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'Australia and India: Common Goals in Corporate Law and Corporate Governance Reform'

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It is a real privilege for me to have the opportunity to speak to you about corporate governance at such an exciting time in India's progress along the governance reform path.

This lecture is part of a series of events that have been organised for me over the course of this week in New Delhi, Bangalore and Mumbai. I have received enormous assistance from the Australian High Commission and Australian Treasury officers, Matt Crooke and Jason Staines, and also my administrative and research assistant Deborah Austin. I take this opportunity to thank them publicly for their unstinting support. I also acknowledge and thank sponsors of my visit, in particular the Australia India Institute, local partner the Indian Institute of Corporate Affairs, and I thank my firm Minter Ellison for their strong support and encouragement of this venture.

An important part of my time in India will be to listen and get a better understanding of the momentous reforms planned through your Companies Bill and other initiatives. Today, however, I propose to share with you a few ideas that stem from the Australian regulatory experience over the last 20 or 30 years.

Corporate governance: common goals

The quotation from *The Economist* shown on the slide is from a feature article and leader published in May 2012. The Economist drew attention to the tremendous contribution made by the public listed corporation to the economies of the United States, the United Kingdom and many other developed economies, from the 19th century through to the present time. But it expressed concern that the public company model is in decline, evidenced by the fall in new listings in the United States and United Kingdom.

The article suggested that one of the reasons for this decline was overregulation. Today no-one denies the crucial importance of effective regulation to promote efficiency and transparency of the securities markets and to achieve fairness between investors and the managers and promoters of corporations. The problem is that in some countries, regulation seems to have gone too far and is discouraging entrepreneurs from using the public markets to raise capital. One only has to note the incredible volume of regulation introduced by the Dodd-Frank Act in the United States, tens of thousands of pages still in the course of being settled, several years after the enactment.

Recent developments in the United States, the United Kingdom and the European community point to the conclusion that the global financial crisis has accentuated the risk of overregulation, and so the challenge to the survival of the public listed corporation is now greater than ever. What is at stake is the weakening of the organisational structure which is at the centre of capitalist economies.

In this context, principles of corporate governance are of very high economic importance. Those principles go to the heart of the operation of the corporation's business. They need to be based on considerations of efficiency and fairness that are workable in each national environment in which they are adapted applied.

Since corporate governance is a relatively young discipline (the phrase was invented in the United States in the 1970s), some of the principles are still developing and even in flux. This is therefore an excellent time for us to share ideas and experiences amongst the countries who are most serious about good governance, India and Australia included. We have to give proper attention to local circumstances, but sometimes good ideas that have worked in another jurisdiction are readily transferable. Therefore international exchanges of ideas, particularly amongst those who have practical experience in how corporations work, are very important.

The emergence of the board's monitoring role in US corporate governance theory

While there is much wisdom in US corporate governance, there is nevertheless a particular focus of attention on the widely-held corporation, a phenomenon that is not necessarily found in other countries. Like other Asian countries, India has a corporate community in which controlling shareholdings (and in particular family-group promoters) are often encountered. Does the preponderance of controlling shareholder firms mean that India should reject the US corporate governance thinking out of hand?

To answer this question, let me first make a few more remarks about the evolution of US corporate governance. The great work by Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property*, 1932, identified the 'agency problem' that has been the central focus of US corporate governance ever since that time: that is, the problem of protecting the owners of the corporation, the shareholders, from the consequences of placing control of the corporation in the hands of others, namely managers. The agency problem as they described it arises in a widely held corporation; if a substantial proportion of the stock is under the control of a single shareholder, then that shareholder has not surrendered control and does not need the same kind of protective principles.Conversely, the need for protection of minority shareholders is increased.

Berle and Means saw the agency problem as a problem about preventing all managers including directors from engaging in opportunistic conduct to the detriment of the shareholders. They did not see the board of directors as having the responsibility to monitor management conduct for the protection of shareholders – rather, the directors were part of the management hierarchy.

