13

ETHICAL OBLIGATIONS AND THE MANAGER: CASE STUDIES

by

Paul Rogers

CASE STUDY: NATIONAL AUSTRALIA BANK

In 2004, National Australia Bank (NAB) announced losses from its foreign investment trading currency activities of approximately $360 million. Four of its currency traders caused the losses by placing NAB's foreign currency options portfolio in a vulnerable position, based on the expectation that the US Dollar would stabilise. The market went the other way and the traders hid their true position, which grew worse before it was discovered. Accountability was the NAB board's "hot topic" and a number of directors were replaced as a result of the ensuing media scrutiny and public disagreements.

Although the Australian Prudential Regulatory Authority's (APRA) report into the situation concluded that the losses were due to the collusive behaviour of the traders, it also stated:

> "However, it can also be contributed to an operating environment characterised by lax and unquestioned oversight by line management; poor adherence to risk management systems and controls and weaknesses in internal governance procedure" (Buck).

APRA also found that there was an exclusive focus on process and documentation rather than looking at the substance of issues and taking responsibility for them.

In response to this, the National Australia Bank's CEO made a number of statements on values and culture in NAB's Concise Annual Report 2004 (http://www.nabgroup.com/vgnmedia/downld/Concise_NAB04.pdf). The fifth paragraph under the heading "Our Strategy" reads:

> "A new Board and executive team is committed to leading culture change by example. A new set of Corporate Principles has been developed and sent to every employee."

NAB's Corporate Principles, which are said to be used as the basis for its core beliefs and values, are:

- "we will be open and honest
- we take ownership and hold ourselves accountable (for all of our actions)
- we expect teamwork and collaboration across our organisation for the benefit of all stakeholders
- we treat everyone with fairness and respect, and
- we value speed, simplicity and efficient execution of our promises." (http://www.nabgroup.com/0,,32714,00.html)

Under the heading "Major gaps in our cultural fabric", the CEO's statement in the Concise Annual Report 2004 reads:

> "While the National had an agreed set of values, people were not held accountable and values were not reflected in the way people were assessed. Culture change programs were voluntary and there was a lack of visible and consistent leadership in this area.
>
> This led to a focus on achieving short-term profits without regard to the way in which this was done, and low levels of employee engagement."

While this lends some context to the CEO's statement quoted earlier, there are a number of organisational culture and leadership issues to consider:

- Is there an indication of shared values among employees in a particular group or groups at National Australia Bank?
- Is there an indication of shared learning? The most encouraging sign of learning appears in the passage "values were not reflected in the way people were assessed" and a suggestion that this needed to be changed via employee assessment processes. Presumably, such processes include monitoring employees "living the five Corporate Principles".
- The statements indicate the practice of "transformational leadership" around imposed core values in National Australia Bank's "Five Principles", and not the Kantian leadership propositions which may lead to "doing the right thing".
- Is there sufficient acceptance that organisational cultures change slowly over time, such as in the fifth principle "we value speed, simplicity and efficient execution of our promises"?

The NAB's Chairman's states in the Corporate Responsibility Review 2008:

> "In these times of economic uncertainty, weaker consumer confidence and ongoing credit supply issues, NAB remains committed to maintaining its focus on meeting or exceeding the expectations of our stakeholders.
>
> This is best demonstrated in our commitment to the achievement of two primary goals:
>
> 1. becoming Carbon Neutral by September 2010
> 2. increasing community investment to 1% of cash earnings before tax per annum
>
> We are delighted that this year's Corporate Responsibility Review demonstrates our progress towards both of these commitments.
> …
>
> On a pre-provisioning basis, National Australia Bank Limited's underlying profit for 2008 was $8.1 billion, up 13.9% on the prior year. Our core banking franchises have performed well despite the volatility in financial markets. While system lending growth slowed in all markets, we achieved satisfactory growth in lending volumes up 12.5% from 2007 to $361 billion in 2008. Retail deposits growth was solid, up 10.8%, in a competitive market. All of our businesses have again demonstrated tight cost control with overall expenses down 2% for the year" (http://www.nabgroup.com/vgnmedia/ downld/NAB_CR2008_WebVersion.pdf).

A further example of the NAB "doing the right thing" is its positive commitment to the environment. This was demonstrated in 2001 when it became a signatory to the United Nations Environment Programme Statement for Financial Institutions on the Environment and Sustainable Development (http://www.unepfi.org/signatories/statements/fi/), which promotes sustainable development and environmentally sustainable business practices in the international financial services sector.

Implications for Managers

There are a number of corporate governance lessons that can be learnt from this case study.

The NAB case study demonstrates the need for a proper and sustainable corporate governance culture in an organisation, with clear lines of authority and internal controls. Risk management needs to be dealt with properly. A divided board cannot stand.

CASE STUDY: AUSTRALIA POSTAL CORPORATION

The current Australian Postal Corporation (Australia Post) Statement of Ethics states:

> "Australia Post conducts its business with integrity, honesty and fairness and in compliance with all relevant laws, regulations, codes and corporate standards. All employees and contractors personally commit to the highest ethical standards of behaviour in their dealings with customers, the Corporation, and with each other. Our leaders encourage a culture in which ethical conduct is recognised, valued and exemplified at all levels" (http://www.auspost.com.au/GAC_File_Metafile/0,,2256_ codeethics,00.pdf).

This Statement can be interpreted as having a number of meanings:

1. The conducting of Australia Post's business is described in the present tense, which gives a sense of certainty and deliberateness to the Statement;
2. The Statement is inclusive, covering "all laws, regulations, codes and corporate standards", although only to the extent that this is "relevant". No specific guidance is given on how judgments on relevance are to be made by the individual employees;

3. Employees and contractors are grouped together in "personally committing" to the highest ethical standards of behaviour. There is no guidance given on how this personal commitment is to take place;
4. Australia Post's "leaders" encourage a culture "in which ethical conduct is recognised, valued and exemplified at all levels". Again, there is no guidance given as to how this culture is to be encouraged or how ethical conduct is to be dealt with in the three circumstances mentioned.

The APC Corporate Values are as follows:

> "Our Corporate Values provide the foundation for our Code of Ethics and apply at all levels. They guide our thinking, actions and decisions; indicate what we stand for and how we will behave towards each other. Our Values are:
>
> - Being committed to customers
> - Recognising and developing capability
> - Sharing business understanding
> - Ensuring participation and involvement
> - Creating and maintaining a safe and healthy work environment
> - Being open and fair
> - Setting high standards
> - Taking accountability
> - Acknowledging achievement
> - Encouraging flexibility and adaptiveness.
>
> Australia Post aims to be a high performance organisation, innovative, competitive and responsive in our markets. A reputation for integrity, honesty, courtesy and fairness in our dealings with customers, suppliers, staff and the public is essential" (http://www.auspost.com.au/GAC_File_Metafile/0,,2256_codeethics,00.pdf).

Accompanying the Statement of Ethics is another statement entitled "If the Code is Breached". It says:

> "Behaviour in breach of the Code of Ethics is damaging to the business and to public and work relationships. Action or omission that contravenes this Code constitutes misconduct and will be subject to counselling or disciplinary action appropriate to the circumstances and seriousness of the behaviour. Disciplinary action may include dismissal. If the conduct involves non-compliance with relevant laws, it will normally also be referred to Corporate Security or any

other relevant area, or to the appropriate law enforcement authorities" (http://www.auspost.com.au/GAC_File_Metafile/0,,2256_ codeethics,00.pdf).

Applying content analysis to these two statements reveals a contextual setting which relies upon regulatory compliance and ethical standards. The implications are largely negative, dealing as they do with the consequences of non-compliance (such as being referred to Corporate Security).

The Australia Post Annual Report 2006/07 states (Corporate Governance, p 49):

> "Code of ethics
>
> Australia Post seeks to conduct its business with integrity, honesty and fairness and in compliance with all relevant laws, regulations, codes and corporate standards. A board approved code of ethics clearly sets out the ethical standards that are expected of directors, employees, licensees and contractors in their dealings with customers, suppliers, the corporation and each other.
>
> Any action or omission that contravenes the code of ethics constitutes misconduct and is subject to counselling or disciplinary action appropriate to the circumstances and seriousness of the behaviour. Disciplinary action may include dismissal.
>
> Australia Post's whistleblower policy encourages the confidential disclosure of serious breaches of the code of ethics, particularly where criminal activity may be involved.
>
> An independently operated contact service is in place for the lodgement of any such whistleblower complaints.
>
> A senior management Ethics Committee oversees the application of the code of ethics across the organisation" (http://www.auspost.com.au/annualreport2007/pdfs/AusPost_ AnnRpt_0607.pdf).

