representation of two distinct elements, one financial and one legal. The financial element (sometimes known as a “rent right”) is the investor’s entitlement to a pro-rata share of the future cash flows of the company, discounted at a relevant rate, along with any periodic dividends that might be paid.11 The legal element (sometimes referred to as a “control right”) is a “package” of legal entitlements, including the ability to:

- Transfer shares.
- Receive regular, accurate financial disclosure.
- Participate/vote on a range of issues that might be put forth during the company’s annual general meeting (AGM) and make decisions on various issues fundamental to the company’s overall operation. (These can include, but are not limited to, selection of board directors, changes in the corporate charter, corporate reorganization, merger and acquisition activity, and AGM resolutions.)12
- File lawsuits (for example, legal actions for abuses related to self-dealing, compensation, information disclosure, breach of duties of loyalty/care). Legal action is often taken in the form of derivative lawsuits, which permit the shareholder to sue the corporation to bring action against directors or executives.

Under corporate law in countries that feature the LLC structure the company (that is, the equity investors as owners of the company) cannot be liable for more than the amount of equity capital that has been invested. Thus, in the event of a loss leading to insolvency, creditors cannot look to
shareholders for additional capital.\textsuperscript{13} (There is one exception to this rule, where investors can be deemed liable for losses in insolvency and be forced to pay from their own personal assets. This phenomenon, known as “\textit{piercing the corporate veil},” is quite rare and not followed in every corporate jurisdiction, so the basic tenet of limited liability serves as the overarching rule.)\textsuperscript{14} The LLC structure also means that a company is only legally responsible to its shareholders, and not to other stakeholders. Although a company might be accountable to other parties, as we discuss in Chapter 4, that accountability is ethical, moral or cultural, rather than legal.

Lenders (such as banking institutions) and capital market debt investors (such as bondholders) also supply companies with a form of capital. In exchange for providing debt capital, lenders/bondholders (collectively, creditors) gain certain rent rights, including receipt of periodic interest rate payments (along with principal repayment at maturity), but have no stake in the future profitability of the firm and no right to vote. They do, however, have other control rights, including the ability to:

- obtain financial covenants in debt capital structures (including those that require the firm to adhere to certain financial performance standards)\textsuperscript{15}
- file lawsuits related to breach of duty
- commence bankruptcy proceedings
- negotiate and liquidate collateral to repay capital lent
- receive preferential financial treatment in the event of insolvency.

Therefore, in exchange for various legal rights and economic rewards, equity investors and debt holders supply a company with the capital that is used to fund revenue-generating assets. Figure 1.1 highlights the balance sheet/income statement summary and conveyance of debt and equity rights in the typical corporate structure.

The equity investor, as lawful owner of a firm, is granted the most prominent position when it comes to legal accountabilities. A company, operating under normal financial circumstances, seeks to maximize the value of the enterprise, a benefit that accrues to the equity investors because the value of the individual shareholding is maximized. But accountabilities shift when a company enters a period of financial distress and moves towards insolvency. In the \textit{pre-petition stage} (one of severe financial distress where the likelihood of filing a bankruptcy petition increases), accountabilities shift; during this period directors are obliged to consider accountability to creditors. No longer are directors and managers concerned with maximizing the value of the equity, they are simply
concerned with maintaining the company as a going concern. Indeed, they may take decisions that run contrary to the shareholder value-maximization strategy, such as investing in lower risk projects and suspending dividend payments to equity investors.

If insolvency actually occurs, the rights of creditors move to the forefront. Since equity holders rank junior to debt holders in the capital structure, they will suffer considerable losses (and may find that their shares become completely worthless). Accordingly, the focus shifts to maximizing the value of corporate assets in order to repay creditors (in liquidation, a pure cash-out of the company, or reorganization, a restructuring of the firm into a new company). Accountability is thus to the debt holders, as we discuss in Chapter 4. The relationship between equity and debt investors is therefore asymmetrical. This becomes evident when a firm is trying to allocate capital to investment projects. If an investment is successful, benefits accrue to the equity investor in the form of greater returns. If it is unsuccessful, the equity investor is protected on the downside through the limited liability structure, meaning debt holders bear the cost. Equity

Figure 1.1 Assets, debt and equity and the conveyance of rent/control rights

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue-generating assets funded by debt and equity capital</td>
<td>Entitlements</td>
</tr>
<tr>
<td>Lenders and bondholders</td>
<td>Interest payments</td>
</tr>
<tr>
<td>&quot;Package&quot; of creditor control rights</td>
<td></td>
</tr>
<tr>
<td>Equity investors</td>
<td>Entitlements</td>
</tr>
<tr>
<td>Discounted future cash flows, dividends</td>
<td></td>
</tr>
<tr>
<td>&quot;Package&quot; of investor control rights</td>
<td></td>
</tr>
</tbody>
</table>

Income statement
Revenues
- Operating expenses
- Interest payments
- Taxes
= Net income
- Dividends
= Transfer to retained earnings

GOVERNANCE DEFINED
investors thus have little to lose once they have committed their equity, and prefer riskier projects. When creditors assume greater control of the company during periods of financial distress they shift the company’s focus from high risk to low risk projects (typically those with a lower net present value (NPV)) in order to protect their own position. This is commonly referred to as the underinvestment problem.

Value maximization and the search for enterprise value

Assume that a company is operating under normal circumstances, meaning accountability is to the shareholders. Shareholders invest in a company’s stock because they expect an appropriate return on their capital: they are not providing a company with funds without the expectation of a fair return. As noted, the return may be in the form of a dividend, or the future cash flows of the firm (expressed by way of an appreciating stock price: all else being equal, as the company exhibits greater potential for generating future cash flows, its stock price will trade higher), or both. A shareholder seeks to maximize the value of the equity investment: this is a rational economic expectation, as no rational shareholder prefers less, rather than more, value.

Since shareholders are driven by value maximization, and since capital is mobile, they are free to reallocate their funds from one company to another if they do not believe value is being maximized. And, for better or worse, the metric that is most commonly used to gauge value maximization is the company’s stock price. It is easy and convenient to monitor, and although it can be impacted by external factors (such as liquidity problems, accounting treatment, and broader systemic issues) it is a widely used measure of a company’s current and perceived future value. In the modern corporate and investment world it has become the primary means of measuring whether a company is succeeding or failing. Despite its convenience (or perhaps because of it), the stock price as a measure of corporate value can be flawed. Since investors monitor a company’s stock price to determine whether value is being maximized, management’s attention can be diverted to short-term actions that boost the stock price over the short run, rather than long-term or strategic investment that can lift the stock price for the long term. This, as we note in Chapter 7, has been a central reason for governance problems at some companies.16

In a rational economic world the search for corporate value is a dominant force, and the allocation of corporate resources, including capital, must proceed as efficiently as possible (although some economic theorists have noted that such allocation may not be optimally efficient if value maximization is the only goal).17 Shareholders, as noted, expect an appropriate return on their capital through dividends and price appreciation.
Price appreciation, in turn, is a function of **enterprise value**: the more valuable the enterprise, the higher the resulting stock price. Enterprise value can be determined in several ways; two of the most common are accounting value and economic value.

**Accounting value** uses a company’s earnings, **earnings per share (EPS)**, and **price/earnings (P/E) ratio** to arrive at either a stock value or a valuation multiple (depending on which variable is unknown). Thus, a company selling at ten times earnings (a P/E multiple of 10) and targeting EPS of US$1.50 should carry a stock price of approximately US$15; alternatively, given EPS of US$1.50 and a stock price of US$15, the company’s valuation is ten times earnings. Not surprisingly, these variables fluctuate continuously. Analysis also focuses on **book value** (the amount a company originally spent on its assets) in comparison with market value (what the assets are currently worth) as an indicator of earnings capacity. In the accounting value model, enterprise value is derived primarily from the balance sheet and income statement, rather than the statement of cash flows. While this approach is quite popular, it has shortcomings, as we note below.

**Economic value** is based on a sum of the company’s expected cash flows over time, discounted back to the present through an appropriate discount rate. That discount rate is a combination of a risk free rate (compensation to the investor for the time value of money) and a risk premium (compensation for the riskiness of the company). The cash flows used to compute enterprise value are net of investments in the company’s growth. Under this model, free cash flows over the entire life of a company’s business are extremely important, while short-term cash flows become less relevant.

In contrast to the accounting model, enterprise value under the economic model is based almost exclusively on the company’s statement of cash flows. This is an important distinction because it is the company’s ability to generate cash that keeps it operating as a going concern and gives it the funds needed to invest in growth directly (using cash flows to invest in a given project) or indirectly (using cash flows to pay for the interest on the bond or loan funding the project). As we discuss in Chapter 6, the availability of cash, or liquidity, is vital: in good times, certainly, but especially in bad times, when the company’s resources come under stress. If the company’s operations are truly able to generate cash, rather than just accounting value, the enterprise has a better chance of carrying through a period of financial distress. The availability of real cash flows can therefore be the difference between success and failure (indeed, a popular Wall Street adage rightly notes that “earnings are an opinion, but cash is a fact”). Focus on cash flow is also important because it draws attention away from EPS and accounting manipulations as short-term mechanisms to maximize stock price.
Consider these simple examples. Since the accounting value approach emphasizes EPS, costs that are expensed via the income statement will yield earnings that are different from those capitalized on the balance sheet and amortized over time. Choosing the latter can boost reported EPS by avoiding the income statement entirely (a mechanism that firms such as WorldCom and Enron used to excess). With the exception of certain tax effects, no such “disguise” is possible using the cash flow method. The same types of “earnings games” can be played with purchase and pooling of interest accounting in corporate mergers. Under the purchase method (used when the seller only accepts cash or buyers cannot issue equity), goodwill amortization – a non-cash, non-tax deductible item – has no effect on cash flows but has a negative effect on EPS. Pooling of interests, which adds the book value of assets purchased without any goodwill effect, can have a positive effect on EPS. Thus, a company might make an important merger decision based on its EPS impact, and not whether the merger makes sense from a long-term value enhancing perspective. (Again, firms such as Global Crossing, Waste Management, Ahold, and Asea Brown Boveri have driven merger decisions from the perspective of short-term EPS enhancement rather than true enterprise value enhancement.)

Treatment of research and development (R&D) is another potential problem area. Accounting for R&D as a current expense through the income statement, rather than capitalizing it on the balance sheet and amortizing against earnings over the projected payoff period, can actually lead to an understatement of EPS, a different sort of problem (but, again, one that would not arise by examining cash flows). Under this scenario, the stock price capitalizes expected future payoffs from R&D, while earnings are charged with current period expenses (a factor, perhaps, in the very high multiples granted to technology companies in the late 1990s). Various other examples can be given to distinguish between the two approaches (such as treatment of deferred taxes and inventories, and full cost versus successful efforts accounting), but all follow along similar lines: changing the timing, nature, and/or magnitude of reported earnings and cash flows, in order to impact perceived enterprise value, and the stock price. And, though some of these examples are specific to the US and/or UK Generally Accepted Accounting Principles (GAAP), similar parallels exist in other accounting regimes, such as International Accounting Standards (IAS).

In the search for enterprise value, investors and other stakeholders must focus on how value is created and determined, whether accounting or economic measures dominate investment decisions, and how a company’s cash flows and liquidity position are actually performing. This is not to say the stock price cannot, and should not, be an area of focus; it is a key metric. The issue relates to understanding what drives the stock price. For instance, shareholders seeking to maximize enterprise value over an
extended period of time might prefer philosophies based on cash flow maximization rather than those that simply manage (and in some cases manipulate) accounting-based numbers. The stock price might not necessarily have the same boost in the short run, but might well perform better in the long run. An important part of the exercise distinguishes between the quality and quantity of earnings. To be sure, earnings and earnings growth can be an important indicator of performance, but it is essential to understand what creates the growth. Rapid growth can be a misleading indicator of “value added” because it can be accomplished by simply adding capital to the equation. But capital, as noted in the economic value model, must provide fair compensation. If it does not, then low returns being generated mean that earnings expansion reduces, rather than increases, value. This is certainly not the goal of any rational shareholder.

**Diffusion, control, and the agency problem**

Although shareholders are de facto owners of the company they do not run business on a daily basis. Others, with the appropriate expertise, do it for them. In most corporate systems shareholders appoint board directors, and charge them with running the company on their behalf. Directors are thus agents of shareholders, and in a properly functioning agency relationship, act in their best interests. Directors, in turn, hire senior managers (such as the CEO, president, and CFO) and give them the power to run the corporation on a daily basis. Since directors are not actively engaged in company affairs every day, they delegate certain discretionary powers and authorities to the executive team through *residual rights*.

Executives are agents of the directors, and can make decisions related to the management of the firm, including those involving financing plans, acquisitions, and hiring/dismissal of personnel. Although executives have daily responsibility, directors wield considerable power in the running of a corporation. They are protected by set terms (although they are re-elected annually in most systems), and have the ability to change aspects of the capital structure, set dividends, hire/fire and compensate executives, develop the AGM agenda/slate, and so forth. Given these responsibilities, they have effectively obtained a substantial amount of power from shareholders (who are more readily confined to voting on directors and select corporate issues).

The focus then shifts to the relationship between board directors and executive management. Although some systems have turned steadily towards the use of more outside/independent directors in recent years, many still permit a majority of insiders (or outsiders with close ties to management). In addition, in some systems the head of the board and the chief executive of the company are one and the same. Board directors may thus be very close to management. Accordingly, shareholders have ceded
control directly to board directors and indirectly to the management team, certainly as far as daily affairs are concerned.\(^{21}\) This gives rise to what is commonly known as the *agency problem*, a conflict centering on the “mistrust” that arises between shareholders, directors, and management. Specifically, the agency problem is concerned with understanding whether directors and managers are acting in good faith and advancing the interests of shareholders (for example, maximizing enterprise value). In fact, the agency problem can be extended to include other stakeholders, such as creditors and clients. For now, however, we confine our discussion to the shareholder/management dimension.

A central tenet of modern corporate theory, originally put forth by Berle and Means in 1932\(^{22}\) (and supported empirically and anecdotally since that time), is that the twentieth and twenty-first century shareholder has ceded an increasing amount of control to management: the divide between investors (as owners) and managers (as effective control) is growing larger. Even though shareholders theoretically control the company through the rights conveyed via their investment, they actually do not; and while their capital is at risk and they should take an active interest in managing it through their legal rights, they often fail to do so. The same division can occur between small shareholders and concentrated shareholders (who actually appoint management, and are thus the true source of control; indeed, the division between concentrated and small shareholders appeared for a time in the United States and UK in the nineteenth and early twentieth centuries, and remains prevalent to the present day in Germany, Japan, Mexico, East Asia, and other countries and regions). Diffuse shareholders that fail to exercise their rights lack the power to influence management. Indeed, as noted below, only large institutional equity investors and bank lenders are likely to be able to influence management. Even then, however, there is no guarantee that they will be successful.\(^{23}\)

Thus, separation between ownership and control occurs because shareholders are increasingly diffuse, spreading out their investment capital across many companies, diversifying their portfolios, and attempting to avoid instances of illiquidity (such as might arise by holding a concentrated stake).\(^{24}\) An increasing amount of investment capital directed towards professionally managed funds (such as mutual and pension funds) compounds the issue: investors effectively migrate from a single company focus to a broader mix of portfolio issues. A growing investor base also means more shareholders hold smaller stakes in companies, indicating any control they might command diminishes continuously. The void in effective control created by dispersed investors means the source of power turns inward, to the corporate board and management structure.

By holding only the smallest percentage stakes in any given company, investors lack access to detailed information about the company’s opera-
tions, and take a very passive role in the management of their rights, such as opting not to vote at AGMs or on interim resolutions. In some countries the majority of shareholders fail even to attend AGMs, leave their voting proxies blank, or vote in an uninformed manner by simply “signing on the dotted line.” Accordingly, they have no effective way of monitoring and controlling management. For example, those in effective (if not legal) command of a company might profit more by taking advantage of the company and its resources than by investing in productive processes that generate profits. Investors may discover this only after it is too late. (This form of “looting” is unfortunately not a theoretical concept, but a practical reality that has been demonstrated by firms such as Enron, WorldCom, Tyco, Adelphia, Lernout and Hauspie, and others.)

Indeed, there is a widespread belief that as a result of diffuse ownership, the single shareholder cannot make a difference. Fractional ownership conveys fractional benefits, but not fractional costs. If the single shareholder wants to improve the quality of information on what management is doing it must bear the full cost of doing so (other shareholders are unlikely to help defray the cost unless they all band together which, again, implies a cost). As the size of the corporation and the number of shareholders grow, control gravitates to the board of directors. If most directors are insiders or selected by management, control actually rests with executives. Although shareholders should theoretically determine the fate of the company on important issues, management practically speaking, has a “wide berth” to direct the daily affairs of the company.25

Large shareholders have a greater ability to absorb information and monitoring costs, and narrow the agency problem. If these are regarded as valuable activities, then investors have incentives to hold larger blocks of shares (while still trying to remain sufficiently diversified and liquid from a risk perspective). This presumes they actively manage their rights and have access to information, a supposition that does not hold true for all large shareholders in all countries, as we shall discover. In some cases large shareholders prefer to sell their shareholdings rather than challenge management. In other cases they simply side with management, regardless of the issue.26 In the main, however, large institutional shareholders can exert greater control over management. In some countries this is a practical solution, in others it is a more complicated issue.27

It is possible, of course, for a company itself to make more information available; doing so, however, is an expense for the company (and, ultimately, the shareholder). Nevertheless, more transparency and cooperation among management and shareholders is likely to lead to some level of sustainable wealth creation for shareholders, and may be a cost worth bearing. We stress again that the agency issue, while most commonly associated with the separation between shareholders (as owners) and managers
(as control), can also exist between minority shareholders (as owners) and concentrated/controlling shareholders (as owners and control). This is characteristic of systems where family groups hold large blocks of stock and exercise considerable control over minority shareholders. In fact, the corporate ownership structure evident in different countries influences, to a large degree, whether the main agency conflict is between shareholders/managers or minority shareholders/controlling shareholders.

The effective control of a corporation has therefore devolved from the investor to management. Berle and Means have characterized two forces at work: control is a centripetal force, tending to concentrate in a small group of managers, while beneficial ownership is a centrifugal force, tending to divide and subdivide among an ever-increasing group of investors. The shareholder has moved from being a legal owner of private property to a recipient of some capital return (assuming the venture is profitable). In practical terms there is little that investors can do to influence management on a daily basis. Investors (particularly minority investors) that are dissatisfied may only be able to sell their stock and redeploy capital elsewhere. Berle and Means have summarized the net result succinctly:

The value of an individual’s wealth is coming to depend on forces entirely outside himself or herself, and his/her own efforts. Instead, its value is determined on the one hand by the actions of the individuals in command of the enterprise – individuals over whom the typical owner has no control, and on the other hand, by the actions of others in a sensitive and often capricious market. The value is thus subject to the vagaries and manipulations characteristic of the marketplace ... in the corporate system, the owner of industrial wealth is left with a mere symbol of ownership while the power, the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control.

**Forms of ownership and control**

Diffusion of shareholders leads to divergence between ownership and control. This is particularly true in systems where individual share ownership is large (such as the UK and the United States); where it is not, traditional ownership/control divisions may shift to the minority/majority ownership/control divisions. (For example the systems in France, Germany, Indonesia, and Mexico feature fewer individual holdings but significant family, main-bank, or corporate holdings, which imply a different level of control.)

When those responsible for running a company own a majority of the voting stock, control and partial ownership are the same. In general, when management is distinct from the providers of capital, it has a duty to use
assets efficiently in order to maximize value. Only when managers and capital providers are identical does this not hold true; that is, managers can do whatever they want with the firm’s assets as they own them completely and directly. However, assuming rational behavior, we would still expect the same thesis to hold true (although there may be instances where managers might pursue other goals, such as market share or corporate expansion rather than value maximization). As we shall discover, this means it is vital to identify the proper means by which managers are held accountable to capital providers.

In some cases effective control can be achieved by holding only a minority interest. Although this is more difficult it can be accomplished, and leaves most of the ownership group without control. Separation between ownership and control reaches its most extreme point when even a minority interest stake ceases to exist. Through certain structural schemes, control of the company’s physical assets passes from the ownership group to those directing their use.

From a formal perspective we can consider different levels and structures of ownership and control. These include:

- **Total control:** this exists primarily in the case of family-owned or private companies. Given the legal power of owners to dominate management, ownership and control are the same.

- **Majority control:** this is similar to the concept of total control, particularly in cases where the minority shareholders are diffuse and apathetic. This gives the majority shareholder effective control, enabling even amendments to the corporate charter or articles of association to be concluded with relative ease.

- **Legal mechanism control:** this occurs when legal or structural mechanisms permit effective control without a majority stake. For instance, in a pyramid holding company, a sequence of majority shareholdings in each individual company can lead to effective control with only 5 percent or 10 percent of outstanding shares by the time the fourth or fifth sub-holding company is incorporated. Control might also be gained through the issuance of non-voting stock. Under this mechanism the capital structure features multiple classes of stock, but a majority of investors lose the legal power to vote (that is, they become disenfranchised). A reverse structure is also possible, where a minority group of shareholders is granted outsize voting rights through a special class of stock.

- **Voting trust control:** this occurs when stock is held with trustees who have total, or near total, discretion over how to vote the block (a true
separation of ownership and control, as the trustees do not own any of the stock but have significant control).

- **Minority control:** under this scheme, which is relatively uncommon, small groups of investors band together to form “working control” of a company; this is generally accomplished by attracting enough proxies from diffuse owners. Minority control can only work if no other large *block holder* exists (that is, all shareholdings are diffuse).

- **Management control:** this occurs when management itself emerges as the controller of activities. As with minority control, this process only works when ownership is so diffuse that even an organized minority interest fails to dominate the company and its actions.

When ownership and control coincide, such as in the case of the family-owned corporation, owners can effectively operate the company as they choose. When they diverge, the main issue relates to whether the control group will run it the way the ownership group indicates. This may ultimately depend on whether issues of self-interest coincide. Controlling interests, in whatever form they take, limit the ability of outside investors to influence the process; they might be considered *insider systems*.

Companies in Continental Europe, Japan, East Asia, and Latin America are structured as insider systems: each one features a large number of firms with concentrated ownership positions (either minority or majority control). Firms in Germany and France, for example, have large corporate and family shareholdings, as well as influential minority bank shareholdings; companies in Mexico, Indonesia, and Thailand are centered heavily on concentrated family shareholdings.31

Where controlling interests do not exist to a significant degree, shareholder influence can theoretically be stronger, as long as investors are active and are not subject to the agency problem; these might be though of as *outsider systems*. The United States, the UK, Canada, and Australia, for instance, feature a large number of companies with very diffuse ownership and are considered to be outsider systems. Figure 1.2 summarizes the insider and outsider ownership systems.

**ACCOUNTABILITY AND THE NEED FOR CORPORATE GOVERNANCE**

The shareholder is in a difficult position. Diffusion and agency barriers lead to lack of control. The shareholder often cannot influence or monitor management and lacks access to information, and the cost of overcoming these hurdles is considerable.32 It wants rights to be upheld (that is, profit
maximization and fair treatment) but it cannot be certain that they will be. In the face of these challenges the shareholder can become passive and even apathetic. The concept of **equitable control** – where managers obtain power from diffuse shareholders and act in the best interests of the firm – is not guaranteed to work without proper structure, incentives, and checks and balances. Perhaps the interests of shareholders and management are

**Figure 1.2** Insider and outsider ownership systems
not aligned; perhaps, as Berle and Means presciently noted, management can “serve their own pockets better by profiting at the expense of the company than by making profits for it” (as seen in Enron, WorldCom, Tyco, Kmart, Daewoo, HealthSouth, Lernout and Hauspie, et al.). Even if management does not behave fraudulently, it might still be interested primarily in building empires or focusing on activities that provide lucrative short-term financial reward. If dissatisfied, it may be easier for the shareholder to sell the stock and redeploy capital in another opportunity than to try to “fight the system.”

Since shareholders are diffuse, lack effective control, and have rights that require protection, strong governance is of paramount importance. If investors cannot exercise proper control, then mechanisms must be created to ensure some type of accountability. They need a framework by which they can oversee and discipline management. The same can also be extended to other stakeholders, who have interests that need to be represented properly.

Governance assumes various forms in modern corporate systems. These elements of governance, which we discuss at greater length throughout the text, are centered on both internal and external mechanisms.

**Internal governance**

Internal governance is based on specific mechanisms and actions taken by individual firms to enforce control and accountability. These can vary by company, industry, and country, but broadly speaking include:

- establishing a capable and unbiased board of directors
- creating appropriate responsibilities and norms within the ranks of executive management
- developing independent control groups, including finance/accounting, legal, risk management and internal audit
- creating and promulgating a code of conduct.

We consider these mechanisms at greater length in Chapter 2.

**External governance**

Supplementing internal governance processes are external forces that establish overarching frameworks which define, or operate with, internal mechanisms. Again, although specific external elements vary by country and economic system (depending on law, custom, and behavior), key forces include:
establishing appropriate regulatory oversight
creating proper legal and bankruptcy regimes
ensuring efficient capital markets access
encouraging corporate control activities (such as mergers and buyouts)
permitting block holder monitoring of corporate activities
encouraging the participation of activist institutional investors
requiring thorough and comprehensive external audits
facilitating credit rating agency reviews.

We consider these mechanisms in more detail in Chapter 3. Figure 1.3 summarizes the monitoring and accountability requirements conveyed through internal and external governance measures.

As we have indicated, different countries feature different types of shareholding structure, and make use of a range of internal and external governance mechanisms. We discuss these in greater detail in the chapters that follow, but set the stage here with some introductory thoughts. (Naturally, some of our discussion is generalized; we are only seeking to illustrate general characteristics of different national systems and models, knowing that exceptions can exist in any specific situation.)

Still, it is clear that some countries have very diffuse shareholdings and rely heavily on market forces to instill governance and control discipline.

![Figure 1.3 Summary of internal and external governance mechanisms](image-url)
Others feature concentrated shareholdings and focus primarily on long-term relationships and monitoring to enforce governance. In fact, these models have developed over a relatively long period of time (several decades at a minimum), often in response to the specific characteristics of the national or regional marketplace. Different power and control groupings and structures thus emerge to cope with particular characteristics or inadequacies of the system (such as lack of a capital market, lack of a strong regulator, lack of a strong legal framework and lack of long-term relationships).

We can consider the following models:

- **The market model.** This model, which characterizes the United States, UK, Australia, Canada, and several other countries, features very diffuse shareholdings, liquid capital markets, dynamic capital reallocation, advanced legal and regulatory frameworks, and an active market for corporate control. At a micro level the board of directors relies on both board committees and internal controls to monitor company management. In practice managers hold considerable power over the board, tend to operate in a decentralized, entrepreneurial fashion, and are often compensated handsomely. Management is very focused on investments with measurable returns that seek to maximize enterprise value and the stock price, particularly over the short run. Shareholders are widely recognized as the primary stakeholders. In general those in the market model tend to focus on transactions rather than relationships, the short term rather than the long term.

- **The relationship model.** This model, found in Japan, Germany, Italy, the Netherlands, and France, among others, features greater concentrated ownership stakes and cross-shareholdings, moderately liquid capital markets, less active capital reallocation, and less corporate control activity. Regulatory processes are strong; although legal frameworks exist, they are often supplanted (or at least supplemented) by informal negotiation arising from long-term business relationships. At a micro level company management is monitored by a board (in form), and by main banks, or large company or family shareholders (in practice). Company management is rigid and tends to favor centralized operations; managers, who receive less compensation than market model company managers, are not driven by short-term stock price activity, and are thus less likely to make hasty investment decisions or seek only to maximize projected NPV and enterprise value. (Indeed, intangible investments are acceptable.) The primary stakeholders – practically, if not legally – are often employees, rather than shareholders. (Note that even within the relationship model differences can arise.
For instance, Japan still features fairly diffuse shareholdings compared with Germany, Japanese boards are almost exclusively insider and most lack board committees, German boards have labor representatives, and so forth. While companies in both are interested in perpetuating the existence of their firms, German companies favor technical leadership and Japanese companies market share.) In general, those in the relationship model focus on cooperative relationships rather than transactions and have a much longer time horizon.

While the market and relationship models are dominant in developed nations (particularly where the regime and practice of regulation, law and bankruptcy are well established) we can also consider a third model that appears to be linked closely with some emerging nations.

- **The hybrid model.** This model, which is found in various developing nations (such as Indonesia, Thailand, Malaysia, Korea, and Mexico) contains significant elements of the relationship model, but also includes dimensions of the market model and certain unique characteristics of its own. For instance, capital markets are illiquid, the market for corporate control is either inactive or nonexistent, and regulatory and legal frameworks are often in a nascent state. In a micro level, family interests often hold large ownership stakes, related company conglomeration is common, ownership ties between companies and banks can be significant, and relationships/agency with government bodies are very prevalent. In the absence of well-established regulations and/or legal foundations, business dealings are often based on trust and relationships. Although some aspects of this model have changed since the significant economic/financial dislocations of the late 1990s (such as less conglomeration and less linkage with political forces) many of the characteristics remain unchanged.

These general models are worth bearing in mind when considering governance measures, flaws and potential solutions. Table 1.2 summarizes some of the key characteristics of the market, relationship and hybrid governance models.

As our discussion proceeds, it is important to consider whether forces of globalization, competition, deregulation, and technology will draw the hybrid model closer to the relationship or market models and, more importantly, whether the market and relationship models will eventually converge, or whether national and cultural differences will force them to coexist as separate systems. Indeed, there is considerable academic debate on whether an “optimal” corporate governance model exists, and there are at least three views:
Table 1.2  General governance models and summary characteristics

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<th>Market</th>
<th>Relationship</th>
<th>Hybrid</th>
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<tr>
<td><strong>Examples</strong></td>
<td>US, UK, Canada</td>
<td>Japan, Germany, France</td>
<td>Indonesia, Korea, Mexico</td>
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<tr>
<td><strong>Time horizon</strong></td>
<td>Short-term</td>
<td>Long-term</td>
<td>Long-term</td>
</tr>
<tr>
<td><strong>Shareholdings</strong></td>
<td>Diffuse</td>
<td>Semi-concentrated (banks, corporations) (e.g. Japan) to concentrated (banks, corporations, family) (e.g. Germany)</td>
<td>Semi-concentrated to concentrated (family business groups, corporations)</td>
</tr>
<tr>
<td><strong>Capital markets</strong></td>
<td>Liquid</td>
<td>Somewhat liquid (e.g. Germany) to quite liquid (e.g. Japan)</td>
<td>Illiquid</td>
</tr>
<tr>
<td><strong>Corporate control</strong></td>
<td>Active</td>
<td>Inactive (e.g. Japan) to somewhat active (e.g. Germany)</td>
<td>Inactive</td>
</tr>
<tr>
<td><strong>Capital reallocation</strong></td>
<td>Active</td>
<td>Moderately active</td>
<td>Inactive</td>
</tr>
<tr>
<td><strong>Regulatory framework</strong></td>
<td>Strong</td>
<td>Strong</td>
<td>Weak to moderately strong</td>
</tr>
<tr>
<td><strong>Legal framework</strong></td>
<td>Strong</td>
<td>Moderate</td>
<td>Weak to moderate</td>
</tr>
<tr>
<td><strong>Primary stakeholders</strong></td>
<td>Shareholders</td>
<td>Labor/employees</td>
<td>Controlling shareholders</td>
</tr>
<tr>
<td><strong>Board</strong></td>
<td>Primarily outsiders</td>
<td>Primarily insiders (e.g. Japan) to mixed (e.g. Germany)</td>
<td>Primarily insiders</td>
</tr>
<tr>
<td><strong>Board committees</strong></td>
<td>Common</td>
<td>Rare (e.g. Japan) to mixed (e.g. Germany)</td>
<td>Very rare</td>
</tr>
</tbody>
</table>
An optimal model exists and full migration will eventually occur.

An optimal model exists but only partial migration will occur as the costs arising from political/cultural frictions are too high.

Multiple models can, and should exist, so no meaningful convergence will occur.

Although the market and relationship models have each appeared “dominant” at particular points in time (for instance, relationship models in the 1980s, market models in the 1990s), the rather striking corporate governance problems experienced in each makes it clear that neither one is perfect. For the present, no single standard seems likely to dominate, and a fusion of the two may ultimately result. Although it is early in the process, some anecdotal evidence suggests a very gradual merging of the two may already be commencing. For instance, through deregulation and legislative changes, certain Japanese companies have started implementing structural reforms (such as reducing board size, adding more outside directors and committees, and improving disclosures); the Japanese and German corporate control

<table>
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<tr>
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<th>Market</th>
<th>Relationship</th>
<th>Hybrid</th>
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<tbody>
<tr>
<td>Internal controls</td>
<td>Strong</td>
<td>Moderate (e.g. Japan) to strong (e.g. Germany)</td>
<td>Weak</td>
</tr>
<tr>
<td>Management view of stock price</td>
<td>Very sensitive to short-term moves</td>
<td>Very insensitive to short-term moves</td>
<td>Mixed</td>
</tr>
<tr>
<td>Internal investment style</td>
<td>Measurable returns</td>
<td>Measurable returns, intangible value</td>
<td>Measurable returns</td>
</tr>
<tr>
<td>Management style</td>
<td>Decentralized, entrepreneurial</td>
<td>Centralized, rigid</td>
<td>Centralized</td>
</tr>
<tr>
<td>Broad goals</td>
<td>Value</td>
<td>Market share (e.g. Japan), Technical leadership (e.g. Germany), perpetuation of firm</td>
<td>Market share, maximization, or perpetuation of firm</td>
</tr>
</tbody>
</table>

Table 1.2 continued
markets are beginning to feature more activity as long-term corporate and bank investors liquidate their cross-shareholdings; UK companies are becoming more sensitive to long-term stakeholder relationships; US shareholders are demanding greater restraint in executive compensation, and so forth. The most important breakthroughs may occur when the overarching goals that characterize the extremes of the market and relationship systems (a high stock price at any cost, versus a large market share at any cost) head towards rational middle ground.

The benefits of governance

Governance exists so that individual stakeholders – investors, creditors, directors, management, and employees – as well as broader industries and economic sectors can benefit. As we shall note throughout the book, good governance benefits stakeholders by resolving conflicts of interest – such as those that might arise during acquisitions, financial reporting, compensation, and director selection – instilling controls and a sense of ethics, and encouraging transparency. It also promotes firm-wide operating efficiency and provides investors with a fair return on invested capital. Good governance can also benefit a company. If a firm gains, it has incentives to create and enforce good governance. In fact benefits do exist, either directly (in the form of better flow of funds and improved access to lower-cost capital) or indirectly (in the form of better reputation and business opportunities). For instance, companies that feature strong governance can be rewarded in the marketplace through cheaper capital; those with strong internal controls and discipline might achieve better credit ratings (which can lead to lower debt funding costs) or higher stock price valuations (which can lead to less equity dilution when additional stock is floated).

A McKinsey survey conducted in 2002 indicates that investors place corporate governance issues on par with financial analysis when making investment decisions, and would willingly pay a significant premium for strong governance (the premiums range from 12–14 percent in North America and Western Europe to 20–30 percent in Latin America, Eastern Europe, and Africa). Strong corporate governance, in the view of these influential investors, must include global accounting/financial standards, strong shareholder rights and regulatory enforcement, and helpful boards (that demonstrate more time commitment and a better selection process). In fact, a majority of the investors surveyed (63 percent) would simply avoid companies without any governance process (or with bad practices, which they define to include companies with a majority of directors who are insiders or have ties to management, that are unresponsive to investors, lack a formal director evaluation process, or lack stock or a financial stake in the company). In emerging nations, where macro governance mecha-
nisms are in a rudimentary state and a great deal more political and economic work is required to strengthen them, company-level governance is vitally important. If individual firms can create their own controls and ethics (in advance of any comprehensive rules imposed by regulatory authorities), they might be in a better position to attract investment capital.

Regulatory and government officials are well aware of the impact of governance on national and global economics. Properly governed companies, supported by deep and transparent financial markets and robust legal systems, allocate resources efficiently, promote financial and economic stability, and boost national and global growth rates; poorly governed companies can do the opposite. As if to reinforce this point, US Federal Reserve Chairperson Greenspan testified in 2002 that diminished confidence in US corporate earnings (following a spate of corporate earnings restatements and financial improprieties) can be linked to lower equity prices, higher borrowing costs, slower investment, and increased reliance on internally generated funds. All have the potential of negatively impacting an economy. (Indeed, this was very apparent during the Asian financial crisis of 1997, where financial instability, external capital withdrawal, and poor corporate and macro governance practices led to regional corporate and economic collapse.) A properly functioning financial system requires that investors have confidence in the companies that contribute to economic output; good governance can help provide such confidence.

Promoting good governance, as we note throughout the book, can be accomplished through best practices, rules, or guidelines, and can be imposed or recommended by regulators, stock exchanges, or industry groups. The governance requirements may be formal, mandatory, and well codified in the national system, or informal and voluntary. Good practices have to be supported by corporate and securities law, bankruptcy procedures, corporate control practices, and internal/external controls. Such good governance is intended to provide the vital link between ownership and control, and also benefit other stakeholders. It is certainly not an easy process, as events of the past few years have shown. Although there is a tendency to talk about proper governance practice, much of it is based on “form” rather than “substance.” As we consider different dimensions of governance practice and failure in the next chapters, we stress that governance must be grounded in substance. We shall also bear in mind that good governance alone does not create a good company – that depends on the nature of a company’s leadership and strategies – but bad governance can certainly destroy one.
We have noted that corporate governance is based on both internal and external mechanisms. The internal mechanisms, which we consider in this chapter, are centered on three segments – the board of directors, executive management, and independent control functions – each with its own set of vital, and unique, responsibilities. In many systems the activities of the three groups are reinforced by codes of conduct that are intended to promote proper behavior.

If the corporate responsibilities associated with these functions are too vague and diffuse, subject to too much interpretation, or not diligently followed, the governance process is vulnerable. If they are too rigid and onerous, enforcement costs mount, shareholder returns decline, and actions centered primarily on form (rather than substance) may result. Internal mechanisms must therefore achieve an appropriate balance of flexibility and rigor, as indicated in the last chapter. Figure 2.1 summarizes key internal governance mechanisms.

In various national systems the law holds the board of directors and senior executives to certain standards in order to enforce proper accountability. These standards revolve around attention to business, fidelity to corporate interests, and exercise of reasonable business judgment. Theoretically, if these standards are upheld, shareholders and other stakeholders should be protected. Although multiple stakeholders always exist, the overriding legal accountability, certainly in pre-bankruptcy situations, is to shareholders, as the providers of risk equity. While this has always been true in the market model followed by companies in the United States and the UK, it can also be found in the relationship model used by companies in Japan and Continental Europe (which have traditionally counted employees/labor as the key
stakeholders, morally, if not legally). Accountability to multiple stakeholders on all issues is impossible to achieve when their objectives diverge; in such instances, directors and executives must generally give legal priority to shareholders.

In an ideal world the internal governance process operates efficiently, drawing on different expertise in order to keep the company running securely. In summary form, the board of directors, having considered the nature and requirements of its stakeholders, defines the purpose, mission, and ethical values of the firm, creates an appropriate business and risk strategy, discharges duties to management, ensures proper controls are in place, monitors management through use of various mechanisms (audits, risk limits, compensation, financial performance, and ethical standards), revisits the process on a regular basis, and makes adjustments as necessary, thus creating a cycle. Each element of the process has an important role to play in the furtherance of the company and must be performed diligently. Figure 2.2 highlights the basic elements of the internal governance process.
Although the board of directors is generally responsible for creating and implementing an internal governance framework, some companies formalize aspects of the process by appointing a dedicated governance officer to coordinate design and implementation, and ensure adherence to external reporting requirements. In most instances the governance officer is a senior level executive reporting directly to a board member and the CEO. Others may discharge the duties when the function does not formally exist as a separate position (for instance, a senior internal counsel).

**THE BOARD OF DIRECTORS**

The **board of directors** is a body that represents the interest of shareholders, and is accountable to them for a series of specific duties, including definition of corporate strategy and philosophy, oversight of executive management, and implementation of internal controls. Directors, as agents of shareholders, are compelled to carry out their instructions, although such instructions are often limited in scope. Under normal circumstances board directors do not manage the daily activities of executives; such micromanagement would be impractical. Rather, they hire the best possible senior executives, provide advice and counsel on a periodic basis, and ensure the system of controls is functioning properly. Only in crisis situations are directors likely to be more visible, representing the interests of stakeholders more actively. Although it is not present in daily management matters, effective governance depends on a board that is capable of dealing with management firmly and decisively.

The nature and structure of corporate boards varies by system and can change over time. In some countries boards have become independent, energized, and capable, although there are still many exceptions to this rule (which can lead to rather significant problems, as we shall discover in Chapter 7). To provide some perspective on how boards have changed, we briefly consider how a typical board functioned until the 1990s. (Although we generalize somewhat, the characteristics below are applicable to a large number of public companies operating under the market model and, with slight modifications, the relationship model).

For instance, from the 1950s through the 1970s board directors were essentially part of the chief executive’s team. Since the CEO generally hand-picked directors, they were willing to support executive management in its tactical and strategic plans. The value of board directors was often in status rather than leadership or oversight. (In fact, CEOs were often on the lookout for strong candidates with financial, economic, political, or social connections that could benefit executives and the company.) The function performed by boards was generally pro forma, with “rubber stamp” approval
of virtually every matter requiring a decision. Boards generally performed only cursory financial reviews, approved new projects (including capital expenditures, investments, R&D, and acquisitions) with little discussion, rarely questioned or challenged executive management (acting against the CEO was virtually unheard of), and ensured the agenda was smooth and predictable. They spent little time on company matters, and were only physically present during periodic board meetings. They were not required to purchase shares in the company or go through any type of formal training/education; in fact, there was generally no guidance for directors on corporate matters, beyond a basic review of duties of care and loyalty (which we describe below). Even though directors had to be re-elected periodically, the process was simply a matter of course, and many served for decades, until they chose to retire.

In this setting it is easy to imagine directors acting as an extension of management, and therefore being unable to assess the executive team independently and manage the corporation in an unbiased manner on behalf of shareholders. This pattern remained relatively unchanged until corporate crises began occurring with greater frequency in the 1970s and 1980s. In some cases regulators and courts found that board directors were not performing their duties properly, and called for greater accountability. This led to certain changes related to director selection and duties, a trend that has generally accelerated with each successive wave of problems. While boards have certainly become more independent and active in some systems in recent years, the trend is far from uniform; companies in some countries (such as Japan and Switzerland) still feature boards with some of the pre-1990s characteristics described above.

In general, legal doctrines give directors the strongest voice in advancing the interests of the company and its shareholders. If the board is capable, independent, and efficient it can represent the company and serve shareholders; if it is not, it may be ineffective in doing either. Although a board should be a strong shareholder advocate, in some firms – typically those operating under the relationship and hybrid models – it plays a less dominant role. Indeed, in some situations the board is simply a management committee comprised of the firm’s most senior operating executives; this effectively means that there is no strong supervisory role or shareholder representative. Throughout the modern corporate era and into the twenty-first century, this type of board has featured quite prominently in Japan, Mexico, and major portions of East Asia, often as a result of business tradition or concentrated ownership structures (for example, in Japan via main bank shareholdings and group company cross-shareholdings, in Mexico and various East Asian nations via family control blocks). That said, there is some evidence that boards in such countries are being structured with more outsiders, and are gradually
becoming more attuned to management supervision and shareholder representation.

Before considering specific board responsibilities we consider the structure of the single and dual board systems that are commonly encountered in the corporate world. Under a **single board system** the board of directors – generally nominated on an individual basis through an internal committee and/or executive management recommendations, and elected by shareholders – acts as an independent monitor of company management. The board, headed by the chairperson, typically includes 10 to 20 directors, although it can grow to more than 30. It is common for companies in countries such as the United States, Canada and the UK to feature smaller boards (10–15 directors), and in other countries, such as Japan and Korea, to have quite large ones (30+). In some countries the chairperson also serves as CEO and thus performs two distinct functions, managing the board of directors and the executive team, a role that has the potential of leading to conflicts of interest. Many companies in the United States (more than 85 percent) continue to combine the chairperson/CEO role. Companies in other countries, such as the UK, Canada, Switzerland, and Spain, recommend (and in some cases require) a split of the two. Best practice and regulatory or activist pressures in the United States, which have mounted in recent years, mean there is now a greater desire to divide the roles. We consider this later in the text.

The Japanese board is rather unique: it tends to be very large and features a significant number of executive managers. The supervisory and operational management duties are thus embedded in a single body, although the creation of a “corporate executive officer” (shikko yakuin) to separate supervisory and executive duties is increasingly common under reforms to the Commercial Code.

The **dual board system**, which is found in Germany, Austria, the Netherlands, and certain other Continental European countries, as well as Indonesia, China, Taiwan, and various other emerging nations, mandates a division between two bodies: the **supervisory board** and the **management board** (which is sometimes confusingly referred to as the board of directors). Note that some countries, such as France and Italy, allow firms to decide whether to use the single or dual board system (although if single boards are selected, director/executive separation must exist and the board must discharge its duties properly). The supervisory board (the German aufsichtsrat, French conseil de surveillance or Indonesian board of commissioners), roughly equivalent to the board of directors under the single board system, is headed by a chairperson (corresponding to the chairperson of the board in the single board system) and is responsible for the independent oversight of company management.

Specifically, the supervisory board, acting as agent of the shareholders, is responsible for appointing, supervising and advising members of the
management board, and developing fundamental corporate strategy. Board size can vary from 10 to 24 directors, depending on country, with nominating committees or executive managers identifying, and shareholders electing, individual directors (although in Germany, under *labor codetermination* rules formalized in 1976, a certain percentage of board members must be labor representatives elected by employees; similar mandatory labor representation exists in Austria, the Netherlands, Denmark, Luxembourg, and Sweden, while voluntary representation can be found in Switzerland and Finland).7

The management board of a dual board system (that is, the German *vorstand*, French *directoire* or *conseil d’administration* or the Indonesian board of directors) is equivalent to the executive management team in companies following the single board model. This board, which typically includes 5 to 15 senior executives appointed by the supervisory board, is headed by a chairperson (corresponding to the CEO in the single board model) and is responsible for daily management of individual businesses/divisions or control functions; the chairperson serves as coordinator of their work. Given the division of duties between the two boards, the question of segregating the roles of chairperson and CEO is moot: the two chairpersons are different individuals with different duties and responsibilities.

There is no apparent consensus or empirical evidence on which board structure is more effective or efficient. Some believe that the single board system provides for better information flow, stronger relationships, and greater cooperation between directors and executives; others feel that the dual board system permits greater independence as a result of separation of duties. It is difficult to conceive of mandated use of a single structure across national boundaries. Even in the context of the European Union (EU) this is unlikely to be desirable, as legal and regulatory codes and national characteristics are still quite different in key areas; however, some basic harmonization in board functions is possible and advisable.

Independence between board members and executives must be regarded as an important and desirable feature. When a board is truly independent it is able to act in the best interests of shareholders without potential for conflict. Board directors who are “insiders” (for example, associated with the company through current or former employment) and those who are financially tied (for example, through consulting contracts or other economically driven relationships) may not be sufficiently independent to be effective agents. They might be unwilling to challenge or criticize, let alone discipline or fire, those on the executive management team for fear of ruining personal relationships or jeopardizing lucrative financial contracts.

Although US and UK boards have gradually turned towards majority (at least 65–75 percent) independent directors over the past two decades, the
same is not true in all countries. For instance, companies operating under the hybrid model, including firms in Mexico, Thailand, Indonesia, Korea, and the Philippines, have little experience with independent directors. Companies that are controlled by family interests represent a special challenge, because directors need to be independent of controlling family shareholders as well as management (which may be one reason the governance process often fails to work properly). Japan features an insider-dominated system, where directors serve primarily as strategists/executive managers rather than supervisors. Although culturally Japanese companies remain uncomfortable including outsiders on their boards, certain companies are starting selectively to add more independent members. In Germany, supervisory board members elected by shareholders are typically outsiders, but in practice may come from firms or financial institutions that have some type of relationship with the company; whether these directors are actually independent may be uncertain. The same is true in Switzerland, where outside board directors generally come from firms that have an existing business relationship with the company; in fact, the pool of directors is so small that watchers have coined the term *filz* (interwoven material) to describe the interlocking ties that exist between company boards.

In considering the general role and function of the board of directors, then, we refer to the single board system board of directors and dual board system supervisory board. Essential duties include the following:

- Represent, with a view towards advancing and protecting, the interests of shareholders and other stakeholders. This means taking an independent view on the actions and activities of the company and its executives, and dealing firmly with all relevant executive management issues.

- Create an ethical environment; codify ethical principles and ensure that they are followed.

- Establish and run specialized committees as needed (e.g. audit, compensation, nomination) to provide additional support and expertise.

- Ensure adequacy of internal and external controls; monitor specific controls and their efficacy on an ongoing basis.

- Develop communications dialog/reporting links with internal control groups and serve as an independent “sounding board” and confidential counselor.

- Oversee the general commercial affairs of the corporation.

- Oversee the strategic and business performance goals of the corporation.
Define strategy as related to corporate goals, business and financial targets, and financial and operating risk tolerance.

Provide for appropriate crisis management planning, including business interruption, disaster recovery, and liquidity management.

Develop and implement director and executive management succession plans and executive compensation plans.

Consider in detail all corporate control activity (such as potential mergers, acquisitions, or buyouts) and possible defenses.

Monitor the performance of management and effect changes when necessary.

Ensure financial disclosure accurately represents the company’s position.

Communicate regularly with key shareholders and regulators.

In order to discharge their duties properly directors must devote enough time and energy to the process, and possess appropriate knowledge regarding the technicalities of the business they are overseeing. Although boards rightly try to have a mix of views, backgrounds, and experience, they are still strikingly homogenous; the “average” director in a company (regardless of model) is likely to be a 45–65 year old male, with 20 plus years of business experience. (Women and minorities are consistently under-represented in virtually every national system.) Many are generalists, which may be a disadvantage in an increasingly complex and technically challenging business world; if directors are unaware of the technical aspects of business (such as accounting, production, marketing, strategy, financial risk, operating risk, budgets, revenue targets, funding, liquidity, leverage, and capital structure and policy) they will be unable to query or challenge management effectively and are susceptible to being led astray, intentionally or unintentionally. In practice, boards of companies in the market model system tend to use committees to focus on specific issues, including audit and financial control, director nominations, and compensation. In the United States, for instance, committees have been used actively since the 1970s and 1980s, although their characteristics have changed (for example, they have become more technically focused and increasingly feature more independent members). Boards of companies in relationship model countries are starting to make much greater use of committees, while those in hybrid model countries have not yet made much progress.

Ideally, the relationship between board directors and executive management should be strong and constructive. Even in preferred situations where a majority of directors is independent, there is no cause for
adversarial relationships. However, it is important for directors to be able to question, critique, and challenge management, and not simply acquiesce blindly, or take strict instructions from CEOs. Ideally, board directors should meet frequently with executive management and should be free to meet among themselves, without any representative of the management team. In practice this occurs to varying degrees. When the CEO is also the chairperson, there is now a growing practice of holding such non-executive sessions under the leadership of a lead independent director or presiding director (an independent director who serves as leader of the other independent members of the board).

As we have noted above, various national systems have laws that require directors (as well as executive managers) to adhere to certain legal directives in discharging their fiduciary duties (the duties that they, as trusted agents, have in representing shareholder interests). Where it exists in law, the threat of class action, direct, or derivative lawsuits by investors for breach of fiduciary duties is an additional check (although the existence of insurance contracts to cover possible breaches provides some modicum of protection and renders the threat partly ineffective). Specifically, directors (and executives) are required to exercise a duty of care and duty of loyalty when performing their duties. Although there is considerable discretion in exercising these duties, they must generally be done with a view towards maximizing value.

Duty of care means that directors (and executives) must make informed decisions, gathering and evaluating all relevant material before arriving at a decision. In many countries courts defer to directors and executives regarding the nature of the decision (under the business judgment rule). Their interest is in ensuring that an informed decision has been made. (If courts were responsible for considering whether “optimal” decisions were being made they would be second-guessing directors and executives, and taking a front-line management role in the corporate world, which they are not empowered, qualified, or prepared to do. If shareholders choose to challenge the nature of the decision (whether it was good or bad, rather than whether it was informed) then they have the legal burden of proving that directors or executives breached their fiduciary duties.)

Duty of loyalty, in contrast, relates to the fidelity that directors and executives owe shareholders when discharging their duties; any actions they take must be consistent with proper treatment of shareholders. Those responsible must always act in good faith, reasonably believing that the actions they take are in the best interests of the company and its shareholders. A director encountering potentially conflicting duties must not exercise any influence over the situation, but simply act in the interests of shareholders. When acting in good faith and not trying to defraud, the director cannot be held liable. (Liability only arises in instances of gross
negligence or inattention to duty, meaning the director has not been “reasonably careful” and “reasonably able.”)

Berle and Means have defined the director as a fiduciary of the corporation “pledged to adhere to standards of conduct which do not deplete the assets or earnings of the company.” By enforcing fiduciary standards, courts in various jurisdictions have attempted to make sure that directors and executives are focused on their actions and the potential impact they might have on stakeholders. This, however, is a complicated issue. Whether directors can be loyal and serve the corporation, investors, and other stakeholders simultaneously is an issue that is continuously debated and tested. The director is a fiduciary for the corporation, but also for each individual shareholder and other stakeholders; which has priority and do the priorities change? If so, when, and on what basis? We have already mentioned that legal doctrines provide directors with the power to advance corporate interests. This means that the interests of any individual shareholder (or group of shareholders) might at any time be sacrificed for the “greater good” of the company; directors are given considerable latitude in interpreting the precise scope of the “greater good.” The issues cross legal, ethical, and practical boundaries, meaning that, *ex ante*, there is no correct answer.

At the risk of complicating matters further, the fiduciary duties of directors change as a company’s financial condition deteriorates. This, as we briefly mentioned in Chapter 1, relates to the increasingly important role assumed by creditors when insolvency draws closer. As a company’s financial situation worsens, representation shifts primarily from equity investors to lenders, bondholders, and other creditors. Specifically, when a firm enters a pre-petition period and becomes technically insolvent, the duties of board directors shift from shareholders to creditors; they become trustees for the company’s creditors, and must do everything in their power to preserve the value of corporate assets for the benefit of creditors (and ultimately shareholders, to the extent there is any financial value after all senior claimholders have been paid). We discuss this topic further in Chapter 4. It is important to stress that duties of directors can change before any insolvency has been declared, when the company is in the vicinity of insolvency (close to insolvency, but not technically insolvent). This can again be a subjective matter, making the agency relationships even more complex.

When a company’s financial condition is deteriorating directors must exercise greater diligence over audits, controls, and financial/operating risks. Financial distress can cause management to take unwise, and sometimes even fraudulent, actions in order to maintain the solvency of the company (or derive some personal gain). Directors must therefore be focused intently on controls and safeguards covering a broad range of activities, including cash management, securities dealing, accounting/
reporting policies, and related party transactions. Directors must also be sensitive to any behavior/communication intended to mislead, obfuscate, shield, hide, or destroy, and be prepared to enact crisis management programs quickly (such as emergency liquidity management programs and public relations announcements).

**EXECUTIVE MANAGEMENT**

Since an element of corporate structure and activity is based on a fundamental principle of “mistrust” – ownership versus control, where owners must constantly try to monitor those who appear to be in control – it might seem incongruous to suggest executive management has a role in promoting the internal governance process. However, management’s role in governance is vital; it if fails to uphold the strictest standards problems might develop. The tone established by executive management has a considerable influence on the culture and control practices of any firm. Management must set the ethical/moral standards for the entire organization and lead by example; executives who are incompetent, secretive, unethical, or dishonest are likely to tolerate similar traits in others, which will eventually weaken the control framework. Some of this, as we discuss below, can be managed through the code of conduct developed by the board and promulgated by executives. But the process goes beyond ethical behavior. Executives must also demonstrate vision and knowledge in the tactical and strategic operation of the firm, and display skill in managing the firm’s daily operations in a controlled manner (and with a view towards maximizing value). Therefore, the role of executive management in promoting strong internal governance, good leadership, and undoubted behavior is critical.

To prevent the pursuit of “self-interest” – which might lead ultimately to abusive practices – executive management must remain under the general supervision of directors and be constrained by certain structural parameters, including those related to internal controls, dissemination of information, and certification of financial statements. In order to be effective in working toward the best interests of the company (and, by extension, shareholders), the economic interests of executives must be aligned with those of shareholders. This is most often done through a proper compensation package that allows executives to benefit as they create shareholder value. Indeed, alignment through compensation is an important governance tool (although one that has to be structured correctly in order to avoid abuses, as we discuss later in the book).

Executive management, led by the CEO or equivalent (such as the shacho in Japan or President Directeur in France) has daily responsibility for
guiding the corporation and its activities, with the basic intent of maximizing enterprise value. Executive management is the key link between the company and the board, and must convey critical information to directors; as we have noted, the more effective it is in performing the role, the lower the associated agency costs. If a share of stock is a “capitalized expectation” that is valued by the marketplace based on the condition of the company and the industry, the marketplace requires information in order to assign value. Executive management must therefore be able to produce accurate information for board directors and the marketplace, and be held accountable for any disclosure errors, such as willful misstatement, negligent misstatement, or failure to disclose a material fact. Willful misstatements are relatively easy to demonstrate after the fact, negligent misstatements somewhat more difficult. Failure to disclose is harder yet, as it relates to knowing what to disclose, who needs to be aware of particular information, and so forth.

As we have noted, in certain cases (particularly in the United States) the leader of executive management is also the leader of the board of directors. While this can enhance information flows and cooperation and ensure cohesion between management and directors, it has the potential of breeding significant conflicts of interest. A combined CEO and chairperson controls the executive management team and the board of directors, and must therefore strike a balance between two very important, distinct, and sometimes conflicting, roles. The same duties of care and loyalty described for directors are applicable, of course, to executives. Executives must act in an informed manner, bearing in mind the best interests of shareholders. The entire executive management team must demonstrate the same diligence. Although the structure and function of executive teams vary by country, most include the president/chief operating officer, CFO, chief legal counsel, head auditor, treasurer, and senior heads of business units. Ultimately executives are agents of directors and, by extension, of shareholders. However, to protect against any pressures of self-interest that might arise, their actions must be monitored on an ongoing basis by both internal forces (such as directors and internal controllers) and external forces (activist investors and corporate control mechanisms).

Regardless of the specific system, governance-related duties assigned to executive management generally include the following:

- Manage the firm’s operating, financing, and corporate activities on a daily basis, remaining accountable to the board of directors for progress and performance.

- Create tactical business plans and operating strategy in conjunction with the board of directors. Manage the results and adjust them as necessary.
Define the firm’s short and long-term financial operating goals (for example, revenues, income, liquidity, leverage, financing plans, and acquisitions) and manage to these goals.

Define and monitor financial and operating risk exposures in conjunction with the board.

Ensure internal controls (audit, financial control, compliance, risk management, treasury) are in place and functioning properly. Ensure all such controls are independent of business units.

Provide the board of directors with timely and useful financial data and any other information directors deem necessary. Communicate regularly with internal and external parties on items of corporate importance.

Ensure transparency in the financial and operating frameworks of the firm.

Create a proper human resources management function and framework. Delegate authority internally to hire and fire workers.

Promulgate a code of conduct and other board directives/policies and enforce vigorously.

**INTERNAL CONTROL GROUPS**

In order for internal governance mechanisms to work effectively the board of directors and executive management must rely on a cadre of technical experts that can independently review, assess, and control a company’s operations. These groups are the essential link between high-level policies passed by the board and the daily business that forms the core of every company’s activities. Although firms often feature a variety of internal control groups – including finance/accounting, risk management, operations/settlement, technology, law and compliance, internal audit, and human resources – most groups share two common characteristics:

- They are independent of the business and management units, meaning they are not accountable to, or compensated by, those whom they are charged with monitoring. In some companies internal control groups have multiple (matrix) reporting lines, into executive managers as well as board directors or board committees.
- They possess technical expertise that allows them to control the firm’s activities. A great deal of corporate operating knowledge is specialized
(such as accounting rules, market or credit risk management techniques, and legal interpretations), which is why such individuals and groups are so essential to corporate governance. The board, executives, and others must be able to look to these experts to both advise and guide.

If control groups do not feature both characteristics they are likely to be conflicted, ineffective, or both. Control groups that might be regarded as essential to the effective monitoring of corporate operations include the following:

- **Financial control/accounting.** This unit is typically responsible for independently tracking and monitoring all activities that impact the firm’s financial operations and statements, and reporting on these activities internally and externally on a continuous basis. It is common in many companies for the unit to report directly to the CFO who, in turn, reports to the CEO/president.

- **Risk management.** This unit is generally responsible for monitoring and managing the firm’s financial and operating risks. Though risks can vary by company and industry, financial risks generally include credit risk, market risk, and liquidity risk, while operating risks include business interruption risk, property and casualty destruction, worker safety, and technological and operational risk. The risk management function may report through the CFO, or directly into the CEO/president.

- **Legal and compliance.** This unit is responsible for all aspects of legal and documentation risk, ensuring that the firm’s legal interests are properly protected and its relationships with external parties (such as suppliers, customers, and creditors) are properly considered and documented. Legal units often act as an interface to regulatory authorities, and in some cases may also be responsible for specific corporate governance activities. The department, headed by chief counsel, may report directly into the CEO/president.

- **Internal audit.** This unit is typically responsible for conducting internal reviews and audits of the firm’s business and control processes to ensure they are robust enough to prevent, or at least detect, problems. It also performs random inspections of financial accounts, and works closely with external auditors in verifying different aspects of the control framework. In many companies the chief internal auditor reports directly to the CEO/president and the audit committee of the board.

- **Operations and technology.** This unit is generally responsible for creating and managing processes that permit the firm’s customer and
supplier businesses to function in an efficient, automated, and controlled fashion. This can include development of appropriate infrastructure (technology, networking, communications data), and establishment and management of trade/transaction flows. The group is often charged with implementing disaster recovery and business interruption plans, and managing dimensions of operational risk. Heads of operations and technology may report directly into the CEO/president, with matrix lines (but no compensation ties) into the specific business and control functions they support.

Depending on organizational structure, other types of internal control groups may also feature in the corporate scheme, including **Treasury** (responsible for the asset and liability management of the firm’s balance sheet, although this function is sometimes accorded line/revenue-generating responsibilities and may not thus be a true control function); **Investor relations** (responsible for managing relationships and communications with external parties, including shareholders, regulators, credit rating agencies, bankers, the media, and so forth); and **Human resources** (responsible for managing issues related to a company’s personnel and staffing, including compensation, reviews, benefits, and counseling). Internal control groups often work together very closely in support of overall corporate controls; indeed, the most effective structures promote cross-group communication and cooperation.

Regardless of the specific control units a firm possesses, they are responsible for carrying out a standard series of tasks that are intended to ensure a prudent and secure operating environment, another key link in the governance chain. Duties can include the following:

- Create policies and procedures to support independent control of finance, audit, risk management, operations, and compliance.
- Install proper technological infrastructure for accurate measuring and reporting of financial statements, risk profile, legal issues, documentary status, and so forth.
- Update regularly the board of directors/board committees on the status of, and substantive changes in, all control issues.
- Review and audit all aspects of the company’s business and control process and infrastructure on a continuous basis, with a special focus on potential weaknesses that can create losses or problems. Ensure substantive audit findings are elevated and resolved.
- Prepare and disseminate all relevant corporate information (such as financial statements and risk profile) to internal and external parties.
- Prepare, test, and implement crisis management plans related to business interruption/disaster recovery.
- Ensure compliance with applicable regulatory requirements and reporting.
- Work with external auditors on continually reviewing and strengthening controls.

Naturally, the effective governance process demands that internal controls be reviewed and updated on a regular basis. Since the corporate world is characterized by constant change – in business and product lines, market and client coverage, supplier and client relationships, rules, laws, regulations, and so forth – an internal control framework that is rigid and unchangeable will not be able to adapt. When this occurs business might be driven away or continue without appropriate security; either must be regarded as unacceptable.

**CODE OF CONDUCT**

Many companies, especially those in market and relationship-model systems, feature codes of conduct (or codes of ethics; we use the terms interchangeably). Such a code, often drafted by the board of directors and promulgated by directors and executive management, is intended to establish the ethical and moral norms of the company; in essence, to set the standards for behavior and action when dealing with those inside and outside the firm. Although the nature and detail of such codes vary by firm, industry, and country, they generally aim to ensure a clear understanding of basic ethical principles, including proper treatment of stakeholders. In addition to specifically declaring such ethical parameters (which we discuss in greater detail in Chapter 11), the effective code must provide for penalties or sanctions for those who violate specific provisions. There is little point in creating rules if they can be flouted or overlooked without fear of reprisal. In order to be truly effective, a code of ethics cannot simply be seen as a set of statements of good behavior. It must form part of a company’s culture and belief system, and become a factor in everyday business dealings. Importantly, it must be driven from the top of the organization; if a firm’s top management is seen violating basic ethical principles, there is very little incentive for others to behave properly. Thus a code of ethics must be believed and followed, in the first instance, by executives and directors.

A basic code of conduct is likely to include certain fundamental principles, including the following:
Create an environment, policies, and procedures where internal or external conflicts of interest are avoided or eliminated.

Make certain that employees do not engage in corrupt practices or other activities that might prejudice or jeopardize the firm’s reputation.

Treat all stakeholders, including suppliers, clients, employees, and others, fairly and honestly.

Develop mechanisms where violations of company policy can be reported without fear of retribution.

The latter point is very important in any large corporate organization. The framework must provide proper encouragement and support for those inside the company that detect problems or abuses. As we note later, the whistleblower – an employee who detects a significant violation of corporate conduct and advises those in executive management or the board of directors – can be an effective internal governance check and balance. Employees operating in the daily flow of corporate business often have access to valuable and important information that allows them to detect potential violations that might not be apparent to others in the management hierarchy. They must, however, be properly protected and encouraged, or they may be unwilling to share information.

Figure 2.3 highlights aspects of internal governance for companies operating with a single board structure and a combined chairperson/CEO role. We consider variations on this reporting structure in Chapter 9.

**IMPLEMENTATION OF INTERNAL GOVERNANCE MEASURES**

The internal governance mechanisms we have summarized above – an effective board, appropriate executive responsibilities, strong internal controls, proper standards of behavior – can be developed and enhanced through a company’s own efforts, via recommendations put forth by best practice codes, or through rules developed and enforced by regulators. While a company’s own efforts (as driven by its charter, articles of incorporation, and/or internal assessments) can obviously be helpful, they may not be sufficient. In such cases best practices and regulations supplement the process. These may be implemented in prescriptive or non-prescriptive form.

Under the **prescriptive approach** a company adheres to certain standard governance practices and formally discloses to shareholders that it is in compliance.
Under a non-prescriptive approach, a company can select the practices it chooses, but must disclose exactly what standards it has selected; alternatively, if it chooses not to comply with any standard, it must explain its reasons.

The potential danger of prescriptive methods is that they can become targets to aim for, rather than behaviors to practice and inculcate, turning the framework into one of form over substance. This can lead to problems,
including false comfort in the control environment, ineffective mechanisms, and excessive costs. Non-prescriptive methods, in contrast, may be too flexible and discretionary, and fail to create the desired level of control. In either event, directors and executives must take care that all governance practices are implemented with due care and consideration.

**Best practice codes**

The development of internal best practice governance recommendations, which we consider at greater length in the Appendix, began in the 1990s with the publication of various governance reports prepared in response to corporate problems based on lack of effective board oversight. In some cases they were expanded to include other governance issues, such as disclosure and use of board committees. The original reports – the *Cadbury Report* (UK), *Dey Report* (Canada), *General Motors Board of Director Guidelines* (US), *Vienot Report* (France), and *King Report* (South Africa) – have served as an important foundation for those developed by dozens of other countries in recent years. Supranational organizations such as the Organization for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS) have provided additional cross-border recommendations of their own. Examples of some of the major best practice reports are summarized in Table 2.1 (note that this is not all-inclusive, simply representative).

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<thead>
<tr>
<th>Country</th>
<th>Governance document(s)</th>
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<tr>
<td>Supranational: OECD</td>
<td><em>Principles of Corporate Governance</em></td>
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<tr>
<td>Supranational: BIS</td>
<td><em>Enhancing Corporate Governance for Banking Organizations</em></td>
</tr>
<tr>
<td>European Union</td>
<td><em>Euroshareholders Corporate Governance Guidelines</em></td>
</tr>
<tr>
<td>Australia</td>
<td><em>Corporate Practices and Conduct (Bosch Report)</em></td>
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<tr>
<td>Belgium</td>
<td><em>Report of the Belgium Commission on Corporate Governance (Cardon Report)</em></td>
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<tr>
<td>Brazil</td>
<td><em>CVM Recommendations on Corporate Governance</em></td>
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<td>Country</td>
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<tr>
<td>Canada</td>
<td>Guidelines for Improved Corporate Governance in Canada (Dey Report)</td>
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<tr>
<td>France</td>
<td>The Board Directors of Listed Companies in France (Vienot I Report)</td>
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<td>Report of the Committee on Corporate Governance (Vienot II Report)</td>
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<tr>
<td>Germany</td>
<td>German Corporate Governance Code</td>
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<tr>
<td>Italy</td>
<td>Corporate Governance Code</td>
</tr>
<tr>
<td>Japan</td>
<td>Revised Corporate Governance Principles</td>
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<tr>
<td>Korea</td>
<td>Code of Best Practice for Corporate Governance</td>
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<tr>
<td>Malaysia</td>
<td>Malaysian Code on Corporate Governance</td>
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<tr>
<td>The Netherlands</td>
<td>Corporate Governance in the Netherlands: Forty Recommendations (Peters Code)</td>
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<tr>
<td>Singapore</td>
<td>Report of the Committee and Code of Corporate Governance</td>
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<tr>
<td>South Africa</td>
<td>King Report on Corporate Governance</td>
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<tr>
<td>Spain</td>
<td>Governance of Spanish Companies</td>
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<tr>
<td>Sweden</td>
<td>Introduction to a Swedish Code of Good Boardroom Practice</td>
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<tr>
<td>Switzerland</td>
<td>Swiss Code of Best Practice for Corporate Governance</td>
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<td>SWX-Directive on Information Relating to Corporate Governance</td>
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<tr>
<td>UK</td>
<td>Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report)</td>
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<td>Study Group on Directors’ Remuneration: Final Report (Greenbury Report)</td>
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<td></td>
<td>Committee on Corporate Governance: Final Report (Hampel Report)</td>
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<td></td>
<td>LSE: The Combined Code: Principles of Good Governance and Code of Best Practice</td>
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Best practice codes are generally voluntary, or they may follow the non-prescriptive “comply or explain” rule. In some instances recommendations are reinforced by enabling legislation or regulations that require companies to adhere to specific dimensions of otherwise voluntary behavior. For instance, although the United States has featured voluntary best practices since the mid-1990s, elements have become mandatory through the passage of new regulatory requirements (such as the New York Stock Exchange (NYSE) listing rules and the Sarbanes–Oxley Act of 2002).

Best practice codes typically cover a broad range of internal practices. Although these can vary by country, they often include:

- mission and responsibilities of the board of directors
- separation of the chairperson/CEO roles
- composition and qualification of board directors, director independence, and use of external advice
- use and composition of board committees (for example, audit, nominating, compensation)
- nature and depth of disclosure (for example, financial, audit, risk, compensation)
- extent of shareholder rights and voting
- nature of executive compensation policies.

Although we review aspects of best practice codes in greater detail in the Appendix, we consider here a brief example on how board functions/independence might be treated across various countries. This helps demon-

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<tr>
<th>Country</th>
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<tr>
<td>UK (continued)</td>
<td><em>Internal Control: Guidance for Directors on the Combined Code</em></td>
</tr>
<tr>
<td>United States</td>
<td><em>Report of the National Association of Corporate Directors Commission Business Roundtable</em></td>
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<td><em>Statement on Corporate Governance</em></td>
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<td><em>NYSE Corporate Governance Rule Proposals</em></td>
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<td></td>
<td><em>Conference Board Commission on Public Trust and Private Enterprise: Findings and Recommendations</em></td>
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</table>
strate that individual countries can handle the same topic in a variety of ways (and suggests that uniform global standards are unlikely to be achieved on all governance topics).

In countries such as Canada and France, the recommended functions of the board of directors are very specifically delineated (for example strategic planning, risk identification and management, selection, oversight, and compensation of management, succession planning, financial controls/integrity, legal compliance, and shareholder communications). In other cases, duties are defined with much less precision. Swedish and Japanese codes, for instance, convey little detail on the actual functions of board directors. Most codes discuss board director criteria in some detail, focusing on desired experience/skills, nomination procedures and independence; many suggest the use of nominating committees so that the influence of executive management in the selection process is reduced.

There are, however, considerable differences with regard to director independence. In the United States, the UK, Japan, Brazil, Canada, and Australia, among others, a majority or “substantial” majority of independent directors is recommended. In Korea, South Africa, and Mexico “some” independence is suggested; in Sweden no particular recommendation is made. The issue of what constitutes independence also varies widely. In South Africa, Japan, and Italy a director cannot have a business relationship or be related in any way to management, and cannot receive compensation other than a director’s stipend. In Malaysia, Spain, and France a director must not be linked to management and/or controlling shareholders(s) (although no definition of what constitutes a “link” is provided). In Sweden no independence metric is proposed. National differences exist on many other topics.

Internal governance mechanisms, including those reinforced through best practices, are obviously a critical dimension of individual corporate behavior and action. To be effective, however, they must be supported and guided by broader external governance forces. We consider these forces in the next chapter.
Now that some background has been provided on the nature of internal governance mechanisms, we turn our attention to the governance forces operating outside a corporation. National governments are typically responsible for establishing, enforcing, and enhancing mechanisms that support external governance. From a financial markets perspective, a proper system permits efficient mobilization of capital, management of risks, identification of investment opportunities, and exchange of assets. All of these functions support and benefit governance. From a structural perspective, a proper system creates authorities that enforce rules and regulations, including a judicial process to handle legal and bankruptcy issues, and supervisory bodies to oversee local capital markets, external auditors, and credit rating agencies. These also benefit the governance process.

In this chapter we consider various financial and structural governance mechanisms, including regulatory oversight, legal/bankruptcy regimes, capital markets access, corporate control activity, block holder monitoring, activist institutional investor monitoring, external audits, and credit rating agency review. Some of these factors, such as regulatory oversight and external audits, are found in many national systems; others, such as markets for corporate control or block holder monitoring, are common to only some. Figure 3.1 summarizes the key external forces we consider in this chapter.

**REGULATORY OVERSIGHT**

Regulators form an extremely vital part of the external governance process. Although companies feature their own internal monitoring mechanisms,
regulations are still necessary because individual firms might not design proper checks and balances, or might choose not to honor them in the future; if shareholders are diffuse, they might not be able to challenge such behavior. Supervisory and regulatory agencies attempt to create frameworks that protect all stakeholders: not just investors, but also suppliers, creditors, customers, and others. Regulations might be developed by legislators and then promulgated and enforced by financial supervisors or listing exchanges (for instance, securities market regulations enforced by exchanges in their capacity as self-regulatory marketplaces).

Regulators also attempt to protect broader macro-economic mechanisms (such as the stability of the banking and insurance sectors, without which economic growth might be stifled or jeopardized). In addition, they are often concerned with protecting social welfare, and limiting or minimizing adverse externalities (such as excess public costs and environmental hazards and risks). Although specific regulatory directives vary by country and industry, most focus on the following areas:

- financial soundness and stability (for example, adequate capital and liquidity, sound asset quality)
- operating and financial risk control processes
- accounting and disclosure standards
- legal compliance standards
- codes of conduct/ethics.

Figure 3.1 Elements of external governance
With each new corporate governance dislocation, regulators analyze the quality, scope, and depth of their regulations and examination procedures to determine whether enhancements are required. In fact, regulators may discover that the *ex ante* protections designed to protect stakeholders are not sufficient or cannot be enforced properly, and must be restructured or abandoned. Of course, regulations can hinder or alter governance mechanisms and corporate operations, and must therefore be applied with care. The regulatory community and corporate sector are sensitive to the burdens and costs that accompany over-regulation. In general, companies want to operate in a free marketplace with a minimum of regulation. Many of the deregulation measures taken over the past few decades in various countries and industries appear to indicate that certain legislators and regulators support similar views, imposing new rules only after the onset of a problem. For example the Bank for International Settlements created minimum capital requirements in the aftermath of the Latin American debt crisis of 1982–8, US regulators developed new capital, asset quality, and accounting requirements after the savings and loan crisis of the late 1980s/early 1990s, US legislators passed new governance requirements via the Sarbanes–Oxley Act following the corporate crises in 2001–2.

**LEGAL/BANKRUPTCY REGIMES**

National legal and bankruptcy regimes, which link corporate actions and behaviors to the framework of law, help ensure that stakeholders are properly protected. While the law is too blunt an instrument to hone in on very specific governance problems (such as management inefficiencies and resource misallocation), it provides a very important set of safeguards. In fact, micro corporate governance can only function properly when the law is effective at the macro level.

Global corporations require a legal framework to define their activities and conduct business. Investors, in turn, need a legal foundation to protect their rights and promote good conduct. Although individual countries often deal with these matters in unique ways, the effective legal system must:

- create and support mechanisms for the incorporation of public and private firms
- enforce key corporate tenets, including limited liability, control rights, property rights, shareholder rights, and fiduciary duties
- define and support contracts and other legal mechanisms for conducting business
establish an unbiased insolvency process and provide legal mechanisms for reorganization and liquidation; support the role and status of debtors and creditors.

In the first instance, the control rights of investors we mentioned in Chapter 1 must be protected properly from a legal perspective. In many systems shareholders that believe directors or executives have breached their fiduciary duties have the right to take legal action, via derivative lawsuits or direct individual/class action lawsuits. In fact, some have argued that even the existence of such legal mechanisms helps ensure directors and executives adhere to their duties of care and loyalty.

Structurally, a company is organized through legal mechanisms that define and convey property rights, private ownership of assets, extent of liability, and so forth. Under common law frameworks the legal creation of a company is relatively standardized and can often be accomplished “off the shelf.” In civil law countries creating a company is a bespoke, time-consuming endeavor, as standardized articles of association and off-the-shelf companies are largely unknown. Once created, a company’s daily pursuit of business is based on legal principles embodied in enforceable contracts. For instance, entering into supplier or client relationships is often done through legal purchase/sales contracts; borrowing from a bank is arranged through loan and collateral agreements; floating stock or bonds to raise capital is done through bond indentures, offering circulars, subscription agreements, and prospectuses; entering into long-term plant and equipment investment is done through legal purchase and sale contracts and sub-contracting agreements; creating an offshore financing entity is done through legal special purpose entity contracts, and so on. These are all essential to the business of the corporate world.

If there is any question or doubt as to the strength, fairness, and independence of the legal process, corporate activities may be called into question and the element of legal comfort disappears. For instance, if a company’s supplier breaches a purchase contract and the company sues in the local jurisdiction, proves its case, but has the case dismissed or a judgment passed against it for illogical or frivolous reasons (that have no basis in law), the company has no legal protection and cannot use the legal mechanism as a part of its governance framework. In general, industrialized countries with a long history of legal action and case law possess effective systems. Certain developing nations lack strength and depth in key areas such as private property, property rights, creditor rights, foreign investor rights, contracts, and intellectual property. When the legal system is not yet as robust as government authorities, companies, and investors might wish, greater emphasis must be placed on relationships and cooperation between supervisors, companies, and large shareholders. However, this must only
be regarded as a short-term substitute, not an acceptable way of enforcing corporate duties.

A bankruptcy system is equally important to the governance process; companies and their stakeholders must understand their rights in the event of financial distress and/or bankruptcy. This is particularly true for the large group of creditors supplying debt risk capital. As we have noted (and discuss further in Chapter 4), creditors emerge as key stakeholders, outranking even shareholders, when a company enters a phase of financial distress. The security provided for creditors depends on a country’s default system and the strength of its creditor rights. For instance, if the national bankruptcy system indicates that senior secured creditors receive first priority in the event of forced or voluntary corporate liquidation, and the rights are upheld through bankruptcy proceedings, creditors gain comfort in the legitimacy of the system. If the senior secured creditor is prejudiced or abused (perhaps the security interest or charge over the assets is discarded or disallowed, assets held as security are stripped away, and proceeds from the asset sale are granted to more junior creditors or shareholders), the bankruptcy system is not functioning as it should. Stakeholders cannot then predict *ex ante* how they will fare in bankruptcy, and cannot necessarily assume equitable treatment through the courts. Ultimately they may be unwilling to supply capital and will not be present as monitors.

The insolvency process should be defined clearly. Ideally, formal procedures that coordinate creditor actions should exist in order to reduce recovery costs, time, and confusion. Although insolvency should not necessarily lead to liquidation of a company, it can do so if formal procedures do not exist or are poorly defined. A proper procedural framework might center on commencement of insolvency proceedings, management of the company during the insolvency period, decisions of liquidation versus reorganization, creditor priorities, reorganization mechanisms, and protection of the company in the event of reorganization.

Some insolvency systems favor the borrowing company, others the broad group of debt risk capital providers. For instance, in the United States bankruptcy law appears to favor the debtor rather than the creditor. Although Chapter 7 of the Bankruptcy Code provides specifically for liquidation, Chapter 11 reorganization protects management and invokes an *automatic stay* (or freeze) on asset seizure/disposal and lawsuits. Reorganization creates incentives for management to seek “debtor-in-possession” (DIP) protection from creditors, and provides protection against the full impact of bad decisions. The UK and French insolvency systems appear to be more creditor-oriented; although both allow for reorganization procedures they do not permit executives to retain managerial control of a company. In the event of insolvency, a bankruptcy receiver/administrator
becomes manager of the firm, so that no DIP restructuring is possible. The German system tends to favor creditors as well, although it features a “self-administration” element that is similar to a US-based Chapter 11 DIP process. Although some have argued that the approach taken by the systems of UK, France, and Germany (and other creditor-friendly systems) can lead to instances of unnecessary liquidation – rather than attempts at restructuring – the main point is that the insolvency processes in these countries are well defined and understood. Some emerging nations use established insolvency systems as a guide for developing or refining their own: for instance, Malaysia has modeled its process largely on the UK’s, while Indonesia features elements of the Dutch framework (which it enhanced in 1998 to shift from a debtor focus to a creditor focus).

**CAPITAL MARKETS ACCESS**

Capital markets – the marketplace for the public and private issuance and trading of debt and equity capital – are an integral part of the global financial system and individual national economies. They allow companies to raise, on a primary basis, the debt and equity funding we mentioned in Chapter 1. Without primary capital, companies would be unable to finance their operations and would cease to exist (indeed, corporate governance would be irrelevant as there would be no suppliers of capital requiring protection).

These markets also permit funding of the corporate control activity we consider later in the chapter. The capital markets are thus the essential conduit between the company, as issuer and user of funds, and investors, as providers of different forms of risk capital. The secondary trading marketplace is obviously of considerable importance to investors, as it provides a mechanism by which to crystallize the value of a security. An investor holding a share of stock and wanting to reallocate capital to some other venture needs some way to transfer that share (directly or through a dealer/market maker); a capital market with enough liquidity ensures that the share can be transferred efficiently and transparently. Intermediaries, primarily large financial institutions, support the primary and secondary markets by providing services such as due diligence, arranging, syndication, pricing, distribution, and trading. The capital markets become an effective external governance mechanism when they can:

- raise capital for companies that are financially deserving of funds
- assign the appropriate cost of capital to companies based on financial and managerial strength and control
create a proper process for scrutinizing corporate issuers (for example, enhanced disclosures, due diligence)

supply funds for corporate control activities.

Capital market activity in advanced economic systems has grown steadily since the 1950s. As companies began requiring additional capital for expansion, they turned with greater frequency to their bankers (for standard loan products) and the capital markets (for bonds and equities). By the 1960s and 1970s capital market financing had become a driver of growth in the corporate sector, and the expanding number of pension funds, mutual funds, and other institutional investors meant that the supply of corporate equity and debt capital was easily absorbed. Further investment and tax deregulation in the US, UK, Canadian, German, and Japanese markets fuelled more expansion from the 1980s onward, and European integration in the late 1990s helped build a critical mass of capital and liquidity among participating countries. Emerging nations, which lack the same level of depth and breadth in their markets, do not gain the same capital expansion and corporate control benefits.

A transparent and regulated capital market serves as an important external governance mechanism in a number of ways. First, it supplies capital to companies that deserve funds. Second, it differentiates between the strength of various companies, allocating cheaper funds to those that are “better” and more expensive funds to those that are “worse.” Third, it makes possible corporate control transactions that provide another layer of corporate scrutiny and discipline. In advanced systems the capital markets are typically supported by specific securities market regulations, set by financial regulators and enforced by listing exchanges, that require all public securities issuers to register their issues (generally by filing detailed disclosure statements), submit regular financial reports, prohibit insider trading/trading abuses, adhere to various governance practices and financial standards, and so on. Those unwilling to comply are generally denied access. This, again, serves as an important check and balance.

Companies choosing to tap the public capital markets of a developed nation thus open themselves up to a considerable amount of scrutiny. (It should be noted, however, that the process is not fail-safe.) Intermediaries responsible for issuing securities perform in-depth due diligence, or financial investigation, into the company’s operations and prospects. Depending on the nature of the offering and the specific regulations governing the marketplace, this can be a rigorous process that incorporates the work of lawyers, accountants, and credit rating agencies. Through this inspection, the intermediary should theoretically only admit companies that deserve public capital; that is, those that are financially sound and able to perform
on their obligations, and can provide investors with a fair rate of return. The diligent intermediary, in adhering to standards of the marketplace, will refuse to let “unworthy” companies raise capital; the cost of doing so is too great, for the intermediary (who might become financially liable through underwriter’s liability), end-investors, regulators, and the marketplace at large. For instance, it is more prudent for an intermediary to reject a request for capital from a company that is financially weak or poorly controlled, than to blindly ignore such facts, raise capital, and hope that the obligations will be repaid.

The advanced capital market can differentiate between companies and make certain that those that are stronger raise capital at a better price than those that are weaker. This is consistent with a general risk/return framework that requires a weaker (riskier) company to pay a higher cost to secure its capital. What makes a company stronger or weaker is obviously a matter of debate, and varies across marketplaces. Those involved in the capital-raising process use different definitions, but for our purposes we consider a stronger company as one with a better financial standing/outlook (including liquidity position, leverage profile, cash flow, and earnings quality), management team, strategy, market share, competitive advantage, governance, and controls. A weaker company is one that deserves capital – it has not been excluded from the market through the “filtering” process – but because it lacks the same financial, management, and/or control standing, is riskier and thus has to compensate its investors. A weak company can use, to its eventual advantage, its cost of capital as a signal that it needs to improve on aspects of its corporate operation.

The ability for intermediaries and sophisticated investors to discern the riskiness of companies and allocate capital at appropriate prices is an important element of external governance. The mechanism, however, does not always work as intended. As we note in Chapter 5, there are times when advanced capital markets permit unworthy companies to access funds, or fail to differentiate properly the cost of capital between strong and weak companies (such as not charging a sufficient risk premium). In emerging nations, where the depth and sophistication of the markets are not nearly as great, the mechanisms fail even more frequently. That said, the overall capital market is still extremely effective in providing additional checks and balances, and can boast of a reasonably good track record in keeping unworthy companies at bay.

**CORPORATE CONTROL ACTIVITY**

The market for corporate control is the sum total of all corporate merger, acquisition, and restructuring activity occurring within an economic system. It includes:
- **Open market purchases**: the purchase of a block of shares in the open market that gives the acquirer effective control of a target company.

- **Tender offers**: a purchase offer made by an acquirer directly to a company’s shareholders.\(^5\)

- **Negotiated swaps**: an exchange of assets (for example, subsidiaries, companies, or blocks of shares) between two parties.

- **Proxy contests**: an acquisition offer that is contested through proxy voting.

- **Friendly takeovers**: an acquisition that is agreed on amicable terms between two parties.

- **Hostile takeovers (contested transactions)**: an unsolicited acquisition offer that the target company’s directors/executives do not favor and attempt to thwart.

- **Leveraged buyouts/management buyouts (LBOs/MBOs)**: the acquisition of a public company by a specialist or management group that results in retirement of the public equity through the assumption of a large amount of debt (in other words, the company is taken private).

- **Recapitalizations**: a process of converting the nature and voting characteristics of a company’s equity (for example, by assigning more or less voting power to an individual share).

- **Spin-offs**: a process of selling off an asset (for example, a company or subsidiary) to a third party or through an IPO.

The market for corporate control transactions features prominently in certain market-model countries such as the United States, the UK, and Canada, moderately in some relationship-model countries, including Italy, France, the Netherlands, and Germany, and very modestly (or not at all) in various other relationship/hybrid model countries, such as Japan, Thailand, Korea, Indonesia, and Mexico. An active market is often regarded as an important external governance check; some have even referred to takeovers as “governance intervention mechanisms.” The premise is that external forces – including other companies, institutional investors, buyout funds, or “corporate raiders” – can monitor the performance of management and directors to ensure they are operating efficiently and attempting to maximize shareholder value. If an external group feels a company is not operating as it should – reflected, perhaps, through continuous mismanagement of corporate resources or long periods of inefficiency or losses leading to a weakened share price – it might bid for the company.\(^6\) If the bid is successful, the corporate action can result in a spin-off, restructuring,
or consolidation, thereby returning to shareholders incremental value that might otherwise be tied up in unproductive endeavors. In fact, if the transaction works as intended, shareholders might gain some incremental value on their risk capital. Thus, the corporate control market can force companies to do what directors and executives may be reluctant, unwilling, or unable to do; it is an important external governance check when it allows participants to:

- bid for, and acquire, a company through some form of efficient corporate mechanisms (for example, a transaction or structure with a minimum of defense mechanisms and barriers)
- access local capital markets for appropriate funding and exit
- restructure, refloat, or consolidate a firm and return incremental value to shareholders.

Market competition demands that a company strive for operating efficiencies. Since capital is expensive, companies that are trying to operate efficiently cannot afford to squander it; those that do will eventually pay a higher cost of capital and lower their shareholder returns. Thus, the capital markets can provide a check on operating efficiency. This mechanism does not, however, guarantee that management will not use the capital for private gains, as several companies have demonstrated all too clearly in the early part of the new millennium. Indeed, the fact that corporate control activity is prevalent appears to indicate management does not always allocate its resources properly, and is therefore not maximizing profits or serving the shareholder as it should. Although academic studies centered on corporate control activity of the past few decades point to mixed results regarding wealth formation in the aftermath of such deals, various studies point to the creation of greater operating efficiencies.

Corporate control activity has its share of critics. Some argue that the threat of corporate control activity can impose undesirable rigidity or skew corporate behavior. Management, fearing a takeover, might only pursue activity that reflects positively on short-term share price movement, at the expense of long-term value creation (in the absence of a takeover threat, companies can spend more on long-term investment). A high stock price obviously makes it more expensive for external groups to bid for a company; it might also mean that stockholders are “satisfied” with management (regardless of how the stock price is being boosted) and will refuse to support a proposed corporate finance transaction. Hostile takeovers and LBOs/MBOs, in particular, have sparked a public outcry over the years, as transactions can lead to excessive leverage, large layoffs, operational disruption, shortening of investment time
horizons, slowdown in R&D/capital investment, and so forth. In certain countries this activity has led to the passage of antitakeover laws (specific legislation barring certain corporate control activities) and the creation of poison pills (defense mechanisms). As we note in Chapter 5, antitakeover defenses can actually work against the best interests of shareholders, and thus hinder the governance process.

In practice, the number of hostile transactions has declined markedly in recent years. Although a wave of hostile transactions appeared in the United States in the 1980s and Europe in the 1990s, it is generally agreed that such deals are a very costly way of enforcing governance. However other forms of corporate control activity, including friendly takeovers, LBOs/MBOs, and spin-offs, remain common and viable alternatives.

Although a certain amount of corporate M&A occurred globally during the 1960s and 1970s, the true era of corporate control activity began in earnest during the 1980s, when countries such as the United States and the UK experienced growth in hostile takeovers, tender offers, “greenmail,” LBOs/MBOs, and restructurings. Empirical evidence suggests that throughout most of the 1980s many corporate control deals brought benefits. Only towards the end of the decade did deal-pricing become overly aggressive (for example, buyout prices as a multiple of cash flows rose, and management put in less equity), making it difficult to determine whether activities were truly warranted. In retrospect, some of this activity appears to have been excessive, breeding a culture of greed and financial abuse.

However when corporate raiders, buyout funds, and other corporate control companies made acquisitions based on underlying cash flows, they were often able to generate value for shareholders and creditors (although not necessarily for employees). They delivered value back to investors by dismantling or consolidating companies in industries that had gone through periods of excessive, and often ill-advised, diversification and overinvestment (such as oil, tires, packaging, chemicals, and paper/forest products). Germany, France, and other Continental European markets featured much less activity during the 1980s primarily because of the dominant position of banks in corporate affairs (via ownership, proxies and board seats), the nature and extent of voting right limitations, and the sizeable ownership stakes retained by governments. In Japan, corporate control activity was extremely limited, primarily because the system, for cultural and historical reasons, relied on other external forces to accomplish a similar purpose (for example, main bank monitoring and cross-shareholding, as noted below). Transactions that occurred were friendly and designed to provide greater critical business mass. Activity in East Asia and Latin America was virtually nonexistent.

Although much of the US/UK corporate control activity of the 1980s subsided during the 1990s, it reappeared later in the decade, and continues
into the new millennium. Even once-quiet markets, such as Japan, are beginning to experience more activity. Although the days of greenmail, corporate raiders, and large amounts of junk bond financing and bank-supplied leverage are gone (indeed, a period of considerable corporate “de-leveraging” and “re-equitization” took hold in the 1990s, helping put greater focus back on shareholders), the core market of M&A, LBOs, and spin-offs continues to thrive. The nature of the transactions is, of course, different: institutional investors assume the role once played by corporate raiders, and friendly, rather than hostile, deals are the norm. Some transactions are slower paced, such as gradual restructurings of corporate operations through spin-offs (rather than quick attempts at change by replacing management, firing workers, and disposing of assets). Cycles of activity exist: like most other financial business, corporate control transactions go through cycles that are driven by the state of the economy, regulation, and public and political perception.

Individual countries have come to use distinct types of corporate control transactions that depend on the nature of local capital markets and legal frameworks. For instance, in addition to LBOs, the United States is active in friendly and hostile M&A and voluntary spin-offs. The corporate control markets of the UK, Sweden, and the Netherlands are based largely on MBOs and voluntary divestitures of subsidiaries (in order to instill greater focus and shed underperforming assets); hostile acquisitions occur in all three countries, though not very frequently. France and Germany feature less conglomeration, so there are fewer opportunities for spin-offs. There is more activity, however, involving flotation of family-controlled units and privatizations. Hostile acquisitions are still somewhat rare, primarily as a result of interlocking directorships, variable voting rights, and loyal shareholders (such as the French noyau dur). France, Germany, and other Continental European countries have a much broader view of stakeholder interests, including those affecting labor/employees, and appear sensitive to the effect of corporate control activities on these parties; for companies in these countries it is not simply about maximizing shareholder value, but considering the best solution for all stakeholders.

**Mergers, acquisitions, and spin-offs**

Since the United States features the most active corporate control market, it is useful to consider some background on its M&A and spin-off activity; this provides guidance on corporate control as an external governance mechanism. Much of the US corporate control activity of the 1980s was based on decomposing sprawling conglomerates that had been created in the 1970s. The existence of rigid antitrust regulations restricted the market shares that companies could accumulate in specific industries, leading
some to diversify into unrelated areas and expand internationally. Management justified expansion by promoting the supposed benefits of diversified revenues, synergies, and dynamically allocated capital. Board directors—some of whom were indifferent, inactive, or unqualified—often approved such strategies. The theoretical advantages of conglomerate ownership to investors centered on the possibility of lower corporate taxes and diversified earnings streams. However, in many cases the end result was the creation of firms with unfocused operations, excessive centralized costs, and sub-optimal capital usage. Investors were also subject to potential moral hazard risks, as management could subsidize the “losers” in the portfolio with the strong performers. Investors or regulators did not scrutinize companies since the diversification was often self-financed (the external market was still considered somewhat “unreliable”). Investors remained relatively passive throughout this era. The gradual drift in management focus was not immediately reflected via poor returns or EPS, and underutilization of resources was not actively measured (cross-subsidies and internal transfer pricing remained convenient ways of subsidizing businesses within the conglomerate portfolio). It took time for the problems to become apparent.

Over the medium term the languishing stock prices of conglomerates proved that it was far more efficient for investors to hold a diversified portfolio of shares than for a company to acquire those assets and attempt to manage them as a corporate investment portfolio (synergies notwithstanding); the “conglomerate premium” never translated into better EPS or stock prices. In fact, corporate control groups discovered that it was possible to acquire companies, decompose them, and leave core shareholders with better performing shares. A decline in financial self-sufficiency during the late 1970s and early 1980s (as a result of oil price spikes, inflation, economic instability, and growing global competition) meant a turn to the external capital markets. The capital markets thus became a central element of the process, not only providing capital but, as noted above, instilling the framework of discipline and oversight through mandatory financial disclosure.

Capital raising demands the release of detailed financial information, giving investors and corporate control parties better tools by which to analyze potential targets. Much of the activity of the 1980s was therefore based on dissolving conglomerates, generally to good effect: excess capital was released through share repurchases or one-time dividend payments, non-core assets were sold, and proceeds were reinvested in core businesses. In fact, 60 percent of “unrelated” US acquisitions completed between 1970 and 1982 were divested by 1989. The concept of unrelated diversification was rejected in favor of focused operation, consistent with economic theory, which suggests that specialization, rather than diversification, results in increased productivity. The era of the diversified conglomerate
(and of “good business paying for bad”) ended with that wave of activity and has not reappeared in a meaningful way. This does not mean that seemingly unrelated purchases cannot, or will not, occur or that they will not be successful, simply that they will be scrutinized more closely by market participants, who are much more knowledgeable about what to expect.¹⁶

In addition to growing proof that diversification was not working properly, relaxation of antitrust provisions during the 1980s meant it was possible for companies to acquire others within their own industries and command greater market shares in specialty areas. Large firms thus began combining their operations (such as tires, food, banking, airlines, oil, and retailing), a process that continues to the present time. There has been no compelling financial evidence to suggest that dismantling of antitrust barriers has resulted in economic mistreatment of different stakeholders.¹⁷ In fact, some of the intra-industry merger activity has been useful in boosting enterprise value by squeezing out excess capacity and returning to shareholders capital that is otherwise generating an insufficient return.¹⁸

LBOs and MBOs

LBOs and MBOs are seen as effective mechanisms for moving away from the management of EPS in order to boost stock price. As private companies, LBO managers can focus on increasing after-tax cash flows by minimizing reported earnings (and thus taxes paid). (Of course, as private companies they are no longer in the public eye and thus fail to be scrutinized to the same degree.)¹⁹ Indeed, heavy leverage associated with LBOs and MBOs demands unerring focus on operating efficiencies. Lack of access to equity capital also means a much greater discipline in resource allocation. Ultimately, the combination of leverage, payout policies, and concentrated equity ownership can lead to very focused operation. A typical LBO boosts debt to equity from an average of 20 percent to 90 percent, and remaining equity is concentrated in the hands of a few managers,²⁰ meaning the corporate operation changes considerably. The board becomes smaller and more expert, managerial compensation is scrutinized more closely, targets and goals are prioritized, cash flow is managed as the overriding priority, divisional subsidies and accounting fictions decline, and information becomes more transparent and available.

The properly priced and executed LBO has proven to be a popular corporate control mechanism. Under the “blueprint” LBO, a company (perhaps one that has diversified too much, but has tangible assets and few incremental capital requirements) is taken private by a management or investment group through the use of debt. The initial premium paid to shareholders (that do not form part of the management or buyout group) is meant to be recouped by improving asset utilization and efficiencies or
spinning off non-core units/subsidiaries. Since the focus on debt service becomes acute, considerable attention is placed on corporate cash flows (a good discipline to have, as it happens). The typical exit strategy is based on de-leveraging through re-equitization or third party sale. The company that emerges should ideally be a more efficient and valuable operation, precisely what a shareholder would want to invest in. However, critics of LBOs cite deals with short time to “cash out” as evidence that buyout groups are primarily interested in short-term gains; such a short-term perspective, they argue, can deprive companies of investment required for long-term growth.

In order for LBOs to function, the pool of available buyout candidates has to be sufficiently large to yield promising opportunities, the capital and credit markets have to be deep enough to provide the required amount of leverage, and the capital/investment markets must allow for a proper exit strategy (either public reflotation or outright sale to another company or investor group). While the United States has featured an active LBO market since the 1980s (since it possesses the minimum criteria), so have several other countries. For instance, companies and investor groups in the UK and Ireland have arranged MBOs for the past two decades, designing leveraged structures that are quite similar to those found in the United States. Continental Europe started becoming active in the mid-1980s as the pool of available candidates broadened (for instance, through state company spin-offs and privatizations) and the financing markets deepened. During the 1990s France, Sweden, and the Netherlands all experienced greater LBO volume. (Germany, in contrast, has not, as capital protection rules mean certain corporate control techniques, such as LBOs, are generally prohibited.) Japan lacks meaningful activity, primarily because of long-standing relationships and cross-shareholdings. Developing model companies rarely feature LBOs as a result of concentrated family stakeholdings and limited capital markets capabilities.

**Antitakeover defenses**

When companies choose to adopt antitakeover defenses to protect against takeovers/LBOs they must proceed with caution. Some defenses are justified, as they are intended to protect shareholders from potentially unfair behavior by would-be acquirers. For instance, many companies have adopted *fair price provisions* that provide protection against the two-tier acquisition offer, where the first tier comprises a generous, front-loaded cash offer, and the second some lower premium package (such as a combination of cash and bonds). An acquirer attempts to entice shareholders to tender quickly by giving them access to the first tier on a “first come, first served” basis. The first tier gives the acquirer control and leaves other
shareholders, that do not tender in the first stage, with a worse deal. The fair price provision requires that all shareholders receive the same (or a substantially similar) buyout price, meaning an acquirer cannot pay a premium price for shares up to the control point, and a reduced price for the balance. Other defenses – such as poison pills and dual class recapitalizations (structural transformations which increase or decrease the voting power of a share) – can protect management and directors, rather than boost shareholder value, and are indicative of flawed governance; we discuss this at greater length in Chapter 5. In fact, some countries prohibit or limit the use of antitakeover defenses.

When considering any corporate finance activity it is incumbent on the board of directors to demonstrate a duty of care by weighing shareholder interests, the best price that can be obtained for shareholders, the potential value of the company pre- and post-corporate finance activity, the expected financial condition of the company after potential action (such as degree of leverage, credit rating, access to liquidity, and goodwill), the nature of, and potential protection provided by, takeover defenses, and the interests of other stakeholders. In some jurisdictions board directors must also contend with a concept known as the omnipresent specter, which requires a board to show that it is not acting in its own self-interest when rejecting a corporate control bid: that is, that the rejection is appropriate and takeover defenses are required in order to protect shareholders. Only by diligently exploring all of these issues will directors know whether a deal should proceed or if defensive measures are necessary. When litigation arises out of failed or rejected corporate control activity, plaintiffs (rejecting the transaction) generally bear the burden of proof regarding duty of care, while defendants (pursuing the transaction that has been rejected) generally bear the burden of proof regarding the omnipresent specter.

