Wielding Corporate Power - the ethics of corporate governance

Published by the Hong Kong Ethics Development Centre

Ivan Boesky, the highly successful arbitrageur of the 1980s, received rapturous applause when he told business school students at the University of California that “greed is healthy: it is the basis of the capitalist system.” Subsequently, he went to jail on insider dealing charges.

As markets and business have become global and more open to international scrutiny, more attention has been paid to corporate ethics. Well publicised financial scandals, such as those involving Boesky and the firm Drexel, Burnham, Lambert in the United States; the Guinness Company in the UK, the Recruit Company in Japan and Rothwells in Australia, turned the spot light onto corporate social responsibility. As John Shad, previously Chairman of the US Securities and Exchange Commission and sponsor of the Harvard Business School’s Program in Leadership, Ethics and Corporate Responsibility, said: “failed leaders were revealed in every walk of life... sad examples of excess, greed, and cynicism …”

Environmental tragedies, such as the explosion of the Union Carbide plant in Bhopal India, which killed and maimed many people and the Exxon Valdez oil spill in Alaska, sharpened the focus on the broader responsibilities of business leaders. Increasingly today, public opinion is calling for boards of directors to exercise their considerable powers for good and harm with responsibility and in the interests of the many who can be affected, rather than solely in the interests of shareholders and the short term “bottom line”.

Markets are not typically good arbiters of the public good. Yet some directors feel that their job is done if they ensure that their company is as profitable as possible year by year, whilst staying within the law. “If society wants companies to behave in a specific way,” they argue, “appropriate legislation must be passed.”

But in the end of the day, directorships are positions of trust, demanding absolute integrity, including the ability to make moral judgements, which recognise the broader societal interests that may be affected by board decisions. Directors also need to be able to take a longer term perspective, realising that balancing the interests of all legitimate stakeholders is the only way to ensure long term survival and success. Moreover, directors need to distinguish the company’s interests from their own.

Ultimately, the success of every enterprise depends on the calibre of its directors and the effectiveness of its board. Management runs the business, but it is the directors who ensure that is being well run and in the right direction. This applies not only to large, public companies but to family firms, subsidiary and associated companies, and not-for-profit organisations. All corporate entities need to be governed as well as managed.

But what *is* corporate governance?

Essentially, corporate governance is about the exercise of power over corporate entities. It is concerned with the structure and processes of the governing body (often the board of directors) and of the directors' relationships with shareholders, regulators, auditors, top management and any other legitimate stakeholders. Figure 1 illustrates the scope of corporate governance in a limited company:

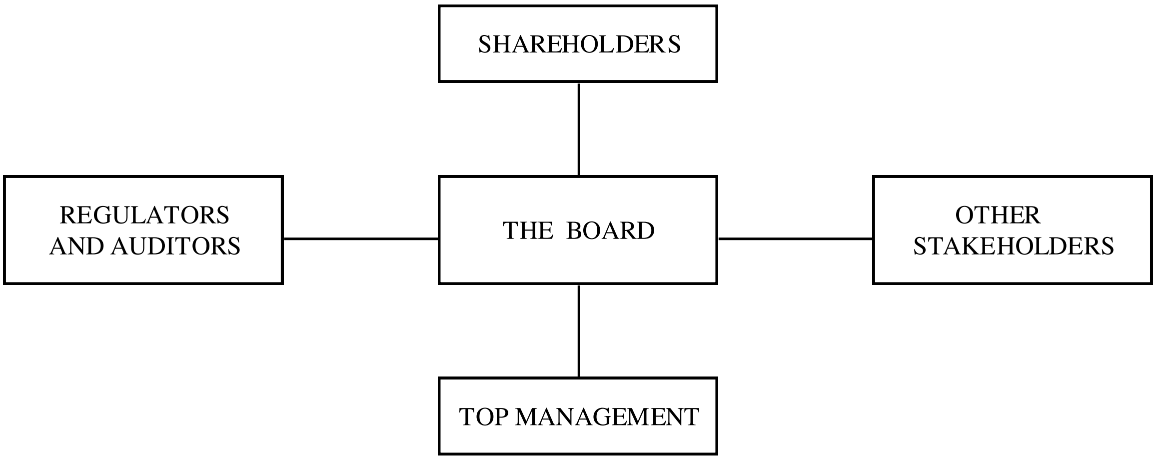

Figure 1 Corporate Governance in a limited liability company

Despite the need to recognise the longer-term interests of all the legitimate stakeholders in a company, the directors' primary role is to act for the good of the shareholders - *all* of the shareholders. Similarly, in other types of corporate entity, such as charities and public associations, the members of the governing body have a duty to act in the interests of the members of their association.