CASE STUDY: BARINGS BANK

In February 1995, one man single-handedly bankrupted the bank that financed the Napoleonic Wars, the Louisiana Purchase and the Erie Canal. Founded in 1762, Barings Bank was Britain's oldest merchant bank and Queen Elizabeth's personal bank. Once a behemoth in the banking industry, Barings was brought to its knees by a rogue trader in its Singapore office. That trader, Nick Leeson, was employed by Barings to profit from low-risk arbitrage opportunities between derivatives contracts on the Singapore Mercantile Exchange and Japan's Osaka Exchange. A scandal ensued when Leeson left a $1.4 billion hole in Barings' balance sheet due to his unauthorised derivatives speculation, causing the 233-year-old bank's demise.

Nick Leeson grew up in the London suburb of Watford and worked for Morgan Stanley after graduating university. Leeson then joined Barings and was transferred to Jakarta, Indonesia, to sort through a back-office mess involving £100 million in share certificates. Leeson enhanced his reputation with his employer when he successfully rectified the situation in 10 months (Risk Glossary). In 1992, after his initial success, Leeson was transferred to Barings Securities in Singapore and was promoted to general manager, with the authority to hire traders and back-office staff. Leeson's experience with trading was limited, but he took an exam that qualified him to trade on the Singapore Mercantile Exchange (SIMEX) alongside his traders.

The collapse of Britain's oldest merchant bank, Barings, should hold a number of lessons for directors and other officers responsible for a company's operations. Most important is the need to realise that no amount of external or internal regulation and surveillance is going to prevent determined people from committing illegal behaviour. Instead, directors should realise that they can expect a sympathetic hearing after having made real and sensible efforts to ensure that management addresses issues to do with the culture of the organisation they control.

The investigation ordered by Britain's Chancellor of the Exchequer concentrated on issues related to internal control and compliance mechanisms. Thus a golden opportunity to address issues of the management of derivative-related risks may have been squandered because the seeds of the destruction of Barings lay instead in the micro-culture of the dealing room.

The crisis precipitated in Barings' Singapore dealing room could just as easily have been the basis for a spectacular triumph. As is so often the case, censure has followed failure. Leeson's behaviour was condemned because he bet the wrong way and then compounded his error by chasing losses. Had his judgment (or luck) been a little better, he might now be enjoying the fruits of an enhanced reputation and a healthy bonus. It may appear a little cynical, however, one must wonder whether Leeson's superiors would have castigated him for the same deals if they had led to windfall profits.

Perhaps Leeson's superiors would have been concerned. After all, it seems he disregarded instructions relating to the running of his book. His task was, essentially, to buy securities futures on the Japanese exchanges and then sell them, in short order, to buyers on the Singapore exchange. His profits were to be generated through the price differential — the classic role of the arbitrager. At its best, the work of arbitragers can improve the efficiency of markets. We have now seen the results of their work at its worst.

Why Did It Happen?

Events such as these are a direct product of the environment in which derivatives are traded. For the most part, traders operate as relatively isolated individuals whose remuneration is specifically linked to performance. That is, there is a direct nexus between profit and the size of the year's bonus. The remuneration policy rarely, if ever, acknowledges or rewards the *way* in which the profits are generated. Hence the apparent indifference that some banks show when considering the interests of clients. Consciences are salved by the notion that clients entering the over-the-counter trade should have known better. Relationships between "counterparties" are disdained.

At the same time, a climate of radical individualism in a highly competitive market breeds a culture in which errors are disguised in the hope that a sudden reversal in fortune will save the day. In these circumstances, traders are loath to admit a mistake and, in some cases, will commit the cardinal error of chasing losses. What needs to be understood is that this can happen even when the motive of greed is absent. Aggressive behaviour and a need to hide any weakness dominate the psychology of the players.

Then there is the problem of the market's speculative bent. Derivatives were originally synthesised as a tool of risk management. The idea of "hedging" goes back to the old agricultural practice of building hedges to keep in the good and exclude the bad. Yet, the market has made a virtue of speculation (which is the euphemism used to describe what others freely admit to be gambling). A gambler is often blind to the consequences of each action. The temptation is to raise the stakes even higher. As can been seen in this case, there are clear winners and losers. What is more, the winners have no mercy. They press home their advantage to the last.

So What Might be Done About This?

The first thing to note is that derivatives are neither inherently good nor bad. Used as a risk management tool they are innocuous. It all depends on the attitudes of the people who make the trades. Secondly, those who caution against over-regulation are right to point out that formal rules have only limited effect.

Given this, managers need to be cautious about adopting a response that is based on a technical "quick fix". That is, it would be a foolish (and very brave) board that thought that it could satisfactorily address the risks it faces by the sole measure of bolstering the internal systems of surveillance and control. To be sure, such measures are needed and play an important role. However, there are inherent limitations in their efficacy. Rather, there is a need to consider a radical reappraisal of the way in which treasury operations are conceived and executed.

Implications for Managers

There are a number of corporate governance lessons that can be learnt from this case study:

- A board might need to assure itself that profit expectations are realistic and not likely to add pressures of a kind likely to stimulate "rogue" behaviour.
- Remuneration policies may need to be reviewed so that a trader is rewarded not just for results but also on the basis of how the results were achieved.
- There should be consideration of the utility of introducing some form of inter-personal accountability, perhaps through the development of "dealer teams", perhaps by fostering a wider sense of obligation to the company and its diverse stakeholders.
- The company needs to define (and explain) the nature of its strategic position in the marketplace. For example, those operating at the leading edge, in product design and delivery, may need to think through the extent to which their clients will look for and rely on a reputation for trustworthiness. Learning to trust is a shared practice that is best developed at home.
- Most importantly, there is a need to address questions about the fundamental values of an organisation. What does the organisation value in practice, as opposed to what it says it values?

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth), better known as the "CLERP 9 Act" came into force on 1 July 2004. Many of the corporate law reforms in the Act were derived from the September 2002 Federal Government Discussion Paper: "Corporate Disclosure: Strengthening the Financial Reporting Framework".

CLERP 9 represented a major reform of Australian corporate law, regulating the corporate governance practices of companies along with the ASX Best Practice Recommendations. The effects of the reforms have been significant, particularly in the areas of audit and financial reporting.

Managers must have adequate measures, processes and procedures in place to meet the obligations of the Act, especially those involved in auditing and company financial reporting. The requirements of the CLERP 9 Act are explained in the following regulatory documents:

- Regulatory Guide 180: *Auditor registration* [formerly PS 180]
- Regulatory Guide 34: *Auditors' obligations: reporting to ASIC* [formerly PN 34]
- Regulatory Guide 66: *Transaction-specific disclosure* [formerly PN 66], and
- Regulatory Guide 173: *Disclosure for the on-sale of securities and other financial products* [formerly PS 173].

CLERP 9 Impact on Audits

CLERP 9 provided for the establishment of the Auditing and Assurance Standards Board (AUASB), a statutory body issuing legally enforceable auditing and accounting standards. The Australian auditing standards it issues became enforceable from 1 July 2006. The introduction of legally enforceable auditing standards has so far had little impact on audit quality, with some in the profession saying it has merely resulted in a greater compliance burden and increased costs. A study released in August 2008, *The Introduction of Legally Enforceable Auditing Standards and their Impact on the Auditing Profession in Australia* notes:

> "According to the firms [surveyed], the additional significant costs of increased documentation, training, monitoring and reviews have not met the government's desired objectives of

'upholding public interest' in conformity with [international auditing standards] and high quality [Australian auditing standards]".

The authors of the study said there was limited support, mostly from the regulators, for the assertion that the new rules had increased audit quality, but the consensus from industry and regulators was that there had been no impact on public and investor confidence in audits. Auditors interviewed reported increases in audit costs of 10 to 30 per cent as a result of the compliance requirements, including substantial upfront costs in training, mapping of methodology and documentation. In addition to reviews by the Audit Quality Review Board, set up in February 2006, there was also an ASIC review.

However, professional bodies interviewed (including CPA Australia, the Institute of Chartered Accountants in Australia, the Institute of Internal Auditors Australia) and regulators, said these cost increases should have been factored in earlier, when new Australian audit standards were introduced prior to them becoming legally enforceable.

One professional body said the fee hike was in part attributable to an overreaction to the new regime. An audit firm also commented that the mandatory regime had increased costs because it had limited flexibility to prioritise their focus based on risk. The regulators acknowledged that there had been lobbying from smaller audit firms who argued that the new regime's costs would reduce their ability to compete, but said compliance costs had been minimal so far.

The authors of the study concluded that they found no strong support for the Australian Government's introduction of the legally enforceable standards as an appropriate response to achieve an increase in the quality of audits. But they emphasise that the study was conducted after the regime had been in operation for only one year and there had not been enough time since the changes were introduced to assess their full impact.