In order to avoid being acquired or restructured by external parties, management and directors might choose to undertake internal restructurings. In situations where corporate control transactions are not successful, such as thwarted hostile takeovers or rejected LBOs, internal action may follow. However, the pace of change may be slow. Unlike corporate control transactions, which are generally designed for reasonably quick implementation, voluntary restructuring may occur over a period of years. Greater investor patience might be required if it appears voluntary changes are actually being undertaken. Companies choosing to restructure their own operations might try and do so to address some of the actual or perceived concerns driving a potential outside bid, including low stock price because of inefficient operations, poorly regarded management, lack of focus, and insufficient investment. This type of internal restructuring has been apparent since the 1990s (following the first major wave of takeovers of the 1980s), and continues to the present time.
The market for corporate control cannot guarantee good governance, but it can subject companies to additional scrutiny, and create greater efficiencies (and possibly increased enterprise value) if appropriate transactions can be structured. But individual transactions can be costly and time-consuming, and may damage some stakeholders, meaning that the balancing act comes into play once again. In systems where corporate control activity does not exist or is inactive, an element of external governance is lacking; meaning alternate mechanisms, including internal restructuring actions by board directors and executive managers, or external monitoring by block holders or activist investors, must assume a greater role.

**BLOCK HOLDER MONITORING**

Shareholder diffusion is characteristic of many modern corporate systems. There are, however, some exceptions to this rule. Companies in some systems feature blocks of shareholdings that are concentrated with institutional parties, either banks, family groups, other companies (which we discuss below), or activist investors (which we consider in the next section). Though concentrations may not be sufficient to exercise effective control following the schema noted in Chapter 1, they can be large enough to allow an active monitoring role. This can often be done with share stakes ranging from 1–3 percent up to 10–15 percent. (In fact, the influence wielded by such shareholders is often much greater than their stakes might suggest.)

A key corporate governance problem we mentioned earlier – problems associated with agency costs – declines with active monitoring. Block holders generally have much greater access to management and information than diffuse shareholders. Where this is not true, they are able to bear the cost of acquiring information and/or monitoring management. (They are, after all, significant shareholders, and typically have enough resources to pay for monitoring activities, particularly if they view the shareholding as a long-term investment commitment.) Block holder monitoring can thus serve as an additional external governance check by allowing large investors to:

- monitor the activities of management and directors in light of corporate goals and stakeholder interests, and take actions when results are unsatisfactory
- evaluate the decisions being taken by management more directly
- nominate or appoint board director(s)
- exert influence through financing or voting pressures
promote long-term value creation by de-emphasizing short-term metrics.

From a theoretical perspective, investors might seek an “optimal” level of shareholding that justifies the costs of influencing their rights and monitoring management. Some have noted that this type of framework provides for continuous monitoring of directors and executives, whereas diffuse shareholder monitoring is primarily crisis-induced.

Institutional monitoring through banks and large companies occurs in various relationship-model countries, such as Germany and Japan, where business activities are centered on long-term, mutually beneficial dealings. (In fact, most of our comments in this section are geared towards the German and Japanese markets, as they are the most significant by virtually every financial measure; they are, however, applicable in various other countries.) Although the ultimate goal is to ensure a fruitful and long-lived business relationship (such as a financial credit relationship in the case of banks, a supplier/customer relationship in the case of other companies), a direct by-product is often an effective governance monitoring mechanism.

This type of long-term relationship, and the governance checks it can create, is in sharp contrast to the market model followed by companies in the United States and the UK. Indeed long-term, group ties centered on main bank participation and extensive corporate cross-shareholding are viewed with suspicion by those in the market-model system, who believe that conflicts of interest or breaches of anti-trust rules can occur. For instance, in order to protect an equity stake a bank might be willing to provide more credit than is prudent, or in more extreme circumstances actually restructure the finances of a weak company through no-interest loans, extended maturities, continuous rollovers, and so forth. (There is considerable evidence that this happened in Japan during the country’s bad debt crisis of the past decade.) A main bank might also use its role within a corporate group to gather captive credit business. In addition, compliant banks and an insider-controlled system mean there is little room for corporate control activity, and greater possibility of entrenchment and complacency.

In Germany it is common for a large relationship bank (hausbank) to act as an important shareholder of, and lender to, a large company. The bank might not actually appoint directors to the supervisory board (although it most likely can), but still plays an active role in monitoring the activities of the management board. Although it often sides with management on particular issues, it does not always do so. German banks exercise their influence through relatively small shareholdings – much smaller, in fact, than corporate or family shareholding blocks – primarily as a result of the vollmachtstimmrecht system, which allows them to vote bearer shares on behalf of
investors through their role as depositories. Although the right of proxy must be renewed every 15 months, apathy on the part of individual shareholders often leaves banks with the ability to vote the bearer shares as they see fit, for or against management. Intercorporate shareholdings are also a common feature in Germany, meaning such investment blocks must be considered a source of monitoring and influence. Corporate cross-shareholdings are long-term, strategic investments that are often unrelated to specific trading/supplier/customer relationships. Family-owned blocks can also play an influential part in monitoring. Although corporate and family shareholdings represent the two largest institutional voting blocks in Germany, they are generally not considered to be as important as banks in the monitoring process.

A similar approach can be found through the Japanese keiretsu structure, where a main bank, acting as shareholder and lender to a group company, oversees the activities of management. Indeed, since the Japanese system still features insider boards that are occupied with line management responsibilities, investors and other stakeholders have come to view main banks as “independent” corporate monitors of the system. Main bank monitoring can also be supplemented by other corporate cross-shareholder monitoring (although, as in Germany, this tends to be of secondary importance). Unlike Germany, the Japanese intercorporate shareholdings (known collectively as the mochiai system) often arise from business or trading relationships. Through keiretsu relationships group companies own stakes in one another, helping reinforce group business ties (although the ties do not confine business dealings to other keiretsu members, as we discuss in the next chapter). Although individual company shareholding in a typical keiretsu relationship is relatively modest, perhaps 2 to 3 percent, group shareholdings rise to a more significant 15 to 25 percent when considered in totality. By virtue of these business-driven cross-shareholdings, a bank and other group companies have the ability to monitor a firm’s activities; the entire system and framework might be characterized as benign and cooperative.

While Japanese and German banks have been important corporate monitors over the years, market circumstances are forcing a change in their role. Banks in both countries are attempting to cope with problem credits, and may be less willing to “paper over” bad loans to distressed companies. They have watched their “hidden” reserves disappear through charge-offs and falling asset prices, and have been forced to sell off portions of their cross-shareholding stakes. Indeed, it is clear that bank shareholders have suffered poor returns for the better part of a decade as a result of imprudent lending policies in a bad economic environment. (This is especially true in Japan.) It seems unlikely that there can be much more tolerance for weak returns, meaning a reduction in
relationship lending, redeployment of capital to more profitable opportunities, and further sale of cross-shareholding stakes. (Such blocks might ultimately end up in widely dispersed hands, bringing the Japanese and German relationship model somewhat closer to the “diffuse ownership versus control” theorem.) In addition, corporate customers have begun accessing capital markets directly, reducing their reliance on bank credit. This suggests the traditional role of banks in the governance monitoring process might be on the wane temporarily, and perhaps permanently. Ultimately, banks may have less monitoring influence over companies, meaning parties may have to rely on other control mechanisms in order to promote sound governance; however, it will be several years before the full effects of possible change are known.

Monitoring through main bank and corporate cross-shareholdings, as we have indicated, is far less common in countries such as the United States, the UK, and Canada. Where block holder monitoring does not exist, or is restricted by law, activist institutional investors and corporate control transactions often fill the void. In fact, activist institutional investors (which we discuss at greater length below) can help reduce the agency problem by ensuring more diligent monitoring, but the goals and approaches are different from those of German and Japanese block holders.

The activist institutional investor identifies companies that it believes should improve their governance practices, takes an investment stake, and begins a campaign of reform (often centered on proposals to be considered at the AGM, director nominations, proxy voting, and so forth). Although the investment horizon might indeed be very long-term, it need not necessarily be so. When activist investors have been successful in reform or given up the fight, they move on to other targets by reallocating their resources. The German and Japanese block holder model, in contrast, calls for long-term (arguably permanent) monitoring based on financing and business relationships, rather than specific short or medium-term governance cures. Indeed, one of the central elements of the relationship-based approach to investment, and the resulting governance forces it imposes, is the time horizon. The shareholdings of banks and industrial companies must necessarily be long-term if they are to be regarded as relationship-based. Such shareholders cannot pursue the short-term views/goals of professional investors in the market model (such as US money managers, who are primarily interested in quarterly and annual return horizons). Those with a long-term view are likely to be better synchronized with a company’s long-term capital investment and R&D programs which, if managed correctly, will yield results, although perhaps not for many years. Even if the NPV hurdle rates are positive, the short-term money manager has no patience to wait for the returns expected from a 5, 10, or 20-year project, unless they are immediately embedded in the stock price.
The presence of large block holders, particularly banks, in a governance monitoring role is not always an ideal solution and lends itself to concerns about overmonitoring, collusion, self-dealing, moral hazard, and management complacency/entrenchment. For instance, close relationships between block holders and companies can insulate managers from market pressures; a lack of discipline can lead to poor focus and sub-optimal investment decisions, including expansion into unrelated or non-economic areas. It is important to stress that effective block holder monitoring by main banks is only possible when banks themselves are independent of government and/or family shareholder control. If they are not, they might actually be quite ineffective, and find themselves in a position of lending excessively to the very companies they are meant to be monitoring. Banks must thus be monitored closely and be subject to the same governance forces applied to all other firms. Financial regulators must enforce rules against excessive risk-taking and concentration, proper treatment of bad loans and loan loss reserves, deposit protection, and so forth. Not only do banks play an important governance role in some major economic systems, they are also an essential element of a systemic network that must be handled with prudence.

ACTIVIST INSTITUTIONAL INVESTOR MONITORING

Activist shareholders take a stake in a company based on a view that directors and management are not doing a proper job of protecting or advancing the interests of shareholders. The size of the actual stake can vary: in some cases it might be a token amount, just large enough to endow relevant shareholder rights, but often it is large enough to permit the investor to be taken seriously when communicating with the company. Most activist investors, certainly in the United States and the UK where this activity predominates, are institutions, including investment funds (such as pension funds and mutual funds) and financial institutions (such as insurance companies and trust units of commercial banks). In some cases dedicated activist shareholder groups or very wealthy individuals also participate. The time horizons taken by such investors can also vary. In some cases an investor might hold a stake for a few months or years, until it has either succeeded in its endeavors or decided to give up. In other instances shareholdings might be held for many years, on a semi-permanent basis, even after governance changes have been enacted. As with block holders, activist investors can be an effective external check by engaging in the following processes:

- Monitor the activities of management and directors in order to help advance corporate goals and shareholder interests.
- Evaluate the decisions being taken by management more directly.
- Exert influence through direct communication with directors, AGM/proxy actions, and lawsuits.

Not all institutional investors seek an activist role. Indeed, many are focused purely on value maximization (just like all other shareholders) and are not necessarily interested in pursuing governance issues. For instance, many mutual funds (unit trusts), under pressure to generate suitable quarterly returns for their clients, might simply choose to reallocate capital to other opportunities if they encounter a bad governance situation.

The activist investor movement started off slowly, with certain investors pursuing minor reforms during the early 1970s; most remained passive on key issues until a series of cases in the United States and UK focused attention on the potential liability of directors and executives. Over the next decade additional corporate misdeeds and litigation accelerated the pace of activism, and by the late 1980s the movement had become an increasingly important external governance force. Certain groups in the United States, UK, Italy, and France have become extremely well organized and disciplined in their activities, and are recognized as a powerful force. For instance, well-known US pension funds such as TIAA/CREF, California Public Employees Retirement System (CalPERS), New York State Teachers Fund, the State of Wisconsin, and the State of Florida, have actively pursued corporate governance reforms through their activist policies for several years. Private funds and corporate investors such as Providence Capital, Soros, Buffett/Berkshire Hathaway, and Templeton Asset Management have also been quite visible. In Europe, efforts have been led by the UK’s Hermes Investment Management, pan-European Deminor, French-based ADAM, and others in Italy and the Netherlands.51

Dedicated investment funds that limit their investments to companies with good governance practices have also started appearing. The movement is not, however, universal. Similar activism is still relatively rare in Germany and extremely rare in Japan. (Indeed, the Japanese marketplace continues to feature relatively few shareholder lawsuits and a proxy system that favors management, meaning little chance for any advocacy or committee movement.) Interestingly, organized activism has appeared in various emerging nations, including Russia (where there has been a meaningful challenge to corporate disclosure standards and the widespread practice of “asset stripping”) and Korea (primarily in response to the significant governance problems apparent in the chaebol system, which we consider in Chapter 7). Similar activism is difficult to find in other East Asian nations as there is little “middle ground” in shareholdings. The primary blocks are either controlling interests held by family conglomerates, or...
very small stakes held by retail investors. The “mid-sized” institutional investor, which has driven much of the process in other countries, is largely absent.

In practice investors use various techniques for achieving their reform goals, ranging from private dialog to confrontational tactics. Investors often start by communicating with directors/executives on particular issues, then escalate matters as needed (for instance, voting proxies at AGMs and filing shareholder lawsuits to effect or block particular changes). Thus, an investor group might focus on a target company that appears to be failing in some aspect, purchase a stake, possibly join with other investors sharing similar views, identify and draft a reform agenda, attempt to progress the agenda through direct management dialog and the proxy process, and persist until some level of success has been achieved (or until it is clear that nothing can be done without more drastic measures or larger expenses). Investors can only pursue a limited number of issues simultaneously, and most need to focus on fairly basic problems that can be identified through the analysis of public information. The most active investor groups put forth specific governance criteria that they believe companies should follow as a matter of best practice; their ultimate goal is to create an environment of proper control and fair play. Others track companies that they believe require governance reform, and make the information available to interested parties.

As noted, investor groups often have different interests and roles in promoting activism. Institutional investors that simply have a short-term trading view (such as certain mutual funds) are unlikely to be concerned with governance issues/reforms (wanting only to meet the next quarter’s return targets), while those that have long-term horizons (such as pension funds) have more of a vested interest in good governance. For instance, index fund managers are unlikely to be strong shareholder advocates as their primary goal is to adjust portfolio weightings continuously to match an index, not to pursue governance reforms for companies whose stocks they happen to hold. Potential conflict of interest might also dictate an investor’s stance on governance issues. For instance, a mutual fund might be concerned about governance problems and want to vote against a management slate at the AGM, but if it is attempting to win a contract to manage that company’s 401(K) plan (an US form of employee investment savings plan) it may abstain from taking an activist stance.

There are limits as to what activist institutional investors can, and will, do in pursuit of governance reforms. Although some of these entities are particularly powerful, command tremendous resources, and wield important voting influence (which they must use, or risk legal action), they are also constrained by the realities of their role. They are fiduciaries, and thus subject to liability if the activities they pursue are overly risky. They might also be criticized if they behave imprudently or operate outside the sphere
of competence and technical expertise. Although the activist investor movement is obviously not a comprehensive solution to governance problems, it is another important external force that can be applied to narrow the ownership/control gap. Figure 3.2 summarizes the occurrence of block holder monitoring and activist institutional investor monitoring across various national systems.

**EXTERNAL AUDITS**

The process of corporate auditing by external accounting firms has existed for many years and is well established in many countries. Indeed, many stakeholders rely on the independent advice and expertise auditors bring to

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<th>Block holder monitoring</th>
<th>Activist institutional investor monitoring</th>
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<td>Germany, Japan (banks, companies)</td>
<td>US, UK, Canada</td>
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<td>France, Italy, the Netherlands, Switzerland (banks, companies) Asia, Latin America (families)</td>
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**Figure 3.2** Monitoring by block holders and activist institutional investors
the review of a company’s financial position; when performed properly, the function adds an extra level of scrutiny and control. The global audit sector consists of four primary auditors (KPMG, PricewaterhouseCoopers, Ernst and Young, and Deloitte Touche Tohmatsu), a second tier of slightly smaller national/global firms, hundreds of local auditors (which have alliances/agreements with one of the “Big Four”) and thousands of small, independent auditors which operate without affiliation. In some countries regulators must specifically approve local auditors before they can review companies and issue audit opinions; this, however, is not a uniform requirement.

Although the professional scope of external audit firms varies across countries (for instance some are focused strictly on audit work, while others are also active in the tax and management consulting business), investors, regulators, and directors generally count on them to perform certain basic duties, including the following:

- Verify the strength and integrity of internal financial controls.
- Test a sample of transactions impacting the income statement, statement of cash flows and balance sheet.
- Review off-balance-sheet structures and transactions (for example, special purpose entities, derivatives, commitments, contingencies).
- Test a sample of asset and liability valuations (for example, historical valuations, mark-to-market or mark-to-model valuations).
- Review reserving and expensing policies and test transactions.
- Ensure compliance with relevant accounting standards and principles (for example, Generally Accepted Accounting Principles, International Accounting Standards).
- Make certain financials meet regulatory reporting requirements/standards.
- Review interim and/or annual statements.
- Prepare management letter with audit opinion.

The external auditor works very closely with a company’s internal auditors to investigate the nature and source of potential control weaknesses. Indeed, if internal auditors are discharging their duties properly, they should be highlighting potential areas of concern for independent review by external auditors. The external audit team is also likely to review issues and findings with executive management and the board. Depending on the
nature of potential issues or problems, it could also engage in additional forensic accounting work to discover the nature and impact of different errors.

The role of the external auditor in the governance process is a difficult one; it can be very beneficial if it works according to plan, but problematic if not managed closely. A typical process calls for a team of junior audit members (under the management of a senior auditor/partner) to review particular areas of interest or concern throughout the fiscal year. The main task, however, centers on preparation of year-end financial statements for regulators and investors. During the third and fourth quarters of the fiscal year, audit teams begin a process of testing and sampling to verify financial valuations and flows, and the integrity of controls; they may also do random checks and reconciliations to prove the value of transactions or accounts, and adherence to accounting rules. But these can only be a small sampling, meaning that if no problems appear (or those found are within error bands and are not considered “material”) the auditor is required to sign off on the supposed integrity of the entire operation.

In a complex corporation this might be a considerable leap of faith. Events might later reveal deeper problems and errors, including those that render the financial statements irrelevant or unreliable (despite the presence of a “clean” opinion from the auditor). When this occurs, auditors might suffer from reputational damage and even face legal action or regulatory sanction. Such problems, centered solely on core audit service problems, can be compounded by conflicts of interest arising from other parts of the audit organization, such as offering a client a variety of management consulting and tax-related services (which often generate much more fee income than basic audit business). In fact, audit problems have appeared with such frequency in recent years that we consider the issue at greater length in Chapters 5 and 8. Resolution of issues regarding technical competencies, non-audit service conflicts of interest, general audit practices/procedures, and repair of certain reputational issues associated with bad audits, should allow the external audit community to regain some of the credibility that has been lost in recent years. Despite problems, the external auditor must still be seen as an important external check on the activities of a company, and remains an important element of governance.

**CREDIT RATING AGENCY REVIEW**

Credit rating agencies can play an important role in the external governance process by adding another layer of scrutiny to companies seeking to access the public debt capital markets. Rating agencies rate the creditworthiness, or financial strength, of individual companies to determine
their capacity to repay obligations (such as the debt risk capital mentioned in Chapter 1, along with other balance sheet, and off-balance-sheet, liabilities). Since credit ratings are an assessment of a company’s ability to repay obligations, they relate to debt and hybrid securities, rather than equity securities. Agencies thus focus primarily on the repayment ability and financial condition of companies: liquidity, leverage, cash flows, earnings, market shares and competition, litigation and contingencies, and so forth. Although the exercise is largely quantitative, an essential part of diligent credit analysis involves a qualitative review, including an examination of the nature and quality of the firm’s management and internal controls. All other things being equal, a company that has sufficient financial capacity to pay its obligations, and features strong management and controls, will receive a higher rating that one that has sufficient financial capacity but weak management and controls. Rating analysis techniques vary by agency, and may be based solely on analysis of publicly available information, or supplemented by management discussion and the review of non-public information.56

It is now virtually a requirement for every issuer of public securities to be explicitly or implicitly rated by one of the major global and/or national credit rating agencies (see Figure 3.3 for a sampling). Indeed many investors refuse, or are not permitted, to purchase securities unless they are specifically rated. As a result of this requirement/restriction, credit rating agencies occupy an unique position. They provide a valuable external check and balance that can be of considerable use as an external governance force, but they also have considerable oligopoly powers, which can potentially generate conflicts of interest. Since access to the public capital markets almost always depends on a credit rating, and since issuers (rather than investors) pay for such ratings, the rating agencies have indirect control over who can access the capital markets. If a company is unwilling to pay for the rating, it will most likely be barred from the marketplace.57

Although there are more than 70 rating agencies located around the world, the number of “globally recognized” agencies is very small (it includes Standard and Poor’s, Moody’s, and Fitch). This means that there is little competition or flexibility that can benefit the issuing company.58

Extending the rating concept further, various agencies have begun to review the quality of governance processes within a company, and offer ratings services on that basis alone (for instance, Standard and Poor’s provides a separate corporate governance rating on a scale of 1 (poor) to 10 (excellent)). In fact, credit rating agencies are not the only ones that evaluate a company’s corporate governance process. For instance, Institutional Shareholder Services (ISS) uses 60+ governance factors (such as number of outside directors and executive compensation disclosure) to derive its “corporate governance quotient.”59 GovernanceMetrics International
(GMI) uses 600 variables to establish its governance ratings. (Note that ISS and GMI do not rate a company’s credit capacity and ability to repay debt, only its governance attributes. In addition, they base their ratings on public information available through regulatory filings and annual reports. Standard and Poor’s bases its governance ratings on public and non-public information, including discussions with board members and review of board minutes.) Care must be taken when considering the approach to rating governance measures, since an analysis based on a pure “checking of the boxes” might yield a very different result from one focused on the existence of control measures that are less obvious but more useful and substantive. Rating a firm’s credit strength and governance process can never be an exact science. Nevertheless, in a world where investors are willing to pay a premium for a well-governed company, rating agencies fill

**Figure 3.3** Sampling of global and national credit rating agencies
the void by providing some assessment of the strength of individual financial and control frameworks. We might therefore conclude that the agencies have a role to play in helping force some minimum standard of governance.

With some background on internal and external governance mechanisms that are theoretically intended to protect investors and others, we now turn our attention to specific stakeholders that have an interest in a company’s ability to run a secure, efficient, and profitable organization.
We have noted in Chapter 1 that the modern global corporation must typically serve multiple constituencies. It has a large number of stakeholders with specific needs that must be addressed and protected. In most companies shareholders, as providers of risk capital, remain *primus inter pares*; without equity capital a company simply cannot exist, so defending the financial and legal rights of shareholders becomes the overriding goal of the process. Indeed, some feel that shareholder interests alone merit consideration, since they are the only stakeholders that possess an open-ended contract without specific protections (creditors, for instance, have finite contracts with protections such as collateral or covenants, suppliers have performance contracts with defined terms, and so on).¹ But while access to equity is essential, the availability of other forms of capital funding (such as retained earnings, bonds, and loans) and the growing belief that companies need to work cooperatively with other constituents suggests that other stakeholders also deserve attention. In fact, many parties contribute to the prosperity of a corporation, and their interests must be considered as well. If they are treated poorly and repeatedly lose out to shareholders they will soon depart, leaving companies without the critical mass and mix of human resources, clients, suppliers, or credit needed to continue in business.²

Obviously not all stakeholder issues can be given priority at all times, as this would result in conflicts and inefficiencies. Benefits accruing to other stakeholders are important, but they are often by-products of the primary shareholder goal; where conflicts arise shareholders are still generally accorded priority. (Indeed, it is often legally impossible for multiple stakeholders to be served simultaneously.) Still, it is clear that other stakeholder interests must be considered and supported whenever it makes sense to do so.³ It is difficult to conceive of a company generating long-term enterprise value without taking account of broader interests. For instance, we know that equity capital is scarce and must be rationed and employed efficiently.
But the same can be said of human resources: a dearth of qualified professionals can be damaging to a company’s progress, meaning employee/labor interests must also be managed carefully. There is growing realization of this fact, and it is being embodied formally or informally in corporate practices. The King Committee, assembled in 1994 to investigate corporate governance in South Africa, was one of the first best practice codes to acknowledge explicitly the importance of corporate sensitivity to broader constituencies, and the corporation’s responsibilities to society. (Many others have since followed, as noted in the Appendix.)

There is a distinction, of course, between accountability – an implicit or explicit mandate, often supported by law – and responsibility – an ethical or value-driven belief system – and the two occasionally conflict. Accountability established under law and statute means that a company cannot be liable to all stakeholders at all times. It can, however, be responsible to multiple stakeholders simultaneously. Stakeholders must take care not to allow management to use the existence of multiple stakeholders as an excuse for not acting responsibly or achieving certain goals (for example, executives might be tempted to focus on employee or environmental issues as a way of avoiding pure value maximization goals).

The overall bargaining power of stakeholders depends on their strength and influence with directors and executives. The importance accorded to different stakeholders also depends on national social and economic goals, and how corporations are meant to respond to such goals. For instance, in the market model the primary objective is to maximize shareholder value. Governance directives emphasizing the duty of the board to properly represent the interests of shareholders support this objective. For instance the “mission statement” of the board of directors often explicitly indicates that the sole, main, or overarching goal is to promote the value of shareholder interests. In such countries, corporate law indicates that companies are to be run in their own economic interest and, by extension, the interests of shareholders. This does not mean that other stakeholders are ignored, simply that they are not the focus of legal attention.

In the relationship model the interests of shareholders are, of course, important, but so are the interests of other stakeholders. Societal and economic norms place a much greater weight on the totality of a corporation’s relationships, and this is reflected in governance practices and corporate law. In Germany, for instance, although the supervisory board is legally responsible for ensuring shareholder interests are properly addressed, it is also expected to take a broad and active role in monitoring and supporting the interests of other stakeholders. In relationship model countries, company/stakeholder ties by definition drive much of the process, meaning that informal mechanisms of control and behavior can be more important than formal ones. (In fact, relationships are so important...
that they often supplant courts, law, and contracts, unless absolutely necessary.) This also means greater subjectivity in conducting business. For instance, even if it would prefer not to, a bank might feel obligated to continue funding a company as a result of its long-standing ties; likewise, although a company might prefer to shut down a factory, it might continue to operate it at a loss in order to preserve relations with employees and the local community. It is notable that directors and managers of companies in such countries often express an explicit interest in corporate sustainability, ensuring that their organizations exist in perpetuity, providing returns and benefits for multiple generations of shareholders and stakeholders. This demands close ties and cooperation with a broader constituency. Stakeholder interests in the hybrid model found in East Asian and Latin American countries are similar to those found in the relationship model.

We obviously generalize these approaches across national economic systems in order to help convey key traits; however, there is sufficient anecdotal and academic evidence to support trends, tendencies, and activities. At the micro level, individual companies can still choose how they will treat particular stakeholders (acting, of course, within the confines of applicable law and regulations). Thus, a company that operates under the market model must hold shareholder interests above all others, but may also choose to devote considerable time, energy, and resources to ensuring its relationships with the community, or employees, are as constructive. Equally, a company in a relationship model system may believe that shareholder interests rank behind those of labor/employees, but it may act in a way that demonstrates strong concern for the position of shareholders. (Indeed, in some relationship and hybrid model countries where large government shareholdings are being sold through privatization programs to much more demanding private and institutional investors, the focus on shareholder demands and rights is stronger than ever.) Although each system has positive and negative traits, as we note in Part II, we re-emphasize for now that corporate stakeholders are accorded varying degrees of treatment and importance because individual companies approach business in specific ways, and are guided by unique cultures, rules, and regulations.

**DIRECT AND INDIRECT STAKEHOLDERS**

Although there are various ways of classifying the universe of stakeholders, for our purposes we define direct stakeholders – those most immediately and directly impacted by a company’s activities, prospects, and actions – to include shareholders, creditors, employees, customers, suppliers, professional service providers, and communities. We may also consider a group of indirect stakeholders – those that can be impacted by
a company’s success or failure, although often less obviously or directly – which includes regulators, competitors, and taxpayers. These groups are summarized in Figure 4.1. We explore the interests of each in the corporate process at greater length below.

**Shareholders**

We briefly discussed in Chapter 1 the rent and control rights of shareholders, and the role that governance plays in protecting these rights. In most national systems shareholders, as providers of equity capital and ultimate bearers of corporate risk, are the main beneficiaries of corporate accountability and responsibility. A company’s directors must strive to maximize the value of the shareholding by allocating capital in support of activities that achieve the highest possible economic returns. While maximizing enterprise value is often the critical end result of corporate governance activities, proper protection of legal rights (such as voting rights, power to elect directors, and preemptive rights over future equity issuance) is just as vital.

In practice, shareholders in the modern corporation have exchanged definitive rights for uncertain expectations, and are guided by a group of directors who are meant to act in their best interests. But we know that directors have...
wide discretion in managing the affairs of the corporation (directly and via further delegation to executives), so the treatment of shareholders may sometimes appear tenuous or conflicted. Indeed, some might view the shareholder as a supplier of capital on terms that are weaker than those of creditors (to wit, the “open ended-contract without specific protection”). The separation of ownership and control means the shareholder is less attached to the rights theoretically conveyed by shares, and has a more liquid and portable investment; in the financial environment of the twenty-first century the participation of the shareholder is measured in terms of pure market price rather than a share of corporate assets and control.

If a company wants to preserve access to fresh capital, it must do what it can to maximize the value of the shareholders’ investment and protect the rights conveyed through shares of stock. This is true for all of a company’s shareholders: institutional, retail, majority, and minority. Protection of the control rights attached to equity investment is often reinforced through specific legal mechanisms, hence the importance of a robust legal framework. While all shareholders need to be protected, corporate reality suggests that large institutions have greater influence with directors and executives, and may thus receive “preferential” status. While management may accept input or engage in dialog with large investors, rarely (if ever) will it do the same with smaller interests. Thus stratification exists within the general class of “shareholder interests.”

In fact, institutional investors and company executives have a particularly symbiotic relationship: each relies on the other for ultimate success. The institutional investor seeks to create value in its shareholding over the short and long term, and will identify ways in which the company can boost value. The institutional investor also faces the possibility of a “liquidity trap” – being unable to sell a large shareholding quickly and efficiently without sustaining some price loss – and therefore prefers to hold for the long term or exit in an orderly manner when the company is in an uptrend. Management, in turn, favors a friendly, stable, long-term shareholder supporting its activities: patience can help create long-term value. Although care must be taken not to be seen as secretive and working against the interests of small shareholders, institutional players have the ability and clout to work constructively with executives in developing a better enterprise (for instance agreeing not to take “hostile actions” if management appears to be heading in the right direction, and supporting particular defense mechanisms). This could ultimately (though not necessarily) benefit the small shareholder as well.

In practice minority interests need to be protected directly. This can occur through corporate policies, formal regulations, or listing rules that explicitly recognize the rights of minority interests and ensure the fair and equitable treatment of all shareholders. While this is rather simple to state, it is often
more difficult to enforce, and may remain entirely unclear until some corpora-
tive control action is underway. For instance, in order to protect minority
interests a company might raise the percentage of votes required for the
passage of certain corporate activities/decisions, permit cumulative voting,
allow flexible proxy voting (for instance by mail or electronic communica-
tion), and require that minority shareholders be formally represented through
a seat on the board.6

The presence of controlling shareholders means that control and
management are very closely aligned (for example, the family sharehold-
ers appoint management teams that are friendly, cooperative and can be
directed/influenced). In such instances the agency problem appears
between controlling and minority shareholders. Under these circumstances
minority interests should theoretically be safeguarded and respected, but
are often ignored or abused. Indeed, controlling shareholders are likely to
dictate the agenda and strategy so that they can run the firm as they choose;
minority shareholders that are interested in value maximization may be
disappointed, as controlling shareholders may pursue goals that are entirely
different (such as market share instead of value maximization). Short of
specific rules or regulations protecting minority interests, there may be
little for these investors to do but sell their shares and redeploy capital.

**Labor/employees**

Employees are key stakeholders in the governance process, acting simulta-
necessarily as value generators and controllers/monitors (and, in some instances,
shareholders). They occupy a special position in the corporate structure
because it is through their efforts that a corporation exists as a (hopefully)
productive concern. Employees also have a unique perspective on internal
corporate affairs through their daily business and control work; that allows
them to act as internal monitors. Employees working as part of a division
have an interest in ensuring that the division is functioning as it should, and
is being treated properly by all other divisions and management; they expect
to receive, and provide, some basic level of support and respect. Many of the
corporate-level issues we have discussed related to sharing information,
making sound business judgments based on reasonable command of the
facts, and operating in a prudent and controlled fashion, apply at the internal
division level staffed by employees.

A dearth of qualified employees means a company will soon cease to
function profitably or efficiently, so protecting employee interests is vital.
These interests include the implicit (and sometimes contractually explicit)
promise of a job on fair terms, safe work environment, normal and incen-
tive compensation, benefits and retirement income. (The latter is particu-
larly important in an era where government or state-provided pension
plans/benefits are often deemed insufficient for the average worker; in such cases employees seek jobs partly to provide for their own future security.) Employees in the United States, typically receive more compensation than their counterparts in Continental Europe, Japan, or Asia, but tend to have less job security. In Japan and Europe perquisites, benefits, and post-retirement packages are often more attractive than in the United States. In countries with a strong labor representation and union tradition, job security is often strong. In the poorly managed company any, or all, of these interests can be jeopardized.

In certain firms, primarily those operating under the market model, it is increasingly common for some or many non-executive employees to receive a portion of compensation in the form of company stock. When this occurs the employee’s interests are aligned with those of the company and shareholders. In a properly performing company this can be a powerful incentive and provides appropriate stakeholder protections. However, in a company that is in financial distress (and which may ultimately become insolvent), the financial and personal consequences can be considerable: loss of employment (and thus income), and loss of investment value as the company’s stock becomes worthless. The debacles at Enron, Adelphia, Swissair, and other firms that allocated stock to their employees serve as a potent reminder of the risks that employees face as multiple stakeholders in a firm’s success.

Although labor/employees are obviously important stakeholders in every company, the status and protection they are accorded vary by system. In relationship model countries employees are often regarded as the primary stakeholders in the company’s success and longevity; indeed, employees tend to receive the main focus of corporate governance efforts, outranking even the shareholders. When the shareholder is no longer the sole, or primary, beneficiary of a company’s returns, goals other than enterprise value maximization can legitimately arise (such as market share and long-term employee/stakeholder benefits). There is some evidence to suggest that in national systems with an intense labor/employee focus, there is greater weight given to employee input on matters of corporate importance, and a greater amount of “consensus building,” such as harmonious, often protracted, discussion to achieve proper majority agreement on a particular proposal, process, or course of action. This occurs in Japan, for instance, where the “company community,” comprised of core long-term employees, directors, and managers, is the main beneficiary of corporate attention. This body stands at the center of governance in practice (if not in law), and plays an important role in internal selection and monitoring of executives, long-term investment plans, and general consensus-building. Although employees are important in market model countries, they are not viewed as the primary stakeholders.
Protection of employee interests is sometimes formalized through board-level mechanisms. We have noted that in Germany, labor codetermination requires the appointment of labor representatives to the supervisory board – as much as half the board in the case of large companies in specific industries. The same is true in other nations (for instance in the Netherlands one-third of the board must consist of labor representatives, and in France, if employees own at least 3 percent of the company’s stock, one or two representatives must be elected to the board). Curiously, in Japan, where employees are the most significant stakeholders, there is no specific board-level labor representation; the practice is also unheard of in companies operating under the market model. The presence of labor on boards can lead to interesting tactical and strategic behavior; for instance, in Germany labor representatives who do not favor a hostile takeover because of its possible implications on employment can use their influence to block the transaction.

Even within systems that hold employees as primary stakeholders, changes are underway that might ultimately undermine their “preferred” position. Japan’s labor situation, for instance, is in transition. Although the Japanese corporate sector has a long history of insulating employees from downturns (“guaranteeing” their jobs as a form of social insurance), the process has begun to change in the new millennium. Companies are being forced to deal with the realities of a competitive global marketplace that places greater focus on economic returns, efficient use of capital, cost control, and operating targets. This means the Japanese tradition of “lifetime employment” has started to erode. Companies are willing to shed the administrative guidance from ministries and banks (which had, for many years, “suggested” that employment policies remain unchanged); the system can no longer guarantee job security. While this does not mean jarring mass firings (such as might be evident in the market model system), it does mean job loss through natural attrition and early retirement, as well as bans on new hiring, elimination of overtime, and so forth. Employees, for their part, are already demonstrating less allegiance than in the past; changing jobs, seeking greater pay elsewhere, and so forth. This gradual erosion of lifetime employment does not suggest, of course, that employees are no longer regarded as the primary corporate stakeholders in Japan, simply that management and board directors accept the fact that they need to focus on bottom line returns.

Creditors

Creditors are important stakeholders with a role and priority that changes with a firm’s financial condition. In the first chapters of the book we noted the importance accorded to debt holders through their role as suppliers of debt risk capital. Because few modern corporations can operate without
some amount of debt capital – accounts payable, trade credit, short-term notes, medium and long-term bonds, working capital loans (and certain other “hybrid” debt/equity securities, such as convertible bonds, exchangeable bonds, bonds with warrants, and so on) – the interests of creditors must always be considered very carefully. In general, creditors that lend directly to a company through an instrument such as a loan have more concentrated interests and therefore greater incentive to monitor the borrower’s activities; those that lend in securitized form (through bonds or notes) are more diffuse and lack the same level of influence. (Their investments, however, are more liquid and portable.) In either event, they must handle corporate relationships with care, as they are exposed to considerable information asymmetries. The corporation as a borrower knows more about its own financial standing than the creditor can ever know; accordingly, the creditor must do all it can to protect itself through monitoring, structural protection, rewards, sanctions, and available regulatory mechanisms (such as reporting requirements and periodic scrutiny). Ultimately, the creditor must answer to its own shareholders and regulators regarding its performance.

In the normal course of business, creditors receive financial gains in the form of periodic interest payments; this represents an economic return on risk capital supplied. At the conclusion of the financing transaction, unless prior “rollover” arrangements have been made, they receive back their principal. Such credit obligations are legally documented through loan agreements (often with specific performance covenants), trade financing agreements, bond indentures, and so forth. In certain cases a creditor will only supply a company with funds on a secured basis, receiving a security interest in, and gaining a claim on, a valuable asset (such as property, equipment, securities, or accounts receivable); this relationship is again documented legally and forms part of the creditor’s legal recourse in the event of insolvency. Creditors also receive a priority claim in insolvency. Although creditors lack the voting power of shareholders, they rank senior in the event of liquidation or reorganization, meaning they will receive greater residual value than shareholders after corporate assets are sold (or more “valuable” securities post-reorganization). For instance, under the absolute priority rule, shareholders only receive payment after creditors have been fully repaid. Within the broad category of creditors seniority claims also exist, with secured creditors ranking above senior unsecured creditors, and so forth, as illustrated in Figure 4.2. Consistent with a standard risk/return framework, creditors accepting less seniority (by lending in a more subordinate form) assume more risk and therefore demand a higher return (via a risk premium).

Concentrated debt holders (like concentrated equity holders) can, in fact, be a powerful stakeholding force. The governance power created
through legal rights embedded in debt, when held by just a few banks or
debt holders, conveys greater power, including the ability to force bank-
ruptcy, renegotiate terms quickly (which is important during periods of
financial distress), and influence corporate cash flows (for example large
creditors, working with directors, might choose to alter the company’s
activities, moving from high risk investments to lower risk ones). This
power is dependent, of course, on the presence of a strong legal/bank-
ruptcy framework, as we noted in the last chapter. The power of the debt
holder can be quite significant in industrialized countries with a strong
tradition of legal and bankruptcy experience; the same is not necessarily
true in emerging nations, which often lack the same background and
framework.

Figure 4.2  Capital class, seniority, and expected return
In the normal course of business we know that a firm has certain financial obligations to its creditors, namely the timely payment of interest and principal; where relevant it may also be required to post or assign collateral/security. However, the main benefits and rights accrue to equity investors. When a company migrates to a state of financial distress (either the vicinity of insolvency or complete insolvency), the fiduciary responsibilities of directors and executives shift to creditors, who emerge as the most important stakeholders in the process. The primary operating edict under such circumstances is to preserve as much corporate value as possible so that creditors can maximize their recovery in liquidation or reorganization. Equity investors, though still the rightful owners of the company, lose control and no longer have any influence over board directors. While corporate governance standards for companies in financial distress (for example, in the pre-petition phase or in the vicinity of insolvency) are defined in case law, they are continuously tested in practice, so precisely when duties shift from investor to creditor is a matter of debate. US courts have argued that duties shift when a company is in the vicinity of insolvency (although this, again, is likely to be a rather subjective interpretation).11

When a company is technically insolvent, the metrics are rather simple to gauge (the market value of assets is less than liabilities, and interest payments are missed); when a company is in the vicinity, there are no such metrics. This is a “gray area,” although evidence suggests that during the sensitive pre-petition period the business judgment rule applies, meaning directors have considerable discretion on how and when to shift their duties.12 The increase in director and officer malfeasance is apt to make board directors cognizant of their duties as distress deepens. For instance, when considering bankruptcy, board directors must remember that retrospective scrutiny (a review of what the board of directors knew and when, what action it took, and to whose benefit) by external examiners (including regulators, lawyers, and auditors) is a key element of the process. Preparing for such scrutiny is vital.

Once insolvency occurs, an administrator or debtor-in-possession must run the company’s business on behalf of creditors. The same duties of loyalty and care still apply, but they are directed towards creditors rather than equity investors. It is important to note that a company’s legal obligation is to each creditor separately, suggesting that a negotiation of asset disposals or renegotiation of a company’s credit terms when in financial distress, and then insolvency, can be difficult. In fact, the bankruptcy and reorganization process is generally lengthy and complex. As we have already noted, some systems (as in the UK and Malaysia) appear to favor creditor rights, while others (such as the United States and the Netherlands) seem to favor debtor rights. These can lead to differences in liquidation versus reorganization, and the appointment of an independent administrator versus retention of
management and addition of a debtor-in-possession; it may also have some bearing on how different classes of creditors ultimately fare. In legal systems where an automatic stay prohibits creditors from automatically liquidating corporate assets to repay outstanding credits and managers are permitted to remain in their positions to manage the company through a transition period (until an administrator or debtor-in-possession takes over), the control power of debt holders is reduced.

Regardless of the system, a creditor committee is often formed by institutions that have a claim on the company to coordinate actions and maximize value in liquidation, or approve the company’s status as a new entity in reorganization. Similar committees representing shareholder interests are relatively uncommon, for obvious reasons. Rarely do shareholders receive any meaningful value in bankruptcy, so the costs of creating a committee are difficult to justify. (Certain groups are attempting to formalize an equity investors’ committee which then meets regularly, tries to jointly represent best interests and so on, unless a company is “hopelessly insolvent”; shareholder bargaining power increases slightly when the market value of the company’s assets is stronger, but is still largely a losing battle.)

**Customers and suppliers**

The majority of companies purchase what they need and sell what they produce. Few (if any) companies are so structured – both vertically and horizontally – that they do not need strong relationships with external suppliers and customers. While some broadly structured vertical conglomerates, controlling large parts of the input process, might be able to supply most of what they require in order to produce a particular good, they will always demand additional inputs that cannot be sourced internally; this requires constructive supplier relationships. In fact, while direct ownership of inputs can give a company greater control over the entire supply and production process, it may not be as efficient or cost-effective as outsourcing. Third-party supplier dealings through long-term procurement relationships (rather than outright vertical relationships) permit greater specialization on core businesses, but demand greater reliance on third parties.

Even if a company controls most of its supply chain, it still needs a marketplace in which to sell its products, and must therefore be sensitive to client dealings. Again, although a broadly structured conglomerate might have captive customers within its overall group (subsidiaries, sister companies, affiliates, and joint ventures, which collectively absorb products), it is still likely to need some amount of external customer sales and distribution to offload excess production and inventory.
Companies also do well to protect and respect the rights of customers and suppliers as they often act as creditors, supplying valuable liquidity that can be used to manage short-term assets and liabilities. For example, in many systems it is common for suppliers to invoice companies for future payment of goods/services already delivered, giving them perhaps 30 to 90 days to pay. This can be an important extension of credit, and companies need to protect their supplier relationships in order to preserve funding access. Similarly, customers often prepay for goods or services they buy from the company, again extending credit; they, too, must be handled with care. A company cannot neglect its customer and supplier relationships.

In some countries, the strength of these relationships has a bearing on a company’s investment practices: the stronger the bond, the greater the willingness to develop long-term, mutually beneficial, ties, which may include cross-investments. This is particularly true in Japan, through the *keiretsu* system. Long-term relationships with *keiretsu* group companies lead to actual economic or financial investment rather than just reciprocal supplier/customer trade; this can ultimately strengthen relationships even further. However, with a potentially “captive” marketplace, corporate complacency may arise; perhaps management will be less efficient, dynamic or visionary in its execution of business if it knows that it can purchase at a particular cost or sell at a particular price. In fact the power of competition exists within the *keiretsu* system, and significant non-group business occurs; there is no particular evidence to indicate that mutually beneficial stakeholder relationships harm the competitive spirit or pursuit of profits (although instances of “favorable pricing” might detract from overall revenues). The specter, however, exists.

The legal nature of dealings between companies, customers, and suppliers varies by country and local practice. For instance, in the market model arrangements are driven by very precise, well-defined arrangements that are governed by contract law. There is a clear definition of the nature of the agreement, duties, consideration, conditions of performance/non-performance, and so forth. Companies prefer formal, legally binding contracts and market-driven competitive bids from suppliers, sub-contractors, and customers. Very clear boundaries thus separate and define these stakeholder relationships. In the relationship and hybrid models, legal relationships are often more amorphous. Business dealings rely heavily on implicit contracts developed through long-standing relationships rather than detailed legal documents; these arrangements are far less formal, though no less understood or followed.

For instance, in Japan the approach to corporate business arrangements is intricate and operates on multiple levels, so that formal, detailed contracts are not required: implicit business contracts are supplemented by management transfers between companies,15 information sharing, and
cross-equity ownership (even outside *keiretsu* companies, but generally via smaller stakes). This, as we noted in the last chapter, is supplemented by additional monitoring from main banks, who are present to ensure that business is being conducted on proper terms. While a so-called “basic agreement” exists as a legal mechanism for commencing a long-term relationship, the actual contract lacks detail, precision, and enforceability; the “real contract” relates to internal norms and behaviors, not legal parameters. This creates self-enforcing and self-perpetuating behaviors that do not necessarily have a firm grounding in legal code (meaning that governance changes centered on legal or legislative reform are not necessarily easy to implement).

The contract process in Continental Europe is less defined than it is in the United States or UK, though not as “vague” as in Japan; indeed, European companies routinely rely on certain contractual formalities, although they also give considerable weight to relationships and informal agreements. Companies in hybrid model countries often choose informal contracting relationships. For instance, it is common in Mexico, Thailand, and the Philippines to rely very heavily on informal arrangements for many aspects of supplier/customer business; somewhat more detailed contracting may arise in the event of large, unusual, or very long-term arrangements.

**Professional service providers**

An important bilateral relationship exists between companies and professional service providers; each relies on success and goodwill by the other in order to advance. Companies that use professional service providers (such as accountants, auditors, consultants, compensation consultants, and lawyers), for “intellectual” services must treat them fairly or risk reputational problems or regulatory sanctions. Equally, service providers have a vested interest in the continued success of a firm, and may thus be considered as stakeholders.

We distinguish these service providers from others (like those that provide raw materials or inputs), primarily because of the reputational and goodwill aspects that are involved – the intangible dimension of business. This can often create a strong mutual bond between the two parties, because the services provided are not necessarily fungible or easily replaced. While a company requiring steel might turn to one of several steel manufacturers, it may not be able to do so when it is seeking very specific advice on a tax-driven structure, special purpose entity or a legal takeover defense mechanism. The company relies on very unique skills supplied by the specialized service provider. If business functions smoothly, both parties gain: the company enjoys the advice or work supplied by the provider, while the provider generates fee-based
revenues plus some additional referrals, and perhaps strengthens its reputation in the market. The more serious matter arises when business does not function as intended; the damage to the service provider (and company) may be very significant. If the service provider is found to have given faulty advice, the client company might suffer losses (or worse); the service provider’s reputation might be severely damaged and other clients could decamp. Alternatively, if the company has abused the advice it has been given it will damage its reputation and the service provider’s; since the provider must rely strictly on intangibles and cannot fall back on hard assets (as the steel factory can produce more steel), its judgment and skills might be called into question by other clients, regulators, and supervisors. Indeed, reputational damage to professional service providers can drive away new or existing clients. Thus, the interests of these firms coincide: both need to ensure proper behavior in order to avoid the downside scenario.

Communities

Broader communities are also stakeholders in a company’s success. Communities generally enjoy some type of symbiotic relationship with one or more companies operating in the geographic locale. The community relies on companies to provide employment for local citizens; the jobs they supply provide employees with wages to purchase goods and homes, which generate direct and indirect economic flows for the community (for example via sales and real estate taxes, and personal income taxes, which can be used to expand infrastructure and services to the benefit of many). Companies, likewise, rely on communities to supply not only a qualified base of labor, but also infrastructure (such as power, water, and communications). In some cases they might also turn to communities for certain advantageous tax treatment (at least for a period of time). For instance, in order to attract corporate activity a community might be willing to offer certain corporate income tax concessions; although this represents a cost in the short run, it could yield benefits over the medium term in the form of additional capital investment and employment, and expansion of the tax revenue base. In return, the community might expect some minimum level of capital investment and expansion, job creation, and assistance with environmental issues (companies must be held responsible for ensuring no pollutants damage the community and its surrounding environment). Communities thus have an interest in ensuring companies remain strong and viable, thus helping to ensure a more prosperous local economy. Likewise, companies have an interest in building and maintaining good relations with the broader community in order to access the multiple resource advantages offered.
Indirect stakeholders

We have mentioned the nature of key corporate stakeholders that have a direct interest in the continued success and prosperity of a company, and interests that must be legally and/or morally protected. Indirect stakeholders must also be considered: those that benefit in some way from a company’s positive endeavors, or are damaged when things go awry. While these parties may have relationships with a particular company, they are often more distant than those characterizing employees, creditors, and suppliers, for instance. Among the key indirect stakeholders we consider are regulators, competitors, and taxpayers.

Regulators

As noted in the last chapter, regulators provide the financial, legal, or corporate supervisory framework and rules that let companies operate in a safer environment, and protect stakeholders such as employees and customers. They are stakeholders in the process because success by a company in operating securely, with due respect for all applicable laws, means less chance for regulatory infractions and broader stakeholder losses. When the opposite occurs – perhaps a company violates rules and regulations, or engages in abusive practices that threaten stakeholders (and even the system at large) – regulators face difficulties and challenges that must be resolved. Failure to do so can lead to even greater problems, including loss of public confidence, systemic instability, and reputational damage. (We need only consider the regulatory difficulties that swept through many parts of Asia during the 1997 currency crisis to understand the potential magnitude of the problem.) Regulators thus have a vested interest in ensuring companies that fall under their purview are operating prudently and functioning properly. This usually means companies must have in place robust governance mechanisms, including strong internal controls. Equally, companies have an extremely strong interest in respecting all regulatory provisions in order to avoid sanctions or penalties.

Competitors

Competitors emerge as indirect stakeholders in a company’s performance as they can gain in the event a firm has difficulties, or lose if the company continues to prosper. The truly competitive economic system (rather than an oligopolistic or monopolistic one) allows companies to challenge one another for clients and market share by providing properly priced products and services. If a company is unable to do so, it will lose ground to its competition. If it stumbles as a result of management, financial, or control
problems, competitors stand ready to move in and take up the slack (take on the company’s customers). This does not mean that competitors always hope for companies to fail; a stable market can be of much greater benefit to all companies than one where a market leader is plagued by problems and scandal. It does, however, mean that competitors have a vested, if more distant, stake in the fortunes of companies they consider competitors.

**Taxpayers**

Taxpayers are indirect stakeholders in many corporate ventures, though often on the downside. If a company is operating properly – securely, prudently, and profitably – taxpayers are unlikely to have much involvement or even awareness (though they stand to benefit from corporate tax revenues coming into the community). However, if a company is not operating as it should – perhaps it is managing its financial affairs imprudently, or being negligent with regard to product safety or the environment – the taxpayer might be financially impacted. If, for instance, a large bank has poor credit standards and lends indiscriminately, it will soon amass a significant bad loan portfolio. The bad loans might jeopardize its ability to operate; if the bank is deemed by regulatory authorities to be so important to the local financial system that its failure would create broader systemic problems, it could arrange a “bail out”, effectively giving the bank additional funds so that it can write down the bad loans and return to profitability. (Hopefully, as part of the process, the regulator will be wise enough to replace those responsible for the bad loans, and ensure credit controls and standards are strengthened.) Under this scenario, the taxpayer ultimately pays for the bank bail-out. Although regulators might physically tap a reserve fund to cover the bail-out, the cost is ultimately borne by the taxpayer.

We can imagine other scenarios where financial losses from corporate problems related to environmental clean-up, product safety liability, and so on, are absorbed by taxpayers. Taxpayers are thus indirect stakeholders in the corporate process, and have a vested interest in seeing companies operate prudently so that they are not called on as a financial “backstop.” In practice, they must rely on a framework of regulation and oversight to ensure proper protection.

**PROTECTING STAKEHOLDERS**

Fundamentally, a company protects all of its stakeholders by conducting its operations in a secure and equitable manner. While the priority accorded to different stakeholders obviously varies by country/system, and by time or
financial condition (as generalized in Table 4.1), those that are directly or indirectly affected benefit when a company is managing its affairs properly. From a business perspective this means conducting business prudently and ethically, within the defined scope of operations. From a governance perspective it means focusing on the controls we mentioned in Chapter 2 (creating a strong board of directors, hiring skilled executives, and implementing internal controls and a code of conduct). To assist every company, external forces such as regulations, legal/bankruptcy codes, capital markets capabilities, and external audit practices must always be as strong as possible. With these minimum standards all of a company’s stakeholders – shareholders in the first instance, but also employees, creditors, suppliers, clients, communities, and the broader group of indirect parties – stand to benefit.

It should be clear that a company has numerous stakeholders that can benefit or be harmed directly or indirectly. There is a close relationship between them that must be developed and maintained in order to foster stability. Although a company must be prepared to recognize all of its stakeholder interests, problems can, and do, occur. When governance flaws appear, many of the parties mentioned in this chapter can be damaged in some form, often quite severely. We consider this point in the next part of the book.

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**Table 4.1 Primary and secondary stakeholders**

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Part II

Corporate Governance Problems
FLAWS IN GOVERNANCE

We know from Part I that internal and external governance mechanisms exist to protect stakeholders, and in practice often work as intended. Occasionally, however, they break down as a result of some flaw, such as a failure within the board of directors or the executive suite, ineffective internal controls or corporate policies, and inadequate regulations. Any of these might lead to a corporate problem. In some cases several shortcomings might appear at the same time, increasing the possibility of a more extreme outcome, such as an excessively large and unexpected loss, a liquidity crisis, financial distress, or even bankruptcy.

Governance flaws generally develop slowly, over an extended period of time. It is unlikely in the modern corporation that an aspect of governance can suddenly fail and lead to immediate distress or liquidation. Even a company like Enron, which encountered liquidity difficulties in late September 2001 and filed for bankruptcy two months later, had sown the seeds of its destruction long before its relatively short collapse period. Indeed, problems related to controls, oversight, and behavior – and the culture that permitted these to exist – started at least five years before the company’s ultimate demise. If governance flaws are relatively slow to develop, directors, managers, auditors, creditors, and regulators theoretically have the opportunity to spot problems and take corrective action. While this often happens, sometimes it does not, perhaps as a result of comfort with the status quo, unwillingness to challenge executives, satisfaction with returns being generated in a bull market (“the rising tide carries all ships”), insufficient technical skills, and so forth. These behaviors must be corrected in order for governance flaws to be detected and acted upon.

Those deeply involved in governance matters, including board directors and regulators, are well aware of problems that can arise. Consider the
results from a 2002 McKinsey survey (conducted after Enron, Tyco, Adelphia, Swissair, Daewoo, et al.), where board directors commented on potential shortcomings and problem areas:¹

- 21 percent had no mechanisms for assessing executive compensation practices or financial/operating risks, and a further 30 percent felt their mechanisms were ineffective.
- 37 percent had no CEO succession plan in place, and a further 27 percent felt that their plan was inadequate.
- 19 percent had no formal plan for dealing with risks, and another 24 percent felt their plan was ineffective.
- 45 percent felt their companies should, but did not, have an annual director re-election process.
- 60 percent felt their companies should, but did not, have formal board evaluations, and 66 percent thought they should have formal director evaluations.
- 42 percent of directors felt they had only “some” knowledge of how the company’s business creates value, 36 percent felt they had only “some” knowledge of the major risks facing the company, and 47 percent felt they had only “some” knowledge of competition and strategy.
- 60 percent of directors did not independently observe the activities of the company’s chief risk officer, 39 percent did not observe internal auditors, and 28 percent did not observe chief legal counsel.
- 43 percent of directors were dissatisfied with board oversight of external counsel.
- 25 percent of directors would decline to serve again because of liability concerns.

Perhaps most revealing is the fact that 90 percent of directors felt that governance improvements were needed: 74 percent wanted more responsibility assigned to the CEO, 73 percent wanted more responsibility assigned to audit committee review of risk, 73 percent wanted a lead independent director, 70 percent wanted a ban on external auditor/consultant business, 69 percent favored a split in the CEO/chairperson roles, 52 percent favored the creation of a board-level risk management committee, and so forth. These director-level findings are not surprising when we examine the nature and extent of flaws that can impact the typical corporation, regardless of industry or location. Indeed, the potential problems we cite in this section (and which we illustrate “in practice” in Chapters 7 and 8) can be found in any
country with an active corporate sector. Flawed governance has no boundaries, although the strength of the checks and balances that characterize a system and surround a company can help determine the potential depth and breadth of problems. Ultimately, inadequate governance means a loss for the stakeholder. Regardless of the nature and extent of the problems, someone must pay for the loss of value, revenues, income, jobs, and tax base; shareholders, employees, creditors, suppliers, and even indirect stakeholders are vulnerable when a company has governance problems.

Detecting governance flaws

Although governance problems are often years in the making, detecting them in advance of a problem can sometimes be difficult. While internal and external controls should (and do) play a leading role in identifying problems, sometimes a major systemic change—such as a severe market dislocation or widespread deregulation—is necessary to point out shortcomings within a firm, industry, or economy. Indeed, during booming economic times, when corporate earnings are strong and stock prices keep rising, few are likely to be searching for potential problems. Oversight in such situations can be lax; governance might be seen as a theoretical exercise, and even investors must bear part of the responsibility. Those along for the ride by way of climbing stock price and increasing dividends might prefer the status quo to activist stances demanding greater transparency, better controls, or more qualified directors.

The same might be true when markets are heavily regulated and competition is negligible; with such protections, corporations need not necessarily operate efficiently, or even prudently. Only when deregulation is under way and new competitors are permitted to enter and challenge might deeper governance problems become apparent. For instance, not until Japan’s speculative bubble burst in the early 1990s did it become clear that local corporations—including some of the world’s most admired—were suffering from significant flaws related to inactive boards, overinvestment, opaque disclosure, entrenched management, and so on. Similarly, the Asian currency crisis of 1997 exposed governance problems in Korea, Thailand, Malaysia, the Philippines, and Indonesia. Currency devaluation, asset price collapse, and capital flight left the regional economies in dire straits: economic growth slowed and then contracted, major companies declared bankruptcy, and banks were saddled with large amounts of bad loans. The scope of the micro governance problems, while largely glossed over during the boom times, suddenly became strikingly clear: lack of internal controls, conflicted management, ineffective boards, and accounting fictions contributed to widespread corporate failure. Macro governance shortfalls, including weak legal and regulatory systems, poor banking regulation and oversight,
nonexistent accounting standards, and broad systemic corruption/fraud, also become obvious. The collapse of the technology/media/telecom bubble and the implosion of the US energy trading sector, both occurring at the start of the twenty-first century, serve as further examples.

In certain situations flaws exist but companies manage to continue operating without any apparent impact on their ability to generate revenues, post profits, or boost stock prices; not every flaw appearing in the governance framework is thus “fatal,” or even damaging. But many are, and it is difficult to know, ex ante, which ones will harm stakeholder interests most severely. Ultimately, the responsibility for trying to find weak points falls on many parties: internal and external auditors, employees, activist shareholders, regulators, risk managers, executive managers, and board directors. Each comes into contact with different aspects of the corporate process, and may have a unique view on whether a company’s governance framework is dysfunctional (or, indeed, whether external forces are ineffective). The responsibility is continuous, applicable in every market cycle. Although many firms and their stakeholders are now more attuned to potential failures in governance as a result of Enron et al., it is worth considering whether the momentum and discipline will remain, or whether subsequent bull markets (and associated return to record corporate profitability) will mean a return to old habits. This, as noted at the start of the book, has been the case in the past. Although certain structural changes might be enacted during bad times to prevent future problems, the desire to remain control-minded has a tendency to vanish when profitability returns. Detecting, and ultimately solving, problems must therefore be part of the corporate culture.

Although governance flaws can be classified in many different ways, we continue with the internal and external accountabilities framed in Chapters 2 and 3, with some additional detail and stratification. At the highest corporate level governance problems can arise from:

- failure of board directors and executive management
- failure of internal controls
- failure of external controls.

Figure 5.1 summarizes these micro governance failures.

**FAILURE OF BOARD DIRECTORS AND EXECUTIVE MANAGEMENT**

Governance failures at the level of directors and/or executive management can take many forms, each potentially serious. Generally, these can include:
Ineffective boards
- ineffective boards
- conflicted CEOs
- breach of duties of care and loyalty
- entrenched management
- failed corporate policies.

We consider each of these points, highlighted in Figure 5.2, below.

**Ineffective boards**

As we know, in the market and relationship models (and, to a growing degree in hybrid models that are migrating away from pure family control) the board of directors is the starting point in creating an effective governance process,
and the selection of directors is the starting point in creating an effective board. Accordingly, failure to select directors who are skilled, strong, independent, and value-added has the potential of setting in motion much larger problems. An ineffective board can fail to provide proper governance protections for a variety of reasons, including:

- lack of independence/conflicts of interest
- lack of strength
- unwillingness to challenge
- unwillingness to bear responsibility
- knowledge gaps
- excessive commitments
- insufficient focus on substantive issues
- lack of alignment
- excessive board size.

**Lack of independence/conflicts of interest**

Lack of independence, which can arise when a director has business or personal ties to executives in the company, can lead to ineffective monitoring, unwillingness to challenge, and poor judgment. Unfortunately, it is still common for directors in many companies to maintain professional relationships with their companies (providing services to the firm, and acting as “consultant” on a variety of executive management matters); some may also be personally associated with senior executives. Lack of independence can also develop through *interlocking directorates*, where CEOs serve on the boards of other companies. (Various companies in the Netherlands, Germany, Switzerland, France, Korea, Indonesia, and Mexico exhibit this characteristic.) This can breed “clubbiness” between sectors of the corporate world, creating conflicts of interest and decisions that may not be in the best interests of investors; it may also mean board members have less time to deal with board issues. In any of these situations the basic flaw lies in the possibility (and some might argue certainty) that non-independent directors will be unwilling to properly monitor and discipline executive management for fear of losing what might be a lucrative financial relationship or valued personal relationship. When this occurs, the shareholder suffers: the agent charged with supervising management becomes more interested in benefiting from its relationship with management. Naturally, the same lack of independence issues that characterize individual directors can extend to entire board
committees, such as those we have referenced in Chapter 2; this can also lead to conflict, confusion, or opacity on a variety of corporate issues.

There are no uniform standards on director independence. Although many best practice codes recommend independence, few systems or countries have mandated it specifically. In addition, it can be difficult to determine whether or not a director is independent; while the obvious cases are easily discounted, others fall into the “gray area.” (Is an executive who worked for a company ten years ago and is now joining the board as a director truly independent? What if it is only five or three years since his or her departure? Or what if the board candidate is a former regulator who was responsible for overseeing the company?) The topic is complicated and subjective. Many US and UK corporate boards feature a majority of outside members with no direct or indirect ties to management (although this is still no guarantee of a problem-free environment, as demonstrated in the cases of Enron and Tyco). Japan, in contrast, still features boards that are dominated by insiders, typically the very executives responsible for operating particular divisions within the company, as well as senior regulators and former executives, who join as “alumni” representatives immediately after they retire. Indeed, outside directors are still a rarity in the Japanese corporation of the early twenty-first century. Companies in East Asia and Latin America feature very few independent directors; while some are making greater strides in the direction of independence (such as Malaysia and Brazil), many others still feature a majority of insiders on their boards (often hand-picked by controlling family shareholders, as in Thailand, Korea, Indonesia, and Mexico). Companies in Germany and various other Continental European countries feature a reasonable amount of director independence (somewhere between the extremes of the United States/UK and Japan/East Asia).

Lack of strength

A weak board – which lacks presence, energy, drive, or technical skills, or is burdened by the conflicts of interest we have just mentioned – can be influenced by the CEO or executive team. When this occurs, executives might crush potential dissent before it becomes a significant threat, prohibit criticism of tactical and strategic motivations, or deny full access to information. A boardroom culture that discourages constructive conflict in favor of rote consent and overly collegial relations as a result of director weakness creates a cycle that might ultimately lead to corporate failure. Governance has to be proactive, not reactive, to be effective. Board directors must be sufficiently strong, capable, and independent to question and probe a potential issue before it becomes a problem, not act as a crisis management body after significant damage has been done.
There is considerable evidence to suggest that a weak board can be the root cause of very significant corporate problems, including financial distress. During the 1980s, for example, the CEOs of companies such as General Motors, IBM, and Eastman Kodak dominated their boards, permitting no challenge to their authority. Board members appeared weak and indecisive, unable to steer their companies for many years. Shareholders ultimately paid a steep price: all three firms lost billions of dollars on errant strategies, including high-cost production processes, overinvestment in capacity, and unfocused acquisitions. Although all the executives were ultimately fired after the flood of red ink became too significant, board directors were weak and failed to discharge their duties as they should have. The same types of board problem have been apparent in more recent cases, including those involving Enron, Vivendi, Swissair, and WorldCom. Board members were too ineffective (and/or conflicted) to take action until crisis struck. The same has been observed in Japan, where it is widely recognized that many corporate boards are inactive, technically under-qualified, and insufficiently independent to guide, manage, and challenge. Although exceptions exist, the generalization is valid and has been a central reason for problems such as poor resource allocation and low returns.

**Unwillingness to challenge executives**

A corollary to the “lack of strength” flaw occurs when board directors are unwilling to challenge executives. Directors serve to protect shareholders, meaning they must challenge and question executives constantly, making certain that actions are consistent with the advancement of the enterprise and shareholder interests. In many cases challenges simply do not exist. Where boards lack truly independent directors, this may be a matter of course: when directors have ties to the CEO and other senior executives, the desire to challenge is unlikely to be strong. This can readily be seen in countries with large family shareholding concentrations, such as Indonesia, Thailand, the Philippines, and Mexico. In such cases boards are appointed by the controlling family interests and are generally staffed with friends, associates, and other family members: parties who will agree with, and support, the wishes of management, meaning challenges are unlikely to occur.

However, even in situations where independent directors comprise a majority of board members, or where shareholdings are sufficiently diffuse that family members do not appoint their own representatives, there may still be a lack of intense challenge. The reasons can vary, including discomfort in acting against executives, or lack of knowledge, focus, time, or energy. It can also be based on cultural norms. For instance, in Japan decision making is often based on consensus building rather than direct
confrontation. It is awkward for a director to publicly challenge an executive, meaning that the shacho, or chief executive, is generally in control and board meetings are largely “rubber stamp” exercises – form over substance.\(^\text{12}\) It can also arise from board homogeneity (drawing candidates from a small pool of available directors). In some national systems the pool of directors is relatively small, meaning the same top executives serve on the boards of various companies (through interlocking directorates, as in Switzerland). Executives may have similar educational, technical, and professional backgrounds, and share similar views on corporate and financial matters, meaning they do not bring a fresh perspective to the management of board matters; this lack of diversity can simply stifle the process, and render directors unwilling or unable to go against the norm. It might also arise from job security: since directors are generally re-elected every year, they may be reluctant to challenge executives for fear of losing their positions. Although shareholders vote for directors, in many countries executives still have considerable influence on nominations to the annual slate of directors, and might choose not to support the renomination of those who have been troublesome. Regardless of the specific reason, any board that cannot confront management is an ineffective agent. Failure to challenge might ultimately spawn significant corporate problems, including excessive risk, ill-planned expansion or acquisition strategy, and unhealthy financial structure (such as excess leverage, or insufficient liquidity).

**Unwillingness to bear responsibility**

In some cases board directors are unwilling to take responsibility for problems that occur during their watch. When financial problems occur as a result of failure to exercise proper board leadership, directors might choose to shirk their responsibilities, claiming lack of knowledge or information, or feigning ignorance (the “see no evil, hear no evil” defense). Problems can be compounded when directors refuse to accept bad news from management, demanding to hear only what is favorable; once this becomes known within the company, management may be loath to deliver any disappointing news (such as conflicts, poor earnings, and failed strategies). This behavior is disingenuous in the extreme, particularly since directors have a legal duty to act in the best interests of the shareholders and make informed decisions. However, during some of the most significant corporate governance failures of the past few years – Barings, Enron, WorldCom, Tyco, Swissair, HealthSouth – board members disavowed knowledge of problems (or claimed to be unaware of the breadth and depth of problems), in order to insulate themselves from criticism or financial liability.
**Knowledge gaps**

Boards may also suffer from knowledge gaps, failing to understand the technical aspects of a company’s business. Such lack of knowledge can be serious: if directors are unaware of the key technical issues impacting a company’s operations, they cannot make informed decisions or provide insightful leadership, and cannot effectively discharge their fiduciary duties. Although directors are meant to bring particular skills and knowledge to the job, some have been, or are still, ill equipped to deal with the tasks at hand. This has been made increasingly obvious with the growing complexity of the twenty-first century corporate environment. Directors and executives must deal with very complicated, and sometimes opaque or subjective, issues, and may lack the appropriate depth. In many cases specific director knowledge needs to be improved in key areas such as accounting treatment, tax policies, environmental and product liability, financial risk, derivatives, SPEs, off-balance-sheet transactions, and related-party transactions. These, of course, are the very areas that have pushed some companies into considerable financial difficulties in recent years. In order to provide for greater technical depth, boards often create committees that focus on particular issues, such as audit/financial controls and compensation; this is logical since these areas are particularly important and often quite technical. However, in some instances these supposedly expert committees still lack the requisite knowledge to make effective contributions.

**Excessive commitments**

Being a director in a large corporation is an important and time-consuming duty; doing an effective job requires a significant commitment of time and effort (along with requisite experience, intellect, skills, and training). In some countries, such as the United States, Germany, Switzerland, and Mexico, it is common for directors to serve on multiple boards simultaneously. This necessarily means a director’s time, attention, and responsibilities are divided between competing demands. Ultimately, none of the companies being served gains the full time and attention of such “multi-board” directors. Although some may be able to cope, many others may be unable to deliver the required performance.

The same applies to top executives that serve on the boards of other companies. Occupying an executive position in a major public company is an intense and demanding job. Adding to this the responsibilities that come from being a director on one or more boards means doing an effective board job can become exceptionally difficult. Despite the potential for problems, the practice remains quite prevalent in many countries. In the
United States, CEOs still hold the largest number of outside directorships on the boards of Standard and Poor’s 500 companies (20 percent); in Switzerland, Mexico, and other countries it is common for top executives to sit on the boards of five to ten other firms.

**Insufficient focus on substantive issues**

When boards fail to focus enough time, energy, and debate on substantive and important corporate issues, they are not serving as effective agents. While directors may meet regularly, they may not engage in proper analysis and discussion of topics that are of critical importance to the company. For example, although the boards of Tyco, Swissair, Enron, and WorldCom met regularly, they do not appear to have focused on the substantive issues – related to corporate strategies, acquisitions, controls, potential conflicts of interest, and financial reporting – that ultimately propelled their companies into financial distress. Individual studies reveal that US boards have historically spent more time discussing compensation issues than financial reporting/control and integrity issues. While compensation is an important topic, it is less vital to most companies than financial and accounting issues, yet it often assumes the most prominent position.

More extreme cases of this problem emerge when board directors are simply not engaged on any corporate issue and act primarily as a “rubber stamp”, permitting executive management to do what it wants, and not devoting time, energy, or resources to due diligence or investigation. Although this problem can exist in any system, it is particularly noticeable in Japan, South-East Asia, and Latin America, where board meetings are largely ceremonial functions, rather than forums that promote meaningful debate and decision making. In legal systems where duty of care is a requirement, this could be construed as a breach.

**Lack of alignment**

One theoretical solution frequently proposed as a way of minimizing governance problems and narrowing the agency conflict is to align the interests of shareholders and executive management properly, generally through a common link such as stock holdings. The same might apply to directors: although they should not have the same level of shareholding or leverage (as it could skew their priorities), they must have some financial stake in the company’s success to make certain they remain diligent and aligned (perhaps a shareholding funded through personal means). In fact, board directors in many relationship-model and hybrid-model companies have little at stake regarding the company’s success, and generally lack a direct link with specific performance metrics, such as the stock price. In
such instances the primary motivation for doing a good job relates to reputation (and perhaps continued business dealings if directors have consulting or business contracts with management); economic reward through higher stock prices does not factor into the equation. This, coupled with generous directors’ and officers’ liability insurance cover, means directors have no specific financial interest in the company’s ultimate success, and can simply depart when pressures and problems appear too great.

**Excessive board size**

In some countries, such as Japan, Korea, and Germany, boards can be especially large, numbering from 20 to 40 (and sometimes more, depending on the country and industry). Although a large board size may be necessary in order to accommodate labor representatives, it is often a vestige of culture and tradition, meaning it does not necessarily serve a specific purpose or add any particular value. A large board cannot operate as efficiently or productively as a smaller one. Coordinating schedules and meetings, ensuring proper participation by all members, making certain every director has a chance to voice an opinion, managing conflict and dissension, and so on, are all time-consuming steps which are made more difficult when boards are excessively large; this time might be better spent on focused, substantive discussion. In Japan, for instance, corporate boards routinely grow beyond 40. There is significant representation by company insiders (such as divisional business unit heads, and retired executive alumni), and seniority and equitable treatment of peers mean current or former executives at a particular level must all be represented on the board, even if they are not adding any value.

**Conflicted CEOs**

As noted in Chapter 2, many companies (particularly in the United States) continue to combine the roles of CEO and chairperson. For companies that know how to manage the process and feature strong and independent boards (with lead independent directors) this may be functional in the short term (although regulatory pressures are increasing the move towards a split in the medium term). However, in some companies the joint role simply does not work. When handled improperly, dual roles can create conflicts of interest: the CEO, as leader of management and daily corporate affairs, carries certain operating responsibilities that might run contrary to those favored by the chairperson, as leader of the board of directors and agent of the shareholders. When the roles are combined, duty of care and duty of loyalty issues may be more difficult to perform, and if the board is particularly weak, the opportunity for self-dealing can increase. The effective-
ness of the supervisory role normally accorded the chairperson must be viewed with suspicion.

**Breach of duties of care and loyalty**

Directors and executives in many systems have a duty of care responsibility to investors: that is, they must make informed decisions. The courts are not concerned with the actual outcome of the decisions (as long as there is no criminal/fraudulent activity involved, in which case regulators and government supervisors are likely to intercede), only that decisions be informed. This means board directors and executives must gather all relevant material regarding an issue, give it due consideration, and then make a decision. Failure to do so represents a breach, and is an obvious governance failure. (When it represents a legal breach it may also carry penalties for gross negligence.) Directors might violate this duty because they are indifferent or inactive, or suffer from lack of time or expertise.

The duty of loyalty, which requires directors and executives to act in the best interests of shareholders, represents another potential problem area. If decisions taken by directors and managers in guiding the company bring them into conflict with shareholders – to the ultimate detriment of shareholders – then the corporate process is not operating properly. Directors, as agents, must never put their interests first, and where conflicts can arise they must recuse themselves. For instance, if the opportunity for a leveraged buyout arises, executives as future owners will obviously want to buy out existing shareholders at the lowest price possible. However, given their duty of loyalty, directors must strive to sell the company to the executive-led LBO group for the highest price possible; failure to do so is a breach of a key fiduciary duty. Again, directors and executives might breach this duty because they are unethical or conflicted, and more interested in self-dealing than advancing shareholder interests.

**Entrenched management**

Instances arise when management is insulated from external forces. When this occurs executives become entrenched and may have little incentive to operate efficiently or in the interests of stakeholders. If there is no threat of removal, management can act as it chooses and pursue any strategy it desires. Entrenchment can occur when large, management-friendly shareholdings exist and the market for corporate control is ineffective. It may also arise if the board is weak or under the control of executives. Friendly shareholdings, in particular, can serve as a barrier against outside pressure by denying other shareholders the opportunity to act uniformly. A friendly shareholding (together, perhaps, with an interlocking directorate or weak board) can lead
to continuous support of management, regardless of problems or difficulties. For instance, an allied bank or company that holds 5 percent or 10 percent of a firm through long-standing relationships might be unwilling to take dramatic action in the face of problems; the shareholding, while not a control block, might be sufficient to dissuade other shareholders from acting against executives. In addition, an ineffective corporate control market means that the discipline such corporate control transactions can instill is lacking; management need not fear a hostile takeover, LBO, or unwanted advance, and therefore has no particular need to reform itself.

We mentioned in Chapter 3 that the Japanese and German systems (among others) feature strong ties between block holders and individual companies. While this can improve monitoring and reduce agency costs, it has the potential to shield management. Management does not need to operate efficiently or make optimal corporate decisions; banks and corporate shareholders are unlikely to stand against management (at least in the short term, unless a situation is particularly dire). Pressure to perform may not be particularly strong, so the status quo may prevail. In fact, empirical research shows that in Germany outside supervisory directors are only appointed when stock prices have fallen dramatically and remain depressed for a long period of time; until that point, management is left to its own devices and may remain unchallenged. In Japan, corporate managers have been insulated from market forces for many years as a result of seniority, majority inside directors, friendly keiretsu cross-shareholding stakes, and lack of corporate control forces. Similar management entrenchment is apparent in Indonesia, the Philippines, and Mexico, where family-controlled conglomerates select, support, and defend their management teams, and in Korea, where the government has often protected incumbent managers (rarely ejecting them even in the event of corporate financial distress).

## FAILURE OF CORPORATE POLICIES

A company operates through corporate policies that provide guidance and direction on the execution of tactical and strategic plans; these are ultimately designed to allow a firm to function efficiently and profitably. It is no surprise, then, that a bad or misguided corporate policy can lead to problems. Although the list of potential corporate policy problems is extensive, and depends largely on the nature of the company, industry, and system, we briefly consider those related to:

- disregard of shareholder rights
- skewed compensation schemes
- unclear strategy
- misallocated resources
- improper corporate control defenses
- excessive short-term focus
- opaque disclosure
- unethical behavior.

Many others can, of course appear, and must be given due consideration.

_Disregard of shareholder rights_

When shareholders are unable to voice their concerns and force management, through directors, to take corrective action, or when directors and executives take actions that infringe on the rights of shareholders, governance is not working as it should. We know from Part I that investors have rights that must be respected; failure to do so leaves the investor in a precarious position, bearing all the financial risk but exercising no control. Shareholder rights can be disregarded knowingly or unknowingly. We consider just a few examples:

- **Waiver of pre-emptive rights.** It is increasingly common for corporations to seek a waiver of pre-emptive rights. As noted in Chapter 1, shareholders have traditionally been granted pre-emptive rights in order to retain their relative economic position in the company’s assets and profitability in the event of a new issue. If they choose not to take up their rights, they can sell or assign them to another party, but the decision is an affirmative one, taken by each shareholder. If a company can obtain a waiver of these pre-emptive rights it significantly increases its ability to issue new equity and dilute existing shareholders, almost at will.16

- **Dividend policy.** Under some systems (such as those based on common law), directors have the right to determine dividend policy, including how much shareholders should receive (and when). Directors may also choose not to declare any dividends if, in their view, it could hurt the company’s interests, even if the company is currently profitable.17 Directors thus have considerable discretion over dividend payments, sometimes to the disadvantage of shareholders.

- **Charter amendment.** Corporate charters that provide the power to amend are routinely adopted, giving management and directors great flexibility in altering the scope of corporate activities, voting power, the treatment of specific classes of shareholders, and so forth. Corporate
charters can be changed by either direct legislation or a direct majority vote of the corporation (as authorized by legislation or the corporate charter). Thus, the actions of a simple majority of shareholders can be used to change the position of all shareholders.

- **Corporate control defenses.** Adoption of certain corporate control mechanisms can lead to violation of shareholder rights. If one of the central goals of the corporation is to maximize enterprise value to the benefit of shareholders, defense mechanisms that block or impede such efforts obviously run contrary to rational governance. (We discuss this at greater length below.)

- **Legal protections.** Although some systems permit shareholders to bring derivative or direct class action lawsuits against management/directors when they feel that their interests are being abused, many systems (particularly those without a strong legal tradition and framework) lack protections, or limit them in some way. Shareholders may therefore not have adequate legal recourse to what might be regarded as abusive or unfair practices.

- **Minority interests.** Minority shareholders are at particular risk because they lack influence; although they supply valuable risk capital, their rights can be mistreated by management or controlling shareholders in various ways, including:
  - Lack of information: since management controls the information flow, what it chooses to disclose to shareholders is highly discretionary. While large institutional investors might try to work cooperatively with management or “fight the system,” there is little that minority shareholders can do. They must therefore try to make decisions on the basis of limited information.
  - Inadequate corporate control premiums: the history of the corporate control market in the United States, the UK, France, Germany, Japan, and other countries suggests that minority interests may be treated poorly from an economic perspective when takeovers or buyouts are negotiated, primarily by failing to obtain the same premium as control or majority shareholders (where fair price provision rules do not exist).
  - Unfavorable corporate decisions: controlling family shareholders (such as might be found in Mexico, Indonesia, or Thailand) may arrange for the payment of special dividends to majority interests only, or undertake excessively risky investments or bad business projects. If the voting structure permits these activities without the consent of minority interests, the actions of the controlling family shareholders will put minority interests at a considerable disadvantage.
**Skewed compensation schemes**

One of the most significant (and sometimes egregious), policy flaws occurs in the area of executive compensation. This is especially true in the United States, where many executives have been criticized over the magnitude of their packages, which are enormous by any measure, certainly in comparison with the average employee’s pay. While activist institutional investors have targeted these skewed pay practices regularly since the 1990s, they remain a divisive issue.

Although the absolute size of compensation is a concern, the lack of correlation between executive pay and corporate performance can be just as problematic. In fact, executives are often paid handsomely regardless of what happens to a company’s revenues, earnings, and stock price. Several reasons have been posited for the high executive pay levels in the United States: widespread use of compensation policies that are benchmarked to industry studies and peer group rankings (which can lead to “upward creep”); greater use of options as an alignment tool; and the growing practice of rewarding executives in strong years but not punishing them in weak years (keeping their compensation flat to the prior year). The pay gap widens, creating internal conflicts (with employees) and external conflicts (with shareholders).

Creating the right compensation package is essential in attracting and retaining talent, but implementing the wrong package exposes a company to bad incentives, excess costs, and possible abuses. Compensation schemes can be skewed in different ways, including tying packages solely or primarily to short-term stock price performance, failing to index option grants, granting awards with fast vesting periods, granting options for retention purposes, revaluing underwater options, concentrating option holdings, granting golden hellos without any performance targets, designing poor performance measures, awarding excessive severance packages, not expensing options, and failing to independently review packages. We consider each in brief.

- **Tying compensation primarily to short-term stock price performance.** We have noted the importance of aligning the interests of shareholders and executives; if both are working toward the same goal, such as a maximization of enterprise value, both stand to benefit. It makes sense, therefore, for executives to be shareholders of the companies they manage. However, if executives have very large shareholdings they may be unhealthily drawn to stock price performance in order to bolster their own personal, paper-based wealth, sometimes at any cost. Over the past decade there has been a tendency for the market to punish companies that fail to meet their earnings numbers; when this happens,
stock prices plummet and executive wealth evaporates (for a time, at any rate). Some executives, as significant shareholders, have thus been driven to do whatever is necessary in order not to jeopardize EPS expectations. There have been well-documented cases of executive management manipulating financial operations/statements in order to produce a better picture and boost the stock price (such as Tyco, WorldCom, and Lernout and Hauspie). Even when no malfeasance occurs, a singular focus on stock price performance can lead to short-sighted accounting, financial, operating, or investment decisions.

- **Failing to index option grants.** Compensation packages often include option grants, allowing executives to buy a share of company stock at a set strike price at a future date. In many cases, however, the options are not indexed to specific targets, but granted to executives without performance conditions. This means that executives are entitled to the options (and the economic benefits they convey) regardless of performance, as long as the stock price rises. Indexed options, which only permit an executive to claim the award once certain predetermined performance targets have been attained, are still relatively rare.

- **Permitting rapid option vesting periods.** Although options are generally granted with long maturities and reasonable vesting periods, they are sometimes given with no, or only limited, vesting periods. When options are permitted to vest too quickly, they lose their effectiveness as a tool for retaining talent and binding executive performance to long-term corporate interests. For instance, while a standard grant might vest at 20–25 percent per year over four to five years, an accelerated program might call for immediate vesting once certain performance targets are reached, or short-term vesting of 100 percent of a given year’s grant within 12 months.

- **Granting options for retention.** In many cases options are granted in order to retain talent. This may be acceptable when coupled with a proper set of index goals and a lengthy vesting period. In some instances, however, grants are given as the share price is falling, so that executive talent does not leave. In such cases, perverse incentives are created (executives are rewarded as the share price is declining and corporate value eroding).26

- **Revaluing underwater options.** When a company is going through difficult times and its share price declines steadily and persistently, options granted in prior years become worthless. They are said to be “underwater.” Depending on the future performance of the firm, they may expire worthless or regain value. However, in order to “encourage” employees and keep them focused and motivated (and “boost
morale”), management might choose to “revalue” existing grants by resetting the strike price to the new lower stock price. (In fact, this practice was fairly common in the late 1990s and early 2000s at many technology companies.) This means employees and managers have no incentive to work efficiently (since they believe their compensation will be “marked to market” when times are bad) and shareholders have to bear the additional cost of the writedown.

- **Concentrating option grants.** Although properly structured options can be regarded as a good incentive tool for a large number of employees, many companies prefer to keep the spoils concentrated within a very small number of top executives. (For example according to some studies, 90 percent of US employees get some form of option grant, but 80 percent of the value is awarded to a very small percentage of top executives.) In fact, broad distribution of options (by value) is not yet the norm in any system, a practice that sends very negative signals to middle and junior managers.

- **Granting golden hellos without any performance targets.** In order to attract new senior-level executives it is occasionally necessary to provide an upfront lump sum to the candidate(s). This is only justifiable if the package includes proper performance targets; if no targets exist, the package undermines the long-term incentive compensation process, as each future employer simply buys out the last employer’s package through a non-indexed golden hello.

- **Designing poor performance measures.** Although portions of an executive’s pay might be indexed to performance targets, they might be too easy to achieve, subject to too much interpretation, and/or “recalibrated” to new levels every year, making them ineffective as a performance-based metric.

- **Granting excessive severance packages.** Just as important as the entry and ongoing performance elements of the package are the exit dimensions; those that are overly generous in the case of forced departure (for any reason other than cause: that is, overt wrongdoing) can again remove incentives to perform as expected or desired.

- **Not expensing options.** Although there are gradual moves in some countries (such as the United States, the UK, and other nations of the EU) to expense options via the income statement (rather than simply referencing them as a note to the financials), this has historically not been corporate practice, meaning the true cost to shareholders has largely been hidden, in terms of both expense and dilution. When multi-million-dollar option grants are created for executives and
employees, the direct financial impact on operations should be recognized, but generally is not, resulting in an overstatement of net income.31

Failing to determine compensation packages independently.
Although board-level compensation committees responsible for ensuring fair play are becoming more common in some systems, CEOs may still have input into the compensation process. Indeed, in some cases a quid pro quo has developed between CEOs and board directors: in exchange for potentially lucrative compensation packages, CEOs may be willing to grant directors preferential treatment (such as consulting and project fees well in excess of the standard director’s fees).

Although compensation schemes skewed to the upside are generally the most abusive, those that provide no link between a company’s performance/share price and an executive’s pay can also be damaging. In this case executives have no particular incentive to take actions to boost long-term revenues, net income, enterprise value, and the stock price; they will simply do whatever they choose to do, knowing that it will have no direct impact on their personal wealth. This type of arrangement is relatively common in Japanese companies, where executive compensation is generally not linked directly to bottom-line performance. The same is true among family-controlled companies in East Asia and Latin America.

Unclear strategy
Corporate strategy, developed by executive management and sanctioned and guided by board directors, is the linchpin of long-term corporate activity. A properly executed strategy helps build sustainable, long-term shareholder value through competitive practices, efficiencies, market share, and so on. Unfortunately an improper strategy can turn a promising company into a misguided one. Companies that focus primarily on short-term trends and take significant corporate actions in response to competitive pressures (or as “quick fix” solutions) are not necessarily working towards sustainable shareholder value maximization. The essence of corporate strategy is to create and execute a long-term vision (bearing in mind flexibility that might be needed to respond to market opportunities); it is not about altering course to respond to the latest trends.32

Corporate control transactions are a common strategic tool in some systems. Those that squeeze inefficiencies out of a company may ultimately add value to the shareholder, while those that are used to expand into new markets or products may or may not add value. In particular,
transactions that are driven by unjustifiable empire building, or that are poorly conceived and executed, may lower enterprise value (indeed, there is enough evidence to suggest that corporate diversification can destroy value). Strategic diversification via acquisition into unrelated areas can lead initially to poorer returns, and ultimately some form of acquisition or divestiture (as demonstrated by Westinghouse, General Mills, Beatrice, Gulf and Western, ITT, Daewoo, Hyundai, and many others). Unfocused diversification can be driven by a desire to make use of excess cash (common in Japan) or manage earnings more actively (common in the United States). For instance, in the United States the practice of **EPS bootstrapping** – buying companies with low P/E ratios through a stock swap in order to boost overall EPS – occurs periodically; it is, unfortunately, an accounting fiction, virtually guaranteed to detract from corporate value over the medium term. Unfocused diversification can also be used to expand the corporate network as a show of strength and power, often at great financial cost and risk. For instance, many East Asian family conglomerates have acquired minority, majority, or controlling stakes in other companies over the years to create or expand market presence (often using bank financing in order to retain effective control, and increasing leverage to dangerous levels in the process).

Even expansion into related areas can be problematic. It is often easier for managers who are not held accountable for the use of corporate capital to acquire businesses externally than to build them internally. Taken to extremes, strategies based on rapid, large, and/or repeated acquisitions can be unwise; although the policy may be sanctioned by directors and executives, it does not necessarily mean it is a rational approach to business. Any multi-year, multi-unit acquisition must be analyzed rigorously and justified before being implemented; if it is not, the policy may lead to significant financial problems, including distress and bankruptcy. (We need only examine the unwise expansion strategies pursued by firms such as Asea Brown Boveri, Swissair, Akai/Semi-Tech, Daewoo, Global Crossing, WorldCom, and Ahold to understand that quick and large acquisition programs – even in “home industries” – can be very damaging.) Problems include financial strain through excess leverage and goodwill, inability to digest personnel, culture, and resource requirements.

The reverse of the expansionary strategy finds a company stagnant, rooted in its traditional methods of conducting business, and unwilling to adapt. This approach may be just as flawed, because in a dynamic business environment characterized by deregulation, free trade, technology, excess capacity, and corporate restructuring, a company must consider new higher-return businesses, as well as the redesign of existing processes if it is to maximize enterprise value. This is especially true for established companies in mature industries.
**Misallocated resources**

Misallocation of corporate resources can take many different forms, from misuse of company property (for example theft, damage, fraud, and asset stripping) to retention of excess cash and unwise investment decisions. While the misallocation is often unintentional (such as waste, not operating efficiently, or not properly gauging investment returns), it can also be fraudulent (as with senior executives flagrantly using corporate resources for their own personal gain/benefit) or poorly conceived (for example, stripping out corporate assets and moving them to offshore subsidiaries to gain preferential tax/regulatory treatment). When resources can be misallocated, corporate policies and controls are obviously ineffective and shareholders suffer losses.

The misallocation of capital in support of corporate investment activities can have a significant impact on shareholders. A pattern of poor investment (in negative, or only marginally positive, NPV projects), or unfocused and unwise acquisitions (as above) means that capital is not being deployed optimally and shareholder returns are not being maximized. Companies that lack a disciplined approach in evaluating their investment allocations face a basic flaw in their monitoring and management process. A company with excess capital that cannot find adequate returns should return capital to shareholders. Failure to do so leads to ill-advised investment, expansion into dying industries or unfamiliar areas, build-up of excess capacity, operating inefficiencies and, ultimately, poor returns.

Excess capacity, a problem that plagues many industries during specific economic cycles, can arise for a number of reasons. Trade globalization and deregulation might allow the quick entry of new competitors with supply of their own; market demand might fall below available supply (“demand reduction,” such as might occur during a protracted recession); capacity might expand through technological and production efficiencies; current inventories might be made obsolete by advances; market participants (such as venture capitalists) might continue funding projects that inject new supply into the marketplace; new production management techniques might speed product time to market (as with “just in time” manufacturing, and total quality management); and so forth. Since it appears in different sectors over time (such as automobiles, tires, telecommunications services/fiber optic capacity), companies must remain vigilant by focusing on information flows that indicate whether capacity is growing, margins are eroding, and exit is warranted. Inability to understand these shifts might indicate broader management, strategic, or informational problems.

Accumulation of excess capital has been a problem in countries such as Japan and Korea. For instance, from the 1980s through the millennium Japanese companies built up excess cash on their balance sheets, which
they have either retained in liquid form (Japanese industrial companies average 10 percent liquid assets, a much greater proportion than similar companies in other countries) or reinvested in projects that create excess capacity or provide exposure to unrelated areas. The end result was, and in some cases remains, poor returns for shareholders (discounted cash flows well below those from core operations). In fact, there has been a considerable misconception regarding the profitability of Japanese companies for some time: the return on equity of many companies has declined steadily since the mid-1990s as a result of reduced profits arising from ill-advised expansion and lax investment decisions. Many firms have been extremely inefficient and unprofitable at the operating level, only boosting net profits through extraordinary gains (such as asset sales) or zaitech operations (financial speculation activities).

Misallocation of resources is not unique to Japan and Korea, of course. US companies face similar types of problem, in part because they are too often concerned with the short-term environment (as noted below). They might sacrifice attractive, long-term, positive NPV projects in favor of short-term actions designed primarily to boost EPS or the stock price. In such cases resources are not being used to maximize enterprise value over the long term; the supposedly “efficient” US capital markets thus permit sub-optimal allocation of corporate resources. In general, many US companies demonstrate lower investment in property plant and equipment (PP&E) and R&D than their Japanese and German counterparts. This is not because PP&E and R&D commitments do not have attractive returns, but because they tend to be very long-term in nature.

It is not enough to identify the existence of excess capital. Mechanisms must exist to return capital to shareholders, and if a company cannot do so efficiently, then the external environment is flawed. If companies do not, or cannot, return capital regularly, they may jeopardize their ability to raise fresh funds in the future; if shareholders do not feel that they are properly protected from other stakeholders in the allocation of risk resources, they will be loath to commit additional funds. In countries such as the United States, the UK, and Canada, it is relatively easy for firms to return excess capital by granting special dividends (depleting the retained earnings account by the desired amount) or conducting stock buybacks (increasing the treasury stock contra account by the desired amount). German companies can return capital through tax-advantaged dividend payments (although they cannot repurchase shares). In Japan the process can be far more difficult (and may be at least one reason for the cash retention and unfocused corporate diversification that have plagued the system for the past two decades). For instance, Japanese companies were unable to repurchase stock until 1995 (and still face certain limits and restrictions), and dividend payments to other companies are often tax-disadvantaged.
Improper corporate control defenses

M&A, LBOs and other corporate finance transactions can play a role in helping impose management and director discipline. In active markets it is generally held that even the specter of acquisition/restructuring serves as an important governance check. Actual transactions can, of course, force changes and crystallize value. The wave of activity that started in the 1980s and continues to the present time has caused companies in the United States, the UK, Canada and the Netherlands, among others, to adopt a range of corporate control defenses.45 (Defenses in Japan are still rather uncommon, primarily because alternative mechanisms are used in place of corporate control transactions: main bank monitoring, keiretsu cross-shareholdings, and so on. Although Germany features main bank monitoring, it has adopted most US/UK-style defense mechanisms and has extremely stringent antitakeover defense laws.) In some cases defenses are constructed very quickly and approved by shareholders without much consideration; on further inspection some of them appear not to advance the governance cause (and may actually do the reverse). In fact, some activist investors actively critique these antitakeover defenses when they run contrary to proper corporate governance.

When defenses are created to protect the company they may be entirely justifiable (for example, ensuring minority shareholders receive a fair price for their shares, or blocking the payment of greenmail). Indeed, they are likely to be an excellent way of ensuring that stakeholder interests are upheld in the face of hostile forces. In the United States, many states have adopted antitakeover legislation that is intended to protect companies from damaging hostile activity (such as the greenmail-style and asset disposal techniques). However, the same defenses can also be used to shield or protect management. When this occurs – again, at the expense of shareholders – governance is flawed. In fact, by shielding the company from an advance through defensive mechanisms, the board is deflecting its primary responsibility: to decide the fate of the corporation, in light of the facts of a specific deal, and with a view towards advancing the best interests of shareholders. When the board insulates itself from this responsibility by creating a wall of defenses, the interests of investors may not be represented properly. In fact, directors and executives may be more interested in preserving the status quo and protecting their own interests. This becomes clear when we examine certain techniques that are designed to block the possibility of a corporate takeover: in some cases the defenses invoked can result in significant value destruction, rather than protection. Although not every defense mechanism can be used in every country, common techniques encountered in the overall corporate control market include:
Poison pills: a broad category of antitakeover measures, designed primarily to make a target company’s stock look less attractive to a suitor. For instance, a flip-in pill allows existing shareholders (but not the acquirer) to buy more shares at a discount, and a flip-over pill permits stockholders to buy the acquirer’s shares at a discount after the takeover. Through their structural characteristics many pills make it virtually impossible for hostile cash tender offers to succeed. Pills often have an extremely dilutive effect, which works against the acquirer’s plans (and potentially against existing shareholders, who see more of the “profit pie” divided among a larger number of investors). Pills have become quite popular in various countries as they can usually be designed and enacted quickly, without specific shareholder consent (although in some countries, such as the UK, directors cannot use pills to thwart hostile takeovers).

Dead-hand clauses: provisions contained within some poison pill defenses that permit only incumbent (dead-hand) board members to redeem proxy contest offenses.

Staggered (classified) boards: a tactic where an external bid automatically triggers a change in the board re-election policy, from annual to staggered and lengthened: for example, only a third of directors re-elected every year, so that the entire board can only be replaced over a three-year period. This means a potential acquirer will be unable to engage in a proxy battle within a one-year time frame to remove the board and undo poison pill defenses, which acts as a potential deterrent. Staggered boards are seen as quite controversial, as shareholders lose the ability to remove board members freely on an annual basis, which is a key right in most systems.

Voting caps: provisions allowing companies to restrict votes to a particular percentage of a company’s stock, regardless of the stake held; such caps are quite common in Germany.

Dual class recapitalizations: as noted in Chapter 3, DCRs can serve as a defensive mechanism in a hostile takeover. If a dominant group has absolute voting power/control, the company cannot be taken over without the agreement of management.

Supermajority votes: a defensive tactic requiring a supermajority, rather than just simple majority, vote by shareholders on any proposed takeover or corporate control action.

Delay mechanisms: any legal tactic employed by management to delay a time-sensitive vote or action (such as requiring registration of shares).
Scorched earth defenses: a broad group of defenses that, when enacted, create a significant amount of “corporate destruction”; the strategy centers on conveying the existence of such defenses to would-be acquirers in the hope that it will be sufficient to dissuade any action.

- Macaroni defense: a defensive tactic where the target company issues a large number of bonds with redemption clauses requiring the securities to be redeemed at an excessive premium in the event of a takeover.
- Crown jewel defense: a defense calling for the immediate sale of prized corporate assets to a third party in the event an acquirer’s bid is successful. This ultimately lowers the value of the company to the acquirer.
- Pac Man defense: a defense where the target company submits a counterbid for the acquiring company (the “hunted” becomes the “hunter”). This can result in a significant increase in the target company’s own leverage profile.

Golden parachutes: the payment of large compensation packages to executives who are forced to leave following a takeover. The amounts may be quite considerable and are designed to protect executive management.

Again, the ultimate test of any corporate control defense mechanism is to determine whose interests are being served: shareholders, managers, or directors. When a company implements defenses that are designed primarily to serve managers or directors, and not shareholders, then a governance problem exists.

Excessive short-term focus

Companies adhering to the market model often have a predilection for shorter-term time frames, and the focus on near-term earnings and stock price movement as the barometer of corporate performance is an unfortunate by-product. In some instances it has taken deep root in the corporate culture, creating a practice of only reporting good financial results in order not to disappoint the marketplace. Investors, managers, and directors come to favor the market, earnings, and stock price gains that can be achieved during the next quarters, rather than the sustainable value that can be created over the long term. While it is always tactically important to pay attention to near-term performance, focusing an excessive amount of energy and resources on short-term goals and expectations as a corporate policy can be unhealthy.
Influential financial analysts (who publish negative comments if quarterly EPS targets are not met) and powerful short-term institutional investors (that routinely sell blocks of stock in response) are the primary sources of external pressure. In order not to disappoint these constituencies, executives (with or without the consent of directors) manage short-term EPS via reserve movements, revenue recognition policies, and so forth. This phenomenon appears to have accelerated in recent years, fuelled in part by technology, easy access to information, and “day trading,” as well as executive compensation packages weighted heavily towards the stock price. The extreme version of this behavior centers on management willingness to do whatever is necessary to keep the stock price buoyant from quarter to quarter; this may occur legally (although perhaps not rationally) or illegally. Short-term institutional investors must bear some of the blame, as they are often quick to sell their holdings when expectations are not met. Ultimately, an intense focus on short-term measures jeopardizes longer-term, value-producing activities, including R&D and capital investment, which may be put at risk. (For example, directors and managers may feel unable to explore strategic plans properly as a result of the short-term pressures to which they are exposed.)

**Opaque disclosure**

The information asymmetries that characterize most director, executive, and shareholder relations are central to the agency problem we described earlier. Management controls the critical information flows within the company, meaning it can decide what to share with others. Since this is a “gray area” where management has considerable discretion regarding timing and detail of disclosure, the potential exists for abuse, or misuse. In order to advance its own position management may chose to provide board directors (and ultimately investors), with very opaque information, or perhaps no substantive information at all, although it does so at its own risk. It may express information in some “non-traditional” way that does not convey an accurate financial picture (such as *pro forma earnings reports*, which express profits by excluding exceptional costs, such as merger expenses, or including exceptional gains, such as one-time asset sales). In the most egregious (and illegal) cases it may convey fraudulent information in order to exploit corporate resources rather than maximize value (as in the cases of Enron, Lernout and Hauspie, Adelphia, Tyco, and WorldCom).

