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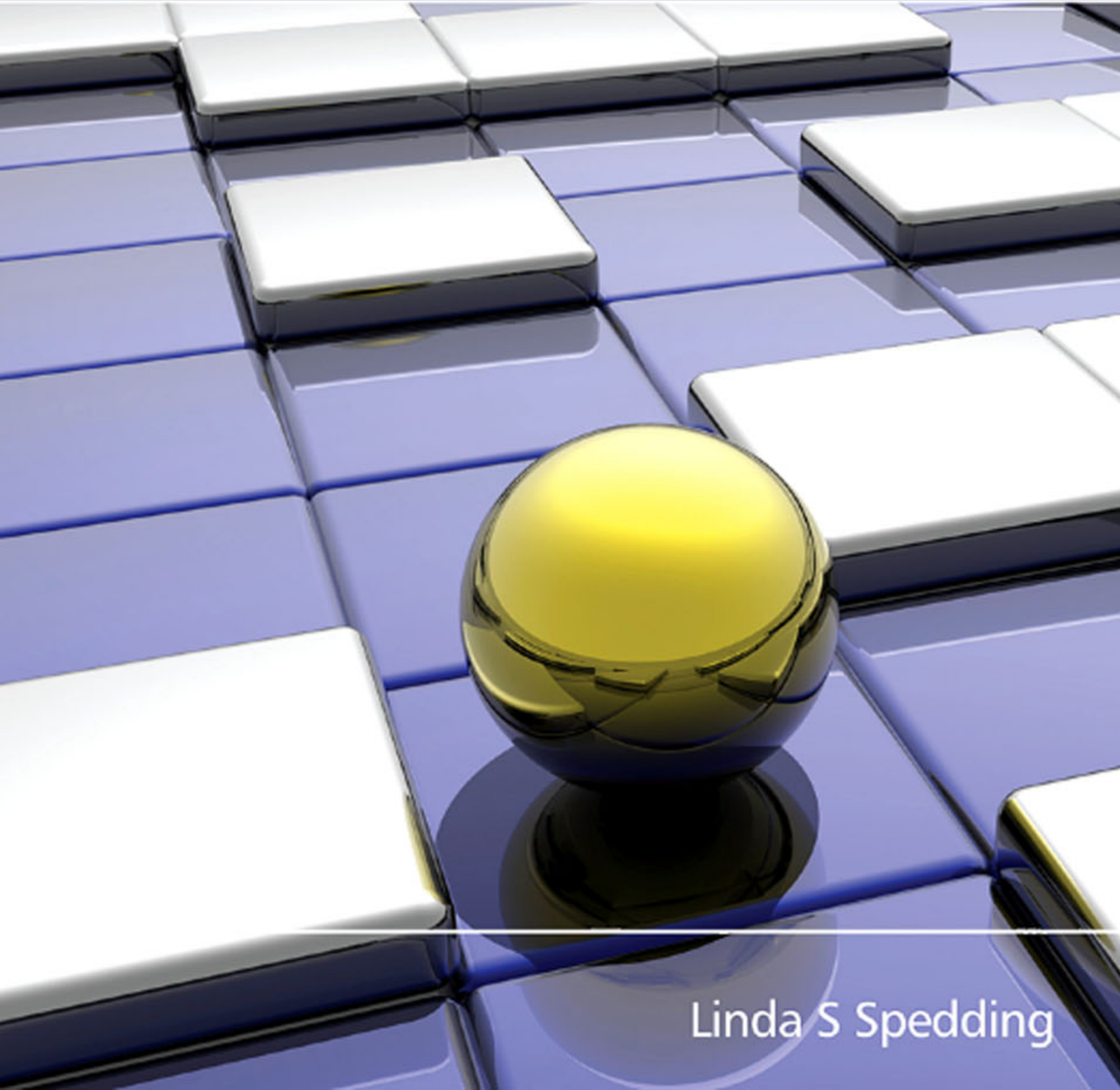
Corporate Governance, Risk Management and Business Planning



Linda S Spedding

The Due Diligence Handbook

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Corporate Governance, Risk Management and Business Planning

Linda S. Spedding

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To all of my family, especially Ajan and his father:

‘One way to remain clear is to identify with everything outside oneself. When looking at water, experience the water as oneself. If one sees a bird, feel that bird. Really understand how connected people are to trees, plants and clouds …’.

Dr S Purna, *The Truth Will Set You Free* (1987), Element Books, p. 81.

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Finally I would like to express my appreciation to all those who have inspired and supported me but I have not mentioned above.

While I gratefully acknowledge the assistance of all of the above, the contributors and I accept responsibility for the final publication. Nevertheless it should be emphasised that, since the information included is not legal advice, any reader should, of course, seek relevant expert advice on areas of specific concern.

Dr Linda S. Spedding

Foreword

The International Chamber of Commerce (ICC), the world business organisation, promotes an open international trade and investment system and the market economy. Our conviction that trade is a powerful force for peace and prosperity dates from our earliest years, when the small group of business leaders who founded ICC called themselves 'the merchants of peace'. Increasingly, experience is demonstrating the significant benefits brought by international trade and investment in faster economic growth and significant reductions in poverty – as strongly evidenced by the current economic success of India and China resulting in the ability to reduce poverty levels in both these countries significantly. However, for the effective operation of the international trading system, good governance at country level and at company level are both essential. ICC promotes the benefit of a rule-based trading system and clear self-regulation in all aspects of operation built around an effective corporate governance system. For corporate governance to be effective, clear policies must be in place but also the tools, guidelines and experience must be available to translate policy into effective implementation.

It is for this reason that we welcome the second edition of this publication by Dr Linda Spedding, which clearly demonstrates and endorses the importance of effective due diligence, not only when making international acquisitions, but also as an integral continuing corporate approach. It provides clear guidance and case studies to help all involved understand the complexity of the issues involved and to demonstrate the detailed work that is necessary both to ensure that the benefits of an acquisition can be realised and that there are no unexpected problems, for example through damage to corporate reputation that more than offsets the targeted benefits. As high profile business failures tarnish the reputation of international business, it is essential that business responds by having the policies and practices in place in day-to-day operations and in particular, as this book so effectively demonstrates, when a major business development such as an acquisition is being implemented.

Dr Spedding is well known to the ICC as an international lawyer with a substantial reputation as consultant, author and speaker on significant commercial matters. She is to be congratulated on this valuable and timely contribution to the debate on due diligence and sound corporate governance.

Andrew Hope
Director
ICC United Kingdom

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Preface

As was mentioned previously, the times and business priorities are changing at a rapid pace: no longer do organisations aspire to profit for shareholders alone – they are increasingly answerable to other stakeholders. As a result of regulatory and media pressure, in particular, best practice, transparency, openness and fair play are needed to be successful and sustainable in business. While traditional concepts still exist and are referred to in this handbook, new meanings are also developing. It is a constant evolutionary process which few organisations can avoid, regardless of their size, sector or location.

The effective running of any business, large or small, is no minor undertaking. We are in an era of instant communication, media interest and increasing global management demands, requirements and trends. As a result, enhanced business knowledge, improved commercial awareness in addition to the appropriate technology and tools are vital. Traditional barriers and divisions of responsibility are being dismantled and the concepts of due diligence, corporate governance and risk management must be recognised as holistic business issues.

The second edition of this handbook is not intended to deal with every aspect of due diligence – the intention is to consider due diligence having regard to corporate governance, risk management and related drivers in the context, also, of business planning. It combines traditional business strategies with recent trends in due diligence and corporate governance in an accessible manner that enables business and their advisers representatives to operate in a more proactive and responsible way. The objective is to provide an overview of the key concerns while offering some practical tools in the form of checklists and case studies that can assist with business strategy.

A preliminary overview of the traditional approach to legal due diligence is dealt with at the outset. However, the reader should appreciate that this handbook regards the due diligence process as an ongoing exercise. It extends to areas of business activity that go well beyond the transaction/deals with which it is usually associated to embrace many aspects of business operations and performance.

Corporate governance and risk management can also be seen as part of an organisation's ongoing internal due diligence. While certain matters clearly have a basis in regulation it is important to regard this handbook as a business resource rather than a legal text. As a general rule, the stated position relates to the UK unless otherwise mentioned or indicated. Wherever it is helpful, comparative and/or regional or international trends and standards are also discussed. In view of the global nature of the developments and their extensive impact, the international dimension is considered. Selected countries include India (with some comment on the SAARC region), Hong Kong, China, Australia and Japan. These chosen jurisdictions are responding to the need for improved corporate governance and remain important. Bearing in mind the enormous influence of US developments in general, and the *Sarbanes-Oxley Act of 2002 (SOX)* in particular, the handbook provides a revised overview of the American framework.

The reader should be aware that this is a vast and developing debate – indeed many of the issues are each worthy of a book in themselves. As such, the treatment in this handbook must be selective with the intention to provide a different approach or angle to a subject that is covered regularly by the media and the Internet. In view of the significant acceptance by the scientific community of the impact of Climate Change since the first edition – and the urgent need for business to respond in a responsible manner – substantive additional material regarding Climate Change issues has been included in this edition. Moreover additional material on the growing problem of economic crime has been included.

Finally, it should be emphasised that throughout this edition attention is given to the impact of developments on smaller organisations, including small- and medium-sized enterprises (SMEs), as far as is practicable. Since they are regarded as the backbone of most economies, any comments addressed to them therefore have a broader relevance for the economy and society.

It is to be hoped that the reader enjoys the contents as much as the author has enjoyed engaging in such an important debate.

Dr Linda S. Spedding

Author and contributors

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Founded in 1871, Bradley Arant Rose & White LLP has over 250 US-based attorneys who serve a wide variety of national and international clients in numerous practice areas. Laura, Britt and Laura are members of Bradley Arant's Corporate and Securities Practice Group, focusing on, among other things, public companies and their compliance with federal and state securities laws, mergers and acquisitions, private equity transactions, and business entity formation and capitalisation. Laura Washburn is also a Member of the firm's Sarbanes-Oxley Task Force and has developed expertise advising public and private companies of the impact of the Sarbanes-Oxley Act of 2002 on corporate governance. Bradley Arant is the largest law firm headquartered in Alabama and one of the largest in the Southern United States. It maintains offices in Birmingham, Huntsville and Montgomery, Alabama; Jackson, Mississippi; Charlotte, North Carolina; and Washington, DC. Bradley Arant serves clients in numerous industries including accounting, automotive, banking and finance, biotechnology, construction, education, emerging business, energy, equipment leasing, forest products, health care, insurance, manufacturing, materials and aggregate production, media and

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Angela Wang & Co. (Chapter 13)
Established in 1995, Angela Wang & Co. is a business-focused Greater China legal practice with a dedicated group of local and expatriate lawyers qualified in multiple jurisdictions. Experienced lawyers in their Hong Kong and Shanghai offices advise a wide range of business clients on all aspects of corporate and commercial law, mergers and acquisitions, corporate finance, employment law and commercial litigation in Hong Kong and the People's Republic of China (PRC). In this edition Emma Xin Yang has updated the chapter. She attended University in Shanghai and has revised the section. She has qualified as a lawyer and an accountant in the PRC and is currently completing her qualification as a CPA in Australia and working at the Australian National Law firm Hunt & Hunt.

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Nicola Jones, Solicitor (Chapter 18)
Nicola Jones is a solicitor in England and Wales (1987), and was called to the Bermuda Bar in 1997. She specialised in UK taxation, corporate and trust law. She is currently working as a family business and wealth adviser and contributes to professional press and international public speaking engagements.

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List of key abbreviations

ABI	Association of British Insurers
ACCA	Association of Chartered Certified Accountants
ADR	Alternative dispute resolution
ADR	American depository receipts
AGE	Action Group on the Environment
AGM	Annual general meeting
AICSRR	Association of Independent Corporate Sustainability and Responsibility Research
AIM	Alternative Investment Market
AIRMIC	The Association of Insurance and Risk Managers
ALARM	The National Forum for Risk Management in the Public Sector
AML	Anti-money laundering
ASB	The Accounting Standards Board
ASIS	The American Society for Industrial Security
ASSOCHAM	Associated Chambers of Commerce and Industry of India
AR&A	Annual Report and Accounts
ASTM	The American Society for Testing and Materials
BCCI	Bank of Credit and Commerce International
BCI	Business Continuity Institute
BERR	Business Enterprise and Regulatory Reform
BiE	Business in the Environment
BP	British Petroleum
BPO	Business process outsourcing
BRM	Bali Road Map
BS	British Standard
BSA	Bank Secrecy Act
BSI	British Standards Institute
BTR	Blackout Trading Restriction
CARB	California Air Resources Board
CASC	The China Accounting Standard Committee
CBI	The Confederation of British Industry
CC	The Charity Commission or climate change
CCS	Carbon capture storage
CCX	Chicago Climate Exchange
CCR	Current customer review
CDD	Cultural due diligence
CDM	Clean Development Mechanism
CEM	Certified Emission Reduction

CEO	Chief executive officer
CERCLA	The Comprehensive Environmental Response, Compensation and Liability Act
CFA	Conditional fee agreement
CFATF	Caribbean Financial Action Task Force
CFCs	Chlorofluorocarbons
CFO	Chief finance officer
CFR	Cost and freight terms
CICPA	The Chinese Institute of Certified Public Accountants
CIF	Cost, insurance and freight
CII	The Confederation of Indian Industry
CIO	The Charitable Incorporated Organisation
CLB	Company Law Board
CLO	Chief legal officer
CMA	Computer Misuse Act
CMI	Computer Managed Instruction
CNAO	The China National Audit Office
CO	Companies Ordinance
COP/MOP	Conference of the Parties
CORE	The Corporate Responsibility Bill
CPP	Coincidence Point Processes(??)
CPR	The Civil Procedure Rules
CPSC	Consumer Product Safety Commission
CRM	Cause-related marketing
CSA	Canadian Standards Association
CSPI	Center for Science in the Public Interest (??)
CSR	Corporate social responsibility
CSRC	The Chinese Securities Regulatory Commission
CSRR	Corporate Sustainability and Responsibility Research
CTPT	Combating Terrorist Financing Programmes
DHS	Department of Homeland Security
DJGI	Dow Jones Global Index
DJSI	Dow Jones Sustainability Index
DNV	Det Norske Veritas
DOC/NIST	National Institute of Standards and Technology (???)
DPA	The Data Protection Act 1998
DTI	The Department of Trade and Industry
DU	Downstream users
EB	Executive Board
EBRD	The European Bank for Reconstruction and Development
EC	European Commission
ECE	Economic Commission for Europe
ECHA	European Chemicals Agency
ECJ	Court of Justice of the European Communities
EDD	Environmental due diligence
EDIFAR	Electronic Data Information Filing and Retrieval

EEA	European Environment Agency or Enlargement Area
EFI	Environic Foundation International
EGTT	Expert Group on Technology Transfer
EHS	Environment, health and safety
EI	Employee Involvement
EINECS	European Inventory of Existing Commercial Chemical Substances
EMAS	Eco-Management and Audit Scheme
EO	Executive order
EPA	Environmental Protection Agency
EPA 1990	The Environmental Protection Act
EPCRA (or SARA Title III)	The Emergency Preparedness and Community Right-to-Know Act
ERU	Emission Reduction Unit
ESA	Endangered Species Act
ESG	Environment, social and governance
ETI	Ethical Trading Initiative
EXW	Ex-works ex-factory terms or free on board
EU	European Union
FAQs	Frequently asked questions
FAS	Free alongside ship
FATF	The Financial Action Task Force
FCA	Free Carrier Association
FDA	Food and Drug Administration
FDCPA	The Fair Debt Collection Practices Act (amended 1996)
FDI	Foreign direct investment
FDIC	The Federal Deposit Insurance Corporation
FEMA	The Foreign Exchange Management Act 2000
FIUs	The Financial Intelligence Units
FOB	Free on board
FPA	Free of particular average
FPB	The Forum for Private Business
FRC	Financial Reporting Council
FRS	Financial Reporting Standard
FSA	The Financial Services Authority
FSB	The Federation of Small Business
GAAP	Generally accepted accounting principles
GAFTA	The Grain and Feed Trade Association
GDP	Gross domestic product
GDR	Global depositary receipts
GHG	Greenhouse gas
GIO	Global Innovation Outlook
GITIC	Guangdong International Trust and Investment Corporation
GLBA	Gramm-Leach-Bliley Act (Financial Modernization Act of 1999)

GM	Genetically modified
GRI	The Global Reporting Initiative
HAZOPs	Hazard and operability studies
HIPAA	Health Insurance Portability and Accountability Act of 1996
HKAS	Hong Kong Accounting Standard
HLG	High Level Group
HMG	Her Majesty's Government
HS&E	Health, safety and environmental
HSE	Health and Safety Executive
HSSE	Health, safety, social and environmental
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standard
IBE	The Institute of Business Ethics
IBLF	International Business Leaders Forum
ICAEW	The Institute of Chartered Accountants in England and Wales
ICAN	The Institute of Chartered Accountants in Nepal
ICAP	The Institute of Chartered Accountants in Pakistan
ICC	The International Chambers of Commerce
ICCR	The Interfaith Center of Corporate Responsibility
ICFR	Internal control over financial reporting
ICSA	The Institute of Chartered Secretaries and Administrators
IDR Act	The Industries Development and Regulation Act 1951
IEC	The International Electrotechnical Commission
IFRS	The International Financial Reporting Standards
IIA	The Institute of Internal Auditors
IiP	Investors in People
ILO	The International Labour Organisation
IMF	The International Monetary Fund
IMO	The International Maritime Organisation
IMoLIN	The International Money Laundering Information Network
INEDs	Independent non-executive directors
INGOs	International NGOs
IOD	Institute of Directors
IOSCO	The International Organisation of Securities Commissions
IPCC	Intergovernmental Panel on Climate Change
IPPC	Integrated Pollution and Prevention Control
IPRs	Intellectual property rights
IR	Investor relations
IRM	Institute of Risk Management
IRRC	Investor Research Responsibility Centre
ISO	International Organization for Standardization

ISS	Institutional Shareholder Services
IT	Information technology
ITES	Information technology enabled services
IVIS	Institutional Voting Information Service
JI	Joint Implementation
KPI	Key performance indicator
KYC	The know-your-customer
LCC	London Chamber of Commerce
LCD	Lord Chancellor's Department
LCFS	Low carbon fuel standard
LLC	Limited Liability Corporation
LLP	Limited Liability Partnership
LSE	London Stock Exchange
Ltd	Limited
M&A	Mergers and acquisitions
MARPOL	International Convention for the Prevention of Pollution from Ships
MIC	Mercer Investment Consulting
MIT	Ministry of Information Technology
MOF	The Ministry of Finance
MOU	Memorandum of Understanding
MPS	Metropolitan Police Service
MRV	Measurement Reporting and Verification
MTRP Act	The Monopolies and Restrictive Trade Practices Act 1969
NASSCOM	National Association of Software and Service Companies
NBCC	The National Building Construction Corporation Limited
NCCT	Non-cooperative countries and territories
NEDs	Non-executive directors
NEPSE	Nepal Stock Exchange
NGOs	Non-governmental organisations
NIC	The National Informatics Center
NMFS	National Marine Fisheries Service
NPCSC	The National People's Congress Standing Committee
NSDL	The National Securities Depository Limited
NYSE	New York Stock Exchange
OCC	The Office of the Comptroller of the Currency
OECD	The Organisation for Economic Cooperation and Development
OEM	Original equipment manufacturers
OFR	Operating and financial review
OSHA	Occupational Safety and Health Administration
OSOR	One Substance One Registration
PCAOB	Public Company Accounting Oversight Board

PDA	Personal Digital Assistant
PEPs	Politically exposed persons
PEST	Political, economic, social and technological
PFA	Prevention of Food Adulteration
PICG	Pakistan Institute of Corporate Governance
PLC	Public limited company
POA	Protection of Assets
POCA 2002	The Proceeds of Crime Act 2002
PR	Public relations
PRC	The People's Republic of China
PwC	Pricewaterhouse Coopers LLP
QA	Quality assurance
QLLC	Qualified Legal Compliance Committee
QPSIP	Qualified Pension Scheme Indemnity Provisions
R&D	Research and development
REACH	Registration, Evaluation, Authorisation and Restriction of Chemicals
REDD	Reducing emissions from deforestation
RGGI	Regional GHG Initiative
RJSC	Registrar of Joint Stock Company
ROZs	Reconstruction Opportunities Zones
RPC	Rules of Professional Conduct
S&P	Standard and poors
SBP	State Bank of Pakistan
SCEEMAS	The Small Company Environmental and Energy Management Assistance Scheme
Sch	Schedule
SCR	Sovereign Credit Rating
SCRA	The Securities Contracts (Regulation) Act 1956
SEBI	The Securities and Exchange Board of India
SEBI Act	The Securities and Exchange Board of India Act 1992
SEC	The Securities and Exchange Commission
SECP	The Securities and Exchange Commission of Pakistan
SEE	Social, ethical and environmental
SEED	Social, ethical and environmental disclosure
SERM	Safety/Social and Environmental/Ethical Risk Management
SET	Strategic Energy Technology
SETC	The State Economic and Trade Committee
SFO	Securities and Futures Ordinance
SHSE	The Shanghai Stock Exchange
SICA	The Sick Industrial Companies (Special Provisions) Act 1985
SIR	The summary information return
SMEs	Small- and medium-sized businesses
SOEs	State-owned enterprises

SORP	The Statement of Recommended Practice for Charities
SOX	The Sarbanes-Oxley Act of 2002
SRI	Socially responsible or sustainable and responsible investment
SRI	Statutory rate of interest
STR	Suspicious transaction report
SU	The Strategy Unit
SVHC	Substances of Very High Concern
SWOT	Strengths, weaknesses, opportunities, threats
SZSE	The Shenzhen Stock Exchange
TA 2000	The Terrorism Act 2000
TCG	The Climate Group
The Co-op	The Co-operative Bank
TI	Transparency International
TPY	Tons per year
TSE	The Tokyo Stock Exchange
UBS	United Bank of Switzerland
UEAPME	The European representative body for small business
UK	The United Kingdom
UKELA	The United Kingdom Environmental Lawyers Association
UNCLOS	The United Nations Convention on the Law of the Sea
UNDP	The United Nations Development Programme
UNEP	The United Nations Environment Programme
UNESCO	The United Nations
UNFCC	The United Nations Framework on Climate Change
UNICEF	The United Nations Fund for Children
UPU	Urban and peri-urban (areas)
US	The United States
USA	The United States of America
USCAP	US Climate Action Group
USDA	United States Department of Agriculture (??)
UTI	Unit Trust of India
VAT	Value-added tax
VCU	Voluntary Carbon Unit
WB	The World Bank
WBCSD	World Business Council for Sustainable Development
WEEE	Waste Electrical and Electronic Equipment
WEF	World Economic Forum
WICEM 2	Second World Industry Conference on Environmental Management
WRCAI	Western Region Climate Action Initiative
WTO	The World Trade Organization
WWF-UK	The World Wide Fund for Nature or World Wildlife Fund UK

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1

Introduction and traditional due diligence

1 Introduction and traditional due diligence

CHAPTER OVERVIEW **1.1**

In today's business world, the concepts of due diligence and corporate governance are of increasing importance. Both concepts have broadened as regards their scope and meaning. Indeed their application has also come to overlap as a result of the regulatory and voluntary frameworks that are emerging globally. From purely economic roots they have come to encompass many aspects of corporate behaviour. Moreover, in view of the corporate scandals that continue to attract media headlines and demonstrate the need for improved corporate governance, all organisations – regardless of their size or location – should regard these issues as paramount. An understanding and respect for due diligence and corporate governance make absolute business sense. Moreover in our modern demanding global marketplace, the value of diligence can be demonstrated aptly in the following thoughts and quotations:

> 'Without diligence, no prize' (Ohne Fleiss, Kein Preis), German Proverb;
>
> 'What we hope to do with ease, we must first learn to do with diligence', Samuel Johnson; and
>
> 'The expectations of life depend upon diligence; the mechanic that would perfect his work must first sharpen his tools', Confucius.

Methodology **1.2**

An overview of the traditional approach to legal due diligence is dealt with in this chapter. This handbook takes the approach that the due diligence process is an ongoing exercise. It extends to areas of business activity that go well beyond the transaction/deal with which it is usually associated to embrace many aspects of business operations and performance. However, this chapter will focus in some detail on giving an account of the processes, context and typical aspects of due diligence in its traditional mould, that is, that relating to corporate transactions and particularly merger and acquisition activity. As such, this chapter gives an overview of the legal issues and concepts relating to due diligence in corporate transaction, the process, documentation and some information regarding typical stumbling blocks and tactics. The chapter also begins to flag the route to a view of due diligence through a corporate governance framework (which will be seen to be necessary, given current trends). It concludes with three helpful appendices contrasting typical due diligence steps and a specimen auction or tender process letter.

Definition of due diligence **1.3**

Traditionally due diligence has involved a process of discovery that is relevant in key business transactions, as well as operational activities. As is seen in more detail below, due diligence has become the norm in decision-making as regards:

- joint ventures;
- mergers and acquisitions;
- selecting appropriate partners;
- choosing the right jurisdiction or location;
- buying and selling assets.

In the context of such transactions, highly defined methodologies have evolved, some of which may be found in the sample checklists in **Item 1** of Appendix to this chapter and the Appendix to **Chapter 2**. Historically the process was rather drawn out since it involved the physical examination of extensive documentation on site. More recently the development of technology has brought about effective due diligence that can be much more timely and pressured, involving both Internet and Intranet capability (see **Chapter 9**).

Any search of a law dictionary reveals the meaning of 'due' as payable or immediately enforceable. 'Diligence' involves care, attention and application. In Scottish law 'diligence' also means proceeding for payment. Together, therefore, the words have an interesting emphasis on the enforceability of the process. Having regard to the purpose of due diligence and the evolution of the term, it is no surprise that the legal process has become increasingly comprehensive as regulatory and other business frameworks have developed.

It is essential, however, to set some parameters around the terms that we want to review and analyse. For due diligence, there is an endless variety of related words in the dictionary that we can apply. For the present purpose it is not very useful to set out all of the available definitions, nor to suggest all the legal terms that appertain to due diligence. It is more helpful to propose a few meanings that support the premise in this chapter. For example, Charles Bacon, CEO of Due.Com Group of Companies (a US group providing decision-making software to support due diligence), has defined traditional due diligence as:

> '… mainly a legal and financial course of action, first designed to avoid litigation and risk, second to determine the value, price and risk of a transaction, and third to confirm various facts, data and representations'.

A variation on that definition is to:

> 'Assist management to justify the price of a merger, acquisition, alliance or joint venture by verifying, validating and analysing available data.'
>
> *(Charles Bacon, CEO, Due.Com)*

Due diligence activities, as with everything, need a starting point. If there are talks about a possible merger, each party to the transaction must be willing to commence a due diligence activity. However, this is where the definition of the activity of due diligence can become blurred. In a merger situation, there would normally be a significant amount of due diligence prior to any informal or formal conversation. The diligence required is to determine whether there is enough information that can lead to conversations about a possible merger. Thus the starting point for any due diligence activity is never one single step with a single starting point. Consequently, the actions surrounding due diligence must be adaptable within a framework that places the organisation and its owners, employees and advisers in a constant state of data collection and data organisation that can support whatever process is being started.

Therefore, a third definition of due diligence can be to:

> 'Provide a framework within which organisations can continuously confirm that their actions and transactions are supported by the policies, procedures, and management decision-making methodologies.'
>
> *(Charles Bacon, CEO, Due.Com)*

All companies will perform due diligence in some manner – informally or formally. Of course, larger organisations require a more structured formal approach. Too many people doing everything their own way can create an abundance of data with no information. On the other hand, smaller organisations may do everything informally with no notes, no documentation and a lot of ad hoc decision-making. Within each company, there needs to be an understanding of how due diligence works for the common good. Classically this is the role of management as they set the policies, procedures and culture of the company and how it conducts its business.

US origins **1.4**

In the context of commercial transactions, the term 'due diligence' evidently originated in the USA in section 11(b)(3) of the *Securities Act of 1933*. This section provided a defence of due diligence to those who had made reasonable investigation into matters contained in a prospectus for the issue of securities. This process of evaluation in the USA has been termed 'due diligence' since then. Moreover, its scope has been extended internationally beyond investigations into the accuracy of prospectuses to include:

- any investigation into the acquisition of a company or assets in a commercial context;
- risk analysis in financing;
- general pre-contractual enquiries.

For further discussion of commercial due diligence in selected sectors see **Chapter 6**.

The clear majority of traditional due diligence projects are directed and performed by legal professionals and secondarily by tax and audit financial professionals. It is widely recognised that the legal professional's primary obligation in traditional due diligence concerns the prospective liabilities, and the financial professional's primary obligation concerns the financial data integrity. In the USA, there is a frequently used phrase 'ledgers and liability' that clearly shows this emphasis. Indeed, even in the USA, which has led the way as regards due diligence developments, due diligence is not yet a focus that the educational community has recognised. As a separate discipline, due diligence is not taught in law schools. Within the business education community, due diligence is only covered within the accounting world, typically integrated as an audit topic.

Due diligence in practice
The practice of due diligence has evolved over decades by tradition in the USA. Practitioners comment that not only is it customary to never question whether the foundations of traditional due diligence are sound, but it is a widespread practice to look no further into a prospective acquisition or merger beyond the mere basics.

In the US business community, when a transaction is underway and as the target or the candidate becomes more impatient as the due diligence process gets longer, the reluctance to push for important information also rises. Subsequently the due diligence process is curtailed. As the time lengthens and the costs rise, it becomes easier to justify minimising or even ignoring anything that is more difficult. The reality is that many, if not most, firms suffer from mild to extreme reluctance to consult more qualified outside expertise. Finally, all too often, the deal is done before any real due diligence, traditional or otherwise, takes place.

The application of due diligence 1.5

Different meanings of due diligence can apply in different situations:

- A buyer or seller of a company or business or assets – the investigation of the assets and liabilities of a company or business for the purposes of buying or selling its assets.
- A lender providing finance – the assessment of the viability of the project and the status of the borrower; this will often involve the banker's lawyers checking the due diligence undertaken by the borrower's lawyers where the borrower is acquiring another company.

- A potential joint venture partner – the investigation of the assets being transferred to the joint venture vehicle and potential joint venture partners.
- The state enterprise for the purposes of privatisation.
- A company listing on a recognised stock exchange – the process of verifying when preparing the listing prospectus, and entering into a contract – an analysis of the ability of the other party, or parties, to the contract to perform.
- A state body undergoing privatisation – the investigation of its assets and liabilities.

Essentially in all such situations there will be:

- the transfer of assets from one party to another or the creation of obligations;
- the existence of risks that may affect the future value of such assets or obligations;
- the need to apportion the risks between the parties.

Therefore, due diligence is applicable in varying extents or degrees whenever there are asset swap transactions and the creation of obligations. In view of the many circumstances that may arise, it is important to note that the same level of due diligence cannot be applied uniformly. Even where the due diligence process is required for a corporate sale or business, the documentation should be applied selectively. It is self-evident that the detail, scope and intensity of the process will have to be adapted according to the size, value and significance of the transaction, as well as having regard to the human resources available to each of the parties to the transaction. For instance, in a deal that involves a company purchase run by the chief executive of the purchaser, the finance director of the vendor's group of companies and one partner from each of the purchaser's and vendor's lawyers and accountants, the organisation of dedicated due diligence teams and data centres will not be required.

Legal due diligence

The purpose 1.6

The purpose of legal due diligence by a purchaser (buyer) or party entering a joint venture is to ensure that:

- the assets have the value that the vendor (seller) has given them;
- the vendor has good title to those assets free from encumbrances, including intellectual property and – in particular – the key assets that are being acquired;
- there are no risks, liabilities or commitments that reduce the value or use of the assets, for example another party having the right to use them;
- there are no other existing or potential liabilities that may adversely affect the object of the due diligence (the target or candidate).

Primarily, therefore, the purpose of the legal due diligence relates to the verification of the legal affairs and good standing of the target, which, in turn, impact on or verify the consideration being given.

Topics usually covered by traditional due diligence

Topic	Examples
Assets	Primarily, assets are considered tangible property, such as buildings, computers, furniture, etc. However, other important assets include people, contractors, business ideas, and product relevance in the marketplace.
Contracts	Contracts for work to be done and commitments by others to do work for the company. The contract can be with individuals or companies. Keep in mind that it is not just the contract terms but whether the terms are in fact enforceable. A lot of employment contracts have appropriate terms, but if the individual has a serious accident and is incapacitated, none of the work-related terms may be enforceable.
Customers	Customers for products and services are important elements – who they are and where they are. When reviewing this topic, consider whether there is a secondary market for the resale of products such as through Amazon or eBay. Customer support may start to come from locations not anticipated.
Employee agreements	This requires appropriate legal support to make sure that the agreement is not so restrictive that the employee could easily break the agreement for it being unfair, etc. These agreements may also require consistency which is a process that due diligence can support.
Employee benefits	This is not just about health insurance. Due diligence requires the comparison of planned benefits with the benefits that are actually received.
Environmental issues	These can form a significant part of any due diligence activity. Environmental impact statements have to be considered a never-ending part of business operations as well as the business planning. Regulators from government agencies as well as non-governmental organised groups can delay or prevent a specific development project (see also **Chapter 16** for further discussion of environmental issues).
Facilities, plant and equipment	Classically, this item is included within the asset category. It is separated here to indicate the requirements for a continuing due diligence for the potential retirement or sale of any old facility that is no longer effectively supporting the enterprise business. Examples of this can be old buildings. In the USA recently many municipalities have torn down old sports stadiums to construct new ones with 21st century features like adequate bathrooms and enough executive suites.

(*Continued*)

Topic	Examples
Financial condition	Traditionally this is the province of the accountant. It has expanded to recognise the confluence of cash availability, debt limitations and restrictions, the industry's economic climate, the country's economic climate and the global economy. All of these components can be monitored on a continuing basis as part of the overall financial review of the business.
Foreign operations and activities	Globalisation is the major element of 21st century business. Outsourcing, multiple worldwide locations, different business and governmental regulations, currency conversions, transportation issues, employees and cultural differences all add up to substantial impact on company operations.
Legal factors	Legal issues from country to country, state to state, municipality to municipality all have to be considered and monitored.
Product issues	Product life cycles need to focus on old products, products about to be launched and products in the development pipeline. Moreover, due diligence includes the need to monitor competitor's products. It is a growing issue considering the expanding global economy.
Supplier issues	Companies are segmenting the manufacture and delivery of products and services. Some companies want to control all aspects of manufacture. As noted, trends in today's economic climate show that more companies are outsourcing parts of all of the development cycle. Due diligence needs to include the viability of the supplier's ability to deliver on time, on budget and within the established quality parameters. If the supplier declares bankruptcy there may be significant issues impacting the completion of company products as well as the financial impact of not receiving value for payments already made.
Tax issues	Tax increases, tax decreases and taxing authorities all need to be monitored. Due diligence needs to include the potential liability of taxes. On the other side of this coin is the potential for the impact of economic loss on the tax liability. In some cases, the liability may be greatly reduced and/or turn to a cash refund. In this event, due diligence needs to make sure that this is an accurate calculation and then consider what to do with the returned funds.

These topics are not the only categories of information that an appropriate due diligence exercise will want to assess and analyse. However, they do demonstrate the range of issues that should be addressed in order to fulfil the purpose of due diligence. When establishing due diligence activities, it is essential that the assessments have to expand beyond the most basic levels. This is true wherever the exercise is taking place (for an example of a simple due diligence exercise in India see **Item 1** of Appendix).

From a 21st century perspective, the traditional due diligence methods account for 10 to 25% of a complete due diligence process, especially in light of the fact that approximately two-thirds of all mergers and acquisitions fail completely, or fail to deliver the value expected. In the USA, the reported worst performer in 2007 was Vulcan Materials which makes construction aggregates. It agreed to purchase Florida Rock Industries for $4.5 billion just as the US Housing Market began its decline. Vulcan shares have underperformed the S&P index by 29% since the merger. Further comment on the level of failure is made below (see also **Chapters 2** and **8**). For the present purpose it should be noted that not all failures are due to the lack of data gathering and appropriate due diligence procedures. Quite often, it is the process of due diligence that reveals appropriate information that this merger is not a good deal for one or both parties. For example, the cultural due diligence exercise can assist towards more successful outcomes (see **Chapter 8**).

With enormous emphasis placed on the short term by most firms, especially those in the public markets, a quick increase in price or earnings for the stock market is in many cases the sole reason for a merger and acquisition transaction. For instance, according to the best and worst M&A deals last year reported in the *Financial Times* on 27 December 2007, technology groups Google and Oracle and energy companies XTO and Transocean enjoyed the best share price performance among US corporations making large domestic acquisitions according to Dealogic data. Such data shows that shareholders have been willing to reward big deals in these sectors whereas financial services groups have been unable to offset the problems of the credit squeeze with large acquisitions. The Dealogic analysis has been in place for four years and offered some evidence of investor reaction to big consolidation moves. Easy revenue increases or cost reductions often make management the 'hero', albeit almost always at the cost of the stakeholders in the long term. Having regard to the purpose of due diligence, in most places traditional business views are based on a historical perspective. Examples of this type of view are:

- What was the level of earnings?
- What did the CEO do?
- How were sales made in the last quarter?
- More analysis of completed transactions.

Following this model, traditional due diligence looks at the past, not the future, to assess what a company can accomplish from today onwards. This analytical method is often performed too quickly and with too narrow a focus on completed transactions that may not be an appropriate predictor of future behaviour. Clearly there are now more modern tools and resources available that can support a more thorough analytical process.

The process 1.7

In most jurisdictions the typical traditional due diligence process in general looks at the target or candidate company, its financial performance, products, market and employees – usually in that order of priority. The typical traditional process starts with a legal questionnaire and disclosure documents attested by the candidate, and is coupled with a review, compilation or audit of financial records. Generally, a regulatory agency records search is performed. Most often various public records are searched. Often, research is added in areas such as the industry niche(s) of the candidate, and sometimes the media. Also, additional research is sometimes added by contacting various industry and government organisations. In the course of this process the use of warranties and indemnities has developed to facilitate the transaction. Although, as is discussed further below, the vendor may provide warranties that provide assurances on the above, the purchaser should check them in any event. The verification approach reduces the potential for conflict because problems can then be identified at an early stage. It can happen, for example, that the vendor is unaware of the problems or issues that emerge through the due diligence process. It is important to note that warranties and indemnities given by vendors often are qualified in certain respects as follows:

- Generally they are subject to time limits and last for only a few years, by operation of law and contract.
- Usually they are limited by amount, including a maximum liability under the warranties and an aggregate level of claims.
- The compensation can be incomplete either because of the inadmissibility of the claim or the restrictive method of calculating the damages, as well as the fact that sometimes it is difficult to evaluate the compensation accurately as in the case of loss of brand reputation (which is discussed in detail in **Chapter 7**).
- Normally there is a de minimis limit in respect of individual claims.
- Any claim will only be successful if it is conducted in accordance with the requirements for the conduct of claims.
- Claims can be disputed, thereby they can be expensive and drain resources.
- Even in the absence of a defence it can be costly and time consuming – as well distracting – to claim.
- The terms of the warranties and indemnities can be difficult to enforce.

The repercussions of entering litigation, as well as the available alternatives, are set out in **Chapter 5** when considering some organisational or management issues. In the light of the above, in many developed economies the due diligence process requires the vendor to disclose all relevant information. Such disclosure enables the purchaser to evaluate the target or candidate properly and to negotiate from the perspective of a level playing field. Therefore the process of legal due diligence can be used to provide information on the legal affairs of the target. Such information can, of course, assist in the decision whether or not to purchase and can check:

- the assumptions made by the purchaser or agreed with the vendor, for instance the rate of cancellation of contracts by customers;
- the valuation of the target;

- the operational capability of the target;
- the identification of any adverse factors.

Once the purchaser has such information the process enables options that include:

- proceeding with the transaction as agreed;
- cancelling or 'walking away' from the transaction;
- negotiating specific indemnities;
- changing the terms of the transaction.

Another important benefit of the legal due diligence process is that the information reveals how the target has been managed. This is very relevant to the overall discussion in the handbook that relates to corporate governance and the broader understanding of due diligence as an ongoing internal tool. It can take account of the background to the target and candidate and its objectives, including its chosen structure in the form of a company, partnership or owner manager operation. While many due diligence exercises involve very large transactions, there are also many smaller deals that attract the due diligence process. While some of the issues in the process are more suited to the larger transaction, others are equally applicable whatever its size. For example, late or inaccurate returns to the authorities, such as the Inland Revenue and corporate registries, will reflect upon the management of the business. They may also indicate financial difficulties, such as in financial statements lodged late with the corporate registries. Moreover, as suggested, once the purchase is completed the due diligence information can provide an invaluable tool in the ongoing management of the target. Some of the management aspects of a business are considered more fully throughout the handbook.

Areas of legal due diligence **1.8**

Key topics that are usually covered in the course of the due diligence process to fulfil its purpose have been indicated above. Moreover **Chapter 2** sets out the relevant issues in the context of corporate finance. Many competent due diligence professionals have begun to use a more comprehensive due diligence process. They have established a broad range of topics that have to be monitored and reviewed on a continuous basis that can also be useful in the overall context of corporate governance. As can also be seen from the discussion in **Chapter 9**, 21st century technology is the tool that enables this kind of continuous or ongoing due diligence. These areas include, but are not limited to, the following list:

- accounting issues;
- behaviour;
- business organisation streamlining;
- business planning;

- business processes streamlining;
- change;
- competitive analysis;
- culture;
- customer defections;
- distribution channels;
- employee retention;
- environmental issues;
- executive retention;
- global business operations;
- global partnering;
- human resources;
- information systems integration and compatibility;
- intellectual capital;
- intellectual property;
- internal auditing;
- interviewing customers;
- interviewing former employees;
- joint venture partner and other alliance reviews;
- legal contract reviews;
- litigation or claims reviews;
- logistics costs;
- manufacturing;
- operations;
- post-deal planning and integration;
- potential market growth;
- potential revenue growth;
- problem identification;
- product distribution;
- product portfolio expansion;
- quality assurance;
- quality control;
- research and development expansion;
- revenue losses;
- risk management;
- security matters;
- strategic planning;
- strategic questions;
- suppliers;
- supply chain;
- tax issues;
- technology – internal/external;
- technology – Internet//Intranet/Extranet;
- technology planning;
- vendors;
- warehousing.

It has been commented that the traditional due diligence process is largely driven from a legal perspective. The legal practitioner typically delivers numerous documents with the goal of being as legally reliable as possible. The legal professional specifically builds a careful legal paper trail, and gathers as much detail as possible regarding the legal condition of the candidate firm. With the benefit of technology, the point should once again be made that 21st century due diligence should enable an improved approach through ongoing information gathering that keeps the business abreast of its status in terms of corporate governance.

The discussion here focuses on circumstances in the UK by way of example. In the UK, the typical legal due diligence exercise will cover some or all of the areas listed. As has been noted in this handbook the selected checklists can only exemplify some of the general concerns, and provide the basic concerns that should be amended to reflect the individual circumstances of the transaction. Therefore, the list below does not purport to be conclusive and will require tailoring according to such factors as:

- whether the transaction is a share purchase or asset purchase;
- the target's industrial sector;
- the geographical location of its activities;
- the size of the transaction.

The principal selected headings of traditional due diligence are:

- corporate structure;
- company secretarial;
- corporate acquisitions and disposals;
- compliance programmes;
- trading activities;
- competition law;
- personnel;
- health and safety liabilities;
- pension schemes;
- land and buildings;
- environmental management;
- plant, equipment and other fixed assets;
- computer software;
- intellectual property;
- investments;
- lending to third parties;
- banking facilities/borrowing from third parties/financial grants;
- guarantees/indemnities/letters of credit;
- product liability;
- investigations, litigation, disputes;
- insurance;
- taxation;
- non-compliance with agreements/change of control;
- voidable transactions/reconstructions;

- impending legislative changes;
- compliance with special industry sector legislation;
- the effect of the Euro or different currencies on contracts, including payment arrangements.

Transaction documentation

Types of documents **1.9**

In a transaction, such as the sale of a business, the materials and main documents will typically include some of the following documentation:

(a) Pre-exchange – including:
  - due diligence preliminary enquiries, further enquiries and the seller's responses to them;
  - heads of agreement;
  - due diligence terms of reference – engagement letter – accountants;
  - instructions for accountants' short and long form report;
  - due diligence terms of reference – engagement letter – lawyers;
  - environmental audit – engagement letter;
  - exclusivity agreement;
  - confidentiality agreement;
  - data room letter;
  - due diligence rules of engagement;
  - funding comfort letter;
  - environmental comfort letter;
  - due diligence reports;
  - report on title;
  - legal opinion of foreign lawyers.

(b) Exchange of contracts – including:
  - disclosure letter;
  - sale and purchase agreement;
  - guarantees;
  - tax indemnity;
  - service agreements;
  - intellectual property assignments and licences;
  - real property transfers;
  - assignment of contracts;
  - directors' meeting minutes.

(c) The closing or completion of the transaction – including:
  - shareholders' resolutions and circular;
  - announcements;
  - letters to customers;
  - stamp duty and company registry forms;
  - governmental consents;
  - release of charges and guarantees;
  - closing agenda.

Ongoing action for due diligence teams regarding transaction documentation **1.10**

Throughout the transaction, the legal due diligence team leader for both the seller and the buyer needs to peruse any transaction documentation which might affect the due diligence exercise. Each draft of the documentation should be checked for any amendments made affecting the due diligence. One document that the legal due diligence teams on both sides are usually responsible for is the disclosure letter. As will be seen from the discussion below and the appendices to this chapter, following the initial meeting with the client, the buyer or seller and its lawyers will have a number of tasks to undertake, including:

- selecting and instructing other advisers;
- the preparation of legal due diligence enquiries;
- agreeing terms of engagement and reference with them and any in-house due diligence teams;
- planning the campaign;
- agreeing various preliminary documents with the other side, including:
  - heads of agreement;
  - a confidentiality agreement;
  - a lock-out agreement;
  - rules of engagement;
- project and data management;
- starting the data acquisition/disclosure process.

Typical transaction procedures **1.11**

This chapter has already commented on the usual due diligence process. However, the due diligence process may vary according to the following situations:

- sale by auction;
- sale by treaty.

In the case of both a sale by auction and a sale by treaty, a number of preliminary steps may be taken:

(a) The seller will obtain a valuation of the target and possibly instruct a corporate financier to find a buyer.
(b) The seller will:
    (i) instruct its corporate financier (if any), accountants and lawyers to do some analysis of the target to identify any major issues to be addressed (such as subsidiaries to be split off);
    (ii) analyse the taxation ramifications of the sale for the seller;
    (iii) begin to prepare or ‘groom’ the target for sale.
(c) The seller may prepare an information memorandum regarding the target for potential interested parties.

(d) The seller will require any interested parties to execute a confidentiality agreement before issuing the information memorandum to them.

(e) The buyer may undertake some basic due diligence into markets, political risk, compatibility of organisational cultures.

(f) The buyer may also involve its accountants in some preliminary analysis of the seller's financial accounts.

Sale by auction or tender **1.12**

It is evident that the seller can improve the terms of its sale by creating a competitive environment where a number of bidders are given access to the due diligence data and make bids for the target. In many cases the sale is not strictly an auction in that the seller is not obliged to accept the highest bid. The typical sequence of events in a sale by auction is as follows:

- With the issue of the information memorandum, the seller may request that bidders respond by a specified date with an indication of the price to be offered and the assets desired.
- The seller is likely to issue a data room agreement to each bidder.
- Each bidder will be allotted a certain amount of access to the data room and possibly to target personnel for additional information.
- The bidders may submit requisitions for further information which the seller may respond to.
- The buyer's in-house due diligence team, if any, prepares their due diligence reports.
- The buyer's accountants prepare their draft due diligence report. Often, this is sent to the seller for comment on any inaccuracies.
- The buyer's lawyers may provide a due diligence report, which is not usually provided to the seller.
- The bidders submit their bids.
- The seller will select one or more bidders with whom to continue negotiations unless a bidder persuades the seller to enter into an exclusivity agreement whereby the seller agrees not to negotiate with any other party for a period of time or not to conclude a sale with any other party.
- The buyer may negotiate basic heads of terms with the seller.
- The buyer may be permitted additional time to undertake due diligence.
- The negotiations concerning the warranties, which have been ongoing for some time, are finalised close to exchange of the sale and purchase agreement.
- The seller's lawyers produce a draft disclosure letter, exempting facts and documents from the warranties.

It should be appreciated that this is a basic structure for the process of conducting a sale by auction or tender. An example of a sales process letter is also found in Item 3 of Appendix. All of these should, of course, be amended to reflect the individual circumstances of the transaction. Similar comment applies to the discussion of sale by treaty below in **1.13**.

Sale by treaty

1.13

The typical sequence of events in a sale by treaty is as follows:

- The buyer may negotiate basic heads of terms with the seller.
- The buyer may insist that the seller enters into an exclusivity agreement whereby the seller agrees not to negotiate with any other party for a period of time or not to conclude a sale with any other party.
- The seller nominates either a member of its own staff or of the target to handle the due diligence enquiries from the buyer and its professional teams.
- The buyer sends its in-house due diligence team to the target's offices where it is usually given a room or a data room is set up by the buyer (where the seller wishes to keep the buyer away from its offices). Alternatively, the data may all be sent to the buyer to analyse at their own offices.
- The buyer instructs its accountants to commence due diligence. They will also usually be based at the target's offices.
- The buyer and seller instruct their lawyers.
- In addition to the commencement of preparation of documentation, the buyer's lawyers forward a set of preliminary enquiries to the seller's lawyers. Normally, the seller will warrant the accuracy and completeness of the written responses.
- The buyer's lawyers are rarely based at the target's offices.
- At the same time as the due diligence teams commence work, the parties and their lawyers start to negotiate the various agreements. These activities will continue in parallel during the due diligence exercise, with the agreements and their terms being amended to reflect the results of the due diligence exercise.
- The seller's lawyers pass the preliminary enquiries to the seller's nominee for handling enquiries, who will arrange for the collation of requested documentation and for answers to the buyer's questions.
- The seller's lawyers will vet, filter and qualify the representative's responses and, where appropriate, restate them in their own terminology before sending them to the buyer's lawyers.
- The documents the seller has collected will usually be indexed and sorted into separate sets of folders known as the 'disclosure bundle'. The written responses will refer to the appropriate documents by their index number in the disclosure bundle.
- The seller's lawyers prepare further enquiries from time to time, based on the answers to the preliminary enquiries and earlier further enquiries and results of its independent information collection activities.
- Omissions in the disclosure bundle and any gaps in the written responses by the seller's lawyers are made good during the negotiations with additional written responses and deliveries of documents.
- The buyer's in-house due diligence team, if any, prepares their due diligence reports.
- The buyer's accountants prepared their draft due diligence report. Often, this is sent to the seller for comment on any inaccuracies.

- The buyer's lawyers may provide a due diligence report, which is not usually provided to the seller.
- The negotiations concerning the warranties, which have been ongoing for some time, are finalised close to exchange of the sale and purchase agreement.
- The seller's lawyers produce a draft disclosure letter, exempting facts and documents from the warranties.

The formal and informal due diligence processes 1.14

When considering the typical process concerning non-data room due diligence exercises, it can be seen that there are two due diligence processes underway. These are:

- The formal process, involving the buyer's lawyers.
- The informal process being undertaken by the buyer, the accountants, the merchant bank (if any) and any other advisers.

Often, the facts and data that the seller warrants the accuracy and completeness of are those supplied under the formal process, that is the facts and data that are:

- provided in the answers to the preliminary enquiries and further enquiries posed by the seller's lawyers;
- stated in the warranties.

The formal process tends to exclude most data that does not refer to the legal affairs of the target or candidate, thereby excluding much significant information obtained by the buyer, its accountants and other advisers.

Disclosure – the traditional approach 1.15

The traditional approach to handling the legal affairs of an acquisition target has often been to place primary reliance on the warranties provided by the seller. Some analysis of documentation and data on the target's legal affairs is made, but this tends to be largely confined to the documentation and data disclosed by the seller against the warranties that they have given. An example would be a warranty with which there is no outstanding litigation and a disclosure made against this in the disclosure letter, which outlines existing litigation and attaches relevant papers.

Disclosure is carried out by the seller in response to:

- the preliminary enquiries raised by the buyer's lawyers;
- the obligations on the seller to provide details of the warranted items contained in the warranties in the sale and purchase agreement;
- the benefit offered to the seller by disclosing information known as the 'excepted items' against the warranties in order to dilute the warranties.

The disclosure process often does not commence until the seller and buyer have entered into an agreement, in principle, or in the case of a controlled auction, until a non-binding bid is made. It should be noted that there is a certain amount of overlap between disclosure and due diligence which causes some confusion when referring to the respective exercises.

As a result, due diligence investigations into the legal affairs of targets or candidates are undertaken to varying degrees. Some buyers' lawyers do not undertake extensive investigations in advance of receiving the sellers' disclosures. This can mean that the extent of the buyer's knowledge of the legal affairs will depend on the extent of the 'warranted items' negotiated into the warranties. A problem with this approach is that it is always possible that the seller will negotiate down on the warranties and remove the reference to warranted items, so that very little information is actually provided to the buyer. Another disadvantage of relying on the disclosure exercise for information is that the seller will often only turn its mind to the process of collecting the disclosure documents once the negotiation of the warranties is complete, immediately prior to exchange. This will leave little time for quality data to be collected, let alone adequate time for the buyer's due diligence team to review and report on the data.

Due diligence and the seller's duty to disclose 1.16

The obligations on the seller to disclose information are discussed here. As noted, this discussion principally relates to the English transaction.

The classical common law position is that there is no duty on the parties to disclose material facts to the other party. The historic approach of English contract law has been to allow each party to look after their own interests. This was the 'apotheosis of 19th century individualism' and a result of the application of the doctrine of 'laissez faire'. Accordingly, the maxims *caveat emptor* (let the buyer beware) and *caveat venditor* (let the seller beware) are the starting point for consideration of this issue. Over the years the traditional common law position has been gradually eroded and a variety of exceptions to the general non-disclosure rule evolved. These include:

- fiduciary relationships, including *uberrimae fides* (of the utmost good faith);
- the duty of disclosure on sellers in real property transactions;
- the obligation on the seller and the buyer not to make misrepresentations.

Fiduciary relationships 1.17

These are relationships between persons that involve trust and confidence. Typical examples are those between solicitor and client, trustee and beneficiaries. In all such relationships there is a duty of disclosure of all material facts. This also applies to relationships that are *uberrimae fides*, that is of the utmost good faith, such as between insurer and insured. A failure to comply with the duty of good faith in an insurance situation will lead to the insurer being able to treat the contract of insurance as voidable. The obligation of utmost good faith can also be imposed contractually by a buyer and seller in a corporate transaction. The parties can expressly contract to create a duty of utmost good faith and thereby place a duty of disclosure of all material facts.

Real property transactions **1.18**

In the UK, particular rules have been developed by the courts in relation to transactions regarding land and buildings that is real property. This real property framework has been based on the fact that, traditionally, the nature and state of the seller's title could only be determined by the buyer questioning the seller. However this duty has been weakened to some extent by the regime for registering land which was introduced by the *Law of Property Act 1925*. As a result the seller is under an obligation to disclose to the buyer any latent defects in the title to the property which will not be removed before the completion of the transaction, or closing. (Note also the recent introduction of the Home Information Pack (HIP) for residential conveyancing whereby all homes marketed for sale from 14 December 2007 in England and Wales need a HIP; a key component is the Energy Performance Certificate (EPC)). According to English law a defect may be described as latent if:

- it cannot be discovered by the exercise of reasonable care on the inspection of the property;
- it amounts to a deficiency in the seller's documentary title which might affect his or her ownership of the property or his or her right to deal with it.

It has been suggested that there is no reason why the common law duty on the seller to disclose any latent defects in title should not apply in an asset purchase. This is because the property conveyance is occurring in much the same way as in any other real property transaction. However, the question is less clear and therefore more arguable in the case of a share acquisition as the transfer of the real property occurs as a corollary of the share purchase.

Matters subject to the duty of disclosure **1.19**

The seller is under an obligation to disclose such information as that referred to here following, including as was decided by the Court of Appeal as long ago as 1899 in the case *Re Brewer and Hankin's Contract (1899) 80 LT 127* where they were outside his knowledge:

- type and tenure of title;
- leases and tenancies;
- matters registered at the Central Land Charges Department;
- local land charges;
- restrictive covenants;
- easements;
- exceptions and reservations.

Due to the heavy burden of common law disclosure on the seller, the parties may agree to vary the duty. This is done as a matter of course in English property transactions.

Remedies **1.20**

The remedies for breach of the duty of disclosure by the seller in the case of real property transactions fall into three categories flowing from the type of breach.

1. Non-disclosure

   Where the non-disclosure relates to a substantial defect, the buyer will be entitled to rescind the contract before the completion of the transaction, or closing. They may alternatively seek a reduction in the purchase price.

2. Misdescription

   The failure to disclose a matter in relation to the type or tenure of the seller's title or a misleading physical description of the property in the particulars of sale leads to liability in misdescription rather than non-disclosure. The remedies for misdescription are similar to those for non-disclosure.

3. Misrepresentation

   This is a vast area of discussion that has led to legislation and extensive case law that has been the subject of textbooks. Therefore it should be appreciated that the discussion of the law of misrepresentation that is set out below is only intended to cover the position in the broadest sense in order to provide some basic guidance to personnel involved in the due diligence exercise.

Misrepresentation – an outline **1.21**

When considering a due diligence exercise, there are two general circumstances in which the seller might make a misrepresentation to the buyer:

- by way of an incorrect statement (often a warranty) contained in the sale and purchase agreement or a statement made in the disclosure letter (including the disclosure bundle);
- by way of an incorrect statement outside the formal due diligence or transactional process, such as a written statement in documentation not contained in the disclosure bundle or an oral statement.

The seller should monitor and vet all data disclosed to the buyer throughout the transaction, both at the time it is made and as at the date of exchange, to ensure it is still accurate. The personnel of the seller should also take care to avoid making statements outside the sale and purchase agreement or disclosure letter/disclosure bundle, whether orally or in writing, which might later be used by the buyer to rescind the sale and purchase agreement or claim damages from the seller. Conversely, the personnel acting for the buyer should take steps to accurately record any statements which the seller makes to them, which they rely upon in entering into the agreement.

Generally, agreements relating to the sale and purchase of a business or a joint venture will specifically list those statements that the buyer is relying upon in entering into the agreement. These warranties are usually negotiated and worded with some care. There is usually an 'entire agreement' provision in the agreement, whereby the buyer acknowledges that it has not entered into the agreement in reliance on any representations other than those contained in the agreement or the disclosure letter. However, such a provision will only be effective if the seller can prove that it satisfies the requirement of reasonableness as stated in section 11(1) of the *Unfair Contract Terms Act 1977*. Section 11(1) provides the requirement of reasonableness. This requires that the term should have been a fair and reasonable one to be included, having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made.

In a commercial transaction, particularly one where the parties are seasoned business people, the buyer may have difficulty in persuading a court that it was not reasonable to include an entire agreement clause in an agreement which contained an extensive list of warranties. The buyer may also have difficulty in persuading the court to find that he or she relied on the representation in entering into the agreement, when he or she had the opportunity to include this in the warranties but did not do so.

Nevertheless, the courts have held entire agreement clauses in commercial contracts to be unfair. In *Goff v Gauthier (1991) (62 P & CR 388)*, which involved a contract for sale of land, the seller orally represented to the buyer that he would withdraw from negotiations with the buyer unless contracts were exchanged immediately. The court found that the seller had no such intention and his statement was a misrepresentation that induced the buyer to enter into the contract. The buyer was permitted to rescind the contract notwithstanding the entire agreement clause which was held to be unreasonable within the meaning *of* section 11(1).

Accordingly, circumstances can arise where a misrepresentation might be actionable by a buyer in a business acquisition, avoiding an entire agreement clause. This might particularly apply where the misrepresentation was outside the usual ambit of the warranties, as in the *Goff* case, or where the warranties were brief. Entire agreement clauses may also be held to be unreasonable if they purport to exclude claims based on misrepresentation even where there was fraud. For instance in *Thomas Witter Ltd v TBP Industries Ltd [1996] 2 All ER 573* the court held the clause to be void on the grounds of unreasonableness because it purported to exclude liability for misrepresentation. Therefore, the seller should draft the provision so as to preserve the buyer's rights in the case of fraud.

The courts have also shown that they will construe entire agreement clauses narrowly. Accordingly, sellers are well advised to seek an acknowledgement from the buyer that it does not enter into the agreement in reliance on any other representations.

There are many cases in which statements will be made during the precontractual negotiations and will be at risk of change during the course of those negotiations. For example, *With v O'Flanagan [1936] Ch 575, [1936] 1 All ER 727*, demonstrated this concern. A dental practice was to be sold and accurate supporting financial information was provided. The negotiation took five months to conclude during which time the seller fell ill and income was lost. These losses were not notified to the buyer who purchased the business in good faith based on the original figures. It was held that, as the buyer had continued to place reliance on the original figures believing them to be true, those figures being uncorrected amounted to a misrepresentation.

Another matter relates to silence. It has long been understood that, by itself, silence will not amount to a misrepresentation (see *Keats v Lord Cadogan (1851) 10 CB 591*). However, if a party is deliberately silent regarding certain information which, if known, would distort the information provided, then there may be an actionable misrepresentation. There is also no reason why the parties to the agreement cannot place themselves under an obligation of disclosure, as long as that obligation was carefully drafted, so that the detail of the disclosure required was unambiguous. In addition, if a party makes a disclosure upon a particular matter which details certain facts but omits others, this may be regarded as a misrepresentation. The test is whether, by only proving certain facts, they would mislead the party placing reliance upon them in the absence of having knowledge of the omitted set of facts.

One of the key sources of information that a buyer will rely on will be the audited financial statements of the target. The question therefore arises whether the buyer has any recourse against the seller's accountants if those accounts prove to be incorrect. Under English law in 1990 the matter was considered and decided in *Caparo Industries plc v Dickman [1990] 1 All ER 568*. The House of Lords unanimously rejected the concept that auditors owed an unlimited duty of care in the preparation of accounts which extended to anyone who used those accounts. Accordingly, the buyer should identify those facts and statements presented in the financial accounts on which it is relying and seek warranties on them from the seller.

There may be other circumstances where the target's accountants may be liable to the buyer and each case should be considered on its facts. The buyer may actually experience some difficulty claiming against the target's auditors even they had prepared draft accounts at the request of the buyer and make certain statements regarding the level of profits (see *McNaughton (James) Papers Group Ltd v Hicks Anderson & Co [1991] 1 All ER 134*). Accordingly, a buyer should ensure that it takes appropriate warranties from the seller to increase its protection and to avoid any defence of contributory negligence by the accountants for not having done so.

Where the buyer relies on a prospectus previously issued by the target, the buyer may have a remedy under section 150 or section 166 of the *Financial Services Act 1986*. These sections provide protection for those acquiring shares. It should be noted, however, that the House of Lords' decision in the old reported case of *Peek v Gurney [1861–73] All ER 116, LR 6 HL 377*, supported in *Al-Nakib Investments (Jersey) Ltd v Longcroft [1990] 3 All ER 321*, held that the purchaser of shares must be an original allotee to succeed in an action for misstatement in a prospectus.

Remedies for misrepresentation **1.22**

Where the buyer wishes to make a claim that it has been induced to enter into the contract in reliance on a misrepresentation, its remedy will depend on whether the misrepresentation was contained in the warranties or otherwise. The sale and purchase agreement will usually provide for remedies in the event of breach of warranty, which will generally be damages or, rather exceptionally, rescission (setting aside a voidable contract). Alternatively, the buyer may be able to claim rescission or damages on the basis of misrepresentation. Misrepresentations made outside the formal documentation would also be made under this heading.

Criminal sanctions **1.23**

A key concern for the seller and its advisers must be to ensure that they do not become exposed to criminal sanctions when dealing with the buyer. This may be as a result of regulation making it an offence to make misleading statements in a sale of shares knowing them to be misleading or reckless as to their truth, for the purpose of inducing any person to enter into an agreement to acquire securities. This will affect the sale of shares but not the sale of assets. In addition, two or more persons may be guilty of the common law offence of conspiracy to defraud if fraudulent statements are made with the intention to deceive. This would apply to both sales of shares and sales of assets.

Contract subject to due diligence **1.24**

In the vast majority of commercial transactions to which due diligence is applied, the due diligence exercise is carried out prior to signing and exchange of contracts. However there may be cases, especially where the seller is desperate to dispose of the target or candidate company or business, where contracts are signed and exchanged subject to the buyer being satisfied with the results of a subsequent due diligence exercise. The due diligence is then carried out within specific time limits. Generally such an arrangement is unsatisfactory from the perspective of the seller because it gives the unscrupulous buyer an open-ended opportunity to withdraw from the contract. Moreover, the obligations on the buyer to act in good faith and de minimis provisions are capable of being disregarded. It is often argued that such a deal structure amounts in reality to the grant by the seller to the buyer of an exclusive option to purchase the target during a specific period of time. Therefore, however desperate the seller may be, the disadvantages may well outweigh any advantages.

Legal due diligence – the limitations 1.25

The key to a successful due diligence exercise is the data. It is important to bear in mind that all investigations undergone in the due diligence process depend very much on the quantity and quality of the data supplied by and on behalf of the vendor. The purchaser has to rely on such information in making any decision regarding the target. Therefore the purchaser is very much exposed to potential non-disclosure and misrepresentation by the vendor. This is considered further above (see for example **1.15** and **1.21**) in the context of English law.

Having regard to such limitation in the due diligence process it is important for the purchaser to support the due diligence investigation by obtaining warranties from the vendor on those matters that are uneconomic or impossible for the purchaser to check. It is of course important for the vendor to warrant the completeness and accuracy of the date supplied to the purchaser.

Financial professionals concentrate primarily on comprehending and delivering historical financial reports, and often a valuation of the candidate – traditional financial review focusing on what was, rather than what lies ahead. Over the past decade there has been significant growth in understanding the need to focus on all aspects of future financial issues. This is not only for the repayment of outstanding debt, such as a mortgage; rather it is for the consideration of all current and future financial obligations. This includes knowing what obligations are falling due and when, synchronised with the company's capability to make payment as scheduled. Thus due diligence is both an internal and an external looking effort.

The legal or the financial viewpoints are not focused on the actual validation of the acquisition or the merger deal. Traditional due diligence is essentially an audit of legal and financial aspects of deals. Legal and financial reviewers, lawyers and accountants work within the same context and structure as due diligence is an essential part of any decision process.

Financial due diligence 1.26

Financial due diligence entails:

- identification of the commercial rationale for the transaction or deal in terms of growth, technology or synergy savings;
- the differentiation between facts, assumptions and projections;
- the financial facts, assumptions and projections.

The underlying process regarding the facts involves accountancy policies with a degree of central control. The accuracy is affected by the access to auditors, late adjustments and the management accounts and financial accounts. Qualitative issues relate to the budgeting style, performance pressure and internal audit.

As regards the financial audit, the basis for assumptions will often be:

- seller knowledge;
- buyer knowledge;
- target information;
- speculation.

The basis for projections are the financial facts and assumptions, as well as commercial facts and assumptions. The gap between due diligence conclusions and contract has to be bridged by accounting warranties, completion accounts and commercial warranties. Due diligence conclusions are often a mix of facts, assumptions and projections. It may be said that value judgements with commercial and sustainable views, together with real advice, go beyond such conclusions in order to realise the due diligence objective and achieve a successful outcome (see also **Chapter 2**).

Risk and insurance due diligence 1.27

Traditionally insurance brokers or advisers have focused on the target's existing insurance arrangements as the relevant element of risk financing. However as this meant a rather limited exercise, the discipline of risk and insurance due diligence evolved. The more modern approach considers as a priority the target's business, enabling a detailed risk profile to be developed. A clear risk profile is achieved by thorough identification, analysis and evaluation of the risks and exposures of the business, including:

- an assessment of hazard and risk by industry sector and territory;
- an analysis of past, present and future activities and product range;
- an analysis of the loss experience, specifically examining frequency, severity and trends, and may include the preparation of a claims survey if sufficient data is available;
- a review of potential liabilities and relevant outstanding litigation.

An examination and analysis of the target's current organisational and operational structures are conducted in relation to key issues, including:

- the overall risk management philosophy;
- environmental management;
- health and safety programmes;
- crisis management or disaster recovery planning;
- product safety procedures;
- asset protection procedures and methodologies.

The risk financing and risk retention decisions are also reviewed in order to analyse the target's risk financing arrangements. Current and past risk transfer arrangements are audited. Where relevant, an analysis of the involvement of a captive insurance company is also carried out. The main headings of this review are:

- risk financing methodology;
- critical analysis of insurance policies;
- determination of uninsured or underinsured risks;
- examination of self-insured risks;
- analysis of insurers' financial security.

Through the preparation of a risk profile the buyer can understand the candidate's past and present activities in order to assess its potential exposure to unexpected and unbudgeted risks. This has evident connection with the risk management and corporate governance of an organisation as discussed extensively throughout this handbook. The profile will cover any 'forgotten' past activities such as:

- any potential liabilities arising from historic joint ventures and other strategic alliances;
- the past trading activities or product range of dormant companies;
- latent disease liabilities such as asbestos or industrial deafness that could be the subject to future employers liability insurance claims that are unforeseen or unplanned;
- any discontinued product lines that could create a future liability;
- past exposure of employees or third parties to a variety of substances or situations known to cause harm or damage.

It is important to determine the extent of the target's exposure in comparison with the buyer's current activities or product lines. The priorities are to:

- ensure that all activities or product lines are identified;
- review the additional overseas exposures, including information on overseas subsidiaries and legislation or regulation of the respective jurisdictions;
- identify any dependency on a supplier, customer, assembler or manufacturer, particularly in the era of outsourcing;
- check whether or not the target undertakes design work or provides advice to third parties for a fee as this could mean a substantial increase in any exposure to negligence actions.

One critical area that the buyer must review is the outstanding litigation against the target. As a matter of course a schedule of outstanding litigation should be analysed in conjunction with the target's insurance arrangements. The problem of litigation and the threat to the successful business are discussed in more detail in **Chapter 5**.

The risk and insurance due diligence exercise enables the buyer to understand the level of exposure, as well as the adequacy of available cover to deal with the exposed risks. Indeed the key benefits to the buyer are:

- a clearer understanding of the target's business and its risks;
- the identifying of potential 'deal breakers' that mean the need to review the transaction as a whole;

- the prioritising of problem risk issues and potential solutions;
- a recognition of likely cost implications that can enable a keener purchase price to be negotiated;
- the focusing of necessary contractual warranties and indemnities.

Beneficiaries of due diligence 1.28

It should be noted that with the ever-increasing pressure from regulators, security exchanges and stakeholders, there are a growing number of beneficiaries of the due diligence process. When the parties are establishing the methodologies for the due diligence tasks, it is important that the user of this information is considered. For example in many places, if a government regulator is involved, there are specific forms and formats for data to be presented. It will be very frustrating and more expensive to have to recast the information multiple times just to conform to the regulator's penchant for specificity.

Shareholders, investors and stakeholders can be satisfied with accurate and timely information but generally more concerned with the overview or bottom line. In fact, most would prefer simpler rather than complex information. They may be making decisions about company compliance with a specific regulation, but they are also concerned with understanding the company's ability to survive and prosper.

It is important to ensure that employees are not forgotten in this process. Clerks, middle managers, management and all other related individuals who receive compensation from the company enjoy hearing about the company. Due diligence can include preparation of reports, without violating the rules of privacy and government regulations.

Transactional and operational concerns – integration value post-merger 1.29

Corporate mergers and acquisitions across the globe became popular over the last two decades due to:

- globalisation;
- liberalisation;
- technological developments; and
- an intensely competitive business environment.

Most recently, there was considerable transactional activity in 2007. While 2008 has witnessed a slowdown in activity, in this era of heightened corporate governance, it is important to assess the real value of a transaction once the deal has been done, having regard to the growing number of stakeholders. Despite the many processes that may be in place and the detailed checklists that have evolved in commercial circles, the question is often raised: how hard do firms try to gain value from acquisitions? One assertion has been that the majority of acquisitions and mergers do not deliver shareholder value. Indeed some 10 years ago research by the international consultant firm McKinsey in 1998 concluded that around 60% of mergers fail in financial terms. An earlier study in 1987 highlighted that 58% of acquisitions were later divested due to underperformance. In the course of other ongoing studies, other commentators have noted that 70% do not deliver intended value. Whatever is the actual figure today there is no doubt that it will also be high since often the full potential is not achieved and financial repercussions occur. It is interesting to note that many empirical studies show that M&As fail to create value for the shareholders of the acquirers. Synergistic gains from M&A may in fact result from:

- economies of scale;
- more profitable use of assets;
- exploitation of market power; and
- the use of complementary resources.

Key questions that have been asked are:

- Why is effective acquisition integration, that is the method whereby the paper strategy of combination begins to realise value, so elusive?
- Is it that target firms are chosen wrongly in the first place?
- Is it that doing the deal is seen as the conclusion to the merger rather than the beginning of the process of integration?

For in-house and advisory lawyers, the issue of integration is an important area. It is clear that in actually doing the deal itself, the momentum, pressure to close and limited time to assess all information can result in decisions that will seriously impact the ability to integrate in the longer term. This will range from operational detail through to more organisational concerns such as the loss of tacit, codified corporate knowledge that exists in the heads of key personnel that have left the business. Moreover the cultural aspects – which have become of increasing significance (see also **Chapter 8**) – are regularly given insufficient attention. A further example is in information technology (IT) where often only the most basic inventory of physical hardware is undertaken, when programming skills and long-term single-source service deals may in fact be the critical factors to consider (see also **Chapter 9**).

In all these areas, acquirers need advice and assurance that they will have the ability to retain and modify key assets (in the broadest sense of the word) post-merger. To this extent, a key input from legal advisers will be to anticipate the effect on integration that contractual financial arrangements, remuneration practice and the like will have.

In the 1970s and 1980s, acquisitions tended to be typified by the conglomerate approach – acquired companies were viewed as assets to be financially engineered to improve profits, and often a diverse set of companies was brought under one corporation to achieve a diversified portfolio. As such, acquired targets were often only integrated to the extent of being handed a heavyweight financial reporting handbook. Today, such an approach actually attracts a ‘conglomerate discount’ from analysts evaluating the share price of firms – shareholders can create a diversified portfolio of companies themselves.

Since the 1990s, the concept of related diversification by acquisition has been touted as a more effective route to wealth creation. That is, as noted above, for effective acquisition, acquirers should bring a synergy to target firms that will create more value than the previous entities when they were not combined. Such synergy may be brand image, manufacturing know-how, physical asset overlap, research and development skills, cultural aspects or just pure economies of scale. Some of these issues are considered further in **Chapters 7** and **8** in particular.

In reality, accessing true synergy in acquisitions means that:

- the acquirer is fully aware of the depth and breadth of its core skills;
- it is similarly aware of the target's skills; and
- there is always a clear and focused set of acquisition objectives for integration post-merger that will create new wealth from an optimised combination of assets whether intellectual, physical or informational.

Therefore the business school mantra of achieving synergy which is intellectually satisfying leads rather quickly to a potentially vast and complex web of practical detail.

Competitive advantage through successful acquisitions **1.30**

In the more straightforward days of conglomerate acquisition, financial control was often the only overlap that had to be managed. However, when a 'synergistic' acquisition takes place, marketing, manufacturing and IT functions may also have to be combined. Thus the risk and complexity of the acquisition is much higher.

Yet, as is clear from the chapters that follow, this risk and complexity, however daunting, is a vital area of corporate life that has to be managed effectively. There are a number of reasons for this. At the strategic level, it is likely that the ability to achieve successful acquisition will become a competitive advantage as corporations look more and more to this method of accessing growth and differentiation.

Tactics and price **1.31**

At the tactical level, the actual price paid for a target firm will reflect the proposed synergies to be achieved – for example one way of looking at the price of any target is:

- the fair market value of the firm;
- add or subtract any applicable premium or discounts;
- add the perceived operational synergies created by the merger.

If such synergies are not to be a major factor, then the process is merely asset capture (simply put, the purchase of an ongoing business' revenue stream) and the price paid should reflect this. If synergies are to be a major factor in price determination, then the realisation of post-merger synergies should be a priority for business managers. What is the reason for paying a premium for intended synergy and then not integrating properly to get the benefits paid for up front? In a sense this is a double blow for shareholders and other parties involved. A premium is paid for the target firm above true market value. If integration does not then follow, the price paid has been too high and the intended synergies have not materialised, investors lose both ways. Organisational and strategic research has led to the conclusion that unsuccessful or piecemeal integration often leads to merger and acquisition failure.

Integration options **1.32**

It has, therefore, also been asked whether the assessments of the above-mentioned 1987 study (see **1.29**) are correct. Do firms find that acquisitions become too difficult, and that asset capture remains the easiest and most worthwhile route – irrespective of whether or not this affects the overall success of the acquisition? Some answers are available from a study of all UK acquisitions in the period 1991–1994. The study conducted by the Warwick Business School used a framework which usefully highlighted different types of integrations undertaken in real life by acquiring corporations, as follows:

- Absorption – full integration of the acquisition by the buyer.
- Preservation – where the acquisition is not integrated at all and held at arm's length.
- Symbiotic – where there is mutual dependence (but not integration) between the two companies.
- Holding – which indicates that the acquired company is held to be (possibly) traded at a later date.

It has been argued that the simplest way to view these four alternatives is to note that they are separated along two dimensions:

- The amount of resource transferred.
- The degree to which the acquired company is left independent or not.

Data has shown that over three quarters of the companies studied had not attempted to integrate resources significantly. It was concluded that this was due to the inherently difficult nature of integration (and hence risk) and, in terms of acquiring good performing assets, the instinct was not to 'contaminate' the good work for risk of harming performance. The stark conclusion is that in the UK during the 1990s most acquisitions were of a 'purchasing asset' variety involving little or no transfer of resources between buyer and target. Moreover more recent analyses have indicated that whereas companies have become more sophisticated in due diligence and in the M&A process value to shareholders has remained disappointing (see data referred to in **1.6** above).

The best option **1.33**

Although evidence has revealed that only in a minority of cases extensive integration occurs, a number of key changes do happen in all acquisition types. The most common changes are ones which are symbolically important, signalling progress to staff and the city. Therefore management changes, financial reporting changes and communication changes are all quick to take place. Changes that are relatively easy to accomplish and have high impact, such as senior staff movement, will be pursued first. Longer term, if at all, the more complex areas will be tackled such as site rationalisations and IT systems. Therefore, given the focus on share price and city evaluation that drives much business strategy, not least because of the share options link between senior management and company stock price, acquisition integration tends to focus on early indications of success which is a less risky and preferable approach to a longer-term involved integration which may take time to signal success.

In the long run, however, the early win approach may be detrimental to value. If the acquired target is not brought in to the wider corporate structure and is left to continue much as before, it is unlikely that the acquirer will have accessed that premium he paid for in the deal. This may well be part of the reason for the number of divestments that have to be undertaken (see also **Chapter 8**).

The fact that the above study (see **1.32**) was conducted in the UK means that the stock market impact on managerial action will inevitably be a major factor, as it will be in the USA – that is countries with highly active and liquid stock markets. It may, however, be that in European or Asian countries with more conservative stock markets that the focus on short-term delivery is less intrusive – this may facilitate more measured analysis and implementation of integration, and a comparative analysis would be useful. True value creation from acquisitions therefore appears to be only pursued in a minority of actual instances – a clear opportunity for genuine wealth creation therefore remains.

Priorities **1.34**

Textbooks and journals on how to integrate successfully are now commonplace in management literature. They tend to cite sensible advice such as:

- communicate thoroughly with all employees;
- set clear objectives and initiate appropriate organisational change;
- have clear milestones;
- ensure normal business is not hampered;
- act quickly to avoid losing momentum and enthusiasm.

Both the Warwick study (see **1.32**) and this integration literature tend to be descriptive and have not attempted to draw out contingent circumstances of acquisitions. That is, it may well be inappropriate (although technically preferable) to try all elements of integration depending on what the acquirer's objectives actually are. Indeed, there is evidence to suggest that post-merger synergy may not be a primary objective at all – competitive reaction, revenue capture for growth or other strategic issues may actually dominate, and require that resource is only expended on specific key areas. Acquirers should, however, stand back and realise what it is they are actually stating by following this thinking: 'I am deliberately purchasing assets to which I will not add value, and from whom I will probably not gain value in the long run'.

Whatever the case, recent merger activity in the UK suggests that the integration issue is receiving more attention. Interviewed about the merger of Price Waterhouse and Coopers & Lybrand, the integration manager (a good asset) noted a simple but insightful point about the finer details:

> 'The two firms bill their clients and do their time sheers differently. It will probably take two years to sort all that out, and its going to take a huge investment.'

This is a realistic assessment of the kind of effort required and highlights the reality that even with best intentions it is often very difficult in the short term to make significant progress in certain areas – a realistic and flexible evaluation of these areas could ensure expectation about progress is managed.

For example, integrating the culture of two combining firms (often given high profile in merging episodes both in publications on the subject and by management) is very likely not to occur much beneath the surface in the timescale of integration – irrespective of what best practice advises. In many instances, even after several years, a parent culture tends to linger with many individuals. It might be better to realise that the cultures will continue to have a certain flavour and that this is either acceptable or, if it is not, a replacement of key staff may have to occur. In any event, a fundamental review as to how important this is actually going to be should be undertaken and, if it seems manageable but resource consuming, this fact should be reflected in the purchase price. Cultural issues are worthy of a separate debate and are considered to an extent in **Chapter 8**.

It is clear that extensive post-merger integration, if attempted, will often be a difficult and time-consuming task. It therefore would seem to make sense that as part of a negotiated target price this investment in resource and time be used to counter inflated premiums for the target firm. This addresses, in part, the problem of shareholder value return and in fact may be a salutary action to undertake in terms of assessing how viable the wider acquisition or merger will actually be.

In-house lawyers are often key players in determining the strategy and implementation of acquisitions and so it is important that they can provide guidance to their colleagues on the importance of effective integration. Furthermore, when advising on a transaction both in-house and private practice lawyers need to be aware of the buyer's purpose for making the acquisition and integration will be a factor in this. This will influence the due diligence, the transactional documentation and the negotiations. For instance, the purchase of a service sector business, such as an insurance brokerage, will involve a different set of legal analysis and transaction if the personnel are not being acquired.

The facts are, however, that often mergers and acquisitions provide such a strong momentum of their own that it tends to sweep aside all but the most obvious of post-merger integration considerations. In order to realise the objectives of good corporate governance and to achieve realistic purchase prices, and fully access post-merger value, these aspects should be prioritised before rather than after the event.

Other business issues 1.35

At this stage it is useful to bear in mind the due diligence exercise in the context of other business issues and the general objective to understand the:

- risks and rewards of due diligence;
- repercussions of the analysis; and
- interaction with risk management and corporate governance.

Practitioners emphasise the importance of understanding how due diligence must not be blinded by only looking within the company. The external environment in which the company operates, hires personnel, deals with suppliers, etc. is a significant component. In this context the term 'environment' is used to group together the elements that support and impact the company.

To recap, the mission of any due diligence exercise starts with verification of the company goals. The goals have to be prepared and be able to be articulated. A statement such as: 'we want to compete in the bicycle market' is much too vague and does not provide any support for people who are trying to implement a business plan. Clarity and specificity is much better than vague assumptions and generalities if the business goals are to be understood and achieved. Another important reason for clarity is to enable the due diligence team to be able to recognise when the business is heading off course and when the company is moving ahead – the objective is not to find reasons and justifications to keep going. While there are always exceptions to every procedure, the more business operations are guided by consistent principles, the easier it is to identify the exceptions and determine whether this time such an exception is justified or not. With enough exceptions, a company's operations handbook needs to be adjusted to embrace this exception as it is now a standard procedure, not an exception.

There are several key objectives for company operations to support a due diligence environment. Ongoing due diligence demonstrates:

- the company business capabilities;
- the stability of the company, the industry and the overall economy;
- the revenue and expense flows for business operations;
- company support methods;

- risks – business, personnel, economy, environment;
- a clear strengths and weaknesses assessment of the company; and
- specific business continuity issues.

Ongoing due diligence helps to create the framework that enables companies to operate effectively. While each company is different, the objectives are typically the same, to:

- sustain profitability;
- reduce risk to the company;
- achieve business goals and objectives; and
- improve quality of life.

Drivers for ongoing due diligence 1.36

Some consideration has been given above to the drivers for the due diligence process mainly in the context of transactions. Mention has also been made of the growing importance of ongoing internal due diligence that supports the corporate culture and good corporate governance positively (see further **Chapter 4**). In view of concerns raised by the high failure integration rate, it is useful to close this chapter with some highlights of the business issues to set the scene for the **Chapters** that follow.

External drivers 1.37

External drivers include:

- regulatory issues;
- company standards;
- corporate governance issues and trends;
- investor/lender/stakeholder confidence;
- consumer confidence;
- consumer satisfaction;
- government compliance issues.

This list continues to expand – what is essential to understand is how the environment outside the organisation needs to be included within the elements that due diligence reviews. The due diligence team needs access to where this information can be gathered on an ongoing basis. Very often trade associations are a good source for this information and the data collected can be used to compare the company operations with other companies, industries and countries.

Internal drivers 1.38

Internal drivers include:

- employee satisfaction;
- management satisfaction;
- supplier relationships;

- operational procedures;
- operational implementation; and
- multi-office relationships.

While this list is more limited than the external list, this does not mean that any of this information has limits and boundaries that are set in stone. As regards internal due diligence, the team needs to be attentive to the results of interactions among employees and management. Proper implementation requires overall co-ordination and consistency by the people who are empowered to perform the various company tasks. For example, if a bookkeeper is allowed to change the data of a sales entry unilaterally without any transaction trail, then chaos could result. There could also be a problem that could lead to fraud and/or the commission of criminal acts. Exposure to such risks is not what business wants and supports the appropriate use of due diligent activities.

Practical issues **1.39**

In the context of this discussion, practical examples of combining internal and external activities are joint deals, transactions, joint ventures and other relationships. For this work due diligence is actually two sided. Each company within the relationship will have due diligence to perform:

- company one will want to investigate and examine company two and vice versa;
- company two will need to assess company one.

Mergers are especially the subject of a due diligence exercise by each company, their lawyers, their accountants, government regulators (if public companies), insurance advisers and so on.

Bearing in mind the importance of the quality of data, the key is to have each due diligence team determine the level of exposure based on what can or cannot be answered. Many deals or negotiations never get past due diligence because there is not enough documentation about the company's operations. The deal can be filled with risk as there cannot be a total investigation just as there is never a complete investigation of the medical, emotional, financial history for each party to a marriage. There has to be a balance that is part of the risk reward formula for all due diligence activities. For example, in the case of a £50 million deal, not being able to verify a £1,000 transaction may not be worth the thousands that it takes to validate the transaction.

This is where the experience and capability of the due diligence team is essential.

First, they have to possess training and expertise to be able to recognise the important and the unimportant. Second, they need to have the appropriate tools necessary to perform their tasks. The tools can include, but not be limited to:

- Internet research capability;
- legal data bases – especially for lawyers;

- tax data bases – especially for accountants and lawyers;
- industry perspective and data;
- access to company personnel;
- access to all relevant regulations – securities, government, environment, etc.; and
- appropriate computer and resource tools that support this work.

As due diligence continues to expand, companies will rely on the information gathering that can sustain the enterprise, reduce the risk of business activity and reward the various stakeholders.

Other due diligence drivers **1.40**

There are other drivers for the due diligence process that exist and should be mentioned by way of a summary. They are described below.

Macro and micro issues **1.41**

The company operations have to be able to feed appropriate data into the due diligence mixing bowl. Macro issues include the larger pictures, especially those issues that the company has absolutely no control over. For example, the global economy, global politics and global terrorism are examples of very real issues that have to be monitored with appropriate plans in place and ready to be implemented, the moment that a due diligence alert has been sounded. As is discussed below at **1.42**, very practical issues must be considered when embarking on activities that involve foreign risks or jurisdictions.

If country one, which is a buyer of your goods and services, has a major weather-related disaster, a number of events may be triggered. All sales to that country may be suspended, employees may not be reachable or worse, an inventory already in place may be destroyed. As is discussed further in **1.42** and in **Chapter 5**, due diligence efforts can include monitoring possible disasters, and if predictable, taking precautions in the days leading up to the event. Another part of due diligence is understanding the potential of such risks occurring and establishing procedures way in advance of any possible catastrophe that has a full set of operational procedures of what to do. The quality control needed by senior management is to verify that such procedures are in place and employees have been alerted and trained.

The interaction with risk management and corporate governance **1.42**

Risk management and corporate governance have become increasingly linked with due diligence in the last few years. Risk is often regarded dealing with the unknown. It requires making decisions without all of the facts that are absolutely required to determine the outcome. For instance, in sport, horse racing provides the gambler with a chance to exercise risk decision-making. They can establish all they can about the horse, speed of the track, weight, weather conditions, etc. and then make a bet on who he or she thinks will win, place or show. In business, of course, the more responsible players have to reduce the gambling aspect and lower the risk of being wrong. This is particularly true of overseas decisions. When dealing with parties or transaction overseas there are some key issues to bear in mind.

International dealings

International business is not new; the ancient Egyptians, Chinese, Romans and others were all active importers and exporters. Travel and communications may have developed and legal frameworks may have evolved, but many of the pitfalls awaiting the unwary global trader have changed very little. Air travel and the Internet may have shrunk the world, but it should never be forgotten that abroad is still different both in legal and cultural practice. Indeed, even when one is dealing with different member states of the EU or states of India, provinces of China or states of the USA differing considerations may apply. For example, executing a major project in California may have considerably greater legal and regulatory risk than if the same work was to be carried out in Massachusetts or Alabama in the USA.

All of the above examples demonstrate that where major business opportunities arise in a new and unfamiliar territory, due diligence is required and time should be taken to secure appropriate local advice both from professional advisers and from other businesses with local involvement. Most importantly every assumption underlying a bid or negotiating position should be tested. In view of the increasing activity in international business by organisations of all sizes, it is useful to consider some points or issues that may seem obvious but in fact often are not observed sufficiently as part of the risk management process.

Practical steps that can appear to be just common sense can in fact be very effective. For example:

- Foreign negotiators may claim that certain requirements they seek to impose are a requirement of local law. This should never be accepted without taking local advice, from professionals and local consulate or Embassy personnel.
- Where contracts are to be executed in duplicate copies in English and the local language, it is desirable that English be given precedence or at least equal status.
- The efficiency and impartiality of local courts and other dispute resolution bodies should be investigated, bearing in mind that even where judicial proceedings or arbitration in a third country is provided for, it will usually still be necessary to seek the enforcement of a judgement or award in the other party's country (see also **Chapter 5**).

- Any suggestion that while local laws or contractual provisions may contain onerous requirements, these are not enforced in practice, should be checked. This may well be quite true in relation to local businesses, but it is probable that the position will be different where a foreign company becomes involved.

In many cases it will be better to adopt practical mechanisms to protect vital interests such as:

- Where local protection of intellectual property rights (IPRs) is uncertain, it may be possible to retain confidential items such as source codes, and reserve the right to produce and supply crucial components or ingredients.
- Payment structures should be adopted that reduce exposure to default, even where documentary credits and export guarantee protection have been obtained.
- Insurance programmes should be considered for their applicability even where contractual provisions require local insurance to be obtained.

Use of English language

It may be thought that, with the use of English as the global business language, the process of reaching agreement has become simplified. It should not be assumed, however, that because senior management in the foreign organisation is reasonably fluent, this will also be the case at all operational levels. There can be unexpected difficulties with technical and legal terms with which even interpreters can have problems. Where all discussions have to go through interpreters the difficulties are multiplied. A good interpreter does not just turn words from one language to another, but is competent should translate ideas and concepts accurately. This requires that the interpreter should have personal business experience, or at least should have received a thorough briefing about the background to and key issues of the negotiations.

It is vital to appreciate that telephone calls, emails, video conferencing and the like have not replaced the need to meet face to face with a potential business partner to gain confidence in the latter's trustworthiness and ability. However thoroughly the target country may have been researched, there is also no substitute for personal experience of local conditions. It is important not to rush this process, particularly in more distant or unfamiliar locations. Indeed very practical hints and tips should be observed as part of corporate policy when considering overseas activities. It has been observed in many cases that just as with long distance driving tiredness can kill! Negotiations can fail and the other party can take unnecessary advantage. Proper time management and planning are essential to avoid costly and possibly long-lasting repercussions. This applies to travel schedules. It is even more unwise to set a tight and unchangeable departure deadline known to your negotiating partner.

For example, in one project it became well known to the Indian client that the UK bidder's visiting personnel were extremely keen to be on the pre-booked flight home by Friday afternoon. Unsurprisingly, key issues were tabled by the client on Friday morning, with Minutes of Agreement presented for signature just after lunch – when the visitors would be very anxious to get to the airport and would be ready to sign just about anything. Many later difficulties had their origins in such events.

Meeting schedules and local infrastructure
Other local issues reflect the injunction referred to earlier to leave no assumption untested. Project implementation may be dependent on port facilities, access routes, communication links or local services. Meetings in a capital or other major city may give a misleading impression of the facilities available at other locations in the country that may be relevant. Climatic conditions may vary widely with the seasons, and in many key places, such as India, power shortages may cause difficulties during the summer months.

Security advice should be obtained either from specialist advisers or the local Embassy especially where personnel are to be deployed in less-developed territories. In one memorable contract there was a provision allowing the contractor to call out the nearest army unit in the event of local difficulties. While this may have been the most practical measure in the circumstances, it did little for recruitment to the project. Similarly, while it is perfectly possible to obtain 'kidnap' insurance to provide for employer and employees in the event of abduction, even the best cover cannot fully compensate for the trauma to an employee or his family in such an event. In these circumstances, local personnel should be employed wherever possible, not because they are more 'expendable' but because they should be more familiar with the local environment and will not be as attractive targets as expatriates.

Apart from what might be termed the 'micro risks' that can arise during the negotiation and execution of projects, consideration should be given to the 'macro risks' attaching to the foreign territory as a whole. In this regard, an assessment should be made of the political and economic circumstances in the territory under consideration. Some key questions are:

- How stable and developed is the system of government?
- Are fundamental regulations capable of being changed by decree?
- Are there serious internal or external security risks?
- Are there United Nations or other sanctions in force, or likely to be applied?
- Where technology or components are wholly or partly of US origin, for instance, is there any need for clearance under the US Export Administration Regulations?

Political risks

Political instability often gives rise to adverse economic conditions, particularly where corruption has flourished under an authoritarian régime. For example, it was widely recognised in the early 1990s that Indonesia faced potential difficulties when the time came for the ageing President Suharto to leave office. However, at that time it was envisaged that Suharto (in power since 1965) would attempt to engineer a smooth transfer of power to a family member or other trusted associate. Corruption was endemic, with local banks acting as conduits for doubtful monies and providing loans on political rather than financial grounds. When the end came at the time of the Asian economic crisis in 1997, Suharto's fall was accompanied by mass insolvency and a currency collapse, as the Indonesian Rupaiah lost almost 90% of its value against Western currencies overnight. It can well be imagined what devastation these events caused to Western contractors and investors. Supplies of imported components and labour became impossibly expensive while local customers and partners could no longer make payments in hard currency.

Therefore, when operating internationally it is important to take time to fully examine the proposed area of operations, assessing its legal structure and business infrastructure, together with its political and economic prospects. Never miss an opportunity to discuss local conditions with other organisations already operating there. Experience is often the best teacher, better still if the experiences are those of others! Due diligence methods can also monitor situations that can be a level of risk. For instance and by way of analogy, airlines know that bad weather can be a risk to any aeroplane. Consequently, it is essential for all aviation personnel be provided with all data about weather between where they are and where they are going. In this way the risk of being hit by lightning, or worse, can be reduced to a manageable procedure. Airline pilots quite frequently request permission from ground controllers to change their altitude to avoid endangering the plane, passengers and people on the ground. The pilots and ground controllers are trained to be diligent about the risk that can lie ahead. In this example, the passengers are merely freight and along for the ride. Further discussion of exposure to such types of risks and their management is found in **Chapter 5**.

Transactional and operational assessments 1.43

Transaction auditing is a well-known component of the auditor's world. In this activity, the auditor, internal or external selects some number of transactions to determine their accuracy with the company's entire processing cycle. For due diligence, it is also essential to be able to identify specific operational transactions – financial or business. For example, if a patent application requires a series of steps then it is essential that each step be documented so that the work can be proven as being completed.

Operational assessments refer to how the company conducts its business. Planning or zoning requirements vary by country and region. International transportation of goods and services has different regulations and requirements than national business activities. The due diligence team is required to be able to access all that encompasses the business – before, during and after a specific business transaction.

Transactional issues **1.44**

Globalisation is also a potential mine field filled with places that require guidance and careful management. In some respects the due diligence exercise starts with the knowledge of the company's desire to do business within another country. The due diligence team takes over to establish the legal, financial and government regulations that need to be understood. Then procedures can be implemented to make sure that company actions fall within the required guidelines. In this case, it is an absolute requirement to perform due diligence prior to commencing any business activity. It would certainly be expensive, in terms of both time and money, to perform due diligence after the fact and reference should be made to the comments in the chapters that cover the international dimension of due diligence and corporate governance, particularly **Chapters 11–15**.

Reference

1. Angwin, R. and Wensley, R. The acquisition challenge, *Realising the Potential of Your Purchase*. Warwick Business School Paper, Vol. 1, No. 4, 1997. *(See para 1.32 p. 31)*

Appendix

Item 1

Overview of main issues for a due diligence exercise

Submitted by Kaden Borriss, Corporate Lawyers, Delhi

> 'Almost half of all acquisitions fail or do not achieve expectations. Improved advanced planning, target evaluation and due diligence can improve chances.'

The underlying purpose of due diligence is to observe, analyse and examine all the key areas and, as well as the minute details involved in any business, the company, immovable property, etc. that is under consideration. In the present summary we have classified the requirements of due diligence under three headings.

1. Acquisitions: the act of contracting or assuming/acquiring possession of something; 'the acquisition of wealth'; 'the acquisition of one company by another'.
2. Joint ventures: a partnership or conglomerate, formed often to share risk or expertise.
3. Purchase of immovable property, for example land and building, etc.

After the initial stages of buying a business/immovable property or entering a joint venture are complied with, such as that of search of a seller and interaction with the prospective seller to formulate a strategy and conclusion of a transaction, then follows the stage of due diligence. This is the last stage in the buying process. This is the time when the buyer will have access to all of the company's/owner's books, records and files. The buyer will have a predetermined due diligence period in which to investigate the information that it has been given so far to ensure that it is true and accurate. Due diligence is the way to discover everything before the actual purchase that the seller knows. Once the deal is closed there is little or nothing that can be done about it.

The basic requirements for acquisition of a business/joint venture are listed below.

1. Corporate books and records:
   - original certificate of incorporation of the company and all amendments thereto;
   - memorandum and articles;
   - closing record books for any material corporate transactions (e.g. reorganisation into holding company structure, joint ventures, etc.);
   - other relevant legal documents governing the organisation and management of the company;
   - minutes of annual general meetings and other board meetings;
   - shareholder list and other stock records, any shareholder agreements or any agreements relating to shareholders;
   - annual reports and other quarterly and special interim reports since most recent annual report.
2. Financial information:
   - consolidated financial statements, monthly income statements for most recent 12 months, internal financial (profit and loss, capital expenditures, etc.) projections and all supporting information, most recent business plan, list of any off-balance sheet liabilities not appearing in most recent financial statements, auditors' reports ('management letters'), management responses and summary of accounting policies to the extent not disclosed in financial statements;
   - tax materials and documents and records;
   - debt obligations.
3. Employee materials:
   - employment agreements (including, but not limited to, contracts with management personnel or entities affiliated with management personnel) and all other agreements with employees in any regard;

- ○ any labour disputes either pending or disposed of;
- ○ organisational information including detailed organisation chart, list of all directors and officers, biographies of senior management and any outside directors, schedule showing number of employees for each year and interim periods, and list and description of current operations of each key business unit.

4. Contingent liabilities:
   - ○ litigation:
     - list of all pending, disposed of or threatened litigation, appeals, arbitration, administrative or other proceedings involving the company, any subsidiary or any joint venture involving the company or any subsidiary, or any officer or director (including parties, remedies sought and nature of action);
     - list and description of all pending, threatened government or other investigations involving the company, any subsidiary or any officer or director;
     - pleadings and other material documents in material litigation, arbitration and investigations and other proceedings;
     - decrees, judgments, etc. under which there are continuing or contingent obligations;
     - letters from lawyers to auditors concerning litigation and other legal proceedings;
   - ○ regulatory compliance;
     - description of any violations of governmental laws or regulations;
     - material reports to governmental agencies;
     - reports, notices or other correspondence concerning any known or alleged violation of central or state laws and regulations;
     - agreements or commitments with governmental entities or other persons relating to clean up obligations or other environmental liabilities;
     - copies of correspondence between central or state government agencies and the company;
     - list of all governmental filings and consents required for a purchase of the stock of the company.
5. Contracts, agreements and other arrangements.
6. Intellectual property rights owned by the company, complete information and documentation.
7. Plant, real property and equipment.
8. Insurance information and documentation and up-to-date records.
9. Sales/marketing policies/strategies/records.

The basic requirements for acquisition of an immovable property are listed below:

- Files and other records with respect to the immovable property in possession of the land owner.
- Files and other records with respect to the immovable property in possession of the revenue authorities.
- Files, records and other documents with the Register of Companies.

- Contingent liabilities:
  - litigation:
    - list of all pending, disposed of or threatened litigation, appeals, arbitration, administrative or other proceedings involving the owner of the immovable property;
    - list and description of all pending or threatened government or other investigations involving the owner of the immovable property;
    - pleadings and other material documents in material litigation, arbitration and investigations and other proceedings;
    - decrees, judgments, etc. under which there are continuing or contingent obligations;
    - letters from lawyers to the owner or any other legal proceedings;
  - regulatory compliance:
    - description of any violations of governmental laws or regulations;
    - material reports to governmental agencies;
    - reports, notices or other correspondence concerning any known or alleged violation of central or state laws and regulations;
    - agreements or commitments with governmental entities or other persons relating to clean up obligations or other environmental liabilities;
    - copies of correspondence between central or state government agencies and the owner.
    - contracts, agreements, sale deeds, lease deeds, rent agreements and any other arrangements pertaining to the said immovable property.

Item 2

Initial steps in transactional due diligence in the UK

The initial steps taken in transactional due diligence in the UK are:

(a) Outline of general action.

(b) Typically a number of preliminary steps before the negotiations commence in earnest, in an asset transfer transaction such as a share purchase, asset purchase or joint venture, these include:
  - The seller takes a strategic decision to sell the company or business or to enter into a joint venture. This may have been instigated by the seller or initiated by an approach from a merchant bank or purchaser or potential joint venture partner.
  - The buyer takes a strategic decision to buy the company or business or to enter the joint venture. Again, this may have been instigated by the seller or initiated by an approach from a merchant bank or purchaser or potential joint venture partner.

(c) In larger transactions, the seller may undertake its own due diligence, particularly where a controlled bid is being employed.

(d) Discussion takes place between the buyer and seller and an agreement in principle is reached.

(e) Lawyers, accountants and other advisers are instructed.
(f) The first meeting between the seller or buyer and its advisers.
(g) The first meeting between the seller or buyer and its advisers is worthy of specific mention as it encompasses an overview of the issues affecting the transaction as a whole. These will include the following.

Overview of transactional issues

Issue	**Explanation**
Identity and residence of the buyer	Identity is important from the consideration of the strength of the covenant of the party. Residence is relevant from the point of view of enforceability of any agreements and the possibility of tax sheltering any profits arising from the transaction.
What are the key assets the buyer wishes to obtain in making the purchase?	Some typical key assets are: ● management or technical expertise; ● personnel; ● client or customer base; ● suppliers; ● brand name(s); ● technology, including intellectual property such as know-how; ● production capacity; ● distribution network; ● land and buildings; ● regulatory approvals and licences.
Security	Where the agreements are likely to provide for obligations which continue after closing, then the covenant of the obligated party may require to be backed up or reinforced by some form of guarantee or other security.
Consideration	Some input from the lawyers on general valuation considerations may be appreciated at the initial meeting.
Timescale	It will be helpful if the lawyers have an influence on determining a realistic timetable for the deal.
International aspects	International aspects of the transaction will need to be addressed at an early stage and the question of engaging foreign professional advisers should be tabled.
The structure of the transaction	● parties to the transaction; ● asset or share purchase? ● key assets being acquired? ● valuation considerations; ● assets hive down prior to sale of shares? ● key liabilities to be minimised; ● tax considerations; ● general approach regarding indemnities; ● security appropriate for indemnities? ● restrictive covenants? ● staggered closing appropriate?

(*Continued*)

Issue	Explanation
Funding	How is the transaction being funded? Consider the issues arising from this.
Stock exchange requirements	Are any of the parties governed by stock exchange rules? If so, what will this mean?
Other regulatory issues	Are there any other regulatory issues affecting the transaction or the parties individually, for example competition law, foreign exchange requirements?
Consents and conditions	Are there other consents and conditions to be obtained or satisfied, for example shareholder approval, key customers or suppliers?
Confidentiality	Are confidentiality agreements or undertakings in place: • from the buyer; • from the buyer's shareholders; • from the buyer's employees? Is there any confidential information, such as the customer list or secret processes, that the seller wishes to restrict?
Insurance	Will existing insurance arrangements pass?
Lock-out	Is an exclusivity arrangement negotiable for a period of, say, six months?
Heads of agreement	Any entered into? If so, consider the terms. If none, should they be prepared?
Funding comfort letter	Sometimes, whether or not a merchant bank is involved in the transaction, the buyer will be required to supply to the seller a letter confirming it has access to sufficient funds to enable it to close the transaction and, expressly or by implication, satisfy the purchase consideration.
Due diligence overall issues	Discuss the overall strategy. Consider due diligence checklist with buyer and its professional advisers.
Instruction of advisers	It is to the benefit of client and professional adviser to record appointments in connection with specific transactions in letters of engagement, to reduce the possibility of any subsequent disagreement or dispute.
Rules of engagement between buyer and seller	The parties will wish to set out guidelines for carrying out the due diligence exercise and these are normally set out in rules of engagement either in heads of agreement between the parties or a separate letter.
Data room letter	If a data room is to be used, then rules of engagement may be set out in a data room letter.
Other pre-closing documents	Refer to the list of transaction documents.
Civil sanctions for non-disclosure	The seller and target personnel should be reminded that misrepresentations, whether innocent or otherwise, can have serious civil repercussions.

Issues to be considered

Issue	Explanation
Specialised industry sectors issues	Such as the Chemical Sector, Food Sector or Automobile Sector regulations, etc.
Employment matters	• application of transfer of employment regulations; • new terms of employment; • restrictive covenants; • pension provisions.
Insurances	In major transactions it is not uncommon to employ insurance experts to assess risk and risk cover and review insurances generally.
Intellectual property and IT transfers	In the case of a business acquisition, intellectual property assets such as copyrights, registered designs, trademarks and patents will require to be transferred by the seller to the buyer under simple forms of assignment. In the case of share acquisitions, a review of the title to the assets will be required.
Real property transfers	In the case of a transfer of a business any real property assets will be transferred from the seller to the buyer under normal conveyancing procedures. In the case of leasehold property the landlord's licence or consent to the assignment of the lease will normally be required. In the case of share acquisitions, a review of the title to the assets will be required.
Position between exchange and closing	• consents; • closing accounts; • searches; • documents to be agreed; • all charges released.

Basic differences between a share acquisition and an asset purchase

Share acquisition	Asset purchase
Involves sale of share capital in the target by its shareholders to the buyer	Involves the target itself selling assets to the buyer.
Liabilities of the target continue to affect target after sale, unless agreed otherwise	More limited liabilities and commitments pass with the transfer of the target assets.
The target's rights are not affected after sale, unless there are 'change of control' provisions in effect	Tide to the assets and rights have to be transferred by the target to the buyer. Where those rights involve a contract with a third party, their consent may be required to the assignment or the agreement novated with them being a party, unless there is no burden attaching to the right and consent is not required by the agreement.

The due diligence exercise for a share acquisition is therefore complicated by a greater concern of the buyer to identify the liabilities attaching to the target. The potential for unknown liabilities raises a level of uncertainty less present in asset purchases, making asset purchases generally more desirable. However, asset purchases are often impracticable in larger businesses because of the volume of assets and rights which require assignment and novation. This problem of assigning rights has been overcome by certain legislation in England which allows the rights and liabilities of businesses to be transferred by operation of law and without the need to obtain the individual party's consent. Such legislation applies for instance to asset transfers by building societies and insurance companies.

Item 3

Specimen auction or tender process letter

This process could alternatively be contained in an agreement or in the information memorandum itself.

Dear Mr [ ]

SALE OF [name business] ('target')

We attach an information memorandum relating to the above company. This information memorandum has been of will be sent to qualified interested parties, all of whom are bound by similar confidentiality agreements in order to assist them in deciding whether they wish to enter into negotiations to acquire the whole of the issued share capital of the target or part thereof, some or all of the target's assets or a combination of the above.

This information memorandum is provided to you in commercial confidence and on the terms of the confidentiality agreement dated [ ].

Would you please forward to us your proposal in writing for the acquisition of target to our offices by [ ] on [ ], covering the following:

- The purchase price in [state currency] or formula for determining the same, that you are prepared to offer for 100% of the issued shares of target, subject to contract. This would be on the basis that [target's bank and inter-company borrowings have been discharged].
- Your intentions regarding any reorganisation or redundancies of target personnel.
- Confirmation that your bid is made as principal on your own account.
- Details of your financing arrangements for the transaction and a letter from your financial adviser or bank that you have the necessary finance.
- Any specific due diligence issues that you wish to address.
- Details of any regulatory or other consents required (including internal approvals), and the timing therefore.
- An estimate of your share of the [ ] market in [state territory]. Details of any competition clearances or notifications required. If none, a statement as to the reason why none are required.

- Confirmation that there are no other conditions attached to your bid.
- A statement of your ultimate ownership, together with copies of your annual reports for (two or three years).
- We do not envisage providing more information prior to indicative bids being submitted. However, if you do have queries they should be raised directly with [name] who can be contacted by telephone on [#] or email on [#]. (Where contact point is at target – if [he/she] is not immediately available you should leave your name, the company you represent and your number so that [he/she] can return the call. Under no circumstances should you try to discuss this sale or leave more substantive messages with any other member of staff at the target.

Process

Following receipt of indicative offers, the vendor intends to select a small number of bidders to proceed to the final stage of the process, involving:

- A meeting with the target management and a visit to the target's premises.
- Access to a data room maintained at [state location].
- Copies of due diligence reports prepared by the vendor's advisers (these will be arranged through us).
- A draft of the sale documentation will be distributed and bidders will be asked to submit their final offer for the target together with a copy of the documentation with any suggested amendments. Such offers will be binding on the bidders.
- Following receipt of such offers, the vendor will select a bidder with a view to finalising the transaction.

The vendor shall be under no obligation to accept the highest bid offered or any bid at all. The vendor reserves the right at any time and without notice or and without assigning any reason therefore to vary or discontinue the sale process or to sell the target to any person.

Yours sincerely,

[ ]

For and on behalf of [ ].

2

Due diligence in corporate finance

2 Due diligence in corporate finance

CHAPTER OVERVIEW

2.1

The expression ‘corporate finance’ generally refers to the mechanisms and processes by which businesses raise capital or enhance capital values for operations and growth. Capital can be raised in a variety of ways, such as by the issue of shares or debentures, or the provision of loans or banking facilities. Capital values can also be enhanced or protected when businesses are merged, acquired or restructured. The mechanisms and processes can either be private or public in nature, depending on the objectives of the corporate finance exercise.

The mechanism or processes by which corporate finance is provided, or the corporate finance transaction executed, as well as the nature of the transaction contemplated, will determine the level or type of due diligence required or available.

For example, the level of due diligence required for a secured borrowing facility will be significantly less than that required for an equity investment. The lender will simply be looking to ensure:

(a) the loan will be repaid together with interest over the term and that there is sufficient net cash flow cover to ensure repayment; and
(b) the value of the security is sufficient to cover the loan to the value given.

A highly liquid publicly traded stock will have a higher loan to value than an illiquid stock and certain types of real estate, such as development or commercial properties, will have lower loan to values than residential properties. On the other hand, an equity investor, such as a venture capitalist, will be concerned to ensure that the profitability and positioning of the business over the given investment time horizon will be sufficient:

(a) to yield the required internal rate of return on the investment; and
(b) for that return to be crystallised by an exit event, such as initial public offering of flotation, or a trade sale.

The focus will therefore be more on the ability of the management to deliver the returns based on the forecasts or projections for the business.

In some cases, the degree of due diligence available or required will be limited or restricted by the nature of the business or transaction contemplated. The offering circular or document of a publicly traded company which is subject to ongoing disclosure requirements to its shareholders, governing regulator or exchange will differ from that for a private company where there has been no such public disclosure. The due diligence available on a recommended bid for a company will also differ dramatically from that for a hostile bid, where the offeror company simply is not given access to the relevant internal financial and management information, and therefore has to subject the bid to a number of conditions, which it will have power to amend or vary subject to what is discovered or obtained by way of due diligence in the bid process.

In each corporate finance situation, however varying or differing, invariably the same fundamental issues are being addressed:

* What is the investment return available or the level of finance affordable by the business? and
* What risks are there which would result in the expected return not being achieved or the financing not being repaid?

The due diligence process will define the return or pricing of the investment or financing, the amount of the investment or financing to be made available and the structure of the investment or financing.

Invariably too, the due diligence process is forcing an alignment of interests, of risk and reward, as well as expectation. There are competing interests. What a business or company may perceive as a fair return for an investment may differ substantially from what the investor or financier may require. Alignment of interests will not just address the issue of price, but also management commitment, focus and vision, and the ability to deliver the return based on the expectation created. There is also the issue of evaluating external factors, which will affect the return and reward, factors that are either systematic, such as interest rates, inflation and political events that are common to the business and industry as whole, or events that are specific to the business or industry itself and which can be compared to similar businesses. Risk can thus be defined and isolated and then appraised relative to the expected return – a process generally known as risk adjusted return.

The weight given to the critical financial analysis tools used by lenders and equity investors alike will vary. A lender will be evaluating financial risk ratios such as interest coverage and interest coverage adjusted for cash flow and debt to equity ratios, whereas an equity investor will be more concerned with profitability ratios looking at return on capital and return on equity. Both will be concerned, however, with historical business information such as matters affecting the essential ability of the business to pay its debts as they fall due and to turn its inventory or assets over in a sufficient period of days to create cash flow and remain solvent and profitable.

Of course emphasis on all or any of the financial ratios will vary from business to business. They also become subject to fashion trends. For example, many of these core financial ratios were dispensed with during the technology boom of the late 1990s when forecasts and projections were solely used as determinants of value and investment. And between 2003 and 2007, with the advent of large leveraged buy-out deals, the need to be nimble in capital raising and high liquidity levels, borrowers demanded a loosening of lending covenants and ratio tests, with the result of the popular 'cov-lite' lending deals. Inevitably, in mid-2007, this approach fell out of favour as lenders found themselves with inadequate security in a market downturn, caused by the collapse of the sub-prime market and plummeting liquidity levels.

Often, for a corporate finance transaction there will be a mixture of equity or debt or variations of these, and this will give rise to an appropriate review as to what the mixture should be and how it should be priced. The weighted average cost of capital calculation would be a familiar calculation used to determine the correct balance of each and the risks arising.

In coming to a conclusion as whether or not to invest or finance or to undertake the transaction and in evaluating the business or transaction as a whole, various factors will need to be considered. The critical due diligence process would be the assessment of these factors and undertaken by a team of professionals of varying disciplines to examine and investigate different aspects of the business or transaction.

The due diligence process undertaken will vary considerably from one business or transaction to another, and the initial requests for information or the basis of investigation and research will have to be tailored to the business or transaction concerned. Whilst there are broad categories of information that are normally reviewed and requested, it would be a serious misconception to think that one size fits all. The due diligence process will be an important part of the evaluation and structuring process and decisive of the ultimate success or failure of the investment or financing proposed for the business or transaction.

Depending on the business or transaction being proposed or considered, from a high level approach, the due diligence process will then reach down to a more detailed and distilled consideration of the various issues affecting the value of the business – often after combing through a myriad of legal, technical and commercial matters. These considerations will then form the basis of a report or reports on which ultimate investing or credit decisions are taken.

A caveat, therefore, has to be made that, in discussing due diligence in corporate finance, it is very much an introduction and specialised professional advice will often be sought on various matters to be reviewed and analysed. This chapter therefore looks at some typical due diligence topics arising in corporate finance. It is certainly not intended to be a comprehensive checklist, rather a list of examples of due diligence exercises that might be undertaken and the type of issues addressed.

Due diligence process 2.2

The due diligence team would consist of various professional advisers: normally legal, financial, technical, environmental, insurance and actuarial experts working in tandem with each other. These advisers should be brought on board as soon as practicable to give them sufficient time to cover comprehensively the issues involved. The due diligence process is often driven by the lending institution or investment bank who will co-ordinate the due diligence team.

The team that undertakes the due diligence exercise needs to be given clear instructions as to the objective of the exercise and its parameters. Understanding what the business or transaction entails, and what the exercise is intended to achieve will help the team to streamline the exercise, focus on the relevant issues and make it more time and cost efficient. If a company plans to acquire a target with the intention of developing and selling properties, starting or developing, for example, a hotel with a casino, it has to convey these ideas and strategies to the due diligence team. Whether these strategies are realisable and what complexities they entail are the answers that the investing company would wish to find out from the due diligence exercise. For example, before embarking on a proposed transaction involving the purchase, by loan financing, of a hotel operation in India, a first tenet would be to determine whether or not profits could be remitted from India to repay the loan and whether the lender could perfect security in India over the assets being acquired. It is often very surprising how advanced transactions may proceed before critical corporate finance issues are discovered. High level information overviews are therefore advisable from a very early stage.

To highlight this point, an overview list of requested information with respect to the purchase of a regulated financial services business is set out in the Appendix to this chapter. At the core of this acquisition would be the regulated status of the business and its compliance with regulatory provisions. From the information disclosed, the basis on which the transaction is financed and structured, documented and completed can then be negotiated and finalised.

The responses given to the detailed questionnaire would normally be expected to form part of ‘disclosures’ to warranties and representations to be made by or in respect of the business or transaction. Once disclosures are made, for instance, as regards pending litigation, breaches of overdraft facilities or arrangements with creditors, the liabilities would be quantified, the price adjusted or the purchase price deferred and the disclosures warranted as being complete and accurate in themselves, so that the extent of the liability is correctly provided for.

An important part of the inception of the due diligence process is the exchange of confidential undertakings. These structure the environment in which often price-sensitive and valuable information relating to the business or transaction is passed by the business to lenders or investors securely without risk of leakage into the public domain and thereby potentially damaging the value and reputation of the business. Generally, the confidentiality undertakings will expressly refer to what is to be disclosed and how it is to be identified as confidential, usually by reference to the initial or subsequent due diligence lists or questionnaires, to whom it may be disclosed, for what purpose and how it is to be returned or dealt with if the transaction does not proceed.

The undertakings may also extend to non-compete clauses and lock-up periods during which the negotiating parties agree to deal exclusively with each other for a certain time period with respect to the business or transaction concerned. This enhances confidence among the parties and creates a safe environment in which disclosure can take place. Creating the right environment is paramount as no less than full disclosure will determine the right analysis of the appropriate risk and reward. The due diligence team and its advisers will normally be ring-fenced, and each participant required to give its undertaking to be bound by the rules of confidentiality on which engagement takes place.

Important issues to be borne in mind are:

- who is keeping the master disclosures lists;
- who is co-ordinating disclosures;
- who is responsible for evaluating and analysing the disclosures given in the context of the transaction as whole.

In a typical transaction, one would expect to see a combination of reports being assembled for review from the due diligence team. For example, financial reports including reviews of management accounts and forecasts, asset valuations, working capital and historical annual accounts, a legal report on regulatory and compliance issues and title to assets and the business, tax reports on the tax implications for the parties, actuarial reports on pension funds, environmental reports, and other specific valuations and project implementation reports – depending on the business or transaction and the nature of the corporate finance activity.

Anti-money laundering due diligence 2.3

A chapter on corporate finance due diligence would not be correctly balanced without discussion of anti-money laundering and terrorist financing due diligence. This is dealt with as a subject in much greater detail in the chapter on anti-money laundering due diligence (**Chapter 3**).

Money laundering is now an essential prerequisite and integral part of the due diligence exercise for any corporate finance transaction in light of the now very extensive, stringent and punitive money laundering regulations that have been adopted by most countries. The scope of the regulations can be very wide. In the UK, for example, *Money Laundering Regulations 2003* (*SI 2003/3075*)[1] now cover any transfer, conversion, removal, concealment or disguise of funds which constitute the proceeds of crime. Terrorist Financing legislation prohibits engaging in financial dealings for the purpose of terrorism. This means that in looking at a business or transaction as a whole, it will need to be borne in mind that questionable accounting practices or possible tax evasion discovered as part of the due diligence exercise, and which is or could be a criminal offence, may then lead to independent money laundering disclosures obligations for the due diligence team. It also means (as a result of recent combatting terrorist financing legislation) looking more closely at what one might otherwise consider to be low risk transactions on the basis that funds are moving from a 'clean' source.

First steps in any corporate finance transaction would be undertaking appropriate due diligence on the business owners or management, or ensuring that the proposed funds to be invested or lent to the business as part of the corporate finance transaction are clean. The exercise would then extend to evaluating the proper sources of funds coming into and out of a business operation. Where businesses have significant cash revenues, or operate on a cash-based system, this could give rise to a significant number of problems and potential disclosures. Moreover, the professional members of the due diligence team will usually have independent disclosure obligations and may be required to make disclosures to the regulatory authorities without reference to the client or other members of the due diligence team if they have concerns or suspicions. It could be a money laundering offence if an adviser who is regulated fails to detect money laundering when they should have detected or suspected it.

The terms of any due diligence engagement should be very clear on this issue and certainly disclosure will be an exception carved out of any confidentiality agreements.

Financial due diligence 2.4

Financial investigations would typically be carried out with the help of a firm of accountants or an investment bank. The due diligence intends to verify whether all books of accounts and other financial records are up to date and have been accurately maintained. It also seeks to search out the current trading position and prospects of the business, which are not evident from

[1] Augmented by the Third Money Laundering Directive implemented on 15th December, 2007.

the historical or filed accounts. The fact that the books are audited provides some comfort, but usually this information will be significantly out of date. Businesses are dynamic and every day something may change that will affect the overall financial position of the company prior to conclusion of the transaction. For example, on a lending transaction, a lender will frequently require extensive drawdown (drawing of loan at agreed intervals) conditions under which very up-to-date information is provided on the company's affairs prior to drawdown, for example up-to-date debtors and creditors lists, cash balances and reassurance that no material changes or events have taken place.

There is much that can be gleaned from disclosed financial information and the accompanying financial ratios. However, there is still much that can lurk behind the figures, irrespective of the interpretation of the entries and calculations of financial ratios. The information identified from detailed investigation will be highly relevant in the ongoing negotiations for the cost of finance and its structure. At a minimum, accounts should be audited as required by best accounting practices, and should be in conformity with the local law. An important part of historical analysis is to look at any disclaimers or qualifications on the audit reports, or a frequent change of auditors. Equally, at a minimum, management accounts should adopt accounting policies and practices that are consistent with the audited accounts. A more vital review is that the accounting systems used to record information are robust, postings are accurate and properly posted, and the basis on which postings are made are consistent and reliable.

Revenues need to be carefully reviewed. Contracts can be entered into and invoices raised even though there may be no underlying delivery or agreement as to delivery. There also needs to be a careful review that the true costs of revenues are shown – and not hidden so as to inflate earnings and profitability.

Capital commitments have to be carefully considered for onerous or unusual payment provisions, for example, advance payments that do not necessarily oblige delivery or performance. Financial projections based on the projection of capital expenditures and sources of capital for the payment of such expenditure have to be matched against the reality of true cost, delivery and implementation. A capital financing proposed may merely be used to prop up working capital requirements and be insufficient to fund the capital needs of the business on which future growth hinges. Often management understate the true working capital needs in order to enhance earnings and returns.

The inventory and the work in progress should be valued without including profit, but taking into account anticipated losses. It is important to examine the inventory physically to ensure that the stock and the raw materials are not obsolete or redundant, and the value is accurately reflected in the books. On-site stock checks on the closing of a transaction would not be uncommon.

Contingent, disputed and other liabilities, including claims under contracts, should be specifically reviewed, as well as any default or cross-defaults occurring under existing borrowing facilities as a result of the financing, and the consequences of those defaults considered in detail.

There should be a clear analysis of those accounting arrangements which are by definition subjective, for instance, provision for bad or doubtful debts, treatment of capital or revenue leases, off-balance sheet risks and liabilities, the use of favourable inventory methodology, treatment of capital expenses and recurrent expenses. For example, one of the key frauds leading to the collapse of the US telecommunications group Worldcom in 2002 was the capitalisation of costs that were clearly recurrent leading to a massive overstatement of earnings.

In the USA, it is also worth noting that the *Sarbanes-Oxley Act of 2002* (*SOX*) was enacted in the aftermath of the US corporate accounting scandals, necessitating revision of corporate governance standards and increasing the disclosures requirement to protect the interest of the investors. The statute establishes an oversight board to oversee the audit of the public companies, which are subject to the securities laws. *Sections 302* and *906* require the Chief Executive Officer (CEO) and Chief Finance Officer (CFO) to certify that the information contained in the periodic report required to be filed with the US Securities and Exchange Commission (SEC) fairly represents, in all material respects, the financial conditions of the company and the adequacy of the internal controls. Any false certification will attract criminal liability. For further details on the SOX see **Chapter 11**.

Oversight of critical financial issues in the due diligence exercise could result in a company investing in the USA, having a huge task of organising the target company's books post-transaction to be able to make accurate quarterly and annual reports to the SEC.

Tax 2.5

Tax implications will vary depending on the country in which the business operates as well as the country of the lender or investor. Tax is a very important part of the due diligence process, and the tax consequences of a transaction or investment could have significant pricing implications, for example, the withdrawal of reliefs or crystallisation of charges previously held and the understatement or overstatement of deferred tax charges and tax assets as shown in the books of accounts. Historic tax computations will need to be reviewed and the impact of the transaction considered. This will often lead to the manner in which the transaction is structured in order to maximise tax efficiencies, for example, whether as a share acquisition or asset purchase or a financing by way of debt or equity, deferred consideration or instalments.

The tax review would extend to the whole gambit of applicable taxes, for instance, income or capital gains taxes, estate or inheritance taxes, Valued-added tax or sales or service tax and customs and excise duties and charges. In each case, an analysis would be necessary of the likely impact. For example, loans may attract withholding taxes on interest payable, asset purchases may attract a value-added tax and an overseas equity investment may attract a punitive exit charge as a result of foreign exchange controls. As part of any documentation following such review, it would be usual to see tax warranties and representations dealing with the issues of concern as well as full tax indemnities being given in respect of any liabilities or contingent liabilities likely to arise. For instance, the sale of shares may or may not attract capital gains tax. However, in case of the acquisition of a company by a purchase of shares, capital gains tax may be attracted when the underlying asset is then sold. Stamp duty or transaction duty on acquisitions by the purchase of assets can in some countries be as high as 8 times the stamp duty on the purchase of shares. Value-added tax (VAT) is generally not payable on the sale of shares.

Special consideration should also be given to anti-avoidance laws which change constantly. Structures which may already be in place, therefore, may attract significant liability going forward. The linkage with anti-money laundering legislation also needs to be noted in this context. In most countries or jurisdictions, tax evasion is a criminal offence and therefore the flow of funds in and out of a business which is violating tax laws will or may also trigger equally punitive money laundering consequences.

Explicit tax benefits may flow from the transaction for both parties. For instance, in some instances reliefs and tax deductions may be available on exiting the investment or financing. On other occasions, tax may be payable at a reduced rate as a result of group relief or applicable international treaty provisions.

Commercial due diligence 2.6

The focus of this aspect of due diligence is on the true business potential and impact of the transaction. The investor will concern itself with the market conditions, the competition, the brand value if any, the image of the products, the integration and interaction of the employees at different levels, as well as the cost of negotiations with any existing lenders or investors and the consequences (see also **Chapter 6**). It will be an extensive appraisal of the business plan in the context of these issues. The heart of the investigation will focus on assessing the true risk of the return.

Prior borrowing arrangements 2.7

The prior borrowings, including debentures, overdrafts and loans made available to the business, and the terms of the loans should be carefully reviewed. Any new borrowings made available should not exceed the permitted existing facilities, and the total borrowings and the new debt should be within the borrowing limitation prescribed by the constitution of the business. If not, the constitution will need to be amended before extending the additional facilities to the company.

The existing facilities should be in continuity and in force. The terms of the existing facilities should be vetted to ensure that default provisions of the facilities and the implications of amendments are well understood. Additionally, covenants must be taken to the effect that the business has not breached any of the provisions of the existing facilities and relevant disclosures should be obtained if it has.

Where new debt is to be made available in addition to existing debt, it may be necessary to subordinate the existing debt or ensure the prioritisation of the existing debt as part of the transaction. If the existing or new facilities are to be subordinated, subordination arrangements will need to be entered into. Avoiding the triggering of default or cross default provisions under existing facilities as a result of the new investment arrangements or transaction will be a primary concern. Change of control is often an important event of default which is triggered by a corporate finance transaction, as well as the breaching of important debt-to-equity ratios as well as cash flow and interest coverage covenants.

Commercial contracts and arrangements 2.8

The business would have entered into other various commercial contracts that would typically include its suppliers, distributors, marketing agents and export agents. These contracts may be key to business operations and sales. It therefore becomes important to ensure that these contracts are valid and existing, ascertaining the obligations under each of them, and to ensure that the business is not in default nor would be in default as a result of the transaction. In particular, outstanding obligations would need to be considered, such as monies owed or payable.

If the entire business is being acquired, contracts may need to be either assigned or novated (substituted with the agreement of all parties). The consent of the contracting party will be required if liabilities are to be novated, or the assignment otherwise requires consent. This could be quite a cumbersome and time-consuming process.

Termination provisions of the contracts may also be unfavourable, may have lengthy notice periods and may be activated upon a change of control.

Special care will also have to be taken if the business has issued any guarantee, surety or indemnity in favour of any third party for the obligations of a group company or otherwise. Powers of attorneys, option agreements, indemnities, agreements granting pre-emption rights, comfort letters, credit extensions or credit grants or any offer or tender or such other document which could be converted into an obligation for the business as a result of the transaction should be carefully examined. If there are contracts or arrangements, the benefit under which could be assigned to a group company or to a third party, suitable covenants should be taken to prevent the business from doing so if this were to be against the investor's or lender's best interests. All the contracts in which the directors are interested or are not of arm's length may also have to be renegotiated.

Licences and intellectual property rights 2.9

Many corporate finance transactions place value on the brands or licences of the business. If so, the licensing arrangements and the protection afforded to the intellectual property rights should be investigated in detail to ensure value is preserved. For example, a licence may stipulate termination if there is a change in control of the business, or a company may have exclusive or non-exclusive rights to the technology or may have rights exclusive to a particular area or country. The licences should be valid and in force.

If the intention is to acquire the assignment of the license, one will need to ensure that the licence is not personal to the party in whose favour it is given, in which case it may not be capable of being assigned or sub-licensed.

Intellectual property rights (IPRs) capable of registration can be ascertained from the records maintained by the Patents and Trademark Office in the relevant country of use. It is important to bear in mind that registrable IPRs may be territorial and not global. Again, what can be registered and what cannot may differ from country to country. According to the UK Patent Office, computer software may be capable of being patented if it results in a 'technical effect', generally interpreted as resulting in an improvement in technology, and it has to be essentially in the technology sector. Whereas in the USA, as acknowledged by the UK Patent Office, the approach taken is more liberal and the software that would be allowed to be patented would not necessarily qualify for registration in the UK. It is important to establish the source from where the IPR emanates. Warranties and representations should be taken particularly where the IPRs are not registrable. Some jurisdictions may require registration of ownership – license or sub-license of the IPRs may have an additional requirement of registering it within a particular time period.

Care must also be taken that the technology or information employed by the business does not amount to infringement of third party IPRs and that the business is authorised to use such technology or confidential information. Employees dealing with confidential information should be bound by confidentiality agreements.

IT 2.10

The business should have an IT system in place, and have trained support staff to ensure proper handling, operation and monitoring of the business hardware and software. The system should be geared to handle disaster recovery of the date ensuring that the hardware or the software can be replaced or substituted without material disruption. However, it is prudent to have insurance to cover data loss risk. The company should have the benefit of a comprehensive support and maintenance agreement with appropriate confidentiality clauses. Software and hardware licences will also need to be validated as well as compliance with any data protection requirements (see also **Chapter 9**).

Real estate and business assets 2.11

The business may hold real estate as an owner or as a lessee. If title is registered, it should be relatively straightforward to check the title of the business and any encumbrances on the land as all these are registered with the land registry and will be a matter of public record. For unregistered titles, there will have to be a title investigation to ascertain the quality of the title held.

Equitable charges are not required to be recorded as the title deeds are in possession of the chargee, which should serve as a notice to a potential purchaser or charge holder. If the transaction results in the transfer of the property, the stamp duty implications may be significant. Many transactions may therefore be structured to be subject to anti-avoidance laws so as to mitigate the stamp duty charge. Stamp duty laws of the relevant jurisdiction will have to be considered before choosing a structure.

If the property is mortgaged or otherwise encumbered, depending on what the intention of the transaction is, the provisions of mortgage should:

(a) allow transfer of the mortgage to the new owner; and
(b) not trigger an event of default, or acceleration.

However, if the intention is to seek a first charge or a subsequent charge on the property the existing mortgage will have to be amended with the consent of the existing lender.

Planning permissions should permit necessary extensions or alterations if that is essential to the transaction. If the business is a tenant, all necessary protections under the tenancy statute must have been procured. If tenancies and licences cannot be registered with the land registry, the relevant agreements will determine the right of the business to the property. The tenure of the tenancy or the licence would in that case assume importance. The property should have all the essential utilities and the outgoings should not be prohibitively expensive.

For a transfer of business assets, plant and machinery and the stock in trade may have stamp duty implications. In most jurisdictions plant and machinery capable of delivery is exempt from stamp duty.

In addition, real estate will need to be properly appraised, insured and title certificated. A business or transaction that is development or property focused will also, of course, require a much higher level of due diligence with respect to any real estate and properties being developed or built (see also **Chapter 1**).

Employees, consultants and directors 2.12

Normally, applicable regulations will protect the rights of the employees when a business, whole or part, is transferred to another. The employees are automatically transferred on the same terms and conditions. Transfers that do not involve the transfer of business will not be attracted by the provisions of such regulations. Therefore, the transfer of shares will not be affected by the regulations as the employer entity stays the same. Under a business transfer, the new employer assumes all the rights and obligations arising from the employment contracts, including all the collective agreements made on behalf of the employees, but not the benefits relating to occupational pension schemes, which would have to be transferred separately.

Redundancy of any employee as a result of the transfer of business may be deemed unfair dismissal unless the reason for the dismissal is an economic, technical or organisational reason entailing changes in the workforce. Regulations may apply irrespective of the size of the undertaking. Consultation with trade or employee union representatives will also need to be considered as part of any transaction which involves a change of ownership.

It is also important to check the restrictive covenants in the employment contracts. The restrictive covenants would be covenants relating to non-competition, non-disclosure and confidentiality. It would therefore be essential to confirm if the employment contracts have a clause relating to the assignment of the covenants and whether such assignment would be valid in the state where the contract is executed.

Service agreements with directors would likewise need to be reviewed as well as consultancy arrangements.

The human resource factors affecting a business need careful evaluation, including staff turnover, codes of conduct, performance reviews and complaint handling procedures. The employment base is a critical and valuable business asset: it's very life and organ. Very recently the Founder and CEO of Starbucks has confirmed that the value of this business has been achieved through its values of integrity and authenticity that also permeate through its workforce. Breaches and violations of socio-employment laws, covering areas such as racial, religious or sexual discrimination or harassment, could have very harmful reputational and valuation impacts on a business's prospects (see also **Chapters 7** and **8**).

Pension arrangements **2.13**

An actuarial expert will advise the company on various financial aspects of the pension arrangements such as:

(a) debts of the business to the pension scheme;
(b) contributions to be made to the pension scheme;
(c) projected increases and losses to the pension scheme.

In one case, it was discovered that the target's subsidiary had a pension plan since 1976, which it had not accounted for, and the liability under the US Generally Accepted Accounting Principles (GAAP) treatment amounted to US$20 million. Employee benefit liabilities in the other subsidiaries, which were originally estimated to be US$25 million, turned out to be nearly US$200 million [1].

In the UK, a company is obliged to provide comparable pension arrangements to the employees. In the case of a business transfer, it will also have to ensure that the employees who were members of the pension scheme are transferred to the new pension scheme, and that they are properly advised and given complete information on the new pension scheme (*Transfer of Undertakings* (*Protection of Employment*) *Regulations 1981* (*SI 1981/1794*)).

Insurance **2.14**

The insurance cover should be as comprehensive as possible and cover all the assets and risks of an insurable nature – the key to which would be ascertaining the exposures and the risk involved. This in turn will determine the types and the amounts of the insurance covers. Insurance policies generally do not cover terrorism risk, which would require payment of an additional premium. The loss payee provisions and the assignment of the policies are a key in securing a debt and hence it is crucial that the laws of the local jurisdiction do not prejudice the investor or lender.

Environment **2.15**

In an age of awareness of increased risk to ecosystems due to global warming and environmental pollutions, the regulatory authorities have endeavoured to keep the environmental pollution in check by forcing businesses to comply with the environmental laws. If the business requires authorisation to conduct any of its business activities, such authorisations should be valid and existing. Also, increased focus on compliance by a business with 'social responsibilities' and 'carbon foot-printing' will inevitably follow through in the future as an important ingredient of any due diligence process (see further **Chapters 4** and **12** in particular).

Warranties and indemnities **2.16**

While due diligence reveals information on the operations of the business, it does not necessarily address the concerns raised by the due diligence exercise. Following a due diligence exercise, a lender or investor may then seek to get extensive warranties and representations from the business owners and management which can be relied on and form part of the risk return analysis. These are generally heavily negotiated and can often make or break a deal as they go to the heart of the apportionment of liability, and the balance of the risk–reward analysis.

The warranties may take the form of indemnities which are undertakings that reimbursement or the making good of a loss will be made if a specified liability should occur. Indemnities are invariably taken in case of tax liabilities on sale of shares, litigation claims, environmental risks, doubtful claims, third party liabilities and any other matter, which has the likelihood of it resulting into a liability.

As due diligence is an integral part of an acquisition or investment or borrowing, it should be approached with a clear purpose. The purpose will depend on the strategy of the investor behind the investment, or simply the perceived lending risks. The emphasis should be on ascertaining the true risk and reward equation.

A KPMG survey on global deals [2] reveals that the priority accorded to due diligence has increased significantly with 35% of the respondents citing it as the most important pre-deal activity.

Identification of key issues, clear guidelines and accurate analysis and interpretation of the findings is what the due diligence exercise achieves. It is an invaluable tool in a deal if employed properly.

Litigation **2.17**

A review of current, pending and/or potential litigation is a vital component of pre-deal legal due diligence exercise. A cause of action may be derived from design defects, manufacturing defects or a failure to warn. Product liability has emerged as perhaps one of the greatest sources of 'doomsday' risk particularly, but not exclusively, for manufacturing firms. Product liability laws may differ substantially from one jurisdiction to another. In some countries product liability law may be based on strict liability and it may, therefore, not be necessary to show negligence. Potential liability to firms may be capped. Although the majority of high profile cases have taken place in the USA, it is worth noting that pending changes in law within the UK and indeed the rest of the European Union EU may expand the scope for the substantial litigation and potentially multi-million dollar awards often seen in the USA.

Litigation risk is not limited to product liability. Indeed litigation may arise for any number of reasons, some of which may be associated with the proposed transaction and others which may be wholly unrelated. Below is a list of high risk areas (some of which have also been covered elsewhere in this chapter), which should be considered in any legal due diligence exercise:

- Negligence;
- Product liability;
- Contractual disputes;
- Employment;
- Regulatory; and
- Environmental.

Regulation 2.18

Regulation, in addition to posing a potential litigation risk (as identified above), is a substantive issue in its own right to be considered in any due diligence exercise. This is particularly relevant in the case of M&A transactions, where (a) the acquirer and/or target are in a regulated industry and/or (b) the potential transaction itself gives rise to competition issues. In either scenario a transaction may well fail if the relevant regulator does not consent. The recent case of the attempted GE-Honeywell merger, which was abandoned after it became apparent that the required regulatory approval would not be obtained, is an example.

Risk management 2.19

The use of complex financial instruments by multinational trading firms has made risk management an increasingly important aspect of day-to-day operations. As such, a review of a firm's risk management practices and procedures may comprise a significant part of a given due diligence exercise. Formerly this would be seen an exercise only pertinent to transactions involving banks, insurance companies, asset managers, hedge funds and other financial institutions. High profile failures such as Enron and Parmalat, however, have demonstrated that this is clearly no longer the case. Trading firms may be just as exposed to financial market turmoil as financial firms.

Often firms may seek to hedge against a risk to which they are heavily exposed. For a manufacturing firm, it may be the price of a commodity which is a raw material in a given product. Hedging may take place through the use of a variety of contracts (e.g. futures, forwards) which seek to guard against adverse price movements. This may even become a profit centre for firms.

Critical to any risk management review is a basic understanding of the firm's risk model which may be extremely complex. It is then considered prudent to perform some form of stress test on a given model to ascertain the validity of underlying assumptions, that is, the likelihood of loss and the ability of a firm to withstand abnormal events.

Reputational risk **2.20**

This chapter would not be complete without a short reference to reputational risk, which has become a priority area of risk according to many experts including the Aon risk survey referred to in **Chapter 7**.

A business or transaction, however financially attractive, will not necessarily be attractive to the business or organisation as a whole if the association with the potential new business or source of financing would diminish or lower existing brand or management business values. This may be analysed through a simple SWOT analysis, but clearly it is a matter which the vision and values of the leadership of the business or organisation as a whole will determine.

References

1. Warner, E., *Acquisitions Monthly* (supplement), 33–36, October 2003.
2. Pratt, W. and Issitt, M., *Acquisitions Monthly* (supplement), 12–15, October 2003.

Appendix

Example of initial due diligence list for the purchase of a regulated financial services business

	Definitions
Company	ABC and each of its subsidiaries
	Directors and compliance officer and other personnel having supervisory responsibilities for regulatory purposes
Regulator	Financial Services Authority (UK)
Accounts date	31 December
Valuation date	30 June

1. Individuals/owners:
   - due diligence on each of the individuals/owners (e.g. passport, two utility bills/bank statements showing proof of address and professional reference letter);
   - confirmation of regulatory good standing and any material disclosures made to Regulator in respect of Individuals.
2. General information on the company (includes each of its subsidiaries) including financial information, tax, business arrangements and corporate governance:
   - full accounts of the company for the five years prior to valuation date;
   - management accounts of the company for the period from the last accounts date to the valuation date;
   - management forecasts produced prior to the valuation date;
   - the proposed use of any cash balances in the balance sheet;
   - any significant additional bank borrowings anticipated;
   - capital commitments;
   - anticipated capital expenditure, not committed;
   - memorandum and articles of association;
   - shareholders' agreement;
   - estimates of property and investment valuations;
   - details of property leases (particularly to estimate liabilities such as dilapidation), service property commitments, and capital or operating lease obligations in respect of assets and equipment;
   - details of any assets not shown on the balance sheet, such as intellectual property rights;
   - details of key directors and employees contracts including any consultancy contracts or arrangements as well as all service, benefit and pension or bonus arrangements proposed or made;
   - tax computations for the same periods as accounts, as well as confirmation that no outstanding tax obligations or liabilities exist;
   - full disclosure of material non-recurring items;
   - copies of minutes for board, remuneration committee, audit committee and risk and credit committee;
   - details of all pending or threatened litigation or dispute matters;
   - details of any surplus assets;
   - details of all computer software and hardware, licences and dealing platforms and data feeds and any plans to update or replace these;
   - full details of aged:
     - debtors;
     - creditors outstanding as at the valuation date and all book debts written off or provided for;
   - full details of all professional indemnity and other insurance cover and any claims made;
   - details of all material trading exposures and positions at valuation date;
   - details of all bank borrowings and banking facilities;
   - full inventory, asset and investment lists as at the valuation date;

   - full details of any dividends declared or proposed subsequent to valuation date;
   - full details of shareholder resolutions recently passed or made since valuation date;
   - details of all joint venture and other business associations or agreements;
   - group structure chart and group organisation charts;
   - compliance or operating manuals;
   - full copy of customer documentation;
   - full details of all agency and commission arrangements.
3. Regulatory position and standing:
   - details of all licences, permissions and consents issued by Regulator, and confirmation that all remain good standing and have not been revoked, qualified or modified;
   - details of all material correspondence with Regulator, site-visit reports, external audit and management reports and steps taken to resolve and satisfy Regulator on any issues arising;
   - details of any customer complaints and notifications to Regulator and steps taken towards resolution;
   - evidence of compliance in last 12 months of all capital adequacy and/or solvency or liquidity requirements imposed by Regulator or under governing regulation and law.
4. The Company's current trading position (including each subsidiary) and prospects:
   - breakdown of revenue generation prior to valuation date and after accounts date:
     - fees;
     - commissions;
   - revenue forecasts prepared prior to valuation date for next six months;
   - major clients and fee income or commissions representing greater than 5% of revenue;
   - major contracts being performed, for example, funds under management or being managed;
   - major future contracts anticipated at the valuation date;
   - capital expenditure either incurred or anticipated that would have an effect on revenue;
   - sales brochures, giving an understanding of the product, for existing or new products;
   - details of any new products or services likely to come on stream in the near future;
   - spending on technology, etc. for instance for the previous three years;
   - details of any changes of the business in recent years, such as the closure of a division;
   - is there any new legislation or expected legislation likely to affect the business?
   - details of proposed hiring and recruitment of new employees or directors; and
   - details of establishment of new divisions or operating subsidiaries.

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3

Money laundering and terrorist financing

3 Money laundering and terrorist financing

CHAPTER OVERVIEW 3.1

Money laundering is the term given to the recently[1] criminalised act of disguising proceeds of illegal activity[2] as being derived from a legal source. Terrorist financing, also recently criminalised, works in the reverse, as it takes place whereby (legally derived) clean money is used to fund (illicit) terrorist activity. In either case, the stealth nature of the act itself in no way belies the potential legal implications to one who unwittingly (or otherwise) becomes party to such acts. Reputational and other implications will follow any legal sanction and therein lies the significance of so-called anti-money laundering (AML) and combating terrorist financing (CFT) programmes which are now all but mandatory for 'at risk' institutions.

This chapter will consider, in a general sense, many of the factors an organisation should have regard to in implementing an AML/CFT programmes. Examples will be taken primarily from the UK and the USA and for the avoidance of doubt, this chapter is intended to give an international perspective of the issues that are currently at play in the AML/CFT sphere, and not the current state of the law of any specific jurisdiction.

History 3.2

The term money laundering is believed to have originated from a Chicago mafia scheme whereby (cash) proceeds of crime would be attributed to a legitimate cash intensive business such as a laundromat. This enabled the integration of criminal proceeds into the financial system without necessarily raising questions as to the source of funds, and so the phrase 'laundering dirty money' (and with it any number of variations) evolved.

[1] Until 2001 there was no crime of money laundering per se in many parts of the world.
[2] Usually criminal activity.

In the USA, a criminal investigation into money laundering was first established in 1919. Tax evasion was rampant during those times as it was not customary for a bank to ask about the source of funds before accepting deposits. The *Currency and Foreign Transactions Reporting Act*, better known as the *Bank Secrecy Act of 1970* (*BSA*) was passed which required banks to establish a paper trail. After the enactment of the *BSA* other statutes relating to currency transactions and financial accounts were enacted in the USA. Money laundering was formally made an offence in USA when the *Money Laundering Control Act of 1986* was passed.

The term terrorist financing is of a much more recent vintage, having been brought into sharp focus (along with money laundering) in the aftermath of the 9/11 terrorist attacks in New York in 2001. In truth however, the watershed moment in terrorist financing had come a decade earlier in 1991 in the form of the Bank of Credit and Commerce International (BCCI). BCCI was closed by US and UK regulators amid a raft of allegations of serious irregularities. The ensuing investigations and reports yielded findings of BCCI's involvement with Abu Nidal (deceased), the alleged former head of the Abu Nidal Organisation, a group purportedly responsible for carrying out terrorist plots in up to 20 countries resulting in the death or injury of up to 900 people[3]. This says nothing of the allegations of BCCI's involvement with, inter alia, arms trafficking, money laundering, procurement of nuclear weapons, bribery and fraud.

By nature, it is difficult to estimate the amount of money being laundered or being used to finance terrorism. According to the International Monetary Fund (IMF) the aggregate size of money laundering in the world is between 2% and 5% of the world's gross domestic product. Using 1996 statistics, the Financial Action Task Force (FATF) (see **3.3**) calculated the money laundered to be in the range of US$590 billion and US$1.5 trillion. AML/CFT statistics aside, it is patently clear that the potential consequences to an institution for failing to discharge its responsibilities in either respect have perhaps never been more severe.

The Law of AML/CFT **3.3**

Although reference will often be made to AML and CFT together, the differences in the manner in which money laundering and terrorist financing activity takes place means that each usually constitutes a separate and distinct offence under the law of a given jurisdiction. It should be noted however, that the key thrust of CFT legislation is to criminalise the act of terrorist financing and thereby bring such activity within reach of money laundering legislation (i.e. by making it a predicate offence, see below). AML and CFT are typically addressed by separate statute. In the UK, for example, the principal piece of AML legislation is contained in the Proceeds of Crime Act 2002 (POCA) together with the Money Laundering Regulations 2003 and which have been

[3] Country Reports on Terrorism, US State Department (2005).

augmented by The Money Laundering Regulations 2007[4]. The principal CFT legislation is contained in the Terrorism Act 2000 as amended by the Anti-Terrorism, Crime and Security Act 2001.

Anatomy of AML legislation **3.4**

The FATF, a key player in setting international best practice (see **3.20** below) in AML, has issued 40 Recommendations[5] which form the basis on which a given country's AML regime is usually evaluated. Non-compliance with the 40 Recommendations has often resulted in the country in question being placed on the, now empty, Non-Cooperative Countries and Territories (NCCT) List. The 40 Recommendations are used as a guide in outlining the anatomy of AML legislation.

Typically, a money laundering offence is constructed as follows:

Predicate offence + Criminal proceeds + Act in relation to criminal proceeds

Predicate offences **3.5**

FATF recommends that all countries should ensure that a money laundering offence applies to all predicate offences, which includes:

(a) all serious offences; or
(b) to a threshold linked to a category of serious offence; or
(c) offences punishable by a maximum penalty of more than one year's imprisonment; or
(d) terrorist financing (under the 9 special recommendations see 'Anatomy of CFT legislation' below); or
(e) a combination of these approaches.

Predicate offences have traditionally been (wrongly) perceived to be related exclusively to drug trafficking. Clearly this is not the case but perhaps more significantly, recent changes to AML legislation across the globe have cast a wider net in so far as predicate offences are concerned. In the UK, for example, s 340 of POCA, defines a predicate offence (i.e. criminal conduct) as conduct which either constitutes an offence in any part of the UK or would constitute an offence if it occurred in the UK. In theory therefore (in the UK at least), any offence, however 'benign', could be classified as a predicate offence for the purposes of money laundering legislation. The notion that not all offences are capable of yielding proceeds which can attract liability for money laundering is clearly incorrect therefore. A UK institution must consider that (in theory at least) any offence is capable of being a predicate offence for the

[4] Implementing the Third Money Laundering Directive on 15 December 2007.

[5] Reference is often made to the 40 + 9. The '9' representing nine special recommendations on terrorist financing which are discussed in dealing with the anatomy of terrorist financing legislation.

purposes of the Act and provided that the offence in question is one which is capable of yielding proceeds. Dealing with those proceeds can result in the commission of a money laundering offence. Law elsewhere will differ but the underlying considerations are very much similar: *Is the offence in question a predicate offence for the purposes of money laundering laws and therefore could 'dealing' with any proceeds therefore from (potentially) result in a money laundering offence?*

Criminal proceeds **3.6**

Naturally, the determination as to what constitutes criminal proceeds builds firstly, on there being a predicate offence (already discussed) and secondly, whether the proceeds in question flow from that predicate offence. FATF recommendations do not specifically address this issue and so we turn directly to the UK position. Section 340(3) of POCA refers to criminal proceeds as 'criminal property' and defines criminal property as essentially a person's benefit from criminal conduct or that which represents a benefit[6] (of criminal conduct). 'Property' refers to money, choses in action and all other forms of property (realty, personalty or otherwise).

Generally, in cases where the direct proceeds are money or some other readily recognisable asset no question will arise as to whether it is capable of being classified as criminal proceeds for the purposes of money laundering law. A question may arise however 'around the edges', for example, where something not readily recognised as property is in effect the benefit of criminal conduct. In such cases one may consider (a) what constitutes property under its domestic law and (b) whether the money laundering law in question recognises that form of property as potentially being a criminal proceed.

Tax evasion, if a criminal offence in a country, will be, prima facie, a money laundering offence because by definition it will then involve the proceeds of crime.

Act in relation to criminal proceeds **3.7**

The mere fact that criminal proceeds exist does not in and of itself result in money laundering. It is primarily when those funds are dealt with in some way (i.e. after the fact) that creates circumstances in which a money laundering offence can take place. AML writers have considered the three main steps in the money laundering process being:

1. Placement: initial entry of criminal proceeds into financial system.
2. Layering: attempt at concealing the true nature of the criminal proceeds.
3. Integration: criminal proceeds are passed as legitimate.

[6] Extends to pecuniary advantage obtained as a result of or in connection with the conduct: s 340(6) and (7) of POCA.

It is important that one considers the so-called three stages of money laundering in concert with looking at the various acts which can lead to a money laundering offence. Furthermore, it is important to note that money laundering offences occur not only when one is directly involved with the arrangement but also in the case of certain regulated businesses (which are in effect held to a higher standard) where one fails to report, at the very least, suspicion of money laundering. For the purposes of this chapter we will classify these as follows:

(a) Primary money laundering offences: those offences related to the principal acts of money laundering.
(b) Secondary money laundering offences: those offences not related directly to the process of money laundering (typically arising from a failure to discharge disclosure obligations which are discussed under **3.10**).

Primary money laundering offences 3.8

These include:

- conducting or attempting to conduct a financial transaction which involves proceeds from a criminal activity;
- transferring, transporting, converting or removing (or facilitating in any of these arrangements) a monetary instrument or funds or property of any kind where a benefit can be derived from a criminal conduct;
- concealing or disguising the nature, the location, the source, the ownership or the control of proceeds of a criminal activity;
- acquiring, using or possessing funds or any property representing proceeds of crime.

(Under UK law, these are contained in ss 327–329 of POCA.)

Secondary money laundering offences 3.9

These include:

- failure by a person to disclose a money laundering offence to the authorities where that person knows or suspects or has reasonable grounds for knowing or suspecting or where a person should have known or suspected even if there is no actual knowledge or suspicion;
- where a money laundering investigation is being carried out, it is an offence to disclose such investigation to the person against whom it is being or intended to be carried out (also known as ‘tipping off’); and
- any transaction with the funds derived from tax evasion or making a false statement on a return will amount to a money laundering offence as the source of the funds then becomes illegitimate.

(Under UK law, these are contained in ss 330–332 of POCA.)

Reporting requirements and exceptions **3.10**

Reporting requirements will typically apply to persons in a 'regulated business sector'[7] (and not necessarily to all persons). FATF recommendations 13–16 deal with reporting of suspicious transactions. The rationale is that persons in such industries are effectively 'gatekeepers' to the financial system and should therefore be held to a higher standard than ordinary individuals.

There has, however, been much controversy as to how wide a net should be cast in terms of which professions are subject to reporting requirements. Traditionally, only banks and other similar financial institutions had been subject to reporting requirements. Recommendation 16 however, clearly indicates that reporting requirements should have a more broad application and apply to legal professionals and accountants. In EU member states this is an issue which is being addressed through the implementation of the Third Money Laundering Directive which is discussed briefly below.

Reports of a suspicion of money laundering are typically made to the financial intelligence unit (FIU) or to the designated money laundering officer. A person reporting after the commission of any money laundering offence should have good reasons for not reporting before the commission of the offence and the disclosure should have been made as soon as it was practicable. Where the disclosure should have been made but was not made, the person failing to do so should have reasonable grounds for not making such disclosure.

Under the UK law, to prove a money laundering offence it is not necessary that the benefit received should in fact be proceeds of crime. It is enough to have reasonable grounds to believe or suspect that such benefit consists of proceeds of crime (*R v Montilla [2004] 1 WLR 624*). However statutes now make it amply clear that it is an offence not to disclose a money laundering offence even if the person did not know but should have known about it. It is evident that the courts view money laundering as a serious offence and will interpret it strictly and it will be up to the accused to prove his innocence. The burden of proof required is civil and the courts may make far reaching assumptions to require a defendant to provide information for the court to rely on evidence even if not called at trial (*R v Levin [2004] EWCA Crim 408, [2004] 07 LS Gaz R 35*).

It is an offence to disclose to a person who is reported in the suspicious activity report or against whom any money laundering investigation is being carried out or intended to be carried out which is commonly referred to as 'tipping off'. However if the person perceived to be tipping off did not know or suspect that his or her disclosure is likely to prejudice any ongoing or intended investigation, he or she shall not be liable for committing a money laundering offence. Another exception to tipping off would be privileged communication.

[7] Typically financial institutions and other similar entities.

Internationally, there is a lack of cohesion as regards whether:

(a) a lawyer is liable to non-disclosure of a suspected offence if his or her knowledge of that information is part of the privileged communication;
(b) the lawyer's duty to inform the client and give best advice amounts to tipping off.

These issues were raised in the English cases of *P v P [2003] EWHC 2260 Fam, [2003] All ER (D) 141 (Oct.)* and *Bowman v Fels [2005] EWCA Civ 225* pursuant to which the Law Society of England and Wales formulated guidance notes for English lawyers. The main issue in both cases was whether lawyers could be liable for either primary or secondary offences in the course of litigation work. The Bowman v Fels decision (and subsequent Law Society Guidance Note) superseded the decision in P v P and the position effectively gives an exemption from reporting requirements to lawyers in the course of litigation and preserves legal professional privilege in that context.

This Law Society guidance note clarifies that a professional legal adviser does commit an offence of tipping off if he or she makes a disclosure to his or her client in privileged circumstances, that is, in connection with the giving of legal advice to the client, or to any person in connection with legal proceedings or contemplated legal proceedings. According to the guidance note, there is no absolute duty imposed upon the legal adviser to inform the clients that he or she has made or intends to make a report to the FIU. If the legal adviser confers with their client to make a report to the FIU and if the client disagrees, then the legal adviser should withdraw from the case and consider carefully in accordance with the Law Society guidelines, while making a report to the FIU. A legal adviser does not commit an offence when in the course of giving legal advice to the client or acting in connection of actual or contemplated legal proceedings, they inform the client that they have made or intend to make a report to the FIU.

The Law Society has also expressed the view that the above applies not only to litigation but also to transactional work.

The Third Money Laundering Directive 3.11

The Third Money Laundering Directive was required to be implemented by EU member states by 15 December 2007. The directive brings the EU position into line with that of the FATF following the modification of the 40 Recommendations in 2003 (the Second Directive had been issued in 2001).

The principal features of the Third Money Laundering Directive are as follows:

- Widening the application of money laundering reporting requirements to include life insurance intermediaries and all persons doing business which requires cash payments of €15,000 or more (Article 3(7)).
- Widening of the definition of money laundering and ensuring that terrorist financing is a predicate offence in money laundering legislation (Article 3(4)).

- Introduction of ‘fit and proper’ tests for owners of regulated businesses (Article 36).
- Modification of the rules for determining who is a beneficial owner. A threshold of 25% has been set (Article 3(6)).
- Wider acceptance of risk-based approach to due diligence. This will mean for example, enhanced due diligence for politically exposed persons (PEPs) but simplified due diligence procedures for low risk persons. Regulated businesses will be able to rely more widely on verification of another regulated business on client due diligence (Articles 3(8), 11, 14–16).

Anatomy of CFT legislation 3.12

As mentioned in the introduction to this chapter, the main thrust of CFT legislation has been to criminalise terrorist financing such that it constitutes a predicate offence for money laundering purposes. At the international level FATF has made 9 special recommendations on terrorist financing, to which we refer in part below. Terrorist financing offences are typically formulated as follows:

Act in relation to otherwise clean funds + Terrorism

What acts may be caught by terrorist financing law? 3.13

The interpretative note to the FATF special recommendation considers that the relevant act should relate to the wilful providing or collection of funds (defined as assets of any kind) for an act of terrorism or by a terrorist or terrorist organisation. In the UK, the Terrorism Act 2000 (TA 2000) considers specifically funding, fundraising, use and money laundering aspects of the process of terrorist financing. The respective offences can be summarised as follows.

Fundraising 3.14

- Inviting another person to provide money (s15(1)).
- Receiving money or property (s15(2)).
- Providing money or property (s15(3)).

Use and possession 3.15

- Use or possession of money or property (s16).

Funding 3.16

- Entering into or becoming concerned in a terrorist financing arrangement (s17).

Money laundering 3.17

- Concealment, removal, transfer (or otherwise) of terrorist property (s18).

Disclosure obligations will also apply in respect of knowledge or suspicion of terrorist financing. It is noteworthy here that law enforcement agencies typically have enhanced search and seizure powers in relation to terrorist activities.

How is terrorism defined? 3.18

The interpretative note to the Special Recommendation 2 suggests that a terrorist act should be defined as any act which breaches any of a number of international treaties, hijacking aircraft, kidnapping of diplomats, taking of hostages, nuclear non-proliferation and terrorist bombing. In a general sense, the note suggests that terrorist act be defined as any act directed at a civilian population designed to intimidate that population or to compel a government to act in a certain way. Defining terrorism is not an easy task.

CFT legislation has usually sought to address this problem by defining terrorism (in a general sense) with a provision permitting the designation of persons and or organisations as terrorist or terrorist organisations as the case may be. In the TA 2000 for example, section 1 generally adopts the definition above (with the inclusion of acts done to further a political ideology or religious belief). Section 3 provides for the proscription or designation of terrorist organisations.

General considerations in relation to AML/CFT laws 3.19

In closing, there are two general issues one should consider in looking at AML/CFT legislation.

Firstly, one should consider the extra-territorial nature of AML/CFT legislation. Typically, the law will still apply even if the act (e.g. predicate offence) takes place in another country. In the UK, under s 340 of POCA a predicate offence need not take place in the UK. Therefore it is wholly possible for an act to be committed outside a jurisdiction, in a country where it is legal, but still form a predicate offence for the purposes of AML legislation – the consequences are obvious. This has been at times referred to as the 'Spanish Bullfighter Problem' due to the fact that bullfighting is illegal in the UK and therefore a Spanish Bullfighter's earnings would constitute criminal property/ proceeds under POCA[8].

Secondly, one should consider defences to AML/CFT offences. Generally, there is some requirement of knowledge or, in the very least, circumstances must exist which would give rise to a (reasonable man forming a) reasonable suspicion.

International organisations 3.20

Various international organisations are involved in formulating policies and raising awareness of money laundering mechanisms and means of fighting them. A brief description of some of these organisations is given below.

[8] Remedied in part by defence introduced by Money Laundering: Exception to Overseas Conduct Defence Order 2006.

The Financial Action Task Force 3.21

The FATF was established in 1989 by the G–7 Summit in Paris to address the increasing drug problem and to counter organised crime and money laundering. FATF is an intergovernmental body which forms policies and procedures to tackle money laundering at national as well as international level. It has 31 member countries from the initial 16. FATF's original 40 Recommendations made in 1990 were updated in 1996 to reflect 'evolving money laundering typologies'. These 1996 Recommendations were endorsed by 136 countries. In October 2001, FATF included an additional 8 recommendations (since increased to 9) on terrorist financing. A full review of the 40 Recommendations took place in 2003. The FATF 40 and 9 Special Recommendations have been recognised by the IMF and the World Bank as the international standards for combating money laundering and financing of terrorism.

Organisation for Economic Co-operation and Development 3.22

Originally intended as an organisation to harmonise policies amongst the free market democracies in post World War II Europe, the organisation was re-launched in 1961 with a worldwide membership. Although its mandate extends primarily to economic issues, there is some measure of overlap. The Organisation for Economic Co-operation and Development (OECD) houses the FATF at its headquarters.

The Egmont Group 3.23

The Egmont Group is an informal gathering of 106 FIU across the world. The body's principal purpose is to encourage and assist co-operation and the exchange of information between members. Egmont promotes training and the implementation of best practice amongst members.

The Caribbean Financial Action Task Force 3.24

Caribbean Financial Action Task Force (CFATF) is a grouping of roughly 30 countries in the Caribbean/Latin American basin, formed in 1992, operating with a mandate to prevent money laundering and combat the financing of terrorism. The organisation routinely undertakes an assessment of member states compliance with its own 19 recommendations as well as FATF 40 + 9 Recommendations. Representatives of FATF, the USA, the UK, Canada, France and the Netherlands are CFATF Co-operating and Supporting Nations.

Wolfsberg Group 3.25

The Wolfsberg Group is an association of 12 multinational banks formed in 2000 with the principal purpose of developing standards and policies on

AML and CFT. The grouping has issued various documents on different areas of AML/CFT in Banking (e.g. Wolfsberg AML Principles on Private Banking, AML Principles on Correspondent Banking and AML Guidance for Mutual Funds and Other Pooled Investment Vehicles).

The Basel Committee on Banking Supervision **3.26**

The Basel Committee was formed in 1974 and is made up of representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK and the USA. The Basel Committee prescribes broad supervisory standards and guidelines and recommends best practices for internationally active banks.

Though the Committee does not have any formal supervisory authority and the standards it sets have a persuasive effect. The Committee provides a platform for the countries to formulate their banking policies and have in fact been adopted by various countries. Its aim is to implement a common supervisory standard among the banks to ensure that no bank escapes supervision (see also **Chapter 4**).

In October 2001 and 2003, the Committee issued the know-your-customer (KYC) programme which incorporated:

- a customer acceptance policy;
- customer identification;
- ongoing monitoring of higher risk accounts; and
- risk management.

This Committee emphasised the need to have an appropriate legal framework to facilitate cross-border sharing of information. In June 2003, the Committee participated in the joint issuance with the International Organization of Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS) on the assessment of their anti-money laundering/combating financing of terrorism approach.

International Organization of Securities Commissions **3.27**

IOSCO is an international body formed to promote co-operation among securities regulators around the world. It has set standards for enforcement and exchange of information among the securities regulators. IOSCO was formed in 1983 and has 181 members.

European Union **3.28**

The European Parliament and the Council of the EU aspires to strengthen the money laundering checks throughout Europe and have issued directives on the prevention of the use of the financial system for the purpose of money laundering.

United Nations 3.29

The United Nations' Global Programme Against Money Laundering is instrumental in influencing the money laundering policies of its member states. The United Nations (UN) co-ordinates and participates in initiatives taken by other international organisations in combating money laundering. On 24 June 2004 during the UN Global Compact Leaders Summit it was announced that the UN Global Compact would from that time include a tenth principle against corruption. This initiative has also included partnership with Transparency International (TI) and the International Business Leaders Forum (IBF) to engage the private sector in the fight against corruption and economic crime.

International Money Laundering Information Network 3.30

The International Money Laundering Information Network (IMoLIN) is a web-based platform where agencies involved in combating money laundering can share and exchange information. IMoLIN was created in 1996 under an agreement among various AML agencies. IMoLiN can be accessed at www.imolin.org.

Indicators of money laundering and terrorist financing offences 3.31

In many instances where money laundering or terrorist financing takes place very fundamental indicators exist of the true nature of the activity. Below is a list of such indicators compiled from several international sources:

- transactions linked to persons, groups and/or locations of concern;
- transactions involving unusual links to commodities (e.g. diamonds);
- multiple otherwise unconnected individuals operating on same or connected accounts;
- large scale cash transactions;
- unusual underlying business action (cross-border travel to undertake simple transaction);
- unrealistic business turnover;
- large and/or rapid transfer of funds;
- unrealistic wealth compared to client's profile;
- unusually high rates of return for a low risk business activity;
- unrealistic explanation given by customer for account activity;
- unwarranted high security risk – personal transfer of valuable asset;
- new customer attempting large transactions with no supporting rationale;
- unusually complex method of purchasing financial products;
- deposits at a variety of branches and times for no logical reason (possible evidence of 'smurfing', that is, making a number of small deposits under the threshold);
- identifying re-emergence of known financial criminal in the financial services sector;

- lack of knowledge by individual atypical to trade practitioners;
- attempts to avoid identifying final beneficiaries of accounts;
- unnecessarily complex fund structure;
- possible client relationship to previous crimes;
- identification of false documentation;
- suspicious activity of client associates;
- deliberate concealment of fund ownership;
- change of account behaviour without explanation;
- multiple amounts paid into personal account without explanation;
- transfer of assets at well below (or above) market rates;
- over-complex fund movements;
- multiple transactions below threshold;
- transactions with PEPs;
- illogical business activity – sending multiple cheques for cashing at a higher charge;
- multiple use of money transmission services; and
- unconnected parties channelling funds to a single account.

Measures to prevent money laundering **3.32**

FATF has recommended measures to be taken by the financial institutions, designated non-financial businesses and professionals to prevent money laundering and terrorist financing. Apart from the indicators that are listed above, measures should be taken to procure more information about the customer and the transactions that are being carried out for such customer. Financial institutions are persons or entities whose activities include:

- lending;
- financial leasing;
- transfer of money or value;
- trading in:
  - foreign exchange;
  - derivatives;
  - securities;
  - commodities futures;
  - other derivative transactions;
- life insurance; and
- other investment related insurance.

The measures to prevent money laundering are described below:

1. Before opening accounts, the financial institutions should undertake customer due diligence to ensure that no anonymous or fictitious accounts are opened. This is done by verifying the identity of the customer. Documents like passport, a photocard driving licence and at least two recent utility bills should be obtained for the purpose of ascertaining the identity of natural persons. In case of other persons, proof of incorporation or similar proof

to establish legal status, and the identity of directors or trustees or partners and the proof of authority from which they derive power to bind such person. If the information on a customer is obtained from a third person, it should be ensured that the source is independent and reliable and is regulated and supervised and has AML controls in place.

2. The ultimate beneficiary should be known and his or her identity should be ascertained. This is important to understand the ownership and control of the customer.
3. Ongoing due diligence should be conducted of the transactions undertaken at the behest of the customer and of the customer to ensure that information submitted by the customer is consistent.
4. It is imperative that the source of the funds is legitimate and checks should be made and evidence procured to make certain that is the case.
5. Enhanced due diligence and monitoring for PEPs as these prominent public figures may abuse their positions.
6. While dealing with a cross-border correspondent bank or other firm, additional due diligence measures should be adopted which include:
   (a) understanding the business of the correspondent institution;
   (b) determining that it has money laundering checks and regulatory supervision in place;
   (c) ascertaining if any money laundering investigation was carried out against it.
7. Records on the customers and the transactions should be maintained for a minimum of five years. This is to provide a paper trail to the authorities in case they need to take legal action against the customer for any criminal activity.
8. The transactions should be examined in detail especially those which are complex for no apparent reason. Notes on findings and any other information relating thereto should also be maintained.
9. Customer due diligence and record-keeping requirements are also applicable to designated non-financial businesses and professions in the following situations:
   (a) casinos – when transactions are equal to or above the applicable designated threshold;
   (b) estate agents – transactions involving buying and selling of real estate;
   (c) dealers in precious metals and dealers in precious stones – cash transactions with equal to or above the applicable designated threshold;
   (d) lawyers, notaries, other independent legal professionals and accountants – transactions concerning the following activities:
       - buying and selling real estate;
       - managing client money, securities or other assets;
       - management of bank, savings or securities accounts;
       - organisation of contributions for the creation, operation or management of companies;
       - creation, operation or management of legal persons or arrangements, and buying and selling of business entities;

(e) trust and company service providers.

The designated threshold in the case of:

(a) casinos, including internet casinos, shall be €3,000;

(b) dealers in precious metals and dealers in precious stones when engaged in any cash transaction shall be €15,000.

10. Any suspicion that funds are proceeds of a criminal activity should be reported to the FIU concerned.
11. Institutions should have internal controls to ensure adequate compliance management, employee training and policies which do not restrict employee disclosure of suspicious activities.

Most jurisdictions, which have money laundering regulations in place, require financial institutions, designated non-financials and professionals to have a money laundering officer. The employees are required to report suspicious activities to the money laundering officer who will then take it up with the FIU. Employees are required to receive appropriate training on AML procedures, internal reporting procedures on suspicious transactions and reporting lines. Employers may be prosecuted if they fail to give money laundering training to their employees.

Cost effectiveness 3.33

Financial institutions and designated non-financial professionals and businesses are likely to see a fair amount of time, man power and money being expended on implementing money laundering regulations. The US government's position on money laundering regulations is that it is losing billions of dollars on tax evasion and money laundered which escapes the net of the authorities. The UK's Financial Services Authority (FSA) appointed PricewaterhouseCoopers LLP (PwC) to conduct a cost benefit analysis of implementing a requirement for financial institutions to undertake a specific AML 'Current Customer Review' (CCR). The current customers were those who became customers before the institutions were required to comply with the money laundering regulations. PwC recommended two approaches:

(a) review of all the institutions by a fixed completion date;

(b) issuing general guidance and making the institutions largely responsible for compliance.

It was found that approach (a) would cost £174 million and approach (b) would cost £92 million. Approximately 90% of these costs would be borne by the institutions to implement adequate compliance and the balance would be assumed by the customers, National Criminal Intelligence Service (NCIS) (the FIU in UK) and other law enforcement agencies. The FSA concluded that it would not impose a requirement on the institution to carry out a review on the pre-money laundering regulations customers. The decision of the FSA was based on:

(a) the existing FSA regulations on money laundering that oblige the institutions to maintain adequate systems and controls to check money laundering;

(b) the findings which did not convince the FSA that the benefit of imposing CCR on the institutions was proportionate to the cost that would be incurred on the exercise;
(c) the fact that most institutions (33% for approach (a) and 46% for approach (b)) that were interviewed did not consider taking any further action if CCR was introduced as they already had undertaken a similar review or had adequate systems and controls in place;
(d) an increase in the suspicious activity report which would burden the NCIS when it was already under so much pressure;
(e) the fact that the CCR would be just one aspect of money laundering controls.

The other areas include training, new customer due diligence, record keeping and monitoring. It was thought best to let the institutions decide how they want to manage internal controls and procedures to deal with their money laundering obligations in the most efficient manner.

The FSA, however, emphasised that their decision does not undermine the importance of customer identification and forms an elementary part of the AML exercise. The institutions are not complaining as they realise that the money laundering regulations are here to stay, especially in the wake of 9/11 which revealed close nexus of money laundering to terrorism financing. Governments have shown serious determination to tackle this at grassroots and any lapse on the part of the financial institution and professional bodies and businesses in complying with their obligations could cost them dear.

Data Protection Act 1998 **3.34**

The UK *Data Protection Act 1998* (*DPA 1998*) provides that an individual is entitled to be informed by the data controller whether his or her data is being processed, the description and purpose of the data that is being processed, description of the recipient whom the data is being disclosed, and entitled to be communicated in an intelligible form as to what constitutes his personal data and the source of that data (see also **Chapter 9**). An exception is carved out to enable the data controller to withhold the information which would likely prevent detection of a crime or prosecution of the offender. The UK government published a paper in April 2002 exploring the interrelation between the tipping off provision under the statutes dealing with money laundering and *DPA 1998*. The government clarified that the paper has no legal status.

At the first instance it would seem that where a suspicious transaction report (STR) is made the exception under the *DPA 1998* would apply and the data controller is not obliged to disclose the information on STR to the individual concerned. However, the paper warns that no assumption should be made that the exception under the *DPA* automatically applies to STRs. A case by case approach should be taken to determine the applicability of the exception to STRs. When in doubt it is best to consult the NCIS.

Conclusion

3.35

The post 9/11 AML/CFT legislative reforms have given most countries what are widely seen as the weapons necessary to effectively fight money laundering and terrorist financing. Going forward however, it appears that the issue which continues to plague the fight is the lack of a cohesive approach at the international level to the way in which professionals, specifically lawyers and accountants, ought to be treated under AML/CFT legislation. In an age of truly multinational professional service firms, the lack of cohesion coupled with the extra-territorial nature (in particular) of AML/CFT legislation could truly prove counter-productive in the fight. It now seems clear that what will be needed to ensure success in the AML/CFT fight are measured responses to domestic challenges and perhaps more significantly cohesive steps at the international level to ensure that AML/CFT weapons are being aimed in the right direction.

4

Trends and drivers for due diligence and corporate governance

4 Trends and drivers for due diligence and corporate governance

CHAPTER OVERVIEW **4.1**

In view of the importance of this chapter and the extent of the issues covered – as well as their degree of overlap – it is helpful to recall the basic structures as follows:

Internal trends and drivers
    Value drivers analysis
External trends and drivers
    A stakeholder analysis of the drivers and trends in managing risk.
    An environmental scan, trends are reviewed through a PEST template of:
        Political, legislative and governmental drivers.
        Economic drivers.
        Social, ethical and environmental (SEE) drivers.
        Technological and scientific drivers.
Governance key trends and case studies

Opening Remarks 4.2

There is no doubt that the business environment requires that due diligence should be understood as a core feature of doing business in today's world. Whereas the impact of due diligence was originally felt by larger organisations, nowadays drivers such as supply chain pressures, reputation issues, regulatory and voluntary frameworks have meant that due diligence is a matter of concern to most organisations. This is especially true bearing in mind the interaction with risk management and corporate governance. As a result, the business environment demands due diligence as an ongoing tool to deal with both internal and external requirements. This chapter provides an overview of the more recent trends and drivers: any overlap in topic areas has been allowed due to the importance and complexity of the subjects under discussion.

It has been seen in **CHAPTER 1** that internal pressures come about through the deals, transactions, joint relationships and operational issues of the business.

In addition, it may be noted that the key external drivers are regulatory and reporting standards that affect stakeholder and insurer confidence. The issues and concerns that were once only the domain of large businesses have crept into that of small businesses and small and medium-sized enterprises (SMEs) as they deal with the implications of today's business environment and scrutiny of bureaucracy, regulation, customers and non-governmental organisations (NGOs) as well as the media. New business relationships are forcing improved standards on organisations of all sizes and indeed relationships can impact on the reputation of all those involved.

While a jurisdiction's company law governs companies incorporated in that jurisdiction, a jurisdiction's securities laws and regulations govern companies, investors and intermediaries involved in the buying or selling of securities in that jurisdiction. Jurisdictions may have private and 'over-the-counter' markets for equity securities, but the most important equity markets are stock exchanges. These also apply to international organisations. For instance, in the oil sectors, most of the major listed companies have their primary listings on a stock exchange in the USA, and two-thirds of those with primary listings on other exchanges have secondary listings on a US stock exchange. Therefore changes in US requirements have major implications for how business is done generally. For this reason the analysis of the disclosure requirements of the US Act *Sarbanes-Oxley Act of 2002* (*SOX*), set out in **Chapter 11**, is quite detailed.

The US regulatory framework has been considered to be a major driver for changes in Europe and Asia (see comparative developments of corporate governance in **Chapters 11–15**). This reflects the importance of the US equity market within the global capital markets. It makes the US securities laws and regulations generally a critical source of corporate governance law for major companies in these industries, and an important influence over the laws of other jurisdictions seeking to attract global equity capital for their domestic companies. It should also be noted that the UK is the other main source of the global capital markets alongside the USA and has influence as a result on the trends in corporate governance (as is clear from discussions in later chapters: see **Chapters 10, 12** and **14** in particular).

This chapter considers the internal and external environment of the company and how it can be analysed against a wide range of influences, trends, drivers and pressures in order to alter or adjust its *modus operandi*, having regard to due diligence and corporate governance issues. The following assessments are reviewed, including:

- The 'internal' drivers, such as the organisation's costs, revenue, taxes and investment (the value drivers).
- The 'external' risk drivers:
  - A stakeholder analysis of the drivers and trends in managing risk.
  - An environmental scan, trends are reviewed through a template of:
    - political, legislative and governmental drivers;
    - economic drivers;

  - social, ethical and environmental (SEE) drivers;
  - technological and scientific drivers.
- Governance key trends and case studies.

In brief the current trends are:

- Risk and reputation management; corporate governance and due diligence issues are increasing in importance, as are the pressures to address them.
- Intangible assets are increasingly more important than fixed assets.
- Stakeholder pressure and activism is growing, with more investor, consumer and NGO pressure upon organisations to change and face the challenges of the future more effectively. The customer and shareholders used to be 'king', now they are concerned rulers.
- There are increases in legislation and standards and fines associated with non-compliance with these types of governance and due diligence issues.
- There is an increased desire for disclosure and transparency, with reporting of results and verification of these reports of high importance after the financial falsification scandals of recent years.

Internal trends and drivers 4.3

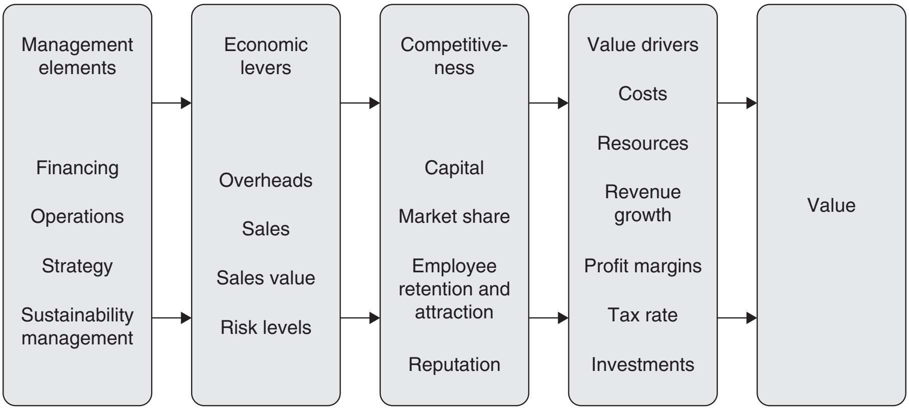
This section reviews some of the trends and drivers of value creation within organisations in the context of due diligence and management of corporate governance issues. From an economic perspective both can be relevant to all the main management decisions companies implemented, from strategies to investment decisions. These decisions can have effects upon the economic levers which in turn influence the competitiveness and value drivers of an organisation (Schaltegger, 2006), thereby having an affect on operations and products. Accordingly they are related to revenue and profits.

Internal system drivers: There are many internal drivers that have an affect on an organisation's value. Effective due diligence systems will help manage down the risk associated with them. Examples include the following category headings:

- Corporate governance structural issues (trends are reviewed in **Chapters 10–15** in particular).
- Finance systems.
- Human resources and employee motivation.
  - Employment law changes are seen as having a financial impact upon organisations and motivation a positive influence.
  - Health and safety issues are becoming crucial bottom line issues.
- Information systems.
- License to operate/reputation.
- Marketing.
- Risk management and due diligence systems.

These can all have profound impacts upon an organisation's operations and value, some of the key internal value drivers and trends are reviewed in the following sections bearing in mind that they are relevant to ongoing due diligence and corporate governance. Since the previous edition the trends and drivers have become even more tangibly linked to the economic performance of the organisation.

The various value drivers' elements of the diagram below are reviewed in the sections that follow:


Management elements
Financing
Operations
Strategy
Sustainability management
Economic levers
Overheads
Sales
Sales value
Risk levels
Competitive-ness
Capital
Market share
Employee retention and attraction
Reputation
Value drivers
Costs
Resources
Revenue growth
Profit margins
Tax rate
Investments
Value

Value drivers 4.4

Costs: Costs are increasing as demand for resources spiral and resources based prices increase when supply cannot expand sufficiently to meet demand. This is having an inflationary effect upon entire supply chains.

The enhanced communication that is often part of corporate governance efforts can help build trust between companies and stakeholders. This can reduce costly conflict and improve decision-making with regard to supplies of key inputs and distribution of outputs. For example, companies that proactively and effectively engage shareholders and address their concerns can reduce the costs associated with shareholder proposals. Also, according to Ann Svendsen, author of '*The Stakeholder Strategy*' (Berrett-Koehler Publishers, 1998), 'When firms and their suppliers trust each other, the costs of monitoring and managing contracts are lower. Companies experience less conflict with their suppliers, resulting in fewer lawsuits, and there is a heightened capacity for innovation'.

Some trends are:

- There have been near once doublings of many naturally occurring primary resources within the last year or two, like: coal, oil, gas, copper and other metals;
- A large secondary impact upon refined resource prices that require large natural inputs to their processes like: paper pulping; construction and building materials; and

- Natural hazard incidence and insurance premiums for liabilities cover are increasing as claims increase. For instance flood risk cover is very expensive or removed entirely in parts of the world and away certain high risk groups.

Resource availability: The other side of the market equation is that supply cannot always be increased. The scarcity of resources is having an effect upon revenue as the natural world's capacity for production can be exceeded by consumption patterns. Current estimates are that we would need two and a half planet earths to meet current demand for materials in a sustainable manner. This leads eventually to crisis points in the supply chain. For example that is frozen food producers are finding fish increasingly scarce to source unless farmed.

Some trends that need to be incorporated into internal due diligence systems are:

- Economic, social and environmental accounting and measurements will converge more.
- Business process changes will continue such as:
  - ○ Dematerialisation: less natural resources requires less expenditure.
  - ○ Decarburisation: the energy required for processes will need to be progressively reduced as price increases, scarcity, and carbon-based taxation have an impact.
  - ○ Eco-efficiency: increases in productivity as fewer materials will be required to produce each unit of production of service.
  - ○ Innovation and eco-design; this also includes industrial metabolism and increased efficiency from chemical reactions and materials flows in systems.
  - ○ Miniaturisation: fewer resources will be required to make the same item.
  - ○ Simplification: fewer items, parts and materials will be required.
  - ○ Substitution: switching to cheaper or more sustainable materials will bring stability to processes over the long term. Where rare natural material dependency occurs this causes delays in meeting financial targets, such as when game systems missing their launch dates due to shortages of rare metals.
  - ○ Waste reduction: is an important goal in the elimination of wasteful and expensive processes that are viewed as 'activities that add cost but do not add value'.
- Purchasing of fewer fixed assets in the form of premises etc.
- Improved organisational effectiveness through improved self-assessment and evaluation as a result of increasing accountability and due diligence and governance systems.

Revenue growth: Sales and profits trends are:

- Building customer loyalty as a protective barrier against price pressurising competition from the rest of the world.

- Cause-related marketing (CRM) will increase and become more closely linked to business strategies. Already in the USA there have been numerous shareholder proposals for resolutions that ask companies for the disclosure of methodologies for selecting charities and the justification of donations made by them.
- Reputation has become a major influence upon organisational value – either directly from product boycotts, etc. or from damage to corporate reputation from media, NGO campaigns, shareholder activities and changing customer preferences. This theme is discussed in more depth in **Chapter 7**.
- The growth of niche markets, for instance the European market for environmental goods and services is now worth €227 billion and is increasing rapidly. Mainstream businesses are purchasing emerging niche players in mature markets for a range of products and services. Examples include Unilever's purchase of Ben & Jerrys, L'Oréal Group's of the Bodyshop and Cadbury's purchase of Green & Black's organic chocolates.
- The expansion of developing world markets. There has been a realisation that although the initial sales volumes seem small in comparison to developed markets, the return on assets and investment can be much more superior in the developing world than in developed or mature markets.
- Pressure upon and from key suppliers and business partners on a range of environmental, social and governance (ESG) issues.

Profit Margins: Many products currently receive a premium price from customers that perceive the company to have outstanding ESG credentials and more companies will seek out these niche premiums. In addition, an increasingly global economy means that companies must find ways of making their products compliant with stricter environmental policies from other regions and this can impact upon costs and therefore margins.

Taxes and Fines: Governments and other bodies are utilising market forces to correct what they see as market imperfections and make organisations more accountable for their external costs and impacts.

Some trends are:

- Green taxes, tariffs and regulation like:
  - carbon emission taxes;
  - usage billing, such as is congestion charges for vehicles in urban areas;
  - waste disposal levies;
  - water use and clean-up tariffs;
  - vehicle and petrol costs and taxes.
- Raised fine levels for transgression of rules like: environmental incidents and clean-up costs; contaminated land reclamation; employment laws; and breaches of health and safety laws.
- Increased court costs of defending against legal actions, court cases and class actions, including product liability expenses.

Investment: The value of organisations is being adjusted as methods for measuring intangible assets, like reputation, expand. Companies' capital assets are also being invested more and more following ESG evaluation criteria. Similarly members of the financial community are adopting more rigorous investment and lending policies. Some trends are:

- Banks: are increasingly applying rules to investment lending decisions. An example is the environmental screening be required by all project financings with capital costs above US$10 million for borrowers of the banks that are signatories to the 'Equator Principles' (www.equator-principles.com).
- Investors: asset managers and stock markets are demanding greater disclosure on risks so that investors can factor these into their own investment decision-making processes and assess the quality of due diligence and governance measures. Research like Deutsche Bank's 'Behind the Numbers' series shows qualitative evidence of how corporate governance behaviour and structures can influence their pricing in the marketplace.
- Insurers: premiums for sustainability related cover are increasing as is the levels of research into future claims of these types (see also **Chapter 16**). Some of the big re-insurers have estimated that human induced climate change could cost them up to €10 billion euros a year by 2010. Insurance products designed specifically for environmental and sustainability risks can help transfer some of the biggest potential losses.

Risk Management: Trends and recommendations include:

- Key risks of companies identified by a range of ESG surveys highlight product impacts and liabilities, supply chain management and ethical business conduct and governance as major risks.
- There is improvement in the integration of these ESG risks within risk management processes.
- More companies are providing internal training and briefings on specific due diligence and governance issues.
- There will be greater risk and potential for damage to a company's reputation from the use of subcontractors. The contracting company can come under increasing accusation of outsourcing of risk which could indirectly impact upon reputation (see also Chapters 7 and 8).

Due diligence considerations: Trends and recommendations include:

- The management of these types of risk issues should become incorporated within the mainstream management of the assets (operations, reputation and markets).
- Organisations should become more transparent about their dealings with these risk issues. They may be conducting much more in the way of risk mitigation work that they are not disclosing to stakeholders. By disseminating this knowledge stakeholders should take a more appropriate view of the organisation's position in the marketplace and society.

- There needs to be some clarification on where the limits of responsibility are, where companies' corporate governance and responsibilities end and the government or other stakeholders' responsibilities begin. An example of this is the level at which customer data can be used for social benefits before there is an infringement of the English Data Protection Act (**Chapter 9**).
- Identification and reduction of potential liabilities: A more accountable company that adopts social and environmental auditing and reporting and stakeholder dialogue can identify practices or situations that could pose liabilities to the company. Early identification can provide companies with the opportunity to resolve problems before they result in costly legal actions or negative public exposure.

Corporate governance considerations: Corporate governance trends can indicate some of the structural changes occurring in organisations with moves towards:

- Increased compliance with governance rules and adherence to voluntary codes where they are thought to be best practice in corporate governance circles.
- Independence of the board of directors:
  - The combination of the roles of chief executive officer (CEO) and chairman are increasingly rare.
  - The chairman or president of the company is increasingly defined as independent of the organisation, with fewer executive chairmen. In the UK the proportion of executive chairmen within the FTSE350 fell from 21.5% in 2001 to 11.6% in 2006 (PIRC 2006).
  - The independence of boards is on the general increase, with threshold as high as two-thirds of the board being independent of management being proposed by the US Securities Exchange Commission (SEC).
- There has been an increase in the proportion of companies that report on their succession planning. In the UK this has risen sharply from 8.4% in 2001 to 46.3% in 2006 (PIRC 2006).
- The calls from shareholders to link management pay with their performance is gathering strength and is said to be having an effect upon the levels of compensation paid. The rate of increase in executive compensation is slowing; in some countries like France the rate of increase is lower than the increase in profits.
- The disclosure of information is increasing, with areas of note being:
  - Director compensation;
  - Policies on the environment;
  - Health and safety;
  - Equal opportunities; and
  - Community customer issues.
- Specific issues of stakeholder interest are being incorporated into reporting mechanisms with greater regularity, for example is that many companies voluntarily report upon their greenhouse gas (GHG) emissions (see **Chapter 16**).

- Shareholder activism is increasing pressure upon boards and this issue is discussed towards the end of this chapter.

External trends and drivers 4.5

For the purposes of this book, the question of drivers is a broad subject that embraces:

- a review of the political and legislative influences;
- economic value drivers; and
- community stakeholders' perspectives on corporate governance.

Those perspectives drive the formal and informal frameworks of responsibility and accountability applicable to the people and institutions that control, manage and influence organisations. It is not intended to go into the details of the formal and informal frameworks of laws, regulations and norms such as the company laws that govern shareholder participation in governance as well as the international human rights framework governing less formal responsibilities of companies – these can be found in specialist texts. Instead, key selected frameworks that pertain to corporate governance are referred to in **Chapters 10–15**.

In this discussion it is intended to raise awareness of the increasing scope of what has come to be due diligence and corporate governance in today's business environment with just a brief mention of the main areas of relevant legislation, which are company law and securities law The growing influence of the outside world on companies has meant that an increasing proportion of organisations' value is based upon perceptions of stakeholders in the wider community.

According to research from the SERM Rating Agency, it has been found that just over half of all non-financial risk to an organisation value is due to indirect risks and pressures for change emanating from the wider 'external' environment. The resultant figures are that companies have an average sustainability risk of 12.5% of value as a result of political, social and environmental issues. These factors are largely dependent on the perception of key stakeholders which are discussed in brief in the first part of this section. This is then followed by a brief environmental scan of emerging trends.

Corporate social responsibility (CSR), socially responsible investment (SRI); shareholder activism and engagement are increasingly important to formulate due diligence and governance policies, processes and structures. These key topics are reviewed in more detail at the end of this chapter, whilst some of the more general trends are as follows:

- Stakeholder importance and influence is on the increase:
  - External stakeholders can have powerful direct effect upon companies, such as investors and the premiums paid for stock, or customers and the price and premium they are prepared to pay for goods and services. Two

major internal stakeholder groups are the board of directors and employees as they may have the most influence on corporate governance and due diligence issues.

- There is a greater demand for transparency of companies' activities: in addition to shareholders who are requesting greater disclosure and reporting on issues that affect value, a variety of other groups are pressing companies to increase the disclosure of their ESG performance:
    - Government regulators, financial analysts, employees, non-profit advocacy organisations, labour unions, community organisations and the news media are among the groups pressing companies to divulge greater amounts of information on decision-making, performance and targets.
    - In addition, many customers, both individual consumers and business-to-business customers, are including a range of ESG criteria into purchasing decisions.
- Increased stakeholder activism: on many stakeholder groups are engaging companies more directly, utilising a wide range of tools, techniques and technologies to bring their interests to companies' attention. These activists are also working to educate lawmakers, the media and the public about companies that are – or are not – deemed to be accountable (see for example the Karmayog ratings system in the **Appendix** to **Chapter 12**). Among the tactics being used by stakeholder groups are public information campaigns (including by NGOs such as the Greenpeace campaign in the context of the shipping industry in India referred to in **Chapter 6**), public protests, boycotts, and class-action lawsuits seeking action and redress for perceived company misdeeds:
    - Shareholders and board members are pressuring firms to disclose GHG emissions, set reduction targets, and study how stricter regulations could impact the bottom line. Environmentalists and shareholder activists are no longer touting the benefits reductions will produce for the environment, but are focusing their campaigns on the financial risks involved with not reducing GHGs. The resolutions on global warming are part of a significant increase in shareholder actions aimed at influencing large corporations (see further **Chapter 16**); and.
    - Increased shareholder engagement is evident. Company shareholders, both individuals and institutions, have become increasingly vocal and aggressive in pressing companies to be more accountable.
- Improved relationships with stakeholders: Companies are finding that if they make an effort to be transparent and accountable for their actions and decisions, and engage with stakeholders, this can build trust among their stakeholders. This also has the benefits of providing valuable insights into the communities in which they operate, and within society more broadly.
- Benchmarking lists are playing an increasing role in defining and driving ESG concerns. For example, *Business Ethics* magazine recently released its eighth annual list of the '100 Best Corporate Citizens', (see also the Karmayog survey referred to above and the SERM methodology referred

to here (below) and in '*The Business Risk Management Handbook: A Sustainable Approach*' by the author and Adan Rose published by Elsevier).

- The growth of (ESG) Reporting Standards and Guidelines will continue, for example:
  - Accountancy organisations like the ACCA, ICAEW and the US Financial Accounting Board recommend to companies to include more non-financial information in their annual reports;
  - The number of companies releasing ESG-related reports is an upward trend and reports such as corporate environmental reporting is now becoming compulsory in some European countries, including Denmark and, more recently, France, and this is likely to spread;
  - A variety of organisations and initiatives are attempting to standardise ESG reporting procedures to let stakeholders more easily compare companies across facilities, sectors and borders. For example, The Global Reporting Initiative (GRI) was established to 'help bring together and harmonise the numerous initiatives on corporate environmental reporting that have developed independently around the world, shaping them into one set of coherent, consistent global standards'. Reporting standards, which are a significant and growing area and business driver, are reviewed in the governance trend section in this chapter as well as in **Chapter 16** (see the **Appendix** to **Chapter 16** regarding the methodology of GRI).

Therefore a key element for structuring your due diligence and governance systems is to recognise that feelings are facts. The top performing companies know that what NGOs, employees, customers, communities and other stakeholders feel about a company's performance and reputation can be much more important than the reality. A stakeholder analysis along the lines of the framework outlined below can go some way to scoping the issues your organisation faces.

Stakeholder analysis **4.6**

In order to find out what is going on in their marketplaces, many companies are taking steps to better communicate their progress and challenges to the stakeholders outlined in the box below. They are increasingly demanding that companies are exhibiting improved standards of governance (although there is strong debate about what these might be) and to demonstrate greater accountability and transparency in their operations and performance.

To meet these challenges, companies are developing a variety of tools, policies and strategies to increase and demonstrate their accountability. One such practical tool is a *Stakeholder Audit* which is reviewed in greater depth in *The Handbook of Risk Management: A Sustainable Approach* by the same author. In this section the intention is to undertake a *Stakeholder Trends Analysis* of the influences proving strong influencers upon opinion and therefore market pricing of companies. A brief overview of the stakeholder groups is as follows.

The SERM stakeholder template

* Academic and research organisations.
* Business partners, suppliers and trade bodies.
* Customers and their representatives.
* Direct actions groups and NGOs.
* Employees and their representatives.
* Financial institutions (banking, investor and insurance criteria).
* Governmental organisations.
* Local and regional governmental organisations.
* International governmental organisations.
* Journalists and media organisations.
* Key competitors.
* Local communities.

Key Stakeholders

A brief overview of some of the main trends by stakeholder group which affect organisations from specific stakeholder groups are set out below.

• Academic centres and business schools are adjusting to change 4.7

The overwhelming majority of today's MBA students believe that:

- businesses should work towards the betterment of society;
- managers should take into account ESG impacts when making business decisions;
- CSR should be integrated into core curricula in MBA programmes.

According to a survey by Net Impact, the non-profit association:

- 81% agreed with a statement that businesses should work towards the betterment of society, although only 18% believed most corporations are currently working towards that goal;
- 78% agreed that the subject of CSR should be integrated into the MBA core curriculum, and 60% said they believed CSR makes good business sense and leads to profits;
- 79% indicated they would seek employment that is socially responsible in the course of their careers, and 59% said they would do so immediately following business school;
- 89% said business professionals should take ESG impacts into account when making business decisions.

- Business and supplier relationships are being deepened **4.8**

  Organisations are improving their procedures for increasing the engagement processes with their supply chains. For example:

  - US Retailer Wal-Mart Stores Inc. is sending engineers into its chain of suppliers to find ways to help them reduce GHG emissions. Whereas Wal-Mart emits about 19.5 million tons of GHG carbon dioxide equivalent per year, its suppliers generate about 200 million tons. The initial results have appeared staggering; at only the first factory they helped cut electricity bills by 60% by installing readily available low emissions lighting and technologies.

- Customer attitudes are changing **4.9**

  There is a growing awareness from consumers on the availability and benefits of new environmental technologies and products. Recent research findings highlight the changing attitudes of consumers:

  - A combined US National Consumers League and Fleischman-Hillard International Communications Report, Rethinking Corporate Social Responsibility found that:
    - 76% of the American public polled believe that their purchasing decisions are affected by how a company treats its employees;
    - 58% of the US public say that they or people like them can find out more information on the Internet about companies' records on ESG issues than a few years ago;
    - 41% of those that frequently use the Internet say they have sent an email to a company about its products or services and 38% to an official body about an issue. www.csrreports.com/FINAL_Full_Report.pdf
  - An Environic Foundation International (EFI) (http://www.environicfoundation.org/) Millennium Survey of 25,000 individuals internationally indicates that public expectations of large companies acting in a reasonable way are both high and universal:
    - 79% felt companies should be 'completely responsible' for protecting the health and safety of workers;
    - 73% for protecting the environment; and
    - 72% for avoiding child labour.

- Direct activism **4.10**

  NGOs, direct action groups, activists and international NGOs (INGOs) are increasingly engaging with companies on issues and even offering to help companies with: problematic issues; to tailor product and service delivery to meet societal or regional needs; reduce negative media coverage; or enhance existing market presence. For example:

  - Nike has partnered with an NGO to help design and implement the company's factory monitoring and community involvement programmes worldwide. The partnership helped Nike gain an awareness of local and global community issues, provided technical expertise in factory monitoring, and showed Nike how the monitoring could be done collaboratively.

- Employee attraction, retention and motivation levels **4.11**

Engagement and motivation of your key employees are all critical to organisational success. Therefore, understanding the new trends that influence these groups of stakeholders' perceptions is important. A survey on employee recognition of corporate responsibility and governance issues by US-based community network Care2 polling of nearly 1,600 employees found that:

- 73% of workers said it was 'very important' to work for a company they believe is 'socially responsible';
- 35% report they have left a company because they believe it was not socially responsible;
- 48% of employees would work for less income if the company is socially responsible;
- 40% would work longer hours on the same basis; and
- The competition for high-calibre employees is increasing as the number of jobs at organisations viewed to be socially responsible is exponentially increasing (see also **Chapter 6**).

It is also relevant that the treatment of one group of stakeholders affects the perception of the organisation by other groups of stakeholders as well. This is demonstrated by the findings of the University of South Africa's research from their Centre for Corporate Citizenship (in partnership with the Bureau of Market Research www.unisa.co.za), which were that:

- 40% of consumers that were participants said that social responsibility will enhance employees' respect for the company;
- almost 60% believed that public commitments to socially responsible activities will enhance the employees' respect for their place of work.

- Financial community concerns about risk levels **4.12**

The financial community is adopting more rigorous investment and lending policies, as mentioned under **4.4**:

- Banks: are increasingly applying rules to investment lending decisions (see also **Chapter 16**);
- Investors: asset managers and stock markets are requiring greater disclosure on ESG and sustainability risks. There is an increasing demand for qualitative analysis on ESG factors and closer scrutiny of companies' due diligence processes as in an era of increasingly marginal competitive differentiations these factors can prove invaluable in selecting investments.
  - The majority of investment banks now publish equity research analysing the financial performance of the carbon markets including Citigroup, JP Morgan Chase, Merrill Lynch and Morgan Stanley.
- Insurers: premiums for sustainability issue cover (see also **Chapter 16**) are increasing as are the levels of research into future claims of these types. Examples of action include:
  - Insurers, brokers and pollution coverage experts say the purchase of stand-alone pollution liability policies is likely to accelerate among multinationals in and around Europe as the threat of liability increases.

  - Among the variables furthering this trend in Europe are the huge expansion in discovered contaminated properties and new liabilities related to EU laws that hold polluters and property owners liable for the remediation of contaminated sites.
  - Flood cover for UK properties is under threat as predictions that global warming will cause sea levels to rise are leading insurers to fret over the rising risk of claims.

Environmental scanning **4.13**

Another useful tool for accessing the external factors for due diligence systems to review is outlined below by a *PEST* (Political, Economic, Social and Technological) framework.

In an environmental scan the external operating environment is seen as a significant influence on the performance of organisations of any size. Key aspects of turbulence include changes in the market, technology, customer demands and competition. An effective environmental scan focuses on dominant issues, and involves trying to understand which issues might take an organisation beyond its current ways of doing things. The scan:

- Indicates the nature of the world in which the organisation will find itself in the future, what it wants and what it needs to do to get there.
- Gives the organisation a wider and longer-term view of the future, stretching strategic and innovative thinking beyond normal boundaries in order to:
  - view risks by scale, whether they are local, national or international, or global; and
  - view risks by current situation or conditions; probable trends, events or developments; and urgent implications.
- Attempts to identify events, trends and developments, or drivers, shaping the future, across the following category areas, for which, in this review we use the classic marketing PEST framework, this reviews external factors under the following main section headings:
  - Political, legislative and governmental drivers;
  - Economic and governance drivers;
  - Social, ethical and environmental (SEE) drivers; and
  - Technological and scientific drivers.

Political, legislative and governmental drivers

Regulatory background and drivers

The balance of interests **4.14**

Regardless of the choice of structure and whether or not the organisation operates in the profit or not for profit sector (see also Chapter 17), one of the main drivers for due diligence and good corporate governance is the trend towards increased regulation and operating standards. Indeed, it is interesting to note that as the business world shrinks and the speed and amount of information grows, transparency is the key note of the day. This is true of all businesses, whatever their size or place of operation. Moreover, the number of interested parties is on the increase as the use of technology enables access to information in a much more cost effective manner. As this handbook emphasises it is also advisable for small businesses to take appropriate steps in risk management (see also **4.46**). They must also bear the impacts of such matters as:

- Data protection laws.
- Product liability legislation.
- Health and safety regulations.
- Environmental requirements.
- Comprehensive EU developments (increasingly important with the enlargement programme meaning a union of 27 countries since 2007). **4.15**

Materialism has largely left few unaffected and the normal human nature is to want as much as it can now – from an increasingly early age. Meanwhile, those who are not benefiting from the overload of consumer items will try increasingly hard to penetrate business practices and prevent unfairness, as well as illegal practices. It is therefore unlikely that the major scandals have failed to impact developments in most places. In some respects this can lead to a real clash of interests between the developed and developing worlds (despite the extraordinary pace of economic growth of such countries as India and China) that is represented by the governance debate (see also **Chapters 10–15**). This can be considered from many sensitive and political angles. While this is not the place to consider such matters in depth it would be a disappointing omission if this context were not reflected upon briefly, especially bearing in mind the use of proxy votes referred to above and the dynamic steps taken by NGOs to influence the business environment. It is noteworthy that in the USA the SEC has repeatedly broadened the permitted subject matter for shareholder resolutions as it has perceived subjects like social responsibility and corporate governance to be of growing concern to investors generally (see also **Chapter 16**).

According to the Chairman of the Sustainable Development Commission and the Forum for the Future in the UK, Jonathon Porritt, when delivering the Garner Lecture at an event held by the United Kingdom Environmental Law Association (UKELA) in 2002, 'the theme of governance is bound up with the issue of sustainable development'. He has described the concept of governance as:

> 'the way in which organisations manage or govern themselves, and the way in which they account for their performance to their respective "stakeholders" – those constituencies or interests to whom they are accountable in one way or another'.

When considering drivers for due diligence and corporate governance it should be recalled that the private sector has become increasingly powerful from the point of view of ownership. This has been seen in the UK through:

- The outsourcing of many 'delivery' activities to arms-length agencies or quasi-autonomous NGO (quangos);

- Systematic privatisation of what were once public assets; and
- The emergence of public/private partnerships as a core element in the 'modernisation' programmes.

Another broad driver may be described as the 'anti-globalisation movement'. Jonathan Porritt commented:

> 'It is in fact misleading to describe this oppositional force as anti-globalisation; what brings the disparate elements of this movement together is its opposition to global capitalism, to global institutions (such as the World Trade Organization, the International Monetary Fund, G8, etc., which are perceived to be in thrall to the power brokers of global capitalism), and often to the United States whose principal mission as the world's sole remaining super power would appear to be absolute global hegemony for its own particularly unforgiving variation of capitalism.
>
> Wherever you may stand on these issues personally, the emergence of such a movement has already sharpened the debate about global governance systems and accountability … It seems hard to believe that the prevailing model of economic globalisation will survive the trauma of September 11 untouched. Globalisation in itself is not the culprit – most development economists have concluded that there is a positive relationship between international trade and economic growth, and that over time economic growth reduces rather than increases poverty. But as the most ardent promoters of the global economy, America and other OECD [Organization for Economic Co-operation and Development] countries have systematically overlooked the economic, cultural and human costs of globalisation, "cherry-picking" the commercial benefits of that economy without accepting enough responsibility for shared social obligations … to enjoy the fruits of globalisation in future, we must ensure that they are produced more sustainably and distributed more equitably … it seems equally obvious that efforts to establish more socially and environmentally responsible forms of development and organisation will be greatly facilitated by open, inclusive and accountable systems of governance at every level.'

For business, part of earning the license to operate is to act transparently and accountably, not just in one's dealings with one's owners, but with all principal stakeholders. In theory, many companies are now seriously signed up to this and more are beginning to do so. Any prevailing practice of minimum disclosure, providing privileged access to information solely on a 'need to know' basis, has to change.

Some recent governance trends **4.16**

- There will be increased moves to standardise accountancy and governance standards, the internationalisation of rules and legislation as companies are held accountable outside their home countries, or fall under the remit of legislation in other countries as a result of economic activity with them (US Sarbanes-Oxley and Alien Tort laws: see also **Chapter 11**).
- Within the UK (see **Chapter 10**) there has been the Combined Code on Internal Controls (including the Turnbull Code); the Pensions Act (1995) Amendments; the Company Law Review; the Companies Act has made it mandatory for business to carry out a business review which should cover the welfare of the employees, community, environment and the company itself; and a recently proposed carbon emissions Kyoto-related bill in 2007.

- New rules on anti-bribery are slowly being drafted, as there is a realisation that bribes are not in the interest of the global economy and only add costs of contracts to projects indirectly and covertly. The World Bank has launched a renewed anti-graft (anti-bribery) campaign but admits it lacks sufficient resources at present; and
- The legal infrastructure has gained a boost as they seek to let cartel members escape prosecution in exchange for information on their agreements with other parties.

Legislative drivers **4.17**

There are increased legal threats and risks including penalties for individuals and organisations as governments seek to shape markets and govern corporations by market forces and public regulation as well as implementing laws that shape the structure of corporate governance. Some trends include the following.

Global reach of legislation **4.18**

There is a globalisation of commerce and trade and the legislation affecting these. Recent activities include:

- Companies and governments are concerned that US watchdogs are extending their powers abroad, post Enron. There is an increasing level of prosecutions of overseas directors being prosecuted for their companies' actions in the USA.
- Growing fears of US financial rules that are encroaching further into the City of London have led UK companies to remove US customers from their books so they do not come into the remit of the SEC Investment Advisers Act of 1940 which calls for companies providing advice to more than 14 US citizens to register with the SEC and make regular reports.
- Recent interpretations of the US Alien Tort Claims Act have allowed companies to be sued for their actions in foreign countries.
- Global companies are increasingly listing on stock exchanges outside their domestic home bases, with these organisations now coming under the remit of a much wider range of governance and due diligence expectations and listing criteria.

Increased levels of litigation **4.19**

In the USA the number of class-action lawsuits against US companies rose sharply in 2004 according to a report by Stanford Law School and Cornerstone Research, the 'Securities Class Action Clearinghouse report' cited a 17% increase in the number of actions filed for 2004 and that the companies being sued lost $169 billion in market value. This figure was almost treble the figure for 2003.

Personal liability of directors **4.20**

There are increasing legal grounds for personal liability of directors and managers. The legal duties inherent in office for company directors may expand in the post Sarbanes-Oxley world. These may involve increased risks for individuals who may be held accountable. Enterprise act/cartel offences, false accounting, corporate manslaughter, assumption of personal duty of care and wrongful trading are examples. The new UK Company Law 2006, has in it, aside from the duty to report on environmental and social matters, a specific duty for company directors to 'have regard to' their impacts on the environment, employees, suppliers and communities (see also **CHAPTER 10**).

Case study: The 2003 EC Account Modernisation Directive
Implementation of this Directive has been occurring across Europe and is a strong case study for how future governance and disclosure legislation will be implemented. The UK requirement for a 'business review' which is derived from the EU Directive is discussed in future sections. In other European countries there has been much progress as well.

France
The Account Modernisation Directive of 2003 (Directive 2003/51/EC) is already implemented in French law. The May 2001 'New Economic Regulations' law, (Loi N° 2001–420 du 15 mai 2001 relative aux nouvelles régulations économiques) imposes an obligation on listed companies to disclose information in their annual report on a variety of issues related to transparency and corporate governance, as well as the obligation to report on how they take into account the social and environmental impact of their activities.

A decree issued in February 2002 implementing this law further specified the nature of information to be mentioned in the report:

* Social factors include employment policy (including employment of disabled employees), workplace safety, gender parity, training of employees, pro bono and sponsorship activities.
* Environmental issues include energy consumption, measures taken to limit threats to biological equilibrium, costs borne to decrease environmental impact, and the existence of intra-company environmental training programmes.

Italy
The Account Modernisation Directive of 2003 (Directive 2003/51/EC) is implemented in Italian law through Article 1 of Legislative Decree number 32, of 2 February 2007, which amends various pieces of legislation. The first paragraph of Article 2428 of the Italian Civil Code mandates a report of the board of directors on the company's performance (*relazione sulla gestione*).

The *relazione sulla gestione* in which the European directive's reforms are to be implemented is a separate chapter requirement in a companies annual report. The legislative decree 32/2007 also states that the performance report for the parent company and the consolidated subsidiaries can be presented as a single document. Legislative decrees generally come into force 15 days after the date of publication in the *Gazzetta Ufficiale* (in this case published on 28 March 2007). In addition this decree applies only to annual reports relative to financial years, which started after the law came into force.

Germany
The Account Modernisation Directive of 2003 (Directive 2003/51/EC) was implemented into German law in 2005. The changes were incorporated into the *Handelsgesetzbuch* (the German Commercial Code). Under Section 289 (which mandates a report of the board of directors on the company's performance, and other disclosure), Article 3 of the HGB states that a large capital company (i.e. any listed company and some non-listed companies over a certain size) must include in their report 'non-financial performance indicators, like environmental and employee matters, in so far as they are relevant and useful to the understanding of the company's development and performance'. The directive's requirements for financial reporting were already amply fulfilled by German law.

Political and governmental drivers 4.21

The direct impact upon organisations of legislative developments is discussed in the following section. Governments (locally, nationally and increasingly internationally) have strong influences upon organisations by other direct mechanisms, such as their purchasing decisions.

Trends are that:

- There has been a general retraction from the notion that government was the best or primary institution for solving large social problems. This trend is expected to continue as welfare reforms continue globally. There will be increased awareness of some of the barriers to this process. In the USA in a post 9/11 era there have been decisions to replace private safety inspectors with a federalised public screening agency staff in the view that government management in this area is superior.
- Governments are exerting more covert influence by implementing due diligence checks for tendering processes. For example, organisations have to reach a minimum standard (like having had to have achieved ISO 14001 to be able to tender), or demonstrate that they have responsible processes and risk management systems (like having had few, or no fatalities at work in order to tender for government building contracts).
- Governments also affect the governance agenda indirectly: are trend is the growth in government informal recommendations whereby, Government regulators at all levels are calling on companies to increase the quantity and quality of information they disclose to the public about their practices and performance.

- Corporate governance legislation and more active public prosecutors are having an effect on bringing corruption and bribery matters to the public attention.
- Becoming a corporate governance activist and more green can be a vote winner for people running for public office. For example, in the USA a recent heading read, 'Environment Wins in Democratic Landslide in 2006'. The story refers to the House Minority Leader, Nancy Pelosi, of California who will move into the Speaker's seat, becoming the first woman Speaker of the House in US history. Her environmental views match those of conservationists, particularly on climate and energy issues.

Governance drivers – an overview of the UK 4.22

In the UK some of the main legislative instruments are the:

- Business Names Act 1985.
- Companies Act 1985 and Companies Act 2006 update.
- Companies Consolidation (Consequential Provisions) Act 1985.
- Company Directors Disqualification Act 1986.
- Financial Services and Markets Act 2000.
- Financial Services Act 1986.
- Insolvency Act 1986.

As regards the EU drivers, as also noted above, there has been considerable activity over the years in the areas of company law, as well as more recent initiatives to deal with corporate mismanagement concerns. The European Commission (EC) has been working on the harmonisation of the rules relating to company law and corporate governance, as well as to accounting and auditing. This is considered essential for the proper functioning of the internal market.

While company law defines the issues that shareholders may or must decide upon at annual general meetings, as indicated, for listed companies the applicable securities laws and regulations governing proxy solicitation have a significant practical impact on the extent to which the vast majority of shareholders, who do not attend the meetings, actually participate in the decision-making at those meetings. The term proxy solicitation has evolved from the key proxy solicitation rules – in that context they are:

- the need for proxies to include the ability to vote against, as well as for, management's proposals;
- the information which must accompany proxy solicitations; and
- the facilitation of shareholder proxy solicitation and proposals.

Generally, company law governs the authority and rights of the different organs of the corporation and their responsibilities towards each other. It applies to all companies under the law's jurisdiction, whether closed, privately held or listed, and is primarily designed to make corporations effective entities for doing business.

A key example of company law revision to take account of improved governance was when some 10 years ago in March 1998, the British government set out, in the paper 'Modern Company Law for a Competitive Economy', its intentions of taking a broad approach to review the framework of company law (see case study in box below). A consultation document was issued in March 2000, entitled 'Modern Company Law for a Competitive Economy: Developing the Framework' by the Company Law Review Steering Group (available from www.dti.gov.uk/cld/modcolaw.htm). The draft statutory statement of directors' duties comprised the following:

- compliance and loyalty;
- independence of judgment;
- conflict of interest;
- fairness;
- care, skill and diligence.

As regards the latter, a director must exercise the care, skill and diligence which would be reasonably expected of a director in his position and any additional knowledge, skill and experience which he has.

The Steering Group presented its Final Report to the Secretary of State on 26 July 2001. The government published its response to the Company Law Review's major recommendations in a White Paper: Modernising Company Law (Cm 5553) published on 16 July 2002 (see also below in the discussions on the business review and SRI).

Securities laws and regulations govern the rights and obligations of corporations that issue securities vis-à-vis investors in those securities. They also deal with the rights and obligations of buyers, sellers and intermediaries involved in the trading of those securities. They are designed to protect investors and encourage the proper direction of capital markets. In the context of corporate governance, these laws generally deal with disclosure of information material to a decision to buy, sell or hold shares in a company. Business must also take account of stock exchange listing rules, which impose governance standards on the companies that list on the exchanges, and cross-border issues, as they relate to shareholder participation.

It should also be noted that the dividing line between what is the proper subject for company laws, or securities laws and regulations, or listing rules differs from one legal regime to another, such as the listing requirements for the London Stock Exchange (LSE) or the Alternative Investment Market (AIM) or the New York Stock Exchange (NYSE), and they do not apply symmetrically to corporations. Global companies incorporated in one country often list their securities on the exchange of another country, and have investors in yet other countries, and the legal framework applicable to their corporate governance can be complex. The most important aspects of these areas of the law – in relation to both the company and securities frameworks, as they affect the corporate governance of listed companies – can also impact on smaller organisations. Therefore they too must be aware of:

- laws and regulations governing the board of directors and management;
- accountability of the board and management; and
- the corporate governance structures and processes that companies have in place in order to carry out good corporate governance.

Moreover in today's fast moving pace of business development, it is important that the growing business should be aware of the potential trends and challenges that will require ongoing attention and decision-making.

Case study: Legislation, voluntary codes and stakeholder pressure in the UK

Modernising UK company law – drivers for reform

For several years company law has been the subject of reform, consultation and codification following the publication by the UK government of the White Paper: *Modernising Company Law* (Cm 5553). The Paper implied greater environmental reporting on the part of large companies and contains numerous proposals for the simplification of modernisation of company law. Its aim was stated as the provision of 'a legal framework for all companies which reflects the needs for the modern economy'.

The introduction to the White Paper indicated a number of drivers behind the suggested reform. One of these was EC activity in pushing forward changes to rules on the annual reports of companies. In addition, the EC had put out a consultation on a proposal on continuing obligations of listed companies to make information available to the market. Whilst these proposals largely cover financial reporting, the proposal included the need for ongoing disclosures in other areas including corporate governance information. In the body of the report itself, the White Paper makes the following statement:

> 'The government believes that all the components for the corporate governance framework will continue to be important. In particular, it takes the view that whilst legislative and regulatory requirements have an essential role, there will also be a continuing need for a code of best practice and other guidance.'

The Business Review

The Accounting Standards Board (ASB) first published a statement on the Operating and Financial Review (OFR) in 1993 and the government stated that it wants more qualitative and forward-looking reporting because companies are 'increasingly reliant on intangible assets'. The information disclosure that government sought should cover the reporting companies' plans, opportunities, risks and strategies. In particular it proposed new requirements for environmental reporting which it described as:

> 'A major contribution to both corporate and social responsibility and sustainable development initiatives.'

The government stated that there is a business case for these for which the OFR provides the opportunity for company directors to respond.

However, following a surprise announcement by the Chancellor on 28 November 2005, the removal of the statutory OFR came into force on 12 January 2006, in a much-criticised move by the government.

Companies will still face the less stringent requirement to publish a business review in line with the EU Accounts Modernisation Directive (Directive 2003/51/EC of the European Parliament and of the Council, 18 June 2003). The Department of Trade and Industry (DTI) consulted on the amendments to the Company Law Reform Bill that replaced the requirement for an OFR with the requirement for a business review, and eventually included comments on non-financial issues that formed part of the original OFR regulation. This was assisted by the threat of legal action by Friends of the Earth, and the government agreeing an out-of-court settlement to widen the original scope of its consultation on the business review.

In response to this consultation, on 3 May 2006 the government announced a package of measures to support its overhaul of company law. This included the explicit statutory purpose for the business review to inform members of the company and help them assess how the directors have performed their duty to promote the success of the company. It also included the requirement (for publicly listed companies), to provide information on the main trends and factors likely to affect the future development of the business.

There were calls by industry and shareholders for a continuation of the OFR on a voluntary basis, in accordance with the ASB's Reporting Standard 1 (RS 1) – now 'converted' into a reporting statement (RS) (ASB, *Reporting Statement – The Operating and Financial Review*, January 2006). The Association of British Insurers (ABI) and the Institute of Directors (IOD) backed the voluntary OFR in a letter to the *Financial Times* (Kate Burgess, call for voluntary code on reporting, *Financial Times*, 2 December 2005).

While the business review has now been given a forward-looking aspect following the DTI's consultation earlier this year, the inclusion of non-financial key performance indicators is only required 'where appropriate' (see also **Chapter 10**).

Other key drivers for reform of governance standards in the UK in recent years are reviewed in brief as follows.

The Combined Code
In the UK, the government has been putting increasing pressure on companies in terms of improving governance standards and disclosure. Tony Blair challenged the top 350 companies to produce social and environmental reports by the end of 2001 (of which only a quarter did so) and in September 1999 the Combined Code, commonly known as the Turnbull Report, was issued, which affected all UK listed companies. This forced UK listed companies to take account of internal risk control, including reputational risk and the management of environmental, ethical and social responsibilities. Further comment on Turnbull is also made in **Chapter 10**.

The Pensions Review
Following the introduction of the Turnbull Report, measures were introduced to encourage SRI in the form of the Pensions Review. The Pensions Review, effective as of July 2000, called for institutional investors to consider their position on SRI, and introduced a legal requirement to disclose a statement of investment principles to articulate their stance on the matter. This has led to a mixed response with a particularly insightful report published by the UK NGO Just pensions (*Do UK Pension Funds Invest Responsibly?*) indicating that poor practice is the norm and examples of best practice few and far between.

Corporate Responsibility Bill
There have also been pressures from other sources in the UK and in June 2002 a coalition of NGOs and campaign groups joined up with Linda Perham, MP, to put forward a Corporate Responsibility Bill, drafted in response to the failure of the voluntary approach to SEE drivers. This Bill required companies to publish reports on their social, environmental and economic impacts, and even though it failed, it succeeded in further raising the profile of CSR.

The Association of British Insurers
The ABI, also in the UK, has issued guidelines and called on institutional investors to give greater regard to SRI principles and for companies to report on important SEE drivers issues that affect their business.

Pressures from Europe
The Account Modernisation Directive of 2003 (Directive 2003/51/EC) is being implemented in the UK and has been discussed in the section ‘Business review’. On a wider scale, in 2001, the EC published a Green Paper on ‘Corporate Social Responsibility’ and launched a

multi-stakeholder forum for CSR in 2002. This forum considered and advised on standards for reporting and assurance and company codes of conduct, with recommendations.

AI000 standard and the GRI

Verification of company disclosures and the quality of the verification are concerns that have been noted by commentators, and there are some prominent organisations within the SRI community, such as the Co-operative Bank, that back tougher verification as a means to improve the situation. A fundamental question has been how and by whom standards of measurement might be developed and agreed upon.

In response to the problem of verification, the Institute for Social and Ethical Accountability formulated the AI000 standard for social reporting and a new professional group of social auditors has been emerging. Also the GRI, set up in 1997 and established as a permanent institution in 2002, has developed a core set of metrics which are sector specific and applicable to all business, and has released a template for SEE drivers. Even though the template is still underdeveloped and part of an ongoing process, it is a move in the right direction. However, the GRI has not been welcomed by all and there has been some resistance to the framework from some companies who see it as setting the standards unrealistically high. It is now in its third incarnation and is available in eight languages at: http://www.globalreporting.org/ (see also the **APPENDIX** to **CHAPTER 16**).

Corporate reporting

Many companies have actively lobbied the DTI over the whole question of mandatory environmental and social reporting. After a three-year consultation period, the Company Law Review was presented to the Secretary of State at the DTI, and the recommendations as to changes in company law are mentioned above. It covered a huge range of issues, many of them touching on the issue of transparency and accountability. Companies are now required to produce a more comprehensive business review to improve flows of information with shareholders and other stakeholders. Nevertheless the debate continues over obliging companies (above a certain size or in certain sectors) to publish an environmental and social report on an annual basis.

Further comment on reporting is made below in **4.46** at the end of this chapter, while the discussion of governance and non-profits is developed further in **CHAPTER 17**.

Economic trends and drivers

Increased attractiveness to investors of ESG factors' financial performance 4.23

While it may be difficult to determine a direct causal relationship between increased accountability and financial performance, a variety of studies suggest that such a link exists:

- The Deutsche Bank series 'Behind the numbers' regularly reviews the financial benefits of governance issues and which are material to organisations shareholder returns;
- A 1997 study by Wilshire Associates, a financial information and consulting firm for institutional investors, revealed that the stock prices of financially underperforming companies improved after implementing corporate governance reforms;
- A growing number of investors are including non-financial metrics in their analysis of the quality of their investments. Research suggests that investors may be willing to pay higher prices for the stock of companies considered to be accountable. Even over a decade ago a 1996 survey of large institutional investors conducted by McKinsey & Co. found stockholders willing to pay an 11% premium for the stock of companies deemed well governed;
- Other studies have also linked good stakeholder relations with shareholder value. For example, an analysis of Fortune 500 companies conducted at the Boston College Carroll School of Management found that financial performance was linked to good treatment of stakeholders, including employees, customers and communities. The researchers also found that companies which are judged to treat their stakeholders well are also rated by peers as having superior management. According to UBS Warburg this attracts an average 12% premium;
- 37% of investors in the 2006 ISS Global Investor Survey identified enhanced investor returns as the most significant advantage of engaging in corporate governance;
- In 'the emerging performance of environmental funds relationship between environmental performance and shareholder wealth'. Ralph Earle, the Managing Director of Assabet Group, studied both academic research and nine different environmentally focused investment funds around the world. He concluded that investing in companies that use environmentally sound business strategies could lead to increased shareholder value. Each of the nine funds examined outpaced their respective benchmarks;
- A study comparing the financial returns of portfolios of highly polluting industry with those of low pollution companies undertaken by IRRC suggested that there was no penalty for investing in a green portfolio. In many cases, such portfolios achieved higher returns both against the high polluters and the S&P 500 Index (Investor Research Responsibility Centre, Environmental and Financial Performance: are they related? 1995);

- During the five years before August 2001 the Dow Jones Sustainability Index (DJSI) clearly outperformed the Dow Jones Global Index (DJGI). While the DJSI had an annualised return of 15.8%, the DJGI increased by 12.5% in that period.

Macro economic trends **4.24**

An overview of the structural nature of the economic environment from the University of Cambridge Programme for Industry Sustainable Economy Report (available at www.cpi.cam.ac.uk) provides a good overview of the trends of note in this section. The report's main conclusions are:

- It is seen that economic systems and pressures are prejudiced towards the short term at the expense of more sustainable opportunities. There is a growing realism that this short-term perspective and other economic values may be incompatible with drives towards sustainability;
- There seems to be a lack of consensus on the long-term goals and objectives of many economies and economic groupings;
- Inappropriate market incentives, failures and interventions can distort markets and create incentives for unjust and unsustainable trade;
- There are embedded weaknesses in: governments who should be providing good governance and policies; the education system in their role to promote sustainability; and the economic distribution systems as there are wide inequalities of opportunity, wealth, health and well-being;
- Traits such as selfishness and greed are prevalent and encouraged by the current systems of economic behaviour; and
- Current pricing mechanisms and metrics for measuring progress reinforce any bias as current measures are misleading, or poor indicators of:
  - ○ environmental performance and the full economic value of resources;
  - ○ health quality issues rather than just duration;
  - ○ social factors like the quality of life and well-being; and
  - ○ prices fail to capture externalised social and environmental costs; therefore, there can be an undervaluing of people and nature.

Business benefits through the balancing of risks to rewards **4.25**

Risk is part of the entrepreneurial culture needed by any organisation that wishes to develop, expand and improve. An effective risk management structure allows an organisation to understand the risks in any initiative and to take informed decisions on whether and how the risks should be managed. Risk management is now a practical feature of business, just as due diligence should be recognised as another proactive tool that is of vital assistance in the management of risk. Nowadays, no matter where an organisation operates and whatever its size, risk management is becoming an increasingly essential part of today's business environment and is of interest to:

- CEOs, financial directors, other executive and non-executive directors (NEDS);
- company secretaries;

- heads of internal audit, risk management or other assurance functions; and
- all managers with an interest in risk management.

Risk should be regarded as an opportunity to improve not only the management of the particular risk or uncertainty in a specific project, but also the business as a whole (see also **Chapters 5** and **10**. As is recognised in the UK's risk community, projects involve an element of risk and the success of any project depends on managing this risk. Controlling risk requires an understanding of the dynamics of change and a healthy respect for the unexpected.

The discipline of risk management extends to, for example, environmental management and provides a range of tools and techniques to help organisations, and the individuals within them, to succeed in a complex world. Although risk management will never be a substitute for prudent judgment, it can sharpen innate wisdom and improve decision-making to help organisations both survive and thrive. This is very important in the UK in the light of the Turnbull Report – a report that has helped companies formalise risk management (which is referred to in **Chapters 7** and **10**). Since 23 December 2000, Turnbull has required that any risk management programme should focus on the way to achieve full disclosure to ensure that processes are embedded in corporate policy at board level for listed companies. Any additional practical advice on how to create an embedded and ongoing risk management process should be valuable. Benchmarking with other companies is a beneficial tool to help in this endeavour (see also **Chapter 6** regarding commercial due diligence). A process to conduct a benchmarking study that embraces the concepts of risk management in a selected sector having regard to the size of the business is clearly useful in today's business environment. The overall objective will be to determine how participating companies manage these risks.

Case study: Small business risks, due diligence and risk management
Environmental and related governance considerations will not go away for the owners of micro businesses (0–9 employees) however much they wish they would. It is said that the talk about jumping on the green bandwagon has died down; being green is no longer fashionable or glamorous, it is a fact of life with a direct impact on profitability.

It is important that the owners of smaller businesses consider the impact of environmental issues on their businesses, but it is equally important that the regulators understand the problems experienced by businesses and adopt a pragmatic and realistic approach. Smaller businesses adopt a risk-based approach; they take priorities in order of apparent importance, owners of small businesses have to be knowledgeable on all types of legislation. They have to monitor requirements that include:

* employment law;
* taxation;

- health and safety;
- consumer issues;
- product liability;
- IT; and
- the environment.

Small business does not have the resources in time or money to be, or to employ, an expert on all aspects of legislation.

As regards the area of environmental risk management (Chapter 16), regulators and enforcers should try to adopt the 'carrot' rather than the 'stick' approach. Nevertheless it will become increasingly more important for small businesses to adopt a thoughtful approach to such issues and accept responsibility for their own environmental impacts. (For example, the *Landfill Tax Regulations 1996* (*SI 1996 No 1527*) relating to landfill tax, *the Special Waste Regulations 1996* (*SI 1996 No 972*) (as amended) relating to Special Waste and the *Producer Responsibility Obligations* (*Packaging Waste*) *Regulations 1997* (*SI 1997 No 648*) relating to packaging waste affect only a small percentage of small businesses but the implications of the *Environmental Protection* (*Duty of Care*) (*Amendment*) (*Wales*) *Regulations 2003* (*SI 2003 No 1720*) incumbent on every business, large and small, are still not understood.) Small businesses need to make an honest appraisal of where they stand in relation to environmental and related issues and develop a simple policy to address their potential problems over the short and long terms. Many regulations exist and environmental enforcement can result in fines – and a criminal record. Small businesses need to understand that the simple approach of good environmental housekeeping can save money.

It is now recognised at European level that, although the environmental impact of individual manufacturing small businesses is small, the total impact could be significant because of the vast number. Lord Strathclyde, when a Minister in the (then) Department of the Environment, said:

> 'Environmental problems are the consequence of millions of decisions taken by everyone in the course of their lives. The solutions to these problems lie in the same hands – individual action.'

That statement is still appropriate for us all in our business and domestic lives but it must always be balanced by the fact that many businesses are smaller than households.

Supply chain encouragement must replace supply chain pressure; there are examples of good practice and these must be extended. Banks have developed environmental criteria within their lending and credit policies, and insurers are becoming even more vigilant about pollution problems.

Simple actions can make all the difference but the information must be in the public domain. The 90:10 rule applies (the 80:20 has not yet been reached!); 10% discusses what they think 90% should do, but the 90% do not even know there is an issue.

Similar arguments can be applied to many aspects of CSR and corporate governance. The trend for all business – whatever its size or location – must be to work towards best practice at all levels. Practical initiatives can change the performance of the workforce and the business as a whole, as well as improve public perception. Risk management strategies are not just the domain of big business. For instance, IT has proven to be one of the weakest areas for businesses of all sizes when implementing the Turnbull guidelines (see further **Chapter 9**). A practical priority is to invest in effective disaster recovery and business continuity plans. Early reports from the DTI's *Information Security Breaches Survey 2004* found that two-thirds of businesses surveyed had to restore significant data from backup due to a computer failure or theft. For small business too, it is wise to ensure that a robust backup procedure has been implemented and that data can be restored efficiently in a worst-case scenario.

Finally, once the business has developed and implemented the risk management strategy, it must be vocal about having such a policy in place. Investing in the development of a comprehensive risk management strategy improves the visibility of processes and demonstrates stability, which is particularly important for high growth SMEs and start-ups that are seeking grants and funding. One may even be able to negotiate more favourable insurance premiums for the business. In many respects all business should consider a risk management strategy as an extension to insurance arrangements, which will serve to boost employee, investor and stakeholder confidence in the business as a whole. Some of the requirements discussed in **Chapter 10** can also be applied to assist small firms to identify the main risks to the business and put plans in place to minimise them. In turn this will enhance the benefits of ongoing due diligence and corporate governance.

Aside from the more general trends with regards to the marketing environment and the market risks current trends include the following.

Competitive marketplace trends with regards to governance and sustainability issues **4.26**

- There is growing competition for ESG and sustainability leadership within sectors;
- There is an increase in measuring and reporting of ESG issues;
- There is more quantification of extra financial risks and enhanced valuing of items like brands as market differentiators; and

- Companies are developing a wide range of management systems to measure, apply, assess and report their efforts to integrate ESG and CSR considerations into all aspects of their operations and due diligence processes.

Economic growth 4.27

- Global growth rates will be maintained although the emphasis of growth will continue to move from the developed to the developing economies, especially as there is an expected slowdown in the developed world as debt correction occurs. This has been vividly withessed in 2008.

Globalisation of commerce, crime, legislation, taxation; trade, and terrorism 4.28

Trends include:

- Companies and governments are concerned that the US watchdogs are extending their powers abroad, post Enron, including US financial rules that are encroaching further into the City of London; and recent interpretations of the US Alien Tort Claims Act have allowed companies to be sued for their actions in foreign countries.
- As set out in **4.4**, the internationalisation of taxation and increasing relevance of sustainability-related taxes will continue. Countries are eyeing a raft of green measures to help combat climate change, including higher taxes on cars, air travel, fuel, lighting and consumer electronics.
- The industrialised countries still account for over two-thirds of manufactured exports although the developing countries' share of this trade will increase, especially from Asia.

Shift to eco-economics 4.29

- There will be an increase in the inclusion of environmental assets and liabilities onto the balance sheet and into company processes like product design and life cycle analysis economics.

Shift to micro economics 4.30

- There is a branch of economics that is addressing the real developing world issues. An example is that Muhammad Yunus won the Nobel Peace Prize in 2006 for his work in tackling poverty in Bangladesh by granting tiny loans known as microcredit, via his Grameen bank. Their repayment success has caught the attention of Citigroup and other commercial banks as the loan recovery rate is almost 99%, despite interest rates up to 20%.

Social, ethical and environmental trends and drivers

Social drivers 4.31

These drivers are largely covered by the stakeholder matrix analysis but it is worth considering some of the drivers from a social and cultural context. Some trends demonstrate the fact that there are large-scale risks present within the socio-economic aspects of our global society, which include: income differentials and the widening gap between rich and poor; human rights violations; debt and economic slavery; inadequate diets and distribution of food supplies; the prevalence of preventable and curable diseases; global conflicts increasingly fought over resources, and rapidly increasing number of refugees from these conflicts as well as from political, environmental and natural disasters.

These are all vast challenges for human society but here we consider these types of risk and societal trends in a business context. The trend is that there will be increased moves to understand and account for social capital by organisations and society.

Social capital

Social capital refers to the institutions, relationships and norms that shape the quality and quantity of society's social interactions. Increasing evidence exists that social cohesion is critical for societies to prosper economically and for development to be sustainable.

Social capital is not just the sum of the institutions which underpin a society – it is the glue that holds them together, according to the World Bank.

Demographic trends in society **4.32**

- The human population of the earth is increasing at approximately 70 million persons per year.
- There is real population decline in 61 countries, accounting for 44% of the earth's population, fertility rates are now at or below replacement levels.
- The global economy faces a transition of unprecedented dimensions caused by rising old-age dependency and shrinking working-age populations among the world's largest economic powers.

Cultural changes **4.33**

- There will be a wide range of cultural changes, with the potential for a renewed emphasis on traditional values of religion, and family, as well as on issues like education, relationships, diversity and an emphasis on women in positions of power, and a reorientation of the environmental movement.
- There will be more polarisation of people by race, ethnicity, lifestyle and class.
- Society will begin to realise the scale of some of the challenges facing it and the ineffectiveness of some institutions with regard to issues like climate change.

Ethical trends and drivers 4.34

Ethical issues are those that have an ethical dimension, viewed as the difference between right and wrong conduct. Some emerging trends are:

- Ethical considerations as regards products and services are being scrutinised by consumers more closely and are thus of increasing importance and focus. Issues cover concerns that it is wrong to clear cut forests and eradicate species, pollute the planet, use inappropriate marketing, etc. (see also **Chapter 7**);
- There may be moves to reinforce values in society like the regeneration of communities, and protecting, guiding, and supporting children, the mentally ill, the disabled and other parties;
- UN General Assembly may consider adopting the Declaration on the Rights of Indigenous Peoples and companies like Alcan are already advancing corporate practice by launching their own policies; and
- Bribery and corruption allegations are of increasing significance to policy makers and the public.

Ethical policies and due diligence 4.35

There are a variety of approaches for businesses to choose from to incorporate and maintain an ethical policy. In the UK the Institute of Business Ethics (IBE) has found that:

1. One approach is for 'companies to make explicit their ethical commitment and incorporate it into their marketing or brand strategies. For instance, the Co-operative Bank (the Co-op) claimed that its 2001 profits rise was due, in part, to its policy of doing business only with those it considered ethical. The chairman estimated that between 15% and 18% of the £96 million pre-tax profit was attributable to the Co-op's ethical values stance. The Bodyshop set out to associate its products with environmental concerns, as do Ben & Jerry (now owned by Unilever). Indeed, as is seen in **Chapter 8,** some businesses can also develop a managed risk culture.
2. Another approach is for businesses to use a 'strategy of associating the company and its products with concern for organisations (often in a developing country) which produce the raw materials or finished products. Members of the fair-trade movement, especially in primary products like coffee, emphasise ethical standards in purchasing policies, for example purchasing from renewable sources, paying 'fair' wages and not employing child labour. In so doing, they seek to attract the sympathy market to their products. Related to fair trade is the growing popularity of CRM. This is the name given to a strategy that associates branded goods with a 'good cause'.
3. A third approach is to make it clear in public announcements by company CEOs and chairmen that they expect the highest ethical standard from their staff and that the company's long-term sustainability depends on this. Examples of these that the IBE has referred to in its report are:

> 'Responsible behaviour makes good business sense … At Rio Tinto we have found that maintaining the trust of local communities is essential for the long-run success

> of our operations. A sound reputation on ethical issues also helps us to recruit and retain high-calibre employees.'
>
> *Sir Robert Wilson, Chairman, Rio Tinto plc (minerals and metals)*

> 'Each of us [in Sara Lee] – in every job, everywhere in the world – has a responsibility to do the right thing and to help our peers do the same. Our success and our future as a business depend on it. Companies that compromise their values and fail to do the right thing are sure to fail.'
>
> *C Steven McMillan, Chairman, President and Chief Executive Officer,*
> *Sara Lee Corp (food processing)*

> 'Perhaps more than anything else we do, furthering our company's values and standards will have the greatest effect on the future success of our company.'
>
> *Ray Gilmartin, Chairman, President and Chief Executive Officer,*
> *Merck Corporation (pharmaceutical)*

> 'Good leadership means doing the right thing when no one's watching. Values governing the boardroom should be no different from the values guiding the shop floor.'
>
> *Carly Fiorina, CEO Hewlett Packard (computer systems)*

As has been indicated, these and other such approaches are valuable in the interests of high standards of business ethics and good corporate governance within corporations and among their stakeholders, as well as with the public.

Case study: Ethical due diligence

The Dutch–British conglomerate Unilever provides an instance of a company undertaking substantive endeavours that are able to support acts of genuine corporate citizenship with innovative investment tactics and a transparent media campaign. This entails deploying journalists and consulting firms to convert the company's stated business policies into moving first person narratives of people benefiting from Unilever's labour-friendly, ecologically sustainable projects. For example, its reports on social responsibility are coupled with journalists' vivid descriptions of a floating medical hospital that provides free medical care in Bangladesh, production and distribution of inexpensive iodised salt in Ghana, and public disclosures of the amount of Unilever's emissions of carbon dioxide and hazardous wastes.

Clearly, the way a company does business is critical to its own sustainability, wherever it operates. Studies by the International Chambers of Commerce (ICC) have addressed this aspect in the context of environmental concerns. A management that adopts a 'when in Rome, do as the Romans do' approach will soon realise that the inconsistencies that result are damaging to long-term success. The US corporation Union Carbide's experience with the chemical plant disaster in Bhopal, India, illustrated that even if a business is not 100%

owned, basic standards are expected to be maintained wherever it operates. The Bhopal incident in 1984 has been described as one of the world's worst chemical disasters. It was caused by a gas leak at the Union Carbide plant in Bhopal, India. The incident killed over 3,000 people and adversely affected the health of many more thousands. It cost the American group over $US 270 million in punitive expenses alone. In addition to monetary losses, all Indian assets were seized and the company was forced to leave India at a time when the market was most attractive to investors. The CEO at the time evidently regarded this event as his most important lesson in corporate management. It set the organisation on a new course of enhanced environmental awareness worldwide (see also **Chapter 16**).

Since autumn of 2002, the NYSE has made the existence of a code of ethics a condition of listing. This should persuade those in the USA and others listed on the exchange who do not have codes to produce one. However, of course, a code is not sufficient in itself to ensure that a high standard of ethics is maintained. For instance Enron in the USA had a 'standards of conduct' code. Such a policy, as with others, has to be embedded within the culture of the company to have any real effect in terms of ongoing due diligence, risk management and corporate governance.

One approach that has demonstrated that good CSR can assist good business performance is the SERM approach.

Environmental trends and drivers **4.36**

A general overview of the current situation of the environment can make harrowing reading. Our systems of global, national and organisational governance and processes are largely reliant upon large volumes of raw materials and the energy gained from them. The industrial revolution of the last century and a half was enabled by a shift in energy technology to oil and gas, mechanisation, and tremendous exploitation of natural resources of all kinds, including clean air, water and soil, to enable massive production and increases in wealth. This has led to a wide range of associated costs, such as:

- Rising sea levels and desertification together will present the world with reduced land resources and an unprecedented flow of environmental refugees – and the potential for civil strife.
- Within this reduced land area the earth; will be required to accommodate population growth of humans and animals, adding increasing demands to our ecosystem at a rate of 70 million humans per year and 35 million livestock, causing pressures upon food security for many countries; and
- Additional losses of biodiversity, quality drinking water, as well as damage to the ozone layer and the increased risk of damage from ultraviolet radiation as a result of this etc.

Environmental legislation **4.37**

In order to try to resolve some of these consequences of our development there has been a growth in the volume of legislation being enacted with several hundred new environmental laws newly passed each year globally. This large body of legal statutes is likely to continue to expend. Examples of recent and emerging laws are:

- Under adopted EU laws, some manufacturers are required to accept returned product packaging, and certain products such as computers, at the end of their shelf life. Risk experts say such regulations will force companies to use materials that recycle more easily or contain fewer toxic ingredients. EU countries will be more aggressive in adopting and enforcing pollution laws;
- The EC supports moves to tighten vehicle emissions limits further than those foreseen in current proposals; and
- Many US states are going ahead with their own legislation as a local response to climate change and other air quality issues, in the face of what they view as limited national action. For example state officials in Wisconsin are developing new rules to limit emissions from coal-burning power plants and other sources of ozone, particle pollution, visibility-reducing haze and mercury (see also **Chapter 16**).

Some further trends more directly relevant in a business context are:

Resource scarcity 4.38

Some resources are becoming source as our ecosystem is impacted:

- Signs appear to indicate that there will be large challenges as global supplies of oil are estimated to peak in 2010 and then start to decline. About 50 countries, including the USA, have already passed their production peak. Therefore the shift away from the internal combustion engine and to fuel cells will gain momentum;
- Reduced land resources as civilisation is being squeezed between advancing deserts and rising seas;
- Water shortages are occurring and will gain in severity of impact. Companies requiring water resources for their processes will find their business models endangered in some severely hit countries. The WBCSD report entitled 'Business in the World of Water' at www.wbcsd.org highlights that the water crisis can hit all business and how the issue will drive up business operating costs; and
- To sustain present levels of seafood consumption, humans would need more than 2.5 times the area of all the earth's oceans. 'The Fishprint of Nations 2006', report estimates that 91 countries, including the USA, over-fished their biological capacity in 2003.

Increased resource efficiency 4.39

The other side of the scarcity debate is that it is a driver for efficiency. There are moves towards resource reuse, repair and eco-efficiency and an example of this is with regard to the development of land in various jurisdictions, as with 'Brownfield' land use for house building sites. (see also **Chapter 16**)

Energy **4.40**

The energy sector accounts for the majority of GHGs; mean while aviation now accounts for 50% of total energy-related emissions of GHGs. (*Source*: www.un.orgesa/sustdev/publications/trends2006/index.htm)

Energy efficiency **4.41**

Oil amounts to 35% of total primary energy supply, with the largest share going to transport, which also increased at 4 times the rate of increase for industrial use from 1971 to 2003. (*Source*: www.un.orgesa/sustdev/publications/trends2006/index.htm) This trend is set to continue and efficiency measures and substitutes will gain prominence as risk issues.

Renewable energy **4.42**

The use and investment in renewable energy will increase – combustible renewables and waste and hydro power account for nearly all the world's renewable energy production. 'New' renewable energy sources like geothermal, solar, tidal, wave, wind and others will rapidly increase from their small proportion of production.

Case study: Climate change and global warming

Climate change (CC) stands at the gateway to the mainstream investment world and it stands on the shoulders of SRI. There have been individual companies and specific issues that have been picked up on in the past that have served to demonstrate that SRI has identified material risk. Never before has an environmental issue promised to be so all encompassing that it cannot be ignored by any sector. The threat posed by CC to our physical world can be seen with biblical numbers of avalanches in the Alps, glacial destruction, increased risks of flooding and of drought. CC needs to be addressed now. The major debate has demanded extensive additions to the discussion of environmental risk management in Chapter 16.

Collective action from investors was slow to organise a response to the concerns. However, in the last few years, both the Institutional Investor Group on Climate Change and the Carbon Disclosure Project (CDP) have been established as positive forces in raising awareness amongst investors as well as companies. The more investors pressure companies, the greater the ability to force companies to give up carbon intensive practices and start to make a transition to a low carbon economy.

SRI has for the most part focused only on CC as another environmental issue. Tackling the root causes and mitigation of CC has not been properly explored, except possibly by the tiny market of alternative investment. Mitigation of CC and producing a low carbon economy is the best way to address CC. There needs to be a paradigm shift to a zero carbon economy.

Collective action looks to raise all members to at least a basic level of addressing CC. However, there are still many investors, mainstream investors, who do not address CC at all. The mainstream fundamentally needs to measure issues in terms of finance. The faster government produces allocations, that carbon trading establishes a more certain figure in terms of cost, the faster all investors will be in a position to take CC into their investment decision process. (see also **Chapter 16**)

Tempered against what is needed for the environment is what is needed for investors. Even in SRI there is the need to establish a sound financial return and for managers to satisfy their fiduciary responsibility. Therefore, CC is looked upon as being an environmental risk, but more often than not only insofar as it is a financial one too. Positive action is needed in addressing CC. Investment is needed for mitigation and adaptation. To achieve this there needs to be greater communication, greater understanding and the identification of those who do not make it a priority. For instance, McDonalds saw a boost in its sales in Japan after joining with the Japanese government in an educational campaign designed to generate popular support for combating global warming. Similarly, Virgin Trains' announcement to promote climate-friendly policies met with an 11% increase in journey numbers over a period of three months.

The current situation, although always guaranteed to prove contentious, is generally accepted within the scientific community to be that the planet is warming. The role that human activity plays in the warming remains more controversial. An address by Kofi Annan, Secretary General of the United Nations, mentions:

> 'Climate change is not just an environmental issue, as too many people still believe. It is an all-encompassing threat.
>
> It is a threat to health, since a warmer world is one in which infectious diseases such as malaria and yellow fever will spread further and faster.
>
> It could imperil the world's food supply, as rising temperatures and prolonged drought render fertile areas unfit for grazing or crops.
>
> It could endanger the very ground on which nearly half the world's population live – coastal cities such as Lagos or Cape Town, which face inundation from sea levels rising as a result of melting icecaps and glaciers.
>
> All this and more lies ahead. Billion-dollar weather-related calamities. The destruction of vital ecosystems such as forests and coral reefs. Water supplies disappearing or tainted by salt-water intrusion.'

Source: Address presented at the UN Climate Change conference in Nairobi, Kenya, on the 15 November 2006.

The concerns have been reinforced by Dr Rajendra Pachauri, Chairman of the Intergovernmental Panel on Climate Change (IPCC), who has received the Nobel Prize in 2007 along with the CC activist and former US Vice President Al Gore. His comments are further referred to in Chapter 16, as well as reference to the latest meeting in Bali regarding the Kyoto Protocol.

Some trends are:

- Weather extremes will increase according to IPCC, drawing on scientific advice from around the world; both drought and floods could be more common due to global warming;
- Global warming is threatening the planet's biodiversity, particularly migratory species like birds and marine animals and species loss is expected to increase;
- GHG emissions trading will take on greater importance;
- The planetary climate will warm over the next several decades, resulting in sea-level increases of some unknown magnitude;
- Increased stakeholder activism on the risks – an example is the CDP which has 225 signatory investors controlling trillions of dollars in assets, with the aim to increase GHG Emission Reporting. (See the key topic section at the end of this chapter); and
- Increased taxation of GHGs. An example is that France is to push coal, carbon taxes in support of the Kyoto protocol. (See comment page key topic in **CHAPTER 16**)

Technological and scientific trends and drivers **4.43**

The pace of technology development will continue at accelerating rates, especially in information, nano, biological and energy technologies (see also **CHAPTER 6** regarding Biotechnology and **CHAPTER 9** regarding IT). Aside from these scientific breakthroughs and the risks associated with them, there are practical effects upon due diligence and governance systems.

A major factor is the continued growth and development of IT which has involved:

- Cost reductions: There has been a doubling of performance versus price curves for computer chips, memory systems, data networks, and this trend will continue to accelerate up. New electronic communications legislation in the USA and UK have reduced the costs associated with companies communicating with shareholders and other stakeholders;
- Digital format: More and more information is digitised, and more information will become available in digital format only. Companies can demonstrate transparency and disclose information at much reduced costs through email alerts and websites;
- Reporting and communications: The Internet has provided companies and those seeking greater corporate accountability an unprecedented ability to share and exchange information on a large scale, cost effectively. Some of the most innovative companies are planning to provide 'sustainability' information in a real-time format;

- Market and process opportunities: The next decade will see computing and telecommunication increase in capacity 5–7 times. This could mean that:
  - computers will become imbedded in clothing and the built environment;
  - business transactions will involve virtual personalities as intermediaries;
  - translating devices and phones will be common, as will voice recognition systems and automatic language translation; and
- Security and surveillance systems will become available on a micro scale posing competitive and information security issues and new dilemmas with regards to the balancing of privacy and access concerns.

Key governance trends

Corporate social responsibility 4.44

Corporate social responsibility (CSR) has been defined as 'essentially a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment' (see the EC Green Paper *Promoting a European Framework for Corporate Social Responsibility*; see also the **Appendix** to this chapter.) The Commission published the Green Paper in July 2001 to promote CSR. In addition, the Commission voted in favour of social and environmental legislation reporting and indeed several initiatives debating and investigating the issue of CSR have emerged.

In the UK, as noted, the government attempted to promote CSR by the Prime Minister's challenge to the top 350 FTSE companies to voluntarily report on social and environmental issues. As of March 2007, 81% of FTSE 100 companies are producing reports on CSR topics of at least six pages in length. Since business did not respond positively and since the EU has put pressure on the UK, the government has been considering CSR legislation and the concept is expected to feature in consultations. In addition an initiative regarding an international standard has taken place.

Business theories

William Vanderbilt once said, 'the public be damned', instead he claimed to be working for his stockholders. Many corporations and modern business schools have discarded the theory expressed above as inapplicable to modern business. In a time where people are increasingly educated, concerned and connected with the world around them, it is impossible for reputation and social management not to be linked with financial concerns. Also, the idea that stakeholders are only financially concerned is becoming archaic. There are many examples of corporations generating loyalty among stakeholders by being socially responsible and generating positive media attention, while also managing risk strengthening the, brand and increasing sustainable growth.

One of the most crucial concerns for modern business is a good reputation. Without it, success and profits are at risk and the confidence of stakeholders is lost (see **Chapter 7**). The evaluation of such risk is therefore a vital tool for business in a climate of media interest, rapid exchange of information and dynamic competition. A reputational risk valuation is used to:

- Quantify the value that CSR adds and produces a direct benefit calculation by showing, for listed companies, the volatility reduction and, through option pricing, the shareholder value added of CSR initiatives;
- Direct CSR efforts to the areas of highest return and exit from CSR areas that are of little benefit;
- Produce a cost/benefit analysis for future CSR activity; and
- Develop a prioritised CSR plan that delivers shareholder value more rapidly.

Reputational risk valuation begins with an assessment of inherent risk – public profile, level of public awareness, longevity of public concern, focus of blame, stakeholder reaction. This is followed by an assessment of residual risk – entry or exit, operational controls and mitigations and managing stakeholder expectations. Both assessments are grounded in SERM's proprietary ratings, permitting statistically valid CSR/value benchmarking against peers or competitors.

Evidence of value from CSR **4.45**

One of the most demanding tasks for CSR professionals is to prove that they add value to their organisation. Increasing sophistication is required to manage the intangible assets of a complex business in order to meet or exceed stakeholder expectations, sustain corporate reputation and enhance brand value. Wider groups of stakeholders scrutinise the way in which risk/reward decisions are made and communicated. Measuring the benefits of CSR is difficult, but not impossible. There are three components worth measuring:

- Risk avoidance;
- Reward enhancement; and
- Reduction in volatility.

Risk avoidance and reward enhancement may sometimes be measured, but CSR also reduces volatility and therefore adds measurable value. In a listed company, volatility reduction can be estimated and the value calculated. Indeed the then Enterprise Commissioner, Erkki Liikanen, delivered the following message to the European Multi-stakeholder Forum on CSR at the end of 2003:

> 'The evidence is getting more solid that it pays off for companies when they invest in corporate social responsibility.'

CSR in this context means companies behave responsibly towards their stakeholders in a strategic way and in their own long-term interest. The European

Multi-stakeholder Forum on CSR, launched in October 2002, aimed to improve knowledge and consensus among businesses, trade unions and civil society and to explore whether common European principles on CSR practices and tools would be appropriate. The discussions were also intended to increase trust and understanding and include reference to broader schemes such as the chemical sector's Responsible Care Programme and the UK's Ethical Trading Initiative (ETI). The potential benefits for companies were an important aspect of the Forum's work. For example:

- Enterprises can gain competitive advantage when they invest in sound relations with their stakeholders and attend to their environmental performance;
- This can boost their reputation among employees, neighbours, customers and suppliers;
- Sound relations with stakeholders can support an organisation's 'license to operate' as societal actors and public authorities that have a positive perception of the organisation will be more in favour of its projects;
- It can spur innovations (innovations produced with CSR in mind can produce sustainability while also streamlining operations, including the supply chain); and
- Ultimately it can potentially improve bottom line performance.

Such assessments are in line with a growing number of scientific findings supporting the business case for CSR (and note links with **Chapter 8**). The latter demonstrate vividly that being a good employer, neighbour and protector of the environment actually increase, rather than reduce, profits.

Since business continues to stress that the positive effects of CSR depend on the ability of companies to tailor activities to their specific situations, the Forum has noted that the following factors can contribute to the success of CSR:

- Firm commitment to the concept from the very top to the very bottom of a company and among all stakeholders;
- The integration of CSR into all day-to-day business;
- The nurturing of skills and the provision of educational tools; and
- The adherence to reliable transparency, including financial details.

While the matter of the necessity of a European CSR framework remains under discussion, the IBE has also considered various related questions. If it were indeed possible to produce evidence that ethics pays – that companies which undertake their business ethically perform better over the longer term – might it help convince more business leaders that it is a worthwhile thing to do – as well as the 'right' thing? According to the report 'Does Ethics Pay' published by the IBE in 2003, the management expert, Peter Drucker, is quoted as saying:

> 'What cannot be measured, cannot be managed.'

Measurement of the measurable is clearly worthwhile if management is to be effective. There are aspects of business which whilst difficult to measure accurately, do need to be managed. Whereas, as noted, some aspects of corporate responsibility can easily be measured, such as enhanced environmental management and performance (see Chapter 16), many others are not. Business ethics programmes are the latter. These may be considered as the soft areas, as was the case with environmental issues some years ago when they were considered to be separate from core business issues or policies. It is better to find indicators of 'tendency' or 'direction' rather than absolute numbers. In addition, some things can only be measured by their effects. Taking risks is an inherent part of operation and innovation in business. After all, businesses and products are initially conceived on the assumption that a consumer will want the goods or services offered.

Corporate safety policies

The IBE survey has found that corporate officers will question or even veto spending on programmes which cannot be shown to yield a benefit to the 'bottom line'. On the other hand, many CEOs and boards of directors are conscious of areas of business activity not susceptible to measurement, yet if not addressed, leave the organisation vulnerable. Their problem is that good policies aimed at lowering risk but which incur cost are difficult to make convincing because they can only be justified by negative criteria such 'we did not have a disaster'. An example of this is corporate safety policy, the basics of which are required by law in many countries.

Generally, extractive industries are concerned with corporate safety due to the obvious high risk nature, especially within deep mining. For example, in South Africa, approximately 200 mining deaths occur annually. This pales in comparison to China, where the industry is not governed by the same standards as in South Africa, and 3,000 mining deaths occur yearly. Improving safety for miners in Africa is not a new issue by any means. However, it was only in the year 2000 that investors in the mining industry connected financial performance with safety concerns, when the chief inspector of mines temporarily stayed the operation of a mine for safety reasons.

Certain corporations, such as Barrick and BHP Billiton, refuse to participate in any deep mining in South Africa because of safety concerns. Cynthia Carroll, CEO of Anglo American, one of the world's largest mining corporations, recently challenged its group's management to reduce their mining casualties from approximately forty per year to zero. This is a difficult proposition, as it will require investments from the company to be made towards improved safety standards. In addition, a cultural change is required to fulfil Carroll's goal, one that entails challenging the deeply rooted incentive systems that inherently encourage workers to take risks. This includes educating workers, a majority of which of whom are illiterate, about proper safety.

Source: Markus Reichardt, *Anglo American digs itself a hole*, