The Three Pillars of Good Corporate Governance (2019 Update)[1]

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Abstract

It is a fundamental principle of good political governance to separate the three arms of government. Montesquieu's separation of powers exercisable by the legislature, executive and the judiciary is the basic tenet of free and democratic societies the world over. Within the world of corporate governance, there are a least three separate pillars or arms of governance: corporate governance, due diligence and compliance programs. Over the last decade, Professor Michael Adams, Professor of Corporate Law & Head of UNE Law School of Law, University of New England, has also made the move to international corporate governance for global entities and the importance of corporate social responsibility (CSR or sometimes called ESG – environment, social and governance). A video explaining a summary of this concept and theory can be found at here.

International Corporate Governance

There is no formal definition of "international corporate governance." However, as corporations around the world have grown, many operate in a size and complexity that impact as if they were sovereign states (the same as a country). This has meant that the corporations must comply with laws and regulation in many languages, countries, currencies and other controls. It is easy to imagine that a UK incorporated company that is listed on the New York Stock Exchange and securities exchange, with a Brazilian-based board of directors, that manufactures product in China, through a joint venture, but that also imports components from its German subsidiary and then ends up with a consumer whom resides in Australia can open many legal challenges.

A real example of this type of corporation, in the Australian context, is the company BHP. As of March 2019, BHP (Australia's largest resources company and second largest on the Australian Securities Exchange [ASX]) was worth A$110.8 billion at a share price of A$37.61. BHP (known previously as BHP Billiton or colloquially as "the big Australian") has been required to produce a number of annual reports and simultaneous disclosures to UK, USA and Australian regulators, as well as various stock exchanges. BHP is required under the different legal systems and regulations to produce financials in different currencies - the UK pound sterling, US dollars and Australian dollars. Complying with the many countries it mines in and sells resources in is a big challenge for the governance unit and board of directors, as well as regional executives and employees.

[1] The original article was published in December 2003, reference: Michael Adams, "The three pillars of good corporate governance", (2004) *Risk Management* 8; republished and updated in: Michael Adams, "Three Pillars of Corporate Governance" (2018) 70(6) *Governance Directions* 302.

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The Three Pillars of Good Corporate Governance

Corporate Governance

The amorphous nature of corporate governance is what makes it simultaneously a beauty and a beast. Quite simply, it defies definition. That said, many commentators have attempted to definitively account for corporate governance.[3]

In 1992, the now world famous Cadbury Report took a simple approach, proposing that corporate governance is "the system by which companies are directed and controlled." A broader definition is found in Cochran and Wartick's 1988 publication *Corporate Governance: A Review of the Literature*, which suggests that corporate governance is "an umbrella term that includes specific issues arising from interactions amongst senior management, shareholders, boards of directors and other corporate stakeholders."

In 1997, the Australian Commonwealth Treasury went a little further in the context of the *Corporate Law Economic Reform Program Paper (CLERP) No.3, Directors' Duties and Corporate Governance*; defining corporate governance as "the term used to describe the rules and practices put in place within a company to manage information and economic incentive problems inherent in the separation of ownership from control in large enterprises." It deals with how, and to what extent, the interests of various agents involved in the company are reconciled and what checks and incentives are put in place to ensure the managers maximise the value of the investment made by shareholders.

In March 2003, the ASX released its *Principles of Good Corporate Governance and Best practice Recommendations*, which contained the following definition: "Corporate governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised. Good corporate governance structures encourage companies to create value (through entrepreneurism, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved." The Principles have been revised three times, with the latest edition in 2014, but the definition has not changed.

Whilst this debate of semantics is provocative in an academic sense, it does little to develop clarity for the commercial world. Seeking to define corporate governance is, perhaps, akin to searching for the holy grail that does not exist.

Justice Neville Owen, in his final report arising from the HIH Royal Commission, hints at the futility of the search simply stating "corporate governance is not a term of art."

[3] For a brief detailed history of this issue, see Michael Adams, 'Board Diversity: More than a gender issue?' (2015) 20(1) *Deakin Law Review* 123, 124-130.