Lack of transparency accompanying the increasingly sophisticated financial dealings of many companies (including asset-backed securitizations, derivatives, SPEs, and related-party transactions) means that it can be difficult for financial controllers and internal and external auditors to
verify the type, quality, and accuracy of disclosure. Directors and investors have little hope of properly judging a company’s position; financial engineering adds another layer of confusion to the information and disclosure process.\textsuperscript{51} When information asymmetries exist between insiders and outsiders it is difficult for debt and equity capital providers to monitor management and make effective use of incentive contracts. The same asymmetries also make it difficult for the corporate control market to function properly. The inability for potential acquirers to discern a company’s true financial position as a result of asymmetries means that unwise bids may be launched or beneficial bids rejected. In either case, the corporate control market, which is an important macro governance mechanism, fails to perform its role.\textsuperscript{52}

Information opacity is still very widespread. For instance, companies in Japan, Switzerland, the Netherlands, China, Indonesia, the Philippines, Korea, and Mexico (among others) typically provide little financial information of substance; most regulators do not yet require clear and detailed disclosure, and few investors have been aggressive in demanding such data. Family-controlled conglomerates in East Asia and Latin America have little incentive or motivation to change their disclosure practices, as they rarely access the external capital markets. Companies in Japan and Switzerland that rely heavily on funding via long-term bank relationships (rather than public capital markets) can likewise avoid the incremental disclosure that might be required for public debt capital issues.

Investors in financial institutions are particularly susceptible to problems created by opaque disclosure. For instance, it can be very difficult in some countries to determine the true nature and status of bank loan quality. A bank may decide to take more risks by buying higher yielding assets or lowering its underwriting standards; this might provide a short-term boost in income (and larger executive compensation packages), but capital providers are unlikely to know whether the risk is being managed properly or generating a fair return (for instance, in some instances prices to determine the value of financial assets are not readily available). This can be compounded by the use of derivative instruments (financial contracts that derive their value from some underlying market price or reference) that permit risks to be shifted or assumed at will, and without much transparency.

\textbf{Unethical behavior}

Unethical behavior among directors, executives, and employees is a problem that can occur directly, indirectly, or systemically. It can arise from lack of knowledge, low morale/indifference, career pressures, pursuit of financial gain/career advancement, and so on. In a direct sense, lack of
leadership from board members and executives regarding ethical corporate behavior will soon be infused throughout a company. In fact, the “tone at the top” sets the direction of behavior in every organization, and if senior leaders do not uphold standards of ethics and morality, there is little incentive for others in the firm to do so. This can ultimately lead to lack of integrity and respect, violation of rules/policies, and mistreatment of clients, suppliers, investors, and others. Poor behavior can manifest itself in many ways, including falsification of financial statements, alteration of product/manufacturing/safety standards, deceptive sales practices, theft, fraud, embezzlement, harassment, and corruption. The problem is, unfortunately, widespread;\textsuperscript{53} there are many examples of poor behavior driven by top management and/or directors, such as Enron, Andersen, Salomon Brothers (prior to its “bail-out” by Buffett and eventual acquisition by Citigroup), Bankers Trust (prior to its acquisition by Deutsche Bank), Drexel Burnham Lambert, WorldCom, Tyco, Adelphia, HealthSouth, Kmart, Lernout and Hauspie, and Bank of Credit and Commerce International.

Unethical behavior can also appear indirectly. It may be expressed not by the specific actions of directors or executives, but by their willingness to disregard violations of ethical behavior in others. Again, many examples of this behavior exist: price gouging by US energy companies during the power crisis of 2001, false research recommendations by Wall Street investment banks during the telecom boom, and so forth. Systemic elements of unethical behavior can be found in certain emerging nations, where a tradition of corruption may be well established and widespread. For instance, in countries such as Indonesia, Thailand, Korea, and the Philippines, there have been (and continue to be) many instances of corrupt practices between companies and regulatory and/or political authorities (such as bribery, and special compensation for favorable treatment/protection). In some cases it can reach significant proportions. For instance, in Indonesia, the practice of “KKN” (an Indonesian acronym for corruption, collusion, and nepotism) has become so prevalent in the corporate sector that it has eroded internal and external confidence to a considerable degree. This has impacted broader economic growth targets. (The problem, unfortunately, is not limited to the corporate sector: many political and governmental institutions are also plagued by similar behaviors.)

\textbf{FAILURE OF INTERNAL CONTROLS}

We noted in Chapter 2 that internal controls – the independent, technically capable groups and associated policies/procedures that are intended to provide proper checks and balances – are an essential requirement of any governance process. Without strength in this area a firm is vulnerable to
pressures and problems. Key areas of potential breakdown, highlighted in Figure 5.3, include:

- lack of technically qualified, independent controls
- liberal accounting policies
- excessive risk-taking
- inadequate internal audits.

**Lack of technically qualified, independent controls**

Independent control functions centered on financial control, risk management, audit, operations, legal/compliance, and so forth, must be both technically capable and independent in order to be effective. Since these functions generally deal with highly technical matters, an appropriate level of expertise is required. Failure to staff areas with the proper skill set and experience sets the stage for potential control failures, which may lead ultimately to losses, or worse. For instance, a risk manager who is not qualified to review technical aspects of market risk might make the wrong decisions regarding the allocation of a particular amount of exposure. Similarly, a lawyer who is incapable of protecting a company’s legal position might cause the firm to be subject to lawsuits or prejudiced positions.

Control units must also be independent, operating under authorities granted by the board and reporting back up through high-level executive or board channels. If the units are managed or compensated by business
groups – the very ones they are meant to be monitoring independently – conflicts of interest can easily arise. For instance, the accounting division might be willing to reflect better results for a business unit if it believes that unit (as manager of its activities) will grant larger bonuses. Alternatively, if a business unit has direct control over operational and accounting flows it can create any fiction it wants in order to boost its performance. Failure to enforce independence is thus a fundamental flaw that can have costly consequences. Some companies have discovered the significant problems that can arise when strong and independent internal checks and balances are lacking. For instance Barings, Daiwa Bank, Kidder Peabody, Sumitomo Corporation, and Allfirst, among others, posted significant losses by failing to separate “front office” trading functions from “back office” settlement and operations functions. Similarly, Enron featured significant breakdowns within its finance department, as those responsible for managing financial controls were also running external investments and manipulating financial results.

Liberal accounting policies

Accounting practices are often a source of governance problems. Some companies use accounting policies that seek primarily to improve reported EPS; business decisions might be taken with a view towards the earnings, rather than cash flow or investment, impact. In fact policies might be more closely aligned with those used by sell-side analysts (such as investment banking research analysts) than those used by long-term buy-side analysts (such as pension and retirement fund analysts). Management might spend time courting sell-side analysts and making business decisions that generate good accounting numbers for short-term investors, instead of focusing on long-term value investors and the proper choices needed to increase sustainable enterprise value. Management’s accounting philosophy may thus be on measuring, rather than creating, value. In the most extreme circumstances this might lead to accounting manipulation and fraud, as numerous corporate failures have revealed.

Accounting is a necessary corporate tool and a vital check and balance; but it is intended to provide internal control and audit measures, not serve as a shareholder valuation tool. When it becomes a stock price valuation metric, there is every temptation to use rules (such as those we have summarized in Chapter 1) as liberally as possible. This may include excessive management (or manipulation) of reserves, liberal capitalization of expenses, aggressive use of SPEs, and so forth. While these may conform to the “letter” of the rules (particularly in a GAAP regime), they may do little to adhere to the “spirit,” or intended aim. Ultimately, aggressive accounting standards (along with inadequate internal or external audits) can lead to the creation of
inaccurate financial statements, which may have to be restated when policies are tightened or errors are discovered (an event that is virtually guaranteed to create investor concern). Unfortunately such restatements are all too common, suggesting that accounting standards and associated controls remain a weak link in the governance process (in the United States alone more than 330 companies had to restate their revenues in 2002, including 74 that restated by more than US$1 billion combined). Accounting standards that are too flexible and liberal, and not firmly grounded in discipline and regulation, can also lead to problems. This often occurs in developing model systems, where local accounting rules may be fluid, subject to interpretation, altered to suit particular market conditions, or simply ignored. These provide investors and other stakeholders with no value.

Excessive risk-taking

Poor internal controls, director inattention/unwillingness to challenge, or lack of formal policy/strategy can lead to excessive risk-taking. For our purposes we classify the risks as execution risk, operating risk, financial risk, and process risk.

- **Execution risk** can be defined as the risk of lowering enterprise value by not being able to gain entry properly into a new market/product or absorb a new acquisition. For instance, when a company acquires another firm, it must spend considerable time, resources, and effort to ensure that proper integration occurs (of culture, technology, employees, infrastructure, and morale). This process is complex, and can lead to control problems and lower enterprise value if not managed diligently. (For example WorldCom, helped by easy access to leverage and a buoyant stock price, acquired many major telecom properties but was unable to integrate them into a cohesive platform. Similar problems occurred at Asea Brown Boveri, Waste Management, AOL/Time Warner, and Swissair, among others.)

- **Operating risk** can be defined as the risk of lowering enterprise value by not being able to conduct daily business operations as a result of business interruption or disaster. A company might not have a business interruption or disaster recovery plan in place, meaning it is susceptible if physical damage prevents continuation of business. While the financial impact can be mitigated by relevant insurance coverage, it is unlikely to result in full recovery of damages.

- **Financial risk** can be defined as the risk of lowering enterprise value by not being able to manage credit, market and/or liquidity risks properly. For instance, the lack of a risk management function (or one that
is not independent or is technically unqualified) can lead a company willingly or unwillingly to assume more financial risk than it is capable of handling. This might be in breach of internal and/or regulatory guidelines and lead to financial pressures. Many companies have fallen victim to this problem: for example Procter and Gamble, Taheto Chemical, Gibson Greetings, Sandoz, and TPI Polene have lost considerable sums through their financial risk activities. Excess financial risk can sometimes be taken without full knowledge of shareholders. Some companies use their treasury operations as profit centers rather than conduits to lower funding costs and hedge risks. The gains and losses generated by such units can be considerable, although the nature and magnitude of risks being taken may not always be clear to investors (or, indeed, directors and executives).

Process risk can be defined as the risk of lowering enterprise value by not being able to manage operational risks properly. A company that suffers from poor internal controls – arising, perhaps, from a combination of weak policy, process, procedures, data, technology, and infrastructure – is very likely to suffer from control failures, settlement problems, and so forth. In some cases these mistakes can be very significant, causing a firm to lose millions of dollars through errors that might be entirely avoidable. Failure to identify properly these pockets of process risk means a flaw in a company’s risk process and controls. Inability to act on such errors also means lack of management attention to what might be a very significant problem.

Inadequate internal audits

The internal audit function is an essential element of the control infrastructure, and must be capable of examining any aspect of corporate operations to determine whether policies and procedures are adequate, secure, and functioning as intended, or whether new controls are required in order to close loopholes or correct errors. Again, such units must reflect an appropriate level of independence in order to be effective. They must also be properly staffed; this means hiring professionals with enough technical skills and stature to perform the job properly. Unfortunately, in some systems internal audit teams are not given the proper resourcing or authority, meaning the quality, quantity, and depth of work can suffer.

Over the past few years it has become evident that internal audit controls do not always work as intended, and can fail to detect problems, mistakes, or fraud (sometimes for extended periods of time). They may even contribute to control problems. For instance, internal audit controls failed rather dramatically at Enron, WorldCom, Tyco, Xerox, Lernout and Hauspie, Cendant, and
Ahold, leading in some cases to large earnings restatements and even outright financial failure. This does not mean that auditors alone are to blame in such cases. They are just one link in the governance chain, and the entire chain must be strong in order for governance to be effective; but they are a vital link, and any weakness can have a negative impact throughout the organization.

**FAILURE OF EXTERNAL CONTROLS**

The failure of external controls can cause, or compound, corporate problems. The macroeconomic environment establishes the framework for corporate investment. A stable system fosters capital formation and investment, while an unstable one – plagued by large deficits, low savings, tax incentives that direct resources from investment to consumption, poor regulations, and weak external scrutiny – creates challenges and problems. Poor conditions in the macro environment influence capacity and willingness to invest; companies may thus lack access to risk capital, meaning insufficient resources for productive development, and little, or no, scrutiny by the capital markets. Many of the external forces we have discussed in Chapter 3 can be flawed in some way. We focus our attention on:

- inadequate regulatory mechanisms
- insufficient legal/bankruptcy regimes
- lack of block holder/activist investor monitoring
- weak/underdeveloped capital markets
- misguided/insufficient corporate control activity
- unacceptable external audit practices.

Figure 5.4 summarizes external control failures.

**Inadequate regulatory mechanisms**

Regulatory schemes are designed to strengthen overall governance processes by requiring compliance with specific rules and behaviors. However, there are instances when regulatory processes fail in practice, and actually weaken the corporate governance process. We consider a small number of examples, noting that many others exist.

- **Lax/ineffective oversight.** In some cases regulatory oversight might simply be insufficient. Regulators may not have the technical skills or
political support/mandate to supervise properly. Regulators might be unable to gain the cooperation of individual companies and lack the clout to punish or discipline; they may also be unable to decipher a company’s financial position and activities as a result of poor disclosure standards. While lax oversight can theoretically occur anywhere, in practice it often occurs in developing markets, where the tradition of regulation is not as deeply established or accepted. In fact, some emerging nations have a relatively underdeveloped system of corporate regulations, which may permit companies to own large stakes in banks, corrupt practices to be ignored, minority shareholders to be mistreated, and so forth. Under such circumstances it is difficult to believe that companies can willingly and effectively institute good governance practices. In the most extreme circumstances regulators may turn a blind eye to potential malfeasance if they can profit personally. Behind the scenes corruption/cronyism between corporate directors and executives, regulators, elected politicians, ministerial bureaucrats, and law enforcement officers is an unfortunate characteristic of certain emerging markets (such as Indonesia during the Suharto regime, and Korea during the Roh-Tae Woo regime). Such regulatory abuses breed corporate misdeeds, nepotism, secrecy, and collusion, to the detriment of corporate stakeholders.

- Moral hazard. Certain regulations can cause companies to behave recklessly. For example, deposit insurance – which is well established in many national banking systems – protects small depositors by reimbursing them for capital lost in the event of bank failure. Individual depositors, knowing that they are properly protected, have less interest in
monitoring banks to ensure that their funds are safe. Bank management, knowing that depositors are not monitoring its activities, might shift more funding from the institutional deposit market to the retail sector, and engage in riskier business in order to try to generate greater earnings (and boost the stock price). This is akin to the moral hazard problem that affects insurance companies (where insureds, knowing they have coverage, will behave less carefully). In a similar light, government guarantees of corporate obligations can cause managers of such companies to behave just as they wish, knowing they have the financial resources of the government supporting their decisions. This may also cause bankers and investors to be less discriminating in lending/investing to supported companies (the practice has been quite evident in Korea, Indonesia, and Thailand in recent years). Another example arises when banks believe the local central bank serves as a lender of last resort. Existence of a financial backstop might lure a bank into lowering its loan underwriting standards or assuming more risk than is advisable or permissible. False comfort may also be obtained when financial authorities are permitted artificially to protect or support a marketplace in order to instill “investor confidence.” For instance, during the 1990s it was common practice in Japan for the Ministry of Finance and Bank of Japan to direct the then-Big Four securities firms\textsuperscript{56} to support the stock market through “price keeping operations” (PKOs), or “buy programs” designed to boost market levels and make investors feel more confident. Such discretionary authority was only limited in 2001 (but still exists, to a certain extent).

- **Restrictive/liberal ownership rules.** Regulatory restrictions barring or capping ownership of some companies can eliminate the block holder monitoring mechanism. We have noted that investors holding a concentrated block in a company are more likely to play an active role in monitoring. However if a bank, family business group, or other institutional investor\textsuperscript{57} is barred through regulations from holding a sufficiently large stake to justify the agency monitoring costs, an important governance mechanism is lost. Regulatory ownership restrictions (combined with a weak market for corporate control\textsuperscript{58}) might also mean that companies need not be as efficient in their operations. The reverse scenario can also be problematic. When regulators permit companies freely to own minority or majority stakes in other companies or financial institutions, governance problems, such as asset stripping or captive borrowing, can arise.

- **Competitive barriers.** Government regulations that bar foreign or local companies from competing against state-owned firms, or that permit the development of oligopolies or monopolies, can create an environment characterized by price gouging, unfair trading practices,
operating inefficiencies, entrenched civil servant management ranks, and so on. While pure market competition instills a sense of management discipline (and, in a perfectly competitive world, ensures management always works in the best interests of investors), a company’s position as an oligopolist or monopolist lets it control its destiny much more closely. Without the pressures of external competition and the additional transparency that is created, a company may choose to operate with greater opacity (for example in matters related to pricing, supply, and financial strength). In some systems, particularly in the emerging markets, oligopoly or monopoly forces can be created through a combination of family/controlling shareholder interests and corruption/cronyism. Through quid pro quo arrangements, companies may negotiate with political officials for special protections, market access rights, and so forth, in exchange for economic payments or political support.

- **Unclear monitoring incentives.** Regulatory mechanisms that lead to joint supervision and ownership conflicts of interest can also create governance problems. For instance, government departments might be direct owners of state corporate/banking assets (for example, in the emerging markets approximately 40 percent of banking assets are state owned)\(^5^9\). In such cases a government agency has little upside in ensuring the firm operates efficiently (costs are borne by taxpayers) and has little downside (losses are borne by taxpayers). Government officials charged with managing these relationships have no funds at risk and serve on the basis of political appointment. Their qualifications and interest in monitoring the affairs of such companies may be tenuous, meaning a robust monitoring function is unlikely to exist.\(^6^0\)

- **Supervisory conflicts of interest.** Regulatory officials, in their role as “watchdogs,” may be subject to a range of conflicts that impinge on effective monitoring. Potential conflicts can arise from possible future employment opportunities at a company under regulatory supervision, potential direct/indirect financial gains, and so on. For instance, in some countries senior regulatory supervisors are often interested in working for the institutions they regulate. Japan, for example, possesses the concept of *amakudari* (literally “descent from heaven”), where senior financial regulators are granted executive jobs/directorships at financial institutions. This may lead to instances of lenient supervision in exchange for future employment (not unlike the problem impacting the audit industry).

- **Inadequate regulatory disclosure.** Although regulatory reporting and standards are often adequate, they can sometimes fall short of the mark
or actually create perverse behaviors, meaning stakeholders may not receive proper protections. For instance, in the United States, pension plan accounting rules were altered in the 1990s to permit companies to “smooth” the quarterly changes in pension portfolio values. Accordingly, gains/losses are not immediately reflected in quarterly financials, but smoothed over a period of years. This change was originally praised as a way of reducing corporate income statement volatility, but has since become a mechanism by which corporate results can be “managed” (for instance, it is difficult to distinguish gains from earnings coming from core operations versus pension activities). Many other examples exist.

**Insufficient legal/bankruptcy regimes**

National legal and bankruptcy regimes ensure that investors are protected, and when financial distress appears increasingly inevitable, the rights of creditors are recognized. In some cases the bankruptcy framework also affords distressed companies an opportunity to seek court protection in order to reorganize their finances and capital structure (preserving as much value as possible and re-emerging as a viable entity). All of these steps must be performed fairly and efficiently so that stakeholders are not prejudiced; systems that cannot provide basic legal and bankruptcy measures risk the safety of many stakeholders. Those that cannot deal effectively with fundamental aspects of corporate law such as shareholder protections, fiduciary duties, derivative actions, contracts, debt covenants, collateral/security, capital markets access, disclosure, reorganization, and liqation, weaken the corporate environment. Without these protections it is difficult, sometimes impossible, for companies to raise capital efficiently: investors and lenders, noting the lack of legal/bankruptcy protection, will rightly choose not to supply capital. While inadequate legal protections can theoretically exist in any system, they are more likely to be encountered in emerging markets, where corporate law is not always as detailed or comprehensive, case law is not as extensive, or legal activities not recognized from a cultural perspective.

**Lack of block holder/activist investor monitoring**

Relationship systems often feature bank or large shareholder monitoring, while market-model systems support some degree of activist institutional investor monitoring; both, as we have noted, can supply important external governance checks. In some instances, however, these monitoring groups do not exist or fail to do a proper monitoring job. When they do not exist (perhaps financial institutions do not hold sufficiently large equity stakes,
or activist groups are not an established tradition), stakeholders lose additional inspection and due diligence capabilities. When they do a poor monitoring job (perhaps they are conflicted or burdened with other concerns), investors may suffer even greater damage, deriving false comfort from an additional level of detailed scrutiny they believe is occurring.

Those that can theoretically monitor but do not must bear some responsibility for governance flaws. Although governance processes exist to protect investor rights, investors themselves must fulfill certain duties if they want to ensure a company is successful in meeting its goal of maximizing enterprise value. Investors have four choices when it comes to dealing with inadequate or ineffective directors and executives. They can remain “engaged” investors, educating themselves on critical issues and voting at AGMs; they can take a more activist stance and attempt to advance changes through formal and informal mechanisms; they can remain passive owners and simply accept what happens; or, they can sell their stock and redeploy their capital in some other investment. In many cases it is easier to remain passive or sell stock than challenge directors and executives; the energy, and costs, associated with trying to discipline wayward management can be quite significant. This means the monitoring opportunity is lost.

If investors are to be effective in performing their role, they must have the mind-set of owners rather than short-term traders. Unfortunately, in some market model systems investors such as mutual funds (unit trusts) have a short-term trading mentality. These investors are more interested in short-term trading gains created through EPS announcements or supply/demand forces than long-term value accumulation created through sound strategies and governance. As long as a company can continue producing ever-increasing EPS and investors can take short-term actions based on that trend, they will have little interest in the composition of the board, nature of the audit relationship, quality of risk controls, or magnitude of long-term investment and R&D. Long-term goals may be sacrificed: a company may underinvest in its future by sacrificing multi-year investment, capital expansion, or R&D in order to bring more money down to the bottom line for disbursement to shareholders (and/or increase tactical activities that will induce a short-term boost in the stock price).

Weak/underdeveloped capital markets

Liquid and efficient capital markets are vital to the smooth functioning of corporations and the corporate control market. A firm must be able to raise an appropriate amount and type of capital in order to conduct operations, and should be able to do so as cost-effectively and efficiently as possible. Tapping the capital markets brings with it an additional level of scrutiny
(through disclosure requirements that accompany most public securities issues), and makes possible the corporate control transactions discussed in Chapter 3. If the capital markets are illiquid and/or undeveloped and a company has access to a captive banker, it may simply choose to build up excess leverage without facing the external scrutiny provided by public investors. For instance, the markets of East Asia and Latin America still feature rather limited depth of liquidity as a result of concentrated shareholdings and a preference for bank financing. Concentrated owners have little incentive to subject themselves to the rigors of the capital markets when they enjoy access to financing through other channels (channels that also allow them to retain control, albeit at the expense of greater leverage). In Switzerland, Germany, and Japan, although the capital markets are reasonably deep and represent a ready source of funds, companies have traditionally relied on bank loans to fund their operations, meaning public market scrutiny is much less intense than in market model countries.

If a capital market is not governed by regulations that provide a check on “quality control” – that is, the markets allow any company, with any particular record of financial performance, to issue securities, without rigorous disclosure – it is simply a question of time before investors are burdened with losses from issuing companies that default. (There is evidence that this occurred in the Russian markets during the financial dislocations of 1998: many Russian debt and equity issuers, that should not have been able to access the public capital markets given their financial standing, raised funds and subsequently defaulted. The same has been observed in Argentina, Brazil, Indonesia, Thailand, and Korea between 1997 and 2002.)

Intermediaries in national and global capital markets can also contribute to governance problems. For instance, commercial and investment banks, universal banks, and securities firms might fail to provide adequate control and actually promote biased behavior. If an intermediary issuing securities on behalf of a company that is not qualified to access public capital chooses to proceed, it may be ignoring its responsibility to protect investors. (It may legally circumvent some of its obligations by making sure that high-risk securities are sold only to professional, institutional investors on a caveat emptor basis; this, however, does not absolve it from certain ethical responsibilities.) Alternatively, an intermediary might use the power of its sell-side research analysts to generate underwriting business from issuers, deserving and undeserving. For instance, in order to win lucrative fee-based business, such as an equity IPO, a securities firm might be willing to give the issuer a stronger equity recommendation than it deserves. The same may also be true for other service providers, including lawyers, accountants, and/or credit rating agencies. Each one of these institutions has an important role to play in the local capital markets, by providing legal
opinions and disclosure documentation, accounting and audit verification, and credit analysis and ratings. Failure by any one of these – through incompetence, conflict of interest, or desire for profit – can jeopardize the character, security, and efficacy of the capital markets, allowing poor companies to access capital without proper investor/credit protection.

**Misguided/insufficient corporate control activity**

If the market for corporate control transactions can be seen as a useful external governance measure, then misguided (that is, ill advised or poorly executed) or insufficient corporate control activity can be seen as a failure of the macro governance process; one that removes the ability to create an environment where value can be maximized.

Misguided corporate control activities, such as might characterize an entire sector going through the late stages of a boom cycle, when the pressure for marginal deals is extremely high, can obviously lead to problems. Forced acquisitions that are destructive or mispriced can damage, rather than enhance, enterprise value. This type of over-extending has been apparent at various points in the cycle of corporate control transactions, as with the expensive, and ultimately unrealistic, US LBOs and UK MBOs of the late 1980s, and hostile or friendly acquisitions of Internet and telecom properties in the late 1990s. Such deals may be driven by perceived pressure to act rather than the creation of sustainable financial value, and may ultimately lead to an excess of goodwill and leverage (and the significant amortization and interest expense burdens that can result).

A dearth of corporate control activities can be equally problematic. Shareholder interests may not be represented properly if buyouts and acquisitions are not possible. Management may become entrenched and misallocate resources or squander profits: the lack of an effective external mechanism to bring such behaviors back in line means enterprise value is unlikely to be maximized. This point is best illustrated by comparing the Japanese and US marketplaces during the 1980s and early 1990s.

Although US firms were certainly not immune from bad corporate control deals, empirical research supports the notion that efficiencies and value were created. Even though US corporations appeared to be lagging their Japanese counterparts, corporate control activity centered on conglomerate spin-offs actually increased value and stock prices; revenues and profit margins recovered, and market shares lost to Japanese competitors were soon regained (for example in tires, automobiles, and banking assets).

The Japanese sector, in contrast, featured no such activity, and governance problems were masked by the pursuit of market share, at virtually any cost. Indeed, rather than attempting to improve profits and margins,
or return excess capital that was not being put to use productively, companies continued expanding into unrelated areas, or investing in projects with sub-optimal returns. Many also tried to boost operating income through financial speculation. The result was an ill-fated use of capital that actually lowered enterprise value and punished shareholders. A stronger corporate control market (combined with a willingness to return capital) might have led to far better shareholder returns. Japan and other advanced relationship-model countries are not alone in their lack of corporate control activity. Most hybrid-model nations suffer from similar lack of corporate control activity as a result of weak or inefficient capital markets, regulatory restrictions, and/or concentrated ownership stakes (often held by families). The additional discipline that can be gained from such activities is not available.

**Unacceptable external audit practices**

When the external audit role functions as intended, it provides stakeholders with an important third-party check and balance. When it fails – through either inadequate attention to duties or conflict of interest – an important element of external governance is lost. In fact, a series of audit failures appearing since the turn of the millennium has called into question the utility and efficacy of the external audit process.

**Failure to perform duties**

The failure by certain auditors to perform their duties adequately, or their actual assistance in suspect/criminal behavior, has dominated the headlines in recent years. We analyze certain failures in more detail in Chapters 7 and 8, but for now simply note that ineffective external audit practices are a weak link in control that can lead to financial restatements or, in more extreme situations, financial distress. One of the potential flaws of the external audit practice is willingness by some to focus on the letter rather than the spirit of accounting regulations. Although an auditor may find that a company is complying technically with rules, it may well be running afoul of what is actually intended from a business management or ethical perspective. This is especially true under a GAAP regime (less so under IAS). Such “technically correct but aggressive” accounting, as noted above, can lead to broader financial problems. Audit standards in many cases may not be upheld, making it very difficult for investors, regulators, and other stakeholders to judge a company’s true financial position (certainly on a timely basis; and after the fact it might simply be too late). Auditors may also lack the correct skills to evaluate complex financial business/transactions; they may agree to a company’s aggressive treatment
of an accounting rule (or acquiesce to its demand for particular reporting); they may not give high-risk audit clients a thorough enough review (a true forensic inspection); they may not respond properly to “inside tips” provided by whistleblowers, and so forth. All these problems have become evident in recent years.

**Conflicts of interest**

Large global audit firms provide multifaceted services centered on audit, accounting, tax advice, and corporate consulting. The latter two can be lucrative, and have been an important source of revenues since the 1990s. Recognizing potential conflicts of interest, the largest accounting/consulting firms began separating their audit/accounting/tax and consulting units (although they created “new” tax consulting services within their audit arms). Although many consulting services are now separate, tax advice generally is not, meaning conflicts of interest can, and do, arise.

Ultimately concerns center on cross-selling services that might lead to loss of independence and judgment when it comes to audit and accounting work. The external auditor’s audit clients are creditors and investors, while its tax and consulting clients are more likely to be directors and managers. If the roles are not formally split (or somehow separated in a convincing fashion), conflicts can arise and credibility can be called into question, rendering the vital independent audit dimension of their work suspect. Most of the remaining Big Four (and other, smaller firms) have been impacted by the problem and must repair the damage, or risk losing further credibility. Even small local auditors, such as might be found in developing systems, can be conflicted. For instance, in Thailand and Indonesia it is typical for auditors to work for the same companies for several decades; with such lengthy terms of service, objectivity can be lost.

It is also important to note that conflicts of interest can arise from within an audit firm’s own audit practice. For instance, an auditor reviewing a specific company account may wish to work for that company in the future (perhaps the compensation is better, or the job more interesting). In order to help secure a future position, the auditor might be willing to compromise audit standards or ignore some malfeasance in order to appear more cooperative in the eyes of company officials. This has been a problem in certain audit failures of the past; although some attempt has been made to regulate when and how auditors may ultimately rotate into companies they are responsible for auditing, the standards are far from widespread.

Based on our discussion in this chapter it should be clear that internal and external governance flaws can appear in many forms. Although they
have the potential of creating a range of problems with varying degrees of severity, the end result is typically some damage to stakeholders. In the next chapter we consider the impact these governance problems can have on corporate operations. Following that we shall consider a number of company and industry case studies that provide important lessons on actual corporate governance problems.
Governance ideally exists to help ensure a company can execute its tactical and strategic vision while maximizing value and advancing stakeholder interests. However, in the last chapter we noted that the process might be flawed: many things can go wrong within a company’s governance framework and the surrounding environment, leading ultimately to stakeholder damage. Although we examine “real life” damage caused by actual corporate problems in the next two chapters, we set the stage in this chapter by discussing the impact governance problems can have on corporate operations, and how proper functioning of a company might be temporarily, or permanently, impaired.

Failure in the process can lead to varying degrees of destruction. Some problems can be relatively mild, involving no more than a bad press report and a temporary dip in earnings or the stock price. For instance, after undertaking a thorough review of its accounting processes, a company might discover that it must restate its earnings downward by 5 percent; it might also note that it anticipates no further problems as a result of new control measures that it has recently instituted. Investors might be temporarily upset by the news, and some might even sell their shares, pushing the company’s stock down a few percentage points. However, if the company has truly strengthened its controls so that no further “accounting surprises” can arise, and investors believe the governance problem has been resolved and the company represents good value, the damage has very likely been contained.

Some governance problems can be more serious, resulting perhaps in a downgrade of the credit rating, reduction or cancellation of credit lines, and a sharper downturn in the stock value. For instance, a company’s CEO
might announce that it is posting very large and unexpected losses, because a failure in its risk management process and internal controls allowed the treasury center to take unauthorized positions in illiquid financial risks over a multi-year period. Furthermore, the cost of marking and unwinding the positions, and revamping internal controls, might be estimated to be the equivalent of two years’ pre-tax profit. In this case investors are almost certain to sell the stock on the news, driving it down rapidly and sharply; it is likely to languish at lower levels for an extended period of time, since the problem will absorb anticipated profits for several years to come. More importantly, the company’s bankers, skittish about the discovery of the problem, might cancel a portion of available liquidity facilities and require collateral on future borrowings (so that they can improve their seniority and security). Credit rating agencies, noting the breakdown in controls, increased leverage (coming from reduced retained earnings), and lower liquidity and financial flexibility (coming from the cancellation of banking facilities), might lower the company’s credit rating several notches, driving up the firm’s cost of capital. This scenario might impact the company for several years, until major stakeholders – namely, investors and creditors – regain confidence in company management and its ability properly to control and monitor operations.

When particularly severe governance problems strike, the “unthinkable” might actually happen: a company might slide into financial distress, the vicinity of insolvency, or even bankruptcy. When this occurs, a range of stakeholders – debt and equity holders, employees, suppliers, creditors, communities, and so forth – run considerable risk of loss. For instance, after uncovering improprieties related to the preparation of financial statements, a company’s board might oust the CEO, CFO, and others on the executive management team. However, discovery of the problem might come too late for any constructive turnaround to take place. The problems might be so large, and in the making for so many years, that creditors pull back on lending, clients cease doing business, suppliers change their dealing terms, and credit rating agencies downgrade the company into sub-investment-grade territory (almost certainly triggering cancellation of other bank facilities and requiring the posting of collateral on existing debt). Alternative financing avenues might shut down (except at exorbitant cost) and liquidity could dry up. The stock price, having been forced down quickly by institutional selling, will reflect increasing loss of investor confidence and growing likelihood of default. In this case recovery prospects might be very bleak. Even if the board moves into a crisis management mode and takes dramatic actions (such as seeking out a potential acquirer, pledging any remaining unencumbered assets in a bid to secure new liquidity facilities, and selling off non-core assets at a deep discount to generate cash) it might be too late.
The time frames covered by these scenarios can vary widely: problems might cover no more than a few days or weeks, or they might linger for months or even years. In the latter case the trading volume and stock price might reflect the overhang of potentially bad news. Investors may be unwilling actively to buy stock if they are unsure about the nature and severity of a firm’s problems, and the price may remain depressed under the weight of potentially bad news.

It is important to stress that many other factors can create corporate problems and lead to financial losses and/or deterioration. Bad governance is not the only possible source of corporate dislocation (for example a firm might encounter difficulties as a result of a poor economic environment, client lawsuits, and regulatory restrictions, which might be completely unrelated to bad governance). The framework we present in this chapter is not exclusive to flawed governance, although it is certainly applicable. Figure 6.1 summarizes stages that might be generated by a governance problem. We consider each stage in detail below.

**Figure 6.1** Stages arising from governance problems
FIRST STAGE IMPACT: REPUTATIONAL DAMAGE

The initial impact of many governance problems centers on reputational damage. When difficulties or errors become known, board directors or executive managers are required, or advised, to disclose them publicly. This typically leads to additional coverage by the financial press, credit rating analysts, and sell-side equity analysts, who attempt to interpret the information and its potential impact on corporate operations. Advanced technology and communications mean information circulates very quickly. Regardless of the specific nature of the problem, a firm is likely to suffer some level of reputational damage; no stakeholder likes to receive bad news about a company, and the specter of uncertainty is likely to create a negative perception. The degree of reputational damage is generally a direct function of the severity of the problem. As noted, relatively minor governance-related problems, such as modest earnings restatements (such as those posted by IBM, Gateway, and Provident Financial (among many others) in 2002–3), often lead to only short-lived negative perceptions. More severe problems mean greater reputational damage.

Some firms can weather reputational damage and limit problems to the first stage if they have a crisis management program that allows them to respond aggressively and proactively to the problem before significant loss of confidence develops. If a company can prevent erosion of confidence it preserves its liquidity, and with sufficient liquidity it can remain a going concern until it can deal with broader governance issues. Obviously no company wants to experience problems, but when they appear, the difference between a minor crisis and a deeper problem can sometimes be traced to the nature of crisis management. Company directors and executives that are viewed by the marketplace as being in command of the problem, providing necessary assurances to a nervous body of stakeholders, buy themselves time and liquidity. Both are vital in order to avoid broader financial distress.

Consider the example of Salomon Brothers in the US Treasury bond rigging scandal. During 1990 and 1991 Salomon’s government bond trading desk repeatedly bid on excessive amounts of US Treasury bonds in contravention of SEC guidance (and, later, formal rules). The CEO took no disciplinary action for several months and adopted a rather casual attitude toward the problem. Salomon was, after all, the dominant government bond house of Wall Street. Regulators were displeased, and other banks started cutting back on their credit lines to Salomon, putting the firm in a very precarious liquidity squeeze; in fact, the firm was soon teetering on the edge of a liquidity-induced bankruptcy. The board of directors moved quickly into action, first by forcing out the CEO and several other senior executives involved in the problem (after regulators made it known that
they expected senior-level departures), then by calming fears within the Wall Street community with a statement regarding the nature of the infractions and resolutions. Finally, they added a strong level of external market credibility, in the form of Berkshire Hathaway Chairperson/CEO Buffett (who had owned a large block of Salomon preferred for several years). Buffett quickly agreed to play an active role in recruiting a new management team. The crisis management program was thus successful; Salomon emerged from the scandal with reputational damage, to be sure, but as a going concern that ultimately rebuilt key aspects of its business. Others have also survived reputational problems induced by large losses from governance failures (for example Sumitomo Corporation and Daiwa Bank), as a result of working with stakeholders to move beyond immediate problems. When damage is confined to the first stage, a company may soon be able to return to normal operations.

SECOND STAGE IMPACT: EARLY FINANCIAL PROBLEMS

When problems are more severe, or directors and executives fail to contain reputational damage through a crisis management program, a company enters a more difficult phase. For instance, during the mid-1990s US banking firm Bankers Trust was found to have been abusive in its practice of selling very risky derivative strategies to corporate clients (including Gibson Greetings, Procter and Gamble, Jefferson Smurfit, Sandoz, and Air Products), and suffered a considerable blow to its character and reputation. It failed to try to alter that perception decisively, by refusing to cooperate, remaining “arrogant” in its posture and attempting to carry on with business as if nothing had happened. (Even after the CEO and senior executives departed, the replacement team did little to help the firm’s cause.) This damage soon carried through into other elements of the bank’s operations: some corporate clients stopped dealing with Bankers Trust, banks cut back on their credit lines, credit rating agencies downgraded the bank’s rating, valued employees left, revenues started declining (particularly once much of the “high margin” derivative business had disappeared), and liquidity pressures increased. We can point to many other instances where reputation and goodwill have been damaged to the point where additional second stage financial problems have developed, such as El Paso, Reliant, Dynegy and other US energy trading companies, Ahold, Tyco, Mitsubishi Motors, and Snow Brand Milk. We consider some of these in the next two chapters.

A firm’s financial operations begin to suffer noticeably during the second stage. Depending on the nature of the problem, industry, company, and market cycle this can take different forms, but we focus on three
primary financial indicators: a decline in the share price, a change in
supplier and/or creditor relationships, and a decrease in liquidity.

The earliest sign of financial difficulty related to the second stage is
generally reflected in the share price. Since the stock price represents
discounted expected economic value, any problem that threatens value will
become evident through a falling stock price. Investors generally, and insti-
tutional investors specifically, are often quick to react to negative news,
and can quickly drive prices down. There are many examples of this
phenomenon: companies such as Sprint, HealthSouth, Ahold, CapitalOne,
Merrill Lynch, and Vivendi, among others, that have announced some type
of governance failure, have experienced sharp declines in their stock
prices. Just how long the stock price remains depressed is a function of the
actual or perceived severity of the problem and the ability of directors and
executives to manage the crisis.

Difficulties related to supplier and trade creditor relationships may
appear. If these stakeholders believe that a client has a problem that
might ultimately lead to greater financial distress, they might change
dealing terms in order to protect themselves. For instance, if a supplier
normally requires net payment on invoices within 30 days, it might
shorten the time frame to 15 days; if a trade creditor normally lends
short-term funds on an unsecured basis it might now require collateral.
These changes, designed to protect their own financial interests, might be
driven by what is, hopefully, only a temporary loss of confidence; and the
action, while disappointing to the company, cannot be unexpected: no
party likes to be surprised by negative news.

Perhaps the single most significant financial difficulty – a decrease in
liquidity – emerges during this stage. If it is not properly and intensively
managed it can lead to precarious third stage, and terminal fourth stage,
problems. In fact, liquidity risk, or the risk of being unable to sell assets or
raise funding without incurring a significant cost, is one of the most criti-
cal risks facing any firm. It is common to consider liquidity in the form of
asset liquidity risk, or the risk of loss arising from an inability to sell assets
at, or near, their carrying value (and then using proceeds to fund opera-
tions), and funding liquidity risk, or the risk of loss arising from an
inability to roll over existing funding or obtain new funding without paying
a large cost. In some instances the two join together to create particularly
significant problems: inability to raise new funds leads to forced asset sales
at distressed levels, resulting in insufficient proceeds to repay other
maturing liabilities, requiring further asset sales, and so forth.

A company survives by having access to enough liquidity to cover its
daily operations (and, in the prudently managed firm, an extra buffer to
protect against any possible surprise or crisis, including those arising from
governance problems). Liquidity allows a firm to meet its regularly occur-
ring obligations and unexpected payments, manage its balance sheet and cover any other commitments in order to remain a going concern. Although access to all forms of capital is crucial, inability to tap long-term capital through lenders or the capital markets is of less importance at this point. While it can certainly hamper investment, R&D, and strategic plans, it is unlikely to result in any real short-term problems, as a company can simply postpone investment or acquisition plans until it has better access. The same is not true with liquidity: if a company cannot manage its liquidity position it will soon experience a funding **liquidity spiral** – where the absence of liquidity causes other short-term creditors and lenders to pull back – leading to even less liquidity, and so forth, until cash is simply cut off. Attempts to sell assets on a distressed basis simply accelerate the spiral.

Problems accessing funding liquidity can become evident in several ways. Bank syndicates, including a company’s lead bank, may demand repayment of outstanding short-term facilities and then reduce the amount of credit available; this depends, of course, on the nature of the banking facility and the degree to which it is committed (for example, whether it can be reduced or withdrawn under particular circumstances). If a company is active in the short-term liability markets, issuing commercial paper, or short-term notes/deposits, it may have trouble rolling over notes as they come due. (It is common practice for such issuers to automatically renew, or reissue, notes as they mature every 30, 60, or 90 days.) Short-term investors may not be comfortable holding these unsecured credit instruments during a period of uncertainty. Or if the company has traditionally borrowed short-term funds on an unsecured basis, it may now find that it has to post collateral to achieve the same goal. Pledging unencumbered assets to support borrowing reduces financial flexibility, and when publicly disclosed, creates further reputational concerns and stakeholder nervousness. The funding liquidity pressures may be compounded by general knowledge that the company has become a distressed seller of assets in order to replenish its cash position. This is unwelcome news, as the firm becomes a price taker and might be forced to sell valuable assets at unfavorable prices, damaging its franchise and earnings power.

During second stage problems a firm’s reputation might become tarnished further as a result of negative equity analyst reports and credit rating downgrades (or “watchlist” status for possible credit downgrade). These compound existing perception problems. Ultimately, if a firm’s crisis management program fails to convince other stakeholders that liquidity is solid and problems have been identified and contained properly – and that they are being addressed through special actions (such as strengthening of controls, external audits, dismissal of executives, or abandonment of a strategy) – then the company will enter into a third stage characterized by growing financial distress.
THIRD STAGE IMPACT: GROWING FINANCIAL DISTRESS

If a company migrates from the second to the third stage – because it is unable to manage the problem situation properly, or the crisis is so significant that it propels the company into a worse state before directors and executives can take action – the fate of shareholders and other stakeholders hangs in the balance. A company that reaches this stage essentially has certain final opportunities to avoid collapse; corporate history indicates that some firms are successful in averting disaster, while others are not.

This critical stage can be characterized by a number of features, including: continued negative perception in the marketplace, causing existing investors to sell their shares and prospective investors to remain on the sidelines; credit rating downgrades from the rating agencies; negative opinions/stock downgrades from sell-side equity analysts; changes in supplier business terms; changes in creditor lending terms; and a further squeeze on liquidity. Although not necessarily visible to the public, the board of directors might be considering alternative strategies during this period. In addition to trying to manage the daily crisis situation – working, hopefully, in close concert with executive management – directors might be exploring other strategic options, including the sale of core assets in order to help secure additional liquidity, the sale of the company to another firm in order to preserve as much value as possible, or the search for a friendly strategic partner (for example a white squire), to which it can sell a significant block of equity in exchange for much-needed liquidity. The board might also start to weigh seriously the interests of creditors. As we know, if a company is truly in financial distress and marking a steady decline towards the vicinity of insolvency, directors are forced to shift their allegiance and actions to creditors. This is unlikely to occur until all other potential measures and actions have been taken; if it does, however, it is likely to be during this stage of the process.

Although the specific reasons a company might migrate gradually or quickly into the third stage are less important than the effects and consequences, it is relatively simple to imagine any number of scenarios. Directors announce that they have discovered a multi-year pattern of financial fraud that implicates senior executives and control officers. Internal and external auditors, having approved a long sequence of very aggressive accounting treatments, are told by regulators to reverse such entries, creating a financial picture that reflects much greater leverage and weaker earnings than previously believed. A regular policy of abusive sales practices, sanctioned by the CEO, has led to very large lawsuit judgments against the company and the departure of many once-loyal customers, and so forth. Indeed, some of the flaws we discussed in Chapter 5 can create such seri-
ous problems that a company that cannot cope effectively is virtually guaranteed to encounter some level of financial distress. As we note in the next chapter, firms such as Andersen, Enron, WorldCom, and Swissair (among others) occupied the third stage for a brief period of time, before being pushed into the final stage.

As in the second stage, the company’s stock price is likely to be depressed; after a sell-off triggered during the first and second stages (compounded, perhaps, by the activities of short-sellers sensing further problems and downside) there is little reason to expect the price to rebound. Negative reports from equity analysts regarding the problems can create further pressure in the market. In light of the actual and potential problems facing the company, which are almost certain to include a liquidity squeeze and lower revenues/earnings, credit rating agencies may begin a sequence of downgrades. This is a critical dimension of third-stage problems, as they can create a vicious cycle, particularly if the ratings actions pierce the sub-investment-grade threshold. For instance, it is not uncommon for companies to enter into supplier and creditor relationships with terms dictated by the company’s credit state. With a strong credit rating the firm is probably receiving very favorable terms: 30 or 60 days to pay suppliers on invoices (and discounts if paid before then), borrowing from banks on a short or long-term basis without posting security or collateral, dealing in derivative transactions (such as over-the-counter swap and option hedges) without collateral, and so forth. As downgrades begin, the supplier and creditor terms begin to deteriorate. If the company remains in the realm of the investment grade (above BBB–/Baa3 as rated by Standard and Poor’s and Moody’s, respectively), it may notice only slight changes in its terms. Perhaps suppliers demand payment on invoices within 15 days, banks shorten the maturity of liquidity facilities, and derivative counterparties require collateral on any transaction exceeding two or three years. These actions can reduce financial flexibility but are unlikely to cause significant problems. The real difficulties occur when the company is downgraded to the sub-investment-grade categories. Suppliers may then shift their dealing terms to a “cash only” basis, banks may curtail liquidity/term funding facilities, and derivative counterparties may require collateralization of exposures. Positing collateral leads to further balance sheet encumbrances, which constrains financial flexibility and can cause the agencies to downgrade the company again. In fact, any action that reduces flexibility and liquidity can lead to more downgrades, meaning even worse dealing terms, less flexibility and more downgrades, and the onset of a vicious cycle.

The issue of liquidity surfaces as the decisive element of the third stage. In the absence of sufficient committed liquidity – in the form of committed bank lines, a note issuance or revolving underwriting facility with committed
funding (requiring banks to fund if investors cease to roll over notes), a portfolio of unencumbered, high-quality securities that can be used in the repurchase agreement (repo) market, a sufficient amount of fairly valued assets that can be sold on relatively short notice, and so on – the liquidity spiral mentioned above comes into full force. Liquidity lenders, seeing the pullback of uncommitted facilities or the lack of unencumbered assets, may cancel their own facilities; other lenders, noting that cancellation, will pull their own, and so on, until the firm is left without cash to cover its daily operations. Once this occurs, the company enters the fourth stage, discussed below.

Throughout this process companies that are still able to access external funding – through either banks or the capital markets – are likely to experience a dramatic rise in their cost of capital. The risk premium that a firm will have to pay to attract debt investors may be significant, perhaps several hundred basis points (several full percentage points) more than it has been accustomed to paying as a “trouble free” credit. Even though creditors receive the benefit of a senior position in the event of insolvency, they will still demand an appropriate risk premium; after all, if the company files for bankruptcy, senior unsecured lenders stand to lose 50 percent, 60 percent, or more, of their principal.

Of course many companies cannot even access external funding during this stage, contributing to overall liquidity pressures. Capital market investors may refuse to roll over commercial paper and medium-term notes, closing off another source of funds. Banks are unlikely to try to raise new capital through bonds or notes, as securities will not be purchased in light of actual or perceived problems. Banks will not provide new funds to the company unless they can do so on a collateralized basis, but even this has issues: if an asset (such as a factory, power plant, or portfolio of securities) has already been pledged as security it cannot be pledged to another party (under terms of the negative pledge covenant characterizing most bank documentation); and if an asset can be taken as collateral, other unsecured debtholders will find that their seniority has been diminished through structural subordination (for example they own securities that were not subordinated to begin with, but have become de facto subordinated through subsequent pledging actions). Rating agencies, recognizing this structural subordination, may downgrade the ratings of securities that have become subordinated, leading to the possibility of more collateral calls.

In more severe situations not only will banks refuse to lend on an unsecured (or even secured) basis, they may attempt to cancel undrawn facilities or demand repayment on drawn facilities by invoking rights under a material adverse change (MAC) clause. Depending on the specific drafting of the MAC a bank can refuse to fund, or demand repayment, in the event of an adverse change in the counterparty’s credit (or the general operating environment, though this is less relevant for the matter at hand).
What constitutes a “material” change in the debtor’s situation may be explicitly defined (for example, downgrade below a certain level, breach of liquidity, capital or interest coverage ratios) or it may be subjective. When it is subjective, judgment becomes the operating guideline, meaning a bank may invoke the MAC and resolve potential disputes regarding the materiality criteria at a later time (perhaps in bankruptcy court). Indeed, triggering a MAC is a serious issue and may ultimately force a company into the fourth stage. Not only does repayment of existing funds or cancellation of undrawn funds squeeze the company’s financial profile, it signals to the marketplace that the bank no longer has enough confidence in the company’s position to continue a lending relationship.

FOURTH STAGE IMPACT: BANKRUPTCY

The fourth, and final, stage of the process ends in default (the company fails to make payments on obligations) or insolvency (the market value of the company’s assets falls below its liabilities so that it has negative equity). This typically leads to formal filing of a voluntary or involuntary bankruptcy petition; in some systems this provides for protection from creditors until a thorough review of claims can be undertaken. When a firm is in bankruptcy it follows one of two paths: reorganization or liquidation. In the event of reorganization, a company has the possibility of re-emerging in restructured form if it can reach an agreement with its claimholders. Chances of success are greater if the company is perceived to have strong asset value, manageable leverage, and “salvageable” goodwill and reputation, but the process is often lengthy, involving extensive negotiation among all parties holding a claim on the firm’s assets: trade creditors, bank lenders, bondholders, and so forth. Depending on the nature of the bankruptcy system, preference might be given to the company or to the creditors; incumbent management may be dismissed or permitted to stay, and a DIP financing group or an administrator will take over management of the firm. In the event of reorganization the company that ultimately emerges is likely to look considerably different; generally smaller and more focused, with better access to liquidity and a new capital structure featuring less leverage.

When liquidation occurs, the claims process divides residual assets by seniority. Referring back to our discussion in Chapter 4, this means senior secured creditors will be paid before senior and junior unsecured creditors, who will be repaid before any subordinated debtholders. Shareholders, ranking lowest, will be repaid last. In fact shareholders often receive no recompense, meaning their investments become worthless. The amount that creditors, as primary stakeholders, receive is dependent on each specific bankruptcy case. The more a bankrupt company’s assets are worth
in liquidation and the lower the overall amount of leverage, the greater the recoveries for each individual class of creditors; the lower the value of the assets and the greater the leverage, the lower the recoveries. To illustrate possible restitution, Table 6.1 highlights 20-year average recovery rates (as tabulated by rating agency Moody’s).

When governance-induced problems are considered, many factors typically contribute to a company’s final collapse; rarely is any single force at work. In fact reputational damage may continue to grow, directors and executives may be unable to manage the crisis and instill confidence, any remaining faith stakeholders have in the company’s prospects may disappear, regulators might severely restrict business operations, the rating agencies might downgrade the company’s credit further, and customers and suppliers might cease doing business entirely. However, as we have stressed several times, the “death knell” can often be traced directly back to a lack of liquidity. As we note in the next chapter, although companies such as Enron and Swissair were plagued by many significant governance problems, their ultimate collapse came from lack of liquidity: in the final days of operation they were literally unable to obtain enough cash.

Ultimately, if a company cannot pay its obligations in order to continuing operating, it will default; once in technical default the company has a cure period (or grace period) during which to make payments. If payments are not made, cross-default clauses contained in loan, derivative, and bond documentation cause all other obligations to be considered in default as well. Creditors may then accelerate their claims and demand immediate repayment (although certain “stays” – or delays – might still be invoked in systems that

<table>
<thead>
<tr>
<th>Category</th>
<th>Average recovery (percentage of face value)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior secured bank loan</td>
<td>61.6</td>
</tr>
<tr>
<td>Senior secured</td>
<td>53.1</td>
</tr>
<tr>
<td>Senior unsecured</td>
<td>37.4</td>
</tr>
<tr>
<td>Senior subordinated</td>
<td>32.0</td>
</tr>
<tr>
<td>Subordinated</td>
<td>30.4</td>
</tr>
<tr>
<td>Junior subordinated</td>
<td>23.6</td>
</tr>
</tbody>
</table>

Table 6.1 Average recovery rates, 1982–2002

Source: Moody's Investors Service (2003), Default and Recovery Rates of Corporate Bond Issuers. © Moody's Investors Service, Inc. and/or its affiliates. Reprinted with permission. All rights reserved.
feature such provisions, as noted below). This does not mean that the presence of additional liquidity will solve all of a distressed company’s problems, it simply means that a company that is on the brink of default can gain some additional time to try to find alternate solutions. Lack of liquidity is, of course, driven by other factors; it does not just suddenly appear as an additional pressure point on corporate operations, it is a direct problem that will have been in the making as early as the second stage (and certainly by the third stage). In some instances, inability by directors and executive management to cope properly with this dimension of the crisis (by acting forcefully, and seeking aggressive and radical solutions) leads to eventual collapse; in other cases directors and managers might do everything possible to avert the crisis, but be overwhelmed by external forces.

It is interesting to consider the role of creditors in the crucial fourth stage. We know that as a company approaches the vicinity of insolvency (somewhere in the latter part of the third stage), the group of creditors assumes greater power and control. Directors begin shifting their duties to creditors, who become the primary stakeholders; the intent when in the vicinity of insolvency is to try to preserve as much value as possible for creditors in liquidation or reorganization. Creditors are typically the primary suppliers (or at least arrangers) of liquidity. Accordingly, they have a critical decision to make when a company is in the latter part of the third stage: whether or not to continue supplying liquidity in order to keep the company afloat and preserve asset value (perhaps even to the point of a complete turnaround). The individual and collective creditors, taken as suppliers of liquidity, must make a risk/return assessment on whether it is in their best interests to continue lending, or cease and cut their losses. In suspending further funding, creditors are often deciding the fate of the company. Creditors thus have the power to determine whether a company should be forced into the fourth stage – bankruptcy – because it is highly unusual for a company in severe financial distress to arrange liquidity without the help of its creditor team. (This might be limited to very infrequent situations where a company in financial distress, lacking further access to liquidity, sells itself to another company.) When creditors refuse to fund any further, it generally means they are convinced that lending additional sums would be to throw good money after bad; in fact, they may be convinced that the chances of a turnaround are virtually nil.

THE IMPACT OF BANKRUPTCY ON STAKEHOLDERS

Not surprisingly most, and sometimes all, of the direct stakeholders we have considered in Chapter 4 lose when a company finally enters the bankruptcy phase. We consider the range of potential damage that might occur.
**Shareholders**

Shareholders, as providers of risk capital and the body to which directors and executives are accountable, generally fare very poorly in bankruptcy. Although shareholders are granted certain voting rights and director support that help them exercise a modicum of control over management and receive a share of a company’s profits while it operates as a going concern, their position in insolvency is extremely subordinated. From a control perspective, board directors will already have begun shifting their focus to creditors as a company enters the vicinity of insolvency; once a petition is actually filed, shareholders will have lost what little theoretical control they once had, as directors strive to maximize any residual, post-bankruptcy value for the benefit of creditors. From an economic perspective, we know that shareholders rank below all other providers of capital and typically receive little, or none, of their initial investment at the end of bankruptcy proceedings. While different classes of debt holders may receive 20 to 60 cents on the dollar for their capital (as noted in Table 6.1), equity holders often receive 0 to perhaps 5 cents on the dollar, meaning a near-total economic loss. While the limited liability structure means other claimholders cannot recover amounts due from shareholders, they, of course, have no recourse to any other body to recover amounts lost: they are thus true risk capitalists.

**Creditors**

Creditors, as providers of more senior forms of capital, will also be financially damaged by the onset of corporate failure. Unlike shareholders, however, they are often able to recover a portion of their initial investment, in amounts that vary according to seniority. If directors have had enough warning about the company’s financial distress, they should ideally have been taking actions to protect the value of the firm’s assets. From a theoretical perspective this generally means rejecting risky investment projects (which would potentially do more to benefit equity investors than debt holders), arranging for the sale of certain assets at “non-distressed” prices, and so on. (Any actions must be taken in full knowledge of preference payment conflicts, as noted below.) The goal of directors during the distress stage is to protect as much asset value as possible; any notion of attempting to maximize earnings, enterprise value, or stock price will have long since disappeared.

Creditors that lend strictly on a secured basis (for example against hard assets that are properly valued, such as plant and equipment, real estate, or securities) fare the best, as their source of repayment comes via sale of the underlying collateral taken as security. Since they have legally binding
security interests in that collateral, proceeds generated by the receiver through liquidation will accrue to those with specifically identified interests. In many instances there is a delay between the filing of a secured creditor claim and the actual disposal of the asset as a result of the automatic stay, which prohibits the rapid sale of collateral. (There are exceptions to this rule, primarily for derivative contracts secured by collateral. Under derivative documentation, dealers holding collateral are exempted from such stays and can automatically liquidate collateral on default.) The delay is necessary as bankruptcy receivers must complete a thorough analysis of the value of the company’s assets and liabilities, and payments made during a preference period (for example a period of up to 90 days before the filing of bankruptcy, during which time payments are made). In some cases the payments may be subject to clawback, or return to the company, if they are found to have benefited one party at the expense of others during the period of financial distress. Thereafter the actual “cash out“ of creditors (either as a cash payment in liquidation or new securities in reorganization) depends on the amount of value generated through asset disposals, and the size and type of individual capital classes. By the time value is allocated to the most junior creditors (such as certain types of preferred securities that straddle the boundaries of debt and equity), recovery values are likely to be very low; as with shareholders, their loss is often near total.

Employees

Not surprisingly, employees can suffer considerably when an employing company fails. Losses can occur on several fronts, financial as well as personal. First, and most obvious, is loss of job, and the salary and benefits that every job conveys. For most, this can lead to rapid and significant financial hardship; it may be difficult to secure other employment, particularly during a weak economic cycle. Second, employees might experience financial loss in their retirement/company savings plans. Although this depends largely on the nature of the retirement programs and portfolios, it is not unusual in some companies for plans to contain some amount of company stock. When this occurs, the employees’ retirement plan will suffer the same losses as those accruing to others investing in the firm’s equity; recovery might be negligible, meaning a substantial decline in the value of a program intended to provide long-term security. Third, and closely related, employees holding restricted stock and options as part of an incentive compensation program will experience additional loss. In fact, for long-serving or very senior employees, the financial losses in the retirement/savings and incentive programs may be particularly large, and force an adjustment to retirement plans or horizons, and savings and spending patterns. Apart from the obvious economic angle, job loss can also create a
psychological or emotional trauma: employees with an emotional attachment may undergo tremendous stress. Many will undoubtedly feel betrayed, particularly if they believe that they have contributed many years of labor and energy to the advancement of the company.

**Suppliers**

Suppliers of raw materials, goods, and services can be impacted by the failure of a company in terms of both current and future business. Leaving aside professional service providers (which we consider separately below), any supplier of goods or services to a company is likely to have some type of current business relationship with the company, supplying goods or services for cash. In fact, as we have already mentioned, it is most common for suppliers to provide goods or services in exchange for payment at a future date, such as 30 or 60 days hence; this implies an extension of credit. In a distress-free environment the supplier is comfortable with the receivables it generates and is *de facto* charging the company interest on the facility. (If the supplier wants to manage its own balance sheet more actively, it might offer incentives (such as discounts) to the firm when it pays within one or two weeks, instead of 30 or 60 days.) We have noted, of course, that the astute supplier that actively manages its credit relationships will already be tightening payment terms as a company enters the third stage, perhaps demanding payment within one week (or, in very extreme situations, prior to delivery).

Assuming this does not occur, however, suppliers are likely to face losses on receivables outstanding at the time a company defaults. Depending on the nature of the receivables, the supplier is likely to become an unsecured creditor and join the queue with all other creditors, hoping to recover some fractional portion of what is owed at the conclusion of proceedings. In addition to loss of current revenues and potential credit losses, the supplier also loses what might have been a significant customer, meaning a reduction in future revenues, and pressure to replace the customer with others in order to remain at the same level of earnings. This is particularly true in instances where the supplier has established a long-term contract with the company (to supply goods or services at set prices over a multi-year period); if it has calibrated its operations to deliver under such a contract, it may suffer incremental losses in trying to restructure the same type of arrangement with another corporate customer.

**Customers**

Customers can be impacted by the failure of a company in a number of ways. First, they may be economically disadvantaged by the loss of a supplier (the
bankrupt company). Once the firm fails, a customer might have to pay a higher price or source from alternate markets in order to replace what has been lost. If the product or service is particularly specialized and limited, this might amount to a significant incremental cost. Second, a customer may also be acting as a creditor and so lose if the company defaults on its obligation to deliver a prepaid good or service. For instance, if the customer contracts to buy a certain amount of goods over the next 12 months and pays in advance for the shipment, it will lose financially if the full shipment is not made. Alternatively, if the customer pays for a particular service that is not performed prior to default, replacing that service will represent an incremental cost. The customer may, of course, attempt to recover any financial loss by joining with other unsecured creditors. As with a supplier, if it has entered into a long-term purchase contract with the now-defunct company (to purchase goods or services over a period of time), it may suffer a loss in seeking out terms with a new provider.

Professional service providers

Professional service providers, which we define to include lawyers, accountants, and auditors of a company before, and during, its failure, have a considerable amount at stake when a client company collapses. Providers that play a leading role in supplying control and governance checks, including audits, due diligence analyses, accounting advice/strategies, legal recommendations, and defenses, stand to lose on two fronts: reputation and income. If any aspect of a company’s failure can be traced to mistakes or erroneous advice, or in more extreme situations conflicts of interest, misrepresentation, or fraud, the service provider’s reputation in the marketplace, and with regulators and other clients, will almost certainly be damaged. Since aspects of such business are based primarily on reputation, integrity, and goodwill, this may negatively impact future business. In certain cases class action lawsuits and/or regulatory sanctions may follow, resulting in potential loss through judgment and penalties (as well as further reputational damage). Even in less severe circumstances, however, the service provider is likely to feel an economic impact through loss of current and future fee-based revenue from the company that has failed, and potential loss of future revenues from other companies choosing not to deal with the provider.

Obviously, there is a body of professional service providers that appears during the fourth-stage process and that benefits from a company’s bankruptcy. These include lawyers and accountants representing investors filing lawsuits against directors and officers, those hired by regulators or other authorities to conduct forensic investigations into the causes and sources of problems, and those employed by creditors to assist in the liquidation or
restructuring process. These service providers can emerge as potential beneficiaries of a company’s collapse through increased revenues and reputational benefits.

**Communities**

Broader communities may also be impacted by the failure of the company. This, again, can manifest itself in various ways. If the company is a particularly significant payer of corporate taxes to the partial benefit of the local community (for instance, where tax payments are used to help fund basic public and community services), there will be an immediate loss of revenue and potential budgetary pressures; this can be particularly devastating in small communities. In addition, if the company is a significant employer in the local community, the loss of jobs resulting from corporate collapse will be felt through lower personal income tax revenues, less spending within the community, greater call on unemployment insurance resources, and so forth; again, this may have a very significant impact on the community’s budget. Vacant real estate (such as corporate offices and factories) may also pressurize community budgets. Finally, if the company is responsible for certain continuing environmental issues that impact the community (such as clean-up of waste or pollutants), it will face additional costs as it pays for clean-up on its own.

We might also consider the impact of corporate failure on the indirect stakeholders we have described earlier.

**Regulators**

Regulators, including central banks, financial or exchange supervisors, monetary authorities, securities commissioners, insurance commissioners, and trade federations, can suffer some amount of reputational damage when a company under their direct jurisdiction or sphere of influence fails. Although much ultimately depends on the nature of the failure and the way in which the matter is treated, regulatory authorities must always be concerned whether controls should have been stronger in order to prevent collapse, and whether any stakeholders will be financially damaged as a result of the problems. (In more extreme circumstances they might need to determine whether a collapse has systemic implications; this should, of course, be addressed before an actual default occurs.)

**Competitors**

Although we risk some generalization, it is often true that in a competitive economic system the failure of one competitor, from a pure supply and
demand perspective, is beneficial to competitors supplying the same goods and services. Several caveats are necessary in order for this generalization to be meaningful. In the first instance, we assume that competitors are not significant losers in dealing with the now-bankrupt company (they are not also suppliers to, or customers of, the company). Second, we assume that the governance problems leading to the ultimate collapse of the company are not somehow associated with a broad industry or sector: that is, competitors are not tainted by the problems of the failed company or are not subject to the same problems. This is not always true, unfortunately. Third, we assume that the absence of the failed company does not meaningfully impact the supply or volume of business activity; thus, if a company is no longer active in the marketplace, it will not diminish business opportunities for others. This is almost certainly a reasonable assumption, as in the competitive marketplace (where antitrust forces prohibit the formation of monopoly, or even oligopoly, powers), business will be distributed to new or existing companies. (Indeed, as Enron was collapsing, there was fear that, because it held a 25 percent share of the energy trading market, volumes would soon disappear. That proved not to be the case, as others in the energy and financial sector stepped in to fill the void, almost without pause. When volumes eventually declined in 2002–3 it was as a result of broader industry problems.) Except for these three conditions, competitors are among the few stakeholders that benefit from the demise of a company.

Other stakeholders can, of course, be impacted by the failure of a company, directly or indirectly. For instance, depending on the nature of the company, its activities and its role in the community or broader economic system, personal taxpayers might suffer some level of economic loss. If a bank is deemed “too big to fail” and the government arranges a bail-out, the cost will eventually be passed on to taxpayers. Likewise, if a company responsible for environmental problems and their associated clean-up ceases to exist, authorities may force taxpayers to absorb the expense.

While we can construct various other scenarios, the central point to bear in mind is that a company with severe governance problems, which becomes insolvent, can financially damage a broad range of stakeholders. Again, though governance problems alone are certainly not the only reason a company might enter the third and fourth stages of the process we outlined above, they can be an important, and sometimes dominant, factor. To illustrate this point further, we review a series of actual corporate and systemic governance problems in the next two chapters. This helps reinforce the point that poor governance can, and does, lead to migration through one or more of the four stages we have just discussed.
In Part I of this book we considered the theoretical framework of micro and macro governance, with a particular focus on expectations, requirements, and accountabilities. Against this framework we have discussed how the governance process might fail and, when it does, what might happen to a company and its stakeholders. In this chapter, and the one that follows, we apply theory to practice by examining a series of case studies relating to flawed governance within individual companies and across broader industry groups. Our intent is to link the theoretical discussion to the reality of daily corporate actions, and demonstrate that failures can arise and damage stakeholders. It also helps us consider, in Part III, the types of reforms that can build a more secure process and minimize the possibility of injury to corporate stakeholders.

We have selected cases that highlight particular breakdowns in management, control, and ethics to help emphasize a variety of different lessons. The spectrum of governance problems is considerable: accidental or intentional financial misstatement, fraud, conflicts of interest, unethical behavior, inadequate controls, inattentive/unqualified boards, failed corporate strategies, and so forth. The ultimate outcomes are equally broad, ranging from reputational damage and temporary financial distress to insolvency and liquidation; this is consistent with the four broad stages of financial deterioration discussed in the last chapter. We therefore focus on cases where companies have managed to survive, albeit reputationally tarnished and financially impaired to varying degrees (such as Ahold and Allied Irish); those that have emerged in radically different form (such as Waste Management, Tyco, and Vivendi); and those that have actually failed (such as Enron, Andersen, Daewoo, and Lernout and Hauspie). This reinforces
the idea discussed earlier: degrees of flawed governance exist, meaning problems can inflict minor, temporary damage, or result in distress and insolvency. We have also attempted to draw in cases from around the world – the United States, Switzerland, Germany, France, Sweden, Belgium, Korea – to reinforce the point that corporate governance failures are not limited by geographic boundaries.

These cases represent only a small cross-section of companies, problems, and outcomes. There are, unfortunately, very rich pickings in the pool of corporate problems which readers may wish to consult for additional information and lessons (the governance failures at Barings, Daiwa Bank, Sumitomo Corporation, Crédit Lyonnais, Bank of Credit and Commerce International, Maxwell Communications, Fletcher Challenge, Olympia and York, Peregrine Securities, Polly Peck International, Drexel Burnham Lambert, and Bankers Trust, among others). Table 7.1 summarizes the cases reviewed in this chapter.

<table>
<thead>
<tr>
<th>Company/Location</th>
<th>Primary Governance Eventual Outcome</th>
<th>Eventual Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Case 1: Enron</strong></td>
<td>Misreporting of financial statements</td>
<td>Bankruptcy</td>
</tr>
<tr>
<td>USA</td>
<td>Lack of proper controls</td>
<td>Liquidation</td>
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<tr>
<td></td>
<td>Lax board</td>
<td>Partial reorganization</td>
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<td></td>
<td>Conflict of interest</td>
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<td>Unethical behavior</td>
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<td></td>
<td>Failure of external audits</td>
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<td><strong>Case 2: Andersen</strong></td>
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<td>Bankruptcy</td>
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<td>Worldwide</td>
<td>Unethical behavior</td>
<td>Liquidation</td>
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<tr>
<td>USA</td>
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<tr>
<td><strong>Case 3: WorldCom</strong></td>
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<td>USA</td>
<td>Lack of proper controls</td>
<td>Reorganization</td>
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<tr>
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<td>Lax board</td>
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<td>Unethical behavior</td>
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Table 7.1  continued

<table>
<thead>
<tr>
<th>Company/location</th>
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<th>Eventual outcome</th>
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<tbody>
<tr>
<td>Case 4: Tyco USA/Bermuda</td>
<td>Fraud Misreporting of financial statements Lack of proper controls Lax and conflicted board Unethical behavior Failure of external audits</td>
<td>Severe financial distress Forced asset sales Management reorganization</td>
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<td>Case 5: Adelphia Communications USA</td>
<td>Fraud Misreporting of financial statements Lack of proper controls Lax board Conflict of interest Unethical behavior Failure of external audits</td>
<td>Bankruptcy Reorganization</td>
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<td>Case 6: Allfirst/Allied Irish US/Ireland</td>
<td>Fraud Lack of proper controls Unethical behavior</td>
<td>Management reorganization Asset sales</td>
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<td>Case 7: Waste Management USA</td>
<td>Lack of proper controls Misreporting of financial statements Lax board Conflict of interest Failure of external audits</td>
<td>Severe financial distress Forced asset sales Management reorganization</td>
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<td>Case 8: SAir Group (Swissair) Switzerland</td>
<td>Flawed strategy Misreporting of financial statements</td>
<td>Bankruptcy Reorganization</td>
</tr>
<tr>
<td>Case 9: Vivendi Universal France</td>
<td>Flawed strategy Misreporting of financial statements</td>
<td>Financial distress Forced asset sales Management reorganization</td>
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<td>Case 10: Daewoo Group</td>
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<td>Case 11: Asea Brown</td>
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<td>Case 12: Kirch Media</td>
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<td>Case 13: Ahold</td>
<td>Misreporting of financial statements, Lack of proper controls, Failure of external audits</td>
<td>Financial distress, Management, reorganization</td>
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<td>The Netherlands</td>
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<td>Case 15: Global Crossing</td>
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<td>Bankruptcy, Reorganization</td>
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COMPANY STUDIES

Case study 1: Enron, USA

The case of Enron, the Houston-based energy concern, has been widely reported and analyzed in the press given its dubious honor as one of the single largest bankruptcies in US corporate history. Although we will not go into extreme detail on the Enron case, there is much to draw on when considering aspects of flawed governance; indeed, the activities of Enron (and its auditor, Andersen) were catalysts in the creation and passage of protective legislation (such as the Sarbanes–Oxley Act, which we consider in Chapter 10). (For readers so inclined, the notes to this chapter contain additional technical details on the nature of the accounting and off-balance sheet problems that led to the company’s demise.)

Enron was created in 1985 through the merger of natural gas pipeline companies in Nebraska and Texas; Lay assumed the role of chairperson and CEO, a position he held through most of the next 16 years, until the company’s downfall in 2001. Although Enron remained focused on its core integrated gas delivery business for several years, it began refocusing its operations in the early 1990s: rather than delivering natural gas via pipeline, the company started matching buyers and sellers of gas, taking fees for intermediating. This model proved successful, and became the basis for future trading and risk management endeavors. The process accelerated when Skilling, future president (and, for a time in 2001, CEO), joined from consultant McKinsey to implement greater strategic changes. Under Skilling’s direction, the company shed more of its physical properties, converting from an asset-intensive natural gas pipeline to an “asset-light,” supposedly market-savvy, “new economy” trader, resembling, in many ways, a Wall Street financial trading institution.

As the US energy market deregulated and energy prices grew more volatile, Enron’s model appeared sound; revenues grew rapidly, and permitted expansion into new areas. During the boom years of the late 1990s the
company positioned itself as a trader of virtually any type of asset: pulp and paper, weather, commodities, credits, and so on. It also expanded into areas that it thought would benefit from rapid growth, including water (following deregulation measures), fiber optic capacity/Internet bandwidth, and so on. These were capital-intensive businesses that were not, however, profitable; indeed, the company would ultimately lose an estimated US$7 billion on its ill-advised investments in bandwidth and water (as well as energy operations in Brazil and India). The board of directors appears to have supported management steadfastly in its efforts to sell physical assets and refocus on trading and “diversified investments.”

Analysts and investors were positive about Enron and its prospects; quarter after quarter of improving EPS in the 1990s caused the stock price to increase steadily (including doublings in 1998 and 1999). The rising stock was tremendous currency for attracting additional talent, and by the turn of the millennium the company had 20,000 employees (many with increasingly concentrated positions in Enron stock in their 401(K) savings plans and retirement programs). In early 2001, as Lay handed the CEO role to Skilling, Enron reached an apex: the company reported revenues of US$100 billion and ranked seventh on the Fortune 500 list of largest global companies. It was rated the “best place to work” in numerous polls, and served as a corporate model for other energy trading firms who hoped to mimic its apparent success (as discussed in the next chapter). With a record stock price near US$90, Enron’s market capitalization reached US$60 billion, far greater than many industrial companies and financial institutions.

In early 2001, however, the company’s problems started mounting: the Internet and telecom bubble burst, calling into question the firm’s aggressive and expensive expansion into the broadband sector. With a slowing economy and a sliding stock market, Enron’s own stock price started falling, triggering financial obligations that would ultimately prove fatal. In August 2001 CEO Skilling left the company for “personal reasons,” unsettling investors even further. Former CEO Lay returned to his old role (retaining the board chair as well). While this was under way, whistleblowers within the firm – aware of widespread financial improprieties – were attempting to convey information to the board of directors; one employee, Watkins, was finally successful in alerting certain board members that all was not well.

The house of cards began collapsing shortly thereafter, as disclosure of financial errors and manipulation radically changed the financial profile of the company. Much of the problem centered on obscure and complex dealings between Enron and various special purpose entities (SPEs), including LJM1, LJM2, JEDI 1, JEDI 2, Chewco, and Raptors I–IV; although these were meant to be “arm’s length” dealings they were intricately entwined with Enron’s own financial structure and performance. In mid-October 2001
the company announced a US$544 million after-tax charge against LJM2, an SPE created and managed by Enron CFO Fastow. The firm also announced a US$1.2 billion reduction in shareholders’ equity as a result of improperly accounted transactions between Enron and LJM2: the news shocked investors and analysts, who had come to believe and support the Enron strategy and growth story (and ever-escalating share price). Just one month later the firm was forced to restate its earnings from 1997 to 2001 as a result of accounting errors between Enron, LJM1, and Chewco Investments (Chewco itself was managed by one of Fastow’s employees, Kopper).

The LJM1 and Chewco restatements reduced net income over the four-year period by nearly US$1 billion, lowered shareholder’s equity by US$2.1 billion and brought an additional US$2.58 billion of debt onto the balance sheet, changing, rather dramatically, the company’s already significant leverage profile, and making clearer the fact that Enron’s supposedly strong record of earnings was largely a fabrication. The news was accompanied by the fact that several Enron employees had profited significantly from the partnership transactions (including Fastow and Kopper, who earned at least US$30 million and US$10 million, respectively). Lay announced at that time that Fastow had been terminated, and the board commenced a formal internal (if limited) inquiry of its own.

Andersen, Enron’s external auditor and architect of the partnerships (for which it earned many millions in fees), indicated that it had not accounted for the SPEs correctly; as a result of errors early in the process, the SPEs were not consolidated on Enron’s balance sheet as they should have been, forcing the restatements. Many of the SPE transactions between Enron and the LJM1, LJM2, and Chewco partnerships were arranged because the company could not, or would not, do them with third parties; the end-game in all cases appears to have been financial window dressing rather than genuine risk transfer.

From this point on, Enron’s downfall accelerated; although fragmented details were reported in the financial press daily during late 2001, the full picture of the company’s problems did not become clear for some time afterwards. The final act took place in November 2001 when banks started canceling Enron’s remaining liquidity facilities; rumors of imminent bankruptcy were rampant, and rating agencies began downgrading the company’s debt, triggering more liabilities and constraining its financial position even further. The firm’s core trading business suffered considerably as the company was forced to post collateral it did not have. When it became clear that Enron could no longer survive the crisis of confidence, Lay attempted to team up with cross-town rival Dynegy for an eleventh-hour merger; even Dynegy, however, did not like what it uncovered in its due diligence and scuttled the deal days later. Enron filed for bankruptcy in early December 2001. Most stakeholders suffered considerably: shareholders saw the value
of their investments vaporize almost completely, thousands of employees lost their jobs (along with an estimated US$800 million in employee pension assets, invested in worthless Enron stock) and creditors lost billions of dollars.13

During subsequent investigations14 it became clear that the company suffered from widespread financial misrepresentation, fraud, self-dealing, conflicts of interest, and unethical behavior, as well as weak controls and a completely ineffective board of directors.15 While most stakeholders lost quite heavily, some executives did very well, selling Enron stock even as they urged employees to buy.16 Certain other groups, including investment and commercial banks, tax advisers,17 law firms, and accountants, received tens of millions of dollars in fees over the years as they helped build Enron’s capabilities. Some of these firms, however, were ultimately damaged by the collapse.

The most direct failure was Andersen, which, as noted below, filed for bankruptcy just seven months after Enron’s filing. Commercial and investment banks also suffered, largely from helping develop mechanisms that perpetuated Enron’s deception. For instance JP Morgan Chase, Citibank, and Merrill Lynch actively lent and/or structured transactions that helped the company increase its leverage or misstate earnings. In the fourth quarter of 2002 JP Morgan Chase took a US$1.3 billion charge18 to settle litigation over Enron (including nearly US$400 million related to a lawsuit with insurers who owed the bank US$1 billion on various surety transactions).19 The bank was accused of creating and financing deals, SPEs and off-balance-sheet transactions that helped hide Enron’s true leverage position (although claims that the bank helped the company commit financial statement fraud were dismissed). Similarly, Citibank entered into settlement talks with the SEC over its role in financing the company through the Yosemite offshore vehicle (which appeared on Enron’s balance sheet as a risk management position rather than a loan). Merrill Lynch pleaded no contest and paid US$80 million to settle civil charges that it fraudulently helped the company overstate earnings through various trading strategies and vehicles; it also fired several senior executives. Many other banks, law firms, and accounting firms were implicated, and settled or defended (including Deutsche Bank, Shearman and Sterling, Ernst and Young, and Deloitte and Touche). Fastow and various other senior Enron executives were ultimately charged on a variety of civil and criminal violations.

Governance flaws

- The board failed dramatically in its oversight duties; it appears to have had little notion of what executives were doing and was not forceful in barring business and transactions with potential conflicts of interest.
When it approved arrangements that allowed the firm’s CFO to also serve as general partner of the SPEs it failed to enforce controls or review performance. Directors, in several instances, do not appear to have understood the nature of the related party transactions they were being asked to approve.20

Internal counsel, internal auditors, external counsel, external auditors, and executive management failed to exercise any meaningful oversight or control over business managers for an extended period of time.

Ethical standards were poor. Conflicts of interest in employee dealings with corporate accounts and investment partnerships were ignored or wrongly approved; the self-dealing reached egregious proportions. CFO Fastow was conflicted, putting self-interests ahead of the company’s interests. Senior executives were actively selling large portions of their Enron shareholdings, even as they encouraged employees to buy more.

The audit and compliance committee failed to perform its duties in reviewing and questioning material SPE transactions; the compensation committee failed to review Fastow’s compensation related to the SPEs.

The tone from top management was aggressive, even ruthless, and seems to have bred the same type of behavior throughout many parts of the organization.
The firm experienced a collapse in its internal controls; the board and management failed to implement a proper system of controls, and failed on many occasions to enforce discipline (only Watkins’ contribution as whistleblower stands apart).

Financial disclosures related to the SPEs, off-balance-sheet activities and related company transactions were opaque, at best. Although LJM, Chewco, and other partnerships were mentioned in the footnotes to Enron’s financial statements, there was little detail about their structure and the dual roles of Fastow and other officers. In a further instance of conflict of interest, the financial disclosures given to regulators and investors were prepared by Fastow’s group and subject to manipulation.

Andersen, as auditor, failed to fulfill its professional responsibilities regarding accounting practices and audits, and failed to bring to the board’s attention possible control concerns. (It also failed to alert the board to concerns some Andersen partners apparently had about related party deals.) The audit firm was conflicted, serving as independent auditor as well as consultant on financial engineering transactions.

Vinson and Elkins, as outside counsel, failed to raise concerns about the SPEs or the nature of the financial disclosure it was charged with preparing.

Stakeholders – including creditors, agencies, and regulators – failed to truly question Enron and its opaque dealings/financial standards for a multi-year period.

Case study 2: Arthur Andersen, USA

Arthur Andersen, founded as a partnership in 1913, became one of the premier accounting firms of the late twentieth century, boasting a strong reputation for diligent audit and accounting work. Despite the series of consolidations that swept through the industry during the 1990s – which turned the “Big Eight” global accounting firms into the “Big Five” – Andersen remained independent. During this critical period the firm’s business focus started shifting from auditing to consulting and advisory services (including management and technology consulting, corporate finance advisory, and tax advisory). Consulting services were more lucrative than traditional audit and accounting business, hence management’s desire to build the practice; indeed, the firm’s audit services became in some ways a “loss leader” as consulting revenues outpaced auditing revenues by a three to one margin during the 1990s.

As the dual business focus grew stronger, the partnership reorganized itself into two separate, though still related, units: Andersen Worldwide
was created as the partnership holding company of Arthur Andersen and Andersen Consulting. As the consulting unit turned into a powerful revenue engine (earning US$9 billion in annual revenues by the end of the decade), tensions between the auditing and consulting units began mounting; in fact, as a separation between the two appeared increasingly inevitable the audit group began forming client consulting relationships of its own, many of them based on tax structures and advice. In early 2000, after a decade of escalating conflicts, Andersen Consulting broke away as an independent unit (renamed Accenture); after legal wrangling, the courts ordered the consulting unit to pay the audit group for splitting away. However, instead of approximately US$15 billion in cash the audit group was expecting, it received only US$1 billion, putting immediate pressure on the audit unit’s revenues and presence (the core unit went from being the largest audit/consulting provider in the world to the fifth largest auditor in the United States).

As Arthur Andersen attempted to rebuild its business operations it began focusing more heavily on revenue growth than audit quality. In some cases it chose not to abandon companies that favored aggressive accounting treatment so as not to lose lucrative consulting/audit client accounts. In addition, the firm apparently lacked proper internal checks and balances to guard against conflicts of interest that were building within the consulting/audit business (and within the audit practice itself). In some instances auditors became very close to client companies, sharing the same office space and often transferring to work for the client firm directly. (Indeed, evidence suggests that audit judgment was not always unbiased, and that those seeking to work for clients directly may have been lax in their audit duties, ignoring problems or providing positive opinions when prudence would have dictated otherwise.)

During the latter 1990s, the firm’s audit client roster came to reflect a growing number of high-risk clients. Bernardino, who became CEO in January 2001, created a risk profile of its 2500 audit clients when he was in charge of the US audit practice. Nearly 50 of those were classed as maximum risk and 700 as high risk. Maximum risk clients, in particular, required special attention because of their financial/structural complexity, aggressive accounting stance, and/or low creditworthiness. (Included in this group were Waste Management, Sunbeam, Global Crossing, Qwest, and Enron, all of which became problematic for Andersen.) Despite their maximum risk status, Andersen never applied overly stringent audit standards; had it done so, subsequent financial reporting problems, lawsuits/fines, and reputational problems might have been avoided.

A series of bad audits and subsequent restatements led regulators to sue Andersen on the Sunbeam and Waste Management accounts: both were reputationally and financially damaging. (Andersen was forced to pay
US$110 million to settle civil actions related to its mishandling of the Sunbeam account, and a further US$220 million to settle problems on Waste Management.) In fact, as a mark of its technical deficiencies and/or conflicts of interest, Andersen signed off on the financial statements of companies that eventually cost investors US$300 billion in “peak to trough” market value losses.

Although Andersen went through many difficult situations during the latter part of the 1990s, and compiled a poor record on some of its audit work, its downfall came through its relationship with Enron and the extensive work it did for the company over a multi-year period. Enron was one of Andersen’s key accounts, generating large accounting and consulting fees; by the start of the new millennium Andersen was earning US$1 million a week from Enron (US$27 million for consulting and US$24 million for auditing in 2001). While the audit unit reviewed Enron’s financial statements, the consulting division was instrumental in helping establish many of Enron’s SPEs and tax “plays” (as discussed above).

Some of Andersen’s Enron-related problems began as early as 1997, when the firm began signing off on audits, despite suspicious findings. For instance, in 1997 Andersen felt that the company should have reported earnings of US$54 million, instead of US$105 million. However, Enron finance staff argued that the discrepancy fell within the 8 percent “materiality” error guideline when examined as an average of the preceding years, and Andersen auditors acquiesced. The same happened on numerous other occasions, but some auditors appear to have operated under duress. For instance, in February 2001 several audit partners expressed concerned about the company’s aggressive practices; rather than investigate the matter, one senior auditor was removed from the account and local Houston partners responsible for the Enron relationship were permitted to overrule more conservative audit recommendations.

As the Enron investigation unfolded in the aftermath of the company’s October 2001 earnings release (and approximately two months before the company filed for bankruptcy), Andersen’s management agreed to assemble Enron documents for the SEC’s own investigation into SPEs. However, instead of delivering the documents to the SEC, Andersen partners, led by chief Enron relationship manager Duncan, commenced a thorough and systematic destruction of valuable (and potentially incriminating) documents. Only when Andersen was officially served by the SEC were audit team members told to stop their shredding activities.

In January 2002, approximately one month after Enron’s bankruptcy filing, Andersen’s management admitted that it had destroyed a large number of Enron documents after the SEC investigation had already started. Duncan and several associates were fired, but CEO Bernardino and other executives denied any criminal wrongdoing; in fact, Bernardino
claimed to be unaware of Enron’s situation until the scandal was in its latter stages. However, pressure was mounting and the partnership had a considerable amount at stake, including 28,000 employees and 2300 audit clients (17 percent of all US publicly listed companies and many important foreign accounts). In March 2002 the US District Court charged Andersen with obstruction of justice in the matter of “wholesale destruction” of Enron documents (the specific focus was on Andersen’s systematic efforts to destroy Enron-related documents between October and December 2001). The partnership hired respected former Federal Reserve chairperson Volker to create an independent oversight board, but the effort yielded no results. Bernardino stepped down as CEO in a final attempt to try to avert further actions against Andersen.

At this point many began to question the future prospects of the firm, which led to a further exodus of clients and employees. By June 2002 Andersen’s client roster had shrunk considerably, and only 10,000 employees remained at the company. Andersen went to trial shortly thereafter and, after six weeks of proceedings, was found guilty of obstructing justice, causing the SEC to ban the firm from further audits of public companies. The judgment spelled the end of the partnership. While Andersen’s base of intangibles – such as knowledge/intellectual property, ethics, goodwill, and reputation – was already in a precarious state prior to the trial, the SEC ban destroyed what little remained of the franchise. Interestingly, the deciding factor seems not to have been the document-shredding exercise or the disregard of policy and procedure, but the actions of an Andersen staff attorney who had urged Duncan to revise a damaging Enron earnings memo. (That is, for third quarter 2001 earnings, Enron management wanted to downplay the information reflecting the US$1 billion+ charges as “nonrecurring.” Andersen’s audit team felt such disclosure could be “misleading,” and reflected that belief in an interoffice memo, but Enron proceeded nonetheless. The Andersen lawyer then urged Duncan to delete any language related to the word “misleading.” The jury ultimately believed she had demonstrated criminal intent in making the recommendation.) Although a number of Andersen’s competitors examined the firm to determine whether any part of it could be salvaged, all opted to pass, believing the liabilities and reputational damage were simply too great. Andersen filed for bankruptcy in late 2002, turning the Big Five into the Big Four.

**Governance flaws**

- The firm was severely conflicted on some client accounts, simultaneously providing audit, accounting, and consulting services, often receiving millions of fees from different divisions of a given company.
Following the split with its consulting arm, Andersen’s executives were focused almost exclusively on rebuilding a new consulting business and generating revenues, to the detriment of the quality and independence of its audit business.

Andersen’s executives failed to control properly the behavior of senior audit partners and internal lawyers, who displayed considerable lapses in judgment, responsibility, and ethics.

Andersen’s audit work deteriorated steadily over the years, to the point where auditors were unable or unwilling to spot repeated financial errors or challenge aggressive interpretation of accounting rules at client companies. The technical capabilities within the audit group appear to have weakened.

Despite classifying accounts as high or maximum risk, the firm was not particularly careful in handling these “special cases”; it did not regularly apply additional examination procedures or reviews.

Local partners responsible for managing client relationships were, in at least some instances, given the authority to overrule the advice of the firm’s own auditors and specialists.

Certain auditors were conflicted, rendering bad opinions or ignoring problems in order not to jeopardize their chances of eventually working directly for clients.

The firm lacked a robust crisis management program through which to defend its reputation and intangibles. By the time executives attempted to control the damage, it was far too late to salvage goodwill.

**Case study 3: WorldCom, USA**

WorldCom traces its origins to 1983 when Long Distance Discount Services (LDDS) was formed to purchase long-distance accounts in a deregulating US telecom market. In 1985 Ebbers, a motel property operator, joined as CEO and started a long and ambitious transformation process, using the newly renamed LDDS Communications to buy larger public firms such as Advantage Communications and Advanced Telecommunications Corp; these gave it a public presence and broader working platform. Many other significant corporate acquisitions followed during the mid to late 1990s, including Metromedia, Resurgens, Williams Technology, IDP Communications (which together gave the rapidly growing firm additional long-distance capabilities), and MFS and UUnet (which together gave it Internet and broadband services). In 1997 the company, by then known as WorldCom, made a successful US$30 billion stock offer for MCI, in the
largest corporate merger of the time (trumping a bid from British Telecom). The large purchase did little to slow Ebbers and the board-approved acquisition strategy: in 1998 the company bought Internet service provider Compuserve and then added a wireless presence via Skytel. It then attempted to purchase long-distance and wireless rival Sprint, but was rejected by government regulators on antitrust grounds.

The telecom boom of the 1990s was a significant help for WorldCom; soaring P/E valuations boosted the company’s stock price, giving it a valuable currency for acquisitions (more than 70 between 1985 and 2000). By the start of the millennium Ebbers had transformed WorldCom into a communications powerhouse, with more international voice traffic than any other telecom company, and an Internet protocol “backbone” serving 2600 cities in 100 countries, but a highly leveraged one, with debt topping US$25 billion (and as much as US$36 billion by mid-2002). Unfortunately WorldCom’s expansion into broadband and wireless, much of it occurring during the top of the market cycle, failed to produce sustainable growth and returns, adding ultimately to the company’s financial woes. In addition to the burdens created by the ever-increasing debt load and goodwill amortization, the company also had difficulties integrating newly acquired operations into a cohesive corporate structure.24

WorldCom’s position was vulnerable to any downturn in the telecom sector, as became apparent when the telecom bubble burst in 2001. The impact of falling revenues and net income was soon reflected in the company’s stock price, which slid from a peak of US$97 in late 1999 (implying a market capitalization of US$115 billion), to US$46 in 2001. In an abortive attempt to restore and crystallize value, Ebbers proposed, and directors and shareholders approved, a plan to separate WorldCom and MCI into two tracking stocks, so that investors could participate in the specific business they preferred (WorldCom for Internet, broadband, and wireless, and MCI for long distance). The plan was permanently abandoned in early 2002 as the company became embroiled in financial scandals. WorldCom’s financial pressures continued to mount throughout 2001, as debt soared past US$30 billion, revenues and operating income slid, and the stock price plummeted. Importantly, through warnings from a dozen insiders and a lawsuit filed by shareholders (backed by interviews with more than 100 WorldCom employees), the board became aware that the company’s finances were being manipulated;25 however, they took no particular action for many months.

By the first quarter of 2002 it was increasingly clear that the company was ailing, although the full extent of its problems was unknown until the SEC announced it was investigating improprieties in WorldCom’s accounting policies (with a specific focus on goodwill, revenue recognition, and reserves, as well as loans to directors and officers). Just one month later the
board (led by the independent directors) announced the resignation of Ebbers, 3700 layoffs (6 percent of the workforce) and internal investigations by the internal audit department into possible fraudulent misrepresentation of revenues; Vice Chair Sidgmore took over as CEO. Ebbers’s ousting was driven by questions regarding the company’s finances and controls (much brought to light by whistleblower Cooper),26 as well as his excessive use of company loans. Directors also replaced WorldCom’s external auditor, Andersen (then under investigation on Enron-related issues), with KPMG. In May 2002 the company drew down US$2.65 billion of credit lines in order to remain operational; there was already widespread concern within the firm that banks would cancel facilities by invoking material adverse change clauses. Just one month later the credit rating agencies downgraded the firm to junk status and liquidity grew increasingly tight.

In June, WorldCom’s audit department reported to the audit committee the discovery of several billion dollars of false journal entries (such as US$743 million in third quarter 2001, US$941 million in fourth quarter 2001, and US$818 million in first quarter 2002), largely related to the capitalization of telecom line costs. KPMG advised that the capitalization policy was in contravention of GAAP, and the board called on CFO Sullivan to justify the accounting actions.27 (Andersen, in its capacity as former auditor, noted that it was unaware of the WorldCom line cost capitalization policy; indeed, during the investigation Andersen indicated that the discovery of the line cost transfers rendered its previous audit opinions unreliable.) The board rejected Sullivan’s explanation and terminated his employment, advised the SEC of the findings, instructed accountants to restate the 2001 and 2002 interim financials, and asked KPMG to re-audit the company’s prior financials. The board publicly disclosed initial restatements of US$3.8 billion, along with a plan calling for the termination of 17,000 workers and the sale of non-core assets. Shortly thereafter the SEC brought civil actions against Ebbers and Sullivan, the agencies downgraded WorldCom’s rating further into junk territory, and banks cancelled remaining credit facilities; the stock traded below US$1. Despite the board’s eleventh-hour attempt to enact a restructuring plan in early July, the damage was too severe and the firm was forced to file for bankruptcy.

In August, as internal investigations continued, revenues were restated downward by a further US$3.8 billion (bringing the total to more than US$7.6 billion). Subsequent investigation revealed that Sullivan and others had created false reports and journal entries in an effort to disguise financial manipulation related to fictitious revenues, reserve management, and line cost capitalization. Indeed, finance officials appear to have engaged in a regular policy of boosting revenues whenever the company was falling behind its EPS targets. Between 1999 and 2002 they made approximately
400 adjustments, creating US$4.6 billion in false revenues. The officers also manipulated results by tapping into reserves that had been established for other purposes (again, contrary to GAAP practice).28 In addition, a large amount of expenses were moved to MCI in order to make WorldCom’s financials appear more robust. More than US$3 billion of expenses were shifted to the subsidiary, and although MCI management pleaded with Ebbers for an explanation, it obtained none. By early 2003 fraudulent overstatements were increased from US$7.6 billion to US$11 billion as additional “cookie jar” accounting was discovered.29

Ebbers’s liberal use of borrowings for personal acquisitions was another source of problems. Banks saw in Ebbers a good client who could potentially lead to lucrative institutional business with WorldCom. Accordingly, many were eager to lend to him, at least initially; ultimately they may not have been quite as keen, but were often reluctant to turn down requests for more credit. For instance, during his tenure as CEO Ebbers drew on loans collateralized by WorldCom stock to purchase yachts, real estate, forest land, and a shipyard. Bank of America, a personal lender to Ebbers, became the lead on US$2.5 billion of financing for WorldCom’s acquisition of WilTel. Citibank was also active. In the latter part of his tenure Ebbers purchased 500,000 acres of land in British Columbia for US$65 million, initially financed by Toronto Dominion and later refinanced by Citibank. Citibank, which had a longstanding relationship with WorldCom (having arranged the MCI acquisition in 1997, for which it earned US$32 million in fees), ultimately lent Ebbers and the company US$552 million (US$88 million of which was repaid prior to the bankruptcy filing).

Citibank was also close to WorldCom and Ebbers through its Salomon Smith Barney (SSB) subsidiary. For instance, SSB analyst Grubman, eventually the focus of SEC fines and sanctions, gave WorldCom stock “strong buy” recommendations, even as the share price was sliding and the financial picture clouding; the positive rating was deemed important in order for SSB to win additional WorldCom mandates.

Banks were not alone in lending to Ebbers. WorldCom itself, through specific board approvals, extended US$415 million in collateralized loans to the CEO (the stock collateral was seized as the CEO’s (and company’s) woes started mounting). Some directors, who appear to have been conflicted, were overly accommodative: worried that Ebbers would sell WorldCom stock to finance asset purchases or other margin calls,30 which would cause WorldCom stock to plunge further, they approved more loans. Indeed, various directors then sold their own holdings, perhaps fearing an eventual plunge in the stock when the “house of cards” collapsed. In all, Ebbers borrowed a total of US$1.3 billion over the years, occasionally repaying credits but always drawing down new ones, so that the absolute total amount of borrowing kept on increasing.
After spending a year in Chapter 11 restructuring (shareholders received little or no value, creditors an average of 35 cents on the dollar), WorldCom emerged from bankruptcy in 2003 as a radically different company with narrower focus, better financial structure (with far less leverage), new directors, and new management (under CEO Capellas, who replaced Sidgmore). The company agreed in May 2003 to settle SEC fraud charges by paying a US$500 million fine (the original amount of the payment was US$1.5 billion, but it was reduced to US$500 million in proportion to the 35 percent recovery accorded creditors). As if to part with its troubled past, the company abandoned the WorldCom name in favor of MCI.

**Governance flaws**

- WorldCom grew rapidly in terms of scope and scale, and internal controls and management oversight were unable to keep pace. Acquisitions in many instances appear to have been opportunistic rather than part of a robust, long-term strategic plan. The large number of acquisitions arranged by management, and approved by directors, led to considerable opacity in the firm’s corporate structure and financials; period-to-period comparison of financial performance was complicated by the constantly changing organization, and investors had few benchmarks by which to gauge performance.
The company experienced a near-total breakdown in internal and external controls. Virtually every aspect of the monitoring and oversight process collapsed (by the board and its committees, internal audit, external audit, and creditors).

The board ignored, or failed to act on, critical information related to financial wrongdoings more than 12 months before the company ultimately collapsed.

By most accounts CEO Ebbers dominated the board, agenda, and information flow, and discouraged criticism; the board appears not to have been forceful in its dealings with Ebbers.

Board review of proposals and acquisitions was often not very comprehensive; directors do not appear to have questioned the significant five-year-plus acquisition spree that left the company highly leveraged and unable properly to integrate newly purchased operations.

Board committees do not seem to have functioned effectively. The audit committee permitted the existence of lax controls precisely when it should have insisted on greater strengthening (for example, after acquisitions and integrations). The compensation committee deferred certain responsibilities to Ebbers; compensation packages for top executives were excessive, and in some cases, inconsistent with the company’s actual performance.

Directors did not behave properly when considering personal loans to Ebbers and other executives; they approved personal loans to Ebbers so that the WorldCom stock price would not suffer from forced sales of loan collateral. In addition, some liquidated personal WorldCom shareholdings when it became clear that Ebbers’s own borrowing activities would continue to place downward pressure on the stock price.

Internal controls failed to detect, for an extended period of time, the line cost capitalization discrepancies and reserve manipulations that resulted in revenue inflation.

Internal audits were focused primarily on operational issues rather than substantive financial and accounting issues, even as a growing number of acquisitions took place. Indeed, the internal audit group had no comprehensive financial/risk control audit plan, so the overall control environment remained weak. (Only the work of whistleblower Cooper stands apart.)

Andersen, as external auditor, failed to detect the accounting discrepancies of 2001 and 2002, or failed to highlight and disclose them properly. The audit standards applied to what Andersen itself described as a high-
risk client were inadequate. Andersen (and the board) were initially unresponsive to the whistleblower’s findings.

The relationship between WorldCom and SSB appears to have been fraught with conflict. At least one bank researcher was conflicted, granting positive recommendations in hopes of winning additional business for his employer. There is also some indication that SSB was involved in IPO spinning with Ebbers (granting favored clients such as the WorldCom CEO prized allocations in “hot” IPOs).

Case study 4: Tyco International, USA/Bermuda

Tyco International, a US-based conglomerate incorporated in Bermuda, was originally established in 1960 as an investment company to hold controlling stakes in two subsidiaries, Tyco Semiconductor and Materials Research Laboratory, which focused on electronics and materials research and development. The firm went public in 1964 and added to its operations during the 1970s and 1980s by acquiring various other firms (such as Simplex Technologies, Arming Plastics, Ludlow Corporation, Grinnell Corporation); most gave it additional capabilities in materials and industrial/electronic products. Tyco’s expansion accelerated during the 1990s once Kozlowski was appointed Chairperson and CEO; indeed, between 1994 and 2001 Kozlowski spent over US$63 billion to acquire hundreds of companies. Kozlowski’s aim appears to have been to emulate GE’s highly successful template, transforming itself into a well-respected global enterprise, represented in a number of key areas and business lines.