Corporate Collapse

Developments in auditor independence have arisen as a result of corporate collapses both in Australia and overseas. The major corporate failures in Australia involved Ansett Airlines, One.Tel and HIH Insurance, while some overseas collapses include Enron and WorldCom. In the HIH Insurance and Enron collapses, there were concerns relating to "a lack or a perceived lack of an independent audit of financial reports". Since the HIH collapse, "the government has introduced stronger legislation and the Australian Stock Exchange has introduced corporate governance guidelines encompassing board and audit committee independence". Other regulatory responses to the HIH collapse include the HIH Royal Commission report and the Corporate Law Economic Reform Program (CLERP 9), which was "aimed at strengthening corporate governance including auditor independence." In the Enron collapse, the former auditor "was perceived as lacking independence, because the accounting firm earned more revenue from non-audit services than from audit services". In response to the collapse of Enron, "the UK government set up a high level group of regulators and ministers to co-ordinate a review of the UK regulatory framework, including the key area of auditor independence" (V Beattie and S Fearnley, "The Reform of the UK's Auditor Independence Framework after the Enron Collapse: An Example of Evidence-Based Policy Making" (2004) 8(2) *International Journal of Auditing* 117).

ASX Corporate Governance Council

The ASX Corporate Governance Council was formed on 15 August 2002, bringing together 21 groups from disparate business backgrounds with varying aims and priorities. Despite the differing perspectives of the Council's representatives, it has an overriding mission: to develop and deliver an industry-wide framework for corporate governance which can provide a practical guide for listed companies, their investors, the wider market and the Australian community.

The size, complexity and operations of companies differ, and so flexibility must be allowed in the structures adopted to optimise individual performance. That flexibility must, however, be tempered by accountability — the obligation to explain to investors why an alternative approach is adopted — the "if not, why not?" obligation. The enhancement of corporate accountability and the adoption of this framework for reporting was a major evolution in corporate governance practice in Australia. The impact on Australian companies must not be underestimated. The ASX Corporate Governance Council is committed to a continuing assessment of the implementation experiences of listed companies and the reactions of investors.

Any corporate governance regime must be sufficiently flexible to cope with a constantly changing environment. Just as a healthy and robust business environment evolves with circumstances, so too must any guidelines for corporate governance good practice. The ongoing relevance and effectiveness of these guidelines will be periodically reviewed by the ASX Corporate Governance Council. As with the ASX Listing Rules, where the spirit and intention outweighs the letter of the law, so must these guidelines be applied: maintaining an informed and efficient market and preserving investor confidence remain the constant imperatives.

On 31 March 2003, the ASX Corporate Governance Council released its long-awaited *Principles of Good Corporate Governance and Best Practice Recommendations*. The Council then revised this material, issuing the *Corporate Governance Principles and Recommendations* in August 2007 (http://www.asx.com.au/about/corporate_ governance/ revised_corporate_governance_principles_recommendations.htm).

CASE STUDY: ENRON

Enron Creditors Recovery Corporation (formerly Enron Corporation) was an American energy company based in Houston, Texas. Before its bankruptcy in late 2001, Enron employed approximately 22,000 people and was one of the world's leading electricity, natural gas, pulp and paper, and communications companies, with claimed revenues of nearly $101 billion in 2000. *Fortune* named Enron "America's Most Innovative Company" for six consecutive years. At the end of 2001 it was revealed that Enron's reported financial condition had been sustained substantially by institutionalised, systematic, and creatively planned accounting fraud. Enron has since become a popular symbol of wilful corporate fraud and corruption. The scandal was also considered a landmark case in the field of business fraud and brought into question the accounting practices of many corporations throughout the United States.

As the scandal was revealed, Enron shares dropped in value from over US$90 to less than 50¢. The plunge occurred after revelations that much of Enron's profits and revenue were the result of deals with special purpose entities (that is, limited partnerships controlled by Enron). Thus many of Enron's debts and the losses it suffered were not reported in its financial statements.

Enron filed for bankruptcy protection in the Southern District of New York in late 2001. It emerged from bankruptcy in November 2004 after one of the biggest and most complex bankruptcy cases in US history. On 7 September 2006, Enron sold Prisma Energy International Inc, its last remaining business, to Ashmore Energy International Ltd. Following the scandal, lawsuits against Enron's directors were notable because the directors settled the suits themselves, paying very significant sums of their own money. The scandal also caused the dissolution of the Arthur Andersen accounting firm, which was convicted of obstruction of justice for shredding documents relating to its audits of Enron, affecting the wider business world.

In early 2007, Enron changed its name to Enron Creditors Recovery Corporation, to reflect its status as a (largely) asset-less shell corporation. Its current goal is to liquidate all its remaining assets. For most of 2007, Enron continued to operate under the name Enron Corp by filing a "Doing Business As" certificate in Harris County, Texas.

The phrase "Doing Business As" (abbreviated to "DBA" or "d/b/a") is a US legal term, meaning that the name of the business or operation does not include the legal name of its proprietor, the names of all partners, or the official registered name of the limited partnership or corporation that owns it. In Canada, the term "operating as" (abbreviated to "o/a") is used. In the United Kingdom, Ireland and Australia (and some parts of the United States), the phrase "trading as" (abbreviated to "t/a") is used.

Complexity abounds in the Enron case; it highlighted the fundamental difficulties facing US corporate governance. In the aftermath of the Enron collapse there were criminal prosecutions and the passing by Congress of the *Sarbanes-Oxley Act* of 2002. This Act represented the most extensive federal regulation of corporate governance since the establishment of the *Securities Exchange Commission Act* in 1933. Congress enacted the *Securities Act* of 1933 (the "1933 Act", the "Truth in Securities Act" or the "Federal Securities Act") in the aftermath of the stock market crash of 1929 and during the ensuing Great Depression. The *Sarbanes-Oxley Act* marked the swing away from self-regulation to increased legal regulation.

CASE STUDY: FOSTER'S GROUP

The Foster's Group Code of Ethics states:

> "Our Code expresses the high level principles that govern the way we do business globally. These principles guide our decisions and actions in our relationships with the following stakeholders.
>
> Shareholders, Creditors and General Community

We will observe the spirit and the letter of relevant laws and exercise high standards of ethical conduct regarding:

- disclosure of information to stock exchanges, shareholders and statutory authorities
- accounting practices
- conflicts of interest
- dealings in Foster's shares.

We will ensure Group personnel act in the best interests of the Group and Foster's shareholders at all times.

Customers, Consumers and Suppliers

We will observe the spirit and the letter of relevant laws and exercise high standards of ethical conduct regarding:

- our marketing and selling activities
- our use of market power and pricing practices
- our descriptions of goods and services
- the quality and safety of our goods.

Employment Practices

We are committed to the principles of workplace safety, equal opportunity, equality of treatment and creating an inspiring workplace where diversity is valued as a source of enrichment and opportunity. We will:

- observe the spirit and the letter of relevant laws
- exercise high standards of ethical conduct
- implement appropriate health and safety practices
- promote the principle of equality of employment opportunities.

The Community

Our policy is to observe high standards of ethical conduct towards the communities in which we conduct business and where appropriate, to support community activities and charities in the areas in which we operate. We will observe the letter and the spirit of the laws that protect our communities and the environment" (http://www.fosters.com.au/ about/docs/ethics.pdf).

The Foster's Group 2006 Sustainability Report (p 4, "Our Approach") states:

"Ethics and Integrity

Our ambition is to ensure Foster's approach to sustainability is not only described by a formal process, but is also evident in the way that Foster's people go about their business. In January 2006, Foster's launched Foster's Ways of Working (WOW) to establish a consistent, values-based framework for the way we recruit, develop, reward and recognise our people. Over time, the WOWs will also help embed an organisational culture that is responsive to sustainability principles. Foster's WOWs are:

1. Do The Right Thing
2. Win As One Team
3. Know The Market
4. Make It Happen
5. Make A Difference

'Do the Right Thing' introduces the key concept of the value of reputation and the importance of compliance, while 'Know the Market' encourages an outward looking culture that solicits stakeholder feedback and acts on it.

Anti-corruption

Foster's employee induction program outlines the Company's Code of Conduct and Code of Ethics, as well as its policies relating to share trading, disclosure and political donations. From time to time, employees are reminded of their obligations under these codes. Foster's 2006/2007 Sustainability Action Plan includes a commitment to 'undertake an integrated staff engagement and education campaign to boost buy-in and compliance with core policies', so this will be a focus of further work in the coming year. Foster's Enterprise wide Risk Management system (ERM) encompasses a regular series of workshops which provide formal opportunities to identify potential corruption risks and take mitigating steps. Foster's internal audit process focuses on any control or systemic weaknesses that could enable corrupt practices."

The 2008 Foster's Sustainability Report (p 4, "Sustainability leadership and policy") states:

"In 2008, the most senior executive forum in the company — the Foster's Leadership Team (FLT) — assumed the leadership and oversight functions of the Sustainability Taskforce. The FLT reviews and oversees the development of sustainability strategies, policies and positions directly linked to business strategy.

...

Our values-based Ways of Working (WOW) framework embeds sustainability into our organisational culture and is supported by a defined set of behaviours expected of all employees. 'Do the right thing' in decision-making has been identified as one of the behaviours that support our WOWs. This behaviour requires all Foster's employees to behave with integrity and is measured and reinforced through our performance management and people and leadership development processes. ...