His Honour's guidance is worth remembering: "I think that any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature corporate governance is not something where 'one size fits all'. Even with companies within a class, such as publicly listed companies, their capital base, risk profile, corporate history, business activity and management and personnel arrangements will be varied. It would be impracticable and undesirable to attempt to place them all within a single straitjacket of structures and processes. A degree of flexibility and an acceptance that systems can and should be modified to suit the particular attributes and needs of each company is necessary if the objectives of improved corporate governance are to be achieved."

This has been followed by the 2018 Royal Commission into the Misconduct of Banking, Superannuation and Financial Services Industry, led by former High Court Justice, Commissioner Kenneth Hayne. Commissioner Hayne in the February 2019 Final Report continued to express the same concepts of corporate governance.[4]

Thus, it would appear that corporate governance is and will remain something of an enigma; that certain *je ne sais quoi* that is evident in all successful companies. Research conducted by the University of Newcastle (Australia) with Horwath Chartered Accountants & Management Consultants suggests a positive link between good corporate governance and shareholder value. What is certain however, is that corporate governance comes down to two fundamental ideas: doing the right things and doing things right.

Once there is a general agreement on what constitute corporate governance practices, the bigger challenge is to demonstrate that good corporate governance produces actual benefits.[5] There is overwhelming corroborative and empirical evidence of the impact of sustainability in governance.[6]

Professor Adams, for example, has stated that: "There are numerous studies as to the benefits of corporate governance for global entities, whether they be the transnational corporations or the more traditional multinational companies. Around the globe, by far the majority of business entities are privately owned (and/or family businesses) with a small percentage being quoted on a local stock exchange, in a single legal jurisdiction."[7]

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[4] https://financialservices.royalcommission.gov.au/Pages/reports.aspx

[5] Michael Head, Scott Mann and Simon Kozlina, *Transnational Governance: Emerging Models of Global Legal Regulation* (Ashgate Publishing, 2012) and Anona Armstrong, 'Corporate Governance Standards: Intangibles and Their Intangible Value' (2004) 17(1) *Australian Journal of Corporate Law* 97 cited in Michael Adams, 'Global Trends in Corporate Governance' (2012) 64(9) *Keeping Good Companies* 516.

[6] Alice Klettner, Thomas Clarke and Michael Adams, 'Corporate Governance Reform: An empirical study of the changing roles and responsibilities of Australian Boards and directors' (2010) 24(2) *Australian Journal of Corporate Law* 148, a report on the implementation of the ASX Corporate Governance Principles between 2003 and 2007.

[7] Michael Adams, 'Global Trends in Corporate Governance' (2012) 64(9) *Keeping Good Companies* 516, 518.

Impressive data was produced by Claessens and Yurtoglu[8] who examined the corporate governance literature from the fields of economics, finance, management and legal scholarship in many countries and jurisdictions over the last decade. The authors' detailed survey of the literature provides evidence of the importance of corporate governance on a number of economic points.

These extensive studies provide clear evidence of a link between economic development and corporate governance. The extensive cross-country research demonstrates that corporate governance is central to financial development. Weak corporate governance can be seen to prevail in financial markets that tend to function poorly by global standards. Poor governance increases market volatility and lack of transparency; creating unfair markets. Countries and companies that adopt best practices in corporate governance are not guaranteed success but do provide evidence that good corporate governance improves sustainability and lays the groundwork for long-term success.

Corporate governance has many elements, including risk management, due diligence and compliance. More accurately, the focus of this article is to highlight the fact that these oft-quoted terms are not merely synonyms for one another, rather, they are three distinct, yet inextricably fused elements of corporate governance.

Consider it this way: a company may formulate a compliance program as part of internal due diligence which, in turn, may have been undertaken because of a company's commitment to sound corporate governance.

As well as the legal duties imposed on officers of the company (of which directors make up 99%), corporate governance will also include other stakeholder interests. This has become known in the literature, as well as by the public as CSR. There is an expectation that a company will be a "good corporate citizen" and not hard on workers or suppliers, nor the environment or customers. Investors also have concerns and they will express them as ESG.