By the late 1990s Tyco employed 240,000 workers through divisions and subsidiaries engaged in five main businesses: security, health care, electronics, plastics and adhesives, and engineered products; ADT Security Systems (purchased in 1997, giving Tyco a Bermuda incorporation) and CIT Financial (purchased in 2001) were two of the firm’s largest operations. Since most of Tyco’s business initiatives developed through acquisition rather than organic growth, the firm suffered from a decentralized (and rather convoluted) organizational and management structure; this was at least one of the reasons for the control failures that ultimately arose. (In fact, there was little notion or practice of integrated management of operations, supply chain management, consolidated operational and financial risk management, and so on.) Although Kozlowski engineered the acquisition strategy and drove the purchases, the board of directors supported the process throughout, including the use of large amounts of debt financing, which decreased the firm’s financial flexibility. Returns during this period seemed strong, and Kozlowski was paid handsomely; his compensation, however, was well in excess of any multiple achieved for shareholders
(although Tyco’s stock increased 13-fold between July 1992 and late 2001, his “legal” compensation grew four times more than that amount). During the latter part of his tenure Kozlowski supplemented his compensation with very liberal, and increasingly large, loans from Tyco.

Underneath the façade of prosperity were growing signs of trouble. Although Tyco appeared to be posting strong profits, an increasing amount was driven by aggressive accounting treatment of acquisitions, and ultimately financial manipulation. One of Tyco’s valuation techniques, subsequently investigated by the SEC, centered on “spring loading,” or understating the pre-acquisition earnings of a target company so that the firm could show a boost in earnings after the purchase. In 2001, with the slowdown in the global economy, decline in the stock market, and reduced corporate profitability, Tyco’s revenues started contracting, and it was forced to close 240 operating facilities and fire 13,000 workers. The 20 percent annual earnings growth rate the company had exhibited during the 1990s came to a halt. Acquisitions could no longer be financed with company stock, as it had devalued from its peak; nevertheless, management continued to pursue its expansion strategy, incurring more leverage in the process. By late 2001 Tyco’s debt had reached a record US$27 billion and the associated interest expense was becoming increasingly difficult to support. Goodwill amortization associated with hundreds of acquisitions was an additional burden. Cash flows suffered considerably, and the company was in an increasingly precarious state.

By early 2002, the combination of Enron “contagion,” rumors of aggressive accounting policies, and excessive leverage began taking their toll on Tyco stock, which declined from its 2001 peak of nearly US$63 to the mid-US$30s. By the middle of 2002 the stock would trade at US$12, representing an US$80 billion loss in market value. Problems came to a head in May 2002 when the US District Attorney’s office began investigating Kozlowski on potential misuse of corporate funds, fraud, and tax evasion (for example through purchase and conveyance of art works from New Hampshire, with no state sales tax, back to New York, with substantial taxes). Following a preliminary investigation, Kozlowski and CFO Swartz were formally charged with abusing corporate funds for personal gain and conspiring to defraud Tyco of US$170 million. Kozlowski was also investigated for US$430 million of “tainted” stock sales and US$43 million of personal tax deductions claimed against US$106 million of corporate charity donations. Tyco’s General Counsel Belnick was charged with grand larceny for stealing US$12 million via unapproved bonus payments and falsification of business records. Three directors were also indicted on charges. (Lead director Walsh, who chaired the compensation committee, controlled two companies that did substantial business with Tyco and received a US$10 million “finder’s
“fee” for the CIT acquisition (along with US$10 million for charity). When the payments were disclosed six months after they occurred, the stock plunged, wiping out US$17 billion of market value; Walsh ultimately resigned and pleaded guilty to various charges.) The remaining board members dismissed the senior management team in mid-2002.

As internal and external investigators pored over Tyco’s operations it became clear that the company was plagued by lax controls, unethical behavior, aggressive/fraudulent accounting policies (some lasting for as long as five years), questionable tax-related activities,33 and operating and financial errors.34 For instance, reserves were routinely used to cover unrelated expenses; reserves were established for acquisitions and then reversed in order to ensure EPS targets were reached; current expenses were regularly classified as long-term costs (and thus capitalized); and accounts purchased from other dealers were written off too slowly (leading to US$1.3 billion of discrepancies). PricewaterhouseCoopers (PwC), Tyco’s external auditor, failed to catch instances of financial manipulation and signed off on the flawed financial statements; it may have been conflicted, simultaneously earning fees from audits, tax services/advice, and computer/technology consulting.

In the wake of the charges and ongoing financial investigations, new CEO Breen recruited a fresh management team in order to repair Tyco’s financial and reputational problems.35 Unfortunately, on at least three occasions after assuming the leadership post, Breen was forced to announce the discovery of additional accounting problems and manipulations. For instance, in October 2002 management declared an additional US$135 million charge for accounting errors in ADT, in March 2003 it took a further US$265 million charge, and in May 2003 another US$1.1 billion (for “newly discovered” problems in both ADT and Earth Tech engineered services, bringing PwC back under scrutiny since it had approved the December 2002 financial statements).

Governance flaws

- The CEO, CFO, General Counsel, and several directors were charged with fraud; internal controls appear not to have detected the fraudulent activities for an extended period of time. The firm’s most senior executives behaved unethically and routinely flouted the firm’s code of conduct.

- The CEO and CFO earned excessive amounts of legal compensation, well above what might have been considered the norm (and certainly well in excess of value returned to shareholders); the board (which had at least several conflicted members) approved the packages. The CEO
borrowed increasing amounts of money from the company on a regular basis, and directors approved the practice.

- At least three board members were subject to conflicts of interest, receiving unusual financial benefits from the company.

- The overall acquisition strategy implemented by Kozlowski and supported by the board was flawed; purchases were arranged very rapidly and financed largely with debt, placing a strain on both the interest expense and goodwill amortization accounts.

- The company’s strategy of acquiring a large number of companies over a relatively short period of time led to decentralization and a sprawling management/operational structure; basic internal controls failed to act as an effective check and balance.

- The company, at the direction of several senior executives, routinely engaged in aggressive accounting practices in order to artificially boost EPS and stock price; financial controls and internal audits do not seem to have highlighted the problem, even though it lasted, in some cases, for more than five years.

- PwC, as external auditor, failed to detect the company’s problems and abuses for an extended period of time (even certifying financial statements after problems were known, only to have management take additional charges for the discovery of new problems). It also appears to
have been conflicted, generating fee income from its audit work, as well tax advice and services, and computer/technology consulting.

Case study 5: Adelphia Communications, USA

The case of Adelphia Communications stands as one of the most significant instances of financial fraud of a US public company. Adelphia, originally based in Pennsylvania, was founded in 1952 as a “community antenna association” that captured television signals and distributed them by wire to customers. The firm was formally incorporated in 1972 and began acquiring cable franchises in the local area. As cable television took greater hold throughout the United States during the 1970s and 1980s, Adelphia expanded its network, primarily through acquisitions. By 1998, the firm – through its Cable Entertainment, Digital Cable, Powerlink Internet, Security and Long Distance units – featured customers in 32 states and had grown into the sixth largest cable provider in the United States. While a proportion of the company’s business was managed on a fair and legitimate basis for a number of years, instances of fraud began appearing in 1998 and grew steadily from that point on. Although Adelphia was a public company, it was effectively managed and controlled by the Rigas family. John Rigas, as chairperson and CEO, appointed other family members to key positions, including CFO/treasurer, and head of corporate strategy.

Not until the firm collapsed in early 2002 did it become clear that the Rigases had used Adelphia as a vehicle for personal enrichment. As investigations unfolded it became apparent that the family had managed (and manipulated) internal processes closely for years, so it could continue demonstrating a financially sound and secure position to outside investors and Wall Street analysts, all the while increasing its personal wealth. Over the four-year period in question, Adelphia systematically hid billions of dollars of liabilities in unconsolidated off-balance-sheet affiliates, inflated earnings to meet EPS expectations, falsified financial statements and public disclosures, and hid self-dealing by family founders. Six senior Adelphia members, including four from the Rigas family, were ultimately charged with criminal wrongdoing.

For instance, between mid-1999 and the end of 2001 Adelphia excluded from its annual and quarterly consolidated financial statements a proportion of its debt by placing the liabilities on the balance sheet of unconsolidated Rigas-controlled affiliates, in direct violation of GAAP rules. Three of the company’s credit facilities featured Adelphia and Rigas subsidiaries as co-borrowers: each could borrow to the full amount, and each was jointly and severally liable for repayment. Under a typical transaction an Adelphia officer would wire funds to accounts that disbursed either to an Adelphia or Rigas subsidiary. The amounts drawn would then be omitted...
from financial reporting (although under GAAP all co-borrowings should have been consolidated, since Adelphia was jointly and severally liable).

Unfortunately these practices could have been revealed and reported at an early stage, but were not. Adelphia officials refused to alert investors to the omission of co-borrower liabilities, and management rejected external auditor Deloitte’s recommendation that it make a declaration. The company also created false transactions to give the appearance that debt had been repaid; for instance, the company claimed that several new public equity infusions were used to pay down debt when they were not. (False documents were prepared to help support these claims.) As a result of these fictions, the company misled investors about its liabilities in all filings and press releases for several years. When Adelphia’s true consolidated financial picture was finally revealed in mid-2002, its leverage was shown to have reached nearly US$18 billion, several billion greater than analysts had expected.36 The firm’s top managers also engaged in other fraudulent behavior, including redirecting funds from other companies to use as they saw fit. For instance Scientific Atlanta, a maker of cable-box converters, was interested in selling its product through Adelphia and agreed to pay the company US$26 per box to help market the product to Adelphia cable customers. Adelphia took the funds (US$84 million in total) but used them to reduce other expenses rather than market the cable boxes.

In filings and press releases the company routinely misstated its performance in important cable industry metrics, including cable subscriber base and cable plant “rebuild” or “upgrade.” The intent, once again, was to portray a better competitive position than actually existed to support the stock price. For instance, in 2000 Adelphia added 15,000 Brazilian and 28,000 Venezuelan subscribers housed in unconsolidated subsidiaries to its total base in order to meet subscriber growth targets. It also included 39,000 US Powerlink Internet subscribers and 60,000+ home security service clients as cable subscribers, inflating its US cable base by nearly 100,000. The company also claimed that 50 percent of its cable plant had been upgraded to 550 Megahertz capacity when only 35 percent had been completed, and preserved similar discrepancies throughout 2001.

Adelphia also repeatedly misstated its earnings before interest, taxes, depreciation, and amortization (EBITDA). For instance, it incorrectly included US$19 million (2000) and US$18 million (2001) of management fees, and created false revenues from a digital converter box “kickback” scheme totaling US$37 million (2000) and US$54 million (2001). From 1998 to 2002 Adelphia also used fraudulent misrepresentations and omissions of material facts to conceal self-dealing activities: although Adelphia was a public company, it paid for personal assets and activities benefiting family members. For example in 2001 Adelphia concluded three open market purchases of US$59 million of Adelphia securities by the Rigas-controlled
Highland Fund using monies from Adelphia which Highland never reimbursed; in early 2002 the Rigases paid approximately US$500,000 for 3600 acres of Pennsylvania land, to which Adelphia “contributed” US$26 million for resource rights. The company also used US$12.8 million of corporate funds to build a golf course under the control of the Rigases. Fraudulent activities continued through March 2002, including the payment of US$242 million of personal margin loans on behalf of the family. (These personal arrangements were never disclosed to investors or contained in regulatory filings.)

During the first quarter of 2002 Deloitte was unable to complete its audit for fiscal year-end 2001 as a result of incomplete documentation, errors, and discrepancies. Accordingly, Adelphia could not file its 2001 Form 10-K with the SEC – an extremely unusual occurrence for any public company – and the entire fraud began to unwind. The independent (or least non-conflicted) board members appointed a special committee to investigate Adelphia and purported wrongdoings; as details emerged, the stock plummeted from over US$20 to US$0.79. The company ultimately filed for bankruptcy and reorganization in late June 2002. Since the firm actually possessed quality hard assets (such as its cable network) that some believed were worth US$10–15 billion, its chances of emerging from bankruptcy as a restructured company appeared favorable. Accordingly, it managed to secure US$1.5 billion of DIP financing in August, and began replacing the management team and board of directors during the latter part of 2002 and into 2003.

Figure 7.4  Adelphia Communications weekly stock price, January 2000–April 2003, US$, NYSE/OTC
Governance flaws:

- There was no evidence of basic moral conduct or behavior at the top levels of the firm. Unethical behavior was a common characteristic among various senior executives, who exploited the company’s resources for personal gain for several years.
- The chairperson and CEO of the company appointed other family members to key executive management and board positions; nepotism and favoritism were rife.
- The Rigas family repeatedly used Adelphia resources for improper personal use and never disclosed this activity; internal controls failed to spot the diverted funds.
- The board was insufficiently independent and unable to challenge increasingly obvious wrongdoings.
- Adelphia’s external auditor, Deloitte, agreed with management’s decision not to correct the omission of co-borrowing facilities in its financial statements. Auditors were unable to detect instances of fraud for several years.
- Rigas family members had enough control over internal matters that independent control functions were generally unable to perform a meaningful, unbiased job. Where the company’s internal controls were independent of management interference, they appear to have been inadequate: accounting, compliance, and audit failed to detect the extent of the financial fraud being perpetrated for an extended period of time.
- The company, through the actions of management, violated GAAP rules in failing to report properly its massive debt burden. It also created false transactions to convince investors debt had been repaid; controllers were unable to detect or challenge the discrepancies.
- The company repeatedly misstated performance measures in order to improve its financial position and meet Wall Street EPS expectations, and thus boost the stock price.
- Even after facts related to the company’s improper reporting of off-balance-sheet liabilities become known, controls were not tightened sufficiently to prevent the payment of personal margin loans.

Case study 6: Allfirst/Allied Irish Bank, USA/Ireland

Allied Irish Bank (AIB), Ireland’s largest commercial bank, operated largely as a domestic bank in Ireland for most of its existence, being represented
internationally through branch offices in the key financial centers of the world. However, in the mid-1980s AIB expanded its US presence by acquiring a Mid-Atlantic bank that became known as Allfirst. The US operation was responsible for a loan and deposit business in Maryland and the Mid-Atlantic region, and also featured a small foreign exchange trading operation. The Allfirst subsidiary operated profitably and without incident for several years. However, in early 2002 AIB was forced to announce losses of US$691 million as a result of unauthorized trading by one of its Baltimore-based foreign exchange traders, Rusnak. AIB’s management indicated that the trader had manipulated controls to hide losses in Allfirst’s foreign exchange trading operation over a period of five years. Specifically Rusnak, who had expected the yen to strengthen against the dollar, took dollar/yen forward foreign exchange positions that were well in excess of his authorized US$2.5 million daily loss limit. When he began posting losses (because the dollar strengthened against the yen), he attempted to cover up his errors by creating fictitious option trades.

Lax operational, financial, and risk controls apparently permitted booking of the false trades; Rusnak was also allowed to transact from off-premises systems, contrary to standard market and regulatory recommendations. In a scene reminiscent of Barings in the mid-1990s (when rogue trader Leeson executed growing numbers of false trades to hide mounting losses), Rusnak engaged in certain high-risk options strategies to help disguise losses; these ultimately compounded the damage. For instance, in order to generate cash to cover his losing forward positions, he sold deep-in-the-money currency options expiring within a short time frame (such as one day), and bought the same options expiring one month out; these left the position looking “flat” and the overall book within risk limits, but just delayed inevitable recognition of the bad positions.

As losses grew, it became increasingly difficult for Rusnak to disguise the activity; an internal investigation that commenced in mid-December 2001 eventually revealed the fraud. In fact prior to the public disclosure, other institutions in the dealer community had expressed concern about Rusnak’s activities and some even refused to deal with him; more than a few Wall Street dealers thought it curious that a small regional bank in Baltimore was routinely trading foreign currencies in such large size (and employing rather odd strategies in doing so). However, this market intelligence was either not received, or not acted on, by management at Allfirst or AIB. Risk control oversight by AIB of its subsidiary appears to have been minimal; Allfirst’s treasury, responsible for foreign exchange trading, supplied basic risk information to AIB’s Dublin-based risk control function (including the fictitious hedge positions), but scrutiny from head office was not strong.

In the aftermath of the discovery and announcement, AIB engaged former US currency comptroller Ludwig to conduct a “post-mortem.” The
findings revealed an almost complete collapse of internal control processes and management supervision. For instance, the most basic operational precautions were ignored, such as obtaining daily foreign exchange prices from independent third parties. (Had this occurred, controllers would have noted discrepancies and caught the fraud at a much earlier stage.) In fact, the accounting department used Rusnak’s own foreign exchange prices when computing his daily profit/loss statement, meaning he could manipulate them to his advantage (to show profits and remain within risk limits). The deep in-the-money options Rusnak bought and sold carried the same prices, despite the fact they had different maturities, but controllers did not detect this discrepancy. Rusnak also exploited Allfirst’s outdated risk management and trading systems, which were incapable of reporting one-day expiring options, allowing for further manipulation of “hedges.” He also convinced operations clerks that the trades did not need to be confirmed externally with clients since no cash position resulted from the simultaneous buy/sell.

Internal auditors did not review intensively the Allfirst foreign exchange trading operation for an extended period of time, and auditors ultimately assigned to the task did not have the requisite knowledge to evaluate the business. In 1999 no sampling of transactions was taken to determine whether confirmations were correct. In 2000 25 trades were sampled, but 24 of them were exchange-traded (where Rusnak did not, and could not, manipulate); the single over-the-counter trade that was sampled was legitimate (50 of the 63 trades on the book at the time were fabricated). The report also noted that AIB group managers in Dublin lacked knowledge and appreciation of the risks associated with Allfirst’s foreign exchange trading business, and Allfirst’s treasurer, Cronin, was simultaneously responsible for trading profits and controls, a structure which has proven repeatedly to fail.

Several senior executives were ultimately dismissed in March 2002; Allfirst’s chairperson and AIB’s group treasurer took “early retirement” as did AIB’s group treasurer (although Allfirst CEO Keating emerged unscathed); AIB chairperson Quinn and CEO Buckley offered to resign but the board rejected their proposals. Rusnak was charged with fraud and imprisoned. Investors only temporarily pushed down AIB’s share price (by approximately 20 percent in less than one week); after gaining comfort that the situation was “isolated” and that new controls were being established, the bank’s share price recovered to its “pre-announcement” levels. Reputational damage, however, lasted longer. In mid-2003 AIB announced lawsuits against Citibank and Bank of America on the grounds that they had helped Rusnak in his scheme by not requiring him to collateralize false trades (which would certainly have revealed his losses at an earlier date). AIB finally exited the US regional bank market in 2003 by selling Allfirst to M&T Bank for US$3 billion.
Governance flaws

- Executive and board oversight of the risk trading activities of the offshore subsidiary – at both the head office and regional levels – appears to have been lax. There seems not to have been strong appreciation of the nature of the trading risk business being undertaken by the US bank subsidiary.

- Internal and external auditors failed to detect any sign of problems for an extended period of time, allowing the trader to create mounting losses through fictional trades. Internal operations and financial personnel appear to have been inexperienced and subject to coercion by the trader.

- Financial and operational controls and technology were inadequate, and failed to catch false, erroneous, and unauthorized transactions. No substantive audit checks appear to have been performed on the trading system and pricing/valuation processes.

- The trader had significant control over back-office/technology process and was permitted to deal from offsite locations, both in contravention of sound control policies.

- The head of the profit-generating treasury unit was also responsible for risk controls, a structure that runs contrary to proper risk governance.

- After discovery of the infraction, various members of the Allfirst executive management team, including the CEO, were permitted to
continue with their duties; they were not penalized or held responsible for the significant control failure.

Case study 7: Waste Management, USA

Buntrock and Huizenga founded Waste Management (WMX) in 1971 to acquire thousands of local and regional waste companies (a corporate “economies of scale” model). By assembling more than 2000 individual local operators over the next decade, WMX became the single largest waste collection company in the United States, although it operated via a complex and decentralized organizational structure with many layers, which ultimately weakened management and internal control. Investors were convinced of the business model, pushing the stock from less than US$2 in 1980 to over US$45 in the early 1990s (on a split-adjusted basis).

After 15 years of very significant growth, consolidation and efficiency gains in the increasingly mature waste collection market began to slow. Accordingly, management, with board support, began expanding into new areas and countries, restructuring its operations into several distinct business divisions including Waste Management (US disposal), Chemical Waste Management (“hazmat” cleanup and disposal), Waste Management International (European, Asian, Australian, South American, and Middle Eastern disposal, along with a 20 percent stake in UK utility Wessex Water), Wheelabrator (air and water supply), and Rust International (environmental engineering). In an attempt to create a new “leading edge” image the group was renamed WMX Technologies. Below these broad groupings were more than 700 direct, and 600 indirect, subsidiaries, which made daily management, financial reporting, and controls a growing challenge.

The complex relationships made financial and organizational issues opaque, and it was not readily apparent that the firm’s non-core businesses were actually losing money. Not until 1996 did investors begin to suspect that WMX’s non-core businesses were a drag on both capital and earnings, incapable of providing adequate returns. Although management continued to report profits, they were often reduced or eliminated by special charges and extraordinary items. These negative actions were eventually reflected in the company’s stock price: although the firm consistently outperformed both the market and the waste sector between 1991 and 1996, it was barely able to keep up with the broad market, and routinely underperformed focused waste companies, after 1996.

The company’s problems were not confined to excessive decentralization and flawed pursuit of often-unrelated expansion opportunities, they extended to the structure and actions of the board. For instance, during WMX’s growth years non-executive board directors participated actively in a phantom stock option plan that gave them a highly leveraged interest in the performance of
WMX stock. They also approved compensation packages and employment contracts for executives that were well outside industry parameters (in terms of size and tenure). This was a potential problem since the board was composed of a majority of non-independent directors: the board of 12 included two full-time insiders, three former employees, and three professionals with consultancy arrangements. (Even the audit committee featured an equal number of inside and outside directors.)

By 1996 institutional investors questioned WMX’s management on its strategy and operation. The Monks/Minnow activist fund Lens acquired a block of shares with a view towards forcing management to disclose more information, create greater accounting transparency, and complete a final clean-up of accounting numbers (rather than incremental, year-on-year, announcements). The fund was also interested in improving the quality and talent of the board, and bringing on a new CFO. Legendary investor Soros also jumped into the fray, acquiring a 5 percent block for US$750 million in mid-1996 – not as a predatory or hostile force, but with the intent of pushing for management change in order to realize the full potential of the firm’s core business.

During the 1996 AGM Buntrock, under pressure, stepped down as CEO (but remained chairperson), handing over the reins to his long-time lieutenant Rooney. But little else changed: two shareholders resolutions put forth, including a ban on consulting fees to directors and annual election of all directors, were defeated. Management and the board were firmly in control. Sensing discontent, however, Rooney soon proposed a plan to sell US$1 billion of underperforming assets by 1998, which boosted the stock price temporarily. Still, management moved slowly, frustrating investors. Further problems developed when the company’s SEC disclosure revealed that executives had received large salary increases and golden parachutes. (Sixteen executives received US$13 million of stock on termination; Rooney was also given a new five-year contract, 25 percent increase in compensation, and 350,000 options, and the company’s CFO and General Counsel were given new contracts, insulating them in the event of termination.) All of this occurred at a time when the company was reporting charge-offs and watching its stock price fall steadily.

Soon thereafter Rooney again attempted to assuage the marketplace with a new plan calling for US$1.5 billion of non-core asset sales, 3000 job cuts, curtailment of international operations, repurchase of the Wheelabrator subsidiary from the open market for US$900 million and reassignment (though not termination) of the CFO. Soros remained displeased, nominated four new directors and repeated calls for Rooney’s expulsion. Sensing no prospect of a let-up the board was ultimately forced to push Rooney out and appoint two new independent directors.

Rooney’s successor, LeMay from telecom company Sprint, proved not to be the solution to WMX’s problems: he clearly viewed the assignment as temporary, although just how temporary surprised everyone. LeMay
purchased no stock, commuted to WMX’s headquarters every week, remained active on other boards, brought no new personnel with him, and was given a compensation package with significant upside but no downside (such as a US$2.5 million guaranteed salary and 4 million non-indexed options); shareholders also wound up paying for a buyout of LeMay’s US$68 million Sprint package. Just three months after he started, LeMay quit (along with the current and former CFOs).42

Rumors of accounting irregularities swirled at the same time. Miller, an independent board member, was appointed acting CEO; he realized the importance of uncovering accounting issues quickly and taking bold actions to preserve WMX’s liquidity. By November 1997 the board had been reconstituted with a majority of outsiders, a new audit committee was created, and a new CEO search committee was established. Miller engaged institutional investors on a range of issues, including directors, compensation, and searches, and began consolidating the company’s operations (reducing regional offices from 250 to 32 and trimming staff by 1200, so saving US$100 million in annual costs).

As Miller dug deeper into the firm’s financials, it became clear that WMX’s accounting and misreporting problems were extremely severe, and would require US$3.5 billion of special pre-tax charges; the SEC launched its own investigation into the company. At the heart of the financial misreporting was a practice of extending the depreciation schedules on capital assets by two to four years, lengthening the useful work life and increasing the salvage value of trucks, dumpsters, and heavy equipment, and inflating the value and extending the useful work life of landfills. Internal and external auditors had failed to pick up the pattern and magnitude of problems for several years; Andersen’s technical competence as external auditor was called into question (which, as noted above, ultimately cost it more than US$110 million).

In March 1998 smaller rival USA Waste acquired WMX in an attempt to restructure the firm and leverage its own market position. However, the process was challenging, as new management struggled to cope with lawsuits, SEC inquiries, and certain scandals related to insider selling of shares prior to poor earnings announcements. USA Waste’s own management was criticized for mismanagement, including overpaying for WMX (a charge with some merit as further problems were eventually revealed). In 1999 the new company was once again forced to report extraordinary charges, including US$1.7 billion related to uncollected bills and unrecorded expenses, the news causing the stock to plummet once again from its June 1999 highs in the mid US$50s. A new CEO, Myers, was recruited to lead WMX into the new millennium, the board was strengthened, and new financial controls were put in place. However the investor base remained unconvinced, and the stock languished in the US$20s for the better part of three years.
The company was mismanaged over an extended period of time; senior management was well entrenched and permitted no new perspectives. Management refused to admit that WMX was no longer a growth company and tried to boost the stock price by pursuing an expensive, unfocused, and ill-advised acquisition strategy. It created a sprawling corporate empire with multiple management layers, complex organization, and inadequate controls.

Success away from the core business was not adequately measured or monitored by management or directors, and the information provided to investors was too diffuse to allow for reasoned decision making.

Management does not appear to have been focused on company operations, and many in the executive suite served on other company boards as directors. Executives were slow to take action or execute plans, and needed significant prompting from institutional investors.

The board of directors was not independent during the primary expansion period of the late 1980s/early 1990s; the audit committee was split equally between independent and non-independent directors. The board lacked the depth of knowledge and energy to oversee management.

Despite years of continual writedowns, directors repeatedly failed to question management’s expansion strategies.
Disclosure was poor and investors were given insufficient information to make reasonable financial assessments from year to year.

Executives were paid when they failed, and so had no apparent incentive to succeed; they were also given protection against termination or takeover, so they had no downside.

The process of identifying and hiring CEO LeMay was done with insufficient care and diligence, and added to the company’s already significant problems.

Accounting problems grew increasingly bold and abusive. Internal audit controls failed to detect a widespread pattern of financial abuse that lasted for many years.

Andersen as external auditor failed to report misapplication of accounting policies for an extended period of time.

USA Waste managers and advisors failed to do thorough due diligence when acquiring WMX; the company’s new shareholders were thus burdened with subsequent earnings restatements.

Case study 8: SAirGroup (Swissair), Switzerland

SAirGroup (SAG) – the holding company that owned Swiss national airline Swissair, domestic and short-haul carrier CrossAir (70 percent), AirGourmet catering, and majority/minority stakes in various other European airlines – was founded in 1930. After many decades of successful operations and measured growth, SAG’s management, led by CEO Bruggisser, commenced an aggressive, multi-year expansion plan. The so-called “Hunter strategy”, which started in 1995, was intended to give SAG a stronger footing in pan-European and regional flight routes. Since Swissair already controlled a reasonable and stable share of the international long-haul traffic to North America, South America, and Asia passing through Switzerland via its Zurich hub, as well as a fair amount of European short-haul travel passing through Basel via CrossAir, it believed the only viable expansion opportunity was through other airlines. Management felt it would need to acquire other airlines and develop alliances if it wanted to remain Europe’s fourth largest carrier in an increasingly competitive environment. SAG’s board of directors, comprised largely of Bruggisser’s friends and colleagues, willingly supported the Hunter strategy, apparently not questioning or challenging the motivation, quality of assets, or financial implications.

Unfortunately, SAG’s management found that buying into existing high-quality airlines was expensive and complex (from both a regulatory and labor perspective). Accordingly, the company began acquiring stakes in
second and third-tier regional carriers, in some cases building up to major-
ity interests over a period of time. These included Sabena (Belgium), TAP
(Portugal), AOM/Air Liberté (France/Africa), LOT (Poland), and Air
Littoral (France); it also arranged less formal code-sharing alliances with
carriers such as Delta (USA). Some have noted that the company’s policy
of paying a full price for such carriers (which often operated with outdated
physical equipment that ultimately needed to be replaced) actually
presaged the company’s eventual downfall.

In 1998, with the acquisition strategy in full motion and global economic
business conditions remaining healthy, the company’s share price reached
a peak of CHF500 (US$308). As the company continued its expansion
(spending on airline stakes, new capital equipment, staffing, and headquar-
ters), it financed itself primarily through debt; leverage grew steadily, and
by the turn of the millennium was becoming a significant drag on earnings.
SAG’s executive team, however, denied any financial difficulties.

By 2000 it became increasingly clear that air traffic within the Hunter port-
folio was deteriorating, not improving. The onset of the global economic
slowdown and extreme competition from pan-European cut-rate carriers
(such as easyJet, Go, and RyanAir) put considerable pressure on the portfo-
lio carrier routes; traffic growth at Swissair and CrossAir also suffered. Also,
since SAG was one of the industry’s highest cost carriers, the company was
soon recording losses and experiencing cash flow strains. (SAG featured
72,000 workers, including 21,000 in Switzerland, far more than any other
carrier operating similar fleet size and routing, and its employees were
among the highest paid in the entire industry; it also incurred additional
expenses from its inconvenient dual hub system (Swissair/Zurich, CrossAir/
Basel).)

Just six months later, in January 2001, Bruggisser was fired and the
board announced it was abandoning the Hunter strategy. As SAG’s finan-
cial picture continued to deteriorate, management called in its main credi-
tor banks (UBS and Credit Suisse) to secure new financing. The banks,
realizing the company’s finances were deteriorating rapidly, demanded
internal reorganizations. In March, nine out of ten board members were
ousted; the remaining director, Corti (who had spent 11 years as Nestlé’s
finance chief and less than a year on the SAG board), was appointed CEO.
The dismissal of virtually the whole board suggests that the company’s
precarious financial state was a direct result of failure by directors to ques-
tion the Hunter strategy and its method of execution during the six-year
period.

One month into his new role Corti announced a US$1.8 billion loss, the
first in the airline’s 70-year history. Much of the loss was attributable to
Swissair’s own bloated costs and interest burden, but also to the earnings
drag created by the poorly performing Hunter carriers (Sabena lost US$180
million, TAP US$92 million, AOM, Littoral, and Liberté a combined US$360 million). The loss depleted reserves and caused leverage ratios to worsen dramatically (total debt increased by US$5 billion, to US$9.2 billion, between 2000 and 2001). Corti put forth a restructuring plan centered on cost cuts, asset sales and a delay to previously committed share purchases in TAP and Sabena. This bought the company some time and allowed Corti to work on a more comprehensive plan. Shortly thereafter, however, he was forced to deal with the collapse of Air Liberté and a massive restructuring of Sabena.

Corti presented a second plan on September 24, 2001, just two weeks after the terrorist attacks in the United States brought international air travel to a temporary halt. The restructuring called for the creation of a new carrier, Swiss Airlines, comprised of Swissair and CrossAir, formed along the lines of the latter’s low-cost model. This would be accompanied by a 10 percent across the board staff reduction (7000 employees). By September 26, as SAG’s financial and liquidity position grew increasingly precarious, several small banks cut their credit lines. At this stage the company had less than CHF200 million in liquid assets, barely enough to keep flying for a few days. On September 29 UBS and Credit Suisse agreed to purchase a CHF260 million stake in CrossAir and grant an interim credit of CHF250 million, guaranteeing flights through October 3. However, in a curious turn of events, signing of the loan documents and disbursing of funds were delayed, meaning SAG ran out of money and could no longer fly. On October 3 SAG canceled all outstanding flights and filed for bankruptcy (leaving 39,000 ticket holders to join the creditors queue). UBS and Credit Suisse were maligned in the national press for not being more effective in preventing what many termed a “national tragedy.”

On October 3 the Swiss Bundesrat (Upper House of Parliament) granted temporary credits so that the airline could continue flying until a reorganization plan was developed. A series of investigations into the management of SAG commenced shortly thereafter. As events unfolded it became increasingly obvious that SAG’s board and management, as well as politicians, had been aware of SAG’s fragile financial position for quite some time and had known that very drastic actions would be required, including politically unpopular wage and staff cuts. Although members of the Bundesrat later admitted that they knew about SAG’s financial weakness, most indicated that they had not expected the dénouement to move as quickly as it ultimately did. Corti disputed that claim, noting that he had approached the Bundesrat members prior to October 1, seeking a CHF500 million credit; when the Bundesrat failed to take action at that point, SAG and the banks were left to their own devices. Subsequent “post-mortem” investigations led by the creditors committee examined aspects of SAG’s strategy, corporate governance
practices, acquisitions, and financial disclosures. There was a particular focus on SAG’s 1999 and 2000 financials, involving consolidation of subsidiaries. In fact, SAG’s foreign airline holdings were not fully consolidated in SAG’s figures, in possible violation of IAS regulations. In addition, there appears to have been violation of EU law, which forbade SAG from holding a majority stake in an EU airline.\(^4^4\)

Following the bankruptcy filing (with shares changing hands at CHF1.27 (US$0.78)), a restructuring operation, dubbed Operation Phoenix Plus, commenced. Corti and most of the board were dismissed, and Dose, former chief of CrossAir, took command. CrossAir immediately took on two-thirds of Swissair’s existing flights in order to keep traffic moving.\(^4^5\) The 70 percent CrossAir stake was taken up by the two lead banks for CHF160 million, and the Swiss federal and cantonal governments agreed to contribute funds as well, at a total cost to taxpayers of nearly CHF4 billion. (The final shareholding split, agreed by shareholders in December 2001, included 65 percent to individual and institutional investors (including 10 percent each to UBS and Credit Suisse), 20 percent to the Federal government, and 12 percent to the cantonal governments.) By December 2001 CrossAir was transformed into the new Swiss International Airlines.

**Governance flaws**

- The company’s expensive and highly-leveraged acquisition and expansion plan appears not to have been questioned or challenged by board members or creditors over a six-year time period. The concept of purchasing second and third-tier carriers at the peak of the market was extremely flawed; the board of directors was very closely aligned with the CEO and failed to critique the strategy at key points, permitting the acquisition of poor assets through considerable leveraging of the balance sheet.

- Financial disclosure was routinely opaque and provided no substantive information on the carrier’s true financial position. Investors, in particular, appear not to have been given information regarding the true state of the airline’s precarious position until it was far too late to take action.

- Executives had little discipline in controlling costs, which ultimately made Swissair an extremely uncompetitive carrier, a significant problem once financial pressures started building.

- Accounting and legal controls failed to discover discrepancies in the company’s consolidated financials or its legal treatment of minority and majority stakes.
The firm lacked a solid crisis management plan to deal with its growing liquidity problem, and relied too heavily on third parties to dictate the future path of events (such as banks and politicians).

Case study 9: Vivendi, France

Générale des Eaux, a French utility company, was founded in 1853 to offer water, utility, and waste services throughout France. The company remained focused on its core business until the second half of the 1990s, when Messier was appointed chairperson and CEO and began a radical transformation of the newly renamed firm, Vivendi. Messier, backed by a friendly board, directed a multi-year strategy centered on the acquisition of entertainment and communication properties (and the transfer of its core businesses into a new, separately quoted (but majority controlled) company, Vivendi Environnement). Messier’s ultimate plan was to create a global media firm by pursuing “digital convergence” strategies (content/distribution) being developed and pursued by other telecommunication and entertainment conglomerates (such as AOL, Time Warner, Primedia, Bertelsmann, and Disney). Unfortunately, the strategy was formed atop a shaky business model and occurred at the peak of the Internet/telecommunications/media boom, meaning the firm ultimately overpaid for all of its significant acquisitions and was unable to realize the synergies and benefits originally expected.

The firm commenced its strategic shift into telecommunications in 1996, when it created Cegetel, France’s largest private telecommunications operator (established in advance of national deregulation measures). In 1997 Messier attempted to purchase French publishing/media group Havas without a formal public bid (which drew the ire of shareholder interest group ADAM, led by activist Neuville); the bid succeeded, but only after Messier agreed to pay a special dividend to Havas’s minority shareholders. The firm continued with more significant media acquisitions from 2000 through 2002. For instance, in 2000 Vivendi purchased Canadian beverage and entertainment conglomerate Seagram for US$39 billion, gaining access to Universal Studios and Universal Music in the process (the firm sold Seagram’s beverage/spirits units to Diageo and Pernod Ricard in order to remain focused on media). It also acquired and consolidated the balance of pay-television operator Canal+, which it had helped create with joint venture partners several years earlier. Vivendi also added to its portfolio USA Network/Interactive, mp3.com and publisher Houghton Mifflin, along with minority or majority stakes in EuroPay TV, BSkyB, and NetHold. The company also retained a diverse mix of other interests – some seemingly inconsistent with its strategy – including stakes in Moroccan mobile phone company Maroc Telecom, rail company Eurostar, and energy firm Sithe Energies.
Expanding rapidly in a highly competitive industry at the peak of the market meant paying top prices for media properties and facing tremendous margin pressures; in just five years Messier orchestrated US$77 billion of acquisitions, many financed with debt. This strained Vivendi’s financial resources and profile; in fact, the firm’s interest burden increased precisely as global economic recession slowed revenue growth and competition compressed margins. When it appeared Universal’s entertainment assets were not performing as well as expected, Messier moved from Paris to New York to monitor them more closely; other top managers joined him.

As Vivendi prepared its 2001 accounts, the realities of the market environment and accounting standards forced a US$14 billion write-down in the value of company assets (primarily through charges against Canal+), creating a US$12 billion loss, the largest in French corporate history. Nevertheless Messier received more than US$5 million in compensation, as his performance incentives were based on “operating,” rather than bottom line, results. Other internal difficulties arose. For instance, in late 2001 the company’s CFO and several other executives exercised Vivendi options, one week before the sale of €3.3 billion of stock (which diluted other shareholders and drove the share price down); this prompted the establishment of an investigative committee. The firm also sent confusing signals to the marketplace which made it appear tentative and unfocused: in September 2001 it announced its intention of canceling 3 percent of outstanding shares through a repurchase (which temporarily boosted the stock price), but never did so. In fact, several months later it raised new shares through the block trade noted above.

As the company entered 2002, its liquidity position grew increasingly precarious and the specter of default appeared greater than ever. Indeed, the leverage that was straining liquid resources was so significant that the rating agencies finally downgraded the credit to junk levels (for example Moody’s cut Vivendi five rating grades, to B1, in less than one year). In June 2002, as the company scrambled for more liquidity, it “sold” a 13 percent stake in Vivendi Environnement to Deutsche Bank in exchange for a US$1.3 billion “loan” (which allowed the firm to avoid tax charges, but attracted the attention of French regulators).

As financial pressures grew larger, ADAM became more critical of Messier; Neuville, who believed the company’s executive stock option plan was excessive, the firm’s finances far too precarious, and its overall strategy misguided, called for a complete external review of the company’s corporate governance process. In a bid to silence the criticism, Messier offered her a board seat, which she declined. Other directors (primarily the Bronfmans, from Seagram) were displeased with Messier’s performance, and demanded his resignation (in fact, the board’s seven non-French directors pressed for his
ousting while the eight French directors remained supportive). As the stock price continued to slide and liquidity pressures intensified, the calls for Messier’s resignation grew, but any potential ousting was made difficult as a result of Messier’s board allies. (Messier served on the boards of Alcatel, BNP Paribas, St. Gobain, and LVHM, and the CEOs of those companies, all directors of Vivendi, were loyal to him. The CEO of LVMH, however, left in April 2002 as it became increasingly clear that the company was deteriorating and no action was being taken.) It took leadership from Axa’s CEO Bebear to force Messier out and bring the matter to a close.\(^{50}\) On departing, Messier attempted to secure €12 million in compensation and “renegotiate” a €25 million company loan, again drawing the ire of shareholders. After Messier’s departure French authorities launched an investigation into financial irregularities that might have occurred during the CEO’s tenure, raiding the homes of executives and directors, as well as Vivendi’s headquarters, in search of documents.

As the company attempted to shore up its finances and reduce leverage under the direction of new CEO Fourtou (recommended by Bebear), it put various assets on the block, effectively rejecting Messier’s overall strategy and undoing what had been assembled at considerable expense over a multi-year period. For instance, in late 2002 Vivendi sold its 10 percent stake in Eurostar for £670 million, or £330 million less than its original cost. It also sold its stakes in a video games unit, Houghton Mifflin, EuroPay TV, and Sithe Energies as it rushed to pay down debt (which was reduced from €19 billion in July 2002 to €15 billion by March 2003). In mid-2003 Fourtou announced a new strategy for the firm, centered solely on telecommunications (via Cegetel and Maroc Telecom); this meant a sale of the expensive, and poorly performing, US entertainment assets acquired in 2000 (which were ultimately acquired by GE/NBC). In announcing the strategy Fourtou admitted that the entertainment/distribution convergence model held “no significant synergies between its components.” Messier’s overall strategy, supported for years by the board, proved expensive for shareholders, who lost 80 percent of their investment value between 2000 and 2002.

**Governance flaws**

- The CEO guided the company through a series of expensive acquisitions, adding significant leverage and jeopardizing the firm’s financial future along the way. The company funded most acquisitions with debt and routinely overpaid for the assets it purchased.

- Most of the board appears to have supported the strategic expansion throughout the multi-year period; only when liquidity was severely strained and the firm’s future was in doubt did board loyalists take action to force the CEO’s resignation.
The board was composed of “CEO-friendly” directors who failed to question management’s strategy and use of leverage in recasting the company; they were also extremely slow to act to oust the CEO when it was already clear that the firm was in financial distress.

General corporate strategies were confused and sometimes contradictory; the firm held various assets that were unrelated to its supposed media/communications focus.

Overall financial management and control was weak: the firm assumed far too much debt in pursuing its goals, spent excessively on both assets and expenses, and put its liquidity at risk.

The company attempted to improve its financial appearance by incorporating “gain on sale” accounting of a subsidiary, in contravention of established rules. It also tried to convince investors that its leverage was better than it actually was by including all the operating earnings of minority-owned subsidiaries. It also seems to have engaged in other inappropriate accounting practices, the subject of official investigation.

Certain executive managers appear to have exercised options for personal gain ahead of market sensitive news (for example, the sale of stock).

The compensation payable to the CEO towards the end of his tenure was unreasonable given the collapse of the stock price and the large decline in the company’s value over the prior years.
operating write-offs the firm was forced to take. Use of top line revenue as a performance goal was not effective in aligning “pay for performance” directives.

**Case study 10: Daewoo Group, Korea**

Kim Woo Chong founded Daewoo Group as a textile trading company in 1967; over the next 30 years he built it into the Korea’s second largest chaebol. In the earliest days of the company’s operations Kim came to the conclusion that the United States would impose quotas on cheap Korean textiles, and moved quickly to boost the company’s export share in order to capture the largest possible amount of quotas. By 1972, he had succeeded in winning one-third of the total allocation, giving him a platform for further corporate expansion.

Over the next few years Kim started buying interests in other businesses, and in 1976 acquired a heavy machine manufacturing company that had fallen on hard times; this market was the company’s first foray into heavy industry. During the 1980s and 1990s Kim built Daewoo into a national economic power: good political connections provided access to a steady flow of government-directed credit, allowing the company to build a portfolio of heavy industry businesses, including autos, industrial machinery, and shipyards.

Although large and rapid acquisitions led Daewoo into financial difficulties in the mid-1980s, the government chose not to curtail credit and force the firm into bankruptcy. Instead, it accepted Kim’s proposal to place Daewoo assets in trust and hire a cadre of professional managers to run the firm’s daily operations. However, neither proposal was ever put into effect, and Kim continued to operate much as he had in previous years. Indeed, the Daewoo shipbuilding unit encountered further difficulties in 1989, but Kim’s solid political ties made possible another bail-out. The government thus missed two opportunities to discipline and control Daewoo properly early in its corporate life. During the 1990s Daewoo continued expanding into new areas, including consumer goods and services. At its peak the conglomerate operated 33 domestic companies and 370 overseas subsidiaries, and employed 320,000 workers in 16 countries.

The business/government ties that characterize many East Asian nations played a significant role in the rapid and broad-based expansion of Daewoo and its group companies. As Korea began pursuing its goal of economic industrialization during the 1970s and 1980s, credit was made available to conglomerates such as Daewoo. Prior to the 1997 Korean financial crisis chaebols generally featured very high leverage ratios that resulted from a combination of plentiful access to government-directed credit, static shareholdings held by family/management control groups (meaning little
external equity issuance) and very low profitability (meaning negligible retained earnings). During this expansionary period an estimated one-third of all chaebols were unable to cover interest payments out of cash flows, indicating that they had to borrow simply to cover their interest obligations. Easy credit thus fueled acquisitions and growth/market share opportunities, while placing tremendous financial pressure on corporate balance sheets and income statements. Just before its collapse in 1999 Daewoo featured US$65 billion in debt, and was forced to make significant interest payments to both private and government banks and bondholders.

By all accounts Daewoo’s expansion strategy was overly aggressive and diffuse, and proceeded unchecked for years; this is not surprising, since Kim directed the board very closely. In fact, board members were “hand-picked” Kim allies, willing and able to support his vision for Daewoo without question. Investment decisions and capital allocations were often made on the basis of completely unrealistic sales and growth projections, and expansion into new markets, products, and industries was often made without due appreciation for operating and financial risks. This ultimately translated into poor earnings, particularly in the latter part of the 1990s (for example, in 1998 US$51 billion of top line revenues translated into a US$458 million loss). Excessive and unfocused investment, high operating costs (from inefficiencies) and soaring interest expenses (from the large debt burden) meant shareholders were earning no returns.

In search of continued revenue growth (if not returns), Kim and the Daewoo group took significant operating risks, establishing business and manufacturing complexes in countries such as Iran and Uzbekistan – locations where other Asian and international companies were simply unwilling to do business as a result of the potential downside. In addition, the company’s expansion into the auto sector was extremely bold – effectively a “do or die” bet on the company’s fortunes. Daewoo built state-of-the-art auto manufacturing facilities in Poland, Iran, Vietnam, the Ukraine, and Korea in an effort to take a commanding share of local and regional auto markets; this at a time when the Korean and global auto markets were already suffering from considerable excess capacity. Kim intended to make 2 million cars per year by 2000 (including 1 million outside Korea); by 1999 the company was well on its way to meeting that goal, producing 1.6 million units. Demand, however, was slack, causing a build-up in inventories and further pressure on company finances. Seeking some relief, Daewoo attempted to negotiate the sale of half of Daewoo Motors to long-standing JV partner GM for US$7 to 10 billion, but the two companies failed to agree on a price (primarily as a result of differences in valuations, some stemming from hidden losses; this was a foreshadowing of events to come).

The beginning of Daewoo’s collapse came with the Asian currency crisis of 1997, which led to speculative capital flight and currency/asset
devaluation throughout developing Asia. Korea was impacted severely as the won plummeted, capital withdrew and the country’s credit rating was cut to junk status. The government, in attempting to cope with enormous financial and economic problems through negotiations with the International Monetary Fund and creditor banks, cut back drastically on the amount of credit granted to the *chaebols*, including Daewoo. Despite the national crisis and the high degree of leverage on Daewoo’s balance sheet, Kim continued to expect a credit “lifeline” from the government. Indeed, many in the local corporate, banking, and investment communities thought that Daewoo was simply too big to fail, and that the government would ultimately intervene to keep the company afloat. But the government was unwilling to direct further credit to Daewoo (and bail it out for a third time). During 1998 and into 1999 the government reduced credit to all of the *chaebols*, signaling the effective end of the close government/business conglomerate ties that had existed for decades.

As the national operating environment worsened, Daewoo management steadfastly refused to sell non-core assets, clean up its balance sheet, or adopt stricter and more accurate accounting controls and standards. On the contrary, the company borrowed from any source possible in order to stave off the increasingly likely specter of insolvency. In 1998 alone it borrowed US$13.5 billion in the short-term markets, paying up to 30 percent in some cases. Bank creditors, sensing growing difficulties, demanded personal guarantees from Kim and other Daewoo executives. The rating agencies downgraded Daewoo deeper into junk bond territory, and Korea’s Financial Supervisory Commission commenced an investigation into possible accounting fraud.56

By August 1999 the company lacked the liquidity to carry on operations and was forced to declare bankruptcy, becoming Korea’s largest-ever corporate failure. The magnitude of the collapse was so significant – investment funds held more than US$40 billion of Daewoo bonds and commercial paper and US$25 billion of bank loans – that President Kim Dae Jung had to reinforce liquidity in the investment trust and banking sectors in order to avoid a panic. Kim left the country just as he was about to be charged with fraud (under Korean law, he cannot be indicted unless he returns to the country). In 2001, more than two years after Kim’s departure, the Korean government charged 20 senior Daewoo executives with US$2 billion of fraud; those charged were ultimately found guilty and imprisoned. From abroad, Kim denied defrauding investors and claimed that the financial misreporting was simply an extreme case of “window dressing.”

Following the declaration of insolvency, the government assumed control of Daewoo through powers of indirect nationalization, and started to dissolve the conglomerate (for instance, selling auto factories to Renault/Hyundai,
and Daewoo Motors to GM).\textsuperscript{57} It did the same with 13 other insolvent chaebols and commenced a reform program in the banking sector.

**Governance flaws**

- Kim, as founder, CEO, and chairperson, controlled all aspects of the company’s strategy and operations, and appears not to have accepted input or criticism from other executives or board members. In reality, the board was simply an extension of Kim’s executive management team, and remained firmly under his control for decades.

- There was no explicit or implicit code of ethics surrounding Daewoo’s corporate culture; bribery, corruption, and exchange of favors, within and outside the company, appear to have occurred with frequency at various levels.

- The company pursued an overly aggressive expansion strategy, and invested, on a highly leveraged basis, in sectors that were suffering from excess capacity or unrelated to core business. Acquisitions were not always based on realistic sales and revenue projections. The goal in most cases appears to have been to gain market presence/market share, rather than profits.

- Government authorities failed to keep a close check on Daewoo’s activities during its leveraged expansion years of the 1990s, despite the fact that they had effectively bailed the company out on two occasions in the 1980s.

- Financial disclosure was completely opaque. Internal financial and audit controls appear to have been nonexistent or severely flawed, as they allowed considerable financial statement manipulation and fraud over a multi-year period.

- Government and private sector banks failed to provide additional monitoring of Daewoo’s operations, granting almost unlimited access to credit for an extended period of time. Illegal “kickbacks” between Daewoo executives and certain bank managers were prevalent, as was discovered during the trial phase of the 20 convicted executives.

**Case study 11: Asea Brown Boveri, Sweden/Switzerland**

Pan-European industrial conglomerate Asea Brown Boveri (ABB) – created through the 1988 merger of Asea AB of Sweden (long associated with the Wallenberg family) and Brown Boveri of Switzerland – developed in the 1990s under the leadership of chairperson and CEO Barnevik into a GE-style powerhouse. The firm, represented in a number of industrial manufacturing
sectors, including industrial robotics and power generation/distribution equipment, developed a reputation for management, marketing, and technical expertise. Barnevik was an aggressive promoter of growth through acquisition, and over the course of five years, led the firm on an acquisition spree involving more than 200 companies. Although some of the acquisitions were beneficial in expanding market presence and product line, others were money losers (such as various Eastern European industrial firms and garbage burning companies), which detracted from shareholder value.

Certainly no acquisition was more damaging than the one involving US-based Combustion Engineering (CE), a troubled boiler maker that ABB purchased for US$1.6 billion. The company used asbestos to line its boilers, and although it was warned by lawyers about the potentially significant liabilities that could accrue from asbestos claims – CE already had US$4 billion of such claims outstanding at the time of acquisition – Barnevik proceeded with the acquisition. In late 1996 Barnevik relinquished the CEO role to focus on strategy as chairperson; his lieutenant, Lindahl, succeeded him.

For all of its supposed corporate savvy, ABB eventually floundered under the weight of excess leverage, weak cash flow, a sprawling, decentralized empire with insufficient control/focus, and a host of lawsuits related to CE’s asbestos claims. The firm’s share price marked a steady decline, and by the early 2000s was trading at 90 percent below its peak, lowering the market value of the company from US$40 billion in the late 1990s to less than US$4 billion by 2002. In addition to poorly performing acquisitions, the company was plagued by other problems, including fraud in one of its UK subsidiaries (which led to US$40 million of losses and the dismissal of several top executives), as well as the discovery of highly controversial retirement benefit packages for Barnevik and Lindahl. Specifically, in 1992 Barnevik reached an agreement with the company’s co-chair to receive US$87 million in pension payments on his departure; the rest of the board was apparently unaware of the full agreement. (Shareholders obviously had no prior notice of the agreement, either.) The board later also discovered, and subsequently disclosed, that a US$51 million severance package had been put together for Lindahl, who was terminated. The board stopped most of the payments to the two former CEOs and demanded restitution; Barnevik and Lindahl eventually returned approximately half of the packages. Dormann, Lindahl’s successor as CEO, noted in the aftermath of the scandal that retirement benefits had been made available under the assumption of proper corporate approvals by the board of directors, which had subsequently determined that approval procedures were “unsatisfactory.”

The company’s fortunes began worsening in 2001. In April 2001 the company reported a US$470 million reserve for further CE asbestos liabilities, and set up additional amounts at various points throughout the year. In converting to GAAP in October 2001, it suffered a 28 percent decline.
in ongoing operating income as it recast its operating inflows as one-time gains. Cash flows grew increasingly strained as a result of the liabilities, weak earnings, and growing interest burden; in fact, operating cash flows were insufficient to cover debt payments and the firm was forced to begin selling off assets acquired in the mid-1990s, often for much less than it had paid. The credit rating agencies lowered ABB’s rating to the borderline of junk; as this was occurring, company management, under the direction of Dormann, renegotiated its bank facilities in order to ensure enough liquidity.

In early 2002 the board announced a US$700 million loss (including US$970 million in asbestos charges and another US$500 million in corporate restructuring charges) and published full details on the controversial pension plans noted above. CE filed for bankruptcy, unable to cope with the financial strain any further: this multi-billion dollar loss was borne largely by ABB shareholders. In the wake of the executive departures, failed expansion strategies, excess leverage, asbestos lawsuits, and severance/pension packages, Dormann continued to try to reshape ABB’s operations. He reduced its size and scope considerably, firing 40,000 workers and putting the Oil, Gas, and Petrochemical division on the block (leaving the Power Technologies and Automation Technologies units as core businesses). He also centralized management in order to eliminate the inefficiencies and control weaknesses that had become a key part of the company’s problems. Indeed, Dormann effectively reversed many of the strategies, acquisitions, and operating methods designed by Barnevik, and sanctioned by the board, during the 1990s.

Figure 7.8 ABB weekly stock price, June 1999–April 2003, US$, SEK, Stockholmsborsen
Governance flaws

- Management’s acquisition strategy was unfocused and the board did not question the wisdom and financial/managerial implications of buying an average of 20–30 companies per year, every year, for more than 10 years.

- ABB’s aggressive acquisition spree – completed over a relatively short time frame – forced the firm to decentralize management; this very diffuse control eventually created conflicts, communication problems, and control weaknesses (such as in the UK subsidiary in the late 1990s). The acquisition program also damaged ABB’s financial position through excess leverage and strained cash flows; these ultimately led to a deterioration in the firm’s credit profile, threatened its liquidity, and forced a program of radical restructuring and asset sales.

- The board permitted Barnevik to acquire a company with a known history of significant liability claims, despite advice to the contrary from legal experts (who were ultimately proven correct). This misadventure was very costly, leading to years of losses and the eventual bankruptcy of the subsidiary.

- The board never properly approved the pension and severance payments given to Barnevik and Lindahl; the amounts were excessive by any measure. Although the packages were large, they were never disclosed to shareholders until well after the fact.

Case study 12: Kirch Media, Germany

Leo Kirch, CEO of privately-held Kirch Gruppe and an insider in Germany’s political and economic circles, operated his business empire with a high degree of secrecy and opacity. Kirch Media – the primary subsidiary of Bavarian-based Kirch Gruppe – was created in the 1970s as a programming and entertainment distribution company. Its early efforts were focused on buying foreign movie rights, dubbing them into German, and reselling them within Germany. In 1984 the German government relinquished its own television monopoly, and Kirch created a broadcaster, Pro Sieben Sat.1, as a viable competitor. Kirch ultimately built Sat.1 into the second largest private broadcaster in Germany, retaining a direct 52.5 percent stake in the entity. (The balance of the shares were held by the public (36 percent) and publisher Axel Spring Verlag (owner and publisher of Germany’s largest newspaper) (11 percent).)

Kirch Media gradually expanded into other media-related ventures, primarily via acquisition (for instance, a 40 percent stake in Axel).
It also entered the digital pay-television market in the mid-1990s; although Kirch had very high expectations for the venture, digital television services ultimately led to the company’s downfall. In fact, the company invested nearly US$3 billion over several years to develop the platform, but failed to gauge demand properly, signing up only 100,000 subscribers: well short of break-even, let alone profitability. (Many potential subscribers were put off when Kirch attempted to pass along the cost of the expensive digital set decoders.) The leverage required to fund the project, coupled with poor demand, created significant financial and cash flow pressures. Financial flexibility was constrained even further when Kirch purchased broadcast rights for movies and sports events from various foreign media companies; although they were important from a programming perspective, the commitment amounts (US$2.6 billion through 2006) were simply too large for Kirch Media to handle without further jeopardizing its financial profile.

In fact, by the late 1990s the firm’s leverage was becoming increasingly difficult to manage. Despite a growing debt burden and obviously weakened financial state, the company continued to raise enough money to keep operating. Since there was no rational financial basis for continuing to lend to such a poor credit risk, many have pointed to government pressures and political influence as the driving forces. Stoiber, the head of the Bavarian state government, and Kirch were close friends, and Stoiber’s CSU party instructed the state-owned Landesbanks to continue lending to Kirch. By funding Kirch’s ill-advised projects through state-owned banks, the government was able to ensure the availability of jobs in a state beset by growing economic and unemployment problems. (Kirch Media was one of Bavaria’s largest employers with 12,000 workers.) In addition, by helping Kirch remain afloat, Germany’s two media titans (Kirch and Bertelsmann) were able to keep foreign media competitors at bay. Hypovereinsbank and Bayerische Landesbank, the state-owned Landesbanks, were thus in a difficult position: although they were “instructed” to lend to Kirch Media, any collapse could lead to the loss of privileges they enjoyed in making risky loans using taxpayer funds. The two banks, which had already lent a combined US$1.4 billion, balked at additional lending as early as 2001, but were “persuaded” by the government to continue, for a time at any rate.

Kirch’s financial pressures mounted in early 2002 as Axel exercised a US$670 million put option requiring the company to purchase Axel’s share of Sat.1. The payment, along with additional sums due under the foreign rights project, US$480 million in trading rights payable to soccer clubs, the cost of carrying the digital television network (estimated at US$1 million a day), and interest payments on US$8 billion of debt, made it increasingly difficult for the firm to continue. Realizing that insolvency would follow
without drastic restructuring, Kirch called in administrators to help with the growing crisis.

The team created a plan in February 2002 that would merge Kirch Media with Sat.1. Under the reorganization a new firm would have two arms: Kirch Media, responsible for rights trading, programming, production, and technology, and Sat.1, responsible for television broadcasting and multimedia. The deal was postponed, and despite the presence of multiple stakeholders that were interested in keeping Kirch operating as a going concern (such as government officials and regulators, banks, institutional investors like Lehman and Al-Saud Kingdom Holdings, and suppliers such as Viacom and Vivendi), the firm’s debt burden proved to be too much. Kirch Media filed for bankruptcy in April 2002, opting for insolvency protection under self-administration. Since aspects of the company remained valuable (including the majority stake in Sat.1, the film library, and various TV rights packages), administrators believed they could reorganize, rather than liquidate, the company. A possible sale of the core of the firm to a group including publisher Bauer Verlag and various creditor banks fell through in December 2002 because of a disagreement over price. In early March 2003 competing bids were submitted by TV Française 1 and private interests, which valued the company at approximately €2 billion; a private investor group readied a final purchase agreement in mid-2003.

**Governance flaws**

- Kirch Gruppe and Kirch Media were vague in their financial disclosures, preserving a considerable amount of opacity. This was to the detriment of stakeholders, who found it difficult to know the company’s true financial position. The organizational and shareholding structure of the firm was convoluted. Although Kirch Media was controlled by private interests it was being supported, *de facto*, by a base of taxpayers who had little notion about the firm, its operations, or its financial status.

- The company embarked on an ill-advised and expensive digital television and programming strategy that does not appear to have been grounded in realistic supply and demand projections. Many of the transactions Kirch entered into represented extremely large, multi-year commitments that severely reduced financial flexibility.

- Leverage was permitted to grow rapidly and soon became too large for the firm to manage. Board directors and bankers appear to have supported the massive leverage throughout, initially on a “voluntary” basis and ultimately on a “directed” basis.

- Conflicts of interest arose between government officials, bankers, and
the company. AAA-rated banks, under the direction of government officials, were instructed to lend to a junk-rated credit using taxpayer funds in order to ensure a continued employment base.

External forces (such as politicians) seeking to achieve other political goals may have caused other stakeholders, including state taxpayers, to pay for the flawed strategies and excesses of the company.

Case study 13: Ahold, the Netherlands

Dutch supermarket and retailing giant Ahold traces its origins back to the Heijn family grocery business that was created in 1887. For many years Ahold was regarded as a solid national blue-chip company that preserved a Dutch, and then European, operating focus. However, in 1993 new CEO Van der Hoeven announced a new strategy centered on global expansion. Indeed, the aim was to create the world’s largest food supplier and supermarket chain. The general strategy, supported by Ahold’s board, appears to have worked, on the surface. Between 1996 and 2001 Ahold spent US$19 billion on 50 acquisitions. (In 1999 alone management was involved in 10 separate, but simultaneous, purchase discussions.) In the United States, one of its major markets, it acquired Stop and Shop, Bi-Lo, and Giant, becoming the fifth largest food retailer in the country. In 2000 it added to its distribution capabilities by acquiring US Foodservice (USFS), a restaurant/hotel food distribution company which eventually grew through acquisitions of its own. By the turn of the millennium Ahold had become the third largest chain in the world – behind US-based Wal-Mart and French-based Carrefour – primarily through the acquisition of key sector companies in North America, South America, and Continental Europe. The earnings growth created by these acquisitions helped boost Ahold’s stock price, which reached a peak of nearly €40 in the late 1990s.

All was not well, however. Underneath the tremendous growth, independent subsidiaries were experiencing control problems, and some were falsifying accounting information. Several of Ahold’s subsidiary operations had weak internal controls, giving unscrupulous managers the opportunity to manipulate information. For instance, within the Spanish Superdiplo unit (which Ahold acquired for US$1.5 billion in 2000), corrupt pay practices and false business records were discovered. Similar problems were apparent in the Argentine Disco retailer joint venture, a Scandinavian unit, and other subsidiaries. Indeed the Argentine venture proved disastrous, as Ahold management effectively ignored the sovereign risks associated with the local economy. When the Argentine government devalued the currency in 2000 the operation started posting losses and Ahold’s partner defaulted. This forced the Dutch firm to buy out the entire stake. Ahold’s disclosure did not reflect
this “contingent liability,” in existence since 1998, until its 2001 annual report. Outside equity analysts also started to question the firm’s earnings sources and growth rate, and became increasingly concerned about inconsistencies and discrepancies.

Difficulties continued to develop, culminating in the company’s announcement in early 2003 that Van der Hoeven and CFO Meurs had resigned, and earnings had to be restated by an initial US$500 million as a result of accounting problems; it also indicated that several senior managers, primarily in the USFS unit, had been suspended pending further investigation. The stock immediately plunged by 60 percent and the credit rating agencies lowered the firm’s rating to a sub-investment grade BB+. As events unfolded it became apparent that Van der Hoeven had offered to resign in November 2002 once external auditor Deloitte discovered the accounting irregularities, but the board had refused. By early 2003, as financial irregularities became increasingly apparent and disclosure deadlines approached, the company met with its bankers to discuss the accounting problem and secure renewal of a €3.1 billion credit facility; only then did the board accept the resignations of the CEO and CFO.

Ahold’s accounting problems appear to have centered heavily on the treatment of allowances in the USFS unit. It is common practice in the food industry for suppliers hoping to boost sales of their goods to give distributors (such as Ahold) “promotional allowances.” These often take the form of invoice price deductions for retailers meeting sales targets. While such discounts are legitimate, managers in various Ahold units routinely booked far more in allowances than they had actually received, or booked them in advance of receipt, effectively overstating revenues. Internal controls were unable to detect the overstatements for more than three years. At least a portion of this behavior appears to be attributable to the demands of Van der Hoeven, who was intensely focused on expanding market share and profitability, and was displeased with those who missed their targets. Indeed, Van der Hoeven demanded that divisional managers continue exceeding their annual 15 percent growth targets (versus 10 percent for the peer group), regardless of market environment or forces. This seems to have led some managers to do whatever was necessary to meet profit targets.

In May 2003, after completing an internal investigation, the firm indicated that it would have to increase its revenue overstatement from the initial US$500 million to US$880 million, and several weeks later it increased the amount to over US$1 billion. It also announced the dismissal of several senior USFS managers and accepted the resignation of USFS’s CEO. The investigation did not implicate Van der Hoeven; it did, however, point to executives at several other firms, including Sara Lee and Conagra, who signed off on false documents saying they owed USFS more than they actually did.
Ahold management was engaged in a high-risk rapid growth strategy through global acquisitions that left it susceptible to a broad range of control and management issues.

Unethical behavior was apparent in different parts of the organization, including divisional managers operating Ahold subsidiaries in several countries.

The company misreported its revenues for an extended period of time. Although external analysts openly questioned the firm’s financial disclosures for the 12 months leading up to the overstatement announcement, internal and external auditors appear to have failed in their efforts to detect the problems until a sufficiently large overstatement had accumulated.

Internal accounting controls at many of the firm’s units were weak, permitting manipulation of financial results. In most cases problems were left unchecked for an extended period of time.

Financial disclosures, particularly of subsidiary operations, were routinely opaque (and often incomplete), meaning investors had no accurate picture of the firm’s financial position (for instance no disclosure of the Argentine contingency, which proved very costly).

Executives bred a culture of pressure that led certain managers ultimately
to do whatever they felt was necessary in order to meet profit targets (including financial manipulation and fraud).

- Ahold’s dual board system featured several directors with excessive time commitments (such as serving in other executive or board director roles); their time and attention to Ahold’s affairs may have been limited.

- Managers at other companies were apparently willing accomplices in the fraudulent schemes, suggesting wider industry governance and control issues.

**Case study 14: Lernout and Hauspie, Belgium**

Belgians Lernout and Hauspie co-founded a technology, communications, and speech recognition/language software company, Lernout and Hauspie Speech Products (LHSP), in late 1987 to develop advanced communication, automated speech recognition, and digital speech compression software. Early growth was based on organic expansion into new geographic and product markets and the establishment of licensing ventures with major technology firms (such as Intel, NEC, and Microsoft). The company later supplemented its operations by acquiring Kurzweil, Dictaphone, and Dragon Systems. The company’s growing presence in the United States led it to create a joint headquarters structure that split management, administration, production, and sales between Belgium and the United States. (The stock was traded on both the NASDAQ in the United States and EASDAQ in London.) Asian business was handled in part via a Korean subsidiary. CEO Bastiaens was responsible for running the company while Lernout and Hauspie, together retaining a 30 percent stake in the firm, acted as board directors and titular co-chairs.

As the firm expanded its operations via acquisition, it came to rely on a growing amount of leverage that constrained its financial flexibility and pressurized earnings. For instance, the acquisitions of Dictaphone and Dragon Systems were funded primarily through debt (US$450 million and US$460 million, respectively); unfortunately, neither operation generated the returns originally anticipated, creating a drag on earnings. Integration of the companies into the overall LHSP structure was also challenging; in reality, the subsidiaries were left to operate as semi-autonomous units. Despite high expectations LHSP’s Asian operations fared poorly, earning revenues of less than US$100,000 during the first quarter of 1999.

With that weak performance, accountants, auditors, and investors should have been more surprised when the Korean office reported quarterly revenues of US$59 million in the first part of 2000. However, several months passed before internal and external auditors (KPMG) began examining the
reasons for the subsidiary’s very strong performance. As they worked through their audit, they discovered a US$100 million shortfall in the cash account; after more investigation they determined that at least 70 percent of the reported sales figures were fabricated. Specifically, from September 1999 to June 2000 the subsidiary reported US$175 million in sales revenue, most false. In reality, LH Korea engaged in sales subject to written or oral “side agreements” that were not contained in the firm’s contract files. These agreements noted that LH Korea would not pursue collection of license fees unless customers generated sufficient revenues from the use of LHSP software to cover the fees. To prevent the appearance of uncollectible receivables on LH Korea’s books, the subsidiary arranged transactions with four Korean banks that made it appear the receivables had been factored on a non-recourse basis (although they were actually secured by blocked deposits). Thus the transactions were secured loans from banks to LH Korea, rather than the sale of receivables to the banks. LH Korea also arranged to have third parties purchase licensing agreements from original customers. Transferees then obtained loans collateralized by LH Korea assets and used the proceeds to pay LH Korea through the original customers. The net effect was a paydown in LH Korea’s receivables, making it seem like customer collections were successful.

This was just one element of a multi-year financial fraud driven by directors and executives. As investigations proceeded, KPMG concluded that management was fully aware of all of these practices, and had actively lied about business structures and revenue streams, and routinely given false financial information. Shortly after KPMG’s discovery, Bastiaens stepped down as CEO (although he remained a board director for a time), Hauspie and Lernout relinquished their posts, and CFO Damnekens was reassigned internally. A new management team was recruited, and announced that the company would restate its financials from 1998 through the first half of 2000 to take account of the falsified revenues. KPMG simultaneously withdrew its opinion on the validity of the 1998–2000 statements, noting that it could no longer rely on LHSP’s accounting practices. The stock, which had already fallen 60 percent between 1999 and 2000, fell a further 30 percent after the announcement. (In fact NASDAQ shares had declined from a 1999 peak of US$72.50 to US$6.22, erasing more than US$8 billion in market value.) The company’s bankers soon canceled a US$430 million credit facility, placing greater financial strain on the company.

As US and Belgian regulatory authorities began their own investigations into LHSP’s operations, the size and depth of the financial improprieties grew larger. By the time the SEC filed charges against the firm in October 2002, it became clear that it had engaged in various revenue inflation schemes from 1996 until the second quarter of 2000. For instance, from
1996 to 1999 two Belgian entities created by LHSP, Dictaphone Consortium, and Brussels Translation, improperly recorded US$60 million in revenues. The two subsidiaries were formed to allow the firm to claim revenues from its own R&D activities. However, under GAAP rules, unless the projects led to marketable products (which they did not), the company could not legitimately claim the revenues, meaning the sales and service transaction fees were actually disguised loans.

By late 1998, as “revenue” from the two entities was declining, LHSP created various “language development companies” (LDCs) that enabled the company to claim more than US$100 million in revenues from license fees. (The revenue contributions of the LDCs were never detailed separately in LHSP’s financials, so the precise source of the income was unknown to investors.) The LDCs were incorporated in Singapore as private companies but had no particular operations (the managing directors were all Belgian nationals); although management indicated that the LDCs were established to develop regional language software capabilities they were actually just shell companies with few employees and no products. LHSP itself supplied, or arranged, financing for the LDCs (and also engaged a Bahraini investment bank to find additional venture capitalists). To the extent that LHSP obtained funds for the LDCs it incurred incremental liabilities, but these were never disclosed to investors. Added to the list of grievances was a “stock price support” scheme where Baestiens used US$25 million of company funds to artificially boost the stock price by buying out Lernout’s share stake at a 12.5 percent premium.

Baestiens, Lernout, Hauspie, and director Willaert were all imprisoned in late 2002 and charged with financial fraud. Despite attempts by management to continue operations, LHSP was burdened by a series of shareholder lawsuits and lack of liquidity; the firm’s stock price fell below US$1 and was delisted. The weight of these financial pressures was too great and the firm was forced to file for bankruptcy in the US, Belgian, and Korean court systems; the firm tried unsuccessfully to arrange DIP financing but was ultimately forced into liquidation. In early 2003 US unsecured creditors filed a liquidation plan calling for an allocation of assets between the Belgian, Korean, and US cases.

**Governance flaws**

- Ethical standards at the top level of the company were non-existent; founders, directors, and senior managers were engaged in unethical business conduct for a period of up to three years, misusing corporate resources, lying, and committing fraud. The scope of the fraud was broad-based and designed to give a false financial picture and boost the stock price.
Accounting practices and disclosure rules were routinely flouted by the firm’s senior officers; disclosures to investors were purposely opaque, providing no substantive detail on the company’s Korean or Singaporean operations.

The CEO conceived a plan to use shareholder funds to boost the stock price by purchasing a co-founder’s stake at a premium.

The corporate strategy of using large amounts of debt to acquire three major companies was ill-advised and severely constrained operating flexibility.

Internal controls were lax, unable to detect the massive accounting fraud undertaken by the Korean subsidiary, the Belgian shell companies, and the Singaporean LDCs for nearly three years.

KPMG, as external auditor, was unable to uncover accounting problems for several years.

**Case study 15: Global Crossing, USA/Bermuda**

Global Crossing, a US/Bermuda-based telecommunications company, was founded by CEO Winnick in 1997 as a platform for laying fiber optic cable and selling capacity to a variety of users, including Internet service providers, long-distance voice/data suppliers, and optical networkers.
The company’s basic business model was centered on management’s belief that network traffic would continue to grow rapidly, and fiber optic capacity would be highly coveted as applications increased and demand for streaming audio and video expanded. During the telecom and Internet boom years of the late 1990s this may have been an acceptable assumption, but only when grounded in an appropriate supply and demand framework. Unfortunately, Global Crossing’s strategy was flawed in various respects: overly optimistic demand projections (based on a model that Internet traffic would double every three months, ad infinitum), accumulation of excess capacity as other companies installed fiber optic cable of their own, and lack of recognition that competing wireless technologies were improving very quickly and might ultimately threaten demand for fiber.

During the next five years, Winnick and Global Crossing embarked on an ambitious, capital-intensive, fiber optic network expansion program that ultimately linked 200 cities in 27 countries. The firm’s growth occurred through both organic development and acquisition (such as the purchase of Frontier in 1999). To fund acquisitions and fiber placement Global Crossing began borrowing heavily against its growing network. Unfortunately it borrowed far too much against assets that were extremely overvalued (a fact that banks ultimately discovered when they sought repayment of their loans). The network that emerged was extremely impressive, although much of it was “dark fiber”: many miles of installed, but unused, cable, often connecting network points that stood little chance of gaining a meaningful volume of traffic. Connecting these out of the way locations was far cheaper, but less useful, than linking major traffic hubs. As the Internet bubble burst in late 2000 and into 2001, it became increasingly clear that Global Crossing (and others) had created far too much capacity for the marketplace. Indeed, the company was unable to secure enough customers to make its bandwidth program economically viable.

By late 2001 the company could no longer source enough liquidity to remain afloat. In addition, the prospects of turning the company around were bleak; despite the existence of hard assets, most were extremely overvalued in an environment with excess capacity and slack demand. In late January 2002 Global Crossing filed for bankruptcy under the weight of excessive debt, becoming the fourth largest bankruptcy in US corporate history. Although the company listed assets of US$22.4 billion, many of these were nearly worthless, as a result of consistent overpayment and lowered value in a weak marketplace. In the aftermath of the filing it became evident that, as financial pressures increased, the firm had manipulated its accounting results in order to boost revenues/profits. These accounting manipulations appear not to have been detected by Andersen (present, once again, as both auditor and consultant).
Some of the problem centered on fictitious “capacity swaps” between telecom carriers,60 designed to inflate revenues. For instance, between 2000 and 2001 the company allegedly booked over US$1 billion in capacity transactions; under these false swaps companies simply traded volume on network routes with one another in order to boost revenues. Other manipulations centered on recording long-term sales immediately rather than over the life of specific contracts. (Since 1999 GAAP has required indefeasible rights of use (IRUs, which provide long-term, unfettered use of network capacity between carriers) to be recognized over the life of the entire arrangement rather than upfront.) A senior finance officer who emerged as a whistleblower (and was subsequently fired)61 detailed many pages of deceptive accounting practices and “false metrics” used by Global Crossing and Asia Global Crossing that were condoned by Andersen. This evidence led to regulatory investigations into financial improprieties (with a special focus on failure to disclose accurate information, preparing and disclosing false information, and using inside information for self-enrichment). The firm’s outside counsel, Simpson, Thatcher, and Bartlett, was also investigated for potential breach of ethical and professional duties.

While under bankruptcy protection Global Crossing restructured its operations with new partners. In August 2002 Singapore Government’s Singapore Technologies Telemedia (STT) and Hutchison Whampoa agreed to inject US$250 million for a 61.5 percent share in the newly restructured firm. Hutchison eventually backed away from the transaction as it did not want to go through an extensive US Department of Justice “scrutiny” process (a requirement, since Global Crossing carried “sensitive” data). Although shareholders and most creditors fared poorly in the rise and fall of Global Crossing, Winnick gained handsomely from his tenure at the company, earning a reported US$700 million on his stockholdings over the five-year period.

**Governance flaws**

- The company’s business model and strategy were based on excessively aggressive demand forecasts for bandwidth; the base operating assumption that Internet volume would double every three months appears overly optimistic by any measure. Possible competition (from direct fiber competitors and new wireless technologies) did not dampen the projections. The firm’s board appears to have backed the strategy and excessive use of leverage.

- The firm opted to expand parts of its network by focusing on areas where it could lay fiber cheaply, and not where true demand would ultimately arise (the more expensive, main traffic routes).
Winnick, as CEO, received extremely high levels of compensation that appear to have been out of all proportion with the performance of a financially healthy company, let alone one that was manipulating its financial position.

Financial accounts were altered to reflect a far healthier picture of revenues and cash flows than actually existed; the external auditor not only failed to spot the problems, but condoned the activity.

Banks failed to act as prudent monitors; many extended far too much debt to a company with an unproven business model based on unrealistic growth/demand assumptions and inflated asset valuations.

**Case study 16: HealthSouth, USA**

HealthSouth, an outpatient healthcare service provider based in Alabama, was founded by chairperson and CEO Scrushy. Over the course of the next 15 years the company’s operations and fortunes grew as demand for convenient medical care expanded; by the turn of the millennium HealthSouth featured 1229 outpatient rehabilitation clinics, 203 outpatient survey centers, and 117 hospitals. Over the years the company’s stock price strengthened steadily, hitting a peak of US$30.56 in 1998. Scrushy profited handsomely from the company’s apparent good fortunes, earning an estimated US$225 million in stock gains. In early 2003, however, the medical

![Figure 7.11 Global Crossing weekly stock price January 2000–April 2003, US$, NYSE/OTC](image_url)
network that Scrushy built came under intense scrutiny. As a result of information from senior finance officers (including five former HealthSouth CFOs who agreed to plea bargaining), the SEC formally charged the CEO with overstating profits by US$1.4 billion between 1999 and 2002; that figure was subsequently increased to US$2.5 billion. Three finance officers pleaded guilty to fraud charges and were ultimately followed by several others.

As the investigation unfolded, a variety of problems became evident. Scrushy, a charismatic CEO, completely dominated the firm’s board. In fact, several directors had close ties to the CEO and appear to have been conflicted. (One director earned US$250,000 a year in company consulting fees, another invested in real estate ventures with Scrushy, a third was awarded a US$5.6 million glass installation contract from HealthSouth, and several invested in Scrushy’s investment firm, MedCenter Direct.) When outside director May (subsequently acting CEO), tried to replace several long-term directors close to the CEO, Scrushy unsuccessfully tried to force him to resign. In contrast to usual practice, the audit committee and the compensation committee duties were combined into a single committee; one that met very infrequently, particularly in 2001. (In retrospect, their inactivity might have been a signal that all was not right.) Board negligence appears to have been prevalent, with directors not pursuing issues or questioning signs of trouble.

As the investigation deepened, details on how the accounting fictions were perpetrated came to light. A team of controllers that grew to several dozen over the years would meet with other top executives to determine which assets needed to be manipulated, and by how much. Most were told, however, that their help in falsifying accounting journal entries to alter the firm’s financial picture would only be needed for one or two quarters (to meet Wall Street earnings targets), after which the entries would be reversed. That, of course, proved not to be the case. The actual process involved inflating revenues (primarily by improperly lowering adjustments to allowances representing the difference between what HealthSouth charged a patient and the amount collected from insurers) and then inflating balance sheet accounting entries for cash, inventories, plant and equipment, and so forth.

The technique was relatively simple – there were no SPEs or related-party transactions, as in the Enron case – but the entries were very small, so discrepancies were difficult for internal and external auditors to spot. (In fact the controllers knew the fixed asset valuation thresholds over which auditors would test, and made certain they did not breach them.) Stripping away the manipulations revealed a much poorer earnings picture. For instance, in 1999 the company should have reported a loss of US$191 million instead of a gain of US$230 million, in 2001 a gain of only US$9
million instead of US$434 million, and so forth. By 2002 assets were effectively overstated by at least US$1.5 billion and possibly as much as US$2.5 billion, including 50 percent overvaluation of the plant and equipment accounts.

Ernst & Young, as outside auditor, claimed to have been unaware of the fraud (noting that senior executives intent on deception can circumvent audit procedures, for example in some cases controllers created false documents to support bad journal entries). However, HealthSouth exhibited certain fraud risk characteristics that should have put the auditors on heightened alert (related-party transactions between executives and directors, an SEC settlement related to Medicare fraud charges, and so on).

During testimony it became known that several top executives had tried to persuade Scrushy to stop the fraudulent practices in the late 1990s but were unable to; indeed, the falsification simply accelerated. Unfortunately, those in a position to act as whistleblowers at this early stage failed to do so.

In August 2002 Scrushy finally agreed to tell the investment community that US$175 million would be lost as a result of Medicare reimbursement changes. (This number was also fabricated, but intended to reverse some of the accumulated overstatement.) The stock plunged 44 percent on the news, and the SEC started an investigation of the company’s practices. In fact, Scrushy was suspended for a period of several months while the investigation was underway, but was brought back by the board in January 2003 (as chairperson, having relinquished the CEO role). However, with reporting and certification of financial statement deadlines for 2002 looming, the CFO confessed the wrongdoings to the SEC, leading to the full investigation and subsequent charges. (Former CFO Owens opted to take a new job within the company as he did not want to be responsible for certifying the veracity of HealthSouth’s financial statements under the new Sarbanes–Oxley provision.)

As investigations continued, HealthSouth’s board and interim CEO May hired a turnaround specialist firm to try to stabilize the company in the face of credit downgrades (to CCC–), a liquidity crisis, and battered stock price (suspended at US$3.91). Banks, led by JP Morgan Chase and Wachovia, froze the remaining US$1.25 billion credit available under a US$3.3 billion facility. Investors suffered considerably, watching the market value of the company drop from US$12 billion to US$1.55 billion. Under an SEC civil lawsuit with accounting fraud (and possible criminal and insider trading charges), Scrushy became liable for treble damages of US$700 million plus disgorgement of profits; the SEC froze Scrushy’s assets in order to collect ill-gotten gains in the event of a conviction.
Governance flaws

- The CEO was a charismatic leader who was firmly in command of the board of directors. Challenges to replace “friendly directors” were fended off.

- Several board members appear to have been conflicted, enjoying personal and business relationships outside their board functions that may have influenced their judgment.

- Ethical behavior was simply not in evidence within the top management ranks of the company. Those who knew of the CEO’s unethical dealings did not come forward for many years, demonstrating similar lack of proper conduct. The company had a history of fraud in its dealings with Medicare, which should have served as a warning signal to directors and auditors.

- Potential whistleblowers who knew about the accounting practice and tried to persuade the CEO to stop did not make their findings public, and thus missed an opportunity to stop the problem years earlier.

- The board’s audit/compensation committee met very infrequently and does not appear to have been effective in discharging its duties. The combined roles may not have permitted enough diligence and scrutiny of issues.

Figure 7.12 HealthSouth weekly stock price, January 2000–April 2003, US$, NYSE
Executives were determined to meet short-term EPS targets set by the analyst community in order to support the company’s stock price, meaning that the falsification of financials became increasingly large.

Internal controls were lax; internal audits and accounting reconciliations, for instance, were insufficient to spot the accounting fictions that were created over an extended period of time.

External auditors were not effective in helping catch the problem, despite the fact that it existed for at least several years.

As we noted earlier, the case studies in this chapter are intended to show the range of governance problems and outcomes that can appear at a company level. While certain aspects of the problems are influenced, or created, by flaws in systemic structures, most of them are very company-specific: they occur as a result of a particular confluence of events, timing, and personalities within individual firms. In the next chapter we shall explore certain cases that are driven, to a much greater extent, by forces in the external environment, such as weak regulations and accounting rules, and improper supervision and standards. When such macro factors are at work, broader “sector-wide” or even national, governance problems can surface.
As we have seen in the last chapter, governance problems can create significant damage at a company level. Although obviously harmful, the fallout can usually be contained to a relatively small circle, namely a specific firm and proximate stakeholders. In some instances, however, governance problems can be much broader, coursing through entire industries or countries; companies in the same sphere may behave in the same way, or be exposed to the same external forces, and thus suffer from similar problems. Although individual companies might be at the center of issues, their flawed activities occur because broader regulatory short-comings or national/sectoral dislocations permit poor controls and bad behavior to go unchecked. Indeed, multiple companies can only be exposed to the same difficulties, or experience identical lapses in control and judgment, when external checks and balances are not performing as they should.

To complete our discussion of “real life” governance flaws we consider several sector studies, including those arising from conflicts or deficiencies in global external audit practices, abusive business practices by US energy trading companies, extortion payment practices by Japanese companies, conflicts and unethical behavior in the US investment research and banking sector, and corrupt and uncontrolled business dealings in the Indonesian business and banking community. As before, we present only a few examples of sector-based governance flaws; we could certainly select from many others. Table 8.1 summarizes the case discussions.
Table 8.1  Summary of governance case studies

<table>
<thead>
<tr>
<th>Sector/ location</th>
<th>Primary governance problem(s)</th>
<th>Eventual outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case 1: External auditors Global</td>
<td>Conflicts of interest, Lack of independence, Insufficient technical expertise, Lack of external controls, Unethical behavior</td>
<td>Lawsuits, fines, regulatory investigations/sanctions, reputational damage</td>
</tr>
<tr>
<td>Case 2: Energy trading companies USA</td>
<td>Unethical behavior, Lack of internal controls, Lack of external controls</td>
<td>Lawsuits, fines, regulatory investigations/sanctions, reputational damage, bankruptcy</td>
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<tr>
<td>Case 3: Sokaiya scandals Japan</td>
<td>Unethical behavior, Lack of internal controls, Lack of external controls</td>
<td>Fines, regulatory sanctions, reputational damage</td>
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<tr>
<td>Case 4: Investment banking/research USA</td>
<td>Unethical behavior, Conflicts of interest, Lack of internal controls, Lack of external controls</td>
<td>Lawsuits, fines, regulatory investigations/sanctions, reputational damage</td>
</tr>
<tr>
<td>Case 5: Corporate/banking groups Indonesia</td>
<td>Unethical behavior, Fraud, Conflicts of interest, Lack of internal controls, Lack of external controls</td>
<td>Reputational damage, bankruptcy, taxpayer-funded recapitalizations</td>
</tr>
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**Case study 1: global external auditors**

Mishaps involving external auditors have appeared with considerable frequency in recent years, and are indicative of governance problems within individual firms and the broader operating environment. Although the global audit sector is comprised of hundreds of independent audit firms, the majority of audit work is performed by what are commonly known as the “Big Four”: Ernst and Young (E&Y), PricewaterhouseCoopers (PwC), Deloitte Touche Tohmatsu (DTT) and KPMG (the fifth of what was once the “Big Five”, Andersen, disappeared in mid-2002 as we mentioned in the last chapter). Indeed, the Big Four constitute something of an oligopoly
power. In the United States, for instance, they are responsible for auditing 80 percent of public companies; they also have a considerable presence in Europe, Asia, and Latin America, both directly and through affiliates. Our focus in this section is on the governance problems related to the Big Four as a sector.

During the 1970s and into the 1980s the audit industry featured eight prominent players, most of them focused exclusively on accounting and auditing practices. Their primary mission was to review financial statements and controls of client firms and render opinions on the soundness of their financial position. The audit firms enjoyed undoubted reputation, and other stakeholders came to rely heavily on their opinions. During the 1990s the financial and corporate world grew more complex, and disclosures became more intricate and technical (for example, through growing use of derivatives and SPEs). Competition in the audit sector intensified, and the industry began consolidating, with the Big Eight merging by degrees into what eventually became the Big Five.

More importantly, in order to remain profitable, these newly consolidated firms (most still structured as partnerships) began searching for new sources of revenue. This led to a growing focus on fee-based tax advice, corporate finance advice, management consulting, and technology consulting. The new businesses were based in separate divisions or subsidiaries and staffed with dedicated, expert professionals. The strategy was generally successful, and by the mid-1990s firms were posting double-digit fee increases, and record revenues and profitability. Tax advice became an especially important driver of earnings, ranking behind auditing as the second largest source of revenues at most of the firms. (The trend remained intact through to the start of the twenty-first century, with tax fees accounting for more than one-third of revenues at PwC, KPMG, and E&Y.) Tax shelter schemes were particularly lucrative for all the companies: the transactions created for corporate and executive clients entitled them to fees of 10–40 percent of taxes saved.

As the business focus and revenue mix of the firms changed, problems began to develop. Although the full extent of the difficulties would not be known for several years, issues related to conflicts of interest, lack of independence, technical inadequacies, and reluctance to challenge clients actually commenced as early as the mid-1990s. We consider each of these points in turn.

- **Conflict of interest.** In some cases, the “new services” auditors offered brought them into conflict with their traditional role as independent, unbiased reviewers of a company’s financial statements. In fact it became very difficult for auditors independently to review and critique tax shelters, corporate finance transactions, or management consulting...
strategies that other parts of their own firms had created. The matter was complicated by the fact that the new consulting services carried high fees – often much larger than those earned through auditing – so turning business away was not considered a rational business option. The situation with tax shelters was, and remains, fraught with conflict: the audit firm creating the tax shelter becomes an advocate for the buyer, so it cannot be an independent monitor of such activity.

- **Lack of independence.** In some instances auditors established long-term relationships with client companies – creating and developing relations over five to ten years (or more) – and became too close to provide the right level of objective scrutiny. In addition, it was common practice (and remains to the present time) for many auditors ultimately to work for the companies they were (and are) responsible for auditing, leading to further conflicts of interest. (For instance an auditor, hoping eventually to work at the client company, might give the client the “benefit of the doubt” on a particular issue so as not to hinder his/her chances of a move.)

- **Technical inadequacies.** In some cases the expertise available within the audit side of the firm was insufficient to keep pace with the increasingly sophisticated structures and transactions being assembled by others in the marketplace, including intermediaries, clients, and their own consulting units; this led to errors, oversights, and bad judgment.

- **Reluctance to challenge.** In some instances auditors were not forceful in adhering to their own recommendations, or were willing to approve aggressive accounting policies when prudence might have dictated otherwise. They did not consistently question aggressive stances taken by client companies or their own tax strategists. (For example, although auditors might have presented company executives with prudent tax treatment on particular issues, they might have ultimately signed off on far more aggressive, although “technically correct” treatment favored by management.) The appetite for confrontation diminished markedly, particularly when other business was at stake.

Much of this behavior was made possible by the operating environment. Regulators did not (and in some cases still do not) prohibit audit firms from offering consulting and audit services to the same client, and did not promulgate rules to guard against potential conflicts of interest; in many instances disclosure of the scope of business relationships was not even required. Prior to 2003 there was no rigorous regulatory oversight related to the technical practices of accounting firms, meaning the possibility for mistakes or misstatement was particularly high. In addition GAAP, and the
regulatory reporting framework, supported many of the technically correct, but morally wrong, accounting treatments approved by auditors.

As a result of these problems the accounting industry went through a period of unprecedented problems, conflict, and losses at the turn of the millennium; indeed many of the issues remain unresolved, and where changes have been made, credibility will take many years to restore. The nature and validity of the independent audit opinion does not carry the weight and meaning that it once did. Apart from the extreme situation represented by Andersen, the remaining Big Four have been caught up in problems of their own in recent years. We review a very small sampling of these issues to provide a sense of the nature, frequency, and severity of these flaws.

- The former chief accountant of the SEC has estimated that investors lost US$200 billion between 1996 and 2002 on earnings restatements and market capitalization losses as a result of direct failures in the audit process.
- Each of the Big Four became the subject of investigation by the Internal Revenue Service (IRS) over the tax avoidance schemes they widely and actively sold their clients during the 1990s and into the twenty-first century. The Justice Department brought suit on behalf of the IRS in 2002.
- Each of the Big Four received numerous censures from the SEC throughout the 1990s and into the twenty-first century regarding auditor independence violations. While some were minor (such as auditors holding investment interests in the companies their firms were auditing), others were major (such as actively marketing the products of a technology company that was also an audit client).
- DTT failed to detect the revenue inflation at Ahold subsidiary USFS for a period of up to two years; by the time auditors discovered the fraudulent activity Ahold was forced to restate its earnings downward by US$1 billion+ (as noted in Chapter 7).
- DTT settled lawsuits related to its failure to corroborate vendor payments in the 1999 case of Just for Feet Inc., which filed for bankruptcy after it was found to have inflated its revenues and earnings.
- DTT was unable to detect the financial misreporting and fraud being perpetrated by top managers at Adelphia Communications for a period of several years (as discussed in Chapter 7). Once in bankruptcy reorganization, the new directors and executives of Adelphia sued DTT for its role in not detecting the fraud and being lax in its interpretation of debt consolidation issues.
Since the start of the millennium E&Y has been sued for more than US$1 billion by several companies on grounds of granting bad tax advice.

E&Y was the subject of intense probes throughout 2002 and 2003 regarding its non-audit services, including those related to tax strategies and venture capital. The SEC indicated specifically that the company engaged in simultaneous audit and non-audit activities with the same companies (such as auditing PeopleSoft’s financials while marketing its software to third parties). Regulators also probed E&Y’s role in creating tax shelters for the CEO and president of US communications firm Sprint. Indeed, the two executives were ousted by the board after it become clear they had used E&Y-developed tax vehicles to shelter gains on stock options. (Sprint itself received certain tax benefits through the structure.) Not surprisingly, E&Y also served as Sprint’s outside auditor.

In May 2003 the SEC issued a report indicating that E&Y lacked appropriate internal controls to deal with independence. Specifically, the SEC noted that the firm’s processes were “unworthy” and “woefully inadequate” as a result of lack of record keeping, lack of accountability, and lack of active steps to ensure independence.

Two E&Y partners were suspended by the SEC from auditing public companies as a result of their failure to perform basic audit checks on the CUC International/Cendant revenue falsification (which led to overstatement of US$500 million in revenues between 1995–7).

E&Y failed to detect US$2.5 billion of revenue overstatements posted by HealthSouth between 1999 and 2002 (as discussed in the last chapter), and may wrongly have dismissed warnings of problems from internal sources earlier in the process.

KPMG was involved in nine separate lawsuits in federal and state courts in 2002–3 related to its tax advice and creation of illegitimate tax shelters. Its FLIPS and OPIS structures, designed to generate losses to offset capital gains taxes, became the focus of IRS scrutiny for both the audit firm and individual clients (approximately 160 individual clients sheltering US$1 billion in taxes).

KPMG agreed to pay US$200 million in 2003 to settle two shareholder class action lawsuits related to flawed audits of Rite Aid and Oxford Health Plans. (Rite Aid acknowledged overstating income by US$1 billion over two years, Oxford revealed errors in its 1997 accounts.)

KPMG became a defendant in the Lernout and Hauspie bankruptcy for
its role in failing to detect financial misreporting and fraud over a two and a half year period (as noted in Chapter 7).

- The SEC sued KPMG in 2003 on charges of civil fraud for “knowingly and recklessly” misleading investors by allowing Xerox to file false financial statements for five years. (This is a significant charge because it is not based on mistakes, but extended and repeated misrepresentation.) The SEC also brought fraud charges against four partners for repeatedly ignoring warnings from international affiliates that results were wrong. (Xerox itself pleaded “no contest” and paid the SEC US$10 million to settle charges that it had misbooked and misrepresented US$6.4 billion of equipment revenue and US$1.4 billion of pretax earnings over the five years.) As part of the investigation, there was evidence that some KPMG auditors only “meekly” challenged Xerox staffers about the discrepancies, and that others had become too close to the company to provide an independent view. Separately, Xerox was paying KPMG fees on various non-audit consulting projects.

- KPMG management reportedly reassigned senior audit partners on the Levi Strauss account after they disagreed with the client’s “aggressive” tax treatment of certain Brazilian and distressed debt investments (originally established by Andersen). Levi Strauss complained to KPMG management, which removed the partners from the account. (The partners subsequently brought suit against Levi Strauss.) A similar “reassignment” event occurred on the Xerox account (two auditors were reassigned at the request of Xerox management).

- Amerco sued PwC on grounds of granting bad advice. The company claimed that PwC violated its duties from 1994 to 2001 through SPEs established by PwC to hold land assets for Amerco’s U-Haul subsidiary. In early 2002, following the Enron SPE scandal, PwC advised Amerco management that it had to consolidate the SPEs on its balance sheet for the previous seven years as a result of mistakes it had made in accounting for the vehicles.

- PwC was unable to detect the financial manipulations being perpetrated by managers at Tyco for an extended period of time (as discussed in Chapter 7). In addition, it signed off on the accuracy of the restated Tyco financials for the year ending 2002, only to subsequently declare by mid-2003 that an extra US$1.5 billion+ of charges were needed.

As a result of these, and other, problems, external audit perception declined markedly starting in the early part of the millennium. For instance, an April 2002 accounting survey by NFO WorldGroup reflected a very poor external perception of auditor performance. Of US corporations responding to
the survey, only half ranked the performance of their auditors as very good, and only half would recommend their auditor to another company. Another survey, conducted by Weiss Ratings, reflects just how frequently the major audit firms have failed to detect problems. For instance, auditors gave a “clean bill of health” to 94 percent of public companies that were subsequently cited for accounting irregularities. (Of 33 “problem companies” in the survey, Andersen was auditor of 11, PwC seven, DTT five, KPMG five, and E&Y four; the remaining one was audited by a smaller firm.) Within the group of 228 US public companies filing for bankruptcy between January 2001 and June 2002, auditors granted a “clean bill of health” 42 percent of the time; in the remaining 58 percent of cases they correctly issued “going concern” warnings. (PwC scored best, warning on 63 percent of its cases; KPMG only warned on 42 percent.) The ability of auditors to predict financial distress more accurately (as reflected through the issuance of “going concern” warnings) only improved when their review and reports occurred within three months of actual bankruptcy filings (91 percent correct); reports issued 9–12 months before bankruptcy were correct only 38 percent of the time.

Although the monetary penalties arising from these actions have been (and will continue to be) severe, the reputational damage has been worse. While the concept of a “clean” audit opinion was meaningful for years, many stakeholders no longer place much confidence in the work performed by these firms. As noted, restoring such credibility may take several years to achieve. Some of the cure will come from recent regulatory reforms in various countries, and some by the actions of auditors and their clients (such as prohibiting inter-firm recruiting, and getting prior board approval sign-off for non-audit tax/consulting work). The process will be complicated, however, by the existence of different regulatory treatment around the world. National regulators often have different standards for auditors and the work they perform, meaning conflicts and problems may continue to arise. Since the Big Four are global organizations (that often deal with global corporate clients), these cross-border differences will continue to present challenges.

Governance flaws

- Global audit firms were periodically conflicted in their business dealings with corporate clients, simultaneously offering tax, consulting, and audit services. It appears that judgment was compromised on some occasions.
- Auditors were permitted in many cases to move on to work for client companies, rendering their independent judgment and opinions suspect.
In some instances auditors had insufficient technical skills to keep pace with aggressive, and increasingly sophisticated, corporate clients and their financial engineering activities. In many cases lack of technical competence appears to have led to repeated failure to detect problems until the onset of financial distress (for example, just several months prior to a corporate bankruptcy filing).

Managers at some accounting firms appear to have been willing to “reassign” auditors who were “unwilling to cooperate” with important clients in the treatment of certain accounting rules.

Some firms do not appear to have treated higher risk clients with special care.

Through 2002 no significant regulatory oversight mechanisms were in place in the United States, the UK, Japan, or Continental Europe to review adequately the performance of auditors.7

Regulatory rules did not, and in many cases still do not, promote the right behavior or eliminate all potential conflicts of interest. In some instances ethical problems arose within audit management units.

The peer review process, requiring external auditors to review one another’s work on a random basis every few years, appears to have provided little meaningful third party control. There exist few incentives to critique another auditor’s work and the process has not, historically, been rigorous.

Case study 2: US energy trading companies

Prior to US power deregulation in the 1990s, utilities with local monopolies sold gas and electricity to residential and commercial customers in specific geographic areas, and controlled access to transmission and distribution. In the early 1990s, state and federal regulators began a process of deregulation that forced local utilities to permit broader transmission access. This, according to the theory, would lower the cost of production, allowing suppliers to ship power around the country at the lowest possible price. Once deregulation measures were enacted, utilities were free to buy and sell electricity in any region, at market-clearing prices determined by supply and demand forces.

Sensing a potential business opportunity, many utilities – including those running regulated utilities to supply power to commercial and industrial companies, and/or tapping natural gas wells and transporting gas through pipelines – started adding energy trading capabilities to their operations. These “strategic” moves, sanctioned by board directors, generally
required division of business into separate subsidiaries: one for regulated business (such as delivery of power to residential and commercial customers, which continued to be governed by price caps and state/federal oversight) and another for unregulated business (such as sourcing, marketing, distributing, and trading of gas and power, with far less scrutiny). The unregulated businesses began increasingly to look like Wall Street trading houses; indeed many shed their physical assets, including gas pipelines and generating facilities, in exchange for traders and trading floors.

Most of the corporate restructuring also involved new branding and marketing strategies: companies dispensed with the staid utility names that represented the core “old line” business in favor of new images reflecting twenty-first century market savvy and trading prowess. Although Enron stands out as a prime example of the problems and abuses of the era, it was certainly not alone. Many other companies – Aquila, Avista, Coral Power, El Paso, Reliant, National Energy Group (NEG, part of PG&E), Allegheny Power, Sempra, Duke, Mirant, Dynegy, CMS Energy, AEP, Williams, Calpine, and others – helped build energy trading into a US$300 billion marketplace in a relatively short time frame. The more aggressive companies, believing that they had become very sophisticated traders, soon branched out into other areas, including Internet capacity/bandwidth trading (which was expensive to establish and built on overly optimistic demand scenarios, as noted in the Global Crossing case in Chapter 7).

The “herd mentality” quickly swept through the industry. Once companies saw what competitors were doing they joined in with multi-million dollar expansion strategies of their own: paying for expensive trading floors, technology, and trading expertise through asset sales and debt. Ultimately these “asset light” trading companies become very aggressive in their pricing, marketing, and accounting techniques. Most engaged in very long-term transactions (where illiquidity and pricing are notoriously difficult to manage and quantify, leaving room for financial error and manipulation), and lobbied legislators for flexibility in accounting rules, including those that let them account for anticipated revenues and income from long-term contracts as if they were current cash. FASB and the SEC ultimately approved these accounting changes.

