Double trouble?

Do good things come in pairs? **Domini Stuart** investigates whether a two-tiered board would better clarify directors' roles and responsibilities and help close the "expectation gap".

A TWO-TIERED BOARD

- May reduce NED liability
- Could reset directors' responsibilities at realistic levels
- May require a substantial change in statutory law
- May dilute the contribution of non-executives
- May be more advisory than determinative

As presenter of this year's McPherson Lectures, Dr Robert Austin expressed the opinion that Australian law governing the role and duties of company directors was in a highly unsatisfactory state. Austin, a senior legal consultant with Minter Ellison, Challis Lecturer in Corporate Law at the University of Sydney and a former judge of the Supreme Court of NSW, also spoke of an "expectation gap" - a substantial divergence between the Australian community's perception of the role and responsibilities of the directors of large listed companies and the perception the directors have of themselves.

"On the whole, the current Australian law is closer to the community's perception than the directors' self-perception and this is because an unsatisfactory and ambiguous idea of corporate management is embedded in the law," said Austin. "There is, at best, deep ambiguity as to whether modern boards, while admittedly having guidance and monitoring responsibilities, also retain the ultimate 'buck stops here' responsibility for more detailed matters of management.

"There may be some areas in which no-fault liability should be attributed to the people ultimately responsible for corporate management - the senior executive team - but it is much harder to justify extending that liability to a board comprising a majority of non-executive directors (NEDs) who, by definition, are less than full-time. It is essentially unfair to expose boards of directors to liability for management defaults where, in the circumstances, no reasonable steps were available to them to prevent those defaults or protect the company from their consequences."

The NSW occupational health and safety laws are probably the most startling example of this unfairness. "Boards of directors are liable for workplace deaths of company employees even though the boards of most large listed companies are not involved in the day-to-day operations of the company," says Kevin McCann FAICD, chairman of Origin Energy and a director of BlueScope Steel.

UNACHIEVABLE RESPONSIBILITIES

Not only is it physically impossible for a director on the board of a large international company to know every detail of the business, Australia's emphasis on director independence actively discourages that level of involvement.

"Corporations were first established hundreds of years ago," says David Gonski AC FAICD*Life*, chairman of Investec and the Australian Stock Exchange. "Today's corporations are dealing with business activities that are much broader in nature than they were when the board structure was first established. It has been put to me that people are being dissuaded from joining boards today because the liabilities are large and the responsibilities are not achievable.

"If you know you can achieve your responsibilities and you don't, it's generally because you've failed in your duty. However, if your responsibilities are unachievable, you

'Boards of directors are liable for workplace deaths of company employees even though the boards of most large listed companies are not involved in the day-to-day operations of the company' KEVIN MCCANN

Photo: Getty Images

WORKING TO CLOSE THE GAP

The "expectation gap" isn't limited to the community. Much policy and law reflects government's incorrect assumption that directors manage a company. A recent ASIC guidance paper on directors' duty to prevent insolvent trading clearly showed that the regulator is labouring under the same misconception.

The Australian Institute of Company Directors takes the expectation gap very seriously and has been working to clarify the roles and responsibilities of directors and management in policy and law. The unintended consequences of personal liability for corporate fault and the blurring of these roles were highlighted in the results of the 2008 ASX 200 company director survey we conducted with Treasury.

We are also strongly advocating a "safe harbour" defence for directors in state, territory and Federal law. This should be available to directors where they have acted in good faith and informed themselves to the extent that they reasonably believe is in the best interests of the corporation.

We were pleased to note that the discussion paper *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, released in January 2010 by the Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen, indicates that the Government acknowledges the need to adopt such a "safe harbour". We made a submission to Treasury in relation to this discussion paper in March 2010.

could find your failure was neither deliberate nor avoidable. The latter is the greatest concern."

