



Australian Council of Super Investors Inc.

**"BEST PRACTICE"
CORPORATE GOVERNANCE NEWSLETTER**

WELCOME

The Australian Council of Superannuation Investors ("ACSI") has been formed by Superannuation Funds and related organisations, with assets amounting to over \$30 billion.

The overriding objective of ACSI is to assist Funds with dealing with key Corporate Governance issues in companies who harbour their investments.

ACSI is a not for profit organisation.

This newsletter will seek to keep members regularly apprised of Corporate Governance developments. This first edition provides a snapshot of the legislative duties of directors particularly relevant in light of recent high profile corporate failings.

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A number of members have enquired about the implications of insolvent trading therefore included is a short snapshot of relevant legal issues on this issue.

A regular feature will include a brief review corporate governance issue developments overseas.

We look forward to your feedback and suggest for the future discussion of issues through this newsletter.

*Michael O' Sullivan
President*

ACSI MEMBERS

Foundation member organisations and their representatives who also form the ACSI Committee include:

- | | |
|----------|--------------------|
| HESTA | Denis Jones |
| STA | G.P. Hanify |
| C+BUS | Ralph Willis |
| CARE | Michael O'Sullivan |
| CSS/PSS | Steve Gibbs |
| Unisuper | Ann Byrne |
| MTAA | Michael Delaney |
| TISS | David Goodear |
| CMSF | Mavis Robertson |
| AIST | Susan Ryan |
| IFS | Garry Weaven |

Sponsoring member organisations and representatives:

- | | |
|----------|----------------|
| AGEST | Bruce Hartnett |
| FINSUPER | Debora Jackson |
| VICSUPER | Robert Welsh |
| TASPLAN | Neil Cassidy |
| TWU | Bill McMillan |
| ARF | Elana Rubin |

DIRECTORS DUTIES

The market capitalisation of the Australian Stock Exchange ("ASX") at 31 December 2001 was \$670.9 billion dollars. The companies represented by this, influence the lives of all Australians, through the provision of services, as repositories for savings and as employers. While shareholder participation has grown to nearly 58% according to a recent ASX survey, these companies and the money they represent are not controlled by the shareholders, but by a handful of representatives elected by the shareholders, the company directors.

These directors are subject to a number of general and specific duties prescribed in the Corporations Law (the "Law") and despite this, there have been several recent well publicised disasters including HIH and One-tel. The new Corporations Law and Economic Reform Program has reordered the

obligations on directors in the Law and sought to clarify them, generally they are as follows:

General Duties

General duties imposed by the Law include an obligation on directors to perform their duties and exercise their powers with the same degree of care that a reasonable person would exercise in the directors place (s.180(1)). The Law goes further, not only requiring that they use the same degree of care as a reasonable person, but that they do so in good faith and for a proper purpose (s. 181).

It is however not merely the powers and duties of directors that give rise to potential abuses of power, the mere position of director itself can give rise to inappropriate conduct. In order to prevent this, the Law provides that directors may not use, either their position, or information that comes into their possession because of their position, to gain an advantage for themselves (ss. 182 & 183). What constitutes an advantage is broadly defined and can include perks such as travel and monetary rewards.

Specific Duties

In addition to these general duties, there are several more specific duties imposed on directors. The first is a duty to disclose material conflicts of interest (s. 191). This duty aims to prevent directors influencing the corporations they represent to enter into transactions from which the director themselves might benefit. A second and particularly relevant duty is the duty to prevent the company trading whilst insolvent (s. 588G). This duty operates such

that where a director has reasonable grounds for suspecting a company is insolvent or is about to become insolvent, they are obliged to prevent any further debts being incurred. The purpose of this, is to prevent companies incurring debts which it can reasonably be expected they will be unable to repay, thereby potentially bringing down third parties with whom they trade.

Penalties

Breaches of both the general duties and the specific duties can attract either civil or criminal penalties. Civil penalties include declarations made by the court that the director has breached the law, the imposition of a pecuniary penalties up to \$200,000 and unlimited compensation orders (s. 1317E). Where the court finds that the directors have acted recklessly or intentionally, the penalties are likely to be criminal and carry with them the criminal sanction of imprisonment.

Although this is only a brief review of the statutory duties on directors, it is evident that the law demands a high standard of directors and in turn provides for severe punishment if those standards are not met. Despite this, because a lack of resources on behalf of the regulator and political will on behalf of the government, that these provisions have been rarely and irregularly enforced.