The top line revenues and bottom line income at many of these once-conventional utilities began to look impressive, driving up stock prices and enriching executives (and, for a time, shareholders). Against this backdrop, energy price volatility kept rising – excess demand driven by solid economic growth in the latter 1990s, supply bottlenecks in the power distribution grid, and information asymmetries all made for a volatile mix – to the benefit of trading teams. The short end of the market was extremely liquid, and online trading platforms soon developed to help fuel more growth (such as Enron Online, Dynegy Direct, and the consortium-oper-
ated Intercontinental Exchange). The long end of the market drew client interest but was far less liquid, and thus an easier way for some firms to “fabricate” earnings.

Recognizing the power they wielded, some energy traders began taking advantage of customers. In some cases they were careless, negligent, or abusive; in other cases they were dishonest and fraudulent. For many, trading in a fairly opaque market provided the means to manipulate prices, accounting results, and financial performance, in order to maximize EPS and stock prices. For instance, in 1998 Enron and various Houston-based energy trading firms sold power to California after artificially congesting power lines. Traders demanded higher prices, which they received. In 2000 El Paso withheld gas in California until the price had risen from a normal average trading range of US$5–9/MMBtu (millions of British thermal units) to US$50–60/MM Btu. Indeed, California was the center of tremendous gas and power price manipulation schemes, and spent billions on inflated pricing to obtain energy.

Traders also began manipulating price indexes (which were less than transparent) in order to boost the value of their positions. For instance, in late 2001, an El Paso trader fabricated 48 trades and sent fake price and volume information to the company responsible for tracking the index. (Dynegy and several others were involved in similar manipulation.) In addition, CMS Energy, Dynegy, and Reliant were all found to have created “round trip” deals where they exchanged the same amount of gas at the same price. This falsely boosted revenues and bolstered market volume statistics in the process (in fact, round trip deals accounted for 80 percent of CMS Energy’s total trading revenues in 2000–1). Although round tripping did not help the bottom line (since the deals cancelled each other out), it did boost future revenues, which became current under new accounting rules; in fact, estimates suggest some US$15 billion of fake revenues were generated through this scheme. Other abuses centered on long-term energy contracts, where the new accounting rules gave considerable discretion in the use of proprietary valuation models and processes, which were sometimes skewed or readjusted to reflect “extra” profits. For instance, when Enron executives were in search of an extra US$9 million of profits in 1999, they simply went back to a 1997 long-term transaction and “recalculated” its value (which Andersen, as auditor, approved).

These “good times” could not continue forever, and the collapse of Enron signaled the beginning of the end. Enron’s demise, together with growing regulatory scrutiny of obviously abusive trading practices, caused many companies to re-evaluate their commitment to the business. Most either scaled back or withdrew, and volumes soon dwindled, declining by up to 70 percent within months. This put additional financial pressures on many of the
firms, which were already suffering under the weight of excess leverage, strained cash flows, and large cost bases. Discovery of the wrongdoings, fraud, and manipulation mentioned above, along with special restructuring charges for exiting the trading business, left most companies with large losses, credit downgrades, and battered stock prices. (El Paso dropped from a 2001 peak of US$74 to US$7, Dynegy from US$57 to US$1, Williams from US$50 to US$2.) In several cases boards ousted CEOs or senior executives who had led their firms into the trading business. As a group, 18 energy companies (excluding Enron) lost US$64 billion in market capitalization between mid-2001 and mid-2002: shareholders were left with little to show for their investments.

A series of regulatory investigations commenced in 2002, with the SEC, Commodity Futures Trading Commission (CFTC), and Federal Energy Regulatory Commission (FERC) focusing on market manipulation, illegal trading, trading abuses, and unjust enrichment; FERC described the pattern and depth of the problem as “epidemic.” In 2003 FERC took action against 60 companies suspected of violating anti-gaming and fraud statutes during 2000 and 2001, seeking payment of fines and disgorgement of profits.14 Some settled the charges after pleading “no contest.” (For instance El Paso agreed to pay the Commodity CFTC US$20 million, Dynegy US$5 million, AEP, CMS, and Williams similar amounts.) FERC also instructed energy companies to refund the State of California US$3 billion based on unjust excess charges. (In one of the most significant settlements, El Paso reached an agreement in March 2003 to pay damaged parties (primarily the State of California’s Department of Water Resources) US$1 billion+ in cash and natural gas as a result of its activities during the state’s energy crisis, although it managed to plead “no contest” in reaching the settlement.15 The fine, the largest ever for an energy company, came from the firm’s assets and retained earnings, meaning another loss for investors.) Following a three-year period of overly aggressive tactics and sometimes unethical behavior – supported by a fairly liberal regulatory and accounting regime – most integrated energy companies returned to their core business of generating and distributing power for a steady base of customers. Some, including Mirant and NEG, filed for bankruptcy.

**Governance flaws**

- Companies embarked, en masse, on ill-conceived expansion strategies into areas that fell outside their traditional expertise (such as trying to acquire and/or append a trading risk culture to their traditional operations in a very short time frame). Board directors appear to have uniformly supported such expansion, as a reaction to competitive pressures rather than part of organically developed strategic plans. It is
unclear whether directors understood the nature of the trading risk business executives were pursing. Potentially valuable physical assets were sold in favor of intangibles (such as reputational assets or skills), and excess leverage was added to corporate balance sheets to fund the shift and activity.

- Strategies for expanding into new asset classes, such as Internet bandwidth trading, do not appear to have been properly analyzed, supported, or justified by company executives or their boards. Large capital commitments to support the build-outs ultimately yielded only losses.

- Regulators approved questionable, and highly subjective, accounting treatment that had the net effect of making all companies look far more profitable than they actually were. They gave wide discretion to the use of mark-to-model techniques in the valuation of fundamentally illiquid risks.

- The inability to control risks properly and value long-term contracts meant companies were almost certainly far riskier, and less profitable, than they disclosed. Considerable opportunities existed to manipulate mark-to-model valuation procedures and use other techniques to fabricate revenues.

- Internal controls at many firms were inadequate. In fact, traders at various firms were able to circumvent internal and external controls to create false trades and manipulate index prices for an extended period of time.

- Ethical norms at many companies appear to have been lacking, and were sometimes corrupt and abusive; these attitudes became widely tolerated throughout individual companies. Collusive practices (such as round trips and false pricing) were quite prevalent; most were designed to take advantage of clients in order to boost revenues, EPS, and stock prices.

- External parties – including major financial institutions and external auditors – appear to have aided and abetted questionable behavior by permitting transactions that disguised actual facts (such as prepaid swaps, and long-term contract valuation changes). Not only did these parties fail to provide proper external monitoring, they actually facilitated abusive practices.

- Energy trading activities housed in unregulated subsidiaries were generally exempt from any meaningful regulatory scrutiny, meaning another key check and balance was absent.
Case study 3: Japanese sokaiya scandals

The Japanese corporate market has suffered considerable governance problems over the past two decades; some have been institution-specific (such as the internal control and fraud failures at Daiwa Bank and Sumitomo Corporation), others sector-wide (such as the widespread zaitech financial engineering and speculation strategies practiced by many companies, and the massive, ill-advised speculative lending against real estate and equities by Japanese banks). These have greatly shaken confidence in aspects of the system, calling into question many of the traditional business mechanisms we discussed in Part I (for instance keiretsu cross-shareholdings, bank bailouts, lifetime employment “guarantees,” and cooperative government/industry relationships). Following the bursting of the speculative bubble that had developed in the 1980s through loose monetary policy and rising asset prices, Japanese regulators and companies attempted to reform aspects of the governance and control system with codes of conduct and improved oversight. However, as the 1990s progressed it became clear that only limited success was being achieved; problems were still evident in different parts of the corporate system. One particularly unique problem (if not as economically damaging as the bad debt problems of banks) centered on so-called sokaiya – or racketeer – scandals, which enveloped many major companies during the 1990s.

Sokaiya – racketeers with ties to criminal elements – have featured in the Japanese corporate system since the 1970s, when companies used them to dissuade shareholder activism (for example Mitsubishi Heavy Industries, Chisso Petrochemical, and many others used sokaiya to quell investor discontent at AGMs). Thereafter they developed into de facto security/protection for companies. In the 1980s, however, their role began to change: sokaiya became shareholders in the companies they were originally “protecting,” and started campaigns of intimidation against executive management. Under a typical scenario an extortionist would contact middle-level management at a target company and demand payment for not disrupting public corporate events (primarily AGMs, but also “ground-breaking” ceremonies, press conferences, and so forth). If payments were not made, the extortionist would coordinate large AGM demonstrations or disclose “inflammatory” information in order to publicly embarrass company executives.

In a system where financial information has traditionally been very opaque and discretion the preferred means of operating, these threats proved to be powerful. In order to avoid public spectacles, many companies chose to pay hundreds of millions of dollars in “hush money.” In addition to paying off racketeers, companies tried to diminish the likelihood of disruption by scheduling their AGMs on the same day, under the assump-
tion that a limited number of disturbances could occur if all companies were simultaneously engaged in meetings. Investors holding shares in more than one company would, of course, find it difficult to attend more than one or two AGMs, meaning their rights were violated. (In fact, into the twenty-first century 90 percent of Japan’s public companies have held their AGMs on the same day and at the same time; the average session lasts under 25 minutes, giving shareholders no particular opportunity to express their views.)

Although changes in the Commercial Code in 1982 made the practice of sokaiya payments illegal (with criminal charges and penalties accruing to company executives violating the Code), executives and sokaiya simply found new ways of arranging payments. The regulations were generally ineffective, as they were not enforced with diligence or energy, meaning the extortion process continued unabated for the next 15 years. For instance, between 1994 and 1996 several of Japan’s leading financial institutions, including Nikko Securities, Daiwa Securities, and Yamaichi Securities, paid just over US$100 million to extortionists threatening to disclose embarrassing corporate material at their AGMs. In 1993 Nomura traded stocks/futures for a known extortionist through a discretionary account (a practice which had been banned by regulators). When the account suffered losses, Nomura executives paid off the extortionist to silence the matter, and made regular payments for several years after that. Dai-ichi Kangyo Bank (DKB, now part of Mizuho Group) had considerable ties to sokaiya through the bank’s chairperson, Okuda, who arranged for 52 illegal loans (amounting to more than US$100 million) to be made to extortionists between 1994 and 1996; Okuda was ultimately found guilty of Commercial Code violations and imprisoned. Many of Japan’s largest industrial blue-chip companies were implicated in similar payment schemes: senior executives of Ajinomoto, Matsuzakaya, Mitsubishi Motors, Mitsubishi Electric, Mitsubishi Estate, Toshiba, and Hitachi, among others, made extortion payments with, or without, the knowledge of others in their companies. In most instances executives falsified internal documents or circumvented internal controls so that stakeholders would remain oblivious to the payments.

By the late 1990s, as it became clearer that the sokaiya practice was growing more pervasive and destructive (one broad corporate survey reported that 70 percent of large companies had received demands from sokaiya), government authorities intervened once again. In late 1997 and early 1998 Ministry of Justice officials arrested, charged, and fined two dozen senior executives from ten companies involved in illegal payments. DKB and the Big Four securities firms were fined, and temporarily banned from granting new business loans and underwriting government bonds. The Japanese Diet, through changes in the Securities and Exchange Law, passed more severe
penalties for both extortionists and corporate payers (including incarceration for executives found falsifying statements), and a separate committee was also established to create more robust and transparent disclosure to shareholders.

As noted, the payment of hundreds of millions of dollars (and perhaps more) is small compared with the hundreds of billions that appear to have been lost in the country’s bad loan crisis, but it represents another example of a systemic flaw; one with criminal and ethical dimensions, rather than just mismanagement or bad judgment. Indeed, the existence of sokaiya is a symptom (rather than a cause) of a corporate system that has historically featured opaque disclosure, lack of senior management accountability, weak regulations, and disregard of various shareholder rights. It also reflects collusive actions and the “herd mentality” that characterize systemic problems (for instance if one company becomes aware that another is making sokaiya payments, then it must be culturally, if not legally, acceptable, so it follows suit). When regulators do not handle such abuses decisively for an extended period the behavior becomes engrained in the corporate culture.

**Governance flaws**

- Top executives willingly used shareholder funds to pay off extortionists, an illegal practice in Japan (and most other countries), and one reflecting bad judgment, poor ethics, and disregard of employees and shareholders. (Investors, in particular, suffered from the financial payments, penalties, and inability to participate in AGMs directly if they owned shares in more than one company.)

- Board directors were either unaware of such activities, or fully supported them, indicating the existence of a monitoring/communication problem or collusion at senior levels. Those who were aware of the payments, but did nothing to stop them, suffered from poor ethical behavior.

- In some instances financial statements were falsified internally in order to prevent payment information from circulating, suggesting, again, the presence of unethical behavior and weak controls. Internal controls were in a poor state at some companies, and thus failed to detect unauthorized payments to external parties; in cases where these payments occurred repeatedly, controls were particularly weak.

- External and internal auditors failed to detect, and report, the illegal payments for years.

- Regulators were ineffective in controlling the practice for an extended period of time, choosing not to enforce penalties for several years.
Indeed, although criminal penalties had been established as early as 1982, there was little meaningful enforcement until the late 1990s.

Case study 4: US investment banking and research

Wall Street’s “sell-side” research analysts have been a feature of the financial system and investment community for many decades. In a properly functioning system these professionals, responsible for analyzing the performance of companies, sectors, and markets, make unbiased investment recommendations to institutional and retail clients. Independent research can be beneficial, as it gives those who lack the ability to analyze and distill what is often complex information a view on how they should invest their funds in order to maximize returns. In an ideal world, research analysts operate separately from other business professionals within a bank and are separated by a “Chinese wall”: controls and rules that are meant to keep research analysts from sharing information with investment bankers or traders (and vice versa). This ensures that those aware of inside information do not disclose it to others.

Research is generally regarded as a “bull market” marketing tool: it tends to be popular and accurate when investors are in a buying mood and the markets are strong, as it is more appealing for an analyst to issue a “buy” recommendation than a “sell” or a “hold”; historically, the number of “sell” ratings has been quite small. Unfortunately research coverage, as we have indicated in Chapter 5, has had the negative side-effect of forcing companies and the investment community to focus intensely on quarterly EPS. Analysts have traditionally been very critical of companies missing their earnings estimates, publishing critical comments (although not necessarily downgrading stock recommendations from “buy” to “sell”), and causing at least some institutional investors to liquidate or reduce their holdings. The power of sell-side research appears to have influenced some company managers to alter accounting treatment, investment decisions, and financial reporting (for example, the EPS management by WorldCom, Enron, Tyco, HealthSouth, and others, to keep research positive and stock prices buoyant).

As it happens, not all research analysts were as independent and unbiased as many once believed; indeed, some were quite conflicted. In the early twenty-first century it became increasingly apparent that some analysts at certain firms (particularly those focused on technology/media companies), were wrongly granting “positive” research opinions on companies that were clients (or potential clients) of the investment bankers. Bankers, in search of incremental business from such firms (such as new equity or debt issues and M&A transactions) pressured analysts into granting positive ratings in order to win new business (or “dissuaded” them from...
downgrading ratings once business has already been won). The rationale was simple: if an investment banking firm trying to win a coveted mandate was able to demonstrate to the prospective client company that its research view was positive, it had a better chance of succeeding; if the firm published a negative opinion, the company would be displeased and award the business to another firm. In fact, analysts at some Wall Street houses were effectively working for investment bankers, sometimes skewing their views and research opinions in order to help bankers win business. In many cases their compensation was determined directly or indirectly by investment bankers, a clear conflict of interest for those meant to be unbiased. Evidence has indicated that more than a few analysts succumbed to pressure from bankers to change investment opinions in order not to jeopardize their bonuses (or their jobs).

These conflicts reached a fever pitch during the technology-media-telecom boom that ran until late 2000; analysts routinely issued inflated, and sometimes false, reports on Internet and telecom/networking companies in order to help win lucrative IPOs. In some cases bankers became overly aggressive, demanding complete say over research opinions, and reviewing “pre-publication” reports in order to make changes before public release. This behavior was accompanied by IPO spinning, a practice where Wall Street firms granted CEOs and senior executives of client companies allocations in “hot” IPOs in hopes of winning more corporate business from them. Research became an effective way for Wall Street companies to gain business, and investment in research functions accelerated rapidly (between 1997 and 2000, investment bank research costs rose nearly 100 percent).

Executive managers at most Wall Street firms were either unaware of the extent of the conflicted practice or were supportive of it, as they did little to stop it and sometimes actually encouraged it. Regulators seem to have been equally lax in reviewing or controlling such conflicts, and were effectively absent from any meaningful oversight or discipline for a period of several years. As a result the abusive practices continued, but only while the markets remained strong.

As the technology bubble burst – and as corporate scandals claimed more victims (such as Adelphia, Global Crossing, Qwest, and WorldCom) – investors that had relied on analyst opinions lost considerable sums of money. An extensive series of investigations and lawsuits followed, revealing the depth and breadth of the problem. Analyst opinions were often inflated, and positive recommendations were granted even when analysts felt otherwise. Completely false reports were issued. The existence (and extent) of other business relationships was generally not disclosed. (For example an analyst recommending a “buy” on a company was not required to advise investors that the firm had, or
was actively pursuing, a banking relationship, making the nature of a potential conflict unclear.) Confusing multiple “recommendation” categories developed, including those that avoided use of the word “sell,” and Wall Street firms paid other firms to publish positive research on companies they were doing business for. As the extent of the problems became known investor lawsuits escalated, the credibility of the major banks was damaged, and their stock prices fell.

Following extensive investigations by the SEC, the National Association of Securities Dealers (NASD), and the New York Attorney General, ten large banks agreed to broad-based reforms designed to alleviate these problems. After months of negotiation in 2002, the firms[^21] agreed to pay US$1.435 billion in fines, and the industry as a whole agreed to:

- separate research units from other business-generating departments, create separate research compliance functions, and ensure research compensation is determined independently
- ban joint research/banking deal calls
- simplify the research ratings structure
- disclose other business relationships with clients covered by the research group
- prevent allocations of IPOs to client company executives
- provide clients with “independent research” produced by other firms.[^20]

It is worth noting that the government settlement and reform did not eliminate the specter of private litigation by retail and institutional investors, which promises to keep lawyers and arbitration panels occupied for many years.[^21]

In the aftermath of the research problem (and taking into account the effects of a multi-year bear market and the need for cost controls), many firms scaled back on their research staffs, firing many high-profile analysts, including some who had made overly optimistic research calls. Shareholders were ultimately forced to bear the cost of this flawed approach to business by funding excessive research build-ups during the boom years, suffering price declines in their stockholdings as news related to flawed research mounted, and paying out at least US$1.4 billion in fines (and likely much more by the time the remaining lawsuits are completed). Most firms suffered considerable reputational damage, to the point where Wall Street research is viewed by many investors with suspicion; repairing the damage is likely to take years, meaning a potential loss of revenues, another cost to be borne by shareholders.
Governance flaws

- Wall Street institutions did not segregate analysts and investment bankers properly; Chinese wall restrictions were violated, joint marketing calls were made, and false or biased research created. Analysts often submitted “pre-publication” research reports to bankers for their review.

- Certain Wall Street institutions did not have quality control checks on their research opinions, even though millions of retail and institutional investors had come to rely on research and ratings for some, or all, of their investment decisions. Managers of stock analysts often failed to supervise the work of their subordinates.

- Law and compliance units often did not properly vet research documents, analysis, opinions, or correspondence, which might have revealed the nature and depth of potential conflicts far sooner.

- Executive management appears to have supported (or been completely unaware of) the conflicted strategy for an extended period of time, despite the obvious conflicts of interest and potential for client mistreatment.

- Executives routinely permitted IPO spinning practices in order to win additional corporate business, in doing so mistreating all other clients.

- On certain occasions management behaved unfairly, even unethically, by terminating or reassigning analysts who had published what was deemed to be negative (but ultimately correct) research on a client.

- Regulators did little to police or halt the increasingly obvious conflicts while the markets remained strong. Only in the aftermath of the market’s collapse (and ensuing investor losses) did a variety of legal and regulatory bodies emerge to “take control.”

Case study 5: Indonesian business and banking groups

Indonesia featured one of the strongest and most vibrant economies in Asia throughout the 1980s and early part of the 1990s. The spectacular growth attracted internal and external credit, which fueled further expansion opportunities. The borrowing and expansion thus continued in a cycle, to the point where the country boasted years of double-digit gross domestic product (GDP) gains, but also accumulated significant domestic and international debts. While the financial picture remained healthy (with a stable currency, good growth, moderate inflation, and reasonable interest rates), the process continued unabated. Much of the growth (and borrowing) was based on the
country’s rather unique, though ultimately flawed, family-based corporate structures. In particular, during the 1980s and 1990s more than 200 private family-owned conglomerates were established. These conglomerates owned and operated over 10,000 individual businesses, and were thus key players in the country’s economic development, accounting for approximately 13 percent of GDP by 1997. The family conglomerates were, broadly speaking, of two types: indigenous (owned and run by Javanese, Batak, Padang, and other native Indonesian ethnic groups) and non-indigenous (owned and run by Chinese and Indian families).

Family conglomerates were also divided into “official” and “non-official” categories. Official groups were those allied with government officials and their families: they carried far more influence and clout as a result of their access and connections (although only 10–15 percent of conglomerates were “official”, they accounted for 60 percent+ of average conglomerate sales). Then-President Suharto and his family, thoroughly enmeshed in the country’s political, economic, and financial sectors, held nearly 17 percent of the Indonesian stock market capitalization under their direct or indirect control (the top five families, including Suharto, held 41 percent). Suharto’s interests encompassed 417 companies with US$24 billion of assets. Indonesia’s most significant conglomerates had strong political connections to Suharto, a key factor in developing and expanding business relationships. For instance, the Salim Group operated through four family groups that controlled 174 private companies (including 117 that were jointly owned by family members and 57 individually owned), and several publicly listed companies (such as Indocement, Indofood, and Fast Food).

In fact, by the late 1990s, 15 major private Indonesian family group companies controlled 61 percent of Indonesia’s public firms; the remaining family group companies controlled an additional 5 percent of public firms, and the balance was widely dispersed.

Family conglomerates had a long history of borrowing from banks, preferring loans to equity in order not to dilute their ownership stakes and subject themselves to additional scrutiny. (In addition, for many years they were able to borrow at very low interest rates from state banks, so they had no financial incentive to access more expensive equity financing.) In the late 1980s, however, low-interest loans were banned and stock market price controls were removed, causing some conglomerates to tap the equity markets; between 1988 and 1997 listings on the Jakarta Stock Exchange (JSX) increased from 24 to 300. Despite the move towards greater equity issuance, family-held concerns remained tightly controlled; when additional equity was needed, rights were generally taken up by friends and family in order to maintain centralized power and control. In fact, it was common practice for family founders to continue owning a majority of shares in companies going public through fully-owned limited liability
companies (*Perseroan Terbatas*, the Indonesian equivalent of an LLC). Concentrated ownership of private and public companies was thus a feature of the Indonesian corporate landscape of the latter twentieth century. 25

Even after low interest rate loans were banned, bank financing remained the preferred source of capital for conglomerates (which borrowed through both private banks and foreign banks that were willing to lend on the basis of political connections rather than financial condition). In fact, many of the largest family business groups held majority or controlling stakes in Indonesia’s private banks, in contravention of “best practice” policy characteristic of many other countries. For instance, the Salim Group controlled Bank Central Asia; the Tirtamas Group, Bank Niaga and Bank Papan Sejahtera; the Humpuss Group, Bank Utamar; the Citra Lamoro Group, Bank Yama; other Suharto interests, Bank Umum Nasional, Bank Surya, and Bank Andromeda. Those that did not control a bank achieved the same end-goal by creating their own non-bank financial companies (such as leasing firms that acted as de facto “group credit providers”). 26

A company with a controlling interest in a bank or non-bank financial institution (operating in an environment with liberal regulations) has a ready source of funds for virtually any purpose. This eliminates the monitoring functions provided by banks (which are unlikely to question or monitor the credit standing of a direct/indirect parent company) and the capital markets. As it happened, these bank/non-bank financials lent to group companies that were directly or indirectly related, meaning that credit exposures to broad family conglomerates were often well in excess of legal lending limits or prudency standards. (In some cases banks lent between 85 percent and 345 percent of their capital to single business groups.) 27 In addition, most banks were undercapitalized to begin with, leaving them with no real margin for error. And despite the fact that the 1992 Indonesian Bankruptcy Law required all bank lending to be collateralized, many bank credit officers waived the requirements, leaving the institutions further exposed.

Companies themselves operated on the thinnest sliver of equity, meaning they were highly vulnerable to any change in their liabilities (such as rising rates or devaluing currency, since most were funded on an unhedged foreign currency basis). Financial accounting standards, disclosure, and audits were effectively useless; financial statements of public companies conveyed little information and were, in many cases, simply false. Regulatory and political officials appear to have turned a blind eye to all these practices, often because of the “special financial relationships” they enjoyed with family companies (such as bribes and other preferred treatment). Indeed, general lack of regulatory supervision was a major factor in the escalating problems, as banks and companies were essentially able to lend and borrow as much as they wanted to, with no risk of regulatory
penalty or sanction. Bank regulators did not enforce prudent lending practices. Lack of external governance forces – in the form of robust disclosure, proven external audit practices, due diligence prior to equity market flotation, and corporate control activity (the market only featured 40 acquisitions between 1992–7, and only five of those outside family controlled structures) – meant that the system featured no effective checks and balances.

The entire system came under stress during the Asian currency crisis of 1997, when the “managed” currencies of several Asian countries, including Indonesia, Thailand, and Korea, finally devalued under the strain of economic policies and financial forces. In July 1997 the Indonesian central bank (Bank Indonesia (BI)) tried to maintain the value of the rupiah by widening the floating rate band around the dollar. Just one month later, however, it had lost an excessive amount of dollar reserves in defense of the currency and was forced to devalue the currency from its long-standing base rate of approximately IRP2300/US$. By December 1997 the currency had deteriorated to nearly IRP5000/US$ and from there to a temporary low of IRP15,000/US$ (before finally stabilizing in July 1998 at IRP9000/US$).

Speculative asset flows that had entered the country during the early 1990s and bid up the price of physical and financial assets withdrew, exacerbating the IRP devaluation and causing an almost immediate collapse in Indonesia’s economic sector. Indeed, by mid-1998 gross domestic product had contracted by 13 percent and inflation had risen to 60 percent. The devaluation of the rupiah meant that companies borrowing unhedged dollars and yen (either through the external capital markets or through dollar and yen-funded loans supplied by local and foreign banks) faced a significant increase in the value of their dollar and yen liabilities. In fact this was one of the most devastating aspects of the crisis, as most firms had been lured into borrowing dollars and yen unhedged as a result of low offshore interest rates and the “artificially” stable currency.

The losses were significant; by June 1998, 214 companies declared IRP39.2 trillion of losses and 53 companies reported negative equity. Many were unable to cope with the new macro-economic realities – the loss of revenues, a rise in the cost of imported inputs, and a sharp escalation in interest expense – and simply defaulted on their debts. Some of Indonesia’s largest public companies and banks, including those directly or indirectly controlled by the family business groups, ceased paying their obligations: Asia Pulp and Paper, Indah Kiat, Bank Central Asia, Bank Surya, Bank Andromeda, Bank Niaga, Bank Papan, and so on. Non-performing assets in the banking sector soared from an already-high 9 percent in 1996 to 25 percent in early 1998 and 60 percent by late 1998, a catastrophe by any measure.
In the aftermath of the crisis, it became clear that Indonesia’s corporate sector required significant reform in order to address the fundamental governance problems that had led to such widespread failure (including corrupt practices, opaque disclosure, weak regulation, poor internal controls, lack of shareholder protections, and liberal “house bank” borrowing). In addition, the country’s banking sector also needed to be recapitalized in order to restart corporate operations and spur economic growth; the restructuring burden was considerable as it involved US$64 billion of external corporate debt and US$75 billion of internal debt. The Bankruptcy Law of 1992 was amended to provide greater protection for creditors, including the ability for unsecured creditors to proceed against a defaulting company based on loan covenants alone, and staffing of bankruptcy administration by private sector professionals.

Governance reform proposals, which had been established under the Corporate Law of 1995, had to be revised as they had proven to be largely ineffective. For instance, although the 1995 laws required Indonesian companies to create dual board structures (for example a board of commissioners (as a supervisory body) and a board of directors (an executive body)) and recommended the creation of board committees and appointment of independent directors, most only did the absolute minimum necessary (they established boards but failed to create committees or hire independent directors). Changes in capital markets laws, including tax neutrality for mergers, were also enacted in order to promote corporate control activity.

The Indonesian government established the Indonesian Bank Restructuring Agency (IBRA) to assist its efforts in managing bad loans and troubled corporate assets. Indeed IBRA ultimately came to control a large amount of Indonesia’s corporate asset base, as it seized collateral held by the banks. (A dedicated Asset Management Unit was created to help manage the portfolio.) Most of those assets were eventually sold to bidders at deep discounts, meaning taxpayers were burdened with significant costs. Although the restructuring process started slowly, some success was eventually achieved. Bank Central Asia and Bank Danomon were restructured, Bank Unum was liquidated, the four remaining state banks merged into the new Bank Mandiri, and so on. Various large public companies (such as Garuda Airlines, Astra, and Cibinong) negotiated with internal and external creditors directly, achieved some compromise, and managed to restart interest payments. The abusive lending practices and poor risk controls, together with insufficient regulatory scrutiny, meant that the taxpayer was forced to pay for the restructuring process (such as liquidation, mergers, and re-equalization). Broader political and economic changes followed, including the ousting of Suharto, the dismantling of Suharto family business interests, and dissolution of several other family business groups. However, through into the twenty-first century foreign investors remained
reluctant to reinvest in Indonesia given the country’s history of macro and micro-governance problems.

**Governance flaws**

- Government regulation and local laws permitted business groups to own cross-shareholdings in other companies without restriction. This meant many family companies held significant, and sometimes controlling, stakes in local financial institutions, giving them direct, and virtually unlimited, access to credit. Banks under the control of influential families lent freely to these related institutions, often in amounts well in excess of their financial capacity.

- Liberal access to bank-supplied credit meant companies were both highly leveraged and exempt from the scrutiny of the public capital markets.

- Foreign banks failed to perform basic credit analysis and due diligence, giving undue weight to political connections rather than credit fundamentals in order not to lose out on business opportunities in a dynamic economy.

- Regulatory mechanisms promulgated by the Indonesian central bank and primary securities regulator were entirely inadequate. They were ineffective in limiting corporate ownership of banks and non-bank financial institutions, and reviewing credit standards and lending practices. They also failed to enforce collateral rules, concentrated lending limits, or minimum capital adequacy standards, and did not strictly review dollar and yen funding and liability activities.

- Corporate financial disclosures were opaque, and accounting standards were either non-existent or not strictly enforced; stakeholders could gain no comfort or information from the presentation of annual accounting statements.

- Ethical norms were, in some cases, non-existent. Collusion, bribery, and corruption were the operating norm for many, and poor behavior went unnoticed or unpunished by regulatory authorities.

- Regulators tolerated corrupt practices and widespread abuse of public interests. Indeed, many government officials were guilty of the same behavior.

- Taxpayers were not protected by regulatory mechanisms, and were forced to pay for the abuses, excesses, and corruption that characterized large segments of the economy.
Macro governance problems can obviously be extremely damaging; unlike the individual company cases we have considered in Chapter 7, these broad failures can impact a wider base of constituents, making the need for reforms all the more critical. Indeed, when entire sectors or economies can be crippled as a result of governance problems, significant change is essential. In Part III we turn our attention to a series of governance reform measures that are applicable to both the micro and macro environment.
Corporate Governance Reforms
The significant failures of the governance process flowing through the global corporate system over the past few years indicate that reforms are needed in order to strengthen the business environment. Ultimately, good governance is essential to good corporate operations, and good corporate operations help build a strong business environment. Many academic studies have been carried out over the past two decades to determine whether particular elements of corporate structure, control, and behavior can lead to better governance. The results, as is often the case with empirical analyses, are mixed: some suggest greater independence of directors adds value, while others find no strong linkage; some indicate that separating the roles of chairperson and CEO roles is important, others do not; some note that the establishment of board committees directly benefits shareholders, others find no such evidence.

While these studies can provide interesting insights, some aspects of corporate structure, activity, and behavior cannot be modeled accurately via econometrics. There might be insufficient data to test a hypothesis properly, the model being used to describe a particular relationship might not accurately reflect the characteristics of business practice, or some other empirical shortcoming might arise. For instance, there is no known study that suggests a conflicted or unethical CFO will detract from shareholder value, but shareholders that held Enron or WorldCom stock from peak to trough lost tens of billions of dollars of market value as a result of that particular governance flaw. Accordingly, our focus on micro reforms is centered on issues that are known to have caused problems or have the potential of doing so, not necessarily on those that have been tested empirically to demonstrate particular findings.
What, then, makes for good governance, and how can it be achieved in a practical sense? In broad terms, good governance is characterized by:

- disciplined, fair, and ethical behavior
- sound, independent judgment
- accountability and responsibility
- transparent operations, strategy, and disclosure.

To create a more robust operating environment a company must translate these characteristics into a framework that is relevant in a corporate environment characterized by growing deregulation and international capital movement, greater cross-border activity, new forms of commerce and trade, and more rapid commercial, transportation, and supply/delivery timeframes. Although certain governance processes are already in place, new ones have to be created and others have to be revamped or strengthened. Some of the reform is likely to be self-imposed, some suggested by national best practices, and some mandated by legislation. Importantly, corporate governance reforms must be part of a continuous process of self-examination and self-improvement.

In this chapter we discuss the micro-level governance reforms that a company should consider when it is evaluating its ability to protect and serve stakeholders. These internal reforms, summarized in Figure 9.1, center on:

- strengthening the board of directors and executive management
- refocusing corporate policies
- enhancing internal controls.

Of course, enhancing governance is not simply a matter of improving internal board and executive practices, or implementing better controls.
It also depends on broader reforms in the external sector, including those related to regulatory activity, legal and bankruptcy systems, external auditors, and so forth; we consider this topic in greater detail in Chapter 10. Governance reform also suggests a company must operate under an overarching code of conduct that establishes a proper ethical tone; we consider this issue in Chapter 11. We believe that these micro, macro, and ethics reforms are central to preventing the failures we have described in Part II, and can help provide stakeholders with protections and comfort that have been lacking.

STRENGTHENING THE BOARD OF DIRECTORS AND EXECUTIVE MANAGEMENT

Boards must be at the forefront of corporate governance reform, considering and resolving a host of issues related to executive compensation; accounting treatment of options; director ties and conflicts of interest; composition, function, and efficacy of board committees; provision of consulting services by external auditors; promulgation of ethical conduct, and so forth. Strengthening the role of the board is particularly critical in countries that lack corporate control activity, block holder monitoring, or activist institutional investors. Directors alone cannot promote strong governance, of course; executives must be engaged equally. If these two groups are ethical, diligent, and unbiased, the best interests of shareholders (and other stakeholders) will be served and the agency problem will be reduced.

To be effective the board of directors must be:

- independent, active, responsive, and small
- energized, dedicated, and technically capable
- aligned economically with the success or failure of the company.

To ensure ongoing progress and improvement, every director should be reviewed annually (with the results posted publicly), subject to annual re-election and limited to a maximum term (perhaps five or ten years). This can help keep views and voices diligent and fresh.

Likewise, the ranks of executive management must be staffed with top professionals, and feature:

- separation between the roles of chairperson and CEO
- economic alignment with the success or failure of the company
- cooperative behavior and willingness to share information with directors.
Ultimately, directors and executives decide the fate of the corporation, so their working relationship must be constructive. Boards should be seen as partners and counselors, not interlopers, and executives should be able to turn to their directors for unbiased and useful advice. The effective board will know when to rein in, and when to encourage and support, its management team.

Establishing active, independent, and responsive boards

A board that gathers strength from all of its members – where every director plays a role – is likely to be the most useful and effective. Boards that are willing to challenge and lead, as a cohesive team, appear more likely to succeed in their oversight and strategic roles. This does not mean that all board members have to be of the same mind; indeed, completely homogenous views might not lead to the best stakeholder outcome. It does mean that all directors must be active and willing to express themselves. A natural leader, who can take charge and focus efforts and priorities, can emerge, but all board members must be engaged. The board must devote time and energy to the tasks at hand and meet with frequency. Regional office, plant, and headquarters visits should be the norm rather than the exception. The practice of convening directors a few times per year for a general overview of issues is no longer appropriate; directors must be prepared to participate actively and frequently in the company’s affairs throughout the fiscal year. The practice of hiring “professional directors” – those serving on the boards of many companies simultaneously – should be revisited; shareholders deserve a proper amount of dedication from every director. The entire team and executive management should evaluate the contributions of the entire board, board committees, and individual board members regularly. Board members who are ineffective, conflicted, or disengaged should be replaced.

Board meetings should periodically be conducted without executive management so directors can consider issues without any potential interference or bias. Focus must be on substantive issues, which necessarily requires a greater degree of technical expertise (especially on board committees, as noted below). Directors have to be versed properly in the company’s operations, risks, financial resources, investment and capital policy, and code of conduct so that they can understand issues in a meaningful way and contribute to the advancement of shareholder interests. They should also be willing to accept and entertain suggestions from shareholders. The board is, after all, a representative of the shareholders, so the effective body must at least consider the recommendations of its constituents; this applies to both institutional and individual investors. (Obviously, certain mechanisms are required to communicate efficiently and effectively with a large mass of
investors, but it is increasingly possible given the advanced state of technology and communications.)

Ultimately, the board must be independent of the company’s executive team; this helps minimize potential conflicts of interest. There is greater awareness regarding the need for truly independent directors, and the trend towards majority board independence is strong in some countries. For instance, in Japan changes to the Commercial Code, based on recommendations from the Ministry of Justice and approved through the Diet, call for greater use of independent directors and independent committees. In the United States, director independence is mandated through NYSE listing rules and provisions of the Sarbanes–Oxley Act; in the UK it is recommended through the Higgs Report, in Spain through the Aldama Report, and so forth.7 In addition to eliminating conflicts of interest, there is evidence to suggest that boards that are majority independent are more likely to remove executive management when earnings are poor,8 prevent overpayment in takeovers, and use poison pills to obtain higher premiums (rather than block bids and protect management).9 Independent boards are also positively received by the market and shown to add market value.10 All of this benefits investors. Obviously, there will always be instances where some directors are insiders; this can actually be a benefit, as it provides the board with greater working knowledge about the company. While outside directors may provide useful technical skills and wholly independent views, they also require more time (perhaps years) to understand the company and its culture. But it is difficult to defend the practice of a majority inside board. When this happens there is no effective “arm’s length” monitoring or supervision, and the interests of shareholders may not be represented appropriately.

Director independence can be hard to define, and varies by country, culture, and practice. In some cases it is defined through legislation (for example, the Sarbanes–Oxley Act provides one such definition for US companies11), other times it arises as a form of best practice. (We consider examples of “independence criteria” set forth in the best practice codes of various countries in the Appendix.) In general, however, we might consider independent directors as those that (a) have no reporting, business, or financial relationship with the company’s executive management, and (b) have no advisory, consulting, or supplier/client relationship with the company. The truly independent, conflict-free, board can challenge and query without fear of reprisal.

Assembling boards with these characteristics is not simple. It is necessary to attract independent directors who are willing to commit time, energy, and expertise. This generally means they must receive just compensation, and feel empowered and personally responsible. From a financial perspective an adequate, though not excessive, stipend is
appropriate, and such fees should conform to well-established industry norms. From an empowerment perspective, this may come through the creation of smaller boards (so that each director feels like his/her contribution matters), and a limit on the number of directorships that each can hold (so that each director can be more focused and dedicated). It may also come from an increase in the specter of personal financial liability (which we discuss below).

In forming boards, countries that have not traditionally allocated directorships to employee representatives or institutional investors should consider doing so; their particular perspective can add value and advance aspects of the stakeholder agenda. In countries where the pool of directors is relatively small and homogenous, leading to interlocking directorates and overly consistent views and opinions, efforts should be made to seek out new candidates from alternate pools. (In some cases this might require regulatory support.)

Reducing board size

In some systems and countries (such as Japan, Korea, and Germany) board size appears to be too large to allow effective business monitoring. Although board size is sometimes driven by law (such as a specific number of labor representatives required under German labor codetermination) it is often the vestige of tradition, culture, and comfort. In such cases it would seem sensible to consider breaking with established norms and reducing board size to a level where members can act efficiently and decisively (and where director responsibility and accountability can be concentrated, rather than dispersed). Many US and UK companies started reducing their boards from a peak size of 20–30 during the 1980s, and most now feature approximately a dozen directors; this appears to be large enough for a mix of views and skills, and small enough for efficient operation. In Japan, the Ministry of Justice has recommended a reduction in corporate boards (and removal of more inside directors), but it is early in the process, and most boards remain very large, and will for some time to come. Companies in other countries have yet to follow suit. Although reducing board size means eliminating a “comfortable” way of managing business, it is likely to prove beneficial in the longer term.

Creating technically expert, independent board committees

Board committees permit subsets of the board to focus on corporate issues in greater detail. Assembling smaller cadres of directors is efficient (it is far easier to gather three or four directors on a frequent basis than one or two dozen), and allows greater time, energy, and focus to be
directed to vital corporate issues. As noted in Chapter 2, companies in many nations have used board-level committees for several years (if not decades). Even in countries that have not historically featured such committees, such as Japan, Brazil, and Malaysia, there is a growing awareness of the value that can be added, provided they are structured and staffed correctly. In fact, various national best practice codes suggest the establishment of committees.

In some instances committees act under the authorization of the full board of directors, meaning they are empowered to make relevant decisions. They report their decisions back to the full board (and ultimately to shareholders, via the AGM and annual disclosure statement) as a fait accompli. In other cases committees are not granted full authority but serve as investigative bodies, gathering information, forming recommendations, and presenting them for further action by the board (or voting at the AGM).

Regardless of the actual level of authority/responsibility imbued in the individual committees, they must be technically proficient. This means individual members must bring some specialization, whether in finance and accounting, risk management, auditing, human resources, or some other critical discipline. When even greater expertise is needed committees should be able to call on outside experts as necessary, at company expense. There should also be a regular regimen of training. Professionals often receive ongoing training in their fields in order to remain at the leading edge, and the same should apply to directors, especially those serving in very technical roles.

In all cases a majority of committee members should be independent and non-executive, and committee heads must be independent. It is important for committees to be able to speak and analyze issues freely, without concern that management presence via inside directors will somehow constrain, influence or direct the agenda. Board committees must concentrate on substantive issues. As we have already noted, good governance centers on creating a process that achieves a control goal of benefit to stakeholders. This is particularly important for board committees, as they play a central and specialized role in considering the technical aspects of a company’s operation. If committees exist to satisfy stock exchange listing requirements, regulatory rules, or recommended best practices, rather than to provide value-added technical expertise, then the exercise is likely to be of limited use.

In the section below we consider the nature and function of board committees that we believe should exist in every public corporation, regardless of industry or domicile. These center on the audit (or internal control) committee, compensation committee, and nominating committee; most of these functions are already familiar to companies in various countries, although their level of independence and technical expertise need, in
many cases, to be strengthened. We also believe that the establishment of a
distinct risk committee is warranted and advisable. While certain firms
have incorporated the function within their audit committees this is no
longer satisfactory: the technical requirements are quite distinct, and the
subject matter is important enough to corporate operations that it deserves
separate review. These four committees are suggested as minimum stan-
dards. Some companies may also wish to consider groups that focus exclu-
sively on corporate governance or human resources, for example, which
may be entirely appropriate in a national or industry context. As long as
each committee is productive and value-added (and not bureaucratic or a
“display of form”), there is no disadvantage in expanding the specialized
focus of different elements of the board.

**Audit (internal control) committee**

The role of the audit (or internal control) committee is well established in
many companies, although the scandals of the early twenty-first century
have added new responsibilities and pressures, and demand a higher level
of technical competence. For instance, at least one committee member (and
preferably more) should have a good understanding of financial statements,
and GAAP or IAS rules, for such areas as expenses, accruals, reserves,
internal audits, internal controls, derivatives, off-balance sheet activity,
related-party transactions, and SPEs.

**Chairperson**: independent, technical expert (for example, accounting/
financial background and experience).

**Committee**: majority independent, with at least a majority that are techni-
cally capable (for example in accounting and auditing).

**Responsibilities**:

- Create independent financial control and internal audit teams, assign
  mandates and delegate authorities.
- Review financial data, control and reporting policies, processes, and
  infrastructure.
- Ensure the existence of appropriate technology and controls to produce
  financial statements; be aware of limitations or vulnerabilities.
- Review quarterly and annual financial statements with a focus on
  changes in accounting policies, period-to-period adjustments or restate-
  ments, compliance with accepted accounting standards/requirements,
  and alternative treatment of accounting items.
- Consider any related-party transactions and their impact on the firm’s
  operations.
- Hire the external auditor,\textsuperscript{13} agree audit fees, term and scope, consider potential conflicts of interest (related, in particular, to consulting and tax services)\textsuperscript{14}, review progress and efficacy, and dismiss if necessary.

- Review and discuss external auditor’s annual financial management letter and management’s response.

- Review and approve internal and external audit plans.

- Review draft internal and external audit findings; hold confidential discussions regarding findings and recommendations.

- Confirm that previous audit findings have been resolved.

- Act as neutral body for discussion of sensitive issues with financial controllers and internal auditors (such as whistleblower findings and troublesome behavior).

**Frequency of meetings:** at least quarterly, and more often as circumstances warrant.

**Risk committee**

With the financial dislocations and resulting disclosure reforms of the late twentieth and early twenty-first century it is clear that audit committee pressures are mounting, and the issues members must deal with are more complex and time-consuming. At the same time, financial and operating risk exposures are growing larger and more complicated. Accordingly, the creation of a dedicated risk committee, focused exclusively on the firm’s financial and operating risks, surfaces as an advisable option for companies.

Developing proper risk strategies and appetite is a vital function for any firm. Too often, however, the job falls to a business or control unit reporting up through the executive management structure. Only when an unexpected loss occurs (such as a significant loss from financial or operating risks that the company may not have understood or been aware of), might a member of the board be charged with overseeing the process. This is not an adequate solution in an era where risk exposures might be especially large (and potentially damaging). A company should proactively shape its risk profile through a dedicated board committee with an appropriate amount of risk expertise. This means ensuring that a proper framework – including tolerance, financial resources, policies, infrastructure and monitoring capabilities, driven by a wholly independent risk management function – is in place for identifying, measuring, allocating, managing, and reporting risks.

**Chairperson:** independent, technical expert (with, for example, financial or risk management experience).
Committee: majority independent, with at least a majority who are technically capable (in, for example, credit/market risk, insurance/operating risk, or accounting/financial control).

Responsibilities:

- Define the firm’s overall financial and operating risk strategies and tolerance levels (such as capital that could be lost in the event various risk exposures impact the firm). Update these as needed and convey to executives, management, and employees.

- Review and approve financial/operating risk data, control, model/valuation, and reporting policies, processes, and infrastructure.

- Ensure the existence of appropriate technology and controls to produce risk management information and reports. Be aware of limitations or vulnerabilities.

- Design and approve the internal risk management function, and mandate and delegate authorities.

- Review quarterly and annual risk profile, with a focus on changes in risk levels and compliance with regulatory risk requirements.

- Act as a neutral body for discussion of sensitive issues with independent risk managers (such as whistleblower findings and troublesome behavior).

Frequency of meetings: at least quarterly, and more often as circumstances warrant.

Nominating committee

Since proper directors are critical to the effective operation of a board and a company, director selection becomes an extremely important process. The formation of a separate committee to screen and select the best possible candidates – in an independent and unbiased fashion – is thus advisable. The same committee can also be used to search for top executives, and ensure the creation and implementation of an appropriate CEO succession plan.

Chairperson: independent.
Committee: majority independent.
Responsibilities:

- Lead process in identifying candidates for directorships and top executive management posts; make use of outside advice and resources as necessary.
- Ensure potential candidates have proper qualifications and experience; for directors, in particular, ensure no conflicts of interest, and sufficient expertise/time to devote to the effort.

- Engage large, committed institutional investors on potential director nominees.

- Work with compensation committee on appropriate structure of compensation package (such as performance targets, bonus payments, and severance and pension).

**Frequency of meetings:** annually, or as circumstances warrant.

**Compensation (remuneration) committee**

Compensation is a complex, and often emotional, issue that must be handled with care and diligence. It demands good knowledge of industry practice and an ability to balance competing forces and realities. An independent compensation committee to evaluate and create proper executive pay packages is absolutely vital; this team can ensure fairness and transparency, two essential ingredients required for stakeholder protection. Indeed, as companies in different national systems gradually adopt more complicated pay structures (including granting of stock options and executive retirement benefits), pressure for proper scrutiny and treatment mounts; a compensation committee can lead the way.

**Chairperson:** independent.

**Committee:** majority independent.

**Responsibilities:**

- Create a compensation policy for executive management and directors that properly aligns the interests of all stakeholders. Make use of outside compensation advisers and benchmarking tools as necessary.

- Disseminate a clear statement to all stakeholders through all available disclosure mechanisms regarding the approach used to determine compensation for executive management (with specific detail on performance targets).

- Ensure that any substantive change in compensation policy is approved by the committee, the board of directors, and presented for vote at the AGM.

**Frequency of meetings:** annually, or as circumstances warrant.

Figure 9.2 summarizes the committee structure/function (under a single board system).
Figure 9.2 Board committee structure
Separating the roles of chairperson and CEO

Certain companies using the single board system continue to combine the roles of chairperson and CEO. While some have moved to separate the two, the basis for migration has been largely voluntary (the recommendation of a best practice rather than a regulatory directive or statute). This, for example, is the case in countries such as the United States, the UK, Switzerland, Canada, and Japan, where guidelines suggest, but do not require, a separation of the two functions. (In fact, approximately 90 percent of UK companies and 70 percent of Swiss companies already feature split roles, while only 15 percent of US companies do.) In France the rules are inverted: the previously combined role of president directeur general is now divided into two separate posts unless shareholders specifically vote to the contrary. Where public companies have chosen not to divide the roles it may be the result of comfort with the “traditional” way of managing executive/board matters, or reluctance by powerful executives to cede control.

Dividing the roles seems a prudent and effective way of ensuring proper focus, and eliminating potential errors and conflict of interest. Running the executive team and corporate operations on a daily basis is an enormous job that requires time and commitment. Running the board of directors and ensuring effective execution of oversight and strategy is equally difficult. Doing both, simultaneously, would seem almost impossible, suggesting that the likelihood of mistakes or neglect rises. In addition, the potential for conflict exists: the CEO runs the company, the chairperson runs the board that monitors the company, so conflicts can surface when these are joint roles. Furthermore, the chairperson/CEO possesses all of the information associated with the company but also controls the board’s agenda and information flow, and can thus communicate or reveal what is deemed “best.” A separation of the two roles solves these problems, and has already been used to good effect in many companies around the world. It does not guarantee that other corporate problems will disappear, but it creates an additional link in the governance chain.

The alternative to a division of the two roles, as recommended by numerous industry groups, is the appointment of a lead independent director (or presiding director). This director acts as de facto leader of the non-executive directors and, while not in charge of the entire board, is readily identifiable as the primary independent interface between directors and executives. This concept has appeal as an interim step; it assigns greater responsibility to an “independent voice” on the board, and though it does not remove all potential problems, is workable and less wrenching than a full chairperson/CEO split. In the medium term, however, the optimal solution should indeed be a full separation of the two roles (and dissolution
of any lead independent/presiding director role that might exist as an interim measure).

Obviously, in countries that follow the dual board system – comprised of both a supervisory board (the equivalent of a completely non-executive single board) and the executive board (the equivalent of completely executive single board) – the distinction is not relevant. The heads of the supervisory board and the executive board are different individuals with separate roles and responsibilities; ultimately, the chairperson of the executive board is accountable to the chairperson of the supervisory board. Thus, companies operating in Germany, the Netherlands, and Indonesia, among others, do not have to focus on this separation. (Even in situations where a former chairperson of the executive board retires and becomes head of the supervisory board, the functions remain separate and unique.)

Figure 9.3 illustrates various versions of “optimal” board/executive management structures.

In situations where it is not possible or practical to divide the roles, a company should take certain minimum steps to ensure that its director/management process is fair, effective, and unbiased. This means:

- appointing a lead independent director/presiding director to guide the board in discussion and action apart from the chairperson/CEO (and act as liaison to executive management)
- conducting frequent meetings of the independent directors (without the presence of executive managers or inside directors)
- ensuring that a majority of directors is truly independent of management
- making certain that all board committees are led by an independent director (and comprised of a majority of independent directors).

When this type of structure is enacted, the roles and responsibilities of each party should be disclosed to shareholders so that accountabilities are clear. (For instance, shareholders should know that when joint roles exist, the chairperson/CEO presides over the board and has ultimate approval over the board agenda and information flow; the lead independent director/presiding director works closely with the chairperson/CEO, chairs independent director meetings, and is the principal liaison between the independent directors and the chairperson/CEO.) When a company chooses not to split its chairperson/CEO roles or appoint a lead independent director/presiding director, and does not feature a board with a majority of independent directors, it should explain its rationale to regulators and investors, and how it intends to operate in the best interests of shareholders. This is an essential minimum requirement for an otherwise unsatisfactory situation.
**Single board system: separation of chairperson and CEO**

![Diagram of a single board system: separation of chairperson and CEO](image)

**Single board system: combined chairperson and CEO with lead independent director**

![Diagram of a single board system: combined chairperson and CEO with lead independent director](image)

* or a presiding director, in some systems

**Figure 9.3** Optimal board/executive management structures
Aligning board director interests

We have noted in Chapter 5 that board members often have no direct economic stake in the company’s fortunes. This means that their interests are not aligned with those of shareholders (as they often are between shareholders and executive management). Granting stock awards or options is not the solution, of course; any free, unencumbered reward tied to the company’s stock price is still a no-risk proposition for directors. Instead, directors should be required to purchase a certain amount of stock with their own money; this ties them to the economic success of the company more directly and makes them sensitive to the long-term direction of the company’s value as reflected through the stock price. Focus should, of course, be on the long term, meaning that any short-term sales should be viewed negatively (or even prohibited). Likewise, purchase of options should be minimized or banned, as it gives directors too much leverage to the firm’s stock price performance.

As noted above, director fees should be the only other form of board compensation (there should be no consulting or business service income), and should be in line with national averages or local practice. If fees are too high, conflicts of interest might arise (such as directors agreeing to go along with management on particular issues in order not to jeopardize an economically important source of personal income).18

Limiting D&O insurance coverage

Directors and executives in many systems have enjoyed liability protection for many years through directors and officers (D&O) insurance coverage. In order to protect their financial interests, and avoid personal economic hardship arising from lawsuits driven by breach of fiduciary duties, most D&O-eligible candidates insist on proper coverage, at the company’s (that is, shareholders’) expense. This typically includes a policy with no deductible (the insurance company pays out from the first dollar of loss) and very high caps or policy limits. (The presence of D&O coverage has, unfortunately, been shown to attract “frivolous” lawsuits in litigious countries such as the United States, tying up the legal systems and consuming valuable resources.)

The need for D&O coverage, certainly in the United States and the UK, became apparent during the takeovers of the 1980s when the incidence of lawsuits increased as a result of failed mergers and acquisitions, payment of greenmail, and so forth. As a “hard market” for D&O insurance developed (there was a lack of insurers willing to write cover, meaning lower supply, higher deductibles, greater exclusions, lower policy limits, and higher premiums), companies often reduced coverage. Those that were
unable to pay the increasingly expensive premiums demanded for adequate protection actually lost directors.\textsuperscript{19} Although the market softened somewhat in the 1990s, giving companies fresh D&O cover at lower prices, it hardened again in the wake of the corporate scandals of the early twenty-first century. For instance in early 2002, several months after Enron’s bankruptcy, US D&O premiums surged 50 percent (primarily for companies with market capitalization in excess of US$1 billion, where premiums rose from US$10,000 to US$25–30,000 per US$1 million of coverage, up to a cap of US$50 million).

In addition to raising premiums, several major D&O insurers have made it more difficult for directors and officers to obtain the same level of coverage they have traditionally enjoyed. Some insurers, for instance, have eliminated severability cover.\textsuperscript{20} If a \textit{severability clause} is retained, the insurer pays no claim if a director is found to have committed fraud, but must still pay legal fees and any judgments against all remaining directors. If the clause is removed, coverage for all remaining directors disappears, even if only one director has been the source of the fraud. Without severability, innocent directors are punished financially along with those committing fraud.

Obviously, eliminating D&O coverage is not a workable solution: directors and officers will simply choose not to serve, as the potential personal financial liability of doing so is too great. (Indeed, some might argue that if D&O actions are slanted towards avoiding liability, rather than maximizing value, coverage should be increased so they need not worry about potential lawsuits.) However, mechanisms can be instituted that will make directors and executives more accountable and focused. For instance, firms might require directors and officers to pay for the first US$100,000 or US$500,000 of lawsuit-driven losses (that is, a policy deductible), a figure that is unlikely to cause personal financial distress, but will help keep them very vigilant. Alternatively, they might require directors and executives to share in losses over some amount on a pro rata basis (effectively coinsurance), limit the amount of coverage they can obtain (a policy cap), or pay for their own insurance premiums. In short, any scheme that limits blanket insurance coverage and puts some amount of director and executive capital at risk must be viewed as a possible solution.

**Piercing the corporate veil for directors and executives**

The concept of limited liability is a central tenet of corporate theory and structure. The investor does not want to be liable for more than the amount of capital placed at risk in the venture, and there is thus no call on personal assets in the event of financial distress (with the rare exceptions we mentioned in Chapter 1). However, another potential mechanism for
increasing the accountability of directors and executives takes the limited D&O coverage concept described above one step further. This involves piercing the corporate veil (that is, breaching the limited liability structure) for directors and executives who have been found to be grossly negligent in the discharge of their duties (for significant fraud-related issues, not frivolous lawsuits brought by disgruntled investors). This means the personal wealth of directors and executives is placed at risk, and is subject to disgorgement whenever grossly negligent actions lead to the financial collapse of a company. Such an approach would undoubtedly cause some directors and executives to relinquish their responsibilities, as personal liability is a serious matter. However, for those who have the courage of their convictions and the willingness to remain attentive and act diligently in the discharge of their duties, it should be of less concern.

Reducing information asymmetries

If a board is to be effective it must have complete and efficient access to all information required for decision making. It should be regarded as unacceptable for the executive management team to withhold or control information, or take any other actions that perpetuate information asymmetries. Transparency and access must be standard operating guidelines. This does not mean board directors need to micromanage the information process, or be deluged with an excess of detail: that would do little to advance their role. However, after working together for a period of time, it should be clear to executives what information directors need to guide the company’s businesses. Once identified, it should be forthcoming without question or delay. Special information should be provided as a matter of course, not when it is specifically requested. Technology can be used to remove information asymmetries. Although it is certainly not true in every case and system, the growing ability to rapidly disseminate large amounts of potentially vital information within the community of directors and executives (and large institutional shareholders), permits narrowing of the information gap.21

REFOCUSING CORPORATE POLICIES

Corporate policies exist to guide a company in its tactical and strategic operations, and should be created, improved, or reinforced to advance stakeholder interests. Effective corporate policies, combined with robust internal controls (discussed below) and proper corporate behavior (which we consider in Chapter 11) allow a company’s internal management to work smoothly and securely. Specific corporate policies should focus on:
- developing rational compensation standards
- creating effective disclosure
- supporting shareholder rights
- returning excess capital
- defining and publicizing strategy
- establishing and demonstrating a long-term perspective
- engaging institutional investors.

**Developing rational compensation standards**

Executive compensation is a complex, and often volatile, mix of ingredients. Packages must align executive and shareholder interests, be large enough to attract, retain, and reward talented executives, and remain cost-effective for shareholders. Reining in executive pay to reasonable levels in countries such as the United States is a daunting challenge, but one that must be undertaken in order to prevent abuse of the shareholder.\(^22\) Stock grants represent a high cost to shareholders, option grants create greater risk of retention (when they are “underwater” the executive has no incentive to stay), and guaranteed compensation removes the incentive to work harder; a balance is thus required. Most schemes have to be tailored for specific industries, as each faces different talent and pay dynamics. In addition, they need to be reviewed frequently, though only changed when absolutely necessary. Board-level consideration of any executive pay scheme must focus on alignment, performance targets, incentives schemes, executive stockholding levels, bonus discretion, and dilution. It must, of course, be surrounded by appropriate independence and disclosure.

If a company wants to be perceived as prudent and ethical, and operating in the best interests of its shareholders, it cannot be abusive in its executive compensation structure. When packages are especially large, directors must consider whether shareholders believe that they are based on proper incentives and competitive retention. If they do not, compensation packages will remain a source of friction and distraction. While few stakeholders would be unwilling to pay executives handsomely when they are creating an increasing amount of sustainable enterprise value (rather than short-term bursts in the stock price), most still want proper structure and commitment to ensure fair play. Executives need to maximize corporate wealth, not just pre-tax or net income, or EPS. Thus, executive wealth\(^23\) must be related to shareholder wealth; if they undergo equal changes then they are aligned, if they do not then they are misaligned. It is not sufficient to keep a large percentage of an executive’s total compensation at risk; this
means only current earnings (such as this year’s income) are at risk, rather than the sum total of all executive wealth. Although it is a complicated issue, some basic standards can be considered. For instance:

- Executive compensation should be determined by an independent board compensation committee. As we have noted above, it should have absolutely no ties to management.

- The executive packages should reflect an alignment of shareholder and management interests, be approved by shareholders, and disclosed clearly. Consideration should be given to linking pay scales to stock price/EPS performance relative to competing firms/peer groups (rather than as an absolute value, which might lead to short-term financial manipulation of results).

- Golden hellos and golden parachutes should be minimized; these should be exceptions, not the rule.24

- Options should be expensed through the income statement to reflect the cost of the value being transferred.25 While this has been widely debated, it is a rational and equitable approach. There is some possibility that certain companies might choose not to grant executives options any more (or at least not such large grants) since the bottom line effect will be noted immediately and repeatedly; accordingly, there is a risk of not retaining top executives or attracting new talent. There is, however, no better way of adding transparency to the executive compensation process. (Indeed, 20 percent of US companies have indicated that they will voluntarily expense options in advance of any specific rules from FASB.)

- Options should contain features that only allow executives to receive large payouts when they are creating sustainable value. For instance, options might only vest when the stock price has reached, and maintained for an extended period of time, a given level, or when very specific revenue or business targets have been achieved repeatedly (targets, it should be added, that are not prone to any type of manipulation). Options might feature certain index-linked strike prices that can only be exercised as increasing targets are reached; they might also contain acceleration clauses that allow for more rapid vesting as goals are reached; and so forth. Under no circumstances should “free” options be granted: those with no goals or requirements. Although trade-offs always exist in option (and share) grants, it might be more relevant from an alignment perspective to move from variable grants (with fixed value) to fixed grants; this effectively means that if the company’s share price falls in half, then half of the competitive value
of the grant is sacrificed. (The trade-off is between greater retention risk and greater shareholder cost. For instance, a poor job by the executive and a falling share price mean a greater chance of departure (which may, or may not, be desirable); a good job by the executive and a rising share price means more compensation.) Options should not be rewritten at new market levels when they are underwater.26

- Performance measures should not be recalibrated every year. Although recalibration maintains total compensation at a competitive level (reducing the likelihood of losing an executive), it also rewards poor performance by increasing the percentage interest in operating profit and stock price appreciation. (It also penalizes good performance on the upside.)27

- Bonuses should never be guaranteed, they must be based strictly on performance.

- Compensation schemes must focus less on short-term stock price movements; structures that remove the emphasis on the stock price can help eliminate the “short-termism” that plagues certain companies in market-model systems. Care must also be taken not to create packages that simply respond favorably to bull market strength (the company’s stock being lifted up with the rest of the market, and not necessarily because the firm has reached performance targets and created additional value).

Other aspects of compensation-related activity must also be addressed. For instance, immediate notice of insider stock and option sales should be given to the public, and compensation consultants creating executive packages must report in directly to the independent compensation committee of the board.

Creating effective disclosure

Providing stakeholders with meaningful, timely, and transparent disclosure is a key check and balance. If stakeholders are aware of the true state of a company’s affairs (depicted, for instance, through cash flow, rather than EPS, rules) they can critique or support what management is doing; the information asymmetries that characterize most agency relationships can narrow (although they will never disappear entirely, of course), and monitoring capabilities improve. Although there is considerable academic debate on “optimal disclosure” – its impact on the capital markets, whether it can convey meaningful information in a manner that allows investors to react, and so forth – the simple discipline of the disclosure process leads to better transparency and control. Thus, even if the information being
presented is historical in nature, the process used to develop the disclosure is a key control mechanism.

Failing to disclose information or disclosing false information, must of course be regarded as serious infractions, and should be treated severely under both criminal and civil codes (for example by forfeiture of bonuses, and penalties). As we shall note in the next chapter, legislative reform in the United States requires executive officers (CEOs and CFOs specifically) to certify financial statements. Failure to do so, or to certify false statements, leads to civil, and possibly criminal, liabilities. Some feel that this is an extreme step and that it is impossible for the executive officers to be 100 percent certain about 100 percent accuracy. We would argue, however, that ensuring the accuracy of the company’s financial picture is precisely the responsibility of the CEO and CFO. Accordingly, a regimen of executive liability for a range of disclosure issues, including financial statement certification, is entirely appropriate.

Corporate disclosure must be substantive, providing useful information about the company, its performance, and its prospects, and must be readily understood so that investors and other stakeholders do not have to decipher or interpret what is being communicated. In addition, information should be available very soon after it is produced. Technology, network communications, and database infrastructure permit delivery of useful information on a timely basis. Annual reports with glossy covers, “public relations” information, and summary financials with illegible footnotes, produced months after year-end, are certainly more form than substance. These historical snapshots are often of very limited use. For instance, a quarter-end glimpse of the firm’s key risk numbers can tell an investor very little, but a description of the risk profile, trends, averages, stress loss outcomes, pockets of concern or uncertainty, and so forth, conveys meaningful information. The same is true for revenue analysis, liquidity, funding, and so forth. Indeed, in an ideal world stakeholders should be given significant portions of what financial and risk officers, accountants, and executives use in daily management of controls and businesses. Although there may be some proprietary information that needs to be excised to avoid a competitive disadvantage, stakeholders should be able to reference much of the material that internal managers see and use. Stakeholders must therefore demand useful and timely details on the company, including:

- revenue analysis, trends, extraordinary items
- operating cash flows
- liquidity profile, sources, and restrictions
- off-balance-sheet activities
- future commitments and contingencies
- related party transactions
- reserve actions
- forward balance sheet construction
- nature and extent of top financial and operating risks
- investments and capital expenditures
- governance controls and issues (such as reporting, voting, and compensation)
- period-to-period changes in accounting policies.

Once stakeholders have good disclosure they can make better decisions. This applies to the proxy process as well. Since the proxy mechanism can be a valuable mechanism for determining issues important to shareholders, providing useful information should be a matter of course. If investors are going to have a say in matters such as director election, change in corporate activities, management attempts to block or initiate a corporate control transaction, and so on, they must be equipped with enough information to make reasoned decisions. Until they have such information they remain exposed to asymmetries, and are unlikely to be aware of the condition of, and prospects for, their risk capital.

Supporting shareholder rights

Protecting shareholder rights is the essence of governance, and must ultimately be an overarching policy goal. Supporting these rights touches on many areas, including:

- Allowing shareholders the power to choose and replace directors (and giving them access to information so that they can make reasoned choices, as noted immediately above).
- Permitting minority interests to be formally represented on the board.
- Giving shareholders information on how directors vote on key issues\(^{28}\) (such as compensation,\(^{29}\) external audit selection/business scope, and risk tolerance levels).
- Allowing easier passage of shareholder resolutions (for example, dispensing with supermajority requirements).
Guarding pre-emptive rights by requiring any change to be specifically approved by shareholders.

Instituting proper reporting controls to track insider transactions.

Permitting shareholders to call special meetings or request additional financial information (on a controlled basis).

Protecting minority interests from the negligent acts of directors and officers by supporting derivative lawsuits, allowing cumulative voting, passing stricter insider trading/self-dealing penalties, and so on.30

Protecting against multiple class recapitalizations, which can dilute existing shareholder voting power31 or concentrate large investor/executive shareholding voting power. (Where it is not specifically provided in law, corporate policy should prohibit such actions without investor approval.)

There is evidence to suggest that systems featuring laws designed to protect outside shareholders generally (and minority shareholders as a subset) relative to management and “insider” shareholders can help firm performance and capital markets development. In many countries shareholders are protected by the duty of care and duty of loyalty provisions we discussed earlier.32 Again, where these do not exist in a specific legal framework, they should be an element of corporate policy.

Japan serves as an interesting example of changing shareholder rights. The country, which has featured main bank guidance/monitoring and keiretsu cross-shareholdings for years, has started to promote greater shareholder protections. Although the system is unlikely to change quickly (indeed, some aspects of it will not, and should not, change at all), it is clear that the ire of shareholders, who were once very passive, has been raised. Investors, although still not activist in any real sense, have a greater voice than they did in the past, as keiretsu companies sell their group interests and banks reduce group lending. As noted earlier, legislation has been passed that requires appointment of more independent directors, mandates greater attention to minority shareholder requirements, and strengthens the proxy voting process. (This is done through better disclosure, more voting choices, simplification of registration and voting procedures, provision of independent shareholder research, and rescheduling of AGMs.) It also promotes new mechanisms such as online shareholder voting. Although derivative shareholder lawsuits are still uncommon, certainly as compared with market model countries, they are beginning to appear, and send a powerful signal to the corporate establishment.33
**Returning excess capital**

Excess capital serves no productive purpose and ultimately hurts the shareholder through lower returns. Thus, companies must be attuned to situations where excess capital builds to unacceptable levels, and should implement measures to return any excess. A company’s management must be prepared to wring excess capacity out of its own operations by redeploying or returning capital. Exiting a marketplace that no longer provides adequate returns can be a difficult and wrenching exercise, but it is one that must ultimately be undertaken if returns are unlikely to improve over the medium term. This may demand a change in corporate policy and mind-set, which can be challenging. Failure to address the issue simply delays the onset of what may be even more drastic action (such as corporate control activity).

Capital can be returned through various mechanisms (but must be supported by proper regulations, as noted in the next chapter). For instance, a firm might grant a one-time stock or special dividend, or implement a stock repurchase program. Either action has the effect of reducing the equity account (by lowering retained earnings or increasing the treasury stock contra balance). Restructuring, with or without a robust corporate control market, is another way of returning excess capital. If a company recognizes through its own discipline that its resources are not being used optimally, it should restructure its operations voluntarily. This may mean spinning off “unwanted” subsidiaries through IPOs, selling them to third parties, or any action that can result in proceeds being raised and returned to shareholders. For instance, in Japan, which has long featured a tradition of overinvestment and unwise diversification (and no truly active corporate control market by which outsiders can “check” the strategies), corporate restructurings are becoming more common (though still relatively modest by US or UK standards). Established public companies have started spinning off non-core or unrelated companies in order to return funds to shareholders. Restructurings and asset disposals have been supported by the passage of proper tax incentives (resulting in more than 300 such transactions between 2001 and 2002).

**Defining and publicizing strategy**

Transparency regarding a company’s strategy permits information asymmetries emerging from the owner/manager division to be reduced. If the firm’s strategy regarding corporate operations, market and product focus, risk tolerance, financial structure, and outlook is defined and publicized, investors have metrics by which to measure management’s success or failure. This permits an equitable assessment of management’s performance...
against stated goals and, where it falls short (or deviates entirely), the opportunity to challenge. Equally, where goals are met or exceeded and consistency maintained, support and reward can be given. If a company can develop and regularly communicate its strategy (including changes or enhancements that it wants to make), it might also appeal to a base of long-term investors that share similar beliefs and goals. Management that is unwilling to commit itself to the publication of its strategy, and to defend or justify its performance against such goals, must be regarded with some suspicion.

Developing and demonstrating a long-term perspective

We have mentioned that the focus placed on short-term corporate performance, including revenues, EPS, and stock price, is one of the shortcomings of the market-model system. We have further demonstrated, through the case studies in Chapter 7, how some firms have violated principles of control, governance, and ethics by placing an excessive focus on short-term performance and accounting-driven numbers. To overcome this, management and board directors must alter their perspective, taking a strong view of the long-term, sustainable performance of the company, rather than the level of EPS and the price of the stock in the next fiscal period. This means emphasizing value-added operations, investments, and corporate cash flows, even at the risk of sacrificing short-term EPS growth or stock market gains.36

This, of course, is easy to state but very difficult to implement, as it demands for many a complete change of mind-set, not only within a company, but also among certain institutional investors, rating and equity analysts, and the financial media. The short-term perspective in many market model companies is part of the corporate culture, and may be extremely difficult – although we believe not impossible – to alter. It must begin with education, meaning management must spend more time with institutional investors and other stakeholders to explain long-term strategy, goals, and progress. Management must be forthright in disclosing information (perhaps, as we note in the next chapter, making committed long-term investors “insiders” for information purposes). Indeed, executives should actively seek out shareholders that are interested in investing for the long term, and give them a greater voice in key areas, such as director nomination and takeover defense construction.

The investment community must also place less reliance on short-term measures of corporate performance and adopt a similar long-term view. Ultimately, the two parties must be aware of the nature and rationale for corporate decisions that will come to fruition over the long term, and refuse to react solely to short-term performance. Part of this will involve a
concerted effort by the company not to provide sell-side equity analysts with any inter-period guidance on how operations are faring. (In fact, a 2003 poll of 600 US corporate members by the National Investor Relations Institute noted that a third are considering ending profit projections in order to begin de-emphasizing short-term results.)

Market-model companies can learn from the relationship-model companies of Germany and Japan. The model they have created, for all its considerable flaws, permits a strong, almost strict, focus on developing long-term relationships with stakeholders. This eases the pressure on EPS and short-term stock price performance, and permits directors and executives to do what they believe is best for sustainable value creation. Japanese and German companies place far less emphasis on interim financial reporting and EPS, and seem unconcerned with what equity analysts and short-term institutional investors might say or do. There is no particular evidence that the approach they have taken is strictly cultural; it is still motivated by economics, and may thus be portable to other systems. (The opposite is, of course, true: German and Japanese companies should always ensure that long-term relationships are not used as an excuse to perform poorly in the short run; complacency and entrenchment that can arise from the long view must be avoided.)

Engaging institutional investors

Continuing with the theme above, it is important for companies fully to engage, and work with, their core institutional investors: primarily those that have, or are seeking, a long-term perspective. (Those with a very short-term horizon are unlikely to be interested in spending the time and energy to impact governance reforms.) By creating a policy of active communication with institutional investors, company directors and executives turn a potentially confrontational and destructive relationship into a productive and mutually beneficial one. Although companies generally had little regard for the institutional investor voice in the 1970s and 1980s, that has started to change, and firms must continue to demonstrate that the institutional investor community is an important force that can contribute positively. This process requires active management by executives. For instance, companies should not permit sell-side equity analysts to be the information conduit into the buy-side investment community, but should take charge of communicating directly with funds. They must also routinely solicit feedback on critical issues, and accept suggestions for improvement. Even if the suggestions are not ultimately accepted (for what are hopefully good reasons), investors will still feel like they are part of the process, working cooperatively with the company towards the improvement of stakeholder interests.
ENHANCING INTERNAL CONTROLS

Every company must possess strong internal controls. These are so fundamental to any effective operation that they should be reviewed continuously, with a view towards ongoing improvement. Internal control enhancement should be based on:

- developing proper accounting policies
- enhancing internal audit controls
- reinforcing a culture of risk management
- implementing crisis management programs
- conducting thorough “post-mortems.”

These control activities can be extremely effective in giving board directors, and ultimately stakeholders, the additional comfort they require. Every employee at the firm should feel empowered to act as an “internal controller” of some type; while formal boundaries and duties exist, it is the responsibility of every employee to be vigilant to potential problems, weakness, or unethical behavior that might be exposed during market stress or crisis. Internal control depends, to a certain extent, on the willingness of those closest to the management of a particular business, unit, or division to elevate problems and errors. The whistleblower – an employee who reports internal infractions to senior management in order to reveal or contain a problem – has an important role to play in the governance process. As we shall note at greater length in Chapter 11, such whistleblowers must be at once encouraged and protected.

Developing proper accounting policies

Accounting policies should create the correct checks and balances, and reflect the economic and cash flow realities of a company; they should not be the core of a philosophy designed to obtain extra earnings, for instance through very aggressive interpretation of gray areas or window dressing (altering the appearance of financial statements through various short-term transactions in order to present a better financial picture, particularly during reporting periods). Accounting policies that convey the actual financial position of the company will be useful to stakeholders and help attract stable investment. For instance, expensing stock options through the income statement, reducing the “manipulation” possible under certain pension fund accounting standards, and managing reserves properly (being realistic rather than aggressive or conservative), are all policies that can
better help convey the true financial state of a company. The process must be driven by strong, independent, and technically competent accountants who can stand up to pressures applied by business managers. Wherever possible policies should be uniform within industries and across countries, so that investors can perform proper comparisons. Although this is a long-term goal that must be promoted through a bridging of the discrepancies between GAAP and IAS, it begins with individual companies presenting their accounts in an accurate manner.

**Enhancing internal audit**

Internal auditors have an important role to play in verifying the nature, extent, and quality of a firm’s control processes and procedures. Unfortunately, in some instances (including several of those reviewed in Part II) the internal audit function fails to perform as intended. Accordingly it should be strengthened where necessary so that it performs reliably. In particular, audit groups must be staffed with qualified, experienced, and capable individuals who are able to detect problems and follow through on actions. In increasingly complex organizations internal auditors can no longer act as generalists. Specialized disciplines require specialized knowledge, and internal auditors must reflect the right technical skills and experience (for example financial risk management, technology, and operations). Auditors must also have stature, refusing to succumb to pressure from business units or managers who seek to press their views and opinions; internal auditors who back down simply weaken governance.

The internal audit function should prepare a multi-year plan that is approved by the audit committee and external auditors. The plan should be properly prioritized, with a greater near-term focus on higher risk areas or those with known complexities or vulnerabilities. It should be reviewed at least annually and adjusted as needed. (Indeed, auditors must remain flexible in order to respond to new problems or issues.) Detailed findings of audits should be discussed with executive management, and periodic updates must be given to the audit committee. Results should also be shared with external auditors so they can use the information to supplement their own studies. Perhaps most important, internal auditors must ensure that proposed follow-ups and recommendations put forth to strengthen a process are completed. Audit findings that result in actions that are left unresolved can weaken the control environment even further.

**Reinforcing a culture of risk management**

The modern corporation faces a host of operating and financial risks in its daily business activities. Some of the risks are taken willingly as part of
core business, while others are by-products. Those that a firm prefers to retain, and hopefully profit from, need to be handled through an active risk management process. Those that are regarded as non-core, detracting from daily business, need to be reduced or eliminated as cost-effectively and efficiently as possible. Creating a professional risk management function, which is independent of the revenue generation activities of the firm, is essential for dealing in a risky, and volatile, business environment.

In order to minimize or avoid the possibility of unexpected losses arising from operating risk, financial risk, and process risk, a firm must have an appropriate risk management philosophy and control framework. This allows it to deal with a broad range of exposures, including physical/operational risks, worker health/safety risks, technology risks, personnel risks, business interruption/disaster risk, compliance risk, market risk, credit risk (counterparty/sovereign), liquidity risk, and model risk. Effective risk governance requires a company, via the board of directors, to develop a risk strategy and tolerance. A firm must indicate what risks it is willing to take, why it is willing to take them, how they relate to core businesses, and how they will be managed. It must also determine some upper boundary of risk (potential loss) that can be used to constrain its activities; there is little point in managing risk without a tolerance level that is related to financial resources and technical capabilities. The board must make certain a proper control environment exists. This is generally done through an independent risk management function that is supported by robust infrastructure (including risk systems populated by accurate risk data, which can be used for management, reporting and regulatory purposes).39

The independent risk management function must interface with the board of directors; this provides high-level oversight of the company’s risk-based activities, and helps ensure adherence to firm-wide strategy. In some companies independent board-level review of risk activities has been assumed by the board in its entirety, while in others it has been delegated to the audit committee. As discussed earlier, financial and operating risk issues have become sufficiently complex that a dedicated risk committee is advisable.

**Implementing crisis management programs**

The successful company navigates difficulties and emergencies without pause or misstep, minimizing, or even eliminating, instances of business interruption. A proper control system requires a fully functioning crisis management program that executives or board directors can enact in the event of a problem. The nature, scope, and depth of a crisis should be irrelevant: the best programs can deal with significant disruptions, including those involving physical or technological infrastructure, product or service malfunctioning, and environmental damage.
Crisis management programs are generally centered on mobilizing key personnel, moving to alternative business locations with redundant technology and communications, releasing information to stakeholders on the nature of the crisis and steps being taken to address problems (an essential dimension of this involves communication with regulators), confirming availability of proper financial resources and liquidity that can sustain the company through the period of uncertainty, and enacting tactical steps to ensure continued product or service delivery to customers. These short-term “crisis actions” are surrounded by a framework of internal controls based on liquidity, accounting, risk management, and operational processes. Although crisis plans are industry and company-specific, the goal should be the same: continued corporate operation in a safe and secure setting, with due attention to stakeholder needs and concerns. Referring back to our discussion in Chapter 6, it should be clear that the presence of a workable crisis management program can help a company cope with second and third-stage problems, and hopefully avoid entering a fourth-stage situation.

**Conducting effective post-mortems**

When governance problems occur, they must be dealt with promptly. This means conducting thorough, unbiased investigations so that lessons can be learned. When corporate governance fails, teams of regulators, legislators, and forensic accountants attempt to determine the reasons for failure. The ultimate goal is to provide guidance on what needs to be done to protect against future disasters. This is obviously well intended and can be useful, as long as it is meaningful and detailed. If investors, stakeholders, supervisors, directors, and managers are to learn from the lessons of the past, then investigations must be comprehensive and detailed. There has been at least some evidence demonstrating that initial enthusiasm for investigations (with marquis lawyers and regulators leading the charge) can wane or become restricted after the public spotlight is diverted (or a bull market or earnings report leaves stakeholders feeling comfortable once again), to no one’s particular benefit. As we have noted, governance must be substantive to be useful. Equally, investigations into governance problems – the post-mortems – must be substantive to be useful. Areas of inquiry should never be limited, no matter how sensitive.

We have noted a number of internal governance mechanisms that companies can employ in order to operate as efficiently and securely as possible. Many of these reforms are common sense and easy to implement; others are more difficult and involved; all, however, can lead to the goal of creating a far more robust and productive environment. Enacting the reforms above does
not mean a company has reached some final goal, of course. The internal governance process must be revisited constantly as the company changes, and as industry, competition, macro-economy, and regulations change. The governance review process should be just as dynamic as the operating environment, or it will become asynchronous and fail to capture what is essential. This means a constant regimen of inspection and adjustment by all those involved in the internal process: board directors, executive managers, risk managers, internal auditors, and so forth. But internal governance measures cannot function in a vacuum: they also depend on, and gather strength from, external measures. We consider external governance reforms in the next chapter.
We noted in the last chapter a series of micro reforms that individual companies must consider in order to strengthen their monitoring and control processes. We now turn our attention to macro enhancements that can assist in the reform movement. A systemic framework that establishes or enhances market mechanisms promotes better standards and imposes stricter discipline, benefiting individual companies and their stakeholders as well as broader industrial sectors and economies. How such global macro reforms should be implemented is, of course, a complicated issue and still the subject of much debate. Although corporate governance specialist groups, industry bodies, academics, regulators, listing exchanges, and others are constantly attempting to advance various reforms, national corporate systems are so unique and complex that efforts are likely to develop and expand very gradually. In this chapter we consider several key areas of macro reform, summarized in Figure 10.1, including those centered on:

- promoting changes in regulatory oversight
- strengthening legal and bankruptcy systems
- deepening local/national capital markets and encouraging corporate control activity
- enhancing external audit practices
- encouraging investor activism.
To consider a comprehensive example of macro change we also review elements of the US Sarbanes–Oxley Act of 2002, focusing on its key features and its relevance outside the United States.

**PROMOTING CHANGES IN REGULATORY OVERSIGHT**

Regulators have an important role to play in making sure national systems of governance function properly so that stakeholders are protected. They can require companies – by law, recommendation or “moral suasion” – to alter their behavior, practices, and controls in order to accomplish certain end-goals. Regulatory changes can be implemented in different ways, including:

- **Passage of enabling legislation** requiring minimum standards of control. For example, companies in the United States are governed by certain rules and regulations created by legislative action and enforced by regulators. Companies in Indonesia must adhere to enhanced capital markets laws and corporate regulations. Companies in Japan must abide by provisions of the Commercial Code (altered in 2002 to reshape governance practices), and so on.

- **Establishment of listing rules** requiring adherence to minimum standards of protection. For example, companies in the United States seeking a stock market listing must comply with governance rules established by exchanges (such as the NYSE and NASD). Companies...
in the UK must adhere to governance provisions embedded in the LSE’s Combined Code. Companies in Italy must follow rules set forth by the Borsa Italiana, and so forth.

- **Creation of “best practice” recommendations** outlining voluntary, though highly recommended, requirements and practices. (For example, companies in dozens of countries are “urged” to follow the governance codes established by their national industry and governmental task forces, as noted in Appendix 1.)

Regardless of the form of implementation, it is important for regulators to intervene when they can add value. While they may be tempted to inspect specific companies or the latest corporate failures, limited resources and political/economic realities suggest that they may be most effective when they focus primarily on strengthening the macro operating environment. Accordingly, efforts should be centered on:

- regulating potential conflicts of interest
- promoting uniform and meaningful accounting rules
- developing proper regulatory disclosure standards
- encouraging long-term investments
- protecting assets, investments, and pensions
- enhancing general governance mechanisms.

**Regulating potential conflicts of interest**

We demonstrated in Part II the damage that can be wrought when internal and external conflicts of interest exist; regulators must ensure that conflicts are minimized, if not eliminated. For instance, they should make certain that those supplying external control services, including audit reviews and legal advice, are not simultaneously receiving payment for other non-control services. They must also protect against financial conflicts that might arise when a company’s bankers perform multiple roles, such as acting as lender, investor, and advisor. (A bank might lend additional money to a distressed company in which it has invested in order to protect the value of its equity stake, or it might lend more than it should in order to win a lucrative equity underwriting mandate.) Regulations should prohibit (or severely limit) companies from owning meaningful stakes in financial institutions.

Formal regulations that ban or limit “dual roles” performed by auditors, bankers, or others are appearing, but efforts are inconsistent and in a
nascent stage. Further change is likely to be an evolutionary process. Although conflicts are sometimes apparent, there is unwillingness by regulators quickly and radically to alter the status quo. For instance, although the split between audit and tax/consulting services offered by the largest accounting firms has been the subject of considerable debate, and is an element of focus under Sarbanes–Oxley, the SEC opted in 2003 not to implement a more extreme version of regulation (such as choosing not to press for a longer auditor rotation schedule, or a complete ban on tax services). Equally, although the SEC requires outside and inside lawyers to report evidence of “material violations” of securities laws to senior executives and board directors, it has backed away from the concept of “noisy withdrawal.” (This would have turned lawyers into whistleblowers and potentially breached client–attorney privileges.)

It is vital, of course, for regulators themselves not to fall victim to conflict. Those who regulate should not be permitted to join companies formerly under their watch in senior roles; they should be specifically banned from working at firms that they regulate until a lengthy blackout period has passed.

**Promoting uniform and meaningful accounting rules**

In an era of increasingly sophisticated accounting and financial engineering techniques it is necessary for regulators to apply strict minimum standards of accounting treatment and disclosure across companies, industries, and borders. Indeed, in the McKinsey investor survey we referenced in Part I, 52 percent of institutional investors cited the most important “top priority” as the availability of broad and timely financial disclosure. (Furthermore, 90 percent seek a global accounting standard.) While regulators are unlikely actually to create or write the standards, they must guide the overall process and retain oversight of rules that ultimately are developed.

Accounting initiatives should center on promulgation of rules that reflect a conservative, rather than aggressive, presentation of a company’s financial position, as well as those that can lead to a more uniform global standard – for example, GAAP, IAS, or some hybrid with enough flexibility to take account of specific national characteristics and concerns. Disclosure rules should, at a minimum, permit the average stakeholder to understand the financial position and outlook of a company, and provide comfort that the information being reviewed is a reflection of fair accounting principles (rather than those that consistently “push the edge of the envelope”).

Standards of transparency must exist in order to eliminate uncertainty and allow stakeholders to make reasoned investment and business decisions. While regulators can assist in the process, organs such as the FASB, IASB, and the Emerging Issues Task Force must be at the forefront of
changes; these bodies must respond quickly to the changing corporate and financial environment, and aim for the greatest possible amount of international convergence. While giving due allowance to national practice, the development of cross-border financial statements that can be understood and interpreted with consistency is a desirable goal. There is some early indication that cooperation is occurring (for example, joint IASB/FASB meetings on M&A accounting have led to consistent rules and treatment), but more is obviously required. External auditors, once they have dealt with their own control problems and regained credibility, must help police new arrangements.8

Narrow technical applications of accounting rules that can lead to violation of the intent behind the rules must be avoided. Although the debate continues, a greater turn towards a principles-based system, such as the one characterizing UK GAAP and the IAS, is advisable. A principles-based system is generally regarded as being less susceptible to abuse because it requires companies to adhere to the intent, rather than the language, of a rule. This means that “technically correct” but “ethically wrong” accounting treatment is not appropriate. Many of the accounting problems witnessed in the United States and other countries over the past few years have had their genesis in rules-based procedures: while some of the technical accounting treatment practiced by various companies may have been correct, it was often used to present an entirely different financial picture.

In a bid to create greater financial transparency in the global corporate world – and thus reduce the chance for willful or negligent misstatements – regulators should demand use of more stringent principles-based accounting standards. Accounting standards of the later twentieth century may no longer be relevant, and should not be followed blindly; this might lead to a repeat of the problems that have arisen in recent years. Potential changes in accounting treatment should center on critical topics such as treatment of off-balance-sheet activities9 (such as variable interest entities, SPEs, commitments, contingencies, and derivatives10); stock options (as an income statement expense with proper valuation parameters, rather than a footnote); pension plan liabilities (for example, coping with income statement volatility if “smoothing” is eliminated); reserves (such as elimination of loopholes allowing reserve manipulation and claiming back of restructuring charges); bad loans,11 and so on.

**Developing proper regulatory disclosure**

Continuing with the theme above, we know that creating the right level of financial transparency is essential for any company that hopes to attract investors, raise funds, and lower its cost of capital. Many of the initiatives it can take are company-specific and must be led by directors and executives.
There are, however, regulatory disclosure standards that need to be enacted (where none exist) or strengthened (where they currently fall short) in order to create a robust control and investment framework.

Global regulators appear to be in varying stages of creating and enforcing minimum disclosure standards. In countries such as the United States and the UK they are quite advanced, while in many others, such as Switzerland, the Netherlands, Korea, Indonesia, Mexico, and Brazil, they require considerable work. In the United States, for example, the SEC (separately and through provisions put forth via Sarbanes–Oxley) requires companies to certify that reports are neither untrue nor misleading, and state when their financial reports do not follow national accounting standards. Companies cannot convey misleading information through pro forma earnings reports, must file earnings in Forms 8-K one to two days after public release, and so forth. Further investment protections are afforded by SEC Regulation FD (“fair disclosure”), which prohibits companies from making disclosures to a select group of third parties (such as equity analysts) without communicating the same information to the broader public. In Germany, companies must now publish executive management compensation and insider trades by board directors. In Malaysia, 1998 Amendments to the Code of Takeovers require greater disclosure of relevant shareholder information, and criminal liabilities for those presenting false or misleading data. Other examples of this enhanced regulatory disclosure process are appearing on a regular basis in different countries.

In some countries disclosure requirements are conveyed via legal documents; this can also help promote minimum standards of reporting and transparency. For instance, in some national capital markets, securities underwriting transactions are subject to minimum requirements regarding information in the investor prospectus. Likewise, in the investment management sector, funds management agreements and investor prospectuses may be governed by minimum standards; the same is often true with loan documents and insurance contracts. These standards are intended to protect investors and other stakeholders by making sure those providing a service or seeking capital report vital data in a timely and accurate manner.

Some quid pro quo must exist. Improving financial disclosure is expensive and time-consuming: human resources, training, and technology are essential in any such endeavor. Companies should thus receive some benefit from the “mandatory” transparency created by regulatory disclosure standards, such as accessing capital at more favorable rates. In fact, conveying a more accurate and transparent financial position should give investors the comfort necessary to supply incremental capital at more competitive rates. If we assume that the risk premium demanded by an investor is comprised of an idiosyncratic component to compensate for the
riskiness of the company and its business, and a residual component related to uncertainty regarding the nature of the firm’s true financial state, the residual should migrate to zero as disclosure improves; the cost of capital should thus be lower. In addition to reducing information asymmetries and lowering the cost of capital, fair accounting rules that promote transparency can lead to more efficient corporate control activity (by giving a more accurate reflection of value and whether some control action is necessary). This, as we have already noted, can create shareholder efficiencies, and in some cases help maximize enterprise value.

**Encouraging long-term investment**

Regulators have the power to shape and influence investment patterns. We have noted above that a stable macroeconomic environment – such as might be created though sound fiscal and monetary policies enforced by central banks and monetary authorities – can increase the supply of investment capital, but does not guarantee that long-term capital will be available. Other measures are needed. Although national authorities may be reluctant to take specific actions that promote long-term investment – perhaps believing that they stand in the way of free market forces and the capital allocation process – reforms that benefit sectors of the market (while not prejudicing others) must always be considered.

We noted in the last chapter that company management should court potential long-term institutional investors and share their strategic vision (while simultaneously trying to minimize focus on the short term); the regulatory process can provide support. For instance, regulators might permit committed long-term investors to access inside information. This can help develop and strengthen a multi-year ownership relationship. They might also consider tax strategies that encourage long-term horizons (such as favorable tax treatment/tax credits for long-term strategies and/or penalties for short-term strategies), or changes in ownership rules that allow investors to hold larger stakes in other companies as a means of exercising long-term monitoring (with due caution, as noted above, regarding corporate ownership of financial institutions).

**Protecting assets, investments, and pensions**

In some cases it is necessary for regulators to take strong actions to protect the financial position of different corporate stakeholders. Again, although free market forces suggest that stakeholders need to “fend for themselves,” some base level of protection must be considered and enforced by regulators. In Chapter 4 we noted that employees are key stakeholders in the governance process by virtue of employment and
assets accumulated through company-sponsored savings, compensation, and pension plans. Regulators should therefore consider taking actions that reduce the financial devastation that comes from the collapse of a company.\textsuperscript{12} This does not suggest the creation of widespread government-guaranteed pension schemes,\textsuperscript{13} since that simply shifts the burden from the employee to the taxpayer. It can, however, mean establishing restrictions on the amount of pension or savings assets that can be invested in company stock, promoting greater flexibility and control in retirement vesting and portability, and so on.

Similar types of protection can be considered for other sensitive financial contract, such as deposits and insurance policies. Although many countries now feature retail deposit protection schemes to protect individuals against possible lost savings should a financial institution become insolvent, some have not yet enacted such programs. Equally, various industrialized nations have established insurance funds to protect policyholders in the event an insurer fails, but protection is not yet found universally. The focus of deposit/insurance protection is, rightly, on individual stakeholders, under the assumption that large institutional clients have enough resources and sophistication to protect themselves.\textsuperscript{14}

**Enhancing general governance mechanisms**

In some cases broader revision of the internal governance mechanisms we mentioned in Chapters 2 and 9 is required; regulators (and legislators) must lead the process to ensure fair treatment and consistency. The nature of governance mechanism reform varies widely, and might center on the structure and function of the board of directors and its committees, use of anti-takeover defenses, disclosure of compensation practices, and so forth. For instance, changes to the Japanese Commercial Code center on strengthening the board and protecting shareholders by shrinking the size of boards, installing a greater number of independent directors, allowing the creation of board committees with independent membership, and promoting shareholder rights through better disclosure and restructuring of AGMs. In the United States, the Sarbanes–Oxley Act assigns greater accountability to senior executives regarding the veracity of financial statements, ensures the creation of independent board-level audit committees, and so forth. In Indonesia, the Capital Markets Law of 1995 sets standards related to conflicts of interest and protection of minority shareholders. Similar governance enhancements driven by regulators can be found in other countries.

In systems that feature a high degree of family ownership, the development of new or improved governance mechanisms must be handled with care. Family owners, in many cases the original founders, are often reluctant to change operating procedures, meaning minority shareholders (as
well as other stakeholders) are apt to be disadvantaged. For this very reason regulators must make relevant changes (such as limiting the ability to pyramid ownership holdings, and requiring a greater percentage of independent and third party ownership for family conglomerates seeking an equity listing, for instance a partial infusion). Such changes, if enacted gradually, may help solve in an orderly manner the governance problems that have been so evident in family-controlled conglomerates.

**STRENGTHENING LEGAL FRAMEWORKS AND BANKRUPTCY PROCESSES**

We have already noted that the legal discipline plays an integral part in corporate structure and operations, helping define fundamental concepts such as limited liability, rent and control rights, property rights, and capitalization structures. In the context of bankruptcy, it helps crystallize important issues related to creditor rights, seniority, security interests, insolvency, reorganization, and so on. An economic system lacking strong legal and bankruptcy frameworks is unlikely to function safely or efficiently. This means the legal framework must uphold findings and decisions, and operate ethically and consistently; the process must be seen as strong and undoubted, and not subject to manipulation or corruption (as has been the case in certain emerging nations). A system that is not regarded as fair will hinder, rather than help, the governance movement.

Shareholders are granted basic legal rights that must be protected properly if the pool of risk capital is to remain available. If shareholders are mistreated by company directors/executives and their rights are not duly upheld through a court process, they will withdraw their capital from the marketplace. The system must pay particular attention to the rights of minority shareholders, as their lack of control puts them in a particularly vulnerable position. Legal support of basic minority protections, such as fair price provisions and cumulative voting, must always be considered. The legal process must also support penalties for corporate malfeasance and violations of shareholder rights. Although “white collar crime” can be very destructive, penalties have historically been rather mild; if a legal system cannot penalize in a meaningful way it risks being marginalized.

The bankruptcy code must provide fair and orderly treatment of a distressed company, and protect the rights of stakeholders exposed to insolvency (whether the system favors debtors or creditors, though important, is less critical than the fact that a proper framework exists). Even in relationship-model countries that have traditionally placed great emphasis on long-term corporate and bank relationships and attendant support, there is
growing use of bankruptcy mechanisms; this must be encouraged and
developed. Although the bankruptcy framework in some advanced
systems is still used primarily as a liquidation mechanism, there appears to
be some desire by parties to try to resolve financial distress situations
through protection and reorganization. Indeed, some might argue that the
"ideal" solvency process promotes informal debtor/creditor discussion and
resolution before proceeding to more "terminal" stages.

In the United States, as we have noted, a company can reorganize its
operations under Chapter 11 of the Bankruptcy Code if it is apparent that
the firm can exist as a going concern once it resolves problems associated
with its financial distress. Indeed, the court system may be more favorably
disposed towards protection and reorganization than liquidation. Similarly,
in Germany, changes to insolvency rules have made it possible for a
company to pursue a negotiated settlement through protection from credi-
tors. In the UK, although the overall system favors creditors, the informal
London Agreement process mentioned in Chapter 3 is designed to create
greater restructuring cooperation between debtors and creditors.
(Malaysia’s system, modeled on English law, also makes use of the London
Agreement approach.) Some, however, are choosing to close “debtor”
loopholes in favor of greater creditor rights. For instance, although Thai-
lane’s original Bankruptcy Law of 1940 (as amended in 1968 and 1983)
contained “debtor-friendly” aspects of US Chapter 11 and the British Insol-
vency Act of 1986, changes enacted in 1997 limit debtor delays and call for
new reorganization procedures that favor creditors (rather than debtors and
incumbent management). Similarly, Indonesia altered its bankruptcy
framework in 1998 from the Dutch model (generally favoring debtors) to
one giving creditors better access and treatment.

Although a strong bankruptcy framework is necessary, a single univer-
sal model is unlikely to be practical or desirable. Despite the fact that
global financial markets are gradually converging, bankruptcy frameworks
are still driven by the existence of different types of companies, legal foun-
dations (such as common versus civil law), and corporate finance tech-
niques. Flexibility to deal with national characteristics is therefore
important. That said, it appears that robust bankruptcy systems share
certain common elements, some of which can serve as a guide for nations
seeking to create or enhance their own.

For instance, strong systems:

- Encourage financially distressed companies to preserve as much
corporate value as possible through early access to court protection.
(Some of this value preservation can be accomplished through a mora-
torium on payments or clawback of payments made during a period of
financial distress.)
Conform to market arrangements respecting the priority of claims post-bankruptcy, such as those summarized in Chapter 4. (Any deviation from agreed claims priority should be approved by all creditors and the courts as fair and equitable, a process sometimes referred to as a “cramdown”.)

Operate quickly and efficiently in the face of a broader crisis in order not to delay the protection/liquidation process and imperil other institutions.\(^{20}\) (Obviously, any measures taken to speed the process must be grounded in legitimate authority.)

Provide proper financing and administration techniques for reorganization situations. (As noted earlier in the book, in the United States this is most often done through DIP financing, where a new or existing syndicate of creditor banks might continue lending on a secured basis, while taking control of some element of the organization. In the UK, Sweden, France, and other countries it is often done through administration, where a professional administrator takes charge of guiding the company through its reorganization).\(^{21}\)

Feature proper technical skills (such as legal, financial, creditor, and risk expertise).

Strengthening the legal framework also applies to capital markets law and securities regulations. The legal process of a capital market should prevent a company from raising further capital when it is well known that it fails to treat investors properly. Prospectuses and disclosure documents related to public and private securities offerings must be true and fair, and carry appropriate liabilities and penalties for those who convey otherwise. (For instance, in the United States and the UK those responsible for performing corporate due diligence and preparing disclosure – lawyers, accountants/auditors, investment banks, and so on – may be held liable for errors or omissions;\(^{22}\) the same should feature in other systems.) In Continental Europe, securities law harmonization is in the process of negotiation and will take at least several years to conclude; the hope, however, is that a fair set of consistent rules regarding capital markets disclosure requirements and liability will emerge.

**DEEPENING CAPITAL MARKETS AND PROMOTING CORPORATE CONTROL ACTIVITY**

National capital markets are an essential element of the financial system, and some countries have used them to mobilize investment capital and
facilitate corporate control activities for many years. Countries that are in the process of building their own capital markets must, of course, continue to do so by ensuring strong regulation and listing requirements, undoubted handling of securities market violations, and appropriate governance and disclosure rules. If these minimum requirements are met, the governance process can be strengthened.

Transparency and efficiency in issuing and pricing securities leads to deeper and more liquid markets. Investors can discern opportunities more accurately and determine the price at which a company’s capital should trade; when this occurs they may be more willing to supply risk capital for corporate expansion activities. Efficient markets also permit corporate control activity (for instance, allowing a large amount of debt to be raised for an LBO or MBO, or an IPO to be launched for a spin-off or reflootation). A proper capital market is a necessary, but not sufficient, requirement for robust corporate control activity. To be truly effective transactions cannot be hampered by other barriers, such as entrenched boards, multiple share voting classes, pre-emptive rights waivers, golden shares, golden parachutes, and unfavorable tax treatment. Where these barriers exist, regulatory actions should be considered to make the environment more equitable. (These include banning multiple share voting classes without prior shareholder approval, implementing fair price provisions, disallowing egregious defenses that seek to protect incumbents, and eliminating capital gains taxes on cross-shareholdings to encourage more unwinding of concentrated positions.)