In the 1970s the foundations of modern corporate governance were laid by US thinkers such as Alfred D Chandler Jr (*The Visible Hand: The Managerial Revolution in American Business*, 1977), Myles Mace (*Directors: Myth and Reality*, 1971), and Melvin A Eisenberg (*The Structure of the Corporation*, 1976). Chandler documented the emergence, over the late 19th and 20th centuries, of a professional managerial class who essentially ran large US corporations. His work was complementary to the theory of Berle and Means, in the sense that according to Berle and Means, the owners of corporations (shareholders) had lost control of their property to managers; and according to Chandler, the managers had become very professional and very good at controlling other people's property. Therefore the risk of management opportunism and self-dealing had been enhanced. The question was posed even more starkly: how do we protect the interests of the owners who have lost control?

In the 1970s the theory began to emerge that the board of directors had a role in solving the agency problem. Mace conducted field research to find out how US boards actually operated, and he concluded that one of the key functions of boards is to provide 'some sort of discipline' over management. Eisenberg took up this idea and argued that, as one of the fundamental powers of the board of directors is to hire and fire the chief executive, and that can only be effectively done if the board monitors the performance of the CEO and senior management, the monitoring role is the board's central role.

In these ways, in United States corporate governance the perceived role of the board was transformed, from about the 1970s onwards, from the role of participants in the management team, providing wise counsel to their executive colleagues, to the role of overseeing management as a separate monitor for the protection of shareholders. The idea that the board's role is to monitor management was then taken up in other countries, including the United Kingdom through the Cadbury Report (1992) and Australia through a series of reports beginning with the Bosch Report 1991.

Of course directors cannot effectively monitor the performance of management if they are part of the management team or are beholden to management. And so the idea took hold that a substantial number of directors should be non-executive, and indeed independent from management.

Does the theory of the board as monitor of management apply in Asian economies?

The agency problem, as articulated by Berle and Means, is not a common problem in most Asian economies, and in particular in India. Empirical evidence shows that a very substantial proportion of listed Indian companies are controlled or substantially influenced by their promoters. They are not widely held by powerless shareholders, but instead, there are two kinds of shareholders, namely those with a great deal of power and those with correspondingly much less power. So the principal task of corporate law and corporate governance is to protect the minority shareholders, as opposed to the shareholders as a whole, from opportunism by the controlling shareholder, to whom management is likely to be beholden.

You might think that since this is a very different problem from the one focused on in US literature, the US literature is not relevant to the Indian scene. However, the US work in corporate governance has not been set aside and disregarded in India, but instead it has been adapted to Indian circumstances. In particular, the idea of the monitoring board is alive and well in India, but with Indian characteristics. Thus, it has been said that in India, outside directors (in particular, independent directors) serve as monitors of controlling shareholders on behalf of minority shareholders:

> "In controlled entities, independent directors can help prevent business decisions that improperly benefit controlling stockholders at the expense of minority stockholders. For example, they can monitor related-party transactions, in which there is a

> controlling stockholder conflict of interest. In addition, independent directors can help protect the interests of minority shareholders and reduce extractions by controlling shareholders through 'publicising, or threatening to publicise, majority shareholder abuse' even if the directors have limited power to decide important issues without the consent of the controlling stockholder." (Afsharipour, 34 Seattle UL Rev 995 (2011)).

What this suggests to me is that corporate governance provides an adaptable set of principles, the utility of which depends upon active and effective comparison, sensitive to local circumstances. Since corporations in many of the countries of the Asian region are unlikely to be widely held, the principles developed to define the role of the board of directors of a widely held company, in the interests of shareholders, can be adapted to solve the problems that arise for companies with a dominant shareholder.

Ideas from Australia

Compared with, say, the United Kingdom, Australia has been notable over the past 30 years for its very active program of corporate and securities market law reform. Somehow the busy legislative agenda has found enough space to enact amending company law statutes, so that over the period from about 1980s to the present time legislative changes to company law or securities market law, or both, have been made at least once per year and often more frequently.

Not surprisingly, with so much activity, we have occasionally introduced reforms that are sweeping and novel. For example, in the 1980s we comprehensively did away with the doctrine of ultra vires, and introduced a statutory 'oppression' remedy for shareholders.

In preparing for my visit to India, I reviewed our history of law reform and asked the question, "what Australian ideas, if any, might an Indian audience be interested in hearing?" I identified nine such areas, which are displayed on the slides.