INSOLVENT TRADING

The recent rash of corporate failures, including Harris Scarfe Pty Ltd, Water Wheel Ltd, HIH Ltd and One-Tel Ltd have focused the public spotlight on

corporate dealings. These failures, have lead to calls by ex-employees, creditors and the Australian Securities and Investments Commission (the "Commission") for greater accountability by directors and the enforcement of the insolvent trading provisions contained in the Corporations Law (the "Law").

The insolvent trading provisions exist to overcome the problems caused by the independent legal personality of companies and to allow creditors a means of recourse against the directors personally where the debts are incurred by the company and the appropriate requirements are met.

Section 588G Insolvent Trading Provisions

Section 588G provides that if a director allows their company to incur a debt **and** the company is insolvent at that time, or becomes insolvent because they incur that debt, **and** at the time of incurring the debt there were reasonable grounds for suspecting the company was insolvent or would become insolvent the director will be personally liable for that debt.

To put this more simply, if a director, on the 1st of the month, has reasonable grounds for expecting the company will be unable to pay its debts as and when they fell due, and continues to trade and the company fails on the 30th of the month and is unable to pay all its creditors, the director may be ordered to compensate the creditors for the debt incurred by the company from their personal assets.

In the appropriate circumstances a court can not only order compensation, but it may also chose to impose pecuniary penalties. These pecuniary penalties can be as much as \$200,000 for every breach of section 588G, such that if ten debts were incurred in the relevant period, the maximum penalty would be \$2,000,000. Where the court considers the conduct to be particularly reckless or intentional, it may go further and order criminal sanctions

Defences

Although section 588G is on its face very straightforward, there are a number of defences if the director is able to demonstrate:

- they reasonably relied on another person for the provision of financial information showing the company was solvent;
- the director was too ill to take part in Board discussions; or
- the director took reasonable steps to try and prevent the debts being incurred.

Problem With Application

The largest problem to the use of section 588G is not the available defences, but the growth in the use of Deeds of Administration. These Deeds allow in effect, directors to negotiate with creditors. The directors may elect to offer a deed to the creditors such that rather than fighting a lengthy court battle, creditors are repaid various amounts from the assets of the company. In order to try and make this amount attractive directors often offer personally

guaranteed minimum amounts. Such Deeds provide for repayment in full of monies owed to secured creditors and often as little as 10 cents for every dollar owed to unsecured creditors. In return creditors obtain rapid repayment of some of their debts and the directors contract out of personal liability. At meetings of the creditors to accept such a Deed, it is often the case that the large secured creditors to whom the majority of the debt is owed and who will obtain full repayment vote in favour and the smaller unsecured creditors, lose their opportunity to seek recourse against the directors unless the Commission believes the conduct warrants the pursuit of the legal remedies.

Section 588G is potentially a highly effective instrument for making directors of companies personally liable for the actions of the company. The penalties imposed may be both financial and criminal and should at first glance provide an adequate deterrent. However, the application of this penalty is not only diluted by the available defences, but by the existence of an escape hatch for directors in the form of deed's of company arrangement which offer a means for directors to negotiate to limit their potential liability under section 588G.

A SNAPSHOT OF INTERNATIONAL CORPORATE GOVERNANCE DEVELOPMENTS

Over the next few editions, this newsletter briefly consider Corporate Governance issues internationally, particularly legislative developments that

provide a framework for dealing with Corporate Governance issues. In this edition we will consider recent developments in the United Kingdom

United Kingdom

The Hampel Report- key findings and subsequent developments

The UK Committee on Corporate Governance (Hampel Report) tabled its report in January 1998. This has been incorporated into a Supercode by the London Stock Exchange and came into effect on 1 January 1999.

This report followed the Cadbury Committee report into the financial aspects of Corporate Governance following some significant frauds and collapses. Following a series of excessive remuneration outcomes amongst executives in newly privatised Gas, Electricity and Transport enterprises, the Greenbury Committee was formed to consider how remuneration for senior executives was approached. Both Committees stated that their findings should be reviewed. The Final Hampel report produced in January 1998 recommended that a combined set of principles and guidelines that are derived from the Cadbury, Greenbury and Hampel Reports should accompany the listing rules of the London Stock Exchange.

As a result of this a Supercode was developed and released for consultation by the London Stock Exchange culminating into a final document coming into effect on 1 January 1999. The two major aspects of the Super Code includes listing

requirements about the disclosure of financial information and remuneration and general information companies should have in their annual reports outlining how they conform to suggested governance principles.

Key considerations arising from the Hampel Report

Primary purpose of business

The Hampel Report conveyed an overriding view that the first and primary purpose of any business enterprise was long term prosperity. This drew some criticism from those arguing that accountability considerations were being diminished. In response, authors of the Report assert that none of the requirements of the Cadbury and Greenbury Reports were removed but rather that without a company experiencing prosperity, considerations of accountability become irrelevant.