An example may be an investment company that does not hold shares in a company that manufacturers or sells alcohol or tobacco products. Many Australian universities will not hold shares in companies that produce fossil fuels (such as coal and gas). Ethical superannuation funds (pension funds) worth over one trillion Australian dollars have been created to avoid investment in products or services which may breach ESG or CSR policies.

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[8] Stijn Claessens and Burcin Yurtoglu, *Corporate Governance and Development – An Update* (Global Corporate Governance Forum, 2012) <http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/corporate+governance/publications/focus_case+studies/focus+10+corporate+governance+and+development+-+an+update>.

Commissioner Hayne in the 2018 *Interim Report* of the Banking Royal Commission, expressed six over-arching principles to be followed:

- Obey the law;
- Do not mislead or deceive;
- Be fair;
- Provide services that are fit for purpose;
- Deliver services with reasonable care; and,
- When acting for another, always act in their best interest.

For the sake of clarity, it is necessary to break down the corporate governance three pillars concept to its fundamental components.

Due Diligence

One generally associates the expression "due diligence" with the American Securities' law defence of due diligence provided by the American *Securities Act* 1933 (Federal, USA) to those charged with the task of investigating prospectuses issued during takeover machinations or fundraising through debt or equities (shares).

In Australia, a similar defence is available in relation to misleading or deceptive statements made in a prospectus under section 731 of the *Corporations Act* 2001 (Cth) but, curiously, there is no such specific defence for misleading or deceptive conduct under section 18 of the *Australian Consumer Law*[9] *(*previously known as section 52 *Trade Practices Act* 1974 (Cth)). The *Corporations Act* 2001 (Cth) also provides officers with a *quasi* due diligence defence under section 180(2) (known as the "business judgement rule") and section 189 (reliance on others). A general due diligence defence of criminal actions is also available under Part 2.5 Division 12 of the *Criminal Code Act* 1995 (Cth).

Due diligence has evolved beyond its original role as a defence. Much of the confusion relating to due diligence results from its treatment under different statutes or in different contexts, as if each use is completely unrelated. It is now a moniker for the process of evaluating everything from a prospectus to the assets of a potential takeover target and, more recently, a corporation's internal legal audit process. Thus, it is no longer merely a concept relevant to a corporation's external transactional activities (such as investigating the veracity of prospectuses during fundraising) but rather the additional meaning of an internal process (for example, legal compliance).

It is when considering due diligence within a corporation's internal operations that the link between and, indeed, the confusion relating to, due diligence and compliance programs becomes apparent. The use of the expression 'due diligence' in common parlance to describe the system implemented

[9] The Australian Consumer Law is a schedule to the *Competition and Consumer Act 2010* (Cth), which replaced the former *Trade Practices Act 1974* (Cth).

within a corporation of checking day-to-day legal statutory compliance (such as intellectual property, trade practices, consumer laws, employment/industrial relations, environmental, corporate and privacy law) is somewhat disingenuous. Due diligence and compliance are related but not to be treated as one and the same. It may be that a corporation, in carrying out its internal due diligence, will conduct a legal risk audit, from which compliance plans will be developed in order to manage and minimise legal risk. However, merely determining a compliance program will not amount to due diligence per se. The diagram below illustrates the paradigm within which both these concepts exist.

Simplified internal due diligence risk model

Step 1 = Legal risk audit

Step 2 = Compliance planning

Step 3 = Implementation compliance plan

Step 4 = Review of compliance program

Step 5 = Adapt compliance plan for due diligence reports to board

Step 6 = After one to two years a new audit of risk commenced (Step 1 repeated)

It is accurate therefore, to say that a compliance plan may come within the broad concept of internal due diligence. However, it is inaccurate to suggest the two are synonymous. The UK case of *Tesco Supermarkets Ltd v Nattrass* [1972] AC 156 illustrates the difference between due diligence and compliance, and how the satisfaction of the former will not necessarily result in the same for the latter. Tesco was prosecuted when a discount sign was left on display after the discounted stock was exhausted and a shop assistant refused to sell at the discounted price. Tesco had put in place a genuine management system to prevent breaches of the law. The court was impressed by the board’s involvement, the good management selection and training process, the regular supervision of stores by four levels of visiting executives, regular communications designed to secure compliance, and operating procedures right down to ones designed to ensure shop assistants complied with the law. The court found that Tesco’s due diligence was sound; it could not reasonably have done more. However, notwithstanding its sound due diligence, Tesco failed to secure compliance with the legal requirements of the law.