For some time, Gonski has been promoting the two-tiered board as a workable and effective way to clarify directors' roles and responsibilities. When he first proposed the idea six years ago it was not well received, primarily, he believes, because of an assumption that, as the two-tiered approach has not worked particularly well in Europe, it wouldn't work particularly well in Australia.

The most familiar German model, for example, includes representatives of stakeholder groups such as employees and labour unions, but this is simply a reflection of that country's history.

Gonski has always advocated the development of a unique Australian model where a supervisory board made up of independent and diverse members of the business community would set strategy and policy, choose the CEO, check that the policy is implemented and ensure all areas of potential conflict, such as the remuneration of the CEO, are tested and properly determined. An operating board, chaired by the CEO, would oversee responsibility for running the day-to-day operations of the company in the hands of full-time managers.

The concept is still not being widely embraced.

Austin, for example, acknowledges that a formal subdivision of board functions would provide a framework for addressing the expectation gap and setting directors' responsibilities at a realistic level. However, he concludes that the implementation of a dual board structure would involve a substantial change in statutory law that would be difficult to achieve; it would be necessary to amend the *Corporations Act* 2001 wherever it speaks of "directors" to clarify whether it refers to the supervisory board, the operating board or both.

"The risk would be that, in the process of legislative amendment, the original objective of the reform would be lost," he says.

Austin's preferred solution is a single board of directors in which the executive directors would form a management committee of the board. The corporate constitution would be amended to remove the current management clause, which vests management power in the board, and replace it with a clause giving the board as a whole the functions and powers identified for boards by the Australian Securities Exchange (ASX) Corporate Governance Council while vesting the operational power and responsibility in the executive committee. Such an amendment would not change the corporate governance structure, but rather it would align the law with the present reality in large companies.

Austin says the reallocation of functions he advocates can be achieved relatively simply by adopting constitutional amendments, supported by amendments to the ASX Corporate Governance Council's *Principles and Recommendations*, without any need to change the statutory law.

Researching the two-tiered board for his PhD thesis left Shann Turnbull, principal of the International Institute for Self-governance, in no doubt that we need a new model.

"Regulators around the world are irresponsible in allowing unitary boards that provide directors with absolute power to manage their own conflicts of interests, and so with absolute power to corrupt themselves and the business," he says.

However, he disagrees with Austin that a two-tier structure must involve changes in the law.

"I created a governance board for a start-up public unlisted company in 1991 simply by obtaining shareholders' approval to change the corporate constitution," he says. But Austin believes there would still be uncertainty as to the application of every *Corporations Act* provision that refers to "directors".

Gonski sees an opportunity in that most big companies have a holding company holding shares in the operating company.

"If the directors of the holding company were non-executives plus the CEO, it wouldn't be a big step to set out their rights and obligations in the constitution of the holding company and the subsidiary along the lines of what Austin suggests for the constitution of a simple company," he says. "The only activity of the holding company would be to hold shares in an operating company which, in turn, has a board made up of the executives responsible for the day-to-day running of that company and the group below it."

Turnbull questions whether the goal of reducing director liabilities could be achieved by a two-tiered board where the shareholders appoint the directors as a supervisory board and the supervisory board then appoints the management board.

"Shareholders would need to appoint a management board and a governance board, with

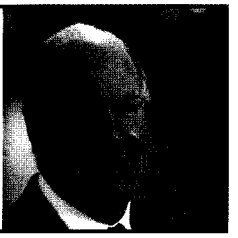
'It seems highly unlikely that the shareholder institutions and their governance advisers would be inclined to surrender what we have for a system that places management more strongly in a position of corporate dominance' STEVEN COLE

the management board being nominated by the governance board," he says. "The governance board would act as a shareholder committee to take over the roles of the nomination, remuneration and audit committees of the current unitary board, or the powers of a venture capitalist obtained from a shareholder agreement in return for providing funding."

SUPPORT FOR THE UNITARY BOARD

While Steven Cole FAICD, chairman of Emerson Stewart Group and deputy chairman of Reed Resources, acknowledges there may be liability reduction benefits for NEDs in a two-tiered system, he would be very reluctant for Australia to move in this direction.