Although there is some evidence of greater activity in various countries, the process will obviously take a considerable amount of time to achieve. Indeed, cultural norms and business bias in some nations suggest that corporate control activity may never become widespread.

Intermediaries are central to the process, and must be permitted to participate actively, yet prudently. Commercial banks, investment banks, universal banks, and securities firms have an important dual role to play. In the first instance they are the essential conduits between those requiring and supplying capital. They have relationships with corporate issuers, and can arrange various forms of financing. They also have access to the end-base of investors – the providers of risk capital – through their sales and distribution networks. In addition, intermediaries can structure corporate control transactions on behalf of third parties, and raise capital for such efforts (for example LBOs and mezzanine buyout funds). In countries such as Germany, France, and Switzerland, intermediaries often act as direct investors as well. Finally, intermediaries can act as external governance monitors, or “gatekeepers.” The diligent financial intermediary should not allow companies to access risk capital if they are somehow unfit to do so (for instance, the company uses questionable or aggressive accounting practices, its directors or executive managers are conflicted, and internal
controls appear weak). Due diligence and disclosure processes exist to allow proper investigation before issuance. Securities regulators hoping to transform local capital markets into more effective financing and control mechanisms must promote strong due diligence practices and hold intermediaries accountable for proper vetting.

**ENHANCING EXTERNAL AUDIT PRACTICES**

While external auditors theoretically have an important role to play in the governance process, the events of the past half-decade summarized in Part II have severely tarnished the industry’s image. Fundamentally, investors must determine whether external auditors are truly independent of a client’s management and technically capable. If investors believe auditors can perform a credible job, then they will add value to the governance process; if they do not, then audit work will be marginalized. In order to restore credibility and make the external audit function a useful element of governance, the sector must be strengthened.

Reinforcing external auditor practices begins with the creation of a better mechanism for “watching the auditors.” Although the concept of “peer reviews” (the periodic, random review of audit work by another auditor) is applied in certain systems, its efficacy is questionable. The development of regulatory or self-regulatory bodies to oversee the quality of an auditor’s work is a more effective path. Indeed, some national regulators have come to believe that the role of the external auditor is so vital to systemic protection that they have created oversight bodies to review the quality of audit work and practices. In the United States this is being accomplished through the Public Company Accounting Oversight Board, in the UK via new rules from the Department of Trading and Industry, in France through the new financial markets regulator *Authorité des Marchés Financières* (which has created a new body to regulate the French system of independent auditors), and so forth. Where this oversight element is lacking it should be developed as a matter of priority.

Auditors should return to their core business. In fact, to restore credibility they should take even more stringent actions than those set forth by regulators, including separating audit and non-audit services with a single client much more decisively. The cases appearing at the turn of the millennium demonstrate that it can be difficult to avoid conflicts of interest (or even the appearance of conflicts) that arise when the two services are offered together. Auditors should not be in a consulting or advocacy position regarding tax structures, tax shelters, SPEs, or technology services, because they cannot fairly and independently audit work that they have created (and received payment for). The first – and arguably only – priority of an audit firm should
be the independent review of companies, and upholding the highest ethical standards when doing so. If an audit firm prefers to concentrate on tax advice for a given client (because it might be more lucrative to do so) it should relinquish the audit assignment, even if regulations permit otherwise. (For instance, in the United States tax advice can be offered by the auditor under certain circumstances and with board approval.)

External auditors must ensure that they have appropriate skills, qualifications, and stature, and are conservative in their judgments (for instance, interpreting accounting rules in the spirit in which they were intended, rather than in light of technical characteristics). They should remain firm in their views and not succumb to pressure from clients. When conflicts or disputes arise with a client and no agreement can be reached, an auditor must be prepared to relinquish the account, not bend its principles and engage in what might ultimately be regarded as unethical or ill-advised behavior. Auditors must also make themselves available to instruct the audit committee on important accounting and audit points (acting as an independent technical advisor on complex issues and discretionary areas that invariably arise). Client companies themselves should minimize conflicts by not hiring employees from external audit firms until a considerable “cooling off” period has passed, and should require rotation of audit partners on a regular multi-year cycle. Broader rotation between external auditors every five to ten years should also be considered; a fresh perspective can be useful for all parties, and the knowledge that a peer firm is going to review another’s work can help ensure proper focus and diligence.

Although changes are under way, inconsistencies exist. While these may be necessary and appropriate in certain cases, they can lead to regulatory arbitrage (for instance, some companies might direct their activities (or the activities of their subsidiaries) to regimes where they find external audit standards more “conducive” to their needs). In Europe, for instance, although harmonization on audit rules and standards has appeared at regular intervals, the framework is still not sufficiently consistent (with regard to, for example, audit practices, rules, test, sampling/verification, and treatment of high-risk accounts). Further consolidation of practices must be a priority, particularly when there is no compelling reason for alternative approaches.

**ENCOURAGING INVESTOR ACTIVISM**

Institutional investors have the ability to exercise diligence over board directors, and thus management. Assuming some level of transparency, they can identify problems and press for changes, through either the proxy process or direct discussion. Indeed, studies have shown that active insti-
tutional investors are more likely to vote against antitakeover provisions and be more diligent in vetting executive compensation plans. They are also more apt to pursue boards and executives that have failed to discharge their duties properly. Large institutional investors have incentives to eliminate information asymmetries and monitor management performance. They can influence the voting slate, selection of directors, and tabling of agenda items, and can negotiate incentive contracts and force out poorly performing executives. These are all powerful elements of governance. Since the opportunities for executive management to control information flows decline as shareholdings become more concentrated, it is incumbent on these shareholders to use the unique position provided by their large shareholdings to full effect. Cooperative efforts between institutional investors can also be useful. Ultimately, those that use their shareholdings in a proactive manner can help all investors by ensuring executives remain focused on creating value.

Instances of activist investor “victories” related to unfair treatment of shareholders prove the value of the approach. For instance, following Cendant’s disclosure of accounting fraud at its CUC International subsidiary, CalPERS relentlessly pursued Cendant for recompense. Starting with a class action lawsuit in 1998, the investment fund diligently followed the process through the courts, proved its case, and in 2003 received an award of US$2.8 billion from Cendant, payable to the estimated 1 million shareholders who had been defrauded.

Not all successes result in specific monetary gains, of course: many of the victories are based on management or structural changes (which can be even more important). For example, certain investors have been diligent in dismantling corporate control defense mechanisms in order to ensure that company directors and executives are not improperly circumventing good governance practices. (For instance, TIAA/CREF has been at the forefront of forcing US companies to eliminate dead hand provisions embedded in poison pills, and through 2003 had managed to eliminate 60 such provisions.) Others have pressed the fight on related fronts. For instance, some activist investors are requiring directors to adopt three-year independent director evaluation provisions (or “TIDE” provisions) in company pills, which require directors to evaluate the nature and status of poison pill defenses every three years to ensure that they are still equitable and appropriate, and do not harm shareholder interests. Others are insisting that companies use a chewable pill, a poison pill defense clause that gives shareholders the right to revoke the pill in the face of a bona fide takeover offer (or which automatically nullifies the pill if the bid meets certain predefined criteria such as fully funded or cash tender offer for shares, with a fairness opinion and a premium of x percent over the average closing price of the stock over some prior period).
In the UK Hermes has taken the lead in pressing for a reduction in three-year director terms, bringing them down to one year through its activist policies. Further activism may appear in the United States and the UK through fundamental changes in mind-set, perception, and regulatory treatment. This means, in part, altering the way money managers are evaluated and compensated, and tax and accounting laws are applied to short-term (versus long-term) investments. If the compensation of money managers can be linked at least partly to long-term returns, then they might begin to focus less on EPS and short-term stock price moves. Similarly, if tax incentives promote long-term investments, focus can be shifted to “sustainable participation.” Any measures that work against long-term investment must be examined closely. Until corrective actions occur, it will be extremely difficult for US money managers, one of the single largest bodies of institutional capital in the world, to realign their perspectives and become long-term enterprise value advocates.

Although the United States and the UK continue to feature the strongest tradition of institutional investor activism, similar forces are gathering momentum in other countries, particularly in parts of Continental Europe. Here the private pension market is growing and the equity culture is deepening (the UK/European pension fund base, excluding life insurance, reached US$3 trillion in 2002). Historically, pension assets have been controlled and managed by government organizations. Not surprisingly, their focus has been on managing assets with a view towards generating returns, rather than pursuing corporate governance reforms through proxies or other campaigns. In recent years, however, many of these formerly state-run pension funds have been privatized, giving them a greater commercial focus. This shift, along with the development of new privately financed (employer/employee) pension schemes, has given rise to greater investment management and custodial opportunities, and more opportunities for promoting the shareholder agenda. Further European activism is thus a virtual certainty, but it must be directed properly through organized activities and constructive dialog. Other countries must take a similar course of action.

Although investor activism is generally associated with institutions (primarily because they hold larger stakes, have greater access and influence, and have the resources necessary to try to combat information asymmetries and other agency problems), it is worth remembering that individual investors have rights and duties as well, which they must exercise if they want to be part of the governance reform solution. We have already noted that investors can either remain passive or vote their proxies. By voting they make use of their rights, exercising that small bit of control that they legally possess. While corporate law limits the issues they can vote on, they can still express a view on matters of importance, including election of directors, amendments to the corporate charter, mergers and
acquisitions, recapitalizations, restructurings, and takeover defenses. These are all important in the governance scheme, and it is incumbent upon individual investors to take action.

THE LEGISLATIVE ANGLE: THE EXAMPLE OF SARBANES–OXLEY

In the wake of Enron’s collapse, as well as the financial restatements, corporate scandals, and/or bankruptcies of Andersen, Global Crossing, Warnaco, Kmart, Tyco, WorldCom, Adelphia Communications, Xerox, Qwest, Sunbeam, and many others, US regulators, politicians, and concerned groups moved swiftly to create legislation aimed at preventing future corporate problems. The end result was the passage of the Sarbanes–Oxley Act of 2002 (S–O), a broad-based reform act centered on the creation of a public company accounting oversight board, and the establishment of strict rules regarding auditor independence, corporate responsibility, financial disclosures, financial controls, analyst conflicts of interest, “white collar” crime, and corporate fraud. The Act, summarized in Figure 10.2, is a significant piece of US legislation. It is notable for not only the scope of its coverage, but the speed with which it was assembled.

Key elements of Sarbanes–Oxley Act of 2002

<table>
<thead>
<tr>
<th>Creation of public accounting oversight board</th>
<th>Ensuring auditor independence and creating audit committees</th>
<th>Assigning corporate responsibility</th>
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<tr>
<td>Enhancing financial disclosure</td>
<td>Resolving analyst conflicts of interest</td>
<td>Expanding white collar crime penalties</td>
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<tr>
<td>Assigning accountability for corporate and criminal fraud</td>
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(Of course, some aspects of the package, such as the split between external audit and consulting practices, were already under way prior to the wave of 2001–2 scandals; the problems simply accelerated the process.)

Although it is well-meaning and likely to be of use in strengthening aspects of governance, S–O has drawn its share of criticism, both in the United States and abroad. Some critics focus on the fact that whenever a financial collapse or crisis occurs, hasty legislative action (even overreaction) can result. In fact, significant legislation and regulation can accompany any major dislocation, as legislators attempt to assuage their constituents. The results may be excessive, biased, discriminatory, or ineffective, and some argue that S–O falls into that camp. Indeed, certain critics feel that the Act is overly intrusive, requiring far too many enhancements that are only achievable at great cost. Some believe that aspects of S–O add yet another layer of bureaucracy to the corporate sector. And there are those who feel that S–O represents another instance of form over substance: while careful attention to the provisions of the Act may be worthwhile, the chance of missing a real governance problem still exists. At the other extreme are parties that feel S–O has not gone far enough, and that the Act represents a lost opportunity, which could have been used to create additional systemic enhancements and controls. For instance, some believe that S–O should have dealt more specifically with off-balance-sheet activities and other financial innovations, and been bolder in recommending changes to the US rules-based GAAP system.

Regardless of the support or criticism, S–O stands as an important element of legislation that will shape the US operating landscape for years to come. Given its broad governance scope, we review in summary form only several key aspects of S–O in this section. (Readers interested in reviewing the Act in its entirety may wish to consult the reference section for additional details.)

**Creating a Public Company Accounting Oversight Board**

Title I of S–O led to the establishment, in 2002, of an independent, non-governmental Public Company Accounting Oversight Board (PCAOB):

\[T\]o oversee the audit of public companies that are subject to the securities laws … in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.42

The PCAOB, which is overseen by the SEC, is required to register, and periodically inspect or investigate, public accounting firms that prepare
audit reports for companies, and to establish an appropriate set of auditing, quality control, ethics, and independence standards related to the preparation of audit reports.

Included within the PCAOB auditing standards is a requirement that auditors maintain detailed work papers for a period of up to seven years, and describe the scope and standards they use in testing a company’s financial and control processes. Importantly, auditors must provide “reasonable assurance” that transactions are recorded so as to convey a company’s true financial picture. To make sure auditors are doing a proper job, the PCAOB periodically inspects and investigates audit firms and their work on selected companies. (Auditors that perform regular audits and issue reports on more than 100 companies will be inspected annually.) Inspections will go to the heart of what auditors themselves do, reviewing standards, control systems, testing, and quality control. Those found lacking will be subject to a range of fines, penalties, sanctions, and temporary or permanent suspension.

The intent of this Title of S–O is to prevent breaches, abuses, and carelessness by auditors, such as was the case with Andersen (and the surviving Big Four). Precisely how the PCAOB will select its inspections remains to be seen, and may change over time as experience is gained. The most likely candidates are the Big Four auditors and the work they do with high-risk industries/companies (such as those that lack transparency, have a soaring stock price, or high levels of executive compensation). Although foreign accounting firms lobbied heavily for exemption from this requirement, their efforts were unanimously rejected, and foreign firms – including the 100+ small independent firms that audit foreign companies listed in the United States – are subject to the same requirements. (Regulators were obviously interested in reviewing their activities because, as Ahold, Lernout and Hauspie, Vivendi, and other non-US problems have made clear, audit and accounting problems can cross national borders with relative ease.) It should be noted also that the SEC decided not to permit UK companies with US listings to include auditor opinion letters in SEC filings that are intended to limit auditors’ liability for inaccuracies.43

**Ensuring auditor independence and establishing an audit committee**

Title II of S–O44 is aimed at ensuring external auditors remain truly independent when discharging their audit duties, and that they are not otherwise providing non-audit services that could affect the quality and impartiality of their audit opinion. Specifically,

[I]t shall be unlawful for a registered public accounting firm … that performs for any issuer any audit required by this title … to provide to
that issuer, contemporaneously with the audit, and non-audit service, including – (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board determines, by regulation, is impermissible.45

In short, under the terms of S–O, an auditor should only be an auditor, so that the credibility of the audit profession can be restored and investors can once again have confidence in the nature of the independent auditor’s opinion. This Title, not surprisingly, also arose from the Enron/Andersen scandal (among others), where Andersen as both consultant to, and auditor of, Enron received millions of dollars in fees and was biased in its auditing function. The Title does permit some flexibility by allowing an audit firm to provide non-audit services (including tax services), apart from the ones cited in (1)–(9) above, if it receives prior approval from the firm’s audit committee (and the revenues generated are modest, for example less than 5 percent of audit-based revenues received from the client). This effectively permits audit firms simultaneously to perform audit and tax business. Within the United States, the days of public accounting firms providing the broadest range of audit, consulting, tax advice, advisory and associated services – simultaneously – appear to have come to an end.

While Title II focuses primarily on auditor independence, the provision also compels auditors to rotate every five years, and provide audit committees at client firms with timely and detailed reports related to accounting policies and alternative treatments of financial information. It also bars public accounting firms from providing audit services to a company if one of the company’s senior executives (such as the CEO, CFO, controller, or CAO) was employed by the accounting firm one year prior to the start of the audit.

With regard to the audit committee provisions, we mentioned in the last chapter (and re-emphasize in Appendix 1) the importance of a proper audit committee; indeed, it stands as “first among equals” in the board committee structure. Title II of S–O provides for the duties of such bodies:

Audit Committee:
(A) A Committee (or equivalent body) established by and amongst the Board of Directors or an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of this issuer; and
If no such Committee exists with respect to an issuer, the entire Board of Directors of the issuer.  

The independent nature of the Committee is given in Title III:

Each member of the Audit Committee of the issuer shall be a member of the board of directors of the issuer and should otherwise be independent.  

A member of an Audit Committee of an issuer may not, other than in his or her capacity as a member of the Audit Committee, the Board of Directors or any other Board Committee – (i) accept any consulting, advisory or other compensatory fees from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.

Assigning corporate responsibility

Title III of S–O assigns specific responsibility for elements of the governance process to individuals within each company, and holds them accountable for discharging these duties. In particular, the audit committee is responsible for engaging and compensating, and reviewing the work of, the external auditor, and terminating the auditor’s services should it become necessary. The principal executive and financial officers (the CEO and CFO in most companies) are responsible for attesting to the veracity of each quarterly and annual financial report filed with the SEC. In particular, certifying officers must ensure that:

(2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact …[and]
(3) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of the operations…

The same officers must also represent that they are responsible for internal financial controls that allow “material information” to be known to officers and others in the company, that the controls have been properly designed and tested, and that any material deficiencies or changes in controls have been reported to the audit committee. These executive certifications are applicable even if a US company decides to reincorporate in a foreign center. The Title also makes it unlawful for corporate officers or directors to misrepresent information to auditors (or to coerce or fraudulently influence them) so that financial statements are rendered misleading, and requires forfeiture of executive compensation as a result of financial reporting misconduct. It also imposes more stringent insider trading restrictions during blackout periods (effectively barring directors and officers from
selling company securities during these periods), and requires a company’s outside attorneys to report evidence of any material violation of securities law or fiduciary duty to the CEO or chief legal counsel (or the audit committee of the board, if no action is taken). (In this sense outside counsel becomes a whistleblower.)

Once again, much of this title was driven by the failure by executive managers and board directors at companies such as Enron, Tyco, WorldCom, and others, to capture, or question, deficiencies and discrepancies in the financial statements and audits. For many, the executive certification of financial statements represents a stronger link between oversight and accountability.

**Enhancing financial disclosures**

Title IV of S–O focuses on improving the quality and transparency of financial statements in order to convey a more accurate picture of a company’s financial condition. It also discusses conflicts of interest, ethical behavior, and required financial expertise. The Title contains a special focus on off-balance-sheet transactions and SPEs, and whether they are being used to materially alter the appearance of a company’s financial position:

> Each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.\(^{50}\)

The driving force behind this element of Title IV relates to the extensive financial misreporting and fraud related to Enron’s off-balance-sheet vehicles and activities (such as Chewco, JEDI, and Raptors: transactions which, as we have discussed in Chapter 7, did much to hide the company’s true leverage, losses, and illiquidity).

Title IV also focuses on stricter disclosure of insider transactions (including the sale of stock and exercise of options) and greater limitation on potential conflicts of interest, including granting of personal loans by companies to their executives. (This is now prohibited: “It shall be unlawful for any issuer … directly, or indirectly … to extend or maintain credit, in the form of a personal loan to or for any director or executive officer….\(^{51}\)) These provisions arose from the widespread sale of stock by company executives in advance of precipitous declines (and in many cases
before the average investor or employee was able to arrange similar sales), and the practice of taking loans from company funds.

Title IV recommends that all companies enact codes of ethics, or where they choose not to do so, disclose publicly the reasons why they have not. Codes of ethics center on honest and fair handling of actual, apparent, or potential conflicts of interest between personal and professional matters, as well as accurate and timely filing of required reports and information, and adherence to all applicable rules and regulations. Another major element of Title IV is the appointment of a “financial expert” to sit on the audit committee of the board of directors of every public company. The aim is to ensure that audit committees have sufficient technical knowledge to be able to understand and question often complex accounting information, rules, transactions, and treatment (such as SPEs, consolidations, and derivatives). The definition of a “financial expert” is fairly broad, and relates to an officer who has previously served as an accountant, auditor, controller, financial officer, or is similarly educated, and can understand GAAP, accounting controls, accruals, reserves, and so forth.

Resolving analyst conflicts of interest

Title V focuses more narrowly on resolving conflicts of interest facing equity research analysts when they recommend the purchase of securities of companies where a business relationship may exist or is contemplated (as with investment banking and securities issuance). As the Wall Street research scandals of 2001–2 demonstrated, some analysts have been compromised, agreeing to (or being coerced into) promoting securities of companies in order to help investment bankers win other fee-based business. Under the Act:

The Commission shall [adopt] … rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information … by (A) restricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engage in investment banking activities … B) limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment activities and (C) requiring that a broker or dealer and persons employed by a broker or dealer who are not involved with investment banking activities may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst … as a result of an adverse, negative or otherwise unfavorable research report that
may adversely affect the present or prospective investment banking rela-
tionship … with the issuer that is the subject of the research report.…. 52

The Title also calls for proper disclosure of any joint research and business relationship a financial firm has with a company, and whether the research analyst benefits, or has benefited, monetarily from that relationship.

Assigning accountability for corporate and criminal fraud

Title VIII of S–O focuses on the creation of criminal fines and penalties for those destroying, altering, or falsifying financial records related to US Federal investigations or bankruptcy proceedings. It also requires auditors to preserve all financial work papers associated with the audit of a company for a minimum of five years since the conclusion of the last audit, or face criminal fines and penalties. This section of the Act was designed to prevent, or minimize, audit, accounting, and financial work paper destruction that might be needed for corporate investigations (such as Andersen employees did in the Enron case).

Expanding white collar crime penalties

Title IX of S–O levies more severe penalties for “white collar” criminals who are found guilty of corporate fraud. A common criticism of regulatory efforts is that those found guilty rarely face any severe punishment, rendering the system vulnerable. This section is intended to address such criticisms. For instance, those found guilty of wire and securities fraud are now liable to receive up to 20 years imprisonment (versus only five years under previous statutes). Those found guilty of criminal penalties under the Employee Retirement Income Security Act of 1975 now face up to ten years imprisonment (versus one year), and so forth. The Title also addresses liability of corporate officers in failing to certify properly financial reports and controls as required under Title III. Specifically, such principal executives are liable for fines of up to US$1 million and imprisonment of up to ten years if they certify falsely the requirements summarized in Title III, and up to US$5 million and 20 years if they willfully certify falsely the same.

It comes as no surprise that Titles VIII and IX have been created in response to public and ethical demands that corporate officers and external advisers/auditors found guilty of fraud, deception, and obfuscation be severely punished.

Note that S–O also contains other provisions. These include those requiring further study of the effect of consolidation within the public accounting industry, the role and function of credit rating agencies within
the capital markets, and the role of investment banks and financial advisers in the collapse of companies such as Enron and Global Crossing. It also provides the SEC with broader abilities to freeze temporarily exceptional payments to executives of companies that are under investigation for possible violations of securities laws.

Following the passage of S–O, the SEC developed a series of regulatory reforms to bring elements of the Act into practice. For instance, in early 2003 it passed new regulations requiring board directors to be more intimately involved in oversight of financial statements; audit committee members to be independent and accept no payments except for standard board fees; and committees to specifically hire, supervise, and/or terminate a firm’s external auditor and put in place procedures to handle confidential communications from whistleblowers. The SEC also tabled a proposal requiring a lawyer that sees evidence of a client committing a material securities violation to advise regulators. (An extreme version of this, the “noisy withdrawal” approach, calling for a lawyer to quit when the board could not rectify the violation, was abandoned on the premise of potential breach of client confidentiality.) The SEC has tasked all US exchanges with monitoring and enforcing these requirements; failure of a company to adhere can result in delisting. Further regulations to enforce aspects of S–O will appear over time.

The international view of S–O

Despite the fact that S–O is comprehensive in scope, it is worth considering whether it is purely a US legislative tool arising from a US problem, or whether it has broader relevance. A review of individual provisions indicates that aspects of S–O already exist in other countries, and where they do not, may or may not be appropriate.

Some of the rules put forth by S–O are already used in other countries. Indeed, rules in certain jurisdictions are even more stringent than they are under S–O. For example, Italian companies have been required to rotate their auditors regularly since 1974 (a stance the United States has rejected). Meanwhile the EU requires auditors to undergo a two-year “cooling off” period before going to work with a former client company (S–O only requires one year). In the UK, the separation of external audit and consulting duties has been in existence for several years.

Where they do not currently exist, some of the S–O requirements would appear sensible for other nations to consider. We note again that many other countries (such as Japan, Germany, Switzerland, Korea, Indonesia, and France) have experienced the same type of governance failures that led US legislators to develop S–O, and may thus benefit from similar requirements. For instance, companies in Japan, the Netherlands, and Switzerland could
improve their financial disclosure standards. Companies in Korea, Indonesia, the Philippines, Mexico, and Brazil (among others) would do well to apply uniform accounting standards based on IAS or a version of GAAP. Finally, companies in most countries would benefit from imposing stricter penalties for directors and executives who abuse controls and financial processes.

At the same time, certain S–O requirements run contrary to corporate behavior, practice, and culture in other systems. For instance, executive certification of financials has not been favorably received in countries such as Germany or the UK. Similarly, board independence is a controversial topic in some nations. (In Japan, for instance, the concept of a truly independent director, with no ties to the company, is still largely an alien concept because executives feel general discomfort (even mistrust) engaging in business with outsiders.) In Switzerland, the Swiss State Secretariat for Economic Affairs has indicated publicly that, while it understands the reasons for S–O and shares many of the same objectives, it is concerned about the application of rules to Swiss-based companies when they run contrary to Swiss practices. (In Switzerland it will be difficult for firms to comply with the same level of financial disclosure, inspections by a body such as PCAOB run contrary to national law, and so on.)

More broadly, in early 2002 the UK government commissioned an independent review of S–O with a view towards understanding whether specific provisions might be relevant to UK companies. The resulting Higgs Report, released in late 2002, has noted that legislation can be overly constraining, and still cannot guarantee governance failures will not occur. Instead of mandated rules, the Higgs Report recommends an approach based on “pressure” and best practice guidelines. Within the Higgs framework certain minimum standards are recommended: ensuring a majority of board members are independent, making sure that directors who are former employees have not worked at the company for at least five years, encouraging independent directors to meet with major shareholders more frequently, urging full-time company directors not to take on more than one non-executive directorship (and not to act as chairperson of a major public company), and so forth. UK adoption of specific S–O provisions is therefore unlikely to occur.

To the extent that international companies list in the United States they have to comply with most, though not all, S–O provisions. Since more than 1300 foreign companies are theoretically impacted by S–O, the SEC opted to make certain concessions. For instance, under the Act, publicly listed companies must have independent audit committees, which conflicts with German laws that require employee representation. The SEC has thus agreed to changes where the structure is “provided for under local law.” Despite some regulatory flexibility, various companies have chosen not to pursue US
listings as a result of the new S–O requirements. The conclusion for now suggests that, although governance failures are a global issue, US legislative actions embodied in S–O may only be considered piecemeal by companies and regulators in other countries. Where specific elements appear useful they may serve as a further guide towards good practice, and where they are contrary to national interests they are likely to be ignored. Accordingly, it cannot be viewed as an overarching model for other countries.
In the last two chapters we have discussed various micro and macro governance reforms that are designed to provide a proper level of control. Successful implementation at a micro level is necessary in order to create a robust corporate operating environment. Ultimately, however, reforms must be accompanied by ethical behavior; corporate governance mechanisms are most effective and useful when driven by appropriate conduct. In the normal course of business a firm must deal with a broad range of ethical considerations. Some require compliance with specific rules or behaviors, such as those provided under national regulation or law, or a company’s own organizational policies and procedures. Others are based more heavily on guidance obtained from, or given by, organizational and personal values. These are not necessarily mandatory, but may be motivated by the desire of a company – its employees, executives, and directors – to act properly.

The topic of ethics is clearly less “tangible” than others we have treated in the past few chapters. Good behavior can be challenging to promote, measure, and enforce throughout an entire firm, and its efficacy can be difficult to gauge on a continuous basis. However, it establishes the tone and character of the company, and therefore plays a leading role in governance. Continuing with our theme of substantive measures, it is important to stress that if a company’s ethical standards are not truly elements of the corporate culture, the process becomes one of form. In fact, ethical behavior cannot be imposed, it takes time to develop and can only be strengthened through repeated activity. The trust of stakeholders can only be gained by demonstrating practiced ethical behavior.

A primary goal of sound corporate ethics is to build, reinforce, and protect a company’s reputation. Although many firms depend primarily on physical production processes and tangible assets to create products that are purchased by clients, they must still rely on reputation to be successful.
If a company is known to mistreat its employees, be unfair or deceptive in its business dealings with suppliers, or lax in its quality control process, it may suffer reputational damage and be financially harmed as clients turn away. Although it may still have factories and physical assets that can partly protect its financial position, it will have lost some of the goodwill created by reputation.

The issue is even more serious for those that possess no physical assets and rely solely on intellectual skills and reputation; this is common of many service industries, such as banking, auditing, insurance, consulting, and law. For instance, if an accounting firm is known to be conflicted or error-prone in its audit work, its reputation will be harmed and it will start losing business. Since it cannot rely on hard assets it may find itself in a more precarious state than the physical producer. Reputation is thus essential to corporate success: those that have a good reputation protect it through good governance and strong ethics; those that lack it have probably fallen victim to bad governance and poor ethics. Repairing reputation and rebuilding stakeholder goodwill can be a lengthy process; it is far better when a company is diligent and astute enough actively to protect it from the start.

To frame the discussion and highlight the importance of corporate culture and behavior, we consider corporate ethics versus corporate responsibility, creation of an ethical culture, and the relationship between ethical norms and the internal governance mechanisms described in Chapter 9.

**CORPORATE ETHICS VERSUS CORPORATE RESPONSIBILITY**

When we consider the notion of corporate ethics, and the “ethical corporation,” we are interested in the way that a company behaves towards its stakeholders. This is distinct from corporate responsibility and the socially acceptable, or responsible, norms attached to the business a company actually does. Our concern centers on understanding how to avoid the justification of bad behavior in the pursuit of overriding shareholder (or management) goals, rather than whether a company’s business is in some way “bad” or “socially irresponsible.” The ethical corporation can therefore be different from the socially responsible corporation. The former bases its operations on principles related to integrity, respect, and fair treatment (via product quality, customer satisfaction, employee fairness, transparency, and so forth). The latter may do the same, but reinforce its operations through specific social and political goals and “political correctness.”

To be sure, the ethical corporation may wish to be attuned to socially responsible behavior in its own operations. Thus, in the pursuit of its business goals it might wish to be sensitive to issues that it regards as socially
important, such as the treatment of the environment or handling of production in low-wage countries. But a code of ethics will do nothing to benefit the environment or emerging country wage rates; that is, it will not change socially accepted values and is not the central point of governance and control. It might not be advisable for a company to attempt to change or influence substantive social issues through direct interference (such as trying to alter a country’s internal wage structure or employment policies in order to fight exploitation of low-wage labor). This can do more harm than good. In practice it might be preferable for the firm to focus on running its own operations in an ethical and transparent fashion: something under its immediate control, and of direct interest and benefit to the broadest range of stakeholders. Again, this does not mean turning a “blind eye” to socially responsible issues, it simply means selecting the proper means and mechanisms for expressing concern and helping with improvements (such as working with political or supranational agencies and non-governmental organizations, and funding special programs). While pursuing a social vision through corporate operations can be an admirable goal, it is not the focus of our discussion.

**CREATING AND REINFORCING A PROPER ETHICAL CULTURE**

Developing a proper ethical culture is a process of initial development and ongoing reinforcement. Like other micro governance practices, it is not enough simply to create particular standards and hope employees, managers, and directors will follow them; to be effective they must be reinforced continually. Once imbued in the corporate culture they become “second nature”; behaviors are acted on instinctively, rather than as part of a methodological practice. When a company’s employees believe behaviors are proper they practice them automatically. Much of this process relates to the nature and quality of a firm’s leadership. If directors and executives uphold the best possible behavior – consistently and undoubtedly – they send the same message to others in the corporation. Ultimately, a company’s board of directors and executives are responsible for enacting an ethics framework. This includes defining and institutionalizing the firm’s ethical norms, monitoring and reporting adherence to standards that have been defined as important, and penalizing those who violate them.

Although there are many ways to consider an ethical framework, the process often begins by defining the firm’s ethical norms. This might center on identifying what the company values (such as integrity and client relationships) and how it can measure success in supporting such values (for instance, standards for customer service or product reliability, association in
the marketplace regarding “leading edge” design or technology, and recognition among prospective employees about the positive workplace environment). The process might also center on how best to protect the firm’s reputation, and how to identify and deal with potential misconduct (such as bad behavior or fraud). The parameters of the firm’s ethical norms must be revisited continuously. Although the core principles are likely to remain relatively constant once defined, aspects should be enhanced over time as the company evolves.

The second part of the process involves institutionalizing ethical norms. It is pointless to define how the company wants to behave, but then fail to communicate and reinforce desired behaviors throughout the firm. The institutionalization process is often based on the development of a formal “code of conduct” or “code of ethics,” and supplemented by training and education. In some systems a code of conduct is a voluntary best practice, in others a regulatory requirement. For instance, best practices in Malaysia, Switzerland, and the UK, among others, recommend that companies voluntarily create and enforce codes of conduct. In the United States, on the other hand, codes are recommended or mandated through various regulatory and legislative actions (such as through provisions contained in state laws, the Federal Sentencing Act of 1991 and Sarbanes–Oxley, for example).

Regardless of whether the approach is voluntary or mandatory, the creation of a code of ethics is a convenient way of condensing and communicating a philosophy. To be useful, however, it must be promoted actively. If the exercise centers on passively transmitting what has been defined, it is likely to fail. It cannot, for instance, be implemented informally (as in the PPP (print, post, and pray) method some companies use). This puts the process of creating an ethical culture into the “form over substance” category, meaning no real value is added. Top management of the firm must promote ethical practices. If a code of ethics represents a company’s character it must be followed by employees at all levels. If the firm’s top directors and executives do not set the standard, there is no incentive for other employees to do so. Lapses by directors or executives in upholding ethical standards invite others to do the same. We have seen dramatic demonstrations of this in the cases of Enron, Bankers Trust, Adelphia, Daewoo, and Lernout and Hauspie, among others, where basic disregard of ethical considerations by top-level executives became apparent at lower levels within each firm. In fact, some surveys reflect a very strong correlation between employees’ perception of leadership and their own behaviors. A company should communicate externally its code of ethics, and be prepared to discuss it with investors, regulators, and other external parties; this is another effective check and balance.

Mechanisms must also exist for appropriate monitoring and reporting: channels of communication within the company that allow compliance to
be verified and ethical problems or violations to be reported. For instance, we have already noted the role whistleblowers can play in helping detect governance problems. Mechanisms must exist to support whistleblowing (such as hotlines to executive management or board directors with proper protection, and specific training on behaviors to watch for). There is much work yet to be done in this area, as whistleblowers often do not feel safe enough to divulge important information. Indeed, some studies show that a large number of employees are aware of inappropriate internal conduct (sometimes so inappropriate that damage to public confidence could occur were the facts to be known), and an equally large number feel that they are unable to approach senior management to voice their concerns.

Such an environment permits bad behaviors to go unchecked and must be avoided. Since whistleblowers are such critical monitors they must be encouraged and protected properly. These individuals, who often work in operating roles with little or no executive or management responsibility, look beyond issues of self-interest (such as compensation or job security) to do what they believe is ethically correct and in the best interests of the company, often at great personal risk. The integrity they demonstrate in highlighting violations and problems must be upheld. Those who wish to report infractions must have access to proper channels of communication, where serious issues can be elevated immediately without fear of reprisal, and where an independent ombudsman or ethics officer can confidentially verify the nature of the claim. With the right type of framework and protection the firm gains on two fronts: more eyes and ears to ensure the company is functioning as it should (particularly at the operating level, where information can often get overlooked), and a greater demonstration of the ethical principles of the company. (For instance, when employees see that the firm values those who spot and report problems, they may come to feel that they are working in a moral and ethical environment.) Ultimately, senior management must create an atmosphere of cooperation rather than persecution.

A code of ethics is of no particular value if it is not enforced. This means penalizing those who violate its principles. Senior management and/or directors must take action when it is required, regardless of the consequences. This, again, is still a problem in many companies. The consequences of acting can be difficult in the short term (for instance, firing a valuable senior executive who generates a great deal of revenue). However, this ultimately minimizes the cost of misconduct, sends the right signal internally and externally, and helps protect the firm’s reputation. The intent must be to show that standards exist and are upheld via penalties, regardless of the seniority of the individual or the nature of the ethical infraction. If a business manager mistreats a
customer, a trading manager violates company risk policies, or the CFO commits fraud, penalties must follow. (They can obviously take different forms, including fines, loss of bonus, demotion, and termination.) The seniority of the individual must never be a factor; any violation of ethical conduct must be treated consistently. Rules that are flouted, and which subsequently go unpunished or seem to favor different parties, will ultimately lead to broader disregard of the company’s code of ethics (creating, perhaps, even greater company-wide governance problems).

In situations where an internal investigation into a reported violation centers on very senior executive management, the board of directors (regardless of degree of independence) should recuse itself and hire independent external counsel to conduct an investigation. (Even external counsel should be different from that normally used, to ensure no conflicts of interest.) Investigations must be thorough and conclusive; in some cases post-mortem investigation into executive wrongdoings stop short of the mark, to no one’s benefit. Of course, proper ethics cannot be promoted just by penalizing those who have committed an infraction: this amounts to trying to cure a problem after damage has been done. To be truly effective, ethics must be based on leadership that avoids getting to the punishment stage.

To guide and reinforce the ethics process, some firms may find it useful to appoint a dedicated ethics (compliance) officer. Such an individual should be independent, and accountable to executive management and the board of directors for guiding and monitoring the firm’s ethics program. The board should be updated regularly on critical issues. Alternatively, the board may establish its own committee to oversee the business ethics process.

**ETHICAL NORMS**

Every company is unique in its business, function, and character. Accordingly, detailed ethical principles are likely to vary by firm. That said, minimum standards exist, and every company – regardless of location or industry – must consider them. These basic ethical norms provide an additional level of control, and reinforce some of the topics we have discussed in the last two chapters. For instance, minimum ethical requirements should include:

- Guarding against any potential conflicts of interest or compromise situations that might arise internally or externally; never waiving or ignoring internal conflict of interest protection measures. 

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10. \[\text{Reference to a page number not present in the text.}\]
Refusing to do business with an individual, company, or country if it involves corruption or graft.\textsuperscript{11}

Treating employees fairly and with respect.

Refusing to sacrifice ethical values to meet corporate financial goals.

Prohibiting thought and action based on “the end justifying the means.”

Dealing with customers, suppliers, creditors, regulators, and others fairly, promptly, and seriously; addressing concerns or complaints earnestly.\textsuperscript{12}

Avoiding harm to any stakeholder and correcting problems and conflicts as they appear.

Ultimately, if a company cannot conduct particular business in a way that is consistent with its ethics, it should sacrifice the business. There is no reason to jeopardize a firm and its franchise in the pursuit of greater EPS, a higher share price, or the acquisition of a few additional percentage points of market share. Sacrificing ethical values to achieve such goals is myopic and will eventually lead to larger value-destroying problems. Figure 11.1 summarizes aspects of our discussion above.

\begin{figure}[h]
\centering
\includegraphics[scale=0.8]{figure11_1.png}
\caption{The business ethics process}
\end{figure}
ETHICAL BEHAVIOR AND INTERNAL GOVERNANCE MECHANISMS

Several of the governance recommendations we have discussed in Part III form part of the broader code of ethical behavior. This should not be surprising, as aspects of good internal governance are based on proper conduct. Thus, crafting a code of conduct by linking it to specific corporate action is sensible. Internal governance mechanisms that tie directly into ethical conduct include the following:

- **Eliminating director conflicts of interest.** Sound corporate and ethical behavior suggests that directors should be free of conflicts of interest; they should not be influenced or tempted by other relationships (for instance, financial relationships with the company via consulting contracts, and personal relationships via ties to executive managers) in discharging their fiduciary duties.

- **Eliminating executive management conflicts of interest.** It is equally important for executive managers to be free of any conflicts. The role they play in guiding the company to its value-maximizing state should not be influenced by personal gain, directly or indirectly. Operating rules (such as compensation and performance measures) should be transparent, rational, and grounded in an actual alignment of executive/shareholder interests.

- **Developing rational compensation policies.** Ethical behavior means fair pay for a fair job; compensation policies should not be structured so that they promote unethical conduct (for example, manipulation of financial statements to boost EPS and the stock price) or lead to unreasonably large packages that are inconsistent with other parts of the organization. (For instance, in Chapter 5 we indicated that one reason for unethical behavior within employee ranks is low morale, which can be driven by tremendous divides in compensation packages into the “haves” and the “have nots.” Bridging this gap means more employees feel like they are being treated equitably.)

- **Reinforcing duty of loyalty and duty of care.** Concepts of duty of loyalty and care, which do not exist in some national legal systems, should nonetheless become corporate principles. Directors and executives should always make informed decisions, and must never put their own interests above the interests of shareholders.

- **Respecting shareholder rights.** The company’s directors and executives must respect all shareholder rights, regardless of the nature of the rights and the size of the stakeholding. This means, for example, that
minority interests should not be mistreated or given less than their due accord.

- **Promoting transparency.** Clear, comprehensive, and meaningful information permits a proper assessment of the company, its financial standing, and its affairs. There should be no secrets, manipulation, or “window dressing,” simply an honest representation of the company. This involves willingly and openly detailing favorable and unfavorable information. Where more complex corporate and financial relationships exist – such as derivatives, related party transactions, and SPEs – the company should be absolutely clear about the nature and extent of, and rationale for, such dealings. The explanations should be simple and upfront, and not wrapped in unintelligible language deep in the footnotes.

Ethical conduct minimizes or eliminates reputational problems and helps ensure a company remains well regarded, liquid and, ultimately, profitable. It also helps a firm stay out of the second, third, and fourth stages of financial difficulties and distress described in Chapter 6. In the final analysis, ethical conduct is relatively simple to consider in concept, but much harder to implement in practice. This is particularly true in a hard-charging, aggressive corporate environment, where competing interests and forces might put basic common sense and decency into conflict with the realities of revenue and market share targets, EPS goals, and stock price thresholds. Because of this difficulty, the corporation must consider very carefully how to move towards a culture of good behavior. This may mean short-term sacrifices (such as steering away from lucrative business that might lead to conflicts, and terminating productive but “aggressive” employees who constantly “push the edge”). However, for companies willing to take the sustainable view, it will seem like the proper solution.
In this book we have presented the central issues that impact corporate governance, with a particular focus on the need for appropriate responsibility, control, and ethics. We have noted some of the theoretical and legal structures that define the modern corporation, the interests that need to be served, and the problems that can occur when processes fail. We have also discussed certain remedies that companies and external parties can consider in order to minimize the possibility of future governance problems. Ultimately, of course, governance requires a migration from theory and concept to execution. The successful corporation must develop and implement a meaningful governance plan. Regulators and governmental authorities must do their part too, fostering meaningful and robust regulations, laws, and market mechanisms.

Corporate operations embody a host of risks – operating, financial, technological, human, legal – meaning *ex ante* performance outcome is impossible to know. With such uncertainty it is difficult to prevent all governance-induced problems, and believing otherwise is dangerous. Accordingly, the best a company can do is create a substantive framework that allows it to minimize the possibility of a governance problem. We stress, once again, the importance of substance. A company can adhere to all of the specific steps required by auditors, regulators, exchanges, and best practice governance codes, but if it does not firmly believe in, and actively practice, proper governance, the exercise is worthless. Good governance is based on the belief, practice, and communication that proper controls and ethical behavior lead to shareholder value and stakeholder benefits.

Substantive governance, as we have noted at various points, is a control framework based on a series of meaningful rules and behaviors. Some of
these rules are based on regulation, legislation, and law. Others are centered on voluntary, non-binding best-practice recommendations. Still others are based on common sense drawn from the lessons of the spectacular bankruptcies, compensation scandals, accounting misadventures, and human resource flaws that have appeared over the past few years. Combining these factors into a framework that directors and employees actively promulgate leads to control as a cultural characteristic of the firm. Substantive governance is not a checklist, a series of scripted behaviors, or artificial “controls” enacted to assuage stakeholders. In fact, such form over substance can be especially dangerous, as it breeds false comfort. If a company believes it has created a proper governance process by “checking all the boxes,” it might engage in even riskier behaviors than it should; only when it discovers that its process is really a façade will it discover the depth of its problems.

SIMPLE RULES OF SUBSTANTIVE GOVERNANCE

A company can create a substantive approach to governance by focusing on several simple rules: while most of these are internal to a firm, some require interaction with, and participation by, important external stakeholders such as activist investors and regulators. Based on our discussion throughout this book, these encompass:

- overarching corporate goals
- business focus
- board of directors
- compensation
- financials
- investors
- shareholder protections
- internal and external controls.

**Overarching corporate goals**

- The appearance of wrongdoing or conflict can be as damaging as actual wrongdoing, and must be avoided.

- A simple but meaningful code of ethics should be created and practiced continuously by directors, executives, and employees.
Communication between the board of directors, executive management, control groups, and regulators must be frequent and meaningful.

Effective crisis management plans must be developed and tested regularly; they should focus on operation continuity, reputational “damage control,” and liquidity protection.

**Business focus**

A company must strive for profitability in order to generate fair stockholder returns (such as capital appreciation and dividends), but must be equally sensitive to its cash flows, the real driver of operations.

Economic value of the firm should never be driven by accounting treatment; business decisions must be made on the basis of disciplined project evaluation with appropriate financial metrics (such as positive NPV projects) rather than accounting rules that are designed primarily to boost quarterly or annual EPS.

Corporate focus on EPS projections, inter-quarter earnings guidance, and other short-term corporate performance indicators should be de-emphasized. The rationale for, and benefits of, long-term investment projects must be stressed.

Capital that is no longer needed should be returned to shareholders. Using excess capital to gain market share or diversify, without providing appropriate returns, must be regarded as unacceptable.

A company’s stock price should ultimately be a reflection of good corporate management, and should not be the driver of management decisions.

**Board of directors**

In single board systems the roles of the chairperson and CEO should be separate; as an interim (although not permanent) step, a lead independent director should be a minimum requirement.

Boards should be constructed as small, efficient, and technically expert bodies with a majority of independent members. Directors must be focused, energized, and devoted, or they should be removed.

Specialized board committees must exist to deal with specific issues related to audit/financial control, risk, compensation, and director/executive nomination. These should always be independent and technically qualified, and must probe all relevant issues.
Directors should be required to hold a stake in the company’s stock, funded with their own capital. All other director compensation should be in line with industry norms.

Directors with conflicts of interest should either eliminate such conflicts or depart; merely disclosing potential conflicts should not be regarded as sufficient.

Directors should have access to all relevant information and should actively review, analyze, discuss, and critique with executives all details.

Directors should be given the freedom to discuss issues apart from executive management whenever they wish.

D&O insurance coverage should be capped and individual deductibles should be increased; D&O severability clauses should be removed.

**Compensation**

- Loans to directors and officers should be banned.
- Disclosure of insider stock transactions should be communicated immediately.
- Bonus and incentive compensation should be related specifically to meaningful performance goals.
- Stock options must be properly structured to prevent abuses related to short-term stock price boosting: they should be expensed, carry performance targets and longer vesting periods, and never be repriced.
- The value of stock-based wealth should be widely distributed throughout a firm in order to align everyone’s interests.
- Significant compensation issues (golden hellos, golden parachutes, executive pensions) should be very exceptional, and always approved in advance by shareholders.

**Financials**

- Financial disclosures should be transparent and written in basic language; there must be no attempt to obfuscate or hide important details. When a complex matter exists, it should be explained clearly.
- Disclosure to stakeholders should be uniform, meaningful, timely, and forward-looking, with a focus on the company’s past trends, current state, and future commitments and prospects.
**Investors**

- Shareholder participation and activism must be encouraged. Shareholders – retail, minority, institutional – should regard themselves as long-term owners.

- Significant institutional investors should be engaged by the board of directors in the preliminary process of nominating directors.

- Proven long-term institutional investors that are committed to reform should be granted direct board representation in order to formalize the role/function they already play, and give them greater access to detailed information.

- Institutional investors should not be paid solely on the basis of short-term results; compensation should be structured in a way that helps combat “short-termism.”

**Shareholder protections**

- One share, one vote should be a guiding corporate principle, unless existing shareholders specifically approve otherwise.

- Shareholders should approve antitakeover defenses only after due consideration and debate. Defenses must never be used to protect management or directors, or deny shareholders an opportunity to realize fair value on their risk capital.

**Internal and external controls**

- Regulators should take meaningful actions to protect investors and other stakeholders, but should not “stifle” or over-regulate.

- Regulators should consider all relevant measures to promote greater market-based corporate control activity and long-term investment.

- Areas of audit, control, and regulatory inquiry should never be limited; no area should be overlooked in the search for potential weaknesses or problems.

- Whistleblowers must be protected and encouraged at all costs, they are vital “eyes and ears”.

- External auditors should have no ties to a company’s management, should not provide non-audit services, should be reviewed by peers periodically, and should be rotated every three to five years.

- Penalties for directors and executives who violate their fiduciary
responsibilities should be meaningful and enforced without question or delay.

- In the event of bankruptcy, all parties must be treated fairly.

There is no correct substantive governance framework, and the world’s companies are unlikely to adopt one standard; through the market, relationship and hybrid models must converge towards some areas of common ground in the medium term. Where regional harmonization makes sense, it should be encouraged: this draws unique corporate systems closer together, ensuring consistency and minimizing possibilities for regulatory arbitrage.\(^1\)

In reality, however, some flexibility is necessary. Overriding standards cannot be imposed forcefully across systems, as that might lead to abuses or reversion to “box checking” whenever governance changes do not coincide with local priorities. Instead, the process should be based on certain minimum standards (such as those above) that are then adjusted to suit the specifics of a given company or country. As we have noted, the process has to be continuous and evolutionary. This should help the best and most effective features of different governance systems to emerge over time. Perhaps the “end-game” will be gradual migration to a robust but accommodating system that draws on the best characteristics of individual models: for instance, the short-term efficiencies and dynamic capital reallocation that are common in the market model of the United States and the UK, combined with the long-term ownership horizons, strategies, and stakes that define the relationship model of Japan and Germany.

**CAN GOVERNANCE CHANGES WORK?**

Can governance changes really work? Is it necessary for companies to be guided by regulation and legislation, or will common sense, pressure from shareholders, and application of voluntary best practices be sufficient? Does it always take major corporate devastations to create behavioral change, and will that continue to be true?

The answers to these questions are still uncertain, but it seems likely that improvements in governance will ultimately require a mix of mandatory rules and voluntary behavior. Some changes may occur in advance of the next corporate crisis, while others will require yet another round of disasters. And while certain companies have already made enhancements,\(^2\) many others have not, preferring to rely on “old behaviors” until they are forced to do otherwise. Naturally, application of substantive governance requirements is highly dependent on individual companies and their operating environments (including cultural sensitivities and
national/regional regulatory requirements). It is impossible for every public company in every country, region, or system to be able to adhere to every specific aspect of an enhanced governance framework. In many instances the changes will be evolutionary, and proceed in stages; true reform is likely to take many years to filter through individual systems. Consider some examples:

- **The United States.** With new legislation in place via S–O, stricter listing rules on exchanges, and greater regulatory oversight by the SEC in the areas of audit, management behavior, and disclosures, the corporate world is now prepared for a new era of standards and behavior. Whether all of these changes will help strengthen controls, or simply act as a regulatory barrier to competitive business, will be proven in coming years. Although it is not clear which aspects of change will be most beneficial, additional refinement of the overarching framework is likely to occur as experience is gained.

- **Europe.** In Europe monetary union, privatization of pension and investment funds, and a deepening of the equity culture are leading to greater governance awareness and changes. The European investment community has begun pressuring public firms to maximize value and generate adequate returns; investors are more willing to invest in firms promoting good governance and rebel against those who flout it. Investor activism and corporate control activity are gradually becoming more commonplace, and there is some evidence that companies are responding; again, however, the “end-game” will take years to achieve.

- **Asia.** In the Japanese system, regulators and companies appear to have agreed that governance changes are vital if greater corporate discipline is to occur; changes to the Commercial Code in 2002 represent a step in the right direction, although all parties recognize that the process will take time. In fact, despite a challenging macro environment with poor economic fundamentals, weak operating margins, troubled bank assets, and low stock prices, management goals through the millennium appear unaltered: adequate profitability, solid market share, stable relationships, and avoidance of outside threats. Altering this approach – which has been driven for decades by powerful political forces, main-bank monitoring, keiretsu cross-shareholdings, large boards, and lifetime employment – will not be done quickly. Following the Korean economic crisis of 1997 and the widespread management and governance abuses found to exist through the chaebol structure, the Korean government embarked on a series of reforms centered on wholesale restructuring of business and financial groups, increased financial transparency and disclosure (including preparation
of consolidated financial statements), addition of outside directors, protection of minority interests, and preparation of governance “best practice” codes. Although these are essential steps, their impact on local corporate operations will take time to determine. Since the local market lacks a deep capital market, corporate control activity, or meaningful activist shareholders, monitoring progress will be somewhat difficult.

Some reforms can be applied broadly, and companies in various countries are beginning to show greater willingness to adopt a range of recommendations. In some instances this means making very hard choices and breaking with years of business practices and relationships, suggesting that the move towards truly substantive governance will take time. However, there seems to be growing appreciation of the fact that when strong macro governance practices exist, national economies benefit and global capital markets broaden and deepen. When robust micro governance practices are enacted, companies perform better and have access to a sufficient amount of properly priced capital. Even when specific recommendations set forth by different parties are not adopted as a result of regulatory or cultural differences, it is our hope that common sense and fair treatment will prevail.
As the corporate world tries to strengthen its governance, ethics, and controls, it can turn to guidance provided by national or supranational best practice frameworks. Since the early 1990s (and, in particular, since the start of the twenty-first century) regulatory authorities, government-sponsored commissions, business associations, directors’ associations, and investor associations in many countries have developed governance practices that represent minimum recommended standards of control. The process has been reinforced on a global scale through supranational organizations, which have issued overarching governance recommendations that are applicable across national borders. In many instances the best practice frameworks put forth are voluntary and non-binding, and companies can choose to adopt them if they want. In other cases certain recommendations are subsets of those required by regulators, stock exchanges, or other authorities, and are thus mandatory. In still other cases companies are not specifically required to comply with particular practices, but must indicate when they do not (and why), so these comprise “comply or explain” rules.

In this Appendix we consider certain recommendations contained in the national frameworks of various countries. Because of space constraints we do not include all governance frameworks or every best practice recommendation. Rather, we have selected several key recommendations (Table A1) set forth by authorities or committees in a select number of countries (Table A2). (Readers interested in delving into the extensive detail behind each national framework are urged to consult the source documents listed in the Bibliography.)

It is worth emphasizing once again that translating best practices into real corporate action is not simple. These frameworks are only as good as the process, thought, and energy that drive them. As we have noted, it is relatively simple for a company to create best practice “checklists” in order to convince itself, and its stakeholders, that it is behaving properly. It is far
more difficult, but ultimately more useful, when a company chooses to focus on the substance of best practices by ensuring that they are part of daily corporate life.

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**Table A1**  Key global best practice governance recommendations

<table>
<thead>
<tr>
<th>Mission of the board of directors</th>
</tr>
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<tbody>
<tr>
<td>Stakeholder interests</td>
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<tr>
<td>Separation of chair and CEO functions</td>
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<tr>
<td>Inside and outside (independent) directors</td>
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<tr>
<td>Independence criteria</td>
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<tr>
<td>Structure of board committees</td>
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<tr>
<td>Outside advice</td>
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<tr>
<td>Disclosure (financial, compensation, governance)</td>
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<tr>
<td>Shareholder rights and voting</td>
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<tr>
<td>Executive compensation</td>
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</tbody>
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**Table A2**  Geographic cross-section of global “best practice” governance reports

<table>
<thead>
<tr>
<th>Country</th>
<th>Governance document(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supranational: OECD</td>
<td><em>Principles of Corporate Governance</em></td>
</tr>
<tr>
<td>Supranational: BIS</td>
<td><em>Enhancing Corporate Governance for Banking Organizations</em></td>
</tr>
<tr>
<td>Regional: EU</td>
<td><em>Euroshareholders Corporate Governance Guidelines</em></td>
</tr>
<tr>
<td>Australia</td>
<td><em>Corporate Practices and Conduct (Bosch Report)</em></td>
</tr>
<tr>
<td>Belgium</td>
<td><em>Report of the Belgium Commission on Corporate Governance (Cardon Report)</em></td>
</tr>
<tr>
<td>Brazil</td>
<td><em>CVM Recommendations on Corporate Governance</em></td>
</tr>
<tr>
<td>Canada</td>
<td><em>Guidelines for Improved Corporate Governance in Canada (Dey Report)</em></td>
</tr>
<tr>
<td>France</td>
<td><em>The Board Directors of Listed Companies in France Report of the Committee on Corporate Governance (Vienot Reports)</em></td>
</tr>
<tr>
<td>Germany</td>
<td><em>German Corporate Governance Code</em></td>
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<tr>
<td>Country</td>
<td>Governance document(s)</td>
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</tr>
<tr>
<td>Italy</td>
<td>Corporate Governance Code</td>
</tr>
<tr>
<td>Japan</td>
<td>Revised Corporate Governance Principles</td>
</tr>
<tr>
<td>Korea</td>
<td>Code of Best Practice for Corporate Governance</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Malaysian Code on Corporate Governance</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>Corporate Governance in the Netherlands: Forty Recommendations (Peters Code)</td>
</tr>
<tr>
<td>Singapore</td>
<td>Report of the Committee and Code of Corporate Governance</td>
</tr>
<tr>
<td>South Africa</td>
<td>King Report on Corporate Governance</td>
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<tr>
<td>Spain</td>
<td>Governance of Spanish Companies</td>
</tr>
<tr>
<td>Sweden</td>
<td>Introduction to a Swedish Code of Good Boardroom Practice</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Swiss Code of Best Practice for Corporate Governance</td>
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<td></td>
<td>SWX-Directive on Information Relating to Corporate Governance</td>
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<tr>
<td>UK</td>
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Note: * The US reports are supplemented by additional legislative and regulatory requirements under the Sarbanes–Oxley Act of 2002, as reviewed in Chapter 10.
SUPRANATIONAL

Governance rules put forth by supranational agencies have the challenge of trying to be precise enough to provide a measure of protection, but flexible enough to accommodate unique national financial and accounting practices. Accordingly, most supranational frameworks tend to be broad-based, voluntary, and non-binding, intended as a guide rather than a requirement. In fact, the frameworks can be viewed as “building blocks” which can be taken and adapted, expanded, or customized in order to fit individual circumstances. We consider in this section best practices put forth by the Organization for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS). Various other supranationals (such as the World Bank and the European Bank for Reconstruction and Development) have put forth their own recommendations, but we shall not review them in this section.

OECD

The OECD’s principles are contained in the Principles of Corporate Governance directive issued in April 1999, which was drafted following a one-year study by a dedicated task force. The Group of Seven (G7) industrialized nations has endorsed the proposal. The OECD framework focuses on the rights and equitable treatment of shareholders, the role of stakeholders, financial disclosure and transparency, and the responsibilities of the board. The original corporate principles were enhanced in 2002 through the development of separate governance recommendations for pension funds. (This was in response to the corporate scandals of the early twenty-first century which left many individual investors and pensioners with large losses in their investment and retirement funds.)

- **Mission of the board of directors:** “A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders. B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly. C. The board should ensure compliance with applicable law and take into account the interest of stakeholders. Together with guiding corporate strategy the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands.”

- **Stakeholder interests:** “Boards are expected to take due regard of, and deal fairly with … stakeholder interests including those of employees, creditors, customers, suppliers and local communities.”
Separation of chairperson and CEO functions: “In unitary board systems, the separation of the roles of the Chief Executive and Chairman is often proposed as a method of ensuring an appropriate balance of power, increasing accountability and increasing the capacity of the board for independent decision making.”

Inside and outside (independent) directors: “Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.”

Independence criteria: “Board independence usually requires that a sufficient number of board members not be employed by the company and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being board members.”

Structure of board committees: “Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.”

Outside advice: “The contributions of non-executive board members to the company can be enhanced by providing … recourse to independent external advice at the expense of the company.”

Disclosure (financial, compensation, governance): – “The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company. Disclosure should include, but not be limited to, information on: 1. The financial and operating results of the company. 2. Company objectives. 3. Major share ownership and voting rights. 4. Members of the board and key executives, and their remuneration. 5. Material foreseeable risk factors. 6. Material issues regarding employees and other stakeholders. 7. Governance structures and policies.”
– “Information should be prepared, audited and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure.”

Shareholder rights and voting: – “The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign
shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase.”

- “Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures that govern general shareholder meetings.”

- “Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.”

#### Executive compensation:
- “The board should fulfill certain key functions, including [reviewing] executive and board remuneration.”

- “[Independent board members] can play an important role in areas where the interest of management, the company and the shareholders may diverge, such as executive compensation.”

#### BIS
The BIS, through the Basel Committee on Banking Supervision, set forth governance practices for financial institutions in its late 1999 document, *Enhancing Corporate Governance for Banking Organizations*. Like other supranational frameworks, the BIS’s is non-binding; unlike the general principles recommended by other supranational organizations or national agencies/industry groups, however, the focus of the BIS relates strictly to suggested governance practices within the financial sector.

#### Mission of the board of directors:
- “[T]he board should establish the strategies that will direct the ongoing activities of the bank. It should also take the lead in establishing the ‘tone at the top’ and approving corporate values for itself, senior management and other employees…. The board of directors should ensure that management implements policies that prohibit (or strictly limit) activities and relationships that diminish the quality of corporate governance…. ”

- “The board of directors is ultimately responsible for the operations and financial soundness of the bank.”

#### Stakeholder interests:
- “[B]anks [must] consider the interests of recognized stakeholders;
stakeholders include employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders.”17

- “Sound corporate governance considers the interests of all stakeholders, including depositors, whose interests may not always be recognized. Therefore, it is necessary for supervisors to determine that individual banks are conducting their business in such a way as not to harm depositors.”18

- **Separation of chairperson and CEO functions:** not explicitly addressed.

- **Inside and outside (independent) directors:** “An effective number of board members should be capable of exercising judgment, independent of the views of management, large shareholders or governments. Including on the board qualified directors that are not members of the bank’s management … can enhance independence and objectivity.”19

- **Independence criteria:** not explicitly addressed.

- **Structure of board committees:** “In a number of countries, bank boards have found it beneficial to establish certain specialized committees, including (a) a Risk Management committee – providing oversight of the senior management’s activities in managing credit, market, liquidity, operational, legal and other risks of the bank. (b) an Audit committee – providing oversight of the bank’s internal and external auditors, approving their appointment and dismissal, reviewing their reports and ensuring that management is taking appropriate corrective actions in a timely manner to address control weaknesses, non-compliance with policies, law and regulations and other problems identified by auditors. The independence of this committee can be enhanced when it is comprised of external board members that have banking or financial experience. (c) a Compensation committee – providing oversight of remuneration of senior management…. (d) a Nominations committee – providing important assessment of board effectiveness and directing the process of renewing and replacing board members.”20

- **Outside advice:** not explicitly addressed.

- **Disclosure (financial, compensation, governance):** “Public disclosure is desirable in the following areas: board structure (size, membership, qualifications and committees); senior management structure (responsibilities, reporting lines, qualifications and experience); basic organizational structure (line of business structure, legal entity structure); information about the incentive structure of the bank (remuneration
policies, executive compensation, bonuses, stock options); nature and extent of transactions with affiliates and related parties.”21

- **Shareholder rights and voting:** not explicitly addressed.
- **Executive compensation:** “Failure to link incentive compensations to the business strategy can cause or encourage managers to book business based upon volume and/or short-term profitability to the bank with little regard to short or long-term risk consequences…. The board of directors should approve the compensation of members of senior management and other key personnel and ensure that such compensation is consistent with the bank’s culture, objectives, strategy and control environment. This will help to ensure that senior managers and other key personnel will be motivated to act in the best interests of the bank.”22

**EUROPEAN UNION**

The European Shareholders Group, a confederation of eight national shareholders associations formed in 1990, presented its *Euroshareholders Corporate Governance Guidelines 2000* shortly after the OECD produced its 1999 guidelines. The prescriptions contained in the document, which are voluntary and non-binding, are intended to harmonize treatment of minority shareholders across participating European Union nations.

- **Mission of the board of directors:** “The board of directors is responsible for the management of the company and therefore setting the company’s objectives, defining its strategy and policy and the ensuring development of results.”23
- **Stakeholder interests:** not explicitly addressed.
- **Separation of the chairperson and CEO functions:** not explicitly addressed.
- **Inside and outside (independent) directors:**
  - “No more than one non-executive board member should have served as an executive board member of the company.”24
  - “[M]embers of a one-tier board should nevertheless have a significant degree of independence between the executive members and non-executive members.”25
- **Independence criteria:** not explicitly addressed.
- **Structure of board committees:**
– “A special committee should be established to set the remuneration of the [executive and non-executive] directors.”

**Outside advice:** not explicitly addressed.

**Disclosure (financial, compensation, governance):**

– “Companies should clearly state (in writing) their financial objectives as well as their strategy, and should include these in the annual report.”

– “Companies should disclose all relevant and important information to the shareholders, but at least the following: clear goals in financial terms and a clear corporate strategy; quarterly results; sensitive stock-related information, which shall be disclosed immediately; members of the board should be required to disclose their interests in transactions or matters affecting the company.”

– “Companies should immediately disclose information which can influence the share price, as well as information about those shareholders who pass (upwards or downwards) 5% thresholds. There should be serious penalties in case of non-compliance.”

– “The principles upon which … remuneration are based should be published in the annual report.”

**Shareholder rights and voting:**

– “Shareholders should have a significant influence over major changes in the company. The principle of ‘one share, one vote’ is the basis of the right to vote. Shareholders should have a right to vote at general meetings in proportion to the issued shareholder capital.”

– “Major decisions which have a fundamental effect upon the nature, size, structure and risk profile of the company, and decisions which have significant consequences for the position of the shareholder within the corporation, should be subject to shareholders approval or should be decided by the AGM.”

– “Shareholders should be able to place items on the agenda of the AGM.”

**Executive compensation:**

– “Given the fact that stock-option schemes … exist at the expense of shareholders, and considering that shareholders have an interest in the effectiveness of incentives, stock-option schemes or any other share incentives scheme should be described in a separate document and should be approved by shareholders.”

– “The payment of executive directors can to some extent be flexible – related to the company’s profitability – but shall not exceed double the fixed payment.”
AUSTRALIA

Australia’s best practices framework is based on the 1991 report entitled *Corporate Practices and Conduct* – widely known as the *Bosch Report* – which was prepared by a cross section of government, corporate, law, and accounting representatives. Although the specific guidelines in the *Bosch Report* are voluntary, the Australian Stock Exchange (ASX) requires listed companies to include a statement of their governance practices. Indeed, in 1998 the ASX started requiring listed companies to reference their practices against those set forth under the *Bosch Report* (as well as those contained in a corporate governance report developed by the Australian Investment Managers’ Association).

- **Mission of the board of directors:** “Directors should use their best efforts to ensure that the company is properly managed and constantly improved so as to protect and enhance shareholder wealth in perpetuity, and to meet the company’s obligations…”  

- **Stakeholder interests:** “Directors should use their best efforts to … meet the company’s obligations to all parties with which the company interacts – its stakeholders.”

- **Separation of chairperson and CEO functions:** “[T]he separation of the roles of chairman and CEO makes an important contribution to increasing accountability and ensuring that the interests of the shareholders as a whole are given due weight…. [T]he chairman plays a crucial role in ensuring that the board works effectively and that the combination of the roles of chairman and chief executive constitutes a concentration of power that can give rise to conflicts. Except where special circumstances exist, the roles should be separate…. Where the roles of the chairman and CEO are combined, the appointment of an independent non-executive director as deputy chairman should be considered.”

- **Inside and outside (independent) directors:** “[T]he boards of listed public companies should include a majority of non-executive directors who have an appropriate mix of skills and experience and whose abilities are appropriate to the needs of the company.”

- **Independence criteria:** “Independence is more likely to be assured when the director: (i) is not a substantial shareholder, (ii) has not been employed in any executive capacity by the company within the last few years, (iii) is not retained as a professional adviser by the company, (iv) is not a significant supplier to, or customer of, the company, (v) has no significant contractual relationship with the company other than as a director.”
Structure of board committees: “Where it is particularly important that boards exercise, and are seen to exercise, independent judgment, such as in the areas of company accounts, remuneration practices and the selection of board members, the independence and objectivity of the judgment can be enhanced by the appointment of appropriate committees…. In such cases it is very desirable that the membership of committees be seen to be predominantly independent.”

Outside advice: “To enable directors to discharge their fiduciary duties properly, it may be necessary for them to be provided with expert advice, particularly on legal and financial matters. Such advice should be objective and as independent as possible. In the first instance, advice is likely to be requested from company officers or advisers but in some circumstances, advice from independent external sources may be appropriate.”

Disclosure (financial, compensation, governance):
- “The remuneration of non-executive directors, including all benefits such as options, rights and pensions, should be fully disclosed to shareholders and approved by them.”
- “[The Australian Stock Exchange] requires listed companies to set out their main corporate governance practices in their annual report.”

Shareholder rights and voting: “Shareholders should have made a sufficient analysis to vote in an informed manner on all issues raised at general meetings…. Shareholders in listed companies should take a positive interest in the performance of the board and should exercise their votes in the election of directors in an informed manner … [they] should [also] take a positive interest in the election of auditors and should exercise their votes in an informed manner.”

Executive compensation: “The primary function of the remuneration committee should include matters such as the remuneration arrangements for the chief executive officer and other senior executives (including incentive plans, share options and other benefits) and service contracts.”

BELGIUM

Belgian governance practices are embodied in the Report of the Belgium Commission on Corporate Governance (also known as the Cardon Report), which was released in 1998. The provisions of the framework are entirely voluntary, intended only as a recommended benchmark for listed
companies. Indeed, the Brussels Stock Exchange (BSE), original sponsor of the report, considers that Belgian corporate law already contains fundamental elements of governance, making a mandatory framework redundant. Further best practices have also been put forth by the Banking and Finance Commission (focused primarily on annual report disclosures) and the Federation of Belgian Companies (which seeks to apply the Cardon proposals to non-listed and private companies).

- **Mission of the board of directors:**
  - “[T]he board must exercise full and effective control over the company … it must meet regularly and must be capable of monitoring the executive management.” 47
  - “[T]he board of directors is responsible for defining the strategic objectives and establishing general policy on the basis of proposals submitted by the executive management, appointing executive management and approving the structures designed to facilitate the achievement of these objectives … [and] to supervise the implementation of policy and the control of the company and to report to the shareholders.” 48

- **Stakeholder interests:** not explicitly addressed.

- **Separation of chairperson and CEO functions:** “[T]here should be a clear division of responsibilities at the head of a company which will ensure a balance of power and authority.… Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board whose authority is acknowledged.” 49

- **Inside and outside/independent directors:** “The board should consist of a majority of non-executive directors of sufficient caliber and number for their views to carry significant weight in the board’s decisions.” 50

- **Independence criteria:** “[A] director may be considered independent if he/she is not a member of the executive management or of the board of associated companies … and has not held any such appoint for the past year; has no family ties with any of the executive directors which might interfere with the exercise of independent judgment; is not a member of the executive management or board of directors of one of the dominant shareholders and has not been selected on the nomination of and has no business, financial or other relationships with, the latter; is not a supplier of goods or services of a nature which might interfere with the exercise of independent judgment, and is not a member of the firm which the company’s adviser or consultant is part; has no other relationship with the company which, in the opinion of the board of
directors, is of a nature which might interfere with the exercise of his/her judgment.”

Structure of board committees:
- “The nomination committee should have a majority of non-executive directors and should be chaired by the chairman of the board or a non-executive director.”
- “The executive management’s pay should be subject to the recommendations of a remuneration committee, where such exists, made up of a majority of non-executive directors.”
- “[A]n audit committee should be established. The board should ensure that the auditors have no relationship with the company, whether directly or indirectly, which could influence their judgment.”

Outside advice: “There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice at the company’s expense.”

Disclosure (financial, compensation, governance):
- “It is the board’s duty to present a clear and accurate evaluation of the company’s situation to the general meeting of the shareholders.”
- “The report and accounts should contain a coherent narrative of the company’s financial position, supported by information on the company’s performance and prospects…. The need for the report to be readily understood emphasizes that words are as important as figures.”
- “Information about the relevant interests of directors should be disclosed in the directors’ report.”
- “The Commission also recommends that the principles underlying the calculation of [executive management’] pay should be disclosed.”
- “The Commission takes the view that companies which are listed on the Brussels Stock Exchange should disclose in their directors’ reports the measures they have taken and development in the areas of corporate governance….”
- “The Commission has based [its] code of best practices on … transparency, integrity and responsibility…. Integrity demands that the financial reports and other information disseminated by the company present an accurate and complete picture of the company’s position…. [T]he responsibility of the board of directors relates chiefly to the quality of the information it provides to shareholders.”
Shareholder rights and voting: “[L]egislation embodies the principle of ‘one share/one vote’….“\(^{62}\)

Executive compensation:
- “The Commission regards it as good practice for part of the executive management’s pay to be related to the company’s performance and/or value.”\(^{63}\)
- “The executive management’s pay should be subject to the recommendations of a remuneration committee, where such exists, made up of a majority of non-executive directors.”\(^{64}\)

BRAZIL

Brazil’s corporate governance best practices are contained in the June 2002 document *CVM Recommendations on Corporate Governance*, which was created under the guidance and sponsorship of Comissão de Valores Mobiliários (CVM), Brazil’s national securities regulator. The practices set forth by the CVM are voluntary, and set at a higher standard than those imposed by law or the CVM for standard financial activities. Local companies choosing not to adhere to the CVM best practices are required to disclose such facts in their annual reports.

Mission of the board of directors: “The board of directors should seek to protect the company’s assets, ensure that the objectives of the company are carried out, and guide management with the goal of maximizing return on investments, adding value to the company.”\(^{65}\)

Stakeholder interests: not explicitly addressed.

Separation of the chairperson and CEO functions: “The chairman of the board and the chief executive officer shall not be the same person. The board of directors supervises management. Therefore, in order to avoid conflicts of interest, the chairman of the board should not also be the chief executive officer.”\(^{66}\)

Inside and outside (independent) directors: “As many board members as possible should be independent of company management.”\(^{67}\)

Independence criteria: not explicitly addressed.

Structure of board committees:
- “[The board] should also set up specialized committees to analyze certain questions in depth, especially relationships with auditors and operations among related parties…. The committees should
study their subjects and prepare proposals, which should then be submitted to the vote of the board of directors."68

- “An audit committee, composed of members of the board of directors with experience in finance and including at least one board member representing minority shareholders, should supervise the relationship with the auditor. As part of the analysis of financial statements, the fiscal board and the audit committee should meet regularly and separately with the auditors, without the presence of executive officers.”69

**Outside advice:** “The board should be allowed to request the hiring of external specialists to assist with decisions, when it deems necessary.”70

**Disclosure (financial, compensation, governance):**

- “Each quarter, along with the financial statements, the company should release reports prepared by management with a discussion and analysis of the factors that most influenced results, indicating the main internal and external risk factors to which the company is subject. The management’s discussion and analysis reports should explain significant changes in the financial statements. Relevant events of the period shall be commented on, from the accounting and strategic points of view.”71

- “The company should adopt, in addition to accounting standards in force in Brazil, either standards promulgated by the International Accounting Standards Board (IASB) or United States Generally Accepted Accounting Principles (US GAAP), attested by an independent auditor.”72

**Shareholder rights and voting:** “The majority of share capital, regardless of type or sort, should have the right to deliberate on decisions of high relevance, with each share representing one vote. Among decisions of greater importance, the following stand out: (1) approval of evaluation reports of assets to be incorporated into the company’s capital; (2) alteration of the company’s activity; (3) reduction of compulsory dividends; (4) mergers, spin offs and incorporations; and (5) relevant transactions with related parties.”73

**Executive compensation:** not explicitly addressed.

**CANADA**

Canada’s best practice framework is centered on the Toronto Stock Exchange’s (TSE), *Guidelines for Improved Corporate Governance in Canada* (also known as the *Dey Report*), which was put forth by the TSE
Committee on Corporate Governance in 1994. Although the specific recommendations within the *Dey Report* are voluntary, companies listed on the TSE and the Montreal Stock Exchange (MSE) have adopted a resolution that requires them to disclose the nature of their corporate governance practices with respect to the provisions of the *Dey Report*.

- **Mission of the board of directors:**
  - “The board of directors of every corporation should explicitly assume responsibility for the stewardship of the corporation … [including] i. Adoption of a strategic planning process; ii. The identification of the principal risks of the corporation’s business and ensuring the implementation of appropriate systems to manage these risks; iii. Succession planning, including appointing, training and monitoring senior management; iv. A communications policy for the corporation and; v. The integrity of the corporation’s internal control and management information systems.”
  - “We define the principle objective of directing and managing the business and affairs of the corporation as enhancing shareholder value.”

- **Stakeholder interests:**
  - “A system of corporate governance recognizes the role of other stakeholders…. Notwithstanding the primary responsibility of the board, the long-term interest of shareholders will not be well-served if the interests of other stakeholders are not addressed.”
  - “In making decisions to enhance shareholder value, the board must take into account the interests of other shareholders.”

- **Separation of chairperson and CEO functions:** “Every board of directors should have in place appropriate structures and procedures to ensure that the board can function independently of management. An appropriate structure would be to (i) appoint a chair of the board who is not a member of management with responsibility to ensure the board discharges its responsibilities or (ii) adopt alternate means such as assigning this responsibility to a committee of the board or to a director, sometimes referred to as a ‘lead director’.”

- **Inside and outside (independent) directors:** “The board of directors of every corporation should be constituted with a majority of individuals who qualify as unrelated directors.”

- **Independence criteria:** “An unrelated director is a director who is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the direc-
tor’s ability to act with a view to the best interest of the corporation, other than interests and relationships arising from shareholding.”

- **Structure of board committees:**
  - “Committees of the board of directors should generally be composed of outside directors, a majority of whom are unrelated directors, although some board committees, such as the executive committee, may include one or more inside directors.”
  - “The audit committee of every board of directors should be composed only of outside directors.”

- **Outside advice:** “The board of directors should implement a system which enables an individual director to engage an outside adviser at the expense of the corporation in appropriate circumstances. The engagement of the outside adviser should be subject to the approval of an appropriate committee of the board.”

- **Disclosure (financial, compensation, governance):**
  - “The disclosure – a ‘Statement of Corporate Governance Practices’ – should be made in the corporation’s annual report or information circular … [and] would address at least the following points: mandate of the board … the composition of the board … if the board does not have a chair separate from the CEO, the structures and processes which are in place to facilitate functioning of the board independently of management; description of board committees … description of decision requiring prior approval by the board; procedures for recruiting new directors … measures for receiving shareholder feedback and measures for dealing with shareholder concerns; the board’s expectation of management.”
  - “The prospectus is the most comprehensive disclosure document and its accuracy is certified by the corporation and the board of directors. The directors, in addition to the corporation, are liable for any misrepresentations contained in the prospectus, although the directors have available a due diligence defense.”

- **Shareholder rights and voting:** “Decisions made by shareholders relate to the election of directors, the election of auditors, and generally to fundamental changes to the corporation’s constitution or business. Good governance also requires shareholder votes in circumstances where the board of directors may be interested in the transaction.”

- **Executive compensation:** “The board must ensure that objectives are in place against which management’s performance can be measured. Not only is this a sensible management approach but the relationship between management performance and compensation must be reasonable.”
France

French governance practices are promulgated through two separate studies – known as the Vienot Reports – which were originally commissioned by the Conseil National du Patronat Français (CNPF) and the Association Française des Entreprises Privées (AFEP). The first, *The Board Directors of Listed Companies in France* (released in mid-1995), focuses primarily on the membership and operation of boards. The second, *Report of the Committee on Corporate Governance* (issued in mid-1999), centers on the separation of chair/CEO roles, the function of independent directors, and the nature of financial disclosure. The collective recommendations of the Vienot Reports are non-binding.

- **Mission of the board of directors:** “The board of directors determines the company’s strategy, appoints the corporate officers charged with implementing that strategy, supervises management, and ensures that proper information is made available to shareholders and markets concerning the company’s financial position and performance, as well as any major transactions to which it is a party.”

- **Stakeholder interests:** “The interest of the company may be understood as … distinct from those of shareholders, employees, creditors … suppliers and customers. It nonetheless represents the common interest of all of these persons, which is for the company to remain in business and prosper.”

- **Separation of chairperson and CEO functions:** “The Committee considers that introduction into French law of great flexibility in the unitary system with a Board of Directors is particularly desirable, and that the Boards of corporations should be allowed an open choice between combination or separation of the offices of the Chairman and Chief Executive Officer. [T]he law imposes a uniform requirement of combination of duties in the hands of a Chairman and Chief Executive Officer allowing no derogation, the only other option being a change to [a] structure with a Supervisory Board and Board of Management.”

- **Inside and outside (independent) directors:**
  - “The Committee confirms that the presence of genuinely independent Directors in sufficient numbers … is an essential factor in guaranteeing that the interests of all the shareholders will be taken into account in the corporation’s decisions.”
  - “The independent directors should account for at least one-third of the Board of Directors.”
Independence criteria: “A Director is independent of the corporation’s management when he or she has no relationship of any kind whatsoever with the corporation or its group that is such as to jeopardize exercise of his or her free judgment.”

Structure of board committees: “[T]he presence of genuinely independent Directors in sufficient numbers on Boards of Directors and Board Committees is an essential factor in guaranteeing that the interest of all the shareholders will be taken into account in the corporation’s decisions. In order to establish the role recognized for independent Directors, the Committee considers: that they should account for at least one-third of the Board of Directors, the audit committee and the appointments committee; that they should be in the majority of the compensation and options committee, having regard to its duties; that they should be identified individually in the annual report.”

Outside advice: “The Board committees should be able to request external technical reviews of matters within their purview, at the corporation’s expense, after informing thereof the chairman of the Board of Directors or the Board itself, and subject to reporting to the Board.”

Disclosure (financial, compensation, governance):
- “[I]t is the Chairman’s duty to provide the market with a regular flow of information on a day-to-day basis, [while] the board of directors is responsible for presenting annual and half-yearly financial statements, and for informing the market of major financial transactions. In such cases, the board must provide quality information, which is sufficiently reliable and clear to ensure the fair execution of the transactions concerned.”
- “The Committee recommends that with assistance from the compensation committee, the membership of which would be stated, the Board of Directors of any listed corporation should include in its annual report a specific chapter relating to disclosure to the shareholders of the compensation collected by the corporate officers.”
- “It is essential that the shareholders and third parties be fully informed of the options and of the allocation of powers selected by the Board…. It ought to be possible to append the rules of operation, having become the basic collection of rules for internal operation, to the by-laws.”

Shareholder rights and voting:
- “[T]he board of directors is collectively answerable to the General Meeting of Shareholders for the fulfillment of its duties…. [I]t informs the shareholders’ meeting through its annual report and the financial statements which it adopts.”
“[T]he board must respect the rights of the General Meeting of Shareholders when it envisages a transaction which is of a nature to affect, de jure or de facto, the company.”

“The Committee believes that the best solution [for minority shareholder representation] is to appoint several independent directors to boards … rather than to provide for special representation of minority shareholders.”

**Executive compensation:** not explicitly covered.

### GERMANY

German corporate governance best practices are presented in the 2002 document *German Corporate Governance Code*. The Code was created through the working group efforts of the Government Commission on German Corporate Governance (the Baum Commission, which tabled its initial findings in July 2001), and was developed around pre-existing legal statutes. Provisions of the Code are voluntary; however, when practices set forth as recommendations are not followed, a company’s management must explain in its annual report reasons for not doing so. When best practices are simply suggestions, a company’s management need not disclose its reasons when it chooses not to follow them.

**Mission of the board of directors:**

- The task of the Supervisory Board is to advise regularly and supervise the Management Board in the management of the enterprise. It must be involved in decisions of fundamental importance to the enterprise. The Supervisory Board appoints and dismisses the members of the Management Board.

- “For transactions with fundamental importance, the Articles of Association or the Supervisory Board specify provisions requiring the approval of the Supervisory Board. They include decisions or measures which fundamentally change the asset, financial or earnings situations of the enterprise.”

**Stakeholder interests:** not explicitly addressed.

**Separation of chairperson and CEO functions:** “A dual board system is prescribed by law…. The Chairman of the Management Board coordinates the work of the Management Board…. The Chairman of the Supervisory Board coordinates the work of the Supervisory Board.”

**Inside and outside (independent) directors:** not explicitly addressed.
Independence criteria:
- “For nominations for the election of members of the Supervisory Board, care shall be taken that the Supervisory Board, at all times, is composed of members who, as a whole, have the required knowledge, abilities and expert experience to properly complete their tasks and are sufficiently independent.”
- “All members of the Supervisory Board are bound by the enterprise’s best interests. No member of the Supervisory Board may pursue personal interests in his/her decisions or use business opportunities intended for the enterprise for himself/herself.”
- “Each member of the Supervisory Board shall inform the Supervisory Board of any conflicts of interest which may result from a consultant or directorship function with clients, suppliers, lenders or other business partners.”

Structure of board committees:
- “The Supervisory Board shall set up an Audit Committee which, in particular, handles issues of accounting and risk management, the necessary independence of the auditor, the issuing of the audit mandate to the auditor, the determination of audit focal points and the fee agreement. The Chairman of the Audit Committee should not be a former member of the Management Board of the company.”
- “The Chairman of the Supervisory Board shall also chair the committees that handle contracts with the members of the Management Board…. He should be Chairman of the Audit Committee.”
- “The Supervisory Board can delegate other subjects to be handled by one or several committees. These subjects including the strategy of the enterprise, the compensation of the members of the Management Board, investments and financing.”

Outside advice: not explicitly addressed.

Disclosure (financial, compensation, governance):
- “Shareholders as third parties are mainly informed by the Consolidated Financial Statements. They shall be informed during the financial year by means of interim reports. The Consolidated Financial Statements and interim reports shall be prepared under observance of internationally recognized accounting principles.”
- “The Management Board will disclose without delay any new facts which have arisen within the enterprise’s field of activity and which are not known publicly, if such facts could, owing to their impact on the asset and financial situations or general development, substantially influence the price of the company’s registered securities.”
— “The Management Board and Supervisory Board shall report each year on the enterprise’s Corporate Governance in the Annual Report. This includes the explanation of possible deviations from the recommendations of [the] Code.”

**Shareholder rights and voting:** “Shareholders exercise their rights at the General Meeting and vote there. In principle, each share carries one vote. There are no shares with multiple voting rights (golden shares) or maximum voting rights.”

**Executive compensation:**
— “Compensation of the members of the Management Board is determined by the Supervisory Board at an appropriate amount based on a performance assessment in considering any payments by group companies. Criteria for determining the appropriateness of compensation are, in particular, the tasks of the member of the Management Board, his performance, the economic situation, the performance and outlook of the enterprise taking into account its peer companies.”

— “[S]tock options or comparable instruments … serve as variable compensation components with long-term incentive effect. These shall be specified in advance using comparative parameters such as the performance of stock indices or the achievement of predetermined share prices…. The details of a stock option plan or comparable compensation system shall be disclosed in suitable form.”

**ITALY**

Italy’s best practice governance guide, the *Corporate Governance Code*, was originally released by the Borsa Italiana’s Committee for the Corporate Governance of Listed Companies in 1999; a revised version was published in 2002. The recommendations of the Code are voluntary, though in some cases coincide with mandatory listing requirements for companies traded through the Borsa Italiana.

**Mission of the board of directors:**
— “The Committee believes that the primary responsibility of the board of directors of a listed company is to set the company’s strategic objectives and to ensure they are achieved.”

— “The creation of value for the generality of shareholders is the primary objective the directors of listed companies seek to achieve. The emphasis placed on shareholder value, apart from reflecting the approach that is internationally prevalent, is in conformity with Ital-
ian law, which sees the interest of the shareholders as the reference parameter for the action of those who lead the company.”

- **Stakeholder interests:** not explicitly addressed.

- **Separation of the chairperson and CEO functions:** “The Committee considers, in principle, that chairmen and the managing directors each have their own tasks, but notes that it is not infrequent in Italy for the same person to hold the two positions or for some management powers to be delegated to the chairman even when there are managing directors. With reference to the powers delegated to the chairman, he is also a managing director. The Committee therefore believes that the board of directors, where it deems this to be desirable in order to achieve a more efficient running of the company, has the right to delegate management powers to the chairman alone or with others. In such case the board should include adequate information in its annual report on the duties and responsibilities of the chairman and the managing directors.”

- **Inside and outside (independent) directors:**
  - “The board of directors shall be made up of executive directors (i.e. the managing directors, including the chairman where he or she has delegated powers, and those directors who perform management functions within the company) and non-executive directors. The number and standing of the non-executive directors shall be such that their views can carry significant weight in taking board decisions.”
  - “In Italy non-executive directors normally outnumber executive directors.”

- **Independence criteria:**
  - “An adequate number of non-executive directors shall be independent, in the sense that they: a) do not entertain, directly or indirectly or on behalf of third parties, nor have recently entertained, business relationships with the company, its subsidiaries, the executive directors of the shareholder or group of shareholders who controls the company of a significance able to influence their autonomous judgment; b) neither own, directly or indirectly or on behalf of third parties, a quantity of shares enabling them to control the company or exercise a considerable influence over it nor participate in shareholders’ agreement to control the company; c) are not immediate family members of executive directors of the company or of persons in the situations referred to in points a) and b).”
  - “Directors’ independence shall be periodically assessed by the board of directors on the basis of the information provided by each
interested party. The results of assessments shall be communicated to the market.”

– “The Committee recommends that, in line with international practice, a number of ‘independent’ directors should be elected to the boards of listed companies that is adequate in relation to the total number of non-executive directors and significant in terms of representativeness.”

Structure of board committees:

– “The Committee therefore recommends the establishment of a remuneration committee consisting prevalently of non-executive directors … to make proposals, so that the power to establish the remuneration … in accordance with the articles of association remains with the board of directors.”

– “The board of directors shall establish an internal control committee, charged with the task of giving advice and making proposals and made up of non-executive directors, of which the majority shall be independent…. In particular the internal control committee shall: a) assist the board in performing the tasks referred to in Article 9.2. [internal control systems]; b) assess the work programme prepared by the persons responsible for internal control and receive their periodic reports; c) assess … the appropriateness of the accounting standards adopted and, in the case of groups, their uniformity with a view to the preparation of consolidated accounts; d) assess the proposals put forward by auditing firms to obtain the audit engagement, the work programme for carrying out the audit and the result hereof … e) report to the board of directors on its activity and the adequacy of the internal control system at least once every six months; f) perform the other duties entrusted to it…”

– “Where the board of directors has established a committee to propose candidates for appointment to the position of director, the majority of the members of such committee shall be non-executive directors.”

Outside advice: “[The remuneration] committee may employ external consultants at the company’s expense.”

Disclosure (financial, compensation, governance): “The information provided to the shareholders’ meeting shall be sufficiently detailed, so as to … be understood.”

Shareholder rights and voting: “The board of directors shall propose for the shareholders’ approval a set of rules to ensure the orderly and effective conduct of the company’s ordinary and extraordinary share-
holders’ meetings, while guaranteeing the right of each shareholder to speak on matters on the agenda.”\textsuperscript{130}

**Executive compensation:**

- “The board of directors shall determine, after examining the proposal of the special committee and consulting the board of auditors, the remuneration of the managing directors and of those directors who are appointed to particular positions within the company and, where the shareholders’ meeting has not already done so, allocate the total amount to which the members of the board and of the executive committee are entitled.”\textsuperscript{131}

- “The board of directors shall form a committee on remuneration and stock option or equity-based remuneration plans. The committee, the majority of whose members shall be non-executive directors, shall submit proposals to the board … for the remuneration of the managing directors and of those directors who are appointed to particular positions and, acting on a proposal from the managing directors, for the criteria to be used in determining the remuneration of the company’s top management.”\textsuperscript{132}

- “As a general rule, in determining the total remuneration payable to the managing directors, the board of directors shall provide for a part to be linked to the company’s profitability and, possibly, to the achievement of specific achievements laid down in advance by the board of directors itself.”\textsuperscript{133}

**JAPAN**

Japanese best practice governance recommendations were originally conveyed through the 1998 report, *Corporate Governance Principles: A Japanese View*, sponsored by the Japan Corporate Governance Forum (an industry group comprising corporate executives, academics and institutional investors). It was updated in 2001 through the *Revised Corporate Governance Principles* document. The framework, which is entirely voluntary, divides its recommendations into two phases: those that can be adopted by companies immediately without any legal or legislative change (“Step A Principles”), and those that can be phased in over time, as the country’s laws and regulations permit (“Step B Principles”).

**Mission of the board of directors:** “The board of directors is positioned as the management supervision body of the company. The board of directors should supervise the management of the company by the Chief Executive Officer (CEO).”\textsuperscript{134}
Stakeholder interests: “The CEO, while observing the law and the Articles of Incorporation and adjusting the interests of various stakeholders based on market principles, should loyally carry out his or her duties in order to meet the management goals of the company.”

Separation of chairperson and CEO functions: “The leader of the board of directors should, as chairperson or leader of the meeting which supervises the CEO and other executives, discharge his or her duties from the standpoint of good corporate governance.”

Inside and outside (independent) directors: “The board of directors should be comprised of outside directors (directors who are not also executives or employees) and inside directors (directors who are also executives or employees). The majority of the board of directors should be comprised of outside directors.”

Independence criteria: “An outside director is someone who is not, and has never been, a full-time director, executive or employee of the company or its parent company, subsidiaries or affiliates. An independent director is someone who can make decisions completely independently from the managers of the Company, and therefore necessarily does not hold any interest with respect to the Company. If companies exchange directors (interdirectorships), those directors should be regarded as lacking independence.”

Structure of board committees:
- “The board of directors should establish a nominating committee, compensation committee and audit committee within the board. The board may, if necessary, establish a litigation committee or any other committee for a specific purpose. Each Committee should consist of 3 or more directors. The majority of directors on the nominating committee and the compensation committee should be outside directors, and there should be one or more independent directors. The majority of audit committee members should be independent directors. An outside director should be appointed as the chairperson of each Committee.”
- “The CEO should not be a member of the nominating, compensation or audit committees.”

Outside advice: not explicitly covered.

Disclosure (financial, compensation, governance):
- “The CEO should prepare an annual report on the state of internal audit and control, and include that report in the business report and the securities report, and it is desirable that the report be audited by a certified public accountant.”
The CEO should endeavor to promptly disclose any information which will influence the company stock price so as to ensure that price reflects its fair value, and should immediately notify the securities exchange or make the information public by other appropriate means when such information becomes available. The CEO should disclose information regularly and whenever necessary in order to show shareholders, investors, employees, customers and local communities, etc. that the corporation’s business affairs have been efficient and fair.”

**Shareholder rights and voting:** “The general meeting of shareholders is important because it provides an opportunity for those people who have invested in the company’s shares to participate in the decision-making process of the company to a certain extent, to take part in corporate governance, to obtain information about the current state of the company by asking questions of the executives and receiving their explanations, and to evaluate the qualifications and capabilities of the executives through questions and answers.”

**Executive compensation:** “The compensation committee should review the executive compensation programs and each director’s and executive’s compensation pursuant to pre-set compensation principles. The objective of the compensation programs is to motivate directors and executives to work diligently, and therefore the compensation committee should respectfully review the incentive plans, which should be designed in a fair and reasonable manner. If the CEO decides to adopt incentive plans to employees, the CEO should obtain the approval of the compensation committee.”

**KOREA**

Korea’s best practice governance principles are set forth in the *Code of Best Practice for Corporate Governance*, published in 1999 by the Committee on Corporate Governance (a non-governmental group comprised of 14 members from business, finance, accounting, law and academia, together with an advisory panel of 13 specialists). The principles are entirely voluntary, although the Committee recommends that companies disclose in their annual reports any divergences from recommended practice. The Committee has also urged the Korean government to enact legislative changes to make the Code legally binding.

**Mission of the board of directors:**

“The Board of Directors … shall make the key management policy decisions in the best interests of the corporation and its shareholders,
and shall perform effective supervision of the directors and management.”

- “At present, the Board is designed to be the heart of corporate operations. The Board, therefore, must perform all of its duties not only to protect minority shareholders and other parties of interest – monitoring and restraining the self-validating management or controlling shareholders – but to prevent corporate insolvency.”

- **Stakeholder interests:** “The corporation holds diverse relations with stakeholders, those being employees, creditors, suppliers, consumers and community. Also, the roles played by the stakeholders are very important to the continuance of the corporation. Therefore, the corporation shall realize that mutual cooperation with stakeholders is, in the long term, to its own benefit, and shall respect and protect the rights of stakeholders as determined by statutes and contracts.”

- **Separation of the chairperson and CEO functions:** not explicitly addressed.

- **Inside and outside (independent) directors:** “The Board shall include outside directors capable of performing their duties independently from the management, controlling shareholders and the corporation. The number of outside directors shall be such that the Board is able to maintain practical independence. Particularly, it is recommended that financial institutions and large-scale public corporations gradually increase the ratio of outside directors to over half of the total number of directors (minimum three outside directors).”

- **Independence criteria:** “Outside directors shall hold no interests that may hinder their independence from the corporation, management or controlling shareholder. The outside director shall submit a letter of confirmation, which the corporation shall disclose, stating that he holds no interest affiliated with the corporation, management or controlling shareholder at the time of his consent to the appointment.”

- **Structure of board committees:**
  - “The Board may, if necessary, establish internal committees that perform specific functions and roles, such as the Audit, Operation and Remuneration Committees.”
  - “An audit committee shall be composed of the following: a minimum of three Board members; a minimum two-thirds, including the committee chair, shall be outside directors; and one member shall be a person possessing professional knowledge of auditing. A corporation without an audit committee shall employ at least one standing auditor.”
Outside advice: “The outside director may receive support from executives, employees or outside professionals through due process when necessary, for which the corporation shall cover any reasonable expense.”

Disclosure (financial, compensation, governance):
- “Corporations shall disclose any information, not just limited to those required under law, that may materially influence the decision-making of shareholders and other stakeholders.”
- “In the annual report, a public corporation shall explain the differences between its corporate governance and this Code, and the reasons for such; any plans to make future changes shall also be explained.”
- “Disclosure should be made of adherence to the company’s code of ethics….”
- “Corporations shall prepare and disclose semi-annual reports, apart from annual reports.”
- “Activities of the Board shall be evaluated fairly, the results of which shall be disclosed … through disclosure, [this] will assist in the decision-making by shareholders and shall be reflected in the business manager human resources market. Such disclosures presented in the annual report are also advisable.”

Shareholder rights and voting:
- “Shareholders shall receive all information prior to exercising their rights, and shall be able to exercise their rights through proper procedure.”
- “Shareholders shall hold fair voting rights according to the type and number of shares possessed, and all shareholders shall equally be in possession of corporate information.”
- “Shareholders shall make every effort to exercise their voting rights. Controlling shareholders, aside from exercising their voting rights accorded to the shares possessed, shall take corresponding responsibility whereby they exercise influence over the corporate management.”

Executive compensation: “Business activities of the management
shall be evaluated fairly, and the evaluation results shall be reflected appropriately in the remuneration. Remuneration for the management shall be decided by the Board, that is, within the limit approved by the general shareholder meeting. If a committee centered on outside directors is established within the Board, then that committee may make the decision.”¹⁶³

MALAYSIA

Malaysian best practices for governance were developed by the Working Group on Best Practices in Corporate Governance, comprised of industry and private sector experts from business, law, and academia. The group’s recommendations, which are contained in the Malaysian Code on Corporate Governance, were approved by the Finance Committee on Corporate Governance in 2002. Although adherence to the code is not mandated by law, the Kuala Lumpur Stock Exchange (KLSE) requires companies to disclose in their annual reports how they apply certain code principles and best practices. Where a divergence exists, companies must provide suitable explanation.

- **Mission of the board of directors:** “The board should explicitly assume the following six specific responsibilities: Reviewing and adopting a strategic plan for the company; Overseeing the conduct of the company’s business to evaluate whether the business is being properly managed; Identifying principal risks and ensure the implementation of appropriate systems to manage these risks; Succession planning, including appointing, training, fixing the compensation of and where appropriate, replacing, senior management; Developing and implementing an investor relations programme or shareholder communications policy for the company; and, Reviewing the adequacy and integrity of the company’s internal control systems and management information systems, including systems or compliance with applicable laws, regulations, rules, directives and guidelines.”¹⁶⁴

- **Stakeholder interests:** not explicitly addressed.

- **Separation of the chairperson and CEO functions:** “There should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the roles are combined there should be a strong independent element on the board. A decision to combine the roles of Chairman and Chief Executive Officer should be publicly explained.”¹⁶⁵
**Inside and outside (independent) directors:**
- “The board should include a balance of executive directors and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board’s decision-making.”\(^\text{166}\)
- “To be effective, independent non-executive directors need to make up at least one-third of the membership of the board.”\(^\text{167}\)
- “Whether or not the roles of Chairman and Chief Executive Officer are combined, the board should identify a senior independent non-executive director of a board in the annual report to whom concerns may be conveyed.”\(^\text{168}\)

**Independence criteria:** “The term independent in the Malaysian context refers broadly to two crucial aspects – independence from management and independence from a significant shareholder.”\(^\text{169}\)

**Structure of board committees:**
- “The board of every company should appoint a committee of directors composed exclusively of non-executive directors, a majority of whom are independent, with the responsibility for proposing new nominees for the board and for assessing directors on an ongoing basis.”\(^\text{170}\)
- “Boards should appoint remuneration committees, consisting wholly or mainly of non-executive directors, to recommend to the board the remuneration of the executive directors in all its forms, drawing from outside advice as necessary.”\(^\text{171}\)
- “The board should establish an audit committee of at least three directors, a majority of whom are independent, with written terms of reference which deal clearly with its authority and duties. The Chairman of the audit committee should be an independent non-executive director.…. The audit committee must have explicit authority to investigate any matter within its terms of reference, the resources which it needs to do so and full access to information. The committee should be able to obtain external professional advice and to invite outsiders with relevant experience to attend, if necessary.”\(^\text{172}\)

**Outside advice:** “There should be an agreed procedure for directors, whether as a full board or in their individual capacity, in furtherance of their duties, to take independent professional advice at the company’s expense, if necessary.”\(^\text{173}\)

**Disclosure (financial, compensation, governance):**
- “The company’s annual report should contain details of the remuneration of each director.”\(^\text{174}\)
- “The board should present a balanced and understandable assessment of the company’s position and prospects.”
- “The board should disclose on an annual basis whether one third of the board is independent….”
- “When evaluating companies’ governance arrangements, particularly those relating to board structure and composition, institutional investors and their advisers should give due weight to all relevant factors drawn to their attention.”

**Shareholder rights and voting:**
- “Institutional shareholders have a responsibility to make considered use of their votes.”
- “The AGM [Annual General Meeting] is a crucial mechanism in shareholder communication. The AGM gives all shareholders, whatever the size of shareholding, direct public access to their boards.”

**Executive compensation:**
- “Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully. The component parts of remuneration should be structured so as to link rewards to corporate and individual performance, in the case of executive directors…”
- “Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors.”