Balance between shareholders and stakeholders

The Report took the view that no corporation can genuinely succeed and prosper without have regard to its stakeholders. The underlying premise here is that there is a clear responsibility on Boards to ensure that management have in place a policy to handle their particular stakeholder relationships. Implementation and monitoring of the policy is essential including ensuring that appropriate reporting of these arrangements are in place to shareholders.

Role of shareholders and mandatory voting

With over 3000 listed companies in the UK, the significant majority of these (85%) report in the period beginning in February to the middle of April. Annual Reports tend to come out a few months later. This makes it untenable for institutional shareholders to come to a detailed view on every annual report. Therefore the Report encourages institutional shareholders to concentrate on the poor performing companies or those with less than satisfactory corporate governance practices is significantly resource intensive and rejects a mandatory requirement that that vote on every issues.

The structure of the board

The Report supported the view of the Cadbury Committee that splitting the Chairman and Chief Executive roles is preferred, but should not be made mandatory.

Director independence

The Committee rejected the introduction of rules and regulations that prescriptively disqualify potentially talented persons from boards. It is however incumbent on board to set out why it considers their directors are independent thereby inviting the scrutiny of those who which to challenge an appointment.

Remuneration

The Report emphasises the important role of committees and proper disclosure of directors and senior executive remuneration in annual reports.

Annual General meetings

The Report recommends a re-think about AGMs. In the UK, voting occurs by a show of hands, which are largely overridden by institutional votes that are called on should a poll be called where the results from a show of hand differ from the proposal submitted to the AGM by the Chairperson.. It was recommended that each chairperson should, after the vote has been taken on a resolution, read out the percentage of support submitted by institutional investors.

Directors duties

The Report largely left to the courts that have affirmed a collective responsibility for being equally liable under the law for their actions or inactions.

Developments since introduction of Code

The Blair government accepted the new Combined Principles and Code as a positive step forward on Corporate Governance.

The UK Department of Treasury commissioned in March 2001 a review of institutional investors in the UK (Myners Report) with the view of improving the quality of both investment decision taking and ensuring that corporate management are properly accountable to their individual an beneficial owners.

The UK Department of Trade and Industry review on how to streamline the proxy voting and communication processes.

A key issue here is ensuring that voting and reporting processes

are streamlined, particularly in relation to overcoming custodian and fund manager related impediments to effective proxy voting activism.

ACSI will be monitoring these developments in the U.K and advising members of scope for similar reforms in the Australian jurisdiction.

CORPORATE GOVERNANCE LINKS

Outlined below are a number of useful links to other pension/investment web sites.

AFL-CIO <http://www.aflcio.org>

AFL-CIO Executive Paywatch
<http://www.aflcio.org/paywatch/index.htm>

American Society of Corporate Secretaries
<http://www.ascs.org>

Asset International (archived PlanSponsor Magazine articles)
<http://www.assetpub.com/archive.shtml>

Association of Investment Management & Research
<http://www.aimr.org>

Business Roundtable
<http://www.brtable.org>

CalPERS Shareowner Forum
<http://www.calpers-governance.org>

Coalition to Preserve Retirement Security
<http://www.retirementsecurity.org>

Conference Board
<http://www.conference-board.org>

Cooper Consultants
<http://www.publicpension.com>
Corporate Governance International
info@cgi.au.com