Ethical and responsible decision-making is also promoted through Foster's Code of Conduct and Whistleblower Policy. The Code of Conduct commits Directors, employees, contractors and consultants to not only comply with the law, but to conduct business in accordance with the highest ethical standards. Any breach of the Code of Conduct is a serious matter that may give rise to disciplinary action, including dismissal and legal action."

The report (p 9, "Ways of Working") also states:

"at Foster's our Ways of Working or 'WOWs' represent the shared culture and behaviours that underpin our business strategy and success. In 2008, we have strengthened the link between our ways of working and people management processes including induction, learning, development, performance management and succession planning. Our current five WOWS 'Know the market', 'Do the Right Thing', 'Win as One Team', 'Make a Difference' and 'Make it Happen' are being updated to reflect the evolution of our business into 2009.

Employee survey

As part of measuring our progress, we regularly survey our global employee population. Since 2003, we have conducted three 'Inspire' surveys with the last survey conducted in 2007. The next global survey is scheduled for March 2009. We are working to make the next survey even more useful. For the first time, data from the March 2009 survey will be available at the team level, to every manager of five or more direct reports. Teams will also create individual action plans, tailored to their specific results and feedback. These actions plans will be recorded and tracked by the Foster's Leadership Team on a quarterly basis. From March 2009, Foster's will also increase the frequency of surveys towards a target of annual, global staff surveys."

It is hoped that the data from these surveys will be made public as part of the transparency of governance within the evolving Foster's Group.

On 15 March 2001 HIH Insurance Ltd went into provisional liquidation, owing an estimated $4 billion. HIH was Australia's second largest general insurance company. ASIC commenced a major investigation and the Federal Government announced that it would establish a Royal Commission to examine aspects of the company's collapse.

On 17 May 2001 the Federal Minister for Financial Services and Regulation and the Insurance Council of Australia announced the formation of a new non-profit company called HCS (HIH Claims Support Pty Ltd) to process the government support package for HIH policyholders in hardship. The non-profit company, set up and run by the industry, would oversee and administer the Federal Government's assistance package. The HIH provisional liquidator gave his in-principle agreement to the structure.

On 17 May 2001 the Minister also announced details of a change in timetable for the new General Insurance Act — a total overhaul of the 1973 regime. The general insurance industry was to be significantly impacted by the significant changes in prudential requirements. Foremost was a stated need that all authorised insurers meet new risk-based capital requirements and a minimum new entry capital requirement of $5 million (raised from the current level of $2 million). A revised timetable for the new General Insurance Act was agreed upon by Federal Cabinet on 16 May 2001 as one part of the overall package in response to the collapse of HIH Ltd.

On 21 May 2001 the Minister announced the criteria for Federal Government relief for policyholders suffering financial hardship as a result of the HIH collapse. The package would cost more than $500 million and be funded from the Federal Government Budget.

On 25 May 2001 the provisional liquidator of HIH Insurance advised the Federal Government that early estimates for the total deficiency of the HIH group of companies were between $2.7 billion and $4 billion. The provisional liquidator advised in his report that he was not yet able to provide a breakdown of the estimated deficiency on a company-by-company basis. However, he was able to confirm that his preliminary views formed on the basis of investigations to date were:

- that each of the major insurance licence-holding companies within the HIH group were clearly insolvent;
- that is, they were clearly unable to pay their debts in full;

- that the financial position of each of the three main licence-holding companies was worse than the stated balance sheet position by a very significant margin in each case;
- that the deficiencies reflected previous optimistic valuation of assets and extensive underestimation of liabilities; and
- that the very substantial losses were not restricted to the last nine months of operation.

On 24 May 2001 ASIC announced that it had obtained court undertakings from former directors of HIH Insurance Ltd. The court undertakings were provided by former Chief Executive Officer Ray Williams, former HIH director Rodney Adler and former Chief Financial Officer Dominic Fodera. ASIC sought these protective orders as an interim step in its broad investigation into the collapse of HIH. Prior to ASIC's court application, Williams voluntarily surrendered his passport to ASIC. As part of the court undertakings Williams agreed, without admission, that he:

- would not deal with any of his interests in personal or household assets (exceeding $50,000), real property, securities or superannuation without first giving ASIC 30 days' notice of his intention to do so;
- would not transfer moneys or assets outside Australia without first giving ASIC 30 days' notice;
- did not have any real or personal property that was otherwise not subject to the court undertaking with a value greater than $50,000.
- would provide ASIC with details of his assets.

Fodera gave undertakings, without admission, that:

- he would not deal with any of his assets, subject to payment of ordinary living expenses and legal costs incurred in the proceedings, without first giving ASIC 30 days' notice of his intention to do so;
- he would not transfer moneys or assets outside Australia without first giving ASIC 30 days' notice;
- if he desired to travel outside Australia he would provide ASIC with seven days' notice, a detailed itinerary and a photocopy of his return airline ticket.

Adler gave undertakings to the Court which expired on 31 May 2001, on which day there would be further argument about any undertakings he should be required to give. Adler gave, without admission, undertakings that:

- he would not deal in any real estate held by him or on his behalf, or shares, securities or future contracts without giving 30 days' written notice to ASIC; and
- he would not transfer moneys, shares, securities or futures contracts outside Australia without first giving ASIC 30 days' notice.

ASIC also commenced civil proceedings against the three former directors, alleging that they had breached their duties as directors in relation to a payment of $10 million by an HIH subsidiary (HIH Casualty and General Insurance Ltd) to Pacific Eagle Equities Pty Ltd, a company of which Adler was a director. ASIC also alleged a breach of director's duties in respect of Pacific Eagle Equities.

The first reported judgment in the HIH collapse, *Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253, took place on 14 March 2002. ASIC sought and was granted declarations of contraventions of the following civil penalty provisions:

- related party transactions (*Corporations Act 2001* (Cth), ss 208, 209, 1317E(1)(b));
- financial assistance to buy own shares (ss 260D, 1317E(1)(c));
- breach of duty of care and diligence (ss 180, 1317E(1)(a));
- breach of duty of good faith (ss 181, 1317E(1)(a));
- misuse of position to gain advantage for oneself or another or to cause detriment to a corporation (ss 182, 1317E(1)(a)); and
- improper use of information (ss 83, 1317E(1)(a)).

On 30 May 2002 ASIC sought and was granted pecuniary penalty orders, compensation orders and disqualification orders following on from the 14 March 2002 contravention orders (see *Re HIH Insurance Ltd* (2002) 42 ACSR 80). Justice Santow of the Supreme Court of New South Wales ordered that:

- Adler be disqualified from managing corporations for a period of 20 years and that he and Adler Corporation pay pecuniary penalties of $450,000 each.
- Williams be disqualified from managing corporations for a period of 10 years and that he pay pecuniary penalties of $250,000.
- Fodera not be disqualified but that he pay pecuniary penalties of $5,000.
- Adler, Williams and Adler Corporation pay aggregate compensation of $7,958.112 to HIH Casualty and General Insurance Ltd.

On appeal (*Adler v Australian Securities and Investments Commission* (2003) 179 FLR 1), Adler was convicted for stock market manipulation and making misleading statements in relation to securities. The Court of Appeal upheld Adler's appeal against the finding that he had breached s 183 of the *Corporations Act 2001* (Cth) (wrongly using information obtained as a company officer) but confirmed all other breaches and orders made by Santow J. The Court upheld the disqualifications, pecuniary penalties and compensation orders against all three defendants, subject to recalculation of interest. The Court of Appeal was of a differing view to Santow J on the conclusion that the equitable test of causation applied to compensation orders under s 1317H of the *Corporations Act*. The Court awarded costs of the appeal to ASIC, in addition to the $600,000 for the original proceedings.

HIH Royal Commission

The report by Royal Commissioner, Justice Neville Owen, into the circumstances surrounding the failure of the HIH Insurance Group, the largest corporate collapse in Australian history, was released on 16 April 2003. The three-volume report identified a number of possible breaches of the *Crimes Act* and the *Corporations Act 2001* (Cth), which were referred to the relevant authorities. It also included 61 policy recommendations. The principal reason for the HIH failure was that the Group did not have adequate reserves against future claims. There was a lack of due process, a lack of limits on authority, a lack of independent critical analysis, a lack of management of conflict of interest, and a lack of information to the board and proper accounting.

Part Three of the report, "Directions for the Future", includes chapters on corporate governance and on financial reporting and assurance. Set out within these two chapters are 17 policy recommendations, a few being of limited application (to corporate governance by the Australian Prudential Regulatory Authority (APRA)) but most applying generally.

CLERP 9 Law Reform

The HIH Report's policy recommendations on corporate governance and financial reporting and assurance were considered in the finalisation of the Federal Government's CLERP 9 amendments to the *Corporations Act 2001* (Cth). The CLERP 9 legislation dealt with continuous disclosure, including the introduction of personal liability for breach; auditor independence; accounting standards; expensing of options; compliance controls; and encouragement of greater shareholder participation at meetings.