What *are* directors' duties?

Typically two basic ideas underlie directors' duties - a duty to act with honesty, integrity and candour towards the company and a duty to exercise reasonable care, diligence and skill in their work on the board.

- a duty to act with honesty, integrity and candour

The primary duty of a director, in law, is to act honestly in good faith for the benefit of *all* the shareholders, giving them equal, sufficient and accurate information on all issues that could affect their interests. Directors may not treat the company as though it existed for their personal benefit. Even in the case of the "closed" company, in which the owners, the directors and the management are the same people, the company is an independent entity and the rights of other parties, such as the creditors and the state, need to be respected by the board.

A director must not make a secret profit out of dealings with the company. Directors must disclose any personal interests to the board. For example, if a director serves on a board which is considering a tender from another company, in which the director also has an interest, that interest must be disclosed. With that knowledge, the board can decide how to act. Insider trading, that is dealing in the shares of a quoted company on the basis of information that is not in the public domain, is now a criminal offence in almost all jurisdictions including Hong Kong

- and a duty to exercise care, diligence and skill

A further overall duty imposed on directors, by statute and case law, is the duty to exercise reasonable care, diligence and skill in their work as directors. The interpretation of what constitutes reasonable skill and care has been changing. In the past a directorship in Hong Kong was not an onerous task. An occasional meeting, perhaps a few questions and an expression of interest and support, for a fee and, maybe, a lunch was often what was required. Now all that has changed. Around the world, legal actions are being brought against companies, boards and, in some cases, individual directors alleging negligence, abuses of power or infringement of the rights of minority shareholders. There is a call for professionalism from directors. More and more is expected of them.

The board of directors is the overall decision-making body in the modern corporation. Yet most directors, and there are millions of them around the world, have never had any formal training for their work as directors. Indeed, most directors are unaware of the growing body of knowledge that is now available about the work of directors, board-level effectiveness and the exercise of power of the modern corporate entity - what is now called corporate governance. This situation is somewhat similar to the position of managers in the 1950s, before the growth of management training, management theories and business schools.

As a general proposition, the standard of professionalism expected of directors is significantly higher than a few years ago and rising. Of course, business decision-making involves making judgements and taking risks. It is not the role of the courts to second guess commercial judgements made by directors, even though by hind-sight they turn out to have been misguided.

What *should* directors do?

Essentially, directors need to look outwards, beyond the company, seeing the business in its competitive, commercial context. They must also look inwards at the component parts of the company. They need to be able to focus on the future of the business in both the medium and the long-term; and they must concentrate on the present position and recent performance.

In contributing to strategy formulation and policy making, directors are adding their abilities to the performance of the company. In monitoring and supervising executive actions and providing accountability, the directors are ensuring compliance and conformance to corporate values and the achievement of the overall corporate mission. In this way every director has a personal stake in the ethical standing of the enterprise and its relations with all whose interests it might affect.

It is every director’s responsibility to ensure that business decisions are in line with the policies, procedures and plans that have been sanctioned. In this way directors ensure that appropriate ethical standards have been identified, understood and are being pursued throughout the company from top to bottom. Directors have the ultimate responsibility to monitor the activities of the top management and to act if not satisfied.

Being a director calls for the highest levels of personal integrity and the ability to act in a non-adversarial yet tough minded way, ensuring that every issue of concern is explored to its heart. As one director commented: “personally, I have no problem with ethical issues, I merely ask myself whether I would mind if my old father read in the local paper about what I have been doing."