Within the Australian context, the Federal Court of Australia has ordered companies to implement or review an existing trade practices compliance program. A sound example is found in *Australian Competition and Consumer Commission (ACCC) v Target Australia Pty Ltd* [2001] FCA 1326 where, having found Target to have breached the former section 52 of the *Trade Practices Act* 1974, (now section 18 *Australian Consumer Law* 2010), the court ordered Target to broadcast a corrective advertisement nationally on 88 television stations and to publish correct notices in 37 newspapers across metropolitan, regional and rural Australia. The court also issued injunctions restraining Target from advertising in the same way for four years, ordered Target to review its trade practices compliance program and ordered Target to pay ACCC costs of $65,000.

Similarly, in *ACCC v Equifax Australia Information Systems* [2018] FCA 1637, the Federal Court imposed a penalty of $3.5 million and a consumer redress scheme for misleading and unconscionable conduct on the company's customers. The Courts are enforcing the legal rights of consumers and investors. The Hayne Banking Commission has moved all the regulators, ACCC, ASIC and APRA to ask the question "why not litigate?" Previously there was more willingness to negotiate a civil outcome, such as an enforceable notice.

Compliance Programs

It is stating the obvious to observe that the commercial environment has become increasingly regulated in recent years. Compliance is demanded with a greater number of statutes, regulations, industry standards and principles than ever before. What is more, society is becoming more litigious, and regulators are having their arsenal bolstered by greater powers and a greater range of penalties.

Australian corporate legislative and regulatory policy is in a state of flux, with an evident more towards criminal and de facto criminal penalties. Research conducted by the Faculty of Law at the University of Technology, Sydney, on behalf of the Fund Executives Association Limited, has uncovered a 289% increase in the number of criminal provisions contained within chapter seven of the *Corporations Act* 2001 (Cth) as a result of the *Financial Services Reform Act* 2001 (Cth). The combined effect of the *Commonwealth Criminal Code* 1995[10] and the *Financial Reform Act* 2001 also introduced the concept of 'tandem criminal liability' into the *Corporations Act* 2001. Such provisions (for example; sections 952C, 993B and 993C) make a contravention of the law both a strict liability and a fault liability offence.

From all contraventions of the Corporations Act from 12 March, 2019, the penalties have been greatly increased by the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019.* Thus, an individual maximum penalty jumps from A$220,000 to 5,000 penalty units or A$1.05 million. Jail sentences also jump from a maximum of five years to 15 years for criminal offences. For corporations, it is now a maximum of A$10.4 million or a maximum of 10% turnover, up to A$525 million. These are significant penalties and are believed to act as a genuine deterrent against directors and executives.

In the event of a breach, these provisions offer the prosecuting authority a choice between pursing a fault liability charge (and thereby a full criminal trial) against an offender – where the prosecuting authority feels it may have a good chance of achieving a successful prosecution – or enforcing the law as a strict liability offence, enabling the prosecuting authority to avoid providing the mental (or fault) elements of the offence.

[10] Australia has a mixture of State/Territory criminal law and statutes, as well as a Federal Commonwealth criminal law and statute.

Furthermore, the ever-expanding incidence of civil penalty provisions, which offer a regulator the attractive (and de facto criminal) combination of the civil standard of proof and pecuniary penalties, highlights a willingness to enable regulators to prosecute breaches of the law more easily. The civil penalty regime provides regulators with substantial pecuniary penalties (traditionally a remedy only available in the criminal sphere) against a wrongdoer and the advantage of only needing to establish a breach of the law to the less burdensome standard of 'on the balance of probabilities'.

These hybrid civil-criminal penalties are a significant weapon in the regulatory arsenal, which the courts have shown a willingness to impose. One need only look to the significant litigation involving former directors of HIH Insurance Ltd for evidence of the civil penalty provisions. The collapse of HIH Insurance in 2001, was Australia's largest collapse at over A$5 billion.