Approach to Corporate Governance

The HIH Report provides authoritative support for the one-size-does-NOT-fit-all policy foundation of the ASX Corporate Governance Council (CGC) recommendations on *Principles of Good Corporate Governance and Best Practice*.

Justice Owen's observations in the report gave ASX-listed entities considerable comfort in choosing the path of explanation rather than mere compliance with the CGC's recommendations:

> "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 which 'one size fits all'. Even with companies within a class, such as public listed companies, their capital base, risk profile, corporate history, business activity and management and personnel arrangements will be varied. It would be impractical and undesirable to attempt to place them all within a single straight[sic]jacket 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."

Culture

Justice Owen emphasised in the report the importance of culture on corporate governance:

> "I am not so much concerned with the content of a corporate governance model as with the culture of the organisation to which it attaches. For me, the key to good corporate governance lies in substance, not form. It is about the way the directors of a company create and develop a model to fit the circumstances of that company and then test it periodically for its practical effectiveness."

Failure by Middle Management

A significant focus of the HIH Report was on failure by middle management. Justice Owen was frustrated by what he described as the disinclination of HIH middle managers to accept responsibility for undesirable practices. He identified the difficulties for the Royal Commission in considering conduct where middle managers had taken steps that resulted in the falsification of the corporation's accounts or returns lodged with statutory authorities. In some instances, he observed, the existing law did not reach the intermediate conduct — for example, where someone prepared a report knowing it to be false but did not sign it. The more senior officer who then signed the document would assert as "reasonable" his or her reliance on the more junior employee who prepared the report, to argue that the senior officer's conduct did not constitute a breach of the law.

The policy recommendations included clarifying the legal duties of employees who are concerned in management but who are not "officers".

Likely Extension of Persons Subject to Fiduciary Duties

Fiduciary duties bind directors, secretaries, and certain other officers, but those officers are a narrower class than existed under the *Corporations Law* prior to amendments made in 2000.

The report recommended expanding the class of "officers" to include those who, before 2000, were also "officers" by reason of being "concerned in management". The policy recommendation went further, however, by recommending that it is the performance of the relevant function that should attract the legal duty, not the precise relationship between the person performing that function and the relevant corporate entity. If adopted, this recommendation would extend fiduciary duties to consultants and independent contractors who perform functions analogous to employees concerned in, or making, management decisions.

This functional delineation of the reach of fiduciary duty prompted a significant debate on the merits of extending duties beyond the employment relationship as there was some ambiguity as to the intended scope.

It was proposed to add another duty similar to both the civil and criminal sanctions. The new duty would apply where an "employee" acted dishonestly in respect of the performance or satisfaction of an obligation imposed upon the corporation under the *Corporations Act* or any other written law. Justice Owen noted that the application of the existing law was not clear where an employee acted dishonestly without gaining advantage for themselves or without intending to cause detriment to the corporation. If the functional approach to the definition of "employee" was used to apply to a wider class of personnel, this duty may attach also to contractors and consultants.

Duties to Group Companies

The report also recommended clarification of the duties owed to a group of companies in which an officer of one group company may be taking actions affecting another group company, where the officer is neither an officer nor employee of the second group company. Extension of the fiduciary duty of the officer to both companies may have been achieved if the recommendation based on functional delineation of duty was adopted.

Remuneration

Recommendation 1 of the report was for the review, as a matter of priority, of the regulation of the disclosure of all remuneration and other benefits paid to directors in whatever form. Justice Owen suggested that the review should cover the entire *Corporations Act*, the relevant accounting standards, and the ASX Listing Rules.

The recommendation was consistent with the approach taken by the CGC and by the ASX in seeking disclosure of executive remuneration in announcements to the market when employment contracts are signed (for the Chief Executive Officer), and in the corporate governance sections of websites and in annual reports. In this area, the report provided support to various Federal Government, ASX and CGC initiatives under way at that time.

Financial Reporting

Justice Owen examined several issues relating to financial reporting and assurance. In relation to financial reporting, he discussed issues of interpretation of accounting standards, adoption of international accounting standards from 1 January 2005, and the need for the Australian Accounting Standards Board and its Urgent Issues Group to be better able to provide timely advice on difficult interpretation issues. Overarching these issues was that compliance with accounting standards, while a requirement of the *Corporations Act*, did not equate with the higher duty under the Act for the accounts to give a "true and fair view" (and for any discrepancy to be explained in the notes to the accounts).

Audit Function

Building on the work of the CLERP 9 Discussion Paper, Ramsay Report and Report of the Joint Standing Committee on Public Accounts and Audit, Owen J made several recommendations aimed at enhancing the audit function, including in relation to the appropriate standard of independence, the provision of non-audit services, the relationships between the company and auditor, and the usability of audit reports.

Independence

Justice Owen emphasised the importance of the audit function for the capital market as a whole and the reliance placed on the audit function by users of financial statements. Having regard to this, he considered that the standard of independence for auditors should be as high as it is for judges, whose standard is based on avoiding the perception of judicial bias. In finding this, he thought that the CLERP 9 standard, which required that a reasonable person, informed of all relevant circumstances, would conclude that the auditor was not independent, was too high. Rather, the standard should be stated in terms that an auditor would not be independent if a reasonable person might conclude that the auditor's independence might be impaired. Additionally, Owen J considered that it was necessary to clarify that, when applying a standard to "the auditor", the standard should be applied to individual auditors and the audit firm.

Non-audit Services

The provision of non-audit services raised the possibility that an individual auditor may be required to review the work of the audit firm in the provision of other services (the "self-review threat").

The self-review threat was addressed in CLERP 9 by requiring two things: mandatory disclosure in the annual report of fees paid for non-audit services in certain categories; and a statement from the audit committee, to be included in the annual report, that it is satisfied that the provision of those services is compatible with auditor independence. Those categories set out in Professional Statement F1 (issued May 2002 and revised December 2004) are:

- "preparing accounting records and financial statements of the audit client;
- valuation services;
- internal audit services;
- temporary staff assignments;
- litigation support services;
- legal services;
- recruitment of senior management for the audit client; and
- corporate finance and similar activities."

Without the benefit of a detailed study on the competition effects of prohibiting such services, and cognisant of the government's stated policy not to prohibit such services, Owen J did not consider recommending a blanket prohibition. However, he noted that "categories" did not provide sufficient information and recommended that the board (or audit committee as noted in his preceding discussion) should include a statement in the annual report that identifies each non-audit service, the fees set out and that states why this service did not compromise independence.

Justice Owen considered that the provision of non-audit services also raised the possibility that the value to the audit firm of such other services may lead to cross-selling, or the inference that preference should be given to maintaining a strong relationship with management. He noted that performance evaluation criteria that included "cross-selling" should amount to professional misconduct under the disciplinary regimes of the professional accounting bodies.

Employment Associations

Employment associations between the audit firm and a company can give rise to what is described as a "familiarity threat". Justice Owen considered that the CLERP 9 Discussion Paper recommendations were insufficient in this area at the time and recommended that:

- lead engagement partner and review partner rotation after five years (as recommended in CLERP 9) be extended to key senior audit personnel;

- the two-year waiting period for audit partners to join a company's board or senior management be extended to four years, and include key senior personnel of the audit firm involved in the audit;
- the two-year waiting period apply for partners of the audit firm that were not involved in the audit; and
- there be a prohibition on more than one former audit firm partner being a director or in senior management of the client at any one time.

He also recommended that restrictions be enforceable against the audit firm and relevant partner or senior employee.

Usability of Audit Reports

While discounting concerns about increased exposure to liability, Owen J supported suggestions that the audit report provide more information and be in plain English. He recommended that the audit should also cover the operating and financial review prepared by companies to be included in annual reports and that the audit reports disclose:

- the impact of the position taken by the reporting entity where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material; and
- significant matters arising in the audit process.

To address what has become known as the "audit expectation gap" resulting from the lack of information in, and understanding of, audit reports, Owen J further recommended that the *Corporations Act 2001* (Cth) be amended to require publicly listed companies to include a brief, plain English summary of the nature and scope of the audit services provided by the auditor for each year.

Conclusion

Generally, it can be said that many of the report's recommendations were aimed at recognising and addressing issues for the regulation of modern corporate groups and information disclosed in relation to such groups to the capital markets. The recommendations relating to financial reporting and the audit function further the then current trend of increasing disclosure: the disclosure of matters affecting audit independence, and disclosure of additional financial information.

The recommendations relating to duties of officers recognised that, with large corporate groups, responsibility is spread through long chains of management and that some of these functions are not necessarily performed by employees. The Government's subsequent adoption of many, if not all, of the HIH Report's recommendations in the CLERP 9 amendments to the *Corporations Act 2001* (Cth) changed the way the law recognises the management and governance of companies and corporate groups.

