



[Reading Room: Governance](#)

## Corporate Governance

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MDL has developed a specialist capability in corporate governance, taking a comparative institutional approach. This note, prepared in April 1996, provides an overview of that capability.

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The starting point is a working definition of the term corporate governance. For MDL, corporate governance is the set of structural arrangements within an organisation whose purpose is to align the management of the organisation with the interests of its key stakeholders. In turn, stakeholders are those individuals or groups who have the ability to impose on the organisation constraints at the of entity level with which its management is compelled to deal in pursuing their prime objectives.

### A Comparative Institutional Approach

The definition is extremely wide in scope. This is deliberately so as a comparative institutional approach to corporate governance encompasses a wide range of organisations and an even wider range of stakeholders. Accordingly, attempts at definitional precision carry with them the risk of excluding important elements.

Instead, taking a comparative institutional approach, design for corporate governance is seen as a process which takes different specific forms in different settings; the skill of the corporate governance practitioner lies in drawing on experience from a wide range of entities in order to design optimal arrangements for each specific circumstance.

In each case, the practitioner is seeking to balance efficient resource use (usually, but not always, measured by return on capital) against other owner and/or stakeholder objectives. Particular concerns may include:

- Reconciling commercial and social objectives.
- Designing structures which are self regulating in order to avoid excessive government regulation, a particular concern in the utilities sector widely defined.
- Selecting appropriate mechanisms for the expression of different interests so as to deal with the legal and organisational constraints facing trustees, directors, and other parties with ownership or governance roles so that different claims on the organisation are each recognised but without creating legal or organisational conflicts.
- On occasions, considering the nature of ownership itself. When properly analysed, ownership can break down into a series of different interests (the pure residual claimant interest in appropriating the organisation's surplus; ownership as regulation - the power to constrain the way in which particular

activity is carried out; ownership as the equivalent of a purchase interest when used to direct an entity to undertake particular types of activity). Many of the tensions in the governance of current or once were public organisations result from an inadequate specification of the interest represented by "ownership". The solution may often be a redesign to separate out those different interests in order to minimise conflict.

MDL, in its corporate governance practice, has frequently found that the lessons learnt in dealing with one class of corporate structures are invaluable in resolving issues arising with another. Thus:

- Familiarity with the separation of owner, purchase, provider and regulatory interests within the Crown estate is invaluable in specifying the different roles of and boundaries between the functions of owners, boards and managements in publicly listed companies. As an example, it helps understand the pure ownership interest within a limited liability company and thus ensure that the roles assigned to owners and board respectively are non-conflicting. Likewise, an awareness of the regulatory role often bundled up within organisational activity helps in the design of self-regulatory structures minimising the need (incentive) for government intervention.
- An understanding of the statement of corporate intent process within state owned enterprises is invaluable in assisting local authorities manage their own trading enterprises, especially as the actual process and the legislation are quite different.
- Familiarity with the governance and accountability arrangements for local authorities can provide the best guidance for establishing the accountability mechanisms for community trusts, something which is essential for maintaining their long term credibility.

## The Company Model

Although corporate governance is an issue for a very wide range of corporate entities, recent interest and much of the innovation internationally has been based, substantially, on the model of the limited liability company. In this model, arrangements for corporate governance are underpinned by three key assumptions:

- The entity sells into contestable product markets so that its ability to earn a market rate of return on capital is a good proxy for efficiency.
- The sole interest of owners is in optimising the return on their investment.
- Because shares are tradeable, the simplest and most effective discipline on under-performing management is the ability of existing owners to exit coupled with the opportunity for alternative managements, who believe they have the skills needed to improve performance, to purchase control.

These assumptions provide the support for governance arrangements under which:

- Management of the entity is vested in the board with very limited powers for shareholder intervention (except by changing the board).
- Directors are required to act in what they, in good faith, believe to be the best interests of the company regardless of the specific views which may be expressed to them by individual (even controlling) shareholders.
- Boards themselves are primarily responsible for matters such as setting the strategic direction for the business, approving and monitoring performance

against budgets, approving major investments/transactions and appointing and monitoring the performance of the CEO. In turn the CEO is responsible for actually running the business.

## Beyond the Simple Model

It has become more and more necessary to move beyond this simple model as a basis for corporate governance for at least the following reasons:

- The fact that the changing composition of share market ownership has made the option of exit, in favour of new owners and management, a much less practical owner response to poor performance. The increasing dominance of share registers, world wide, by institutional investors of various kinds and the huge costs to them of relying on exit as their principal response to under-performance has encouraged the search for alternative disciplines.
- A growing recognition that many product markets are less than fully contestable so that market disciplines, of themselves, may be an insufficient means for encouraging efficiency; in New Zealand, the increasing reliance on limited liability companies as the ownership option for monopoly public utilities emphasises this.
- An increased emphasis on the importance of ensuring efficient business performance from a very wide range of different organisational structures such as crown entities, local authority business undertakings, trusts, co-operatives and statutory corporations which have only recently been of as business undertakings facing much the same kinds of concerns as the conventional limited liability company. These different structures commonly lack the up to date and integrated legal framework which governs the operation of limited liability companies. Instead, a number of these structures operate in a virtual "no mans land" outside the known territory of the legal framework on which they are based. The best example is the major business owning trust, which operates in a legal framework designed for passive diversified investment and so lacks a clear frame of reference for trustees' responsibilities.
- As a consequence of the growth in the numbers and variety of companies which are wholly or partly owned by public bodies, a more diverse range of ownership interests (and other stakeholder claims) undermining the simple assumption that the sole interest of owners is wealth maximisation.

Response to changing circumstance has concentrated on the conventional listed company structure. Developments have included:

- So called "shareholder activism" with major institutional investors taking a proactive interest in the affairs of companies in which they are shareholders with a particular emphasis on board membership and structure and on the relationship between the CEO and the board. The lead role of CALPERS (California Public Employees Retirement Scheme) in forcing change at CEO level in a number of American corporates is the best known example.
- Initiatives by market based participants, in a number of jurisdictions, to define more closely the role and responsibility of boards in corporate governance. Perhaps the best known of these are the report of the Committee on the Financial Aspects of Corporate Governance (the "Cadbury Committee") in the United Kingdom and the various Blue Ribbon Commission reports of the National Association of Corporate Directors in the United States. Reports such as these have spelt out good practice for corporate governance including issues raised by the combined CEO/Chairman role in many companies, the role of the non executive director and the function of board committees such as audit, nomination and

remuneration in improving corporate governance.

- The active adoption, by many stock exchanges of requirements for good corporate governance including obligations on public companies to report their corporate governance practices (not yet the case in New Zealand) and the institution of stricter regimes requiring shareholder approval of transactions where directors or major shareholders may have an interest.
- The rewriting by a number of national legislatures, of the laws defining the role and responsibility of directors and the accountability and reporting requirements of the companies they direct.

## The New Zealand Experience

In New Zealand, listed public companies represent only a relatively small proportion of the range of entities for which establishing an optimal system of corporate governance is a major current issue. Substantially, this reflects the nature of New Zealand's economic and public sector reforms. There has been an emphasis on ensuring that any activity capable of being managed and held accountable along business lines is vested in an appropriate structure. This has had a two-fold implication for corporate governance:

- In order to classify various activities, so as to identify, amongst other things, those components which are best managed along business lines, the Crown and its policy advisors have developed a very sophisticated approach to analysing the various elements within any public organisation so as to distinguish between owner, purchaser, provider and regulatory interests. This framework also provides an invaluable tool for analysing, within conventional listed companies, the separate interests of owners, management and other stakeholders.
- The separation out of the business elements of public sector activity has created a very large number of new entities for which corporate governance is an issue but where the emerging private sector model can not be directly applied for reasons such as:
  - The existence of a single owner (the Crown or some other public body) for whom optimising shareholder wealth is a performance requirement rather than a reason for ownership.
  - The existence of a range of different stakeholder claims, often capable of pursuit through the political process, which needs to be accommodated within governance arrangements.

It is this background which supports MDL's view that advice on corporate governance matters, **for any organisation**, requires a comparative institutional approach. Even the simple limited liability company model benefits from an in-depth understanding of the approach which the Crown has taken to the precise specification of the separate interests it has in its own entities. The same general approach is invaluable in designing structures where there is a need to separate out matters which are the responsibility of owners from matters which are the responsibility of boards/managements. This is so even although it is still reasonable to assert, for the typical limited liability company, that its owners can be seen as having the single objective of optimising wealth; that they are investors rather than seekers after some other objective through the means of ownership.

Typically, for other entities, the corporate governance challenge is how to ensure efficient resource use (usually defined by the proxy measure of return on equity where the currently accepted measure of efficiency is the norm that economic value added should be zero or above) whilst at the same time pursuing other goals. Thus, the Crown may retain ownership of a business primarily to ensure

continuity of a particular service or the retention of a critical mass of particular expertise out of a concern that the private market might not achieve this. A local authority may wish to retain ownership of a service because of ratepayer demands that it do so or as a means of regulating a monopoly activity. A trust may retain ownership because of an (often ill specified) sense that it is holding a particular asset or set of investments for future generations. A co-operative may be best seen as a transaction cost minimiser for its members such that wealth optimisation takes place within members' businesses rather than within the co-operative itself.