1. Single board structure with independent directors

From time to time commentators on Australian company law have toyed with the idea of a dual board structure, modelled very broadly on the German two-tier board. But we have not taken that step. We have, for listed companies, a single board of directors. The company's constitution will almost invariably say either that the business of the company is managed by the directors, or that the business is managed by or under the direction of the directors. But in practice directors very seldom become involved in operational management decisions, except on major matters.

The main governance requirements around the structure of the board and the liability of the directors are found in the Corporations Act. But the statutory requirements are supplemented by *Corporate Governance Principles and Recommendations* published by the ASX Corporate Governance Council (ASX being our principal securities exchange).

2. Board's monitoring responsibility

Notwithstanding constitutional provisions providing for the directors to manage their company, we have adopted the US idea that the primary function of the board of directors of a listed public company is to monitor the performance of the CEO and senior management.

We accept the corollary that a majority of directors of a listed company should be non-executive independent directors.

An independent director is defined as a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with - or could reasonably be perceived to materially interfere with - the independent exercise of their judgment.

The *Principles and Recommendations* list some questions that should be asked when determining the independent status of a director:

(1) is the director a substantial shareholder, or associated with a substantial shareholder, of the company?

(2) is the director employed, or has he or she been employed within the last three years, in an executive capacity by the company or another group entity?

(3) has the director been, or been associated with, a material professional adviser or material consultant to the company or another group entity within the last three years?

(4) is the director a material supplier to or customer of the company or another group entity, or associated with the material supplier or customer?

(5) does a director have a material contractual relationship with the company or another group entity other than as a director?

The *Principles and Recommendations* apply to listed companies on a "comply or explain" basis, and are not mandatory. But there is a high level of compliance, particularly in the largest 300 listed companies. We have not legislated to make the principles legal requirements, and if it were left to me, I would avoid legislation on the board's function and the need for independent directors. A legislative definition of independence is likely to focus on detail and perhaps create loopholes.

I understand that in this country it was decided that a legislative requirement for independent directors was needed because clause 49 of the listing agreement, which currently provides for the requirement of independence, is thought to be a weak provision that lacks an effective enforcement mechanism. The Australian experience is that if the requirement for independent directors is enunciated by a stock exchange body, whose rules are enforceable in court, there is likely to be a high level of compliance.

I referred earlier to the perceived need in India for the monitoring theory of the board to adapt to an environment in which, frequently, there is a dominant or controlling shareholder. The problem has also arisen in Australia. Leighton Holdings is a large construction company. For some years now, the German company Hochtief has held about 54% of Leighton, but until 2010 it allowed Leighton to operate independently, abiding by an informal arrangement under which the majority of directors would be directors not associated with Hochtief. Nevertheless Hochtief maintained that it was free to reconsider at any time it chose to do so, consistent with its status as majority shareholder.

In 2010 the Spanish company ACS made a successful tender offer for control of Hochtief. Since that time questions have been raised as to whether ACS will adhere to the governance arrangements permitting the majority of directors to be independent of the controlling shareholder. Recently three independent directors of Leighton resigned, alleging that the ACS nominee on the Leighton board had sought to interfere with the process for appointment of a new independent director.

On balance, market reaction seems to have been that adherence to the governance arrangements was regarded as an important matter adding value to the Leighton share price. If that view prevails, there is a discrepancy between statutory company law and corporate governance. As a matter of Australian company law, a 54% shareholder can remove and replace all directors, because there is a statutory right of shareholders to remove a director by ordinary resolution. And most other matters that are put to shareholders are resolved by ordinary resolution. And yet corporate governance seeks to prevent the majority shareholder from exercising its proprietary right.

After allegations of similar problems at Bumi and ENRC in the United Kingdom, London's regulators are contemplating listing requirements that would require a majority of independent directors, and would oblige a company with a controlling shareholding to sign "relationship agreements" stipulating that the controlling shareholders would not influence the day-to-day running of the firm.

3. Active corporate regulator with strong powers

Over the past 30 years, legislative reforms in Australia have strengthened the powers and widened the responsibilities of the Australian Securities and Investment Commission (ASIC). ASIC is the regulator for company law, financial services including stock exchanges, corporate insolvency, and significant parts of consumer protection law. ASIC has wide powers to demand production of documents, and to interrogate witnesses on oath.