Implications for Managers

There are a number of corporate governance lessons that can be learnt from this case study:

1. The HIH and Enron collapses demonstrate the need for the monitoring role of a strong board and the important residual role of the regulators and the courts in the scheme of corporate governance.
2. HIH demonstrates the danger of a strong-minded chief executive officer who is not sufficiently monitored by the board. There is a need for proper procedure and documentation in corporate matters as their absence facilitates fraud.
3. HIH and Enron demonstrate that a company can appear to comply with all the latest thinking in corporate governance and yet be mismanaged. The culture of Enron emphasised greed at the expense of responsibility. The greed of key executives was obscured by the increasingly "virtual" aspect of the company's operations. Transactions became more complex and were not adequately monitored by the company auditors, Arthur Andersen. This led not only to the bankruptcy of the company but also the demise of Arthur Andersen. The political fallout led to the *Sarbanes-Oxley Act 2002*, which can be seen as a legalistic over-reaction by the United States with ramifications for the rest of the world.

The social fallout in all of these cases has been considerable: corporate governance matters.

CASE STUDY: JAMES HARDIE

For much of the 20th century James Hardie Industries Ltd was involved in manufacturing and selling asbestos-related products. Some people handling these products, most notably the building material known as "Fibro", developed asbestosis and mesothelioma. In 2001 James Hardie set up the Medical Research and Compensation Foundation to provide financial compensation for victims of asbestos-related diseases caused by their products. In December 2001 the company's shareholders voted unanimously to restructure and relocate its parent company to the Netherlands. In 2003 the Dutch-based James Hardie cancelled a $1.9 billion guarantee to its Australian subsidiary providing a compensation fund for future claims.

The Report of the New South Wales Special Commission of Inquiry was handed down on 21 September 2004. It made the following findings:

- James Hardie had underfunded the Medical Research and Compensation Foundation by about $2 billion.
- Having profited from its asbestos-related products, James Hardie had the capacity and moral obligation to compensate their victims.
- James Hardie made misleading and deceptive statements in relation to the establishment of the Medical Research and Compensation Foundation.
- This conduct should be investigated by Commonwealth authorities.
- Serious questions were raised about the conduct of a number of professional firms.

Subsequent to the inquiry, prosecutors were considering bringing charges against James Hardie's CEO, amongst other senior executives. On the 15 February 2007 ASIC commenced civil penalty proceedings, all relating to the adequacy of funding for the foundation, against a number of former directors and former executives.

The James Hardie Decision

Justice Gzell of the Supreme Court of New South Wales delivered his judgment in *Australian Securities and Investments Commission v Macdonald (No 11)* (2009) 230 FLR 1 on 23 April 2009.

The case brought by ASIC arose from statements made by James Hardie in relation to its restructuring and the capacity of a foundation established by the company to meet future asbestos liabilities.

ASIC's statement of claim stated that the non-executive directors "knew, or ought to have known and it was the fact that" if James Hardie made a false or misleading statement about funding for asbestos liabilities and "if the misleading nature of the statement was revealed, it would be harmful to (Hardie's) reputation and could jeopardise market perceptions of (Hardie) and the separation proposal".

ASIC claimed that the duties of the directors required them to be satisfied that the statements made were correct in all respects. In fact the directors knew, or ought to have known, that the ASX announcement was false.

Managers need to be aware that this important case considers:

- The impact of the decision on the statutory duty of care and diligence, particularly for non-executive directors.
- Practical implications for the:
  - conduct of board meetings;
  - recording of board decisions;
  - directors who are not physically present at a meeting;
  - relative importance of reviewing announcements of decisions as distinct from the decisions themselves;
  - delegation of authority to review draft announcements; and
  - timing of the provision of draft announcements to the board.

Implications for Managers

- Draft announcements on significant matters should be accompanied by the relevant board papers.
- Directors should seek assurance that internal processes for preparing draft announcements have been followed.
- Directors who are not physically present at a board meeting should insist on being provided with the same material as their colleagues or be satisfied that the absence of that material is not important.
- Draft ASX announcements should be treated with the same degree of care as the underlying substantive board decisions.
- Directors should regard communications strategy as an area requiring their full attention.

- For very significant board decisions, the board should consider whether it should approve the final announcement, even if a proper delegation regime is in place.
- In some cases, directors should abstain on a vote rather than simply "go along" with a collective decision, and request that the minutes record their reasons for abstention.
- Formal resolutions should be put on all matters arising for board decision.
- A minimalist approach to keeping minutes of board meetings will come under increasing scrutiny.
- If the next board meeting is not scheduled to take place within one month, draft minutes should be circulated for discussion within a period set by the board.
- Draft minutes should be reviewed carefully before adoption.
- When placing reliance on others and in reviewing announcements, directors will be judged in the light both of what they know and of what they ought to know.

CASE STUDY: LEIGHTON HOLDINGS

The Company's Corporate Governance Report 2007 begins:

> "The Leighton Group has followed all of the best practice recommendations set by the ASX Corporate Governance Council (Council) for the full financial year ended 30 June 2007 (Financial Year), other than Council Recommendations 2.1. An explanation of why this recommendation was not followed is set out in the Company's response to Recommendation 2.1 below.
>
> This report:
>
> - sets out the 10 core principles identified by the Council as underlying good corporate governance; and
> - should be read in conjunction with the Leighton Holdings 2007 Concise Annual Report (Annual Report) and full Financial Report 2007 (Financial Report).
>
> As recognised by the Council, 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. There is no single model of good corporate governance. What constitutes good corporate governance will evolve with the changing circumstances of a company and must be tailored to meet those circumstances"
> (http://www.leighton.com.au/verve/_resources/Corporate_Governance_2007.pdf).

The following principles were identified by the Council as underlying good corporate governance:

> "1.0 Role of the Board and Management
> *Council Principle 1: Lay solid foundations for management and oversight*
> …
> 2.0 Composition of the Board
> *Council Principle 2: Structure the board to add value*
> …
> 3.0 Ethical and Responsible Decision-making
> *Council Principle 3: Promote ethical and responsible decision-making*
> …
> 4.0 Integrity of Financial Reporting
> *Council Principle 4: Safeguard integrity in financial reporting*
> …
> 5.0 Continuous Disclosure to ASX
> *Council Principle 5: Make timely and balanced disclosure*
> …
> 6.0 Communication with Shareholders
> *Council Principle 6: Respect the rights of shareholders*
> …
> 7.0 Risk Management
> *Council Principle 7: Recognise and manage risk*
> …
> 8.0 Performance
> *Council Principle 8: Encourage enhanced performance*
> …
> 9.0 Remuneration
> *Council Principle 9: Remunerate fairly and responsibly*
> …
> 10.0 Interests of Stakeholders
> *Council Principle 10: Recognise the legitimate interests of stakeholders*."

Each Company value is followed by the Council's Principle, then the Council's Recommendation, which in turn is followed by Leighton's Practice.

The Company's value "3.0 Ethical and Responsible Decision-making" is as follows:

> "Council Principle 3: Promote ethical and responsible decision-making

Council Recommendation 3.1: *Establish a code of conduct to guide the directors, the chief executive officer (or equivalent), the chief financial officer (or equivalent) and any other key executives as to:*

3.1.1 the practices necessary to maintain confidence in the company's Integrity

3.1.2 the responsibility and accountability of individuals for reporting and investigating reports of unethical practices

Leighton practice: In September 1995, the Leighton Board adopted a Code of Ethics that sets out the principles and standards with which all Group officers and employees are expected to comply in the performance of their respective functions. Under the Code (which is available on the Company's website), officers and employees are expected to:

- comply with the law;
- act honestly and with integrity;
- not place themselves in situations which result in divided loyalties;
- use Leighton's assets responsibly and in the interests of Leighton; and
- be responsible and accountable for their actions.

In November 1998, the Board established an Ethics Committee whose principal function was initially to review and make recommendations to the Board regarding the maintenance of ethical standards and practices generally within the Leighton Group.

Subsequently each of the Group's main operating subsidiaries established an Ethics Committee which co-ordinates with the Ethics Committee of Leighton Holdings in monitoring and formulating the Group's ethical policy direction and reporting. The Group's Ethical Dimension Reporting system requires each major operating subsidiary to submit a quarterly report to the Board with a view to ensuring the maintenance of ethical practices within the Group and the achievement of continual improvement in this area.

In June 2004 the Ethics Committee was renamed the Ethics and Compliance Committee and its Terms of Reference were expanded. In addition to its responsibilities with regard to ethical standards and practices in the Group in general, specific responsibilities were added with regard to reviewing and monitoring compliance with laws and regulations which impact upon the Group's business and operations generally as well as Group standards and practices in the areas of occupational health and safety and the environment. The Terms of Reference and Procedures for the Ethics and Compliance Committee are available on the Company's website.

...

Council Recommendation 3.2: *Disclose the policy concerning trading in company securities by directors, officers and employees*

Leighton practice: The Company's Constitution requires Directors to hold at least 1000 shares in the Company but additional shareholdings by Directors are encouraged. The Company has a policy which restricts the times and circumstances in which Directors, senior executives and certain employees may buy or sell shares in the Company except for specified short periods after announcements are made to the ASX of the Company's quarterly, half-year and annual financial results. The Company's Securities Trading Policy is available on the Company's website. Directors must advise the Company, which in turn advises the ASX, of any transactions conducted by them in the Company's securities within five business days after the transaction occurs."