**THE NETHERLANDS**

Dutch governance matters are set forth under the report *Corporate Governance in the Netherlands: Forty Recommendations*, also known as the *Peters Code*. The *Peters Code*, which is non-binding, was sponsored by the Committee on Corporate Governance, established in 1997 by the Association of Securities Issuing Companies and the Amsterdam Stock Exchange Association, in order to bring great focus to governance issues.

- **Mission of the board of directors:** “[T]he Supervisory Board … is bound by the interests of the company and the enterprise connected therewith. It is responsible for the supervision of management policy and the general course of affairs in the company.”
- **Stakeholder interests:** “The company is accountable to its various stakeholders…. Companies must seek a good balance between the
interests of risk capital (investors) and the other stakeholders. In the long term, this should not mean a conflict of interests.”

- **Separation of chairperson and CEO functions:** “The Supervisory Board has a chairman who ensures that the Supervisory Board functions properly … the chairman keeps in frequent contact with the chairman of the Board of Directors.”

- **Inside and outside (independent) directors:** “The Supervisory Board should be composed in such a way that its members operate independently critically in relation to each other and the Board of Directors.”

- **Independence criteria:**
  - “Supervisory Board members should not commit to certain subsidiary interests while neglecting other associated interests.”
  - “Neither hierarchic subordination within an interest group, cross bonds, nor any other relations with persons under their supervision should prevent members of the Supervisory Board from performing their duties independently.”
  - “Supervisory Board members should derive no form of personal gain from the company’s activities other than via their remuneration as a Supervisory Board member or from capital growth resulting from shareholding or dividends.”

- **Structure of board committees:** “The Supervisory Board considers whether to appoint from its midst a selection and nomination committee, an audit committee and a remuneration committee. These committees submit reports on their findings and make recommendations to the full Supervisory Board.”

- **Outside advice:** not explicitly covered.

- **Disclosure (financial, compensation, governance):**
  - “Relevant information should … be supplied so that, on the basis of soundly-based sector and investment analyses, it is possible to communicate effectively about and make a critical assessment of strategy, risks, activities and financial results.”
  - “The aggregate number of securities held by all the members of the Board of Directors at the end of the financial year should be included in the annual report….”
  - “[T]he aggregate sum of the remuneration in the annual report should be split into payments made to serving board members and those of former board members.”
  - “The stock options granted by the company in particular financial year to the joint members of the Board of Directors and to other
employees should be included in the annual report, together with the most significant conditions relating thereto.”193
– “The basic outlines of Corporate Governance within the company should be explained in the annual report. The company should give a motivated explanation in the annual report of the extent to which it has complied with the recommendations.”194

**Shareholder rights and voting:**
– “The general principle should be that proportionality exists between capital contribution and influence. The maxim of ‘one share/one vote’ is the customary way of expressing this principle.”195
– “Those who exercise powers on behalf of the real providers of risk capital should, during the decision-making process at the General Meeting of Shareholders, be aware at all times that said powers are in principle vested in those providers of risk capital.”196
– “The Committee believes that investors should be able to exert real influence within the company.”197
– “Each company’s General Meeting is the forum to which the Board of Directors and the Supervisory Board report and to which they are accountable for their performance. The agenda items should include the company strategy, policy – financial and otherwise – and the business results.”198
– “In the General Meeting of Shareholders a thorough exchange of ideas should take place between company executives and investors. Relevant information should therefore be supplied.”199

**Executive compensation:** “Dutch company law prescribes that the General Meeting of Shareholders determines the remuneration of the members of the Board of Directors, unless the company’s articles of association stipulate otherwise. Generally this remuneration is fixed by the Supervisory Board.”200

**Singapore**

Singapore’s best practices were published in 2001 in *Report of the Committee and Code of Corporate Governance*, based on the work of the Corporate Governance Committee (CGC). The provisions contained in the report are voluntary and non-binding, though the CGC recommends that all companies listed on the Singapore Exchange (SGX) disclose the nature of their corporate governance practices, and where they diverge from the recommendations in the code, this should be explained.

**Mission of the board of directors:** “Other than charting corporate
strategy, the Board of Directors is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation.”

- **Stakeholder interests**: not explicitly addressed.

- **Separation of the chairperson and CEO functions**:
  - “The roles of chairman and chief executive officer (‘CEO’) should in principle be separate, to ensure an appropriate balance of power, increased accountability and greater capacity of the Board for independent decision-making.”
  - “As a principle, the CGC is inclined towards the [separation] view, so as to help ensure an appropriate balance of power and increased accountability. Such a separation (of the chairman and CEO) is important because it enhances the independence of the board in monitoring management. This is especially important in Singapore where the board tends to include a significant executive element, unlike most boards of the best-managed companies in the US, where almost all directors are independent. Moreover, as other mechanisms that discipline management (such as an active take-over market and shareholder activism) are less developed here, there is increased need for a dual leadership structure.”

- **Inside and outside (independent) directors**:
  - “There should be a strong and independent element on the Board, which is able to exercise objective judgment on corporate affairs independently, in particular, from Management. No individual or small group of individuals should be allowed to dominated the Board’s decision-making.”
  - “The CGC subscribes to the view that Boards must have some degree of independence from Management in order to effectively fulfill their responsibilities. Accordingly, the Committee recommends that independent directors make up at least one-third of the Board. Such independent board members play an important role in areas where the interest of Management, the company and shareholders may diverge, such as executive remuneration, success planning changes of corporate control and the audit function.”

- **Independence criteria**:
  - “An ‘independent’ director is one who has no relationship with the company, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director’s independent judgment with a view to the best interests of the company.”
- “The NC [Nominating Committee] is also charged with determining annually whether or not a director is independent....”

**Structure of board committees:**
- “Companies should establish a Nominating Committee (‘NC’) to make recommendations to the Board on all board appointments. The NC should comprise at least three directors, a majority of whom, including the chairman, should be independent.”
- “The Board should set up a Remuneration Committee (‘RC’) comprising a majority of non-executive directors who are independent of Management and free from any business or other relationships.... The RC should be chaired by an independent non-executive director who is knowledgeable in the field of executive compensation....”
- “The Board should establish an Audit Committee (‘AC’) with written terms of reference which clearly set out its authority and duties.... The AC should comprise at least three directors, all non-executive, the majority of whom, including the chairman, should be independent.”

**Outside advice:** “The Board should have a procedure for directors, either individually or as a group, in the furtherance of their duties, to take independent professional advice, if necessary, at the company’s expense.”

**Disclosure (financial, compensation, governance):**
- “Companies should regularly convey pertinent information, gather views or inputs and address shareholders’ concerns. In disclosing information, companies should be as descriptive, detailed and forthcoming as possible, and avoid boilerplate disclosures.”
- “Listed companies are thus required to disclose their corporate governance practices and give explanations for deviations in their annual reports for Annual General Meetings ....”
- “Each company should provide clear disclosure of its remuneration policy, level and mix of remuneration, and the procedure for setting remuneration, in the company’s annual report.”
- “Whilst the alignment of interest is important, shareholders also need to be adequately informed on such [equity incentive] schemes and to understand the premise of such schemes, to ensure they are receiving due reward for the dilution that equity participation entails.”

**Shareholder rights and voting:**
- “Companies should encourage greater shareholder participation at AGMs, and allow shareholders the opportunity to communicate their views on various matters affecting the company.”
“Shareholders should have the opportunity to participate effectively and to vote in AGMs.”

**Executive compensation:**
- “The level of remuneration should be appropriate to attract, retain and motivate the directors needed to run the company successfully but companies should avoid paying more for this purpose. A proportion of the remuneration, especially that of executive directors, should be linked to performance.”
- “There should be a formal and transparent procedure for fixing the remuneration packages of individual directors.”
- “It is also hoped that corporations will utilize the use of longer-term incentive schemes, including shares and share option schemes. This is to align the interests of directors and executives with those of shareholders through holding a direct equity stake in the future of the company.”

### SOUTH AFRICA

South Africa’s best practice principles date back to 1992, when the Institute of Directors created the King Committee to explore the topic of governance practices. The findings and recommendations were originally released in the 1994 *King Report on Corporate Governance*. Some of the original recommendations in the 1994 King Report were strengthened by legislative changes and alterations to listings on the Johannesburg Stock Exchange (now the JSE Securities Exchange). The existing best practice standards (which were, and remain, voluntary) were revisited in 2001 to take account of new corporate directives and operating circumstances, and a revised *King Report on Corporate Governance* was issued in 2002. (All citations below refer to the 2002 report.)

**Mission of the board of directors:** “The board is the focal point of the corporate governance system. It is ultimately accountable and responsible for the performance and affairs of the company.”

**Stakeholder interests:** “The stakeholders relevant to the company’s business should also be identified… The relationship between the company and its stakeholders should be mutually beneficial. A wealth of evidence has established that this inclusive approach is the way to create sustained business success and steady, long-term growth in shareowner value.”
Separation of the chairperson and CEO functions:
- “There should be a clearly accepted division of responsibilities at the head of the company, to ensure a balance of power and authority, such that no one individual has unfettered powers of decision-making.”
- “The chairperson should preferably be an independent non-executive director.”
- “Given the strategic operational role of the chief executive officer, this function should be separate from that of the chairperson.”
- “Where the roles of the chairperson and chief executive officer are combined, there should be either an independent non-executive director serving as deputy chairperson or a strong independent non-executive director element on the board. Any such decision to combine roles should be justified each year in the company’s annual report.”

Inside and outside (independent) directors:
- “The board should comprise a balance of executive and non-executive directors, preferably with a majority of non-executive directors, of whom sufficient should be independent of management so that shareholder interests (including minority interests) can be protected.”
- “Non-executive directors should be individuals of caliber and credibility, and have the necessary skill and experience to bring judgment to bear independent of management....”

Independence criteria: “[An] independent director is a non-executive director who: (i) is not a representative of a shareholder who has the ability to control or significantly influence management; (ii) has not been employed by the company or the group of which it currently forms part, in any executive capacity for the preceding three financial years; (iii) is not a member of the immediate family of an individual who is, or has been in any of the past three financial years, employed by the company or the group in an executive capacity; (iv) is not a professional advisor to the company or the group, other than in a director capacity; (v) is not a significant supplier to, or customer of the company or group; (vi) has no significant contractual relationship with the company or group; and (vii) is free from any business or other relationship which could be seen to materially interfere with the individual’s capacity to act in an independent manner.”

Structure of board committees:
- “Board committees are an aid to assist the board and its directors in discharging their duties and responsibilities, and boards cannot shield behind these committees...”
“At a minimum, each board should have an audit and a remuneration committee. Industry and company specific issues will dictate the requirement for other committees.”

“All board committees should preferably be chaired by an independent non-executive director, whether this is the board chairperson or some other appropriate individual.”

“Procedures for appointments to the board should be formal and transparent … assisted where appropriate by a nomination committee. This committee should constitute only non-executive directors, of whom the majority should be independent, and be chaired by the board chairperson.”

“Companies should appoint a remuneration committee or such other appropriate board committee, consisting entirely or mainly of independent non-executive directors, to make recommendations to the board within agreed terms of reference on the company’s framework of executive remuneration and to determine specific remuneration packages for each of the executive directors… This committee must be chaired by an independent non-executive director.”

“The board should appoint an audit committee that has a majority of independent non-executive directors. The majority of the members of the audit committee should be financially literate… The chairperson should be an independent non-executive director and not the chairperson of the board.”

**Outside advice:**

“The board should have an agreed procedure whereby directors may, if necessary, take independent professional advice at the company’s expense.”

“Board committees should be free to take independent outside professional advise as and when necessary.”

**Disclosure (financial, compensation, governance):**

“It is the board’s duty to present a balanced and understandable assessment of the company’s position in reporting to stakeholders. The quality of the information must be based on the principles of openness and substance over form.”

“Companies should provide full disclosure of director remuneration on an individual basis, giving details of earnings, share options, restraint payments and all other benefits.”

“The board is responsible for disclosures in relation to risk management….”

**Shareholder rights and voting:** “Shareowners obtain their power
from the democratic process of voting by which means they can elect or dismiss directors, who carry out the objectives of the company.”

**Executive compensation:**
- “Companies should establish a formal and transparent procedure for developing a policy on executive and director remuneration which should be supported by a Statement of Remuneration Philosophy in the annual report.”
- “Levels of remuneration should be sufficient to attract, retain and motivate executives of the quality required by the board.”
- “Performance-related elements of remuneration should constitute a substantial portion of the total remuneration packages of executives in order to align their interests with those of the shareowners and should be designed to provide incentives to perform at the highest operational standards.”

**SPAIN**

Spanish best practices are contained in a reported entitled *Governance of Spanish Companies*, released in early 1998 and based on the work of a government-appointed Special Committee for the Study of a Code of Governance. The resulting code is a voluntary framework aimed primarily at large listed companies (although it can be applied to smaller, as well as non-listed, firms).

**Mission of the board of directors:**
- “The Board of Directors should take charge of the general function of supervision as its core mission, directly carrying out – not delegating – the responsibilities it entails.”
- “[T]he general function of supervision is the most genuine function of the Boards of Directors … guiding the company’s policies and strategies, controlling management and liaising with shareholders.”
- “[T]he … ultimate corporate goal and consequently criterion that must rule the performance of the Board of Directors, [is] the maximization of the corporate value or … the creation of shareholder value.”

**Stakeholder interests:** not explicitly addressed.

**Separation of chairperson and CEO functions:** “[T]he concern of maintaining optimal conditions for the proper fulfillment of the general function of supervision leads us to recommend that some cautionary measures be adopted whenever one individual is to hold the two posi-
tions … creating counterweights allowing the Board of Directors to operate independently from the management team and to keep its power to control it. Said measures can be issued in many ways, although the most effective one could be to appoint, among the independent directors, a Vice-President with coordination functions."\(^\text{248}\)

■ Inside and outside (independent) directors:
  – “The Board of Directors should incorporate a reasonable number of independent directors who have a good reputation in their profession and are detached from the management team and from the significant shareholders.”\(^\text{249}\)
  – “Outside directors (proprietary and independent) should widely outnumber executive directors on the Board of Directors ….”\(^\text{250}\)

■ Independence criteria:
  – “[T]he name [independent director] applies to those directors who are neither linked to the management team nor to the core of shareholder groups that control and exert a great influence upon management.”\(^\text{251}\)
  – “[W]ould-be directors [must be] independent from the influence that controlling shareholder groups may exert on the management team.”\(^\text{252}\)

■ Structure of board committees: “The Board of Directors should create Control Committees within the Board, made up solely of outside directors, for information and accounting control matters (Audit Committee), the selection of directors and executives (Nomination Committee), defining and reviewing remuneration policies (Remuneration Committee), and evaluating the governance system (Compliance Committee).”\(^\text{253}\)

■ Outside advice: “The right of all directors to collect and obtain the information and advice needed to fulfill their supervision functions must be formally recognized. Appropriate channels should be created to exercise this right, even resorting to outside experts in special circumstances.”\(^\text{254}\)

■ Disclosure (financial, compensation, governance):
  – “[T]he Board of Directors [should be] offering immediate and sufficient information not only on relevant facts that may have a sizeable influence on price formation in the stock market, but also on anything that may: influence the company’s ownership structure … involve a substantial change of governance rules...deal with specifically relevant linked transactions … or have to do with the company’s equity.”\(^\text{255}\)
- “[T]he Committee recommends that director remuneration information policies be grounded on a principle of maximum transparency.”

- “The Board of Directors should include in its public annual report some information concerning its governance rules, providing an explanation in connection with any rules deviating from the recommendations of this Committee.”

- “Any periodic financial information which is made available to markets … must be produced according to the same principles and professional practices as the annual accounts and must be verified by the Audit Committee prior to its disclosure.”

- **Shareholder rights and voting:** “All shareholders are, as a whole, the owners of the company, but the different roles of each of the groups of shareholders requires that moderation or counterweight steps are passed so that none of the groups assumes power at the expense of the interest of other groups.”

- **Executive compensation:** not explicitly covered.

**SWEDEN**

In Sweden, corporate governance best practices are set forth in the 1994 document *Introduction to a Swedish Code of Good Boardroom Practice*, which was sponsored by the Swedish Academy of Directors. The provisions contained in the report are voluntary.

- **Mission of the board of directors:** “The Board of Directors is responsible for the organization of the company and for the administration of the affairs of the company…. The Board of Directors carries the total responsibility for the company … [and] shall initiate changes and evaluate different options. The boardroom work shall be practical and aimed at developing the company.”

- **Stakeholder interests:** not explicitly addressed.

- **Separation of chairperson and CEO functions:** not explicitly addressed.

- **Inside and outside (independent) directors:**
  - “External board members, adding competence to the company, are understood as being very positive.”
  - “In the Board of Directors of the parent company, the ‘heaviest’ owners should be represented [plus] three to four board members,
who by way of their skills can contribute to the development of the company and to support the Managing Director.”

- **Independence criteria:** not explicitly covered.

- **Structure of board committees:** “Several larger companies have appointed Nomination, Remuneration, and Auditing Committees to propose remuneration to board members and to the managing director at the [Annual Meeting]. The Auditing Committee, consisting of some of the board members, shall meet the accountants at least once a year. The managing director is not to participate in this committee.”

- **Outside advice:** not explicitly covered.

- **Disclosure (financial, compensation, governance):** not explicitly covered.

- **Shareholder rights and voting:**
  - “[T]he Annual General Meeting [is] the shareholders’ own institution and the highest decision-making body.”
  - ‘The right of the stockholders to make decisions regarding the affairs of the company is exercised at the Annual General Meeting. It is then, and only then, that the owners of the company in their capacity as owners can make their voices heard.’
  - “Only shareholders entered in the stock register are entitled to vote.”
  - “In case the [company’s] Articles of Association must be changed, the change must be made with at least 2/3 majority of shares as well as of votes at the AGM. The reason is to protect minorities.”

- **Executive compensation:** not explicitly covered.

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**SWITZERLAND**

Swiss corporate governance best practices are contained in the 2002 document *Swiss Code of Best Practice for Corporate Governance*, sponsored by the Swiss Business Federation. Although the best practices set forth are largely voluntary they are consistent, in some cases, with mandatory requirements created by the Swiss Stock Exchange (SWX) under the SWX-Directive on Information Relating to Corporate Governance and its Annex.

- **Mission of the board of directors:** “The Board of Directors, which is elected by the shareholders, is responsible for the strategic direction of the company or the group. The Board of Directors should determine the strategic goals, the general ways and means to achieve them and the
individuals charged with management. In its planning it should ensure the fundamental harmonization of strategy and finances.”

- **Stakeholder interests:** not explicitly addressed.

- **Separation of chairperson and CEO functions:** “The principle of maintaining a balance between direction and control should also apply to the top of the company. The Board of Directors should determine whether a single person (with joint responsibility) or two persons (with separate responsibility) should be appointed to the Chair of the Board of Directors and the top position of the Executive Management…. If, for reasons specific to the company or because the circumstances relating to availability of senior management makes it appropriate, the Board of Directors decides that a single individual should assume joint responsibility at the top of the company, it should provide for adequate control mechanisms. The Board of Directors may appoint an experienced non-executive member (“lead director”) to perform this task. Such person should be entitled to convene on his own and chair meetings of the Board when necessary.”

- **Inside and outside (independent) directors:** “A well-balanced membership of the Board of Directors should be sought for. The Board of Directors should be small enough in numbers for efficient decision-making and large enough for its members to contribute experience and knowledge from different fields and to allocate management and control functions among themselves….The majority of the Board should, as a rule, be composed of members who do not perform any line management function within the company (non-executive members).”

- **Independence criteria:**
  - “Each member of the Board of Directors and Executive Board should arrange his personal and business affairs to avoid, as far as possible, conflicts of interest within the company.”

- **Structure of board committees:**
  - “The Board of Directors should form committees to perform defined tasks.”
  - “As regards committee members, particular rules on independence should be applied. It is recommended that a majority of the members of certain committees be independent.”
“The Board of Directors should set up an Audit Committee. The Committee should consist of non-executive, preferably independent, members of the Board of Directors. The Audit Committee should form an independent judgment of the quality of the external auditors, the internal control system and the annual financial statements.”

“The Board of Directors should set up a Compensation Committee. A majority of the Compensation Committee should consist of non-executive and independent members of the Board of Directors. The Committee should see to the defining of a remuneration policy, primarily at top company level.”

“The Board of Directors should set up a Nomination Committee. The Nomination Committee should lay down the principles for the selection of candidates for election or re-election to the Board of Directors and prepare a selection of candidates in accordance with these criteria.”

**Outside advice:** “The Board of Directors may obtain at the company’s expense independent advice from external experts on important business matters.”

**Disclosure (financial, compensation, governance):**

- “The company should disclose information on Corporate Governance in its annual report.”


**Shareholder rights and voting:**

- “As investors, shareholders have the final decision within the company. The powers of the shareholders are defined by statute. They alone are entitled to make decisions with regard to personnel matters at the top company level … the final approval of accounts and policy on distributions and shareholders’ equity. The shareholders determine in the Articles of Association the purpose of the company and other key elements and rules. Their approval is required for decisions on mergers, de-mergers, changes in the Articles of Association and liquidation. Shareholders exercise their rights in the General Shareholders’ Meeting and have the right to make motions on items prescribed by the agenda.”

- “In the General Shareholders’ Meeting the will of the majority should be clearly and fairly expressed.”
Executive compensation: “The Compensation Committee should take care that the company offers an overall package of remuneration which corresponds to performance and the market, in order to attract and retain persons with necessary skills and character. The remuneration should be demonstrably contingent upon sustainable company success and the individual contribution by the person in question. False incentives should be avoided.”\textsuperscript{283}

UNITED KINGDOM

The UK’s best practices are documented through several landmark reports, including the Report of the Committee on the Financial Aspects of Corporate Governance (also known as the Cadbury Report, released in 1992), the Study Group on Directors’ Remuneration: Final Report (also known as the Greenbury Report, released in 1995), the Committee on Corporate Governance: Final Report (also known as the Hampel Report, released in 1998) and the London Stock Exchange’s LSE: The Combined Code: Principles of Good Governance and Code of Best Practice (also released in 1998, based in part on recommendations set forth in the Hampel Report). These were supplemented by the 1999 publication of the Institute of Chartered Accountants’ Internal Control: Guidance for Directors on the Combined Code (also known as the Turnbull Report) on director and management accountability. The Higgs Report followed in 2003, with a specific focus on the board of directors and the possibility for legislative changes (along the lines of the US Sarbanes–Oxley Act). In the event, Higgs recommended only certain best practice changes be included in the Combined Code.

The Cadbury Report was a pioneering study in corporate governance practices and influenced many subsequent commission studies and recommendations (indeed, it was the forerunner of the Greenbury, Hampel, Turnbull, and Higgs Reports and the LSE’s Combined Code). While aspects of Cadbury and its successors are purely informational and voluntary, the Combined Code requires listed companies to disclose specifically how they apply Code principles (good governance, including recommendations in the Cadbury, Greenbury, and Hampel Reports) and whether they comply with Code provisions (that is, best practices).

Mission of the board of directors:

– “The board should … retain full and effective control over the company and monitor the executive management.”\textsuperscript{284}

– “The single overriding objective shared by all listed companies … is the preservation and the greatest practicable enhancement over time of their shareholders’ investment. All boards have this respon-
sibility and their policies, structure, composition and governing processes should reflect this.”

– “Every listed company should be headed by an effective board which should lead and control the company.”

**Stakeholder interests:**

– “Good governance ensures that constituencies (stakeholders) with a relevant interest in the company’s business are fairly taken into account.”

– “As regards stakeholders, different types of company will have different relationships and directors can meet their legal duties to shareholders, and pursue the objective of long-term shareholder value successfully, only by developing and sustaining these stakeholder relationships.”

**Separation of chairperson and CEO functions:**

– “Given the importance and particular nature of the chairman’s role, it should in principle be separate from that of the chief executive. If the two roles are combined in one person, it represents a considerable concentration of power…. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognized senior member.”

– “There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company’s business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.”

– “Whether the posts are held by different people or by the same person, there should be a strong and independent non-executive element on the board, with a recognized senior member other than the chairman to whom concerns can be conveyed.”

**Inside and outside (independent) directors:**

– “The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board’s decisions.”

– “The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board’s decision-taking.”

**Independence criteria:** “[T]he majority of non-executives on a board should be independent of the company. This means that apart from
their directors’ fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with exercise of their independent judgment. It is for the board to decide in particular cases whether this definition is met.”

**Structure of board committees:**
- “[A] nomination committee should be established to make recommendation to the board on all new board appointments. A majority of the members of this committee should be non-executive directors, and the chairman should be either the chairman of the board or a non-executive director.”
- “Remuneration committees should consist exclusively of non-executive directors who are independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment.”
- “The board should establish an audit committee of at least three directors, all non-executive, with written terms of reference which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent non-executive directors, should be named in the report and accounts.”

**Outside advice:** “Occasions may arise when directors have to seek legal or financial advice in the furtherance of their duties. They should always be able to consult the company’s advisors. If, however, they consider it necessary to take independent professional advice … they should be entitled to do so at the company’s expense, through an agreed procedure laid down formally, for example in a Board Resolution, in the Articles, or in the Letter of Appointment.”

**Disclosure (financial, compensation, governance):**
- “The board should present a balanced and understandable assessment of the company’s position and prospects.”
- “The board should report to the shareholders each year on remuneration. The reports should form part of, or be annexed to, the company’s annual report and accounts…. It should be the main vehicle through which the company reports to shareholders on directors’ remuneration.”
- “[L]isted companies should state in the report and account whether they comply with the [Cadbury Report] Code and identify and give reasons for any areas of non-compliance.”
- “[The Committee] recommends that companies should include in their annual report and accounts a narrative statement of how
they apply the relevant principles to their particular circumstances. Given that the responsibility for good corporate governance rests with the board of directors, the written description of the way in which the board has applied the key principles of corporate governance represents a key part of the process."

- “The cardinal principle of financial reporting is that the view presented should be true and fair. Further principles are that boards should aim for the highest level of disclosure consonant with presenting reports which are understandable and with avoiding damage to their competitive position. They should also aim to ensure the integrity and consistency of their reports and they should meet the spirit as well as the letter of reporting standards.”

### Shareholder rights and voting:
- “The right to vote is an important part of the asset represented by a share, and in our view an institution has a responsibility to the client to make considered use of it.”
- “The formal relationship between shareholders and the board of directors is that shareholders elect the directors, the directors report on their stewardship to the shareholders and the shareholders appoint the auditors to provide an external check on the directors’ financial statements.”
- “Institutional investors should make positive use of their voting rights, unless they have good reason for doing otherwise. The should register their votes whenever possible on a regular basis.”
- “Institutional investors should … take steps to ensure that their voting intentions are being translated into practice … institutions should, on request, make available to their clients information on the proportion of resolutions in which votes were cast and non-discretionary proxies lodged.”
- “The Annual General Meeting provides the opportunity for shareholders to make their views … known to their boards…. [S]hareholders can play a more practical governance role by aiming to influence board policies this way, than by seeking to make the detail of board decisions subject to their vote.”

### Executive compensation:
- “Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual executive directors. No director should be involved in deciding his or her own remuneration.”
- “The performance-related elements of remuneration should form a significant proportion of the total remuneration package of
executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels.”

**UNITED STATES**

Just as in the UK, various best practice frameworks have been put forth in the United States over the years, most of them voluntary and non-binding. Four such frameworks include the 1996 National Association of Corporate Directors’ (NACD) *Report of the National Association of Corporate Directors Commission*, the 1998 Business Roundtable’s (BRT) *Statement on Corporate Governance*, the 2002 New York Stock Exchange’s *NYSE Corporate Governance Rule Proposals* (which are binding for NYSE-listed companies) and the 2003 Conference Board’s *Commission on Public Trust and Private Enterprise: Findings and Recommendations*. As noted in Chapter 10, many of these are reinforced or supplemented by legislative requirements under the Sarbanes–Oxley Act of 2002.

- **Mission of the board of directors:**
  - “The objective of the corporation (and therefore of its management and board of directors) is to conduct its business activities so as to enhance corporate profit and shareholder gain. In pursuing this corporate objective, the board’s role is to assume accountability for the success of the enterprise by taking responsibility for the management, in both failure and success. This means selecting a successful corporate management team, overseeing corporate strategy and performance, and acting as a resource for management in matters of planning and policy.”
  - “A key role of the board of directors is to provide oversight to ensure that management acts in the best long-term interest of the corporation and thus in the best long-term interest of its shareholders…. Only a strong, diligent board, with a substantial majority of independent directors that both understands the key issues and asks the management the tough questions, is capable of ensuring that shareowner interests are properly served.”

- **Stakeholder interests:**
  - “[T]he board should clearly define its role, considering both its legal responsibilities to shareholders and the needs of other constituencies, provided shareholders are not disadvantaged.”
  - “[T]o manage the corporation in the long-term interests of the stockholders, management and the board of directors must take into
account the interests of the corporation’s other stakeholders.… [T]he paramount duty of management and of boards of directors is to the corporation’s stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders.”

– “Although most state corporation laws establish that corporations should be run to enhance that corporation’s economic interests, and therefore the interests of its shareowners, corporations are also expected to fulfill their legal and ethical obligations to other constituencies. [R]espect and concern for a range of corporate constituencies, including employees, customers communities and suppliers, contributes to a positive climate for optimal corporate behavior.”

Separation of chairperson and CEO functions:
– “The purpose of creating [a separation in the functions] is not to add another layer of power but instead to ensure organization of, and accountability for, the thoughtful execution of certain critical independent director functions.… Boards should consider formally designating a non-executive chairman or other independent board leader. If they do not make such a designation they should designate … independent members to lead the board in its most critical functions.”

– “The Commission notes three principal approaches to provide the appropriate balance between board and CEO functions: (a) Each corporation should give careful consideration to separating the offices of the Chairman of the Board and CEO, with those two roles being performed by separate individuals. The Chairman would be one of the two independent directors. (b) The roles of Chairman and CEO would be performed by two separate individuals; however, the Chairman could be a non-independent director … but would not be a member of management and would not report to the CEO. Where the Chairman is not one of the independent directors, a Lead Independent Director position … should be established. (c) Where boards chose not to separate the Chairman and CEO position, or when they are in transition … a Presiding Director position should be established.”

Inside and outside (independent) directors:
– “Boards should require that independent directors fill the substantial majority of board seats.”

– “It is important for the board of a large, publicly-owned corporation to have a substantial degree of independence from management. Accordingly, a substantial majority of the directors of such a corporation should be outside (non-management) directors.”
“A substantial majority of the board should be composed of independent directors. Independent directors should not only be independent in accordance with legislative and stock exchange listing requirements, but should also act independently of management.”

“Listed companies must have a majority of independent directors. Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.”

Independence criteria:

“A director will be considered independent if he or she: has never been an employee of the corporation or any of its subsidiaries; is not a relative of any employee of the company; provides no services to the company; is not employed by any firm providing major services to the company; receives no compensation from the company, other than director fees.”

“No director qualifies as independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.”

“(i) No director who is a former employee of the listed company can be independent until five years after the employment has ended. (ii) No director who is, or in the past five years has been, affiliated with or employed by an auditor of the company can be independent until five years after the end of either the affiliation or the auditing relationship. (iii) No director can be independent if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that concurrently employs the director; (iv) Directors with immediate family members in the foregoing categories are likewise subject to the five-year cooling off provisions for purposes of determining independence.”

Structure of board committees:

“Boards should require that key committees – compensation, audit, and nominating or governance – include only independent directors, and are free to hire independent advisors as necessary.”

“It is recommended that each corporation have an audit committee … a compensation/personnel committee, and a nominating/governance committee and that the membership in these committees be limited to outside directors.”
“The Commission believes that it is important that each corporation establish a committee of independent directors to oversee corporate governance issues, including the statement of corporate governance principles and the performance evaluations of the board, its committees and each director, as necessary. Each listed company, other than controlled companies, should have a nominating/corporate governance committee comprised entirely of independent directors (or functional equivalent consisting solely of independent directors).”

“Audit committees should be vigorous in complying with the numerous new requirements … and proposed listing standards. Members of the audit committee must be independent and have both knowledge and experience in auditing financial matters. The board of directors should assess the independence and qualifications of the members of the audit committee, using outside counsel or consultants if desirable, to ensure that each qualifies for membership on the committee.”

“Listed companies must have a nominating/governance committee composed entirely of independent directors.”

“Listed companies must have a compensation committee composed entirely of independent directors.”

“The Exchange will continue to require each company to have a minimum three person audit committee composed entirely of independent directors … at least one member of the audit committee must have accounting or related financial management expertise.”

“The audit committee must have a written charter that addresses: the committee’s purpose – which, at minimum, must be to: (a) assist board oversight of (1) the integrity of the company’s financial statements, (2) the company’s compliance with legal and regulatory requirements, (3) the independent auditor’s qualifications and independence and (4) the performance of the company’s internal audit function and independent auditors; and (b) prepare the report that SEC rules require to be included in the company’s annual proxy statement.”

Outside advice:

“Boards and board committees occasionally need independent advice. In most cases, the company and the board can jointly satisfy their needs through the retention of a common resource. In other cases, given different roles and responsibilities of management and the board, the board may need to retain its own professional advisors…. Under special circumstances, the board and
board committees may wish to hire their own outside counsel, consultants and other professionals to advise the board.”

- “There may … be occasions when it is appropriate for the board to seek legal or other expert advice from a source independent of management, and generally this would be with the knowledge and concurrence of the CEO.”

- “Boards should develop an appropriate committee structure, retaining outside advisors and staff as appropriate, to fulfill their responsibilities.”

- “In the course of fulfilling its duties, the audit committee may wish to consult with independent advisors. The audit committee must be empowered to retain these advisors without seeking board approval.”

- **Disclosure (financial, compensation, governance):**
  - “Public companies should revise their internal controls to reflect a broad risk-based approach and to support the certification process for both financial reports and internal controls. As part of the requirements of Section 302 of the [Sarbanes–Oxley] Act, the principal executive officer and principal financial officer must certify that they have designed disclosure controls and procedures.”
  - “It is important that each board consider its policies and practices on corporate governance matters. Whether or not a board will formalize its board practices in written form will vary on the particular circumstances.”
  - “Listed companies must adopt and disclose corporate governance guidelines … [including]: Director qualification standards. Director responsibilities. Director access to management and, as necessary and appropriate, independent advisors. Director compensation. Director orientation and continuing education. Management succession. Annual performance evaluation of the board.”

- **Shareholder rights and voting:** “Shareowners, particularly long-term shareowners, should act more like responsible owners of the corporation. They should have not only the motivation, but also the ability, to participate in the corporation’s election process through involvement both in the nomination of directors and in proposals in the company’s proxy statement about business issues and shareholder concerns regarding governance of the corporation…. Shareowner involvement in the corporation’s governance is primarily through the corporate electoral process where shareowners are given the statutory right to vote on only a limited number of matters of significance … including, for example, election of directors, mergers and amendments to charter documents.”
**Executive compensation:**

- “[The] board should … determine the method for selecting and compensating the CEO.”

- “Boards have a responsibility to ensure that compensation plans are appropriate and competitive and properly reflect the objectives and performance of management and the corporation…. Stock options and other equity-oriented plans should be considered as a means for linking management’s interests directly to those of shareholders.”

- “In determining the long-term incentive component of CEO compensation, the [compensation] committee should consider the company’s performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company’s CEO in past years.”

- “Equity compensation plans can help align shareholder and management interest, and equity-based awards have become very important components of employee compensation. In order to provide checks and balances on the process of earmarking shares to be used for equity-based awards, and to provide shareholders a voice regarding the resulting dilution, the Exchange requires that all equity-compensation plans, and any material revisions to the terms of such plans (including the repricing of existing options), be subject to stockholder approval.”
CHAPTER 1: GOVERNANCE DEFINED

1 Items that appear in bold italics are defined and cross-referenced in the “Language of governance” glossary appearing at the end of the book.

2 Naturally, aspects of corporate structure and the rights of shareholders date back even further, e.g. to the seventeenth century when the English chartered various corporate operations.

3 In fact, corporate governance reform proposals have emerged with each bad global economic cycle, including 1970–5, 1978–80, 1991–3, and 2001–3. This is not surprising, as scandals often seem to happen at the peak of economic “bubbles” when markets are strong, profits are being accumulated and few are willing to question, challenge, or analyze how or why money is being made. Only when these economic “bubbles” burst does the extent of the damage become evident.

4 All of these changes have led to growth in local and global equity markets, meaning a greater supply of, and demand for, corporate equities.


7 Enron ranked seventh in the world in revenues in 2001.

8 For instance, in the United States there is widespread belief that corporate misbehavior is the norm rather than the exception. A July 2002 survey revealed that 76 percent of those surveyed believe that all companies are engaged in corporate wrongdoings and have been, or will be, caught; only 16 percent felt that the scandals appearing in 2000–2 were isolated events (CNN/USA Today, Gallup poll). In a Conference Board survey, 79 percent of those polled thought corporate executives take improper actions at the...
expense of their companies very often (or somewhat often) and only 23 percent felt CEOs of large corporations can be trusted (Conference Board, 2003).

9 For simplicity we confine our discussion to senior and subordinated debt and common stock, ignoring intermediate classes of capital that rest between the two, such as mandatory convertible bonds and various classes of voting and non-voting preferred stock.

10 The legal concept of private property is centered on rights over resources that the owner is free to exercise and that are protected from others.

11 Originally, dividends were only paid from surplus profits, such as retained earnings (though US and UK companies did not feature this restriction until the latter part of the nineteenth century). Thus, a “distribution of profit” in the form of a dividend was based on a company’s real ability to generate profit. This structure was intended to protect creditors by making it illegal to borrow money to pay equity holders. Loosening of this restriction has occurred in various countries over the years.

12 Although the history of corporation law is interesting and extensive, it is well beyond the scope of this book. However, some brief background on the development of the common law-based company (e.g. the US/UK model) during the seventeenth century provides some useful perspective. For instance, in the United States and the UK, which draw their legal basis from English law, a company “franchise” could originally be granted only by the state. Although such grants have long since disappeared, what remains is the corporate body as we understand it today (including the right to conduct business in a corporate name, to sue and be sued, and provide for perpetual succession with ownership passing hands). The concept of limited liability – which says that only a company (and not its stockholders) could be liable for its debts – developed during this time. Knowing that responsibilities and obligations did not extend beyond this point allowed investors to allocate their capital to “risky” ventures. The document of grant (for example, a charter, certificate of incorporation) established the number of shares to be issued, officials charged with managing the venture (and the terms), how business was to be conducted and how profits were to be disposed. In the eighteenth and nineteenth centuries most charters – which detailed the scope of enterprise, the method of selecting management, voting rights, and general rights of participants – were specifically legislated (e.g. by individual government legislation), although that soon changed as the number of corporations started expanding.

Once charters granted under specific legislation were abandoned, articles of incorporation were usually drafted with the broadest possible scope so that a wide range of activities could be undertaken (even those that shareholders might not have been aware of). Although shareholders were meant to be risk capitalists, they gained certain protections over time. A corporation was defined and limited in the scope of its activities; capital contributions were
supervised (paid up in cash); and different levels of risk capital were accorded different levels of seniority in the event of liquidation (as we note in Chapter 3). Under common law the concept of residual control arose, namely that the decisions affecting the corporation (e.g. the general interests of the firm) lay with the shareholders. In fact, shareholder power was based on the power to vote on such decisions. For instance, early statutes permitted shareholders to remove company directors at will, a principle that no longer exists in most charters. (The specific power of removal is very uncommon, representing an important “delinking” of ownership and control.) Proxy voting, originally designed as a convenience, is now taken as a standard operating procedure.

Throughout the nineteenth century every shareholder had to pay up capital in order to reap benefits. This was enforced by making those who had not paid in their capital liable for the company’s debts. Indeed, paying up capital was deemed the essential equitable contribution from shareholders to protect creditors. The concept of pre-emptive rights also emerged, giving existing shareholders the right of first refusal to take up additional shares in the company so that their interests would not be diluted, and they had effectively the right to keep their relative participation in the company unchanged. If they chose not to take them up they could sell or assign them to a third party. Paying dividends to shareholders was also strictly regulated; for instance, a company could not pay out dividends if it sustained a loss, a practice that has changed in the modern era. The common stockholder’s position has gradually been eroded throughout the twentieth century through the issuance of preferred stock (paying out a portion of the firm’s dividends to a new class of investors) and the waiver of pre-emptive rights. Thus, during the earliest corporate era a share of stock was equal to a fixed participation in corporate property, with some degree of control. Over time, grants of power permitting management control (without much formal or substantive feedback or accountability) have developed via statutory amendments, enactments based on law, alternations to corporate charters, and so on. As we shall note, many of the original protections are now gone (or are indeterminate at the time of investment), leading to greater need for corporate governance.

For instance, Johns Manville Co., which suffered bankruptcy as a result of asbestos claims, can pay no more claims to remaining plaintiffs, as it has no more capital.

Legal piercing in a bankruptcy situation tends to occur primarily in closely held companies where the company’s managers are also its primary and majority owners, and are found to have acted improperly or imprudently.

For instance, a bank as lender might include a loan covenant that caps the maximum amount of leverage or minimum amount of liquidity. If a company’s potential investment might breach either covenant it will be barred from undertaking the project.
16. Some argue that the current stock price also embeds the future value of the firm through a discounting of expected future cash flows from operations and growth in earnings (and dividends, if applicable) and is thus a fair and important measure. The question remains, however, to what extent the firm is truly capable of generating such cash flows and earnings, and to what extent such cash flows and earnings are based on accounting treatment.

17. For instance, if a company is truly attempting to maximize shareholder value, it might transform itself into a highly leveraged firm that invests in high risk/high NPV projects, and so incur the cost inefficiencies of potential financial distress (for instance, weaker credit terms).

18. For instance, if a company has market value to book value ratio of 1.0, it has no competitive advantage or disadvantage and is only going to earn what might be termed “normal” or “average” profits. In order to boost the value of the firm, the company must have some long-term competitive advantage that allows it to earn more than average on its assets. Thus, a market to book value ratio of 3.0 (compared with the original 1.0), with earnings going straight back to the company, generates twice the normal competitive return, a fact that should be reflected in a higher stock price. During the Japanese “boom years” of the late 1980s, market to book values were routinely in excess of 3.0–10.0, meaning investors saw the chance for companies to earn above average returns for many decades; a highly unlikely event, even for the best and strongest of firms. The same occurred in the United States during the Internet bubble of the late 1990s/early 2000s.

19. More concisely, this can be given as

\[ EV = \sum_{t=1}^{\infty} \frac{NCF_t}{(1 + r)^t} \]

where \( NCF_t \) is corporate cash flow in period \( t \)

\( r \) is a discount rate reflecting the risk free rate and a risk premium.

20. For instance, in the United States over 60 percent of large industry corporations had a majority of inside directors in 1950; by 1965 greater numbers of outsiders started populating boards, and by the 1990s and into the new millennium, most major companies featured some outside directors (in some cases a majority). However, there is still debate as to what constitutes an “outsider”; for instance, in some cases an outside director might still have a business relationship with the company, suggesting the potential for conflict of interest. In other countries, as we shall note, the concept of having a majority of outsiders is still alien.

21. Historically, the management of a company was by contract, which delegated responsibility to board directors, although substantive issues, such as changes in capital structure, change in business scope, and so forth, remained solely with shareholders. Pre-emptive rights, granting existing shareholders the right to take up new shares before they have been offered to outside
shareholders, helped preserve some modicum of control: existing shareholders could opt to keep new shareholders out, by contributing additional capital but receiving additional profit distributions and voting rights. Pre-emptive rights helped avoid dilution. These mechanisms led to the creation of companies with a defined structure. Shareholders were afforded protections via statutory contract or some form of governing law. However, many of these basic structural tenets have dissolved over time, shifting effective control away from shareholders, towards management. We cite just two examples of this gradual control erosion, though we can easily point to many others. For instance, firms are now routinely created as “general incorporation” companies, permitting them to engage in any lawful business. Thus, shareholders no longer need to be consulted by management or directors when expansion into another business is contemplated, and the scope of the firm’s business activities can be altered at the will of management. A second example involves the pre-emptive rights mentioned immediately above; it is quite common for companies to be incorporated without pre-emptive rights (or to seek one-time approval from shareholders on their waiver), meaning existing shareholders have no power over future dilution of their stake. Many other examples of this loss of effective control abound.

22 This was reprinted as Berle and Means 1991.

23 But if these institutional players are strong enough to influence the behavior and path of corporations we must then consider that the institutional players themselves – pension funds, mutual funds, and banks – have a special burden and responsibility, and must themselves be monitored closely. This is most often done through regulation, supervision, and the establishment of fiduciary rules.

24 This type of ownership/control separation was already well entrenched in the United States in the early 1930s. For instance, in 1932, 85 percent of the Top 200 companies in the United States had no shareholders owning more than 10 percent of outstanding shares. This diffusion spread steadily throughout the twentieth century, and it is now uncommon in the United States (and other countries) to see individual stakes of more than a few percent. (Even in Japan and Germany, which arguably have more concentrated family, bank, or industrial shareholdings or cross-shareholdings, absolute percentages are relatively low.) In fact, in many countries it is increasingly apparent that there exists ownership of wealth without control (investors) and control of wealth without ownership.

25 Interestingly, although Japanese companies feature main bank stakes and a certain amount of corporate cross-shareholding, they are actually very representative of the separation between ownership and control. Shareholdings are quite diffuse (except for the items noted above), shareholders are extremely passive, management is entrenched and firmly in charge (boards are largely comprised of inside executive managers), and the interests of
other stakeholders (including employees, creditors, and customers) often rise above those of owners.

26 For instance, German banks typically vote shareholder proxies in favor of the management slate.

27 Large block shareholding (via banks and companies) tends to occur in countries such as Japan and Germany. Although neither country, as we shall discuss later, has a meaningful “activist” institutional sector, legal rules and corporate tradition permit corporate and financial institutions to hold large blocks in other companies, so gaining some degree of leverage over management. This approach is somewhat different in the United States, where legal rules favor those with a large number of small shareholdings, not vice versa. Although laws and rules could be structured to help institutional investors become more active and vocal participants, such is not currently the case. For instance, in the United States active 5 percent shareholders must file 13(d) disclosure statements with the Securities and Exchange Commission (SEC), while 10 percent+ shareholders are subject to “short-swing” profit forfeiture under section 16(b). In addition, so-called “influential shareholders” are considered “control persons” and face significant consequences in the event of bankruptcy, meaning their liability exposure can potentially change. Other legal barriers and legal risks exist (US state law gives managers significant control over the voting agenda and anti-takeover measures). US tax and accounting rules likewise treat large block shareholdings unfavorably. So unless an institution is willing to navigate these legal and tax hurdles (and some pension and investment funds are, to be sure), the theoretical leverage over management may be just that: theoretical rather than actual.


30 In fact, Korean chaebols, or business groups, commonly used pyramiding prior to the 1997 Korean financial crisis and subsequent reform movement. Family-controlled companies in Indonesia and Malaysia also use pyramiding; the structure provides a deceptive view of diffuse ownership and permits maximum use of leverage and minimum reduction in equity control.

31 Companies in various East Asian countries, including Malaysia, Thailand, Indonesia, and the Philippines (and to a lesser extent Korea), often started as family concerns and remain under family control to the present time, primarily through personally owned holding companies or anonymous nominee accounts. The same is apparent in Mexico, where five business groups, controlled by individual family interests through holding companies (“corporativos”), command approximately 60 percent of the country’s stock market capitalization.

32 This is a good example of the “free rider” problem, where many might benefit from changes but few are willing to pay for them.

For instance, Berkshire Hathaway, which operates primarily in the United States and benefits from the liquid capital markets, corporate control activity, and decentralized, entrepreneurial spirit that are characteristic of the market model, also features some of the traits of the relationship model, including support for long-term relationships, insensitivity to short-term stock price moves and keen focus on perpetuation of the enterprise. Many venture capital firms, particularly those centered on emerging technologies that require a medium to long-term commitment, share similar “split” characteristics.

Although the market model is, as the name suggests, more “market oriented” than the relationship model, it is not always more accurate in determining stock price valuations. Although markets are more liquid and transparent (indeed, relationship model systems and their companies can be quite illiquid and thinly traded as a result of concentrated shareholdings), market participants still make valuation errors, particularly when they are relying on “extreme” accounting valuations (as with Internet and telecom stocks during the late 1990s).

Again, although some generalization is necessary, it appears that countries following common law, such as Hong Kong, India, Malaysia, and Singapore, have tended to favor aspects of the market model, although they clearly lack the full set of capabilities that would permit them to conform exclusively to the market model (including a corporate control market and liquid capital markets). Those following civil law, such as China, Korea, and Taiwan, have tended to gravitate toward the relationship model, but again retain certain unique characteristics. Within the Asian sphere itself there are points of convergence and divergence: most countries seem to favor greater board independence and use of committees and improved financial disclosure, but maintain stronger views on corporate social responsibilities and broader stakeholder goals.


CHAPTER 2: INTERNAL GOVERNANCE MECHANISMS: CORPORATE ACCOUNTABILITY

For example, firms such as Disney, Pfizer, and Computer Associates, among others, have found the role to be useful in helping coordinate between different internal constituencies (and sometimes conflicting or competing goals).

Directors may also be shareholders, though their stakes are negligible in comparison with the broader interests they represent.

For instance, the significant financial failures and/or distress at large companies such as Penn Central, Lockheed, Chrysler, and Rolls-Royce, in which
board directors were found to be lacking, helped strengthen aspects of the system.

4 For instance, in Thailand 70 percent of board seats of publicly listed companies are occupied by managers of those companies.

5 In some national systems a block holder is permitted to name a director. In Mexico, for example, a 25 percent shareholder of a private company (10 percent of a public company) has the right to name a director.

6 In 2002 the Japanese Parliament approved changes to the Commercial Code, which included changes to capital increases/new share issuance, stock option grants, share capital attributes/voting classes and corporate governance/board reforms. Under the new voluntary provisions, effective 2003, companies can continue to operate under the “traditional” system, which includes a board of directors and a statutory auditor (which functions much as the audit committee of the board of directors, without the decision-making authority) and a shikko yakuin, who is responsible for implementing, in coordination with other executive managers, strategy developed by the board. Under this structure a company can also create an executive committee composed of subset of board members who, with the salutatory auditor, can approve matters on behalf of the whole board. (Note that the statutory auditor, unique to Japan, cannot be a director or manager, and must be independent. The two primary functions are business audits, which center on ensuring directors are adhering to business judgment rules and articles of incorporation, and financial audits, which center on a review of financial statements prepared by the accounting department and the external auditors.)

Alternatively, firms can opt for the “company with committees” model, which includes a board of directors, three majority independent board committees (audit, compensation, and nomination), a shikko yakuin, and dissolution of the statutory auditor. Few have yet to adopt the new model, although many are expected to over an extended period of time. Note that when a company preserves the original model, the board of directors must be viewed as a management body rather than a monitoring body.

7 The percentage varies by industry: full parity is required in coal, steel, and iron industries, quasi-parity for companies with more than 2000 workers, one-third parity for those with 500–2000 workers. Media companies are exempt from this requirement.

8 As early as 1978 the then SEC Chairperson Williams proposed a complete ban on all inside directorships; the proposal was quickly abandoned.

9 This is despite the fact that the Commercial Code indicates that directors are representatives of the shareholders and requires that they consider a broad range of shareholder issues.

10 Companies like Sony and Orix, among others, have taken a leading role in altering their board practices from the traditional Japanese model to the “company with committees” model.
In fact, US companies began featuring audit committees during the 1970s to focus on financial controls and reporting. By 1982, 98 percent of all NYSE companies had created independent committees. Nominating committees followed as a way of improving the processes related to hiring of directors; by the mid-1980s more than half of the NYSE’s companies had such committees. Compensation committees were last to be added, but became increasingly important as packages became more complex.


In the United States, the duty of care provision is based on the Smith v. Van Gorkom case of 1955. Under this case Van Gorkom, as CEO of TransUnion, may have accepted a low bid for the company from the Pritzker family, and convinced directors to accept it in order to seal the transaction quickly. The directors took no real care regarding the deal, terms, or other potential offers. Following the sale a group of investors sued on the grounds that the sale price received was inadequate. The courts investigated the transaction and found the board of directors was “grossly negligent,” meaning the directors were personally liable for damages. Although the courts agreed that a rapid sale was essential in the particular circumstance, they found no evidence that proper analysis had been done to show the value of the offer. The duty of care was not related to the final decision, but to the process (or lack thereof) in arriving at the final decision.

Insolvency is defined by different legal jurisdictions in different ways. In the United States, for instance, the Delaware Chancery Court (in Geyer v. Ingersoll Publications), has termed insolvency as when a corporation “has liabilities in excess of a reasonable market value of assets held” or “is unable to pay its debts as they fall due in the usual course of business.”

For instance, vicinity of insolvency has been tested in Crédit Lyonnais Bank Netherlands v. Pathe Communications Corp. A controlling shareholder, with a 98 percent stake in the troubled company’s stock, sued the board of directors for breach of fiduciary duty over its refusal to sell the company’s assets (at a price that was deemed to be too low). The investor argued that sale proceeds could have been used to repay bank debt and restore the investor to a control position. The Delaware courts found no such breach of duty, noting that “Where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.”

We need only examine the track record of companies that had incompetent or dishonest executive management to understand the impact on broader organizations: for instance Enron, Bankers Trust, and Drexel Burnham Lambert.

We can point to various instances where proper independence did not exist, which led ultimately to significant problems (for example Barings, Sumitomo Corporation, and Daiwa Bank).
CHAPTER 3: EXTERNAL GOVERNANCE MECHANISMS: SYSTEMIC ACCOUNTABILITY

1. It is also true that in some national systems, government authorities directly own particular corporations, or guarantee their liabilities. In this sense the national system sets the overarching governance criteria that it must then follow. This relationship can be seen in a number of emerging nations, such as Mexico, Brazil, and Indonesia.

2. For instance in Japan regulators play a significant role in corporate oversight, although it is a role that some argue is based more on form than substance. Indeed, regulatory and bureaucratic control is still characteristic in Japan through gyosei shido (“administrative guidance”), a unique combination of regulation, keiretsu group pressure and access to bank credit. Although such administrative guidance, which was in full force through the 1980s and early 1990s, has waned somewhat with deregulation and capital markets access, it remains an important feature of the Japanese corporate landscape. Through administrative guidance the relevant powers (the ministry in charge of a particular industry, group companies, and the main bank) help “guide” a particular company’s activities, actions, and behaviors, so they conform to expectations. However, scandals and financial losses of the past few years, along with the massive bank bad loan problem, have demonstrated that this type of regulatory involvement is not necessarily enough to prevent corporate governance problems.

3. For instance, common law countries (the United States, UK, Singapore, Malaysia, India) and civil law countries (Japan, France, Germany, Korea, Taiwan) treat insider trading of securities in similar way (prohibited, and subject to both civil and criminal action) but filing of shareholder lawsuits in a very different manner (civil law actions are more limiting and inflexible).

4. Although the UK insolvency process based on English common law is well understood and widely used, informal mechanisms are sometimes employed as well. For instance, UK banks (with the support of the Bank of England) often use the “London approach” when a company is entering a period of financial distress. Through this mechanism banks attempt to support, to the extent they can, a distressed company by: maintaining credit facilities and not appointing a receiver; participating in long-term strategic decisions on the basis of full information; agreeing with other banks on whether further financial support can be given, and on what terms; and agreeing to “shared financial losses” for creditors within a single seniority class (while preserving the seniority structure). These provisions are strictly informal and not supported by statutory authority, but are seen as a constructive way of dealing with debtor/creditor relationships without necessarily heading down the path towards liquidation.
5 Cash tender offers reduce the debate over corporate strategy, policy, and direction to a price; an acquirer does not need to negotiate on these points, it simply needs to give shareholders a price that they feel is a fair reflection of the firm’s value. If an investment group seeks to acquire a company by offering a high price through a tender offer, diffuse shareholders are likely to agree; if investors can achieve short-term maximization of value and do not believe they have the ability to influence the company, they have nothing to lose by tendering their shares. Only in concentrated ownership situations, as well as those based on long-term business and investment relationships, does the issue become more complex.

6 There is evidence dating back to the mid-1960s (see Manne, 1965, for instance) of a link between low share prices and activities to replace management through corporate control. For instance, investors that are dissatisfied with management’s performance exit by selling and drive the share price down. At some trigger point “focused capital,” intending to control and change management, begins accumulating a stake in order to make a bid for the company.

7 It is worth noting that in the United States takeovers generally require board approval, while in the UK a potential takeover bidder goes straight to target shareholders for approval.

8 Tender offers are quite popular in the UK.

9 Indeed, the practice of greenmail all but vanished a few years later under the weight of public criticism and unfavorable tax treatment.

10 Germany underwent a period of takeovers/mergers in the mid-1990s based on political reunification forces.

11 Recall from Chapter 1 that voting rights and actual control can be quite separate. For instance, in Germany it is typical for companies to limit the voting rights of any single shareholder to 5–15 percent of all votes, regardless of the size of the stake. This has made it difficult for a potential suitor to amass a significant voting block. It has also been difficult to remove supervisory board members (which might be contemplated in any corporate control action) because of the large labor representation (which often, although not always, sides with incumbent management and directors). When total or majority control exists through family shareholdings (as with certain companies in France and Germany), corporate control activity is very limited (and, some might argue, unnecessary). Activity has also been limited as a result of entrenched boards, multiple share voting classes, pre-emptive rights waivers and standing share repurchase authorizations. Transactions occurring throughout Continental Europe have generally been friendly rather than hostile (for example ABN Bank/Amro Bank, Asea/Brown Boveri, UBS/Swiss Bank Corp, Elf Aquitaine/Total Fina, Generali/INA), as a result of more extensive intercompany networks and cross-shareholdings. Although there has been gradual growth in hostile transactions in recent years, these remain the exception rather than the norm. Many transactions have been
pursued to fulfill horizontal or vertical expansion goals, rather than financial or governance gains. That said, hostile transactions have appeared on occasion: Krupp/Hoesch, Olivetti/Telecom Italia, Continental Tire/Pirelli, Vodafone/Mannesmann serve as examples of prominent hostile deals of the early 1990s and early 2000s.

In fact, the takeover of Hoesch by Krupp in 1991 marked a turning point in German bank support of hostile deals. German banks, in their role as key monitors of corporate activity, had historically not supported hostile transactions. However, Westdeutsche Landesbank (Krupp’s Hausbank) and Deutsche Bank (Hoesch’s Hausbank) each actively supported their companies in the fight. More recently, the cross-border acquisition by the UK’s Vodafone of German giant Mannesmann has put various issues up for inspection. Mannesmann, supported by Hausbank Deutsche Bank, was structured as a diversified conglomerate with interests in coal, steel, and auto production. In the 1990s it entered the telecommunications market with the D2 mobile network; in the late 1990s it also acquired the UK’s Orange network. Under board-directed strategy it started spinning off its industrial assets in favor of telecom properties (straying, some argued, from its core competency). The company experienced rapid growth in its P/E ratio, but lack of an IAS framework or financial transparency made it difficult to discern its real financial position. Vodafone eventually made a friendly offer for Mannesmann, which the CEO and supervisory board rejected as inadequate. Improved terms were then released, but the company continued to fight, even though it lacked any real defense strategy. The board believed labor codetermination would serve as a type of poison pill, as the board’s labor representatives would be unlikely to support the UK telecom company’s strategy, which would almost certainly include layoffs in Germany.

Both companies then appealed directly to shareholders. As votes started swinging towards Vodafone, Mannesmann management attempted to bring in Vivendi as a white knight (a tactic which failed). Shareholders ultimately approved the transaction. After closing, Orange was spun off to France Telecom and large layoffs commenced. The departing chairperson received a €30 million package even as scores were laid off, causing a furor. The board was also accused of, and subsequently sued for, embezzlement and granting of excessive golden parachutes (contrary to shareholder interests). The deal serves as an important study because it shattered several long-held beliefs about the European corporate control market: that labor codetermination means automatic alliance with management; that the Hausbank can always direct or influence the outcome of the deal; that domestic shareholders are unwilling to sell to foreign interests; and that lack of financial transparency will always discourage an acquirer from making a bid.

For instance IBM, GE and others all engaged in large restructurings and spin-offs starting in the early twenty-first century.
For instance, the sale by Diageo of its Burger King unit.

Such as ITT, Gulf and Western, and General Mills, among many others.

A significant portion of the activity in the 1980s was made possible by readily available debt capital, including bank loans and high yield bonds (or junk bonds, securities issued by lower-rated companies). (The bonds were popularized by now-defunct investment bank Drexel Burnham Lambert and its junk bond chief, Milken, who gained notoriety after being convicted of insider trading and other securities law violations.) Junk bonds, in particular, served as a popular method of financing hostile acquisitions, LBOs, MBOs, and the like, granting those with poor credit ratings access to capital markets funding so that they could pursue their corporate control activities. The advent of the corporate control market based on external financing sources also served to remind public companies that they were no longer exempt from the scrutiny provided by the marketplace, which serves as an additional monitoring tool. Although junk bonds and other debt capital market instruments helped make possible some of the era’s corporate control activity, they also drew criticism. Many felt that debt capital raised should have been used for productive growth and investment rather than takeovers, LBOs, or green-mail payments. In addition, the massive amount of leverage accumulated during the 1980s, coupled with an economic slowdown in the early 1990s, led to a record number of defaults in 1991 and 1992 (since surpassed in 2001–2, following another period of leverage and economic slowdown).

It is unclear whether post-1980s unrelated diversification efforts have been successful at all. For instance, General Electric, which is active across a broad range of seemingly unrelated businesses, has generally had strong stock price performance but has also stumbled along the way, and entered the twenty-first century paring back on some businesses. Other unrelated diversification strategies have been disastrous, including those by Enron, Vivendi, and American Express.

For instance, although intra-industry mergers can, and do, lead to layoffs this tends not be a significant problem. In addition, there is no evidence of significant wage cuts for those who remain, no evidence of “pension fund” raiding (only removal of excess funds), and no meaningful cuts in R&D and investment (except in certain areas that are quite capital intensive and potentially duplicative, for example, oil).

For instance, in the 1980s all the major US tire companies were merged or restructured in order to deal with excess capacity problems that company managers were failing to recognize and/or actively address. (Uniroyal and Goodrich were restructured and eventually sold their operations to LBO firm Clayton and Dubilier (which later sold them to Pirelli), General Tire was merged into Continental Tire, Firestone was merged into Bridgestone, and Armstrong into Pirelli.) The corporate control market thus did what management was unwilling or unable to do, to the eventual benefit of shareholders.
19 LBO managers have every incentive to operate as efficiently as possible, as they hold the equity that will be refloated or resold at some future point. Academic studies suggest on average 40–50 percent premiums are earned in selling LBO shares.

20 Concentrated ownership has the added benefit of requiring managers and inside shareholders to bear excess company-specific risks, meaning they are much more likely to operate in an efficient and proper manner. (Returns will, of course, accrue to them.)

21 LBOs have been cited in some academic studies as being effective in reducing agency costs and improving profitability, productivity, and efficiencies by concentrating ownership in a small group of managers. Empirical evidence from nearly two dozen studies of US, Dutch, French, and British companies seems to bear this out, lending some credence to the diffusion and agency arguments discussed in Chapter 1 (although the same evidence also points out that employment and research and development investment can suffer). (See Wright, Thompson, and Roblier in Chew, 1997, for example).

22 Voting blocks are periodically designed to permit the concentration or dispersion of voting power. Although many countries and systems with a history of equity investment have tended to follow the “one share, one vote” rule, that has changed over the years as directors and executives have found that they can recast shares into different voting tranches: those with no votes, unit votes, or multiple votes. In some countries this recapitalization process has allowed companies to change control patterns. When a block of shares can be restructured to give a small incumbent group greater effective control, or to limit the amount of control that can be gained by external parties, the recapitalization can be seen as a defense mechanism. In Germany, regulators have effectively capped the voting power of concentrated ownership blocks at 5–15 percent, thereby creating a synthetic “no voting” class of shares for investors (such as would-be acquirers) exceeding the threshold. The United States has followed a more convoluted path. In the mid-1920s the NYSE banned nonvoting stock, along with common stock with multiple voting classes or non-proportionate voting rights. (The rival American Stock Exchange permitted multiple classes but there was little market activity.) By the 1970s, as hostile takeovers commenced, regulatory and exchange rules changed, allowing companies to undertake dual class recapitalizations (DCRs), structural transformations giving dominant shareholders greater voting rights than minority investors. The NYSE formally dropped its unit vote restrictions, allowing the creation of stock with limited voting rights once approved by a majority of shareholders and independent board directors. This was supported by regulators, who were primarily interested in ensuring investors were not misled. US companies may thus feature multiple voting classes.

The argument put forth for DCRs was that centralizing control among those truly knowledgeable about the company and how it should be run...
would create greater value for all shareholders. In newer companies, the reasons for DCRs generally turn on the need to raise additional capital without reducing the management group’s existing level of control. DCRs can certainly be useful if they are used to raise equity for investment in positive NPV projects without forcing dominant shareholders to bear a disproportionate amount of risk through dilution or uncompensated return. However, if the real reason for a DCR is to simply allow a control group to pass its agenda without challenge, the potential for truly flawed governance arises. In addition, it is worth noting that DCRs basically shift control, as in an LBO at a far lower premium: DCR shareholders get nominal dividends, while those selling to an investor group as part of an LBO usually get a substantial premium of around 30–40 percent. The SEC proposed a rule intended to preserve the dominant shareholders’ position (for example, no dilution) but prohibited alteration of voting rights of existing shareholders. The courts ruled the SEC could not force adoption of the rule, but the NYSE and NASDAQ did so voluntarily (the American Stock Exchange did not). Ultimately the exchanges adopted similar rules, allowing DCRs that reduce the power of existing shareholders (disenfranchising transaction) based on approval of two-thirds of outstanding shareholders, or a majority of shares not held by interested shareholders.

23 It is worth noting that when a bidding war erupts for a company as a result of defensive tactics, a company is basically auctioning itself off, and under duty of care and duty of loyalty provisions, must sell to the highest bidder. Indeed, at some point the board of directors must stop fighting and evaluate all competing bids.

24 For instance, in the Japanese market no specific antitakeover statues exist (meaning that use of, for example, poison pills or staggered boards is untested). In fact, the only specific defensive mechanism legally approved for use is the sale of shares to a white squire.

25 It is worth noting that in the United States changes in Delaware’s corporate law permit shareholders to shield directors from liability arising from violations of duty of care. Such protection, however, must be approved positively by shareholders.

26 That said, the stakes that they hold are sufficiently sizeable to be generally illiquid; that is, they cannot be sold at market prices without considerable advance planning, and must typically be sold over an extended time frame. In fact, some researchers have noted that the most effect block holding monitors are those with particularly illiquid stakes, as there is little they can do to exit the position; far simpler, they note, to simply monitor the investment stake.

27 Although Germany and Japan still feature the most developed block holder monitoring roles, they can also be found in certain other countries. For
instance, it is not uncommon to see main bank, large corporate, and/or family shareholding and monitoring of companies in France, Italy, the Netherlands, Switzerland, Thailand, Indonesia, Mexico, and Malaysia. Until the collapse of Daewoo in the late 1990s (and the subsequent changes to the chaebol conglomerate system), block holding also featured quite prominently in Korea, particularly since the government directly or indirectly controlled the main Korean banks (and often guided their lending and credit policies in support of chaebol growth).

28 This is certainly the case with horizontal corporate ties, for example, those within an industry.

29 Although the United States has certainly featured financial “monoliths” in the role of corporate monitor and relationship manager, much as the Germans and Japanese do now, those days have passed in favor of anonymous markets and investors. The same is true in the UK: although small, yet exceedingly powerful, merchant banks played a type of corporate monitoring role some years ago, that is no longer the case.

30 Although, as noted, this has the potential to breed conflicts of interest, such as the bank lending more to a financially distressed company in order to protect its equity investment, it seems not to have emerged as a significant issue in the German system.

31 In fact, 85 percent of large public firms in Germany feature at least one block holder with a 25 percent share stake.

32 The patterns of ownership of listed companies in Germany, the United States, and the UK are quite different, helping explain why different forms of external governance monitoring have formed. Germany features strong ownership stakes by non-banks, banks, and individuals (primarily families), while the United States features greater ownership by individuals, pension funds, and investment funds, and the UK by insurance companies, pension funds, and individuals. For instance, at the start of the millennium German companies owned 29 percent of the stock of other German companies (in the United States and the UK the parallel ownerships were each less than 1 percent), German banks owned 13.5 percent of other Germany companies (United States and UK <1 percent), German investment funds 13.6 percent (United States 22 percent, UK 12.5 percent), German pension funds 0 percent (United States 26 percent, UK 22 percent), German insurance companies 9 percent (United States 3.5 percent, UK 23.5 percent), and German individuals 17.5 percent (United States 41 percent, UK 16.5 percent).

33 In fact, empirical research reveals that bank directors are appointed to company boards when credit extensions increase. This can be interpreted in a positive light by a company’s suppliers, customers, and small creditors; they gain comfort from the fact that the main bank is represented on the company board, thereby enhancing its ability to act as “watchdog.”
There has historically been an implicit understanding that keiretsu cross-shareholdings are not to be sold; this helps foster long-term relationships. However, with significant economic difficulties plaguing Japan throughout the 1990s and into the new millennium, there has been some loosening of this restriction in order to relieve financial pressures.

Indeed, some important banks have actually failed as a result of their own efforts to bail out others. For instance, Japan’s tenth largest bank, Hokkaido Takushoku, declared insolvency in 1997 under the weight of bad loans.

Some have argued that the most effective Japanese bank monitoring occurred during the 1970s and 1980s when the economy and banking system were relatively free of problems; in the 1990s, as economic fortunes turned, banks found themselves trying to manage corporate crisis situations and solve problems, rather than preventing them from even getting to that stage. The same analogy has been drawn in the German case, where strong economic and banking growth in the 1980s was dampened by reunification costs and problems in the 1990s.

In the United States, for example, legislation exists that limits the degree to which banks can also act as equity investors: the Glass–Steagall Act of 1933 (since dismantled), the Securities and Exchange Act of 1934, the Investment Company Act of 1940, the Bank Holding Company Act of 1956, and the Employees Retirement and Income Security Act of 1974 all restrict equity investment in some way.

Bank monitoring raises the specter of moral hazard, particularly among secondary lenders to companies, such as any bank that might demonstrate reckless lending behavior to a company of any credit quality on the strength of an “implicit guarantee” from the main bank. For instance, in Japan it has been standard operating procedure over the past few decades for main banks to bail out distressed corporations within their sphere of influence. Indeed, one of the unwritten rules regarding bank monitoring is that the main bank, as governance monitor, takes whatever actions are required to ensure that the borrowing company remains a going concern. Under that operating assumption, it seems that non-main bank lenders (who may, in fact, be quite substantial creditors) take comfort in the implicit support, not carrying out proper due diligence and simply lending on the basis of the main bank’s strength and reputation.

Critics also point to the fact that management, rather than shareholders, drives Japanese boards (although that is in the process of very gradual transformation). For instance, a typical Japanese company might have 20+ directors, most insiders, and most responsible for a company business line; in addition, three or four of the directors, along with the company president, are given special rights to represent the company as “representative directors.” It is not clear that director allegiance under this type of structure is to shareholders.
We need only examine the cases of Korea and Indonesia in the 1990s to understand that influence by the government (Korea) or family business groups (Indonesia) over the banking sector can result in deep losses rather than any monitoring gains. In both instances outside forces actively directed bank lending to the corporate sector (well in excess of prudent standards), forcing the banking sectors ultimately to be recapitalized. Again, for banks to be effective governance monitors, they must be free of influence from outside forces.

It is worth noting that most national deposit protection schemes are designed only to protect small depositors. This means that large depositors must be as vigilant as other unsecured creditors in protecting their own interests.

In Germany and Japan, for example, the Bundesbank, Ministry of Finance, Bank of Japan, Japan Securities Dealers Association, and others are formally charged with ensuring that financial institutions are being managed prudently; this provides some comfort that their activities are being checked. That said, it is possible that the regulators have not been stringent enough in controlling group lending to distressed creditors and have allowed too many bailouts to occur.

Indeed, in most countries the equity shareholdings of institutional investors have risen dramatically over the past two decades. For instance, in the US equity markets institutional investor ownership has risen from approximately 20 percent in 1970 to 56 percent in 2002, making these firms increasingly powerful voices. Similar trends are evident in other countries.

For instance, in the 1969 BarChris case, the District Court of New York found the company, and its directors, liable for failing to apply a standard of due diligence in preparing financial statements. American Hawaiian Steamship Company was found similarly liable in a separate case three years later. In some instances the US government agreed to direct settlements with companies having been found guilty of breach of duty or care, and required specific changes in board structure (as with Lockheed, Northrop, Mattel, Phillips Petroleum, Kaiser Steel, and McDonnell Douglas).

For instance, in the 1980s CalPERS focused its efforts on antitakeover measures; thereafter it commenced broader activist measures, including issues directly impacting share prices and enterprise value.

Some such investors might be considered extremely “aggressive,” purchasing stakes and then actively managing the ownership rights that are conveyed. These investors search for significant underperformers (such as those with true corporate governance problems that can be fixed, rather than those that are simply being impacted by market cycles or regulation), and assemble strategies that can be implemented to fix the problems and increase value.

Funds such as Providence provide a valuable activist service by targeting “problem” companies on behalf of other institutional investors that prefer to remain anonymous (for example because they would rather not directly
challenge incumbent directors and executives at the target company, for a variety of reasons). Providence thus takes certain instructions from the “silent” institutional investors.

48 Hermes, which is owned by British Telecom Pension Scheme, has been a leader in UK corporate governance matters for years. It commenced its “activism” in 1990 when it developed its first governance policy guidelines (a policy it has since updated on several occasions). Hermes was instrumental in reducing standard three-year director appointments down to one year, and has actively pursued compensation/shareholder alignment issues for years. Several of its efforts have been included in the London Stock Exchange’s Combined Code.

49 As noted in Chapter 7, ADAM has been active since 1994, when Neuville began working on minority interest rights in order to avoid a repeat of minority shareholder abuse, which was exemplified in Pinault-Printemps’ purchase of La Redoute.

50 In Italy, for instance, various investment funds have started building a record of selling large blocks of shares when they are dissatisfied with governance performance; others, including the Assogestioni asset management trade group, actively use their stakes to pursue “bad company management” (the group has also worked actively with the Borsa Italiana to make hostile takeovers easier and boost transparency on large block insider selling). The Italian investment fund community was instrumental in helping pass the “Draghi Law” in 1998, which prohibits the board of directors from preventing takeovers unless two-thirds of those at the AGM approve the defense. The law also suppresses the rights of the Italian government to veto any acquisition of more than 3 percent of voting shares if a formal offer is made. In addition, once an offer is submitted to the Italian securities regulator (Consob), a company cannot change its capital structure without at least 30 percent shareholder approval; this limits defensive actions.

51 For instance, in the Netherlands a group of 15 pension funds with significant assets under management banded together to investigate potentially flawed corporate governance practices of major listed Dutch companies (such as Royal Philips, which created a large executive options plan without shareholder approval).

52 For instance, in Korea, the People’s Solidarity for Participatory Democracy (PSPD), led by Professor Jang Ha-sung, has successfully challenged the violation of shareholder rights by Korea First Bank and Samsung in the Korean court system. In Russia, Hermitage Capital has led the charge against the practice of asset stripping (such as funneling valuable domestic assets into offshore companies where they can be used for other purposes and/or receive favorable tax treatment).

53 The European shareholder interest groups use different tactics in dealing with corporate governance issues. For instance, Deminor analyzes proxy
voting agendas/slates of troubled or reorganizing companies and advises
shareholders how to vote. ADAM uses the press and media to criticize
unfair shareholder treatment and files corporate lawsuits when it suspects
wrongdoing. Hermes prefers the private “relational approach” and is
decidedly against raider activism.

54 For instance, in the UK investment management best practices are contained
in the Hermes Statement, in Ireland via the IAIM Guidelines, and in France
through the Hellebuych Committee Recommendations.

55 In order to inject some transparency into this potential problem (and to clar-
ify any potential conflicts) the SEC now requires US mutual funds to
disclose publicly how they vote their shares.

56 It is important to note that rating agencies take different approaches to
compensation. Many of the major organizations, such as Moody’s and Stan-
dard and Poor’s, rate on a solicited, fee-based basis (for example, a company,
need to issue public securities, generally requires a rating in order to
attract certain classes of investors; it will thus pay one or more agencies to
come in and review its operations and then receive its ratings). In some cases
firms may also rate on an unsolicited basis (for example, Moody’s), meaning
the company pays no fee, but since the agency is not gaining full access to
non-public information for analysis purposes (as it normally would), its opin-
ion might be skewed in some fashion. Still others (for example, Mikuni)
accept no fees from companies (only from subscribers), and may or may not
have access to non-public information when rating a firm.

57 An exception might exist if a company decides to access the private place-
ment market, where certain sophisticated institutional investors, capable of
performing their own credit analysis, are often willing to buy “unrated” secur-
rities. The private placement market can, however, be more expensive for
issuers and is certainly less liquid: lack of a rating and other private place-
ment restrictions (securities can only be sold to other “qualified institutional
buyers”) mean a smaller investment base and less turnover.

58 In the United States, for instance, the SEC has only sanctioned four credit
ratings agencies as “national recognized statistical rating organizations”
(NRSROs), including Standard and Poor’s, Moody’s, Fitch, and Dominion
Bond Rating Service. Despite the concerns we have mentioned above, the
SEC prefers to add only gradually to the list of approved NRSROs.

59 In fact, while ISS provides a corporate governance quotient for companies,
it also provides a fee-based consulting service for companies seeking to
improve their ISS corporate governance ratings by taking positive actions.
Some have suggested this represents a potential conflict of interest.

60 To be sure, the rating agencies have made some poor judgment calls. For
instance, the agencies missed Enron’s “house of cards” for an extended
period of time although, in their defense, a portion of their analysis was
based on fraudulently prepared, and audited, financial statements.
CHAPTER 4: PROTECTING INTERNAL AND EXTERNAL STAKEHOLDERS

1 See Berle and Means (1991), for example.

2 Indeed the academic M. Dobb, a contemporary of Berle and Means, noted that “[Business] is private property only in a qualified sense, and society may properly demand that it be carried on in such a way as to safeguard the interests of those who deal with it either as employees or consumers, even if the proprietary rights of its owners are thereby curtailed” (Dobb, 1932).

3 Toshiba chairperson Aoi has noted very succinctly and accurately, “in the last analysis … corporate success will depend on management’s ability to satisfy not just its investors and employees, but the entire range of interests that make up our society” (in Chew, 1997: 244).

4 Public perception might be somewhat different, of course; for instance, a Business Week survey found that 95 percent of respondents feel that US companies have a responsibility to all their stakeholders, not just investors (Bernstein, 2000).

5 Specific legal protection of shareholder rights varies by country and legal framework, and different systems can diverge considerably. For instance, in Japan shareholders have wider voting rights than in the United States (for example, they can vote directly on items such as dividends and executive compensation). However, they have less flexible rights than in the United States when seeking legal remedies (for example, they must bring suit under a specific clause of the Japanese Commercial Code).

6 In some countries the specific protections afforded to minority interests are well supported in the law (for example, the United States, Japan); however, in many others they are not.

7 The management of employee pensions has been an equally formidable task for companies and investment managers. In some cases companies may be overextended, promising future financial benefits that it will be difficult, if not impossible, to deliver without financially harming employees. The realities of demographics, the workforce, economic growth, and market volatility mean that the difference between “promises” to employees and the ability to fulfill those promises is growing wider. This may lead to one of two rather unpalatable options: restructuring of plans, or reneging on post-employment benefits. For instance, in 2002 70 percent of Fortune 500 companies in the United States had private pension plans paying out US$111 billion p.a. to 21 million retirees (and covering a further 23 million current workers). The growing ranks of retirees, low interest rates, and a poor stock market indicate that companies, required to pay US$12 trillion in current and future benefits, face a gap of US$240 billion. While some of this can be corrected through favorable market movements, other aspects are structural and will demand more drastic action.
Indeed, the process of consensus building appears to have been used to good effect by management; by remaining sensitive to opinions inside and outside the firm, managers have shown a greater ability to avoid conflict and derivative lawsuits.

For instance, the priority of claims in US bankruptcy is structured as follows (in order of priority): (1) administrative expenses of the bankruptcy case; (2) unsecured claims incurred in the ordinary course of business once bankruptcy proceedings have begun; (3) unsecured claims for wages and commissions earned within 90 days of bankruptcy filing; (4) unsecured claims for employee benefits incurred within 90 days of bankruptcy filing; (5) unsecured claims of individuals arising from deposits/prepayments for future use of goods or services; (6) unsecured claims of the government (including taxes and penalties); (7) secured claims with specified assets as collateral (including derivatives secured by specific collateral): assets are liquidated in bankruptcy and used to cover the secured claims; if insufficient, the unpaid balances are treated as unsecured claims; (8) senior unsecured claims (including unsecured derivatives): this category takes priority over subordinated claims but ranks pari passu with other senior unsecured obligations; (9) other unsecured claims (including subordinated claims); (10) other claims (including preferred stock, common stock, and so on).

Indeed, extensive academic literature exists on the underinvestment problem we mentioned in Chapter 1, a situation where a company in financial distress will be pushed by its creditors to invest in low NPV projects that carry less risk. The investments are intended to protect the position of creditors rather than attempt to maximize enterprise value.

In Crédit Lyonnais Bank Netherlands v. Pathe Communications, as noted in Chapter 2.

See in re Ben Franklin Retail Stores, for example.

For instance in the UK, with its creditor-focused insolvency framework, deviation from absolute priority rules is virtually nil, while in the United States, with a debtor focus, the deviation can be 75–80 percent.

There are exceptions to the automatic stay. For instance, if a company has entered into collateralized derivative transactions that are documented under standard International Swaps and Derivatives Association agreements, and the legal system affords appropriate “safe harbor” exceptions, collateral can be liquidated immediately by the creditor bank and applied against any outstanding sums due.

Management transfers between companies occur at all levels, from junior staffers to senior executives; these allow the development, over time, of personal networks and relationships that help in the implicit contracting process characteristic of the Japanese system.

For instance, between 1998 and 1999 the Japanese government pumped US$77 billion of public funds into the banking sector for support in writing
off bad loans; a large portion of the funds came from general revenue accounts funded by corporate and personal taxpayers. In mid-2003 it also announced the bail-out of Resona Holdings (the fifth largest bank holding company, controlling Asahi Bank and Daiwa Bank); the rescue used US$17 billion of public funds. Other examples of situations where taxpayers partially or totally paid for corporate insolvency exist, such as Swissair.

CHAPTER 5: COMMON FAILURES IN THE GOVERNANCE PROCESS

1 The McKinsey & Co. (2002a) survey included the results of 200 respondents on 500 corporate boards, two-thirds of whom came from companies with more than US$1 billion in market capitalization and/or revenues.

2 Leading Japanese think tank Nomura Research reported that corporate earnings declines in the early 1990s were well in excess of those one would expect to see in a cyclical economic downturn, suggesting some structural issues were, and are still, at work. For instance, the significant cross-shareholdings among keiretsu group members have prevented active pressure from outside investors. In addition, Japanese companies have had a long history of retaining, rather than returning, excess capital (for example, dividend payouts have historically been low, and corporate stock buybacks were not permitted until the late 1990s), meaning that management has had a tendency to invest unnecessarily. This creates excess capacity or diversification into unrelated businesses, which is not particularly helpful in attempting to maximize shareholder value. Indeed, through deregulation Japan (and other Asian countries) have permitted foreign competitors to enter the marketplace and win business by offering competitive products and pricing, thus revealing local companies that are ill-focused, over-extended, inefficient, and unprofitable.

3 Consider the case of E-Trade, the financial services group that helped pioneer aspects of online trading. The CEO and driving force, Costakos, received US$80 million in compensation in 2001, becoming the highest paid CEO on Wall Street that year; his employment package also included company payment of his doctorate studies, home security system, and family travel. The package was formally approved by E-Trade’s board compensation committee, whose head was a close friend of Costakos. In the wake of these announcements, E-Trade’s stock declined sharply (a fact that research analysts attributed primarily to the compensation/governance conflicts). Costakos ultimately returned US$20 million in compensation and was then ousted. The board reconstituted the compensation committee with an independent head.

4 For instance, the Stock Exchange of Thailand requires the appointment of two independent directors but the rules only exclude management, employees, and
relations of large shareholders. It does not exclude those that might have business ties to the company, which is often the source of problems and conflicts of interest.

5 For instance, through 2002 the CEOs of Vivendi Universal, LVHM, and Alcatel, three major French companies, sat on one another’s boards.

6 For instance in Switzerland, where interlocking directors are the norm, one study has found that board involvement in strategic decisions actually declines, as interlocking directors devote less time than they should to corporate matters (see Ruigrok, 2002, for instance).

7 This is intended as a general statement; while the majority of companies feature a healthy number of independent directors, there are still many US and UK companies that lack truly independent representation. Tyson Food, the US poultry manufacturer, serves as an interesting case. The 15 member board includes ten insiders; five board members serve as consultants and two insiders serve on the board’s compensation committee. The compensation committee authorized a US$2 million bonus for the CEO in 2002 for the successful acquisition of the IBP meat packing company. The CEO attempted to renege on this acquisition but was ordered to complete by the courts.

8 The turn toward greater independence has been decades in the making. For instance, until the 1960s the average US and UK corporate board featured approximately equal numbers of insiders and outsiders. By the 1980s outsiders began to dominate (at an average of approximately 60 percent) and have continued to increase steadily from there.

9 This, again, has the potential of creating conflicts of interest and preventing CEOs from being challenged, leading ultimately to some of the significant problems that have plagued Japanese companies (including overstaffing, overinvestment, and lack of focus).

10 It has been common practice in Korea for dominant shareholding families to select board directors from a pool of senior corporate managers, and automatically have them approved at the AGM. The selection of independent directors is not a common practice. Even in companies with a broad base of shareholders (such as non-family controlled companies) it has been common for internal executives to be appointed automatically to directorships on the basis of seniority.

11 The case of GM provides as interesting perspective. Although the firing of chairperson and CEO Stempel – largely through the efforts of director Smale – was radical and revolutionary (and helped set the precedent for similar CEO firings at IBM, American Express, Kodak, Westinghouse, Apple Computer, and others in the early to mid-1990s), it was also a form of failure, because it took so long. Although directors had been aware of Stempel’s poor performance for many years, they were weak and ineffective in challenging, and permitted the chairperson/CEO to go unchecked for several
years. This led eventually to the squandering of billions of dollars on ill-advised projects and excess capacity build-up.

12 Indeed, many aspects of the Japanese board system represent form rather than substance. For instance, board meetings are scripted and allow for little or no discussion (and certainly no dissension). AGMs are highly orchestrated and call for pro forma approval of director nominations, selection of the internal auditors, and acceptance of the financial statements and board recommendation of profit allocations, all without challenge. One corporate survey has found that the average Japanese AGM lasts 26 minutes and 90 percent of them feature no questions from the floor. Little wonder that the sokaiya, or corporate extortion, scandals we discuss in Chapter 8, have been a major source of discomfort to the Japanese system.

13 In a US context, the knowledge gaps can sometimes be considerable. In a survey led by the Institute of Internal Auditors in the aftermath of Enron’s collapse, board directors generally had significant concerns about accounting and risk issues. In fact, the survey revealed significant gaps: 21 percent of board members surveyed were unsure whether their companies used derivatives; only 37 percent thought they had an enterprise risk management process in place; 47 percent felt that their accounting practices were unclear, and so forth. See Institute of Internal Auditors and National Association of Corporate Directors, 2002.

14 The Japanese corporate sector functions largely on the basis of seniority, and continues to feature an older generation of managers who are still firmly in control, ceding little power to the younger cadre of up and coming managers. Their general management style reflects a certain amount of rigidity and inflexibility. In addition, the ranks of executive management are often excessive.

15 See Kaplan in Chew (1997), for example.

16 Consider the example of French conglomerate Suez which, in the early to mid-1990s, lacked focus in its operations; it possessed no apparent strategy and was involved in a broad range of business which, by 1994, led to US$1 billion in losses. As shareholders began expressing their dissatisfaction the chairperson of Banque Nationale de Paris (BNP, now BNP Paribas), proposed a merger between BNP and Suez. After being rebuffed by Suez, BNP then proposed a three-firm combination involving Union des Assurances de Paris (UAP) and was again rejected. On the quiet, Suez management sought a white knight (Pinault Printemps Redoute) and then attempted to issue shares without pre-emptive rights so that the company could freely arrange a stock swap with another company. Shareholders were outraged when they learned of the attempt, and forced the board to abandon the plan and dismiss the chairperson.

17 Although they often cannot withhold dividends to an “unreasonable degree.”

18 In Germany banks control significant voting blocks via proxy, meaning basic legal protections for small shareholders are not always addressed. For
instance, in a public bid in 1994, minority shareholders of Marz Group received the pro-rata equivalent of US$396 million for their shares while controlling shareholders received US$528 million. Many other examples of this type of “valuation discrepancy” abound.

19 In most other countries executive compensation tends not to be as significant an issue: company executives are generally granted much small compensation packages than they are in the United States (although perks are often greater). In many countries, for instance, executive stock options are either unheard of, or extremely rare (such as in most East Asian, and many Latin, companies). Even in Japan the first stock option grants did not legally appear until 1997 (although Sony created certain “phantom options” in 1996, to the chagrin of competitors and regulators). They have expanded relatively rapidly since then: more than 800 companies had granted stock options by 2000, and over 1000 had issued them a few years later. This, however, is still small in comparison with the United States. Among major corporate systems, only the UK is starting to exhibit some inflation in pay packages (and there has been shareholder discontent with compensation awarded to executives at Vodafone, GlaxoSmithKline, and Prudential Assurance, among others).

20 The example of Computer Associates (CA) serves as a good example of abuse in the size of a compensation package. In 1995 CA directors proposed, and shareholders approved, a compensation plan for top executives that would provide for a US$1 billion payout if the stock price rose from US$20 to US$53. Within three years the stock price hit its target, calling for the payout – a cost to the company of US$675 million (after taxes). The stock price plunged on the news and CA was sued; in a rare occurrence the Delaware courts demanded 45 percent of the package be returned.

21 For instance, over the past decade the mean pay for US CEOs has climbed 360 percent (versus 34 percent for the average employee) to a record US$11 million.

22 Critics especially point to executives “cashing out” before the ultimate collapse of the companies they work for: Anschutz (founder of Qwest), earned US$1.9 billion, Nacchio (CEO, Qwest) US$248 million, Winnick (CEO, Tyco) US$734 million, and so on.

23 Though many examples exist, we consider several from 2002. The CEO of Apple Computer earned US$78 million and shareholders earned –35 percent; the CEO of Cisco US$55 million versus –28 percent, the CEO of Tenet Healthcare US$35 million versus –58 percent, the CEO of Honeywell US$68 million versus –27 percent (part in a golden handshake), and so on. Indeed, in the United States median executive compensation rose 14 percent to US$13 million while the broad market traded down 22 percent.

24 The Corporate Board cites Conseco’s CEO’s deal as an example of a very poorly structured package. In 2002 the CEO earned much more in absolute terms than sample companies with market value ten times greater, had
guaranteed payments of more than US$2.5 million (unrelated to any specific performance targets), a very liberal stock grant (20 times annual salary) and a US$45 million golden hello. The contract also allowed for a US$8 million guaranteed bonus (even if the stock remained below US$10 per share), and increasing bonus amounts as it rose above that figure; some additional bonus also accrued through EPS performance targets (even if EPS declined, although not if earnings contracted by more than 10 percent). The CEO also received, under a long-term incentive clause, a guaranteed minimum grant of 500,000 stock options per year, every year (after two years), regardless of performance. He also received a restricted stock grant without performance targets, and was guaranteed the same every year. Given the size of the stock and options grants negotiated through the deal, dilution was a concern. (There existed an overhang, for example shares awarded or subject to conversion under executive compensation schemes, which led to concerns about voting and EPS dilution (a 10 percent+ overhang is generally thought to be significant).) The CEO also had a protective severance clause requiring the company, after a two-year period and assuming termination without cause, to pay the CEO a guaranteed salary and target bonus over three years (estimated at US$7.2 million); and vesting of all options and restricted stock within a 12-month window.

25 A US study published in the Academy of Management Journal in 2003 found no correlation between a company’s performance and the amount of stock/options owned by corporate executives. The study, which was a review of 229 similar research studies conducted between 1971–2001, found that compensation plans designed to motivate executives had no meaningful effect on return on assets or stock price. In fact, dozens of companies actually underperformed.

26 For instance, when Akers served as CEO of IBM in the 1980s through early 1990s, he received an original options package struck at US$145. Over the next few years the price of IBM continued to decline, but Akers received annual option grants at lower and lower strike prices. Thus, if the price of IBM eventually climbed back to US$145, where Akers received his original grant, he made US$20 million, despite the fact that shareholders earned nothing (except very modest dividend returns).

27 In the United States, for instance, within the group of the 250 largest option granting companies, nearly 20 percent of all options were given out to the top five executives between 1999 and 2001, despite the fact such companies featured an average employee population of 69,000. Some of the companies that granted more than 20 percent to the top five executives included those under regulatory investigation for other governance problems (such as Tyco, Qwest, Providian Financial, and Tenet Healthcare). Some firms, such as Baker Hughes, Citibank, Target, and US Steel concentrate options tightly; Baker Hughes, for instance, gave 50 percent of its options to its top five
executives. Some companies, of course, are more enlightened on the matter, and are willing to spread the wealth more equitably: Cisco, Disney, IBM, Microsoft, and Johnson and Johnson, among others, have a well-established tradition of distributing options widely. For instance, Cisco grants options to 80 percent of its employees (and, excluding the top five executives, has generated US$19 billion in option-related wealth for its employees since 1994). See Leonhardt, 2003 for additional detail.

A study by governance research center The Corporate Library indicates that 36 CEOs hired between 2000 and 2002 received average golden hellos of US$15 million each.

Consider the following examples of executive compensation without relevant performance goals. In 2000 and 2001 the chairperson and CEO of Disney received no bonus as he failed to meet the goals set by the board; in 2002 the board simply lowered the goals and awarded the CEO a US$5 million bonus. The same occurred for executives at AT&T Wireless, Sun Microsystems, UST, Estée Lauder, and others (that is, the bonus plan payout rules tied to performance goals were either altered or disregarded). For instance, when UST executives could not meet earnings targets the board created a “contingent merit bonus fund”. Separately, US energy company PG&E Corp, a holding company that filed for bankruptcy in the aftermath of the California energy scandal (which we discuss in Chapter 8) and part owner of National Energy Group (NEG), a troubled merchant energy trader that filed in 2003, created a poorly designed package. In early 2003 the company announced that several senior executives would receive US$34 million in phantom stock option bonuses vesting over a very short time period (one and two years), despite the fact that the main utility (operating under bankruptcy protection) posted a US$2.2 billion loss in 4Q 2002 and that NEG was on the brink of collapse at that time. Executives received these “special share options” for meeting rather meaningless performance goals (for instance, the company needed to be in the top half of the poorly performing energy peer group). Further, the options have no strike price, meaning they convert into cash at no cost to executives. Not surprisingly, the grants are also highly concentrated: of US$57 million allocated to 6500 employees, $34 million goes to the top 12 executives: meaning 0.2 percent of the corporate population has received 60 percent of the wealth. A small group of executives is thus enriched without any real accountability.

We can draw on many examples of this practice. In 2003 CEO Brown of EDS, who was ousted by the board, received a US$37 million severance package even though the firm’s share price had fallen 75 percent during his watch, equal to a US$24 billion decline in market value. ICN Pharmaceutical CEO/founder Panic, who resigned after losing a proxy battle, received a US$33 million bonus, US$5 million lump sum, and US$670,000 in annual consulting fees (for the remainder of his life). Schering Plough CEO Kogan received US$13.2 million in severance and US$26.4 million in retirement
payments, despite a steep drop in the share price and an SEC investigation. Deutsche Bank, in concluding its acquisition of Bankers Trust, arranged to pay Bankers CEO Newman US$100 million to get him to leave. Consider, also, the example of German firm Mannesmann, acquired by the UK’s Vodafone. Prior to final agreement of the acquisition, six directors and senior executives created approximately €150 million in severance packages and bonuses for top executives, including CEO Essen (who received approximately one-third of the total). The executives were subsequently sued for breach of trust by shareholders.

In fact, one research estimate suggests that expensing of all options granted in the United States in 2001 would result in a 35 percent decline in reported net income.

For instance, Kmart, the US discount retailer that ultimately filed for bankruptcy, shifted its corporate strategy on numerous occasions over a short time frame in response to different competitive pressures. Although it began as a highly-focused pure discounter, it then diversified by taking stakes in other retail firms (such as Borders and OfficeMax), losing some of the competitive edge it had once enjoyed. It then decided to challenge market leader WalMart, spending heavily on technology and revamping stores and product lines to try to compete more effectively. The changing strategy was expensive and ultimately doomed the company to failure.

See Scanlon, Trifts, and Pettway, 1989, for example.

In fact, conglomerates that have practiced such EPS bootstrapping eventually see their stock prices fall, even as reported EPS “expands.”

Recall our comment in Chapter 1, where we noted that investment in negative NPV projects can lead to a reduction in earnings growth.

Jensen calls this inability/unwillingness to return excess capital the “agency cost of free cash flow.”

In fact, many Japanese companies have been plagued by an unhealthy focus on market share; a focus that has led, over an extended period of time, to unwise investment in projects with marginal returns and projects with negative NPVs. Although any company wants to expand market share when it is profitable to do so (and in the interests of shareholder value maximization), there are obviously limits to when this can, and should, be done. If management is directing expansion into a market that already features excess capacity, the shareholder loses.

The problem has been widely noted and reported in Japan. For instance, the chairperson of Japanese electronics company Toshiba has noted:

Japanese companies also tend to compound the problem by retaining excess capital rather than returning it to shareholders in the form of higher dividends or share repurchases. Failure to pay excess capital leads to inefficiency. The decline in corporate earnings and share prices
have by far exceeded those that would have been expected in a purely cyclical downturn … such declines [are due] to a structural overcapacity stemming from lax investment criteria employed by Japanese companies.

(Chew, 1997)

39 A certain amount of excess cash is a requirement for Japanese companies as they typically leave some portion of pension liabilities unfunded; however, the amount retained is usually well in excess of this requirement.

40 To give but one of many available examples, Nippon Steel, one of Japan’s largest steel producers, expanded during the 1990s into telecommunications and biotechnology.

41 See Watanabe and Yamamoto, 1992, for instance.

42 Expense ratios are often out of all proportion with what might be considered the norm as a result of excess staffing costs, not from large compensation packages, but from large numbers of employees. No management wants to downsize staff in a system where the employee is still regarded as the primary stakeholder. Although this has begun to change with greater instances of financial pressure, it is still quite common for companies to be overstaffed.

43 Financial engineering and speculation became quite rampant during the late 1980s and early 1990s, with many large and small Japanese companies using such techniques to bolster operating income. Since posting profits in order to boost the stock price is not a primary goal for the Japanese company (while gaining market share and promoting the perpetuation of the company are), management has historically been less sensitive to the nature and quality of short-term earnings. While it might be preferable to earn them from core operations, there is nothing “wrong” with deriving them from non-operating sources, such as financial speculation (volatility of such earnings, and the fact that activities may be outside core competencies, notwithstanding). For instance, during the zaitech period a company would issue offshore low-coupon convertible bonds or bonds with warrants (often denominated in Swiss francs), swap them back into Japanese yen, and invest the proceeds in speculative tokkin funds – anonymous, tax-advantaged equity portfolios – or leveraged structured notes. This activity was initially used to boost earnings, and ultimately used to disguise the fact that core operations were not profitable. (In 1987 50 of Japan’s 250 largest companies would have shown no pre-tax earnings without their zaitech operations; Nissan Motors, Sony, Nippon Oil and others had “non-operating income” in excess of 100 percent of pretax income.)

Zaitech has thus had a history of creating two problems: masking the nature of true earnings performance, and doing so without proper transparency, controls, or expertise. Again, we must question whether it is appropriate for a company to create shareholder wealth when the activity is not
part of its expertise and explicit/implicit corporate mandate. Although many Japanese companies engaged in this practice, a review of Taheto Chemicals serves as a good example. Taheto, which supplied magnesium to the steel industry, went public in 1978 and featured no debt. It then started issuing bonds in the Eurodollar and Swiss franc markets, reinvesting the proceeds in leveraged financial structures rather than core operations. By 1984 80 percent of its pretax profits came from financial engineering. In 1987 the company was very heavily invested in the Japanese government bond market; a bad market bet in bond futures created losses of ¥28 billion, well in excess of the firm’s net asset value. Shortly thereafter it turned to its lead bank, Taiyo Kobe, for financial assistance, and the bank agreed to postpone repayment on ¥20 billion. This led to a considerable amount of criticism: the banks accused securities companies of arranging zaitech transactions, Taiyo Kobe was criticized for not monitoring Taheto’s activities, and corporate executives and board members were criticized for lack of control and lack of knowledge. (One board member thought the large Japanese government bond position was acceptable since he thought “government” meant no risk.) Shareholders, of course, lost heavily.

44 Interestingly, away from public companies, where stock price and EPS pressures are so powerful, US investment in longer-term emerging projects is very strong. For instance, venture capital funds routinely invest significant amounts of long-term funds in a variety of projects and R&D, the absence of market pressures giving them much more freedom to act.

45 In the United States alone approximately 3000 companies have defenses in place.

46 It should be noted that dual class equity structures, which result in the issuance of new dual class equity, are not defensive mechanisms; only a DCR serves as a defense as it permits an increase in control.

47 In the long run, empirical research seems actually to support the fact that Wall Street ultimately responds to economic value and cash flow rather than accounting value and EPS (see Stewart, 1992, for example). This, however, does not change the fact that disappointed investors often “walk” following disappointing EPS performance by a given company.

48 For instance, the board of bankrupt US retailer Kmart sued its former CEO for failure to disclose to the board growing liquidity problems in the third quarter of 2001. The problems, which were material, implied a “gross dereliction” of duties.

49 For instance, Trump Hotels and Casino Resorts in the third quarter of 1999 stated in its “pro forma” report that its earnings were positive, despite the fact they were negative and only boosted through one-time gains. After being charged by regulators, the company pleaded no contest and settled.

50 SPEs have been at the center of some of the most significant governance problems in recent memory, including Enron, as we discuss in Chapter 7. In
the legislative reform act passed in the United States in 2002 (Sarbanes–Oxley, discussed in Chapter 10), the opportunity to address potential accounting and disclosure shortcomings through changes in accounting treatment appears to have been missed (for example, whenever assets are moved off-balance-sheet, to an SPE, for securitization purposes, disclosure must remain as if the assets had remained on the balance sheet). This means that the specter of further abuses remains.

Consider, for instance, asset-backed securitizations, programs where companies can sell assets (for example, receivables) into off-balance-sheet conduits and issue securities backed by such assets. The balance sheet declines in size, leverage can improve (depending on consolidation issues), and fundamental credit and market risks associated with the receivables may or may not be transferred to third parties. The asset-backed commercial paper market has grown from US$16 billion in 1989 to US$700 billion in 2002, the secured business loan market from US$2 billion to US$1125 billion, and the commercial mortgage backed securities market from US$36 billion to US$400 billion. While these are well-established and legitimate markets and financial engineering techniques, the point is that they make it more difficult for auditors, accounting executives, and investors to discern the true financial position of a company at any point in time. Asset-backed programs are just one of many such instruments/techniques; many others exist. For instance, the over-the-counter (OTC) derivatives market, which consists of financial contracts that derive their value from reference assets, exists to transfer or assume risk in interest rates, equities, credits, currencies, and commodities. These contracts have grown at a very rapid pace since their creation in the early 1980s, and now account for US$83 trillion in notional value. Again, although such instruments are useful and legitimate in segregating, transferring, or hedging risks, they add another dimension of opacity to the financial statements.