In the governance context, one of the most significant powers in recent years has been the power to take legal proceedings against directors for "civil penalties". Proceedings of this kind are civil proceedings in which the standard of proof is the civil standard of balance of probabilities. The penalties that may be imposed by a court in the proceedings, if the defendant is found to have contravened a civil penalty provision, include a pecuniary order (essentially a fine), a compensation order and a disqualification order. A disqualification order bans the defendant from managing corporations for a stated period.

4. Directors' duties enforceable by disqualification

Like the Indian company law, Australian company law imposes statutory duties on company directors, requiring them to act in good faith in the best interests of the company, not to make improper use of their position or information, to prevent the company from trading while insolvent, and to act with due care and diligence.

The statutory duty of care is expressed in terms of the director's "responsibilities". Ascertaining responsibilities takes one to corporate governance.

ASIC has used the statutory duty of care and diligence as a major regulatory tool in recent times. It has brought several civil penalty proceedings alleging breach of the duty of care and diligence, with some success. I will mention two cases.

The Australian company James Hardie, a building products manufacturer, had two subsidiaries that had for many years produced asbestos products. In the late 1990s, well after the subsidiaries had terminated their asbestos-related businesses, claims by former workers who had developed asbestos-related diseases were increasing, and the liability risk was depressing the parent company's share price. After much work by the board and management, in 2001 the board approved the establishment of a foundation which would become the holder of the subsidiaries' shares and would receive other assets from James Hardie, and would take over responsibility for handling asbestos-related damages claims. The objective was for the listed company to separate itself from the subsidiaries that were exposed to asbestos claims, so as to strengthen the share price for the benefit of shareholders.

Once it approved the establishment of the foundation, the board authorised the release of a market announcement saying that the foundation would be "fully funded". In fact, as later emerged, the foundation was greatly underfunded and it was necessary for the government to step in to protect claimants.

ASIC took proceedings against, amongst others, the non-executive directors of James Hardie, not for any alleged breach of duty in approving the foundation, but for an alleged breach of duty of care and diligence in approving the market announcement. ASIC ultimately succeeded and consequently the non-executive directors were disqualified from managing corporations for significant periods. The directors were not held to have been dishonest, but they breached their duty of care and diligence because they should have realised that the facts would not permit them to claim, without qualification, that the foundation would be fully funded.

An important aspect of the case is that in approving the market announcement, the directors were relying on reports and advice received from actuaries and other experts, and on a specific assurance from the chief executive officer that the claim that the foundation would be "fully funded" could be made without qualification. But the directors' "reliance defence" failed, essentially because the wording of the announcement was clear and its meaning was obvious, and the directors knew enough about the prospects for future claims that they should have qualified the claim about adequacy of funding. This limitation on the reliance defence moved Australian law a long way from the lenient standard pronounced in the *City Equitable* case in 1925.

Importantly for present purposes, this was not a shareholder derivative action or action brought by the company after a change of control or a winding up order. This was an action brought by the regulator, which had a dramatic effect in boardrooms because of the sanction of disqualification from managing corporations, and the notoriety associated with such an order.

An even clearer example of ASIC setting corporate governance standards by taking civil penalty proceedings was the Centro case. In that case the directors of companies in the Centro group approved financial statements that misclassified about $2 billion of current liabilities as non-current liabilities,consequently representing a much healthier cash position than was in fact the case. The financial statements also failed to report material post-balance date events.

ASIC took proceedings against, amongst others, the non-executive directors on the principal ground that they had breached their duty of care and diligence in not spotting the misclassification of liabilities and non-disclosure of post-balance date events. However, the financial statements had been through a process of review involving the group's internal audit staff, the external auditors, and the board audit committee. Surely the directors should have been allowed to rely on the expertise and advice coming from those sources, which unanimously recommended the financial statements for approval.

It was held that the directors should have asked questions about the high level of non-current liabilities, having regard to what they knew about the Centro group. They were aware from routine funding reports annexed to board papers that the group would be required to refinance substantial amounts in the short term. They were aware of the terms of the relevant financial accounting standard, because the standard was accurately summarised in a note to the financial statements they were asked to approved. Under the accounting standard (a new standard based on the international financial reporting standards) liabilities were to be treated as current unless there was an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date. If the directors had properly approached the financial statements with an enquiring mind, knowing what they did about the group's liability profile, they would have queried the classification of the bulk of the liabilities as non-current. They were required to use their own judgment and commonsense and could not be exonerated by blind reliance on others.