On 14 March, 2002, Rodney Adler (Executive Director), Ray Williams (Chairman) and Dominic Fodera (CFO[11]) were found to have amassed 182 breaches of their duties as directors, which ASIC had litigated under the civil penalty regime (*ASIC v Adler* [2002] NSWSC 171).

On 30 May, 2002, the late Justice Santow of the NSW Supreme Court handed down penalty orders; fining Adler, Williams and Fodera A$450,000, A$250,000 and A$5,000 respectively. The former directors were also ordered to pay more than A$7 million in compensation, and Adler and Williams were each banned from acting as a director of any company for 25 years and 10 years respectively (as to the penalty orders, see *ASIC v Adler* [2002] NSWSC 483, which were revised in no significant way on appeal to the NSW Court of Appeal in *Adler v ASIC* [2003] NSWCA 131).

Cases such as those arising from the collapse of HIH Insurance Ltd also highlight the regulators' and the courts' readiness to impose personal liability upon corporate officers for their role in corporate wrongdoing.

The courts have also reflected the general community feeling that the standards expected of corporate officers need to be raised. For example, the NSW Supreme Court has held that it is arguable that the law now expects more from a well-qualified and experienced chair of the board of a public company than what may be expected of other non-executive directors (*ASIC v Rich* [2003] NSWSC 85). The NSW Supreme Court has also been prepared to sentence corporate offenders to terms of imprisonment for criminal insider trading (such as in *R v Rivkin* [2003] NSWSC 447).

[11] Chief Financial Officer

Finally, where the chief governance officer (known in common law countries as the company secretary) has failed to comply with a procedural requirement of the *Corporations Act* 2001 (Cth) can create legal issues. The company secretary caused the company to bring an application to the court for an extension of time under section 1322. The Federal Court of Australia has been prepared to make an order against the company secretary and directors personally to meet the company's costs of bringing the application (*Re Wave Capital Ltd* [2003] FCA 969).

Similarly, the corporate (general) counsel and company secretary of the James Hardie Industries litigation was held to be in breach of his officers' duties under section 180(1) *Corporations Act 2001* (Cth) by the High Court of Australia in *Shafron v ASIC* [2012] HCA 18.

These burgeoning legal requirements, which in recent times have enjoyed the warmth of the media spotlight, are in some ways nothing new. Nor is the need for companies to instil a compliance program in order to ensure that they do not fall short of their responsibilities on a day-to-day basis. The enormity and importance of compliance was officially recognised in 1998 by Standards Australia, which prompted the release of AS 3806. Entitled *Compliance Programs*, AS 3806 highlighted the role of the compliance program within both due diligence and corporate governance.

Standards Australia Compliance Programs (AS3806)

A compliance program is an important element in the corporate governance and due diligence of an organisation, and should

(a) Aim to prevent, and where necessary, identify and respond to, breaches of laws, regulations, codes or organisational standards occurring in the organisation;

(b) Promote a culture of compliance within the organisation; and

(c) Assist the organisation in remaining or becoming a good corporate citizen

In 2003, this Australian Standard was included within a corporate governance suite of standards, which also includes AS 8000 Good Governance Principles, AS 8001 Fraud and Corruption Control, AS 8002 Organizational Codes of Conduct, AS 8003 Corporate Social Responsibility and AS 8004 Whistle-blower Protection Programs for Entities. This is an area of law, in particular the whistle blowing provisions for private entities, that requires new legislation. The Commonwealth government is reviewing and proposing new laws.

The Three Pillars of Good Corporate Governance

Conclusion

In many ways the precise definitions that an organisation might apply to corporate governance, internal or external due diligence and compliance do not matter. What is important is that the concepts are understood as being an initial part of risk management and that the responsibilities go to both the business entity and the individuals involved. Many senior officers have tried to hide behind the purported protective barrier of directors' and officers' insurance (known as "D&O insurance"), which the courts and regulators can pierce, causing a loss of reputation and financial impact on the individual.

Maybe it is time to be proactive and review the internal due diligence procedures, by whatever name your organisation calls them!

Also, to make sure that the board of directors and executives understand the differences between the three pillars of:

(1) corporate governance;
(2) due diligence; and,
(3) compliance programs.

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