In fact, Germany serves as an example of a system where lack of financial transparency can hinder takeovers. Since German accounting rules favor conservative valuations, many firms hold assets at book value rather than market value, which allows them to create hidden reserves. In addition, up to 50 percent of profits can be reserved with approval of the supervisory board. While these reserves might be attractive to a potential acquirer, their existence and magnitude are uncertain; so, in fact, are any potential hidden liabilities. The corporate control market thus has insufficient information to be able to determine value, and cannot thus support or discipline the company.

One US survey noted that 37 percent of employees polled actually witnessed misconduct within their firms that was severe enough that they believed it would affect the public trust, and a second noted that 60 percent had observed violations of corporate standards during the preceding 12 month period (see KPMG, 2002).
As a further complication, in some emerging nations companies often have multiple audiences for financial information: internal managers require one set of information in order to manage daily business; regulators, supervisors, and creditors a second set; and investors a distinct third set. For instance, in Thailand it is common practice for companies to produce one set of accounts for management and another for the Stock Exchange of Thailand (and thus investors) and tax authorities. This creates additional burdens and costs (multiple books, reconciliation, technological infrastructure), and lends itself to financial and operational errors and possible manipulation.

The Big Four become the Big Three when Yamaichi Securities filed for bankruptcy in 1997; Merrill Lynch acquired most of Yamaichi’s local offices but ultimately shut them down as they were too unprofitable.

Consider, for instance, that in the United States mutual funds might take a more active governance role but for certain restrictions that limit or influence their activities. Under the Investment Company Act of 1940 funds were required to become passive as the government did not want them gaining control of industrial companies. (Although the SEC and government saw the potential monitoring benefits of large blocks held by active funds, they believed the disadvantages were potentially greater.) Accordingly, a mutual fund cannot qualify as a “diversified fund” if it owns more than 10 percent of any company in the regulated portion of its portfolio, which creates tax and investment limitations. In addition, in order to protect unsophisticated investors, funds are strictly forbidden from using a majority of their assets to buy control blocks. There is thus little incentive for such funds to buy large blocks of stock and play the role of active monitor. (Note that the same restrictions do not necessarily apply to all US institutional investors. Pension funds and insurance companies, for instance, fall outside the scope of such regulations and are obviously quite active in corporate governance affairs.)

We have already alluded to the regulatory role that sometimes features in corporate control transactions, and we discuss this at greater length later in the book. For now, it is sufficient to note that there are instances when regulations restrict certain types of M&A or takeover activity, or actually help promote antitakeover measures, resulting, perhaps, in a less competitive environment.

We can consider the case of Korea, where for many decades the Korean government directed the lending standards and activities of government and private sector banks; appointing bank management, intervening when it chose and requiring them to make so-called “policy loans” to weak or speculative companies, or those the government was attempting to promote or expand. Many of these loans ultimately became non-performing assets and had to be written off. In fact, on at least three occasions economic and financial dislocations have been
so severe that the banking sector has been nationalized and recapitalized, at great expense to the taxpayer.

61 Recognizing the inadequacy of this regulation, the FASB is revisiting it in order to make it more accurate and definite.

62 In the United States, the shift of investment assets from long-term to short-term portfolio managers is well documented. For instance between 1990 and 2001 long-term pension fund assets declined from 17 percent of all investments to 12.5 percent, while short-term mutual fund assets increased from 6.6 percent to 18.7 percent (Conference Board, 2003).

63 For instance, the average holding period for US individual investors declined from eight years in the 1960s to one year in 2001; the average holding period for investment funds declined from 16 years to 2.5 years over the same period; the average annual portfolio turnover of US equity mutual funds reached 100 percent in 2001. There is considerable evidence from other markets that investment holding periods have also declined dramatically. The focus on short-term returns, the need to gather more investment assets to sustain margins, the arrival of new electronic trading mechanisms, and the decline of fees and commissions have all been cited as reasons for the shorter and shorter investment horizons of investors.

64 Stewart (1992) correctly points out that share prices do not necessarily decline when company management announces new long-term investment programs. In fact, academic research (for example, McConnell and Muscarella in Stewart) suggests that stock prices react favorably to long-term capital spending, because the market is able to price in estimates of the long-term payoff from current decisions, and can distinguish between value adding and subtracting investments.

65 Over the years risk capital has been raised for many companies that ought not to have been able to access the capital markets at all, primarily as a result of the efforts of “aggressive” intermediaries. Although any intermediary can make a mistake at any point in time and introduce a bad issuer to the marketplace (as an exception rather than a rule), Drexel Burnham Lambert, the US investment bank credited with expanding the market for high-yield junk bonds, stands as an example of an intermediary that systematically brought ill-suited issuers to market, to the detriment, in many instances, of investors. Drexel ultimately collapsed in 1991 under the weight of criminal charges and a liquidity run.

66 US securities firms, in reaching a $1.4 billion settlement with the SEC in 2002–3, essentially admitted to a series of abuses, including “wrongly promoting” companies through inflated “buy” recommendations in order to win more banking business from them. Many of these companies, primarily from the technology-media- telecom sector, subsequently failed, causing investors to lose their risk capital. We consider this topic in more detail in Chapter 8.
For instance, between 1992 and 1997 Indonesia featured a total of 40 corporate control transactions, 35 of which were tax-driven, intra-group transactions. Only five “external” acquisitions or buyouts occurred over a five-year period. Similar lack of activity has been apparent in Thailand, where only nine listed company mergers occurred between 1978 and 1997. (Although the pace has accelerated slightly since then, overall activity remains negligible.)

For instance, auditors certified the accuracy of financials released by IBM, Gateway, Kmart, Vivendi Universal, Tyco, WorldCom, Swissair, Lernout and Hauspie, Adelphia, HealthSouth, Enron, Amerco, Elan, Xerox, Ahold, and many others that were subsequently forced to reveal problems, errors, or restatements.

To wit, Niemeier, former chief accounting officer of the SEC and now a member of the Public Company Accounting Oversight Board, noted that “auditors [have been] willing to look the other way.”

CHAPTER 6: THE IMPACT OF GOVERNANCE PROBLEMS ON CORPORATE OPERATIONS

1 During the 1990s Salomon merged with Smith Barney and was ultimately acquired by Citibank (and now forms the core of the Citibank’s investment banking efforts).

2 For the next 18 months the bank managed to continue operating on a base of lower earnings, capital, and liquidity. Following the 1998 Russian crisis, however, Bankers Trust sustained trading losses and was effectively unable to continue as a going concern; it ultimately had to be acquired by Deutsche Bank.

3 See Banks and Dunn, 2003, for example.

4 Under the US Bankruptcy Code, for instance, a company can file under Chapter 11 (reorganization) or Chapter 7 (liquidation). Those seeking Chapter 11 protection attempt to restructure their operations while under the protection of the courts, hoping to re-emerge as newly structured, if generally much smaller, firms (for example, Kmart, WorldCom/MCI, and US Airways).

5 Although we are only speculating on what might have been it is interesting to compare the instances of Enron and Swissair: the magnitude, depth, and breadth of Enron’s problems, as we shall note, were so severe that even an injection of eleventh-hour liquidity would almost certainly have only delayed the inevitable total collapse. Even last-minute merger partner Dynegy appears to have recognized this fact, walking away from the bargaining table before committing its own liquidity position to helping out Enron. The collapse of Swissair, in contrast, could perhaps have been averted. Although the airline was clearly plagued by many problems – excess leverage, disastrous acquisition strategy, opaque financials – and was in desperate
need of massive restructuring, it appears that its bankruptcy could have been avoided through better coordination between bankers and the Federal and cantonal governments. The availability of such last-minute liquidity might have been enough to pull the company through the worst of it.

6 Although financial advisors caution employees not to invest too much of their retirement assets in company stock (when that option is available to them, as in the United States, at large companies), many continue to do so, despite the lessons of Enron and WorldCom, where many employees lost most of their retirement savings. While advisors recommend employees invest less than 10–20 percent of retirement assets in company stock, in 2002 about half of all employees with access to such plans had 25 percent+ in company stock. Indeed, 17 percent had 50 percent+ of their assets in company stock (as at Procter and Gamble, Coca-Cola, and General Electric).

7 Regulators must periodically consider whether a company is so important – to the economy, investors, employees, depositors, or other stakeholders – that it cannot be allowed to fail. In virtually all cases there are no corporations that are deemed to be “too big to fail,” as the systemic implications of any such collapse are often quite limited (in the United States, the bail-out of Chrysler stands as something of an anomaly). Even in Enron’s case, although the company was an acknowledged leader in the energy sector (holding at times up to 25 percent shares in segments of the energy trading market), and had a considerable web of financial dealings and relationships with many banks and companies, there was no real belief that the company was “too big to fail.” Within the financial sector, however, the question is often more complex, because the systemic implications of collapse can be far greater. The failure of a banking institution can quickly spread through, and destabilize, a financial system as a result of the intricate dealings between institutions, and the confidence and reputation that are necessary to maintain orderly dealings with depositors and customers. If there is a hint of a serious problem, bank runs might appear, exacerbating liquidity spirals and potentially spilling over into other institutions. In general, it appears that most regulators have stepped away from “bailing out” financial institutions: in the United States, Drexel Burnham Lambert was allowed to fail, in the UK Barings was left to fail (although it was purchased at the last minute by Dutch bank ING), in Japan Yamaichi Securities and Hokkaido Takushoku Bank were permitted to go under, and so on. There have been some exceptions in the past, of course: directly or indirectly, regulators appear to have helped orchestrate rescues of institutions such as Continental Illinois, Salomon Brothers, Bankers Trust, LTCM, and Resona. In addition, there is enough evidence to suggest that Japan has not been willing to permit larger banking institutions to fail, and has been able effectively to bail them out by agreeing to very large mergers and taking a more lenient view on bad loan
charge-offs. As noted, taxpayers ultimately pay for such regulatory-driven bailouts.

8 In fact, the collapse of Enron caused many of the energy company’s competitors to fall under the same cloud (of for example false revenue statements and abusive trading practices), and has had a meaningful impact on their ability to conduct business. In the same light, the collapse of Andersen has not necessarily created more opportunities for the remaining “Big Four” accounting firms; they, too, have been called into question over conflicts of interest, flawed accounting practices, and so on, and the stigma associated with Andersen’s wrongdoings has crept into their business.

CHAPTER 7: STUDIES IN FLAWED GOVERNANCE I: COMPANIES

1 The company eventually directed a great deal of its trading through the Enron Online platform, an alternative trading system platform where Enron acted as a direct counterparty on all trades; an estimated US$760 billion notional of transactions was executed through the platform.

2 In fact the fiber optic trading business, Enron Broadband Services, was a complete sham. Although the firm declared on many occasions that it was engaged in “groundbreaking broadband technology” through the Enron Intelligent Network, most of the capabilities were exaggerated and the technology and assets did not even exist. Several of those involved in the platform were charged with fraud in 2003.

3 Under US GAAP, SPEs can be considered independent from the company for accounting purposes if (a) the owner, independent of the company, makes an equity investment of at least 3 percent of the SPE’s assets and (b) the independent owner controls the SPE. Once considered independent, the SPE’s assets and liabilities need not be consolidated on the company’s balance sheet, and profit and loss flows between the company and the SPE are considered separate and distinct.

4 All of the SPEs were apparently created and managed by CFO Fastow, in a role that would suggest conflict of interest. Nevertheless, all available evidence indicates that Lay approved Fastow’s participation in related party deals (certainly for three of the Raptors and an LJM1 hedge transaction). Skilling also appears to have supported Fastow’s involvement with LJM1 and LJM2. Both Lay and Skilling, as executives in charge of the company, failed to introduce or enforce proper controls. Both subsequently claimed to be unaware of the extent of the SPE activities, a curious, and disconcerting, statement given the growing materiality of the operation on Enron’s own financial position.

5 In 1999, with approval from the Enron board, the company entered into business with the LJM1 and LJM2 partnerships, with Fastow acting as manager
and investor. In retrospect, it seems clear that the board should not have approved this relationship given the potential conflicts of interest. Nevertheless, the directors were apparently convinced that conflicts and potential risks would be minimal, especially with proper controls in place (controls that obviously failed to materialize). LJM1 and LJM2 effectively permitted Enron to execute transactions it could not otherwise execute, giving it a buyer for the corporate assets that it no longer wanted. Between mid-1999 and mid-2001 the partnerships executed 20 transactions, primarily asset sales and hedges (which later turned out not to be hedges at all). The board required all LJM transactions to be approved by the chief accounting officer (CAO, Causey), the chief risk officer (CRO, Buy) and president/COO (Skilling). The board also required an annual review by the Audit and Compliance Committee. Evidence is unclear on whether or not Skilling approved the transactions.

There appears not to have been any formal control mechanism for reporting the activities in LJM, and any board committee reviews that were undertaken appear to have been cursory at best, with no meaningful analysis or questioning. The compensation arrangements under the LJM arrangements were never reviewed. Hindsight suggests that these requirements were poorly implemented and not rigorously followed by any of the parties. The nature of the transactions also appears quite suspect. For instance, at the end of the third and fourth quarters of 1999, Enron sold seven assets to LJM1 and LJM2 on short notice; these were removed from Enron’s balance sheet as they were “arm’s length” transactions with an independent entity. However, just a few months after each of the two quarter ends Enron repurchased five of the seven assets, making the deals seem like temporary “window dressing” rather than true economic or risk-shifting transactions. Curiously, the LJM partnerships generated gains on every deal, even when assets declined in market value; Enron, in the meantime, reported earnings as well, e.g. US$229 million in the second half of 1999 based on the seven asset sales. In three of the deals, Enron agreed to protect LJM against losses, meaning no risk was transferred and the transactions should not have been counted as sales. LJM was thus just a vehicle to allow Enron to manage, or manipulate, its earnings.

In addition to asset sales, the LJM SPEs were used to “hedge.” In June 1999 the board approved a deal where Enron transferred its own stock to an SPE in exchange for a note. LJM1 was then meant to source the 3 percent external equity required for non-consolidation. The SPE would assume the risk that the stock price of network company Rhythms NetConnections would fall. Enron was basically hedging its investment in Rhythms, allowing it to offset losses if the stock declined. If the SPE was required to pay Enron on the Rhythms hedge, the Enron stock that had been transferred would be the source of repayment: a big problem as Enron stock started falling in value in 2001 (just as
Rhythms was also collapsing). Enron also hedged via other SPEs known as Raptors (I–IV). These involved complex structures, funded mainly by Enron stock, and were used to hedge any decline in the value of Enron’s merchant investments. LJM2 provided external equity to avoid consolidation of the Raptors. Andersen, as auditors, approved the transactions despite that fact that economic risk was not really being transferred – the deals were simply designed to circumvent accounting rules by recognizing hedge gains against losses.

Enron never truly escaped the risk of loss as it provided nearly all the capital needed to fund the losses, but the company reported considerable revenues and pre-tax profits from these deals. For instance in the second half of 2000 Enron reported pretax earnings of US$532 million from the Raptors, equal to 80 percent of pretax profits. Curious, again, that Lay and Skilling did not know how the firm was really making money – a rather discouraging fact for investors that appoint managers actually to manage a company. The vehicles, however, were structured with Enron investments and Enron stock, so if both declined at the same time, the SPEs would be unable to meet their obligations, meaning the hedges would fail. This is, of course, precisely what happened in late 2000 and early 2001. Indeed, two of the four Raptors lacked enough credit capacity to pay Enron, so in March 2001 Enron should have actually taken a pretax charge of US$500 million. Instead it chose to restructure the vehicles by transferring US$800 million of forward contracts to receive Enron stock before quarter-end. This restructuring was not disclosed at the time, and was in fact inconsistent with accounting rules. As Enron’s stock continued its downward spiral in September 2001, the Raptors became insolvent and had to be terminated. This signaled the beginning of the end.

Chewco was created to hold a stake in another SPE. Between 1993 and 1996 Enron and CalPERS were partners in a US$500 million joint venture investment partnership known as the Joint Energy Development Investment LP 1 (JEDI 1). Since JEDI 1 was jointly controlled, Enron was able to book profits but not show the debt on its balance sheet. In November 1997 CalPERS wanted to liquidate its investment in JEDI 1 so that it could invest in the new, larger JEDI 2 that was being assembled (originally expected to be US$1 billion in size, or US$500 million for each partner). In order not to have to consolidate JEDI 1 on the Enron balance sheet, the company needed to find a replacement investor. Unfortunately it could find none, so Fastow and Kopper created Chewco as an SPE to purchase CalPERS’ JEDI 1 interest. Under accounting rules (see note above) Chewco needed 3 percent of risk capital in order not to be consolidated on Enron’s balance sheet. Enron ultimately lent Chewco US$132 million for JEDI 2 and guaranteed a further US$240 million – of the remaining US$11 million, representing the 3 percent independent equity required for non-consolidation, Enron actually supplied
half – in contravention of accounting rules, meaning that Chewco and JEDI should have been consolidated in 1997, not in 2001.

7 For instance, in March 2001 Enron repurchased Chewco’s JEDI 1 interest on terms negotiated by Fastow and Kopper; original investments of US$125,000 yielded exit profits of US$10 million. When Enron terminated the LJMI Rhythms hedge in 2000, the LJMI partners (including Fastow) did very well for themselves: Fastow’s US$25,000 investment (held in a separate partnership known as Southampton Place) yielded exit profits of US$4.5 million. The Batson Report, an independent review released in early 2003, concluded that Fastow actually made more than US$60 million – rather than US$30 million – from his Enron dealings.

8 According to a subsequent review by the board, the Enron employees (Fastow, Kopper, Glissan, and others) had not received permission, as required by the company’s code of conduct, to participate actively or passively in the partnerships.

9 During Congressional testimony after Enron’s collapse, Andersen CEO Bernardino indicated that Andersen and Enron were “simply wrong” in not consolidating the SPEs.

10 Had the transactions actually been permissible, the accounting would still have generated a false picture for investors and creditors by boosting earnings and lowering debt. They allowed large losses to be concealed by creating the appearance that the company’s investments were hedged, when they actually were not.

11 Numerous investigations took place in the aftermath of the bankruptcy, including the Special Investigative Committee of the Enron Board of Directors, which released a study in February 2002. Its primary task was to investigate the activities of the company off-balance-sheet activities, special purpose entities rather than the specific causes of the firm’s bankruptcy, or management’s business decisions as it was imploding.

12 Portions of the energy trading business were acquired by UBS in 2002.

13 According to estimates from various sources insurance companies recorded credit losses of US$1.75 billion, pension funds US$1.3 billion, banks and securities companies US$6.7 billion, and energy companies US$1.2 billion.

14 For instance, the Batson Report noted that the company improperly transferred US$5 billion of assets to other entities in order to manipulate earnings and leverage. This had the effect, for example, of depicting US$979 million of net income in 2000 (96 percent of which was manipulated) and only US$10.2 billion of debt (versus US$22.1 billion of actual debt).

15 An independent subcommittee investigation by the US Senate into the role of the board of directors in the matter reveals a group that was highly compensated (US$350,000 per year per director) and completely unresponsive and inactive: never challenging or querying, despite plenty of opportunities to do so. For instance: the board never asked Andersen to prepare more
prudent accounting approaches, even after Andersen audit partners advised
the board in 1999, 2000, and 2001 that Enron’s posture was distinctly “high
risk.” The board approved US$750 million of bonuses in 2000 as the
company reported US$975 million in net profit (thus three-quarters of
reported profits went to salaried managers); allowed Lay to borrow cash
from the company and “repay” the loan with Enron stock, effectively liqui-
dating US$77 million of his position through the company; never inquired
about Watkins as whistleblower or the evidence she had accumulated;
approved the Fastow role by waiving the code of ethics, and so on. Accord-
ing to the Senate report, the board represented an “unprecedented breakdown
in governance.”

16 Lay, for instance, sold US$100 million of stock over a three-year period,
even as he insisted to others he was not. (Much was accomplished through
the “internal credit facility” referenced above, which allowed for delay in
reporting the transactions to the outside world.)

17 Indeed, tax schemes became an Enron specialty. The tax department was
created as a business unit with annual revenue targets. The firm essentially

18 This, in addition to charge-offs of US$500 million on other Enron loans and
exposures.

19 Under terms of the agreement the bank paid insurers to guarantee its trades
with Enron, most of which were conducted through the bank-sponsored
Mahonia SPE. Mahonia was used to channel over US$1 billion to Enron as
financing for gas trades. Sometimes the gas delivered was transferred from
Mahonia to JP Morgan, which then sold the gas back to Enron. The insurers
balked at paying as they felt the transactions were “circular,” flowing from
Enron to Mahonia to JP Morgan and back to Enron. They were thus de facto
loans. Ultimately, the insurers only paid out US$655 million of the US$1
billion claimed, leaving the bank to write off the balance of the loss.

20 For example, even when the board committee was told in May 2000 that a
Raptor transaction raised the risk of “accounting scrutiny” there was no ques-
tioning from the committee; precisely because of the complexity and potential
conflicts of interest, the board should have raised questions.

21 Interestingly, Bernardino was a central figure in an early industry-wide
compromise with the SEC on splitting consulting and auditing duties. He
was able to convince regulators to accept an arrangement where consolidated
consulting/auditing services did not have to be segregated, simply disclosed.

22 Andersen was far too close to Waste Management to render objective judg-
ment on the firm’s accounting policies. For instance, between 1971 and 1997
every Waste Management CFO and chief accounting officer came from
Andersen.

23 Although the accounting industry also features a “peer review process” as a
check and balance, it is generally regarded as being of only limited use;
certainly this can be verified through the Andersen case (and others, as we note in the next chapter).

The pace of acquisitions was clearly proceeding too quickly, as few of the firms being acquired were actively integrated into the WorldCom sphere. For instance, MCI customer service dissatisfaction grew quickly after the purchase, and WorldCom managers did little to integrate the operation into the broader corporate structure.

To give several minor examples, one major WorldCom client noted that the firm was cutting bandwidth prices in half for “good clients” and then booking orders twice within the firm’s accounting systems; balance sheet receivables that were more than seven years past due were carried as “current” with no credit loss reserves; supplies were routinely paid on a very delayed basis (forcing WorldCom to pay additional financing charges but allowing it to conserve cash as long as possible); and so on.

Cooper, an internal auditor in operations accounting, grew suspicious of certain reporting and went outside her formal duties to investigate. She ultimately discovered several billion of bad entries, brought her concerns to the attention of Andersen (which disregarded them), approached the board (which initially took no action) and was then confronted by CFO Sullivan (who reportedly asked her not to divulge any further information until he had an opportunity to prepare an explanation). Cooper ultimately went back to the board’s audit committee and received a proper hearing.

Sullivan explained that when WorldCom had sold MCI’s Systemhouse business in 1998 for US$1.4 billion it had used the proceeds to expand WorldCom’s own networks, entering into long-term fixed rate line leases to connect the networks. Since Sullivan believed that the costs would match up against future revenues he chose to capitalize, rather than expense, them. A reversal of this position was necessary in the second quarter of 2002 when the weak economy, industry overcapacity, and lack of customer demand made it clear that future economic revenues would not be realizable.

For instance, when the government disallowed the WorldCom/Sprint merger, which would have given company management additional reserves with which to manipulate earnings, it was forced to shift to the line cost capitalization technique.

Two external reports conducted after the firm’s collapse concluded that Ebbers and top managers conspired from the late 1990s to carry out systematic fraud. Deliberate falsifications occurred every quarter; Andersen was kept in the dark, in part through the falsification of documents by the head of regulatory reporting.

For instance, on the British Columbia loan, Citibank took 2.3 million of Ebbers’s 18 million WorldCom shares as collateral: certainly enough to cause considerable downward pressure on WorldCom stock in the event of forced liquidation. Bank of America, another key lender, had US$253 million
of loans backed by shares. As the price of WorldCom halved in 2000, the bank was forced to give Ebbers a margin call; Ebbers went to the WorldCom directors for a US$50 million loan, which they granted. This occurred again in 2001, when Ebbers persuaded directors to grant a US$25 million loan and a US$100 million guarantee. In a clear conflict of interest, directors then started selling their own shareholdings.

31 The new company featured only US$5.5 billion of debt (versus US$36 billion at the time of filing); bondholders received 34 cents on the dollar plus new equity; original equity investors received nothing.

32 The SEC investigation was extremely large in scope and scale, with 45 Tyco units reviewed over 65,000 person-hours.

33 Much of Tyco’s corporate structure appears to have been designed to exploit onshore/offshore tax differences. The 1997 acquisition of ADT gave the company a Bermuda foothold (Bermuda features a more favorable tax climate than the United States, for example, no requirement to pay US taxes on non-US income) and the firm moved its incorporation from the United States to Bermuda at that time. Over the next five years it created subsidiaries in other tax havens, including Barbados, Cayman, and Jersey. By 2001 it had 150 offshore vehicles that it used to cut its theoretical effective tax rate from 36 percent to 23 percent (although it did not even have to pay taxes at the marginal 23 percent rate). In 2001, for instance, 65 percent of revenues came from the United States, but only 29 percent of its income did, meaning 71 percent was no longer subject to US taxes. Investigations into the firm’s tax dealings were a major focus of regulators.

34 An independent report prepared by outside lawyer Boies, at a cost of US$55 million, concluded that there was no fraud, simply widespread errors; others dispute that finding. In fact, the report may have been more of a publicity event than an actual investigation, as the Boies team investigated only 15 of Tyco’s 700 business units. Since the report was publicly released in late 2002 the firm was forced to declare a further US$1.6 billion of errors and problems. One particular aspect of the Boies report has been roundly criticized: although the Boies investigative team found nothing wrong with Tyco’s treatment of goodwill, many external accounting professionals believe that the firm massively overstated its goodwill position. As Tyco purchased companies it artificially inflated the size of a target company’s liabilities and understated its physical assets, reducing future depreciation and amortization and boosting future earnings.

35 In an effort to lower some of Tyco’s massive leverage, the firm spun CIT off in an IPO, raising US$4.6 billion, well short of initial estimates of US$6–8 billion.

36 Adelphia had US$6.8 billion of bank credit facilities, US$6.9 billion in senior notes, US$1.6 billion in convertible preferreds, and US$2.6 billion in debt from other subsidiaries.
Rusnak had indicated in 1999 that he wanted a pricing feed from Reuters, and asked management to develop a system to download prices into his computer, which he then fed into a shared back-office database. Not until the first quarter of 2001 did an Allfirst risk analyst notice that the finance spreadsheet used to compute profit/loss and risk referenced Rusnak’s manipulated price information rather than the external Reuters feed.

Allfirst used a ten-year-old version of the Sungard Devon system.


Lens continued to push for more outside directors in 1997, as it remained convinced that the company could not be turned around with so many long-term insiders; the fund proposed four new directors in 1997 but the company accepted only one. Lens also filed a resolution for an independent review of the asset divestment program, which was rebuffed. Soros, too, remained vocal: he filed a statement with the SEC citing frustration over management’s lack of progress, and pressed for a complete overhaul of the executive team.

An examination of the company’s disclosure revealed some troubling information, however: Rooney would received US$2.5 million per year for five years, essentially getting paid for doing nothing at all. Lens, too, continued its pressure, organizing institutional investors (for example, CalPERS, CREF, NY State Teachers) to be at the AGM and vote for a resolution calling for a majority of directors to be independent.

In an interesting “turn of events” LeMay and his superior were ousted from the top two positions at Sprint in 2003 as a result of questions over the tax treatment of their Sprint stockholdings.

For instance CrossAir’s pilots were paid only half as much as Swissair’s pilots, the cabin crew only one-third as much.

SAG officers created a vehicle through which to acquire majority shareholdings. For instance, in purchasing Air Littoral, two tranches of shares were issued for a total price of 255 million French francs. Before purchasing the second tranche, SAG sold 46.3 percent of the shares to trustees (porteurs); the porteurs were indemnified against costs and third party claims. Shares acquired by SAG were written off in full in the year they were bought, and the buyback by SAG of equity held by the porteurs was hedged with options. The Chairperson of Littoral held the remaining 4.7 percent stake along with a put option to sell his shares to Sabena (in which SAG had a stake). So SAG had actually controlled a majority of Littoral since mid-1999, meaning the airline should have been consolidated in SAG’s financials. In addition,
between 1999 and 2001 SAG undertook various equity swaps on its own shares, leading to an outflow of several hundred million Swiss francs as the company’s share price slid; these may have been improper and documented in error.

45 Sabena itself ceased all operations in November 2001.

46 Générale des Eaux was actually a participant in the creation of the Canal+ pay-television channel as early as 1983; this, however, was its only media foray.

47 Seagram itself had expanded from its traditional beverage/liquor focus into entertainment during the mid to late 1990s. For instance, in April 1995 it purchased 80 percent of MCA/Universal Studios for US$5.7 billion; in October 1997 it merged with Home Shopping Network, and in December 1998 it bought Polygram Records for US$10.4 billion.

48 Despite the deterioration, management still tried to display Vivendi in a good light by “managing” key ratios, such as Debt/EBITDA (a widely used measure of leverage). In 2001, for example, the firm’s ratio as conveyed by management was only 3.8, but that included a full attribution of earnings from Cegetel and its SFR mobile operator, not the 35 percent of SFR that should have been included. Vivendi managers argued that they had effective control over Cegetel and SFR and were thus entitled to express the leverage as 3.8 instead of 5.1 (a number that is characteristic of companies on the brink of bankruptcy). The credit rating agencies concurred with this approach for a time as they were “assured” that the company would one day acquire the balance of Cegetel and SFR.

49 At considerable expense to the company, it might be added, which was asked to purchase and “update” a US$20 million apartment.

50 In the aftermath, Bebear noted that banks were preparing to withdraw a US$400 million credit facility that could have precipitated a liquidity spiral, so the board needed finally to make a decision.

51 Like Japanese keiretsus, Korean chaebols have historically been considered decentralized business groups. Although their existence and scope in the “post reform” period is now limited, pre-1997 chaebols were formally defined as a group of companies with 30 percent+ shares held by individuals or companies.

52 In fact, government legislation encouraging labor contracts with lifetime job guarantees was partly to blame for the company’s bloated staff structure (which was well in excess of what it needed for its production and sales levels).

53 Kim, and others, actively courted Roh Tae Woo, the former Korean President imprisoned on corruption charges, and many other politicians.

54 Though Korean companies were (and are) not permitted to own banks, many circumvented this restriction by buying or creating other “quasi financial institutions” including merchant banks, finance companies, securities
companies, and investment trust companies, which also served as captive finance conduits.

55 For instance, Korea’s top three auto makers, Hyundai, Daewoo, and Kia were capable of producing 5 million units per year, but were only selling 1.25 million units in the national and export markets.

56 As an example, the Daewoo British Financial Center did not appear on Daewoo’s balance sheet and is generally believed to have operated as a significant executive “slush fund.”

57 Daewoo Motors remained in bankruptcy for two years before GM sealed a deal in late 2001. Though GM originally lost out to three counterbidders (Ford, Toyota, and Hyundai), all walked away for unspecified reasons, leaving GM with the failed conglomerate’s auto operations.


59 In fact, Microsoft made a US$45 million investment in LHSP in 1997.

60 Other firms, such as Qwest, Reliant Resources, and Homestore, among others, engaged in similar practices and were forced to restate their revenues as well.

61 In another possible conflict, the head of the finance unit at Global Crossing had been the Andersen partner in charge of the Global Crossing account for many years.

62 In the aftermath of the disclosures one director admitted, ‘We really don’t know a lot about what has been occurring at the company,’ not quite what a shareholder wants to hear.

63 There is evidence to suggest that the warnings of a junior accountant who left the firm in May 2002 went unheeded by his managers and E&Y. The accountant, working in the asset management unit between 1997 and 2001, believed falsification was occurring through the movement of small items from the income statement to the balance sheet. He refused to take part in the manipulations unless his supervisor signed off on the policy, which she did. (She later pleaded guilty to fraud.) Subsequent events demonstrated that the junior accountant was, indeed, correct.

CHAPTER 8: STUDIES IN FLAWED GOVERNANCE II: SECTORS AND INDUSTRIES

1 Although PwC, E&Y, and KPMG eventually spun their consulting units off (or sold them to third parties), they did not do so until conflicts of interest became increasingly apparent. DTT, which had intended to split off its own unit in 2002, was forced to postpone the process as it was unable to get adequate financing. Although PwC sold its consulting arm to IBM in 2002,
it created another internal corporate finance and tax advisory business; similar “consulting divisions” were also established by E&Y and KPMG.

Such schemes took many forms, including creating paper losses to offset capital gains, and transferring assets to new partnerships. While many may have been (and are) legitimate, others have become the focus of regulatory and tax authority scrutiny.

The firm has a large number of strategic alliances, partnerships, and venture capital relationships with audit clients, and is seen as one of the most aggressive in creating new business products and services. (Average partners’ revenue increased by a third between 1996 and 2000, and the firm derived nearly 20 percent of its US revenues from non-audit business in 2002.)

Interestingly, the OPIS structure was introduced as a successor to FLIPS because, according to the marketing material, it can “better shelter KPMG and its tax product from IRS scrutiny.”


In fact audit/non-audit services continue to be an area of focus and concern. Even after the passage of legislation limiting the combined services, many audit firms in the United States are still earning more revenues from their non-audit businesses. For instance, of US$812 million in audit/non-audit fees paid by the 30 Dow Jones Industrial Average companies in 2002, 62 percent was attributable to non-audit services. (Although this is down from 75 percent in 2001, it includes a more liberal definition of what constitutes an audit fee, and is thus quite comparable.) For instance, Johnson and Johnson paid its auditor, PwC, US$10 million in audit fees and US$83 million in non-audit fees in 2002.

Starting in 2003 various countries established new accounting oversight boards; their efficacy is, of course, unproven.

Although energy companies were the driving force in the market, they were not alone in adopting aggressive approaches to business; Wall Street institutions were also willing participants in certain sectors. For instance, Morgan Stanley was an aggressive trader, while Citibank and JP Morgan Chase extended financing for future delivery of gas and oil through a prepaid swap structure that let energy companies reflect the financings as cash flow from operations rather than debt. (Under a typical prepay an energy company would deliver gas or oil to the bank in exchange for cash (such as a loan), and the gas or oil would eventually be sold back to the company; the process would then be repeated.)

Intercontinental Exchange is the only meaningful platform remaining in existence. ICE had the foresight of acquiring London’s International Petroleum Exchange, with the benchmark Brent crude oil contracts, and has built a solid business around over-the-counter and standardized exchange energy products.

In 2000 California government officials formally accused energy companies of abusive trading practices that appeared during the state’s power crisis.
Energy companies were accused of price-gouging the state, increasing the price of power from less than US$100/megawatt hour to peaks as high as US$2500/megawatt hour. California, in the midst of prolonged heat waves, surging power demand, and grid inefficiencies, was forced to pay these egregious “market prices.” Ultimately, many of the energy trading companies settled civil fraud charges with California and other major clients.

11 Listed commodity exchanges forbid such “wash trades,” but the over-the-counter derivative markets do not. Indeed, 2000 legislative amendments via the Commodity Futures Modernization Act (CFMA) exempted oversight over most aspects of OTC energy market trading.

12 As companies began restating their revenues and earnings in 2002 to reflect the abusive round-trip trades, the extent of their impact became clear. For instance, Encana restated its top line revenues by US$724 million, CMS Energy by US$5.2 billion, and Reliant by US$6.4 billion.


14 Interestingly, the FERC did not permit various western US states to abrogate long-term energy contracts they concluded with energy firms in 2001, meaning they remain valid through their original maturities. California, for instance, agreed US$43 billion of long-term energy contracts, many struck at market levels that ultimately declined rather significantly.


16 For instance, the telecom analyst at Citibank/SSB (who subsequently left the firm, paid the SEC US$15 million in fines and agreed to a lifetime ban from the securities industry) upgraded AT&T from “neutral” to “buy” in late 1999. The reasons for the upgrade remain unclear, but investigations suggest possible pressure from senior management as Citibank attempted to win the AT&T Wireless tracker stock IPO (which it won). The same analyst also had a “buy” recommendation on Winstar Communications, with a US$50 price target just as the firm was filing for bankruptcy. An analyst at Merrill Lynch, similarly, touted hot Internet stocks like InfoSpace (with a US$100 price target) as the firm’s bankers attempted to win more business. InfoSpace subsequently collapsed and the bank was forced to settle customer complaints and lawsuits.

17 In at least one case, the former head of CSFB’s technology investment banking unit (fired in early 2003) demanded that all technology research analysts report through him, a clear conflict of interest (although one that the firm’s management agreed to, as it attempted to climb in the technology banking league tables). The NY Attorney General and NASD subsequently filed obstruction of justice charges related to purging e-mails and other deal-related documents that were becoming the focus of regulatory and legal scrutiny.

18 There is considerable e-mail correspondence from various Wall Street firms between analysts denigrating companies on which they had issued “buy”
opinions; in some cases the differences between private and public opinions are very striking.

19 This group included Merrill Lynch, Citibank/SSB, CSFB, Morgan Stanley, Bear Stearns, JP Morgan Chase, Piper Jaffray, Lehman Brothers, UBS, and Goldman Sachs.

20 These supplemented earlier changes related to companies themselves. For instance, under Regulation FD, if companies want to give analysts inter-period “earnings guidance” they are now required to put out a formal press release to the market at large.

21 The claims center on the creation of favorable reports designed to win banking business, rather than bad stock picking calls. Thus, bad research opinions (such as a “buy” instead of a “hold” or “sell”) that are unrelated to trying to gain other business are out of scope.

22 Some studies point to strong correlation between family-based corporate control, corruption, and legal inefficiencies; this is particularly true when close ties exist between the family companies and government or regulatory officials.

23 We might argue that corporate governance issues are of less importance when considering privately held companies. (After all, if the family groups contribute the equity and control the corporate resources, they are only hurting their own interests if they fail to adhere to proper governance.) We point out the fact that even in the instance of private companies other stakeholders exist, including employees, creditors, regulators, and taxpayers. Their interests must be considered and protected. In addition, any time a private company with a stake in a public company uses that stake to control and influence behavior, governance controls must be enforced.


25 Between 1993 and 1997 the five largest shareholders held an average 69 percent of outstanding shares (the largest alone 49 percent of shares); by 1997 approximately two-thirds of publicly listed companies were owned by companies directly or indirectly controlled by families.

26 Although non-bank financial institutions were not regulated prior to 1995 (despite the fact they made loans). They became subject to certain regulations in 1995–6, including rupiah lending limits of 15 times equity and dollar lending limits of five times equity; these appear to have been widely ignored.

27 See Tabalujan (2001), for example. Similar concentrated lending to “group companies” can be seen in various other developing model countries (for instance, Mexico, where 20 percent of loans at the turn of the millennium were to “related parties,” at rates 400+ basis points below market, with longer maturities and lower collateral provisions).

28 Most currencies were pegged to the dollar (or a basket of major reserve currencies) but were permitted to float in a relatively narrow band; while local economies were strong this was a viable structure and appeared to reflect a fair amount of stability.
Foreign banks – holding US$35 billion of private corporate debt – also lost heavily, although they were not part of any recapitalization program.

CHAPTER 9: STRENGTHENING THE GOVERNANCE PROCESS 1: MICRO REFORMS

1 We urge interested readers to consult academic studies to gain a better understanding of the empirical issues; see, for example, Becht, Bolton, and Roell, 2002, for an excellent overview of the topic.

2 Aspects of corporate governance have been in place for many years and have served company stakeholders very well. For instance, during the early 1990s certain US boards started shrinking in size to become more efficient, and severing business ties to become more independent. In addition, during the mid to late 1990s some became very active and aggressive in critiquing, investigating, and ultimately ousting CEOs and other senior executives.

3 In the United States, for instance, the passage of the Sarbanes–Oxley Act (which we consider in Chapter 10) requires US public companies (as well as those from other nations that choose to list, for example, on the NYSE) to adhere to specific requirements. Best practices, intended primarily as voluntary recommendations of good corporate behavior, are increasingly prevalent around the world; industry and regulatory groups in many nations have spent considerable time and effort in developing local codes of conduct intended to create a safe operating environment. To help supplement the discussion in this chapter, we have included, in the Appendix, a brief review of salient points of governance best practice from around the world.

4 Many research studies have been conducted in different systems over the years, and many seem to support the benefits of properly structured boards. In particular, studies have shown that a small number of directors, who are independent of executives, are most effective; selecting directors from the “management recommendation” list is not necessarily optimal; “marquis” directors do not necessarily add value; directors who are also shareholders appear more willing to make difficult decisions; and, directors who devote more time to the company’s affairs are more effective.

5 During crisis periods it is not uncommon for one or two board members to take the lead in trying to move the company past its problems, such as removing a CEO or grappling with loss of management credibility, as Smale did in removing GM’s Stempel (1991), Burke did with IBM’s Akers (1992), and Bebear did with Vivendi’s Messier (2002), or as Miller and Whitman did in realigning Waste Management (1997 and 1998, respectively). The reasons for this leadership must be understood: is it because the board member is truly a leader, aggressive and more qualified than all other directors, or is it because the remaining directors are conflicted and too close to management,
uninterested, or unqualified? If any of the latter they should probably not be serving as directors, as they are almost certainly not representing the best interests of shareholders.

6 One survey of US directors indicates the amount of time demanded of them has increased by approximately 25 percent over the past decade. By all accounts this figure will only continue to rise in the future.

7 Other national best practice codes call for greater independence as well; see the Appendix for additional details from other countries.

8 See Weisbach, 1988.

9 See Byrd and Hickman, 1992.

10 See Weisbach, 1988, and Rosenstein and Wyatt, 1990, for example.

11 For instance, under S–O, Title III, Sec.301(b): “[A] member of the Audit Committee of an issuer may not, other than in his or her capacity as a member of the Audit Committee, the Board of Directors, or any other Board Committee – (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.”

12 For instance, as we have noted earlier, Swiss law requires 50 percent of a public company’s board to be Swiss. With a small pool of candidates, this requirement should be altered.

13 Due consideration must be given to the fact that some national systems require shareholders to select the external auditor.

14 In most national systems this becomes a central duty, as legislative and/or regulatory action has not led to a specific ban on the provision of accounting/auditing and tax/consulting services. For example, in the United States, the SEC has declined to ban firms from providing tax services (although, under provisions of the Sarbanes–Oxley Act of 2002, it has imposed more stringent rules regarding auditor rotation).

15 These best practices also suggest that when a split in the roles is not made, the reasons be disclosed in the annual report.

16 Enron, Global Crossing, WorldCom, and other governance “disasters” featured separate chairperson/CEO roles.

17 In fact major public firms such as Disney, Cendant, and GE, which featured combined roles through 2003, appointed presiding directors.

18 When director fees are overly high, problems could appear. For instance, in 1995 US commodity firm Archer Daniels Midland (ADM), its directors and executives were found guilty of price fixing. By coincidence (or not), the board of directors featured several ADM family members and received director fees that were three times the national average.

19 For instance, Armada Corp lost eight of its ten directors.

20 Since early 2002 Lloyds’ syndicates, AIG, and Chubb, among others, have stopped writing severability cover for new clients and selectively refused to renew it for existing customers.
Japan serves as an important example. We know from our discussion in Chapters 2 and 3 that the executive managers of large public companies have historically maintained important symbiotic relationships with their main bankers. The main bank supports management if performance is good, otherwise it intercedes. Much of the decision on whether managers are performing as desired has been based on access to tightly-controlled inside information, creating a “closed system,” one perpetuating the power and relationship between the two groups. With the arrival of technology and the ability to create and distribute management information much more readily, the competitive edge provided by the closed system is almost certainly on the decline. Main banks are no longer perceived as having sole access to important information, a process that should help add further transparency and strength to the Japanese governance process.

To consider just how daunting the task is, of 275 shareholder proposals filed in 2002 to better control executive pay, only two passed successfully.

For simplicity we might define wealth as the sum of an executive’s current stock and option positions plus the present value of expected future compensation.

As an example, Hewlett-Packard shareholders approved a rule advising directors to obtain investor approval whenever an executive severance package valued at more than three times salary and bonus is being considered; however, the rule is non-binding.

The IASB has taken the lead in this area, announcing in July 2002 that all EU companies would be required to expense their options through the income statement within a five-year time frame. In the United States similar rules being drafted by FASB are gathering momentum and should ultimately yield the same results, despite a fairly vocal lobby that believes expensing is unfair because (a) it represents no upfront cash outlay and (b) it would cause certain companies to cease giving out options if adopted.

In mid-2003 Microsoft (and others) announced that it would abandon stock option grants as a result of a languishing share price that left many holders with positions that were underwater or had little value. Instead, the company indicated that it would start granting restricted stock to eligible employees.

For instance, assume the CEO receives a bonus equal to 2 percent of operating profit at US$100 million. If operating revenues decline from US$100 to 50 million and the board wants to preserve the CEO’s original US$2 million bonus (for example, 2 percent of operating profit) it must now increase the bonus share to 4 percent of operating profit. Likewise, when operating revenues rise from US$100 to 200 million, the CEO’s share must be reduced to 1 percent. These are confusing and inconsistent signals.

For instance, in the United States individual investors who invest primarily through mutual funds are now protected by an SEC rule that requires fund managers to disclose how they vote the shares in their funds on key issues.
such as executive compensation and environmental practices. It is worth noting that the heads of the two largest US fund families, Vanguard and Fidelity, vehemently opposed the SEC rule prior to their adoption, claiming that it would result in extra costs and administration. Labor unions, not surprisingly, were in full support of the rule, claiming that fund managers too often blindly side with company management on all major issues. (To respond to the charge, Vanguard and Fidelity pointed out that in 2001 alone they voted against management-proposed stock option plans 64 percent and 46 percent of the time, respectively.) This is a potentially significant ruling, considering the fact that by the end of 2002 mutual funds had US$6.6 trillion of investor funds under management. While the rule protects the estimated 95 million mutual fund owners, it does not apply to investment shares held in pension funds, insurance companies, or bank trust units.

To further protect shareholders, the SEC has passed a rule that prohibits brokers holding shares on behalf of individual shareholders from voting on compensation plans, which they have historically done “en masse” when individuals have not voted their own shares.

Of course, some balance between controlling and minority shareholders must exist; controlling investors, after all, have considerable wealth at stake and also have rights that require respect.

For instance, in 1995 the Centre for European Policy Studies (CEPS) issued EU government standards centered on one share one vote, which give shareholders the clear ability to elect directors. Many of the “best practice” standards promulgated in recent years make similar references to the need for equitable voting and election practices. The aim is to limit the ability of management to pass unchecked dual class recapitalizations, which might lead to the creation of stratified voting classes to the benefit of incumbent management. CEPS has also emphasized fair treatment of minority shareholders in takeover situations (for example, ensuring that minority shareholders do not receive less compensation for their shares than a concentrated or controlling shareholder). There is already some evidence that such actions are taking root (for example, minority shareholders blocking the takeover by Schneider Electric of Legrand because it violated aspects of preferred shareholder rights, and minority shareholders suing Deutsche Telekom for large asset write-offs).

In the UK, Denmark, the Netherlands, France, Belgium, Germany, and various other countries, shareholders are protected by a duty of care and loyalty, and by special investigative procedures that are intended to detect corporate misconduct and can lead to court claims and director liability. Such investigations, which can be ordered via the AGM or minority shareholders, and conducted by a court or administrative body, can appear when shareholders suspect wrongdoing or failure to act in their best interests. If a violation has been found, action can be taken to recover damages, for instance in the UK under “wrongful trad-
ing” provisions and in Belgium under *action en comblement du passif*. For instance, directors may be shown to be liable if they have not investigated soon enough the possibility of saving a company that ultimately collapses. (This preserves the business judgment rule but penalizes directors when they keep doing business as the company continues to deteriorate.)

33 For instance, directors of Daiwa Bank (in charge of the bank during the unauthorized trading of the mid-1990s) were successfully sued by shareholders and ordered to pay ¥83 billion in 2000.

34 In addition to returning capital to investors efficiently, repurchases have the added benefit of not imposing taxes on investors (unless existing holdings are sold). Dividends, in contrast, are subject to double taxation in many jurisdictions (as corporate profits in the first instance, and as income to investors in the second).

35 Companies such as Incs, Sanco, and Megachips, all once part of established conglomerates, are now independently owned companies.

36 US investment bank Stern Stewart, for instance, has promoted the use of an “earnings value added” model that focuses on a company’s net operating profits after tax, and after a charge for capital used to produce profits. Projects and businesses must therefore earn real profits on the capital they have been granted. The focus of the model is on cash flows rather than accounting earnings, but it provides a critical link back to scarce capital resources. By doing so, it overcomes some of the accounting shortcomings we noted in Chapter 1, for example, treatment of R&D and depreciation, and expensing versus costing.

37 For instance, Coca-Cola has made an important move in this direction by refusing to give “earnings guidance” between periods; it prefers to start removing the focus on short-term earnings performance. PepsiCo, AT&T, McDonald’s, Gillette, USA Interactive, Gillette, and several others have done the same, but many more need to follow.

38 The director nomination process is obviously a complex one, and must be handled with care and discretion, particularly since high-level executives and corporate officers are involved. However, with the proper process in place – one based on a definition of the ideal characteristics and experiences of directors, the formation of a broad pool of candidates, the engagement of a search firm to winnow down to the truly qualified, and the actual process of screening and interviewing – all parties can feel they are contributing in a meaningful fashion.

39 A survey of US companies by the Institute of Internal Auditors and the National Association of Corporate Directors found that 50 percent of board directors surveyed felt that they did not have adequate risk management systems in place to track their financial risks.

40 For instance, in the Tyco investigation, many questions were left unasked or unanswered regarding the relationship of Tyco and Citibank/SSB; in the WorldCom investigation, many questions remain regarding IPO spinning to WorldCom directors.
CHAPTER 10: STRENGTHENING THE GOVERNANCE PROCESS II: MACRO REFORMS

1. As in the last chapter, various aspects of macro governance reform have been tested by academics over the years. Our focus, again, is not on specific results of such econometric tests, but on understanding what reforms might be of use in strengthening the process.


3. The Japanese system is going through a gradual process of change through a shake-up of the political status quo. In particular, the Liberal Democratic Party (LDP) has held tremendous power and sway over the post-war political and bureaucratic system and has helped shape key aspects of corporate governance, including many of the main bank/keiretsu relationships discussed in previous chapters. Beginning in 1993, however, non-LDP coalitions have repeatedly challenged the LDP (and, by definition, the political establishment). The prolonged economic and bad loan crises, together with the break in the LDP’s hold on power, are starting to lead to what we might consider to be radical, albeit gradual, governance shifts. These are driven by changes in the Japanese Commercial Code and associated regulations, and creation of best practices (for example, dismantling of lifetime employment, addition of more independent directors and creation of independent board committees, and shrinking of board size).


5. In North America, 76 percent have a preference for GAAP; Latin America, 59 percent GAAP; Western Europe, 78 percent IAS; Eastern Europe and Africa, 76 percent IAS, and Asia, 65 percent IAS.

6. For instance, in the United States, the SEC delegates accounting writing standards to the FASB and retains oversight. In the UK, the FSA retains oversight of the IAS standards developed by the IASB as well as UK GAAP.

7. For instance, the EU has issued a directive calling for EU companies to implement IAS by 2005; although aspects of IAS may not always be the most beneficial for shareholders, the directive at least represents a move toward a consistent and verifiable view.

8. While the external audit process has a role to play through certification, it cannot be regarded as a panacea. In the United States, for instance, 15,000 public companies are required to file audited statements with external certifications indicating conformity with the US GAAP standard. This is a necessary, but not sufficient, statement. The real issue is not whether the company has adhered to the standard, but whether the standard reflects an economic reality or an accounting fabrication. In fact, it might be more useful for US companies to follow the UK model, where audit certification means that the financial reports provide a true and fair reflection of a company’s business,
or a new model, where the audit certification is descriptive and actually conveys useful information.

9 For instance, new FASB rules related to variable interest entities – a range of financial structures and vehicles that includes SPEs – may force certain structured finance transactions, including collateralized debt obligations and asset backed securities, to be consolidated back onto sponsor balance sheets. The intent is not to restrict their use but to add a level of transparency to the economic flows and risks that surround such structures. However, such changes could make it more expensive for sponsors to raise funding as they might attract a greater amount of regulatory capital. Accordingly, financial institutions may be less inclined to sponsor such deals.

10 For instance, in a critical decision the FASB announced in mid-2003 that derivatives used as a “financing” rather than risk management tool (for example, a prepaid or off-market swap) must now be considered a financing cash flow rather than an operating cash flow. This closes an important loophole that many companies exploited (for example, Enron had US$8 billion of prepaid swaps that were not counted as financing arrangements; other energy companies had similar arrangements).

11 For instance, in 2003 Japanese financial regulators changed bank loan accounting standards for the 11 largest domestic banks in order to hasten bad loan write-offs. The new standards are based on discounted cash flow analyses, estimating a loan’s value by projecting a borrower’s future cash flow (rather than relying on the “traditional” approach, which examines the historical default probabilities of a borrower’s industry). The new standards are much more closely aligned with those found in the United States and the UK.

12 For instance, the employee pension plans of Enron and Kmart, both of which filed for bankruptcy, were overly concentrated with company stock. Enron’s stock price fell from a high of US$80 to less than US$1, Kmart’s from US$25 to less than US$0.50. Losses, particularly for long-serving employees, were considerable.

13 Some countries do have some government guaranteed pension protection that is invoked in the event of corporate insolvency. For instance, the United States has a guarantee system that covers the pension assets of certain workers.

14 Again, as noted earlier, although these types of protection help retail clients, they can also induce moral hazard: for example clients will be less disciplined and careful in selecting their bank or insurance company if they know they will be “bailed out” of any potential problems.

15 For instance, in July 1995 Germany amended its Takeover Code to better protect the rights of minority interests. New provisions require any company buying more than 50 percent of a target firm to buy the remaining shares within 18 months at a price not less than 25 percent below the premium paid over the preceding six months. The United States and UK also feature fair price provisions.
16 Certain regulators (for example, the SEC) have also attempted to establish resti-
tution funds for employees and other stakeholders that have been the victims of
fraud and “ill-gotten gains.” This has generally had very limited success.

17 For instance, rather than attempting to bail out relationship companies,
German banks have walked away from firms such as Holzman and Kirch
Media, and Japanese banks have let record numbers of companies fail since
the turn of the millennium.

18 Indeed, the debtor-oriented nature of the US system is attractive to certain non-
US companies, some of which are making use of the US court system in order
to arrange cross-border restructuring. If a non-US firm has a place of business
or property in the United States it can seek relief in the US bankruptcy courts.
(Air Canada (Canada), Avianca (Colombia) and JIK Banka (Serbia), among
others, filed for restructuring in the United States in 2003.) The trend towards
this strategy appears to be strengthening as the automatic stay feature puts a
freeze on asset seizure and lawsuits, and allows for considered restructuring.

19 To claim protection in the United States a company does not even need to
prove financial distress. In the UK companies are actually encouraged to
seek protection as the law sanctions companies that do business when insol-
vent. Although protection, and an eventual “clearing of the slate” with regard
to liabilities, can be extremely beneficial, it also raises the specter of moral
hazard. Aggressive executive management of a financially-distressed
company, knowing that protection can always be sought, might indeed
behave even more recklessly in the final stages of the process.

20 For instance, during the Asian currency crisis of 1997, which led to massive
currency devaluation, capital flight, and economic destabilization, many finan-
cial and corporate institutions became insolvent. In Thailand and Korea,
specialized insolvency chambers were created around existing legal principles
in order to deal efficiently with the burgeoning crisis.

21 Although creditors should theoretically play an active governance role in
bankruptcy or insolvency situations, this tends not to happen as a result of
conflicts of interest or unwillingness to commit further time, effort, and
resources to the situation.

22 For example, in the UK those responsible for preparing a prospectus are
directly liable unless they “reasonably believed (having made such enquiries,
if any as were reasonable, that the statement was true and not misleading).”

23 Of course, not every effort at developing or expanding a capital market
works as expected, even in advanced financial systems. For instance,
Germany sought to expand its own domestic capital markets through the
creation of the Neuer Markt conduit for technology shares; the market effec-
tively collapsed after the bursting of the technology bubble in the early
2000s. Similar efforts have proven only middling successes in other coun-
tries, as with Nuova Mercato (Italy), SWX New Market (Switzerland),
Nouveau Marché (France), and EASDAQ (UK).
Consider the case of EM.TV, the German media company that went public in 1997 on the Neuer Markt: a marketplace with basic standards, but certainly not the same level of stringency or quality control as Germany’s main bourse. In 2000 EM.TV lowered its earnings estimates from US$250 million to US$24 million; when the founders were accused of financial reporting falsification and fraud, and selling shares during a black-out period in violation of lock-up rules, the company quickly lost 98 percent of its market value. It ultimately filed for bankruptcy.

For instance in Germany, under the “Eichel Plan” tax code changes encourage disposal of long-term shareholdings. The large difference between book value and market value of shareholdings held over long periods of time has meant a reluctance to liquidate and bear the tax consequences. Through the Eichel Plan piecemeal or strategic sales of share blocks benefit from favorable capital gains tax treatment, meaning more concentrated shares should make their way to the marketplace.

There has been increased activity in the Asian sphere in the aftermath of the 1997 financial crisis which damaged various economic and corporate systems. For instance, in Korea, the government abolished a rule that required any company holding a 10 percent+ stake in another company to seek Korean SEC approval (this was the government’s way of protecting incumbent management). Following the rule change a series of hostile takeovers has occurred.

For instance, the European Takeover Directive was rejected in 2002 after 12 years of drafting and negotiation; this may have some negative effect on capital flows. In particular, the Directive was rejected by some countries that felt that EU companies would not be adequately protected from hostile international bidders. Although it was intended to give shareholders equal treatment, time and information to evaluate a bid, and a minimum guarantee regarding the credibility of the offer, the negotiations fell apart over the “frustrating actions” clause. This says that after a company receives a public bid, it should not take any actions that could “frustrate” the offer.

In Japan, for instance, the main corporate goals are to remain independent and self-perpetuating. Thus a takeover (or bankruptcy) can be regarded as the ultimate form of “corporate failure,” meaning hurdles, barriers, and resistance to such activities will probably exist for some time.

Recognizing the fact that certain skills need to be enhanced, many of the largest firms are requiring their auditors to attend more training. For instance, E&Y requires auditors to go through extensive fraud and internal control training.


In addition to procedural differences, broader differences also exist. For instance, in some countries the external auditor is selected by the board of directors and in others (for example, Germany) by shareholders; in some countries auditors are not required to be admitted or approved by the national
financial supervisory authority, and in others they are; in some countries (Italy, Austria, UK) auditor rotation is mandatory and in others it is not; in some countries non-audit by external auditors is banned and in others it is not (for example, the UK, although disclosure is required); and so forth. In the United States, for instance, institutional investors own 50 percent of the outstanding equity of the 50 largest US companies, and the top 20 pension funds own approximately 10 percent of the ten largest US companies. They obviously have significant clout, if they choose to use it.

Consider the example of media monolith AOL Time Warner (known simply as Time Warner as of late 2003). After the two companies announced, and then concluded, the largest corporate merger in history at the turn of the millennium, investors watched the firm’s stock price decline steadily as it became increasingly clear that the merger was not working as expected. At the end of 2002 the firm announced a US$99 billion write-off of goodwill, the largest in corporate history (and twice Wall Street’s expectations) to bring book value and purchase price in line. The write-off came close to breaching the firm’s debt covenants, and it was forced to sell assets and refocus strategies to remain at investment grade credit rating levels. Disappointed activist institutional investors, led primarily by the Capital Group, worked behind the scenes to press the board into ousting the chairperson, who was chief architect of the merger.

There are obviously occasions when concentrated investors are not actually diversified in their own operations/portfolios, meaning they may have governance issues of their own. In fact, they may be attempting to benefit from the position of influence created by their shareholdings at the expense of other stakeholders (including creditors and minority interests). For instance, they might urge management to shift capital to risky, positive-NPV projects in an attempt to try to achieve higher enterprise value (at the expense of creditors, whose position weakens). In the main, large institutional investors (for example, pension and mutual funds, insurance companies) do not fall in this category.

For instance, Hermes has a voting alliance with CalPERS, where each fund supports the other on key voting matters. Hermes also has cooperative relationships with fund managers in the Netherlands, Germany, and Scandinavia. Institutional investors must, themselves, operate under proper governance procedures. While it is often assumed that those who are interested in promoting proper governance follow such rules as a matter of course, formalization of this point is prudent. For instance, one step in this direction appeared in late 2002 when the OECD issued guidelines on pension fund governance in order to protect against mismanagement or fraud. The guidelines call for the establishment of a formal governance structure with shared responsibilities, regular reviews by an independent auditor, pension fund management accountability, actuarial certification, and so forth. The guidelines are voluntary, but have been adopted by the 30 members
governments; they are also being used by the World Bank and the IMF to assess international standards.

37 Southwestern Airlines in the United States, for instance, has adopted such a chewable pill.

38 Indeed, countries such as France, Germany, and Italy have featured significant “pay as you go” systems, funded by currently working populations and administered by the state. As the population ages in each country and the ranks of the retired grow, gaps start to increase and the pension liability becomes greater. Some minimum level of privately funded and managed pension assets is required (for example, at the turn of the millennium Germany featured 80 percent state funding, 5 percent employer funding, 15 percent personal funding). In the UK, where pension funds hold about 20 percent of total corporate shares, there is no compelling evidence that their large stakes have led to the adoption of stronger corporate governance practices. Indeed the Myers Report, sponsored by the UK Treasury, has indicated that UK pension fund investment expertise is still lacking. Thus, a stronger governance voice may not appear until such basic issues as investment process, policy, and returns are addressed.

39 Interestingly, S–O is not the first “sweeping” piece of US legislation designed to address corporate governance issues. For instance, in 1980 two early bills were sponsored by different members of the US Congress. The Protection of Shareholders Rights Act required companies with US$1 billion+ in assets to have a majority of outside board directors, and audit and nominating committees comprised solely of outside directors, while the Corporate Democracy Act required public companies to have a majority of outside board directors, limiting outside directors to two boards, imposing criminal penalties for directors failing to perform their duties of care and loyalty properly, requiring expanded disclosure, and requiring the formation of a implemented. Indeed, the US corporate scene of 2000–2 might have looked very different had such legislation been passed.

40 For instance, the United States passed the Financial Institutions Restoration and Recovery Act (FIRREA) to deal with the burgeoning savings and loan crisis of the late 1980s/early 1990s, and most national banking regulators adopted the credit risk capital rules framed by the Bank for International Settlements in the face of emerging market loan defaults/restructurings of the late 1980s.

41 For instance, the chairperson and CEO of Sun Microsystems has publicly indicated that adherence to the provisions of S–O will be extremely expensive.


43 For instance, UK auditors have made a policy of including various disclaimers, such as “The auditor does not accept responsibility to anyone other than the company and the company’s members as a body.” This is in contravention of US approaches, where laws permit the public to rely on an audit opinion.
Ibid., Title II, Sec.205(a).
Ibid., Title III, Sec.301(3)(A).
Ibid., Title III, Sec.301(3)(B).
Ibid., Title III, Sec.302.
Ibid., Title IV, Sec. 401(a).
Ibid., Title IV, Sec. 402(a).
Ibid., Title V, Sec.501(a).
More specifically, the report has noted “The brittleness and rigidity of legislation cannot dictate the behavior, or further the trust, I believe is fundamental to the effective unitary board and to superior corporate performance” (Higgs, 2003, introduction).
In fact, the Higgs Report recommended best practice changes be adopted via the Combined Code. Recommendations center on a number of areas, including the board of directors, the role of non-executive directors, independence, recruitment and appointment, professional development, time commitment, remuneration, and liability.
For instance, the UK’s Benfield Group has decided not to list in the United States as a result of the additional cost burden imposed by S–O, while Porsche AG declined to list because the CEO could not honestly say whether the company’s financials were completely accurate. (He did not intend to convey that Porsche’s numbers were misstated, simply that, with hundreds of internal accountants poring over the numbers, he could not verify that the numbers were, in a meaningful sense, 100 percent accurate.)

CHAPTER 11: IMPROVING CORPORATE ETHICS

1 In the United States, surveys on corporate reputation are routinely conducted; firms such as Johnson and Johnson, Harley Davidson, Coca-Cola, UPS, and General Mills, who promulgate good corporate behavior and protect their brand names and goodwill fiercely, routinely top the list. Not surprisingly, those at the center of scandals (for example, Enron, Global Crossing, Andersen, WorldCom), some of which no longer exist (or are radically smaller and different from before), fare poorly. However, those that are believed to have made bad corporate decisions (rather than having been caught up in corporate malfeasance) can also fare poorly (for example, AOL Time Warner, created through a merger that has left shareholders badly wanting, fares poorly).
2 Mitchell (2000) has proposed the idea of “contingent morality,” which is moral/ethical behavior that is contingent on financial rationality. Thus, if moral behavior is only possible at some financially irrational price, it may be sacrificed.
Consider, for instance, the Equator Principles adopted by a number of larger international banks in mid-2003. Ten global financial institutions that actively lend on a project finance basis in emerging nations have agreed to adhere voluntarily to environmental and social principles developed by the World Bank/International Finance Corporation. Whenever these institutions fund a project in a particular locale, they are to abide by certain environment and social standards in order to minimize disruption, damage, or dislocation.

Naturally, there are many theories of ethics and ethical behavior, and we certainly do not intend to address the very complex topic in this chapter. We note, however, that some ethical codes are “rules based” where ethical behavior is based on defined rules and systems. Thus, corporate (and employee) actions must achieve some good or reduce harm, and action is based on a duty to given rules because of the critical nature of those rules. Other codes might be “virtue based” where ethical behavior is based on disposition or motivation: that is, behavior rests solely within the company (or employee) and not because of the existence of eternal rules or systems.

For instance, in some US states legal ethics rules require lawyers to quit when they know their services are being used to commit fraud. A federal version of this, the “noisy withdrawal” approach put forth by the SEC (as mentioned in the last chapter), was deemed to encroach on attorney–client privilege and abandoned. While preservation of this privilege is vitally important, so is protecting investors from fraud; some minimum ground is required.

For instance, in the United States the Federal Sentencing Guidelines of 1991 requires specific individuals within the organization to assume responsibility for compliance with proper standards and procedures. This process includes defining standards and procedures (for example, what requires ethical treatment and why, and how can it be measured and by whom), assigning responsibility for these standards (for example, firmwide, business-unit specific, and board of directors), communicating standards and procedures and monitoring compliance, ensuring consistent treatment of violations, conducting “post mortems” to prevent future failures, and creating enough flexibility to allow adaptation to a changing environment. Recall from the last chapter that under Title IV of Sarbanes–Oxley, companies are required to enact a code of ethics, or provide specific reasons why they have not. Those that create a code should set minimum standards that include: honest and ethical conduct (including fair handling of conflicts of interest); compliance with all applicable laws and regulations; and, full, fair, and accurate financial reporting that is both timely and understandable. These are only minimum standards, and most companies would be expected to go into considerably more detail on desired behaviors.

For instance, if the code requires all employees to sign ethical documentation, or attend ethics seminars, then this must be tracked and reported; likewise, if certain regulatory compliance reports and information have to be prepared, the proper tools must be in place.
Whistleblowers are often mistreated, for example, in one survey 69 percent of whistleblowers lost their jobs or were reassigned (see Rothschild and Miethe, 1999).

For instance, in a KPMG survey (2002), only 64 percent of employees surveyed felt that the CEO/senior management would take action if they were made aware of misconduct.

As noted in Chapter 5, Enron serves as a striking example of this: waiver of internal conflicts of interest on at least two occasions by the board of directors was at least one major reason for the company’s eventual downfall. Had this provision of the firm’s code of conduct been followed strictly and diligently it is possible the company might still exist today.

For instance, in the United States, through the Foreign Corrupt Practices Act, financial institutions are required to attest to the fact that they have no dealings founded on illicit payments or corrupt actions.

This includes dealing with crisis management situations. For instance, in the 1980s, when Johnson and Johnson discovered one of its products had been tainted, it quickly withdrew the product. It then prepared statements advising consumers to return their unused products for a refund, and enacted a series of packaging safety measures to ensure the same could never happen again.

### CHAPTER 12: SUMMARY: TOWARDS SUBSTANTIVE GOVERNANCE

In fact, the EU serves as a good example. With the dissolution of many of the borders and barriers within EU member states, cross-border mergers and capital and financial market integration have commenced in earnest. Despite these common linkages, EU member countries, government and quasi-government organizations, think-tanks and academics/industry research groups have put forth more than two dozen corporate governance “best practice” codes over the past few years (some of which we consider in Appendix 1). While some allowance must be made for individual legal and stock exchange listing requirements, further pan-EU consolidation on governance practices would seem sensible and appropriate. For instance, a pan-EU code could permit the existence of single or dual board systems (and the methods of selecting directors) but also ensure that boards (in whatever form they take) perform the same minimum duties.

Consider, for instance, some of the small, but still significant, changes that have appeared at some global institutions since the turn of the millennium:

- **Disney:** In 2002 the company’s CEO hired a corporate governance lawyer to lead the board, prohibited its auditor from engaging in non-audit
services, required board directors to purchase at least US$100,000 in Disney stock, and required two-thirds of board directors to be independent. While these are all signs of trying to improve governance, the company still has more to do. (For instance, the CEO’s latest employment contract grants 24 million options through 2006, 19 million of which have no performance-based index. In addition, the board is not really thought to be two-thirds independent: of 16 directors, only three have no business ties to the CEO or Disney.)

- **Coca-Cola, McDonald’s, PepsiCo, et al.:** these companies no longer provide interim earnings guidance or discussion, and are attempting to de-emphasize short-term EPS expectations and stock price movements.

- **Sony:** the company has been at the forefront of Japanese corporate governance efforts, breaking with many “corporate traditions” (and sometimes causing others to follow in its footsteps). For instance, the firm has reduced its board size from 20 to 11 and now features eight independent directors; the company has also created an audit committee that is majority independent.

- **Toyota Motor:** following Sony’s lead, the company indicated in 2003 that it would reduce its board from 58 to less than 30, and add more foreign directors to better reflect the international nature of its business. It also noted that it would add another external auditor to its audit process (bringing the total of outside auditors from four to seven).

- **Vivendi:** the firm’s board now features 14 independent directors (out of 19) who all own shares; audit and review committees are now majority independent and meet frequently.

- **Apple Computer, Qwest Communications, et al.:** these companies no longer permit external auditors to do non-audit consulting work.

- **Cendant:** the company’s board is now comprised of two-thirds independent directors, and features three wholly independent board committees and a presiding director to lead non-executive director sessions. It has also created a new code of ethics (with considerable detail on conflicts of interest), has banned stock option grants for directors, and requires shareholders to approve executive stock option grants and any option repricing.

- **Tyco:** the company now features a lead independent director, a corporate governance officer, and prohibits company loans to senior executives.

- **Banco Bilbao Vizcaya Argentaria:** the Spanish banking conglomerate has reduced its board from 32 to 21 and added more directors with specific banking experience.
Swiss listed companies: under new SWX directives the salaries/compensation of executives and board members (and the additional directorships held by board members) must be published annually. This represents a rather radical break with secrecy and tradition.

Again, these are relatively modest changes, but demonstrate willingness to take on broader control changes that should ultimately serve shareholders and other stakeholders.

APPENDIX: IMPLEMENTING GLOBAL “BEST PRACTICES”

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3 Ibid., Principle V, Annotation 42.
4 Ibid., Principle V.E.1.
5 Ibid., Principle V.E, Annotation 41.
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7 Ibid., Principle IV.C, Annotation 38.
8 Ibid., Principle IV.A.
9 Ibid., Principle IV.B.
10 Ibid., Principle II.A.
11 Ibid., Principle I.C.
12 Ibid., Principle II.A.3.
13 Ibid., Principle V.D.3.
14 Ibid., Principle V.E, Annotation 41.
15 Enhancing Corporate Governance for Banking Organizations, III.13.
16 Ibid., III.16.
17 Ibid., II.9.
18 Ibid., V.31.
19 Ibid., III.16.
20 Ibid., III.18.
21 Ibid., III.27.
22 Ibid., III.23–4.
23 Euroshareholders Corporate Governance Guidelines 2000, Section V.
24 Ibid., Section V, Recommendation 10b.
25 Ibid., Section V.
26 Ibid., Section V.
27 Ibid., Section I, Recommendation 1.
28 Ibid., Section IV.
29 Ibid., Section IV, Recommendation 5.
30 Ibid., Section V.
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32 Ibid., Section II, Recommendation 2.
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34 Ibid., Section II.
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36 Bosch Report, p. 7.
37 Ibid.
38 Ibid., Guideline 1.2.
39 Ibid., Guideline 1.1.
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67 Ibid., II.1.
68 Ibid., II.2.
69 Ibid., IV.3.
70 Ibid.
71 Ibid., IV.1.
72 Ibid., IV.6.
73 Ibid., III.1.
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75 Ibid., Guideline 2.2 (2).
76 Ibid., Guideline 2.2 (4).
77 Ibid., Guideline 4.17.
78 Ibid., Guideline 12.
79 Ibid., Guideline 2.
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81 Ibid., Guideline 9.
82 Ibid., Guideline 13.
83 Ibid., Guideline 14.
84 Ibid., Guideline 8.1.
85 Ibid., Guideline 7.13.
86 Ibid., Guideline 7.1.
87 Ibid., Guideline 4.6(3).
89 Ibid., Section 5.
91 Ibid., Section 15.
92 Ibid., Section 23.
93 Ibid., Section 15.
94 Ibid.
95 Ibid., Section 29.
98 Ibid., Section 9.
99 Ibid., Section 5.
100 Ibid., Section 6.
101 Ibid., Section 13.
102 German Corporate Governance Code, 5.1.1–2.
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104 Ibid., Foreword.
105 Ibid., 5.4.1.
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148 Ibid., II.2.1.
149 Ibid., II.4.1.
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Since the practice of governance is global, specialized, and occasionally technical, a unique vocabulary has developed over time. Some commonly encountered technical terms are included in this section.

**ABBREVIATIONS**

BIS  Bank for International Settlements  
CalPERS  California Public Employees Retirement System  
CEO  chief executive officer  
CFO  chief financial officer  
CFTC  Commodity Futures Trading Commission  
D&O  directors and officers insurance coverage  
DCRs  dual class recapitalization  
DIP  debtor-in-possession  
EPS  earnings per share  
FASB  Financial Accounting Standards Board  
FERC  Federal Energy Regulatory Commission  
GDP  gross domestic product  
GAAP  Generally Accepted Accounting Principles  
IAS  International Accounting Standards  
IASB  International Accounting Standards Board  
IPO  initial public offering  
LBOs  leveraged buyouts  
LSE  London Stock Exchange  
M&A  mergers and acquisitions  
MBOs  management buyouts  
NPV  net present value  
NRSRO  National recognized statistical rating organizations
GLOSSARY

Absolute priority rule  A legal concept that indicates shareholders will only receive payment after creditors have been fully repaid. Within the broad category of creditors seniority claims also exist, with secured creditors ranking above senior unsecured creditors, and so forth.

Accounting value  An enterprise valuation model that values a company’s stock as a function of earnings per share and the price/earnings multiple.

Agency costs  Costs arising from the separation of ownership and control/management, which lead ultimately to a reduction in enterprise value.

Agency problem  A conflict based on the “mistrust” that arises between shareholders, directors, and management. The agency problem centers on whether directors and managers are acting in good faith and advancing the interests of shareholders.

Amakudari  Literally, “descent from heaven,” a Japanese term used to describe the appointment of a senior financial regulator to a senior executive position within a financial institution.

Annual general meeting (AGM)  The meeting of a company and its shareholders to review the year’s financial performance and vote on particular items that have been proposed for the agenda.

Antitakeover laws  Laws enacted in some US states and Continental European countries that prohibit, or severely limit, the ability of potential acquirers to bid for
a company. In most instances the intent is to limit hostile transactions.

<table>
<thead>
<tr>
<th><strong>Asset liquidity risk</strong></th>
<th>Risk of loss arising from an inability to sell assets at, or near, their carrying value and then using proceeds to fund operations.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aufsichtsrat</strong></td>
<td>The German supervisory board.</td>
</tr>
<tr>
<td><strong>Automatic stay</strong></td>
<td>A protection afforded debtors in bankruptcy which prohibits filing of lawsuits against the company and limits the ability of creditors to dispose of collateral held as security during the stay period. While creditors in general cannot sell any collateral, those holding secured derivative contracts are permitted to do so under exemption clauses. The delay created by the automatic stay is necessary as bankruptcy receivers must complete a thorough analysis of the value of the company’s assets and liabilities, and payments made during preference periods.</td>
</tr>
<tr>
<td><strong>Block holder</strong></td>
<td>A significant shareholder that has effective veto power over major company management decisions.</td>
</tr>
<tr>
<td><strong>Board of commissioners</strong></td>
<td>An Indonesian supervisory board.</td>
</tr>
<tr>
<td><strong>Board of directors</strong></td>
<td>The body that acts as agents of the shareholders. In many companies the board of directors is responsible for developing strategy and overseeing management. A board may be structured in single or dual form.</td>
</tr>
<tr>
<td><strong>Book value</strong></td>
<td>The value of assets held on a company’s balance sheet at original acquisition cost.</td>
</tr>
<tr>
<td><strong>Business judgment rule</strong></td>
<td>A legal rule that defers to directors and executives on the nature of a decision, as long as it is made on an informed basis (that is, with a duty of care).</td>
</tr>
<tr>
<td><strong>Chaebol</strong></td>
<td>A Korean business conglomerate, generally comprised of a series of companies with cross-shareholdings and business relationships, but no central core company.</td>
</tr>
</tbody>
</table>
Chewable pill  A poison pill defense clause that gives shareholders the right to revoke the pill in the face of a bona fide takeover offer (or automatically nullifies the pill if the bid meets certain pre-defined criteria).

Classified board  See Staggered board.

Clawback  The repayment, to a bankrupt company’s receivers, of any monies deemed to be “preferential” (benefiting one party at the expense of others during the period of financial distress).

“Comply or explain”  A common requirement in corporate governance best practice codes where regulators or exchanges require listed companies to comply with voluntary governance recommendations or explain publicly their reasons for non-compliance.

Conseil d’Administration  A French management board.

Conseil du Surveillance  A French supervisory board.

Contested transaction  See Hostile takeover.

Control right  The legal entitlements granted to an investor through a share of stock, including the ability to transfer shares, receive accurate financial disclosure on a regular basis, participate/vote on a range of issues at the company’s AGM, and file lawsuits (such as legal actions for abuses related to self-dealing, compensation, information disclosure, breach of duties of loyalty or care).

Corporate charter  An authorizing document that delineates the activities a corporation is permitted to undertake.

Corporate control market  The market for transactions that are designed to change the ownership, structure, and/or control of a company. Typical corporate control transactions include mergers, friendly or hostile acquisitions, leveraged or management buyouts, spinoffs, and recapitalizations.

Corporate ethics  The way in which a company behaves towards, and conducts business with, its stakeholders.
Corporate responsibility  The socially acceptable, or responsible, norms attached to the business a company does.

Corporate sustainability  The concept and action of ensuring that an organization exists in perpetuity, providing returns and benefits for multiple generations of shareholders and stakeholders. This generally demands close ties and cooperation with a broader constituency.

Cramdown  A redistribution of claims in bankruptcy, approved by creditors and the courts as being fair and equitable.

Credit risk  The risk of loss arising from failure of a counterparty to perform on its financial obligations.

Creditor committee  A committee, formed by institutions that have a claim on a bankrupt company, that serves to coordinate actions and maximize value in liquidation, or approve the company’s status as a new entity in reorganization.

Cross-default clause  A clause in a loan, bond, or derivative document that results in a technical default of that obligation upon a technical default in any other obligation. Thus, a default by a company on one loan or bond is akin to a default on all loans or bonds.

Cross-shareholding  A practice where companies hold share stakes in one another; this is often done to help strengthen relationships.

Crown jewel defense  A takeover defense whereby certain valuable corporate assets are automatically sold to third parties in the event of a successful takeover bid. The intent is to leave the acquirer with far less value than originally expected, and through this pre-emptive action, prevent any potential bids.

Cumulative voting  The process of allocating all votes in support of a single director or issue; this type of voting is generally thought to serve minority interests.

Cure period  A time frame, typically 30 to 90 days, during which a company that has defaulted on a contractual interest payment is permitted to submit payment without further prejudice, and without
being considered to have defaulted. Also known as a grace period.

**D&O cover**
Director and officer insurance coverage, designed to protect board members and executives financially from the effects of shareholder lawsuits (except those related to fraud).

**Dawn raid**
A takeover tactic where the acquirer purchases a substantial block of a target company when a stock exchange opens and before the target management is aware that it is occurring.

**Dead-hand clause**
Provisions contained within some poison pill defenses that permit only incumbent (dead-hand) board members to redeem proxy contest offenses.

**Debtor-in-possession (DIP) financing**
Financing arranged for a bankrupt company that is filing a reorganization plan; the DIP group generally assumes some level of control in order to protect its new financing commitment.

**Delay mechanism**
Any legal tactic employed by management to delay a time-sensitive vote or action (for example, requiring registration of shares).

**Derivative**
A financial contract that derives its value from another market reference, for example, an equity price, interest rate, commodity, or currency. The contracts are available in different forms, and are widely used by companies to manage financial risks.

**Derivative lawsuit**
A legal action where a shareholder sues the corporation to bring action against directors or executives.

**Dilution**
The act of reducing the proportion of an investor’s financial stake in a company through the issuance of new shares.

**Direct lawsuit**
A legal action where a shareholder sues directors or executives directly, rather than through the corporation.

**Direct stakeholders**
Those most immediately and directly impacted by a company’s activities, prospects, and actions,
including shareholders, creditors, employees, customers, suppliers, professional service providers, and communities.

**Directoire**
A French management board.

**Disenfranchise**
The process of removing voting rights from a class of common stock so that the investor is only entitled to financial gains (for example, a dual class recapitalization may be a disenfranchising transaction).

**Dual board system**
A corporate system where two boards are used to oversee and guide the company. Under a typical structure, oversight and supervision is the responsibility of the supervisory board, while daily management of the company falls to the management board.

**Dual class recapitalizations**
Restructuring of a company’s existing equity into two classes with variable voting rights; a new class which conveys less than one share/one vote is a disenfranchising transaction.

**Due diligence**
A process of investigation into a company’s financial operations and prospects, generally conducted by financial intermediaries, lawyers, and accountants prior to a company’s issuance of securities.

**Duty of care**
A legal requirement in certain systems where board directors and executives must make informed decisions (for instance, they must make every effort to gather all relevant facts and material impacting a potential decision, give such information due consideration, and then make a decision).

**Duty of loyalty**
The fidelity that directors and executives owe shareholders when discharging their duties; any actions they take must be done in good faith and consistent with proper treatment of shareholders.

**Earnings per share (EPS)**
The amount of net income earned by a company that is attributable to each outstanding share of stock; the EPS measure is widely used in market model companies as a reflection of earnings power.
<p>| <strong>Economic value</strong> | An enterprise valuation model that values a company based on expected cash flows over a time period, discounted back to the present at an appropriate rate. |
| <strong>Enterprise value</strong> | The sum of a company’s future net cash flows, discounted back at an appropriate cost of capital or discount rate. |
| <strong>EPS bootstrapping</strong> | A practice where an acquirer buys a company with a low P/E ratio through a stock swap in order to boost overall EPS. |
| <strong>Equitable control</strong> | A concept where managers obtain power from diffuse shareholders and act in the best interests of the firm. |
| <strong>Execution risk</strong> | The risk of lowering enterprise value by not being able properly to gain entry into a new market/product or absorb a new acquisition. |
| <strong>Executive board</strong> | See Management board. |
| <strong>Executive director</strong> | A board director who is also a member of the company’s management team. |
| <strong>Fair price provision</strong> | Legal provisions that provide protection against two-tier acquisition offers, for example, the first tier comprised of a generous, front-loaded cash offer, and the second consisting of some lower premium package. The provision requires that all shareholders receive the same (or a substantially similar) buyout price. |
| <strong>Fiduciary duties</strong> | The legal duties that directors and executives have in representing shareholder interests; this includes, but is not limited to, duty of care and duty of loyalty. |
| <strong>Filz</strong> | Literally “interwoven” material or fabric, a term commonly used to describe boardroom ties, nepotism, and interlocking directorships in Switzerland. |
| <strong>Financial risk</strong> | The risk of lowering enterprise value by not being able properly to manage credit, market, and/or liquidity risks. |</p>
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
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<tbody>
<tr>
<td>Friendly takeover</td>
<td>An acquisition that is agreed on amicable terms between two parties.</td>
</tr>
<tr>
<td>Funding liquidity risk</td>
<td>The risk of loss arising from an inability to roll over existing funding or obtain new funding without large cost.</td>
</tr>
<tr>
<td>Golden hello</td>
<td>An upfront compensation package granted to an executive joining from another firm. Depending on the structure of the package it may serve as a “buy out” of the package being left at the prior company, and thus limit the effectiveness of long-term, performance-driven financial reward.</td>
</tr>
<tr>
<td>Golden parachute/</td>
<td>Compensation clauses that give top executives often substantial guaranteed payouts in the event they lose their jobs through a takeover (parachute) or dismissal (handshake).</td>
</tr>
<tr>
<td>handshake</td>
<td></td>
</tr>
<tr>
<td>Governance</td>
<td>The structure and function of a corporation in relation to its stakeholders generally, and its shareholders specifically.</td>
</tr>
<tr>
<td>Greenmail</td>
<td>A targeted repurchase by the company of a block of shares, at a premium.</td>
</tr>
<tr>
<td>Gyosei shido</td>
<td>The Japanese practice of bureaucratic control (or “administrative guidance”) exercised through regulation, keiretsu group pressure, and access to bank credit.</td>
</tr>
<tr>
<td>Hostile takeover</td>
<td>An unsolicited acquisition offer that the target company’s directors/executives do not favor and attempt to thwart.</td>
</tr>
<tr>
<td>Hybrid model</td>
<td>A corporate system that is characterized by illiquid capital markets, an inactive or nonexistent corporate control market, and nascent regulatory and legal frameworks. Family interests often hold large ownership stakes in companies, related company conglomeration is common, and ownership ties between companies and banks can be significant.</td>
</tr>
<tr>
<td>Indexed options</td>
<td>Options that carry specific performance targets, meaning they are not exercisable unless the targets are reached.</td>
</tr>
<tr>
<td><strong>Indirect stakeholders</strong></td>
<td>Those that can be impacted by a company’s success or failure (although often less obviously or directly than other stakeholders), including regulators, competitors, and taxpayers.</td>
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</tr>
<tr>
<td><strong>Inside director</strong></td>
<td>A non-independent board director who is related to the company and its executives in some fashion (for example, former employment, business or consulting relationship, personal relationship).</td>
</tr>
<tr>
<td><strong>Insider system</strong></td>
<td>A corporate ownership system where controlling interests (for example, family stakes, large corporate or bank shareholdings) limit the ability of outside investors to influence the corporate process. Insider systems are commonly found in Continental Europe, South-East Asia, and parts of Latin America.</td>
</tr>
<tr>
<td><strong>Insolvency</strong></td>
<td>A state where a company has liabilities exceeding the market value of its assets (negative equity) or cannot pay debts as they fall due in the normal course of business.</td>
</tr>
<tr>
<td><strong>Interlocking directorships</strong></td>
<td>A practice where executives from different firms serve as directors on one another’s companies.</td>
</tr>
<tr>
<td><strong>IPO spinning</strong></td>
<td>The Wall Street practice of granting favored corporate clients allocations in coveted IPOs in an effort to win additional corporate finance business; spinning is now illegal.</td>
</tr>
<tr>
<td><strong>Junk bonds</strong></td>
<td>Debt securities issued by sub-investment-grade issuers.</td>
</tr>
<tr>
<td><strong>Kanasayaki</strong></td>
<td>Japanese statutory auditors, drawn largely from within the organization.</td>
</tr>
<tr>
<td><strong>Keiretsu</strong></td>
<td>A Japanese business conglomerate, generally composed of a series of companies with cross-shareholdings and business relationships, but no central core company. A main bank generally serves as de facto corporate monitor.</td>
</tr>
<tr>
<td><strong>Labor codetermination</strong></td>
<td>A regulatory/legal requirement, found primarily in Continental European nations, where a set number of labor representatives are elected to a company’s board.</td>
</tr>
<tr>
<td><strong>Lead independent director</strong></td>
<td>An independent director who serves as leader of the other independent members of the board; the role exists primarily when the chair and CEO roles are combined.</td>
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<td>-------------------------------</td>
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</tr>
<tr>
<td><strong>Legal mechanism control</strong></td>
<td>A structure where effective corporate control is obtained through legal or structural mechanisms without a full majority stake (for example, a pyramid holding company).</td>
</tr>
<tr>
<td><strong>Leveraged buyout (LBO)</strong></td>
<td>The acquisition of a public company by a specialist or management group that results in retirement of the public equity through the assumption of a large amount of debt (that is the company is taken private).</td>
</tr>
<tr>
<td><strong>Liquidation</strong></td>
<td>A state of corporate bankruptcy which culminates in the disposal of assets and payment of any residual value to creditors.</td>
</tr>
<tr>
<td><strong>Liquidity risk</strong></td>
<td>The risk of being unable to sell assets or raise funding without incurring a significant cost.</td>
</tr>
<tr>
<td><strong>Liquidity spiral</strong></td>
<td>A situation where the absence of liquidity causes short-term creditors and lenders to cancel lending facilities, leading to the withdrawal of more liquidity, and so forth, until a company’s supply of cash is cut off.</td>
</tr>
<tr>
<td><strong>Macaroni defense</strong></td>
<td>A defensive tactic where the target company issues a large number of bonds with redemption clauses indicating the securities will be redeemed at an excessive premium in the event of a takeover. This makes the target company potentially unattractive to any would-be acquirer.</td>
</tr>
<tr>
<td><strong>Majority control</strong></td>
<td>A structure where effective corporate control is gained by taking a majority stake in a company.</td>
</tr>
<tr>
<td><strong>Management board</strong></td>
<td>The second board in a dual board system, approximately equivalent to the executive management team in companies following the single board model. This board, which typically includes 5 to 15 senior executives appointed by the supervisory board, is headed by a chair and is responsible for daily management of individual businesses/divisions or control functions.</td>
</tr>
</tbody>
</table>
Management buyout (MBO)  
*See Leveraged buyout.*

**Management control**  
A structure where effective corporate control is gained by management when it accumulates a sufficiently large block to direct activities; as with minority control, this process only works when ownership is so diffuse that even an organized minority interest fails to dominate the company and its actions.

**Market model**  
A corporate system that is characterized by very diffuse shareholdings, liquid capital markets, dynamic capital reallocation, advanced legal and regulatory frameworks, and an active market for corporate control.

**Market risk**  
The risk of loss arising from adverse movement in financial market references, such as equities, currencies, commodities, or interest rates.

**Material adverse change (MAC) clause**  
A clause contained in some bank documents that permits a bank to cancel undrawn credit facilities and/or demand repayment of existing facilities if the borrower experiences a materially adverse change in its operations. A materially adverse change may be defined explicitly (for example, a ratings downgrade) or subjectively.

**Minority control**  
A structure where effective corporate control is gained by small groups of investors who band together. This is generally accomplished by attracting enough proxies from diffuse owners, and can only work if there is no other large block holder present (that is, all shareholdings are diffuse).

**Mochiai system**  
The Japanese system of cross-shareholdings between *keiretsu* companies.

**Moral hazard**  
Altered behavior (for example, becoming less conservative, more reckless) in the knowledge that some level of insurance or protection exists to compensate for any resulting damage.

**Negative pledge**  
A covenant contained in many bank documents that prohibits an asset pledged as security from also being pledged to another party.
<table>
<thead>
<tr>
<th><strong>Negotiated swap</strong></th>
<th>An exchange of assets (for example, subsidiaries, companies, or blocks of shares) between two parties.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-executive director</strong></td>
<td>A board director who is not a member of the management team.</td>
</tr>
<tr>
<td><strong>Non-voting stock</strong></td>
<td>Stock that carries standard rent rights (for example, dividends, price appreciation) but only limited control rights (for example, right to obtain disclosure and sue, but not vote).</td>
</tr>
<tr>
<td><strong>Noyau dur</strong></td>
<td>The French concept of shareholder loyalty: stakes taken by certain institutional or corporate shareholders in other companies with which they have long-standing ties or business relationships can act as a support to management and directors.</td>
</tr>
<tr>
<td><strong>Omnipresent specter</strong></td>
<td>A legal requirement where a board of directors must demonstrate that it is not acting in its own self-interest when rejecting a corporate control bid (that is, that the rejection and any takeover defenses are required in order to protect shareholders).</td>
</tr>
<tr>
<td><strong>Open market purchase</strong></td>
<td>The purchase of a block of shares in the open market that gives the acquirer effective control of a target company.</td>
</tr>
<tr>
<td><strong>Operating risk</strong></td>
<td>The risk of lowering enterprise value by not being able to conduct daily business operations as a result of business interruption or disaster.</td>
</tr>
<tr>
<td><strong>Option repricing</strong></td>
<td>The practice of converting an option with no value (for example, one where the strike price is well above the current price) into one with immediate value by resetting the strike.</td>
</tr>
<tr>
<td><strong>Outside director</strong></td>
<td>An independent board director who is not related to the company or its executives in any fashion.</td>
</tr>
<tr>
<td><strong>Outsider system</strong></td>
<td>A corporate ownership system where no significant controlling interests exist and shareholder influence over the corporate process is theoretically stronger. The outsider system is found in the United States, the UK, Canada, and Australia.</td>
</tr>
</tbody>
</table>
| **Overhang** | Shares awarded or subject to conversion under executive compensation schemes which lead to
concerns about voting and EPS dilution (for example, a 10 percent+ overhang is generally thought to be significant).

**Pac Man defense**
A takeover defense centered on a counterbid for the acquirer by the target company. The counterbid is generally highly leveraged, representing a significant risk for the company.

**People pill**
A takeover defense where a well-regarded management team threatens to depart, en masse, in the event of a takeover.

**“Piercing the corporate veil”**
An exceptional legal circumstance where the tenet of limited liability is suspended and investors are liable to pay for corporate losses from their personal assets.

**Poison pill**
A broad category of antitakeover measures designed to make a target company’s stock look less attractive to a suitor. For instance, a flip-in pill allows existing shareholders (but not the acquirer) to buy more shares at a discount, a flip-over pill permits stockholders to buy the acquirer’s shares at a discount after the takeover, and so forth. Pills often have an extremely dilutive effect, which works against the acquirer’s plans.

**Pre-emptive right**
The right of existing shareholders to be given the first opportunity to invest in new shares. Only when shareholders have waived this right can the new shares be offered to new shareholders.

**Pre-petition phase**
A stage of financial distress, such as the vicinity of insolvency, when a company is preparing to file a bankruptcy petition.

**Preference period**
A period of up to 90 days before the filing of bankruptcy, during which time payments are made by the company to third parties; some of these may be subject to clawback by the bankruptcy receiver.

**Presiding director**
See Lead independent director.

**Price/earnings ratio (P/E ratio)**
A multiplier that is often used as a metric of a company’s value: the stock price divided by EPS.
yields a multiplier that can be compared with past performance, the market, or a specific industry. Alternatively, stock price can be imputed by EPS and an industry or company estimate of the P/E multiplier.

**Pro forma earnings report**

A financial report that expresses profits by excluding exceptional costs (for example, merger expenses) or including exceptional gains (for example, one-time asset sales).

**Process risk**

The risk of lowering enterprise value by not being able properly to manage operational risks, including those arising from failures of policy, process, procedures, data, technology, and infrastructure.

**Proxy**

A document that conveys a shareholder’s right to vote.

**Proxy contest**

An acquisition offer that is contested through proxy voting.

**Recapitalization**

A process of converting the nature and voting characteristics of a company’s equity (for example, by assigning more or less voting power for an individual share).

**Related-party transaction**

Any financial transaction conducted between a company and a related entity, including a subsidiary, affiliate, or joint-venture party.

**Relationship model**

A corporate system characterized by concentrated ownership stakes and cross-shareholdings, moderately liquid capital markets, and only modestly active capital reallocation and corporate control activity. Legal frameworks are often supplemented by informal negotiation arising from long-term business relationships.

**Rent right**

The financial benefit granted to an investor through a share of stock, comprised of a pro rata share of the discounted future cash flows of the company and any periodic dividends that might be paid.

**Reorganization**

A state of corporate bankruptcy that results in an agreement between creditors and the bankruptcy
court to restructure, rather than liquidate, the filing company. In order for a company to emerge from reorganization, creditors must be willing to accept concessions related to the value of their credit claims.

**Residual right**

Discretionary powers and authorities delegated by directors to the executive team, through which it is able to act as the agent of the directors and make decisions related to the daily management of the firm (for example, financing plans, acquisitions, hiring/firing personnel).

**Restricted stock**

Shares of company stock granted as compensation which generally vest over a multi-year period.

**Retrospective scrutiny**

A legal review by regulators and other external parties of a bankrupt company’s financial deterioration, with a focus on what the board of directors knew and when, what action it took and to whose benefit, and so forth.

**Scorched earth defenses**

A broad group of defenses that, when enacted, create a significant amount of corporate destruction. The strategy centers on conveying the existence of such defenses to would-be acquirers in hopes that it will be sufficient to dissuade any action (for example, macaroni, crown jewel, and Pac Man strategies).

**Severability clause**

A clause in director and officer insurance policies indicating that the insurer pays no claim if a director is found to have committed fraud, but must still pay legal fees and any judgments against all remaining directors.

**Shark repellent**

The broad group of takeover defenses that a target company might employ to fend off an unwanted suitor (for example, golden parachutes, poison pills, people pills).

**Shikko yakuin**

The corporate executive officer under the Japanese single board system, responsible for separating the supervisory and executive duties embedded in the board.
**Single board system**  A corporate system where one board of directors oversees and guides the activities of management. Directors are generally nominated through an internal committee and/or executive management recommendations, and are elected by shareholders. The board is guided by the chair (who may or may not also be the chief executive) and normally ranges in size from 10 to 20 directors (although it can grow to more than 30).

**Special dividends**  A mechanism for returning capital to shareholders by granting a one-time stock or cash dividend to them, thus depleting the retained earnings account by the desired amount.

**Special purpose entities**  Off-balance-sheet companies, generally bankruptcy-remote and often located in tax havens, that are often used to arrange financing, derivative, or tax-related transactions on behalf of the corporate sponsor.

**Spin-off**  A process of selling an asset (for example, company or subsidiary) to a third party or through an initial public offering or equity flotation.

**Spring loading**  A form of financial manipulation where the pre-acquisition earnings of a company to be purchased are understated in order to give the acquiring, post-merger company an earnings boost and the appearance of financial strength.

**Staggered board**  A defensive tactic where an external bid automatically triggers a change in the board re-election policy, from annual to staggered/lengthened (for example, only a third of directors re-elected every year, so that the entire board can only be replaced over a three-year period). This means a suitor will be unable to engage in a proxy battle within a one-year time frame to remove the board and undo poison pill defenses, which act as a potential deterrent.

**Stakeholders**  Parties that have a legal or vested interest in a company and its success; these may be direct stakeholders (for example, investors, creditors,
employees) or indirect stakeholders (for example, competitors and taxpayers).

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock buyback</td>
<td>A mechanism for returning capital to shareholders by repurchasing and retiring outstanding stock, that is, increasing the treasury stock contra account by the desired amount.</td>
</tr>
<tr>
<td>Structural subordination</td>
<td>The act of diminishing the level of seniority of existing unsecured creditors by granting a new creditor collateral or security.</td>
</tr>
<tr>
<td>Supermajority vote</td>
<td>A defensive tactic requiring a supermajority, rather than just simple majority, vote by shareholders on any proposed corporate control action.</td>
</tr>
<tr>
<td>Supervisory board</td>
<td>One of two boards in the dual board system, responsible for appointing, supervising, and advising members of the management board, and developing fundamental corporate strategy. Board size can vary from 10 to 24 directors, depending on country; shareholders are responsible for electing directors.</td>
</tr>
<tr>
<td>Tender offer</td>
<td>A purchase offer made by an acquirer directly to a company’s shareholders.</td>
</tr>
<tr>
<td>TIDE provisions</td>
<td>Three-year independent director evaluation provisions that are included in some poison pills to make them more palatable to shareholders. The provisions require directors to evaluate the nature and status of poison pill defenses every three years to ensure that they are still equitable and appropriate, and do not harm shareholder interests.</td>
</tr>
<tr>
<td>Total control</td>
<td>A structure where effective corporate control is gained through complete ownership; this exists primarily in the case of family-owned or private companies.</td>
</tr>
<tr>
<td>Underinvestment problem</td>
<td>A situation where a company in financial distress will be pushed by its creditors to invest in low NPV projects that carry less risk; the investments are intended to protect the position of creditors rather than attempt to maximize enterprise value.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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<td>-------------------------------------------</td>
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</tr>
<tr>
<td><strong>Underwater options</strong></td>
<td>Options where the current price of the company’s stock is well below the strike price of the options, rendering them nearly worthless.</td>
</tr>
<tr>
<td><strong>Underwriter’s liability</strong></td>
<td>The liability a financial intermediary faces in arranging and issuing securities for a company; if due diligence has not been performed (or has been performed in error), investors holding defaulted securities may be able to recover from the intermediary.</td>
</tr>
<tr>
<td><strong>Vicinity of insolvency</strong></td>
<td>A legal concept where the fiduciary duties of directors shift from shareholders to creditors prior to the actual insolvency of a company. This occurs when a company is almost undoubtedly going to become insolvent (though has not technically met the insolvency definition).</td>
</tr>
<tr>
<td><strong>Voting cap</strong></td>
<td>Company or regulatory provisions allowing companies to restrict votes to a particular percentage of a company’s stock, regardless of the stake held.</td>
</tr>
<tr>
<td><strong>Voting trust control</strong></td>
<td>A structure where effective corporate control is gained through trustees who have total, or near total, discretion over how to vote shares (a true separation of ownership and control, as the trustees do not own any of the stock but have significant control).</td>
</tr>
<tr>
<td><strong>Vorstand</strong></td>
<td>A German management board.</td>
</tr>
<tr>
<td><strong>Waiver of pre-emptive rights</strong></td>
<td>Relinquishing the affirmative right to obtain new shares when they are issued.</td>
</tr>
<tr>
<td><strong>Whisper numbers</strong></td>
<td>Earnings guidance provided by company management to the investment community as a general “pre-indicator” on whether targets/expectations will, or will not, be met.</td>
</tr>
<tr>
<td><strong>Whistleblower</strong></td>
<td>An employee who reports internal infractions to senior levels of management in order to reveal or contain a problem. A whistleblower often comes in contact with information that might not be apparent or available to other control functions, and is thus an additional element of the check and balance process.</td>
</tr>
</tbody>
</table>
**White knight**  A friendly partner that acquires a company that is the subject of a hostile takeover.

**White squire**  A friendly partner that acquires a stake in a company that is the subject of a hostile takeover.

**Window dressing**  The practice of altering the appearance of financial statements through various short-term transactions in order to present a better financial picture, particularly during reporting periods.

**Zaibatsu**  Japanese corporate conglomerates with central control (for example, a core holding company controlling the ownership and activities of other companies). The *zaibatsu* structure was outlawed after the Second World War and replaced by the *keiretsu*.

**Zaitech**  Financial speculation undertaken by many Japanese companies in order to boost non-operating income; the practice was widespread during the late 1980s and early 1990s, although some companies continue their activities to the present time.
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