The Centro case had an impact in the boardrooms of Australian companies which was even greater than the impact of the James Hardie case. ASIC had succeeded in establishing the proposition that directors must take personal responsibility for the tasks they undertake and cannot simply rubberstamp recommendations they receive from others. That is a governance proposition of major importance.

5. Dominant national stock exchange

Although other financial markets have been allowed to operate in recent times, for over 20 years there was a single securities market for equity and debt financial products (other than futures and derivatives) in Australia, the ASX. Like SEBI, the ASX is an active regulator through listing requirements. ASX is also dominant in clearing and settlement, having established in the early 1990s perhaps the best electronic settlement system in the world.

ASX works closely with ASIC on market surveillance, for example in detecting insider trading, and also to enforce compliance with the continuous disclosure listing rule.

6. Actively policed continuous disclosure obligation

In the early 1990s the Australian legislature and the ASX, working in close collaboration, made a fundamental change to regulation of the Australian securities market, which put it in the vanguard. Australian law and the ASX listing rules require half-yearly and yearly reporting for all listed entities, and quarterly reporting for mining entities. However, the Australian requirements go further. They oblige a listed entity to tell ASX (and hence the market) any information concerning the entity that a reasonable person would expect to have a material effect on the price or value of the entity's securities.

The obligation arises as soon as the listed entity becomes "aware" of information, and that occurs when any executive officer comes to know about it. Once the listed entity is aware of the information in this way, it must make disclosure "immediately".

There has been considerable uncertainty about what this means. In one case some years ago a listed entity was penalised because it took 70 minutes to respond after becoming aware of disclosable information. Recently, however, the ASX released a guidance note which tells us that "immediately" means "promptly and without delay", in other words acting as quickly as can be done in the circumstances, without postponing the disclosure obligation.

There are exceptions from the disclosure obligation, where (for example) the information relates to an incomplete proposal, or a matter of supposition, or is internal management information. But disclosure must be made if the information ceases to be confidential, or if a reasonable person would expect disclosure.

It may be particularly interesting to this audience that the continuous disclosure listing rule, though essentially a rule proclaimed by a non-government commercial entity (ASX), is reinforced by statutory provisions. Our Corporations Act says (approximately) that if a listed entity fails to make disclosure as required by the listing rules, the entity contravenes a statutory provision that supports the listing rule, which is a civil penalty provision. That means (in this context) that a listed entity is exposed to a pecuniary penalty (fine) or compensation order, either at the suit of ASIC or at the suit of any person (an investor) who has been damaged by the contravention.

Since any person who suffers loss is entitled to seek a compensation order, these provisions encourage class actions in which an enterprising law firm takes proceedings on behalf or investors who have suffered loss because the market was not informed as required by the continuous disclosure rule. The potential liability could be very large.

Not only does the Corporations Act expose the listed entity to civil penalty proceedings for contravention of the continuous disclosure requirement. Any person who is involved in the company's contravention is also exposed to civil penalty proceedings. Obviously the directors of listed entity are prime candidates for this kind of liability. Hence considerable attention is given in boardrooms to disclosure protocols, and to procedures for prompt disclosure.

7. Heavy liability for misleading conduct

Since the 1970s there has been a statutory provision in Australia, originally conceived of as a consumer protection measure, that prohibits any person from engaging in conduct, in trade or commerce, that is misleading or deceptive or likely to mislead or deceive. Aperson who contravenesthis provision is liable to pay damages to anyone who suffers loss "by" the contravention.

The Australian High Court has delivered many judgments explaining the meaning of this provision. Most importantly, it has been held that the question under this provision is not whether there was an intention to mislead or deceive, but whether the conduct in question was misleading or deceptive to the person who suffers loss by that conduct. Further, there is no "due diligence" defence.

This means, for example, that if a company makes a market announcement and it subsequently turns out that the announcement is materially wrong, the company is liable to compensate anyone who suffers loss by virtue of that mistake in the document, regardless of how carefully the company may have proceeded in order to avoid any such mistakes.