'Any watering down would render the senior board largely ceremonial, and not a particularly satisfying role' JOHN STORY



"The prime focus of our system of governance should be sustainable corporate outcomes for overall corporate benefit delivering appropriate shareholder outcomes in the context of the corporation's broader stakeholder base and I believe the unitary system best achieves this," he says.

"It seems to offer greater flexibility and responsiveness to the primary concern of all corporate governance regimes and structures, which is agency risk versus cost, as these boards are more actively engaged and empowered to address such risks. They appear to meet more frequently and, due to their greater engagement in the corporation's decision-making, typically are less exposed to information asymmetry than members of supervisory boards.

"After the global financial crisis (GFC), there is a perception that directors were 'asleep at the wheel' while management abused the agency risk/cost equation for personal remuneration gains. There is pressure for greater shareholder engagement to address this perception and it seems highly unlikely to me that the shareholder institutions and their governance advisers would be inclined towards surrendering what we have for a system that places management more strongly in a position of corporate dominance."

John Story FAICD, chairman of Suncorp-Metway, points out that corporate governance in Australia is strong and effective. "There is always room for incremental improvement but when the system was put to the test during the GFC, it was not found wanting," he says.

"There is a widespread recognition within governance circles globally that the Australians have not done a bad job, and we are now seeing a growing convergence towards the Australian practices. I therefore don't see that the two-tiered board has anything to offer. My primary concern relates to the role of the senior board. The challenge for any non-executive board is to develop a sufficiently comprehensive knowledge and understanding of the drivers of the company to provide the strategic insight and fulfil the stewardship functions.

"I have difficulty in seeing that the members of the senior board are sufficiently close to the activities of the company to fulfil their role effectively. In practice, the junior board is, for most purposes, the 'real board' and being dominated by executives, the insight of the non-executives is diluted or lost. Any watering down would render the senior board largely ceremonial, and not a particularly satisfying role."

Cole also questions whether the best people would wish to serve on a board that was more advisory than determinative in its function. "Based on my experiences of advisory boards, I personally would be less inclined to offer my services on such a basis," he says.

In McCann's view, the biggest issue is cultural. "Under the unitary system we are used to having just one board and, historically, this has had an oversight role, delegating the operations of the company to the managing director who then shares those responsibilities with his or her executives," he says.

"I think it's a system that has worked pretty well and I don't think going to a two-tier board, which is culturally very different, is going to solve the liability problem. I don't think we're going to avoid legislators imposing liability on directors with the structural change proposed."

A MISPERCEPTION?

There have been several high-profile examples where the Australian Securities and Investments Commission (ASIC) has chosen to take proceedings against NEDs. Nevertheless, Ben Slade, a principal at Maurice Blackburn Lawyers and deputy chairman of Sydney's Public Interest Advocacy Centre, believes many directors misperceive the risk of being sued and what they stand to lose.

He sees no reason why a change in structure would or should affect the litigation process.

"We don't sue boards," he says. "Key players, such as the chairman or the chairman of the audit committee, might be in firing line if they have failed in their duty, but only if they are suspected of egregious and extraordinary wrongful conduct. It's very hard to prove a breach of statutory duties and we and other responsible lawyers don't take action unless something has gone very wrong.

"If a director should be sued, the focus will be on his or her insurance policy. We are not interested in suing for personal property in shareholder actions. It's not worth it - shareholder class actions tend to be claiming a lot more money than any individual director may have."

SORTING OUT THE DETAIL

Gonski is quick to acknowledge there is work to be done on the detail.

"I believe a two-tiered board structure would benefit the business community and Australia as a whole because talented and experienced people would be more prepared to be involved in the supervisory aspects of our major listed companies," he says. "I would hope people don't reject the dual board concept because we're not quite sure of the form it can take but rather work on the details to make it viable." ◆

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