Standards of conduct and relationships at a number of organisational levels feature strongly. Interestingly, objective setting and compliance intentions are expressed alongside directions such as "we will notify our supervisor of any failure to comply with the law". Doing the right thing means behaving in a compliant manner, even when no one else is looking. Acting honestly and with integrity is given a broad interpretation, even if it is almost of "Bill of Rights" proportions in listing a range of discriminatory behaviour to avoid.

Implications for Managers

Content analysis shows that there is no specific reference given to the type of laws or contextual settings for Leighton's compliance processes. However, there is evidence of reliance on ethical practices and a non-directing "consensual culture" which renders unnecessary formal compliance processes such as periodic certification.

CASE STUDY: ONE.TEL

The collapse of One.Tel is another example of the ineffectiveness of self-regulation. The dealings of entities within the One.Tel group of companies were carried out in an *ad hoc* manner and important information appears not to have been placed before its board.

This is in turn raised, amongst other issues, questions about the role of a company's chair. Previously, the position of chair has been thought of in narrow technical terms, relating to the law of meetings and whether the chair has an authority to bind the company.

In *Australian Securities and Investments Commission v Rich* (2003) 174 FLR 128, Austin J refused an application by John Greaves, the former Chairman of One.Tel, to strike out the claim brought against him by ASIC in civil penalty proceedings. ASIC argued that as chairman of both the board and the audit and finance subcommittee, Greaves had to be assessed by a standard of care and diligence (*Corporations Act 2001* (Cth), s 180) which required him to take reasonable steps to ensure that:

> ".....the board monitored the company, properly assessed its finances and performance, promptly assessed any material adverse change, had all the information it needed, appointed a qualified finance director, kept the market informed and didn't mislead the public or hide material information, and stayed solvent" (Editorial, *The Australian Financial Review*, 27 February 2003).

His Honour indicated that higher duties should be expected of a company chair, and that the company's Code of Good Corporate Governance should set out in detail those additional duties. There was no determination made on what those duties were or whether Greaves had failed to discharge them; the case dealt only with the limited question of whether ASIC had a reasonable cause of action against Greaves, based on the alleged duties.

His Honour's view reflects a more contemporary view from the Bench, in that it demonstrates a preparedness to develop the law of negligence to reflect social change. In *Panorama Developments (Guildford) Ltd v Fidelis Furnishings Ltd* [1971] 2 QB 711, Lord Denning of the UK Court of Appeal had taken a similar view of the authority of a company secretary to bind the company in its management and administrative dealings.

Justice Austin indicated that the court's role was to articulate and apply a standard of care which reflected contemporary community expectations. It will be interesting to see if his Honour takes a similarly enlightened view of the role and responsibility of non-executive directors who have served on audit committees of failed companies.

The One.Tel saga continued in *Re One.Tel Ltd (in liq)* (2003) 44 ACSR 682, where Bryson J reflected on earlier cases dealing with the disqualification of directors (see Santow J in *Re HIH Insurance Ltd* (2002) 42 ACSR 80). One.Tel former co-managing director, Brad Keeling, and ASIC had asked the Court for agreed declarations and orders effectively disposing of the proceedings. Part of the agreement was that Keeling would pay $92 million in compensation to One.Tel. His Honour made it clear that even taking into account the consent orders in their agreed form, the Court would still have to give genuine consideration to all relevant factors in determining the appropriate period of disqualification (see *Corporations Act 2001* (Cth), ss

206C, 206E). Justice Bryson saw ASIC as a "guardian of the public interest" and the Court took into account ASIC's recommendation, applying the courts' discretion in the circumstances of the individual case, when forming its view that a 10-year disqualification period be imposed.

Implications for Managers

The demise of One.Tel demonstrates that self-regulation sometimes fails, leaving no alternative but court involvement. Self-regulation lacks an effective system of sanctions, which can only be provided by the courts.

CASE STUDY: PONZI SCHEMES

A Ponzi scheme is a fraudulent investment operation that pays returns to investors out of the money paid by subsequent investors, rather than from profit. The term "Ponzi scheme" is used primarily in the United States, while other English-speaking countries do not distinguish colloquially between this and other pyramid schemes.

A Ponzi scheme usually offers abnormally high short-term returns in order to entice new investors. The high returns advertised and paid by a Ponzi scheme require an ever-increasing flow of money from investors. The scheme is destined to collapse because earnings, if any exist, are less than the payments to investors. As more investors become involved, the likelihood of the scheme coming to the attention of authorities increases. However, the scheme is usually shut down by the authorities before it collapses as someone draws their attention to a possible Ponzi scheme or they become aware of a promoter selling unregistered securities.

The scheme is named after Charles Ponzi, who became notorious for using the technique after emigrating from Italy to the United States in 1903. Ponzi did not invent the scheme, but his operation took in so much money that it was the first to become known throughout the United States. His original scheme was, in theory, based on arbitraging international reply coupons for postage stamps but investors' money was soon diverted to support payments to earlier investors and to Ponzi himself.

CASE STUDY: RINKER GROUP

CEMEX was founded in Mexico in 1906 and by the early 21st century had become a global company producing, distributing and marketing building materials such as cement, ready-mix concrete and aggregates.

During the 2006/2007 tax year, CEMEX made an off-market takeover offer for Rinker Group shares. Following the acquisition of Rinker Group Ltd by CEMEX in 2007, the company implemented changes to its corporate identity in Australia. On 1 March 2008 Rinker Australia Pty Ltd (then known as Readymix) formally changed its name to CEMEX Australia Pty Ltd.

On the topic of regulatory compliance, the company's global website hosts its Code of Business Ethics and Standards of Conduct, which states:

> "Creative, strategic, and entrepreneurial; these are a few of the traits that symbolise the company's culture. CEMEX states it is a challenging place to work and a great place to develop the skills necessary to create value for and cement lasting relationships with customers, colleagues, investors, communities, and other key stakeholders.
>
> One of our key priorities is to empower our people to focus their energy and creativity on the new instead of the usual. Through programs like our Idea Bank, we actively encourage our people to 'think outside of the box' and propose well-supported ideas and solutions.
>
> Our rapid growth and geographic expansion also underscore the benefits of a diverse workforce, made up of people with different styles, capabilities, and backgrounds. Consequently, we are committed to developing and maintaining a stimulating, healthy, and productive work environment in which everyone is treated impartially and respectfully" (http://www.cemex.com/cp/cp_cv.asp).

The context of the required compliance behaviour is shown in the following:

> "Values
>
> We strive for excellence in our performance, developing long-term relationships built on trust and our essential values of collaboration, integrity, and leadership.

- Collaboration: Work with others in a collective pursuit of excellence
- Integrity: Act honestly, responsibly, and respectfully toward others at all times
- Leadership: Envision the future and focus on service, excellence, and competitiveness

Embedded in our Code of Ethics and Business Conduct, our values guide our actions and serve as the framework for our decisions and contributions at every level of our organization. They foster the full development of our individual skills and abilities and play an integral part in our company's sustainable growth and development.

CEMEX competencies

From our talent-development programs to our performance-evaluation model, we are focused on developing and reinforcing our company's individual competencies — those traits, attitudes, and abilities that distinguish CEMEX people and define our culture.

- Teamwork
- Creativity
- Focus on stakeholders
- Entrepreneurial spirit
- Strategic thinking
- Customer-service orientation
- Development of others
- Information management
- Development of alliances."

The Chairman's report says:

"While the acquisition of Rinker has strengthened our portfolio and our global position, it has also greatly increased our environmental responsibilities. We are developing ways to lessen the impact of our expanded quarrying operations on local communities and wildlife. We signed a partnership agreement with the conservation organization, BirdLife International. This collaboration will help us build on our efforts to protect biodiversity and create healthy, natural habitats in and around our sites."

Implications for Managers

These statements appear to be based on a mutuality of responsibility for compliance. They also refer to an increase in legal responsibilities and, importantly, where an employee needs clearer understanding, that guidance should be sought.

This raises some points that are able to be addressed using content analysis. First, the main themes of openness, disclosure and responsiveness are apparent. Secondly, the words indicate reliance upon principles such as integrity. Thirdly, there is emphasis on the need for compliance and ethical behaviour. Fourthly, there is evidence of "deeper" levels of compliance culture in areas such as honesty, and potential embarrassment with disclosure of non-compliant actions.

There is an emphasis on unconscious as well as conscious compliance processes and the promotion of co-operation to ensure that actions "reflect well on us".

CASE STUDY: THE RULE IN FOSS v HARBOTTLE

Foss v Harbottle (1843) 2 Hare 461; 67 ER 189 is a famous English court decision that became a precedent on corporate law. In any action in which a wrong is alleged to have been done to a company, the proper claimant is the company itself and not its individual shareholders. This is known as "the rule in *Foss v Harbottle*" and the several important exceptions to this rule that have been developed are often described as "exceptions to the rule in *Foss v Harbottle*".