Note that the misleading and deceptive conduct provision does not apply to prospectuses and takeover disclosure documents, but instead there are liability provisions for misleading documents that are qualified by due diligence and similar defences. But the misleading and deceptive conduct provision does apply to market announcements and, say, an information memorandum in a fundraising that does not require a prospectus.

8. Frequent class actions

Mentioning the continuous disclosure obligation and liability for misleading or deceptive conduct leads naturally, in the Australian context, to the subject of investor class actions. Australia allows contingent fee litigation which provides an incentive for the "plaintiffs' bar" to scour the financial press for cases where a listed entity may not have made disclosure in a timely fashion, or may have made misleading disclosure. When a potential contravention is identified, the lawyer seeks to put together a class and proceedings may be initiated on their behalf.

Contrast Australian investor class actions with the class actions contemplated by the Companies Bill 2012 of India. Clauses 241ff are an approximate equivalent of provisions in the Australian Corporations Act which allow a member of the company to bring proceedings to complain of oppressive conduct or conduct in a manner prejudicial to the members. In Australia, those provisions tend to be used in practice only in the case of closely held companies where the quasi-partners who are the directors and shareholders are at loggerheads. However the drafter of the Indian provisions clearly contemplated that they could be used in the case of larger companies, and clause 245 makes express provisions for the proceedings to be brought as a classaction under the supervision of the Tribunal.

Investor class actions are unpopular in Australian corporate boardrooms, but they do seem to focus attention on matters of compliance. Directors know that if their company breaches the continuous disclosure provisions or makes an announcement misleading the market, in circumstances where there are significant investor losses, a class action against the company (and possibly against themselves personally) is likely to follow.

9. Takeovers Panel

Australian regulation of takeovers has had a unique history. In the late 1970s a new takeover law was proposed that would prevent the bidder from exceeding a 20% interest in the target without making a formal takeover bid or following one of several other permitted acquisition routes. However, difficulties were encountered in drafting the new law, because the drafters were determined to close every loophole. In the result, we acquired a "black letter" Takeovers Code that is very long and complex.

But fortunately an inspirational provision was introduced late in the process of development of the law. That was a provision allowing the regulator to declare an acquisition or conduct to be "unacceptable" even if it complied with the black letter code, and then various kinds of orders could be made.

In the early 1990s the power to declare "unacceptable circumstances" was taken away from the regulator and given to a newly constituted Panel, modelled broadly on the London Panel. But the Australian Panel was quite different from the London Panel in some respects, for example it was a statutory body with statutory powers.

Several challenges have been made to the Panel's decisions on constitutional grounds, broadly similar to the grounds for challenging the constitutionality of the Indian National Company Law Tribunal. Both in your country and in mine, the challenges have failed.

Now the Australian Takeovers Panel exercises jurisdiction over a wide range of control transactions. Recurring issues include the breadth of the concept of "associates", which can cause the bidder to exceed the 20% limit on acquisitions inadvertently. Another current problem is that in Australia, if the bidder or the target makes a market announcement about a current or intended bid (for example, if the bidder says "This is our best and final offer"), the person making the announcement will as a matter of policy be held to it. The policy is intended to defend market integrity, but it comes under pressure if the application of the policy means that target shareholders cannot receive an increased bid because the bidder has earlier said that the bid would not be increased. The Panel is also very active in proclaiming and applying policy to dissuade target directors from engaging in frustrating action to defeat a bid.

Conclusion

I suggest there is utility in our exchanging notes on the way we handle common problems, such as the problem of reconciling the requirement for independent directors with the fact of controlling shareholdings.

It may be of interest to the Ministry of Corporate Affairs and others to observe how our regulator, ASIC, uses civil penalty proceedings to establish, very forcefully, corporate governance norms.

Australia's continuous disclosure regulatory regime for listed companies is onerous, but it means that the Australian securities market is one of the most transparent in the world, and one of the most efficient in terms of price discovery based on full information.

Both India and Australia are seeking to employ class actions for regulatory purposes. Interestingly, in Australia class actions in the corporate and securities context are principally based on the continuous disclosure and misleading conduct laws. India, faced with the phenomenon of widespread controlling companies, is trying something new in the Companies Bill 2012.

The strategies employed in both countries recognise that shareholder or investor class actions can be an effective supplement to the corporate and securities regulator's efforts.

RP Austin 13 May 2013