

# Toothless Tiger

## All roar and no bite

When it comes to policing corporate governance, New Zealand's regime lacks teeth. John Farrar compares local and overseas systems and finds considerable room for improvement at home.

New Zealand's corporate governance systems lag behind those of comparable countries. The result? Loss of investor confidence and a too-high tolerance of unfit directors. Corporate governance is an increasingly complex amalgam of legal and self-regulation. The courts work at one end of the system, acting as the washing machine of our corporate dirty laundry. So, although judges are clearly not the sole guardians of governance standards, they do have a constructive role to play when all other systems fail.

The legal component of corporate governance covers directors' duties, shareholder remedies and meetings. There is a debate whether it covers other law which imposes liability on directors. Systems of self-regulation range from what could be called hard/soft law like stock exchange listing rules and statements of accounting practice, to institutional codes such as the ASX Principles of Good Corporate Governance and Best Practice Recommendations to the codes of individual companies. Sometimes corporate governance is thought to cover business ethics. The form of self-regulation tends to be analysed in terms of rules versus principles, but to these we can add the norms of best practice.

The evolution of modern corporate governance has certain club-like features. The Cadbury Report and its sequel in the UK and the General Motors Guidelines had a cosy insider feel to them and yet the major corporate collapses of the past five years have arguably represented the significant failure of this system. Organi-

sations such as Enron, WorldCom and HIH had all the trappings of modern corporate governance and yet failed to deal with significant misconduct and corporate failure.

The American response was a draconian rule-based system in the Sarbanes-Oxley Act of 2002 (SOX) which marked a significant federalisation of corporate governance and gave new powers to the Securities Exchange Commission. Australia, which under the Howard government relishes its deputy sheriff role, set up a plethora of committees to decide on the extent to which Australia adopted SOX. The results have been the ASX Principles of Good Corporate Governance and Best Practice Recommendations and the amending legislation of 2004.

New Zealand has been more dilatory and the governance environment is more permissive than directors would find in Canada, the United Kingdom, the United States or Australia. This is a paradise for directors; a principles-based regime with few rules to underpin it and regulators with little bite.

How we got to this point can be partly traced back to New Zealand's major free-market reforms in the 1980s, which were introduced very fast and with an emphasis on self-regulation. Subsequent company law changes adopted the broad shape of the Canadian model without much of the associated elaborate regulatory system that underpins it.

The reasonably benign set of principles now promulgated by the Securities Commission is based on some useful initial work by the Institute of Directors, and fol-

lows an attempt at takeover of the subject by the New Zealand Exchange. This system is a form of self-regulation and very much principles-based rather than rules-based.

On the surface, this may not sound like much of a problem. Light-handed regulation has an upside in lower business compliance costs and less 'friction' in doing business. But in the global investment environment, New Zealand has become a less attractive destination because it is a common view that our standards are suspect and we offer less assurance that directors' duties will be adequately monitored and enforced.

That has undoubtedly been an influence in some cases in the past two decades as major listed corporates have shifted offshore. From having a significant and varied list in the late 1970s New Zealand has succeeded through Rogernomics and its sequels to shift the control of major companies to Australia, leaving behind a dwindling and relatively insignificant list of companies. Some of this exodus may have been inevitable for other reasons, but it has been needlessly accelerated to the detriment of the New Zealand economy.

The effect of this is to have a diminished domestic economy making mainstream corporate governance, to some extent, less relevant to the domestic scene. Right now, however, New Zealand's actions are looking more like complacency.

The governance issues vary according to the nature of the business entity. Listed companies are a class on their own and subject to NZX rules – which to some extent are affected by international norms – and the Securities Commission's prin-

ciples of corporate governance. SMEs are subject only to the relatively permissive Companies Act. And around SOEs there is a continuing question about adequate accountability.

So let's look at the changing role of the courts in this environment. To be effective, the judiciary needs to be aware of the major paradigm shifts affecting the context in which they make their rulings.

- The shift from a public law/privilege approach to a private law ordering approach which has recently been partly superseded by a public law/administrative regulatory approach coupled with increased self-regulation;
- In the case of shareholder remedies, a shift from a rights-based approach to an interests-based approach which arguably needs more flexible procedures and more use of alternative dispute resolution.

Courts need to react constructively to the increased administrative regulatory role of securities regulators and self-regulation systems and consider the interface with law and what role they can play to ensure the success of the new regime.

A primary issue is in policing misconduct, which mainly concerns regulating self-dealing transactions and dealing with the most extreme forms of negligence. The approach taken in the United States (and to some extent in Australia) is to be strict on self-dealing and lenient on business judgment mistakes. New Zealand's approach, however, is more lax. We have a listing rule that deals to some extent with self-dealing but carries nothing like the strictness of the Australian legislation.

It is rare to get cases of negligence in New Zealand but that should not neces-

sarily be interpreted as an absence of negligence. There is no business judgment rule but little prospect that civil cases will be brought in these cases. The whole approach of the Companies Act is to put emphasis on private enforcement but, in the absence of incentives such as contingent fees and little apparent interest in derivative actions with the possibility of indemnity, it is a hopelessly optimistic and ineffective system.

Public enforcement is limited to a few cases of serious fraud.

As a result, there is no civil penalty regime and very little disqualification of directors compared with the UK or Australia, and that is a problem. In Aus-

trend is largely positive. Similar to arbitration but less formal, alternative dispute resolution promotes speedier resolutions, lower cost and more control over the procedures. And disputes are usually resolved out of the public eye.

In general, New Zealand judges deal with commercial matters in a sensible way if given the opportunity, but they can only do that within the parameters of the companies legislation and litigation. Litigation is costly and sometimes slow. However, it is slower still to have a Royal Commission look into corporate collapse.

There is something very striking in the juxtaposition of the speedy adjudication by Justice Santow of the initial HIH proceed-



tralia, enforcement of civil penalties and disqualification of directors are increasing significantly.

The shift to an interests-based approach in dealing with shareholder remedies has also pushed Australian and UK courts into new territory, requiring them to adopt more flexible procedures and alternative dispute resolution. This has also been a marked trend in the broader areas of resolving commercial disputes.

From a corporate perspective, this

ings and the subsequent sentencing, and the laborious processes of the HIH Royal Commission which reported later at great cost. We are in no way criticising Justice Owen who carried out the inquiry, but this is not a very orderly way of running a legal system. **M**



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