Two minority shareholders initiated legal proceedings against, among others, the directors of the company. They claimed that the directors had misapplied the company's assets. The Court dismissed the claim and held that when a company is wronged by its directors it is only the company that has standing to sue. In effect the court established two rules.

First, the "proper plaintiff rule" was said stated as follows:

> "First, the proper plaintiff in an action in respect of a wrong alleged done to a company … is prima facie the company itself.' (*Burland v Earle* [1902] AC 83, p93 per Lord Davey)"

Secondly, the "internal management rule" states that if the alleged wrong can be confirmed or ratified by a simple majority of members in a general meeting, then the court will not interfere (*Foster v Foster* [1916] 1 Ch 532).

The rule in *Foss v Harbottle* has another important implication. A shareholder cannot generally bring a claim to recover any diminution in the value of his or her shares in circumstances where the diminution arises because the company has suffered an actionable loss. The proper course is for the company to bring the action and recoup the loss, with the consequence that the value of the shares will be restored.

Because *Foss v Harbottle* leaves the minority in an unprotected position, exceptions have arisen and statutory provisions have come into being which provide some protection for the minority. By far and away the most important protection is the unfair prejudice action in ss 994-996 of the *Companies Act 2006* (UK) and s 232 of the *Corporations Act 2001* (Cth). There is also a new statutory derivative action available under ss 260-269 of the *Companies Act 2006 Act* (UK) and s 236 of the *Corporations Act 2001* (Cth).

Exceptions to the Rule

There are certain exceptions to the rule in *Foss v Harbottle* where litigation will be allowed. The following exceptions protect basic minority rights, regardless of the majority's vote:

1. *Ultra vires* and illegality. The directors of a company or a shareholding majority may not use their control of the company to "paper over" actions which would be *ultra vires* the company, or illegal.
2. Actions requiring a special majority. If some special voting procedure would be necessary under the company's constitution or under the corporate legislation, it would defeat both if that could be sidestepped by ordinary resolutions of a simple majority, with no redress for aggrieved minorities to be allowed (*Edwards v Halliwell* [1950] 2 All ER 1064).
3. Invasion of individual rights (*Pender v Lushington* (1877) 6 Ch D 70 per Jessel MR and, see again, *Edwards v Halliwell* [1950] 2 All ER 1064).
4. "Frauds on the minority" (*Atwool v Merryweather* (1867) LR 5 EQ 464n per Page Wood VC; and *Gambotto v WCP Limited* (1995) 182 CLR 432; and see *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 for an example of what was *not* a fraud on the minority).
5. Whenever the interests of justice required the rule not to apply.

Statutory Derivative Action

March 2000 in Australia (July 1994 in New Zealand) saw the commencement of the "derivative action", also referred to as the "representative action", which was enacted to unveil corporate mismanagement and to alleviate the imbalance of power created by the separation of ownership and control. Although the phrase "statutory derivative action (SDA)" is widely used in Australia to refer to the action available to shareholders under Part 2F.1A of the *Corporations Act 2001* (Cth) the Act itself does not refer to the action as being a "statutory derivative action" (although the term was used by Heenan J in *Westgold Resources NL v Precious Metals Australia Ltd* (2002) 171 FLR 20).

Academics have contrasted the term with "statutory representative action", with the suggestion that "derivative" is a colloquial misnomer. Bruce Welling in *Corporate Law in Canada — the Governing Principles* (2nd ed, Scribblers Publishing 1991) said at p 544, "The term 'derivative action', in its modern corporate use, seems to be American in origin. It is used in America to describe a common law (not statutory) action brought, usually by a shareholder, on behalf of a corporation to redress a wrong done to the corporation." Whilst the term is properly used in the American common law action context it may be that the term is being misused in Australia, Canada, the United Kingdom and other common law jurisdictions. Welling adds that, "There is a danger that colloquial terms in the courtroom may bring with them the technical limitations inherent in those terms in other jurisdictions" (p 546).

> "Shareholder derivative suits are a vital support to the free enterprise economy ... Derivative suits are the major policemen of managerial integrity" (Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993), p 4 with reference to fn 12: AF Conard, quoted in MA Maloney, "Whither the Statutory Derivative Action?" (1986) 64 *Canadian Bar Review* 309 at 315).

The SDA has the potential to "add certainty to the law, in the sense that it specifies much more clearly and logically the situations in which an aggrieved shareholder may pursue a remedy for a wrong done to the company" (Matthew Berkahn, "The Derivative Action In Australia And New Zealand: Will The Statutory Provisions Improve Shareholders' Enforcement Rights?" (1998) 10 *Bond Law Review* 74 at 75).

Although Australia does not permit SDA actions to be funded on a contingency basis, the fact that there have been 77 reported cases from October 2000 up to December 2008 (http://www.austlii.edu.au/ as at 24 January 2009) suggests that, while in its early days, the SDA is more than merely (but still importantly) a deterrent. For the same period there were 21 academic or related articles published with reference to SDAs.

The SDA provides minority shareholders with a mechanism to exercise control on behalf of the company when the directors cannot or will not take action; it serves as a corporate watchdog and bargaining tool in that shareholders can threaten the use of the SDA. Moreover, because of the restrictions on its use and the requirements that need to be satisfied before the complainant is granted leave, it minimises abuse of process and vexatious litigation.

Note that the general law rule may still be of some relevance — for legal proceedings based on breaches of duty before commencement of the new provisions, and for considering when a derivative action should be allowed (*Karam v Australia and New Zealand Banking Group Ltd* (2000) 34 ACSR 545).

CASE STUDY: THE SARBANES-OXLEY ACT

This piece of United States legislation came into force in 2002 and introduced major changes to the regulation of financial practice and corporate governance. Named after its main architects, Senator Paul Sarbanes and Representative Michael Oxley, it also set a number of deadlines for compliance.

The *Sarbanes-Oxley Act* (SOA) is arranged into 11 Titles. As far as compliance is concerned, the most important sections within these are often considered to be sections 302, 401, 404, 409, 802 and 906. An over-arching public company accounting board was also established by the Act, which was introduced amidst a great deal of publicity.

Sarbanes-Oxley Act Section 302

This section appears in Title III of the Act (Corporate Responsibility) and pertains to "Corporate Responsibility for Financial Reports".

Summary of Section 302

Periodic statutory financial reports are to include certifications that:

- The signing officers have reviewed the report.
- The report does not contain any material untrue statements or material omission or be considered misleading.
- The financial statements and related information fairly present the financial condition and the results in all material respects.

- The signing officers are responsible for internal controls and have evaluated these internal controls within the previous 90 days and have reported on their findings.
- There is a list all deficiencies in the internal controls and information on any fraud that involves employees who are involved with internal activities.
- There is a list of any significant changes in internal controls or related factors that could have a negative impact on the internal controls.

Organisations may not attempt to avoid these requirements by reincorporating their activities or transferring their activities outside of the United States

Sarbanes-Oxley Act Section 401

This section appears in Title IV of the Act (Enhanced Financial Disclosures) and pertains to "Disclosures in Periodic Reports".

Summary of Section 401

Financial statements are published by issuers and are required to be accurate and presented in a manner that does not contain incorrect statements or omit to state material information. These financial statements shall also include all material off-balance sheet liabilities, obligations or transactions. The Commission was required to study and report on the extent of off-balance transactions resulting in transparent reporting. The Commission is also required to determine whether generally accepted accounting principles or other regulations result in open and meaningful reporting by issuers.

Sarbanes-Oxley Act Section 404

This section appears in Title IV of the Act and pertains to "Management Assessment of Internal Controls".

Summary of Section 404

Issuers are required to publish information in their annual reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting. This statement shall also assess the effectiveness of such internal controls and procedures.

The registered accounting firm shall, in the same report, attest to and report on the assessment on the effectiveness of the internal control structure and procedures for financial reporting.

Sarbanes-Oxley Act Section 409

This section appears in Title IV of the Act and pertains to "Real Time Issuer Disclosures".

Summary of Section 409

Issuers are required to disclose to the public, on an urgent basis, information on material changes in their financial condition or operations. These disclosures are to be presented in terms that are easy to understand, supported by trend and qualitative information, with graphic presentations as appropriate.

Sarbanes-Oxley Act Section 802

This section appears in Title VIII of the Act (Corporate and Criminal Fraud Accountability) and pertains to "Criminal Penalties for Altering Documents".

Summary of Section 802

This section imposes penalties or fines and/or up to 20 years' imprisonment for altering, destroying, mutilating, concealing or falsifying records, documents or tangible objects with the intent to obstruct, impede or influence a legal investigation. This section also imposes penalties or fines and/or up to 10 years' imprisonment on any accountant who knowingly and wilfully violates the requirements of maintenance of all audit or review papers for a period of five years.