Corporate Governance Network
<http://www.corpgov.net>

Corporate Library
<http://www.thecorporatelibrary.com>

Davis Global Advisors
<http://www.davisglobal.com>

Déminor
<http://www.deminor.be>

US Department of Labor
<http://www.dol.gov>

Directors & Boards
<http://www.directorsandboards.com>

Directorship Online
<http://www.directorship.com>

Domini Social Investments
<http://www.domini.com>

DSW
<http://www.dsw-info.de>

eRaider
<http://www.eraider.com>

European Corporate Governance Network
<http://www.ecgn.ulb.ac.be/ecgn>

Executive Paywatch
<http://www.paywatch.org/paywatch/index.htm>

Florida State Board of Administration
<http://www.fsba.state.fl.us>

Georgeson Shareholder Communications Corporation
<http://www.georgeson.com>

Governance (UK)
<http://www.governance.co.uk>

Hermes Asset Management
<http://www.hermes.co.uk>

Institutional Analysis
<http://www.institutionalanalysis.com>

Institutional Shareholder Services
<http://www.isstf.com>

International Corporate Governance Network
<http://www.icgn.org>

InvestorForce.com
<http://www.investorforce.com>

Investor Responsibility Research Center
<http://www.irrc.org>

Law.com
<http://www.law.com>

LENS Investment Management
<http://www.lens-inc.com>

Local Authority Pension Fund Forum
<http://www.lapfforum.org>

Maryland General Assembly (MD Takeover Law)
<http://www.mlis.state.md.us>

National Association of Corporate Directors
<http://www.nacdonline.org>

National Association of Pension Funds (UK)
<http://www.napf.co.uk>

National Association of Public Pension Attorneys
<http://www.nappa.org>

National Association of Securities Dealers
<http://www.nasd.com>

National Association of State Retirement Administrators
<http://www.nasra.org>

National Conference on Public Employee Retirement Systems
<http://www.ncpers.org>

National Council on Teacher Retirement
<http://www.nctr.org>

National Law Journal
<http://www.nlj.com>

New York Stock Exchange
<http://www.nyse.com>

Pensions & Investments Research Consultants (UK)
<http://www.pirc.co.uk>

Pensions and Investments Online
<http://www.pionline.com>

PlanSponsor.com
<http://www.plansponsor.com>

Proxinvest
<http://www.proxinvest.com>

Proxy Monitor
<http://www.theproxymonitor.com>

Proxy Voter Services
<http://www.pvs.cda.com>

Responsible Wealth
<http://www.responsiblewealth.org>

Securities and Exchange Commission (United States)
<http://www.sec.gov>

SocialFunds.com
<http://www.socialfunds.com>

Stakeholder Alliance
<http://www.stakeholderalliance.org>

Teachers' Insurance Annuity Association

<http://www.tiaa-cref.org>

TIAA-CREF

<http://www.tiaa-cref.org>

World Bank Corporate Governance

<http://www.worldbank.org/html/fpd/privatesector/cg>

World Bank/OECD Corporate Governance Development Forum

<http://www.gcgf.org>

RESEARCH AGENDA FOR 2001/2002

On 25 June 2001, the ACSI Committee approved a comprehensive research agenda for 2001/2002.

The overriding object of the research is to provide members with information on the governance practices of companies that harbour their investments.

The areas for research will include:

- converting the recent study into Australia's top 150 listed companies commissioned by CMSF and undertaken by Institutional Analysis, into an annual analysis of executive remuneration and board composition. The study will more rigorously test CEO performance of the top 100 CEO's and benchmark this against company performance. CEO remuneration will also be benchmarked against CEO remuneration movements within the same industry groupings;

- the extent to which non-executive directors and auditors are in fact truly independent, will be considered in detail. This will involve an analysis of Annual Reports and related party transactions and other information in the Notes to the Financial Statements;
- the sample consideration of multiple directorships in the top 100 ASX companies in the CMSF study will be extended to the top 500 ASX companies;
- executive share options will be subject to closer scrutiny with comprehensive consideration of ASX company disclosure of information on executive share option arrangements. This will extend to the adequacy of the performance hurdles that underpin the share option arrangements;
- build on the work already undertaken by AIST and Melbourne University in identifying practical Corporate Governance issues for Funds, and develop a framework to support more effective proxy voting practices. This will involve a review of contractual arrangements between superannuation funds, investment managers and custodians with the view of developing a corporate governance "best practice" pro-forma proposal for funds;
- ACSI together with AIST and CMSF will review Corporations Law reforms overseas that promote more

effective activism by funds in Corporate Governance issues with the view of calling for similar changes to Corporations Law that facilitate more effective processes on Corporate Governance for funds.

ACSI SURVEY

ACSI has developed a Corporate Governance Survey for Funds. The object of the survey is to assist ACSI with understanding the current Corporate Governance practices by Funds.

ACSI members are requested to submit the survey responses by 26 July 2001. Should you require additional copies please contact Chris Dardoumbas on (03) 9657 4375.

Michael O'Sullivan
President
Level 29,2 Lomsdale Street
MELBOURNE VIC 3000
Tel: (03) 9342 1450
Fax: (03) 9342 1499
Mobile: 0418 996 359
Email: osully@iaa.com.au

Phillip Spathis
Executive Officer
Level 29,2 Lomsdale Street
MELBOURNE VIC 3000
Tel: (03) 9657 4375
Fax: (03) 9657 4378
Mobile: 0417 501 065
Email: pspathis@ifsfairley.com.au

This newsletter is correct to the best of our knowledge and belief at the time of going to press. It is, however, written as a general guide so it is recommended that specific professional advice is sought before any action is taken