Each of these structures raises its own particular difficulties in matters such as:

- Ensuring that the goal of efficient resource use within the entity is not compromised by other objectives.
- The design of monitoring and accountability mechanisms which effectively align the activities of the entity with the interests of key stakeholders (an undertaking sometimes complicated by difficulty in identifying who stakeholders actually are; this is a particular problem with community trusts where the true owners may be difficult both to define and to identify).

A further complication, for many entities, is the potential for stakeholders other than owners to impose significant demands, quite often through electoral/political processes, if they are not properly accommodated within the governance arrangements for the entity. Examples include:

- Consumer pressure on the owners of monopoly utilities such as energy trusts or local authorities.
- Member demands within co-operatives which may result in inefficient capital structures (commonly as a consequence of overly generous distribution policies).
- Unrealistic or inappropriate expectations of trading activities resulting from a failure to specify, adequately, the different interests involved (common with local authority owned trading activities) or from inappropriate attempts to cost shift (common with so called public benefit activities such as museums, art galleries, libraries and so on where cost shifting to non-existent "sponsors" is a temptation).

The design of corporate governance arrangements for this wide range of activities and interests needs to draw on experience with a range of different types of trading activity and ownership/stakeholder interests.

## **Credentials**

McKinlay Douglas Limited brings to its corporate governance practice experience with a diverse range of different entities giving it a solid basis from which to take a comparative institutional approach. The firm's work experience has included:

### **State Owned Enterprises**

Writing for the Institute of Policy Studies the first significant publication on New Zealand's policy for state owned enterprises: "Corporatisation: The Solution for State Owned Enterprise" and acting as advisor to selected state owned enterprises on strategic development.

### **Public Companies**

Acting to advisor to significant owners through the listing process and on post-listing changes in ownership and control in companies with complex constitutional arrangements (restrictions on transferability of equity; differential rights for appointment of directors) involving difficult questions of application of companies and securities law and Stock Exchange listing rules on matters such as "relevant interests", "material transactions" and "related parties" including dealing with shareholders with complex multi objectival interests (multinational companies; local authorities; trusts).

## **Trusts**

Advice on the design of a wide range of trust structures, from incorporated charitable trusts to private trusts, covering activities such as:

- Local economic development (enterprise boards etc).
- Energy trusts.
- Trusts established to operate a range of cultural and recreational facilities including museums, art galleries and sports grounds.

## **Crown Entities**

The preparation for the State Services Commission of a report on crown entities as part of its Whole of Government Perspective Series intended to provide the Commission with a definitive overview of crown entities, widely defined, and the policy/operational issues on which it should focus. Providing advisory services to various crown entities, and departments responsible for them, on issues ranging from business development to managing the crown/departmental/crown entity relationship.

## **Local Authority Trading Activities**

Extensive work for a range of local authorities in relation to major trading activities including advice on corporate governance issues with a particular focus on the development and use of the statement of corporate intent. Specific assignments have included an overview report for the Wellington City Council on its relationship to its LATEs and writing, for the Department of Internal Affairs, a guide to the use of LATEs intended for councillors and senior council officers (in process).

## **Co-operatives**

Extensive work on the design of co-operative structures ranging from small scale community co-operatives to major co-operative businesses. Significant work has included the delivery of a paper on co-operatives and capital to the Asia Pacific Ministerial Conference on co-operatives in Sydney, Australia in February 1990 (a paper commissioned by the Geneva based International Co-operative Alliance as a contribution to its work on cooperative structures) and "Aspects of Co-operatives: A Study for the Ministry of Agriculture and Fisheries" prepared to assist that Ministry in its consideration of a rewrite of the Co-operative Companies Act.

## **Museums and Art Galleries**

A detailed review of the principles for structuring and funding museums and art galleries including a paper comparing and contrasting the strengths and weaknesses of three different corporate structures (incorporated charitable trusts; incorporated societies; local government business units) as options for their

governance and the management of complex stakeholder interests.

## **Educational Institutions**

Advice on governance and ownership arrangements for education institutions including the design of structures to reconcile, without compromising, the interests of academic freedom on the one hand and economic efficiency on the other.

## **Regulation**

From a background as advisors to major ownership interests in the utilities sector (broadly defined) an overview of the merits and demerits of self regulation, through the design of governance and accountability requirements as compared with government regulation as with, for example, the information disclosure regime in the electricity industry which is currently degrading into a rate of return regime much inferior to what could be achieved through effective self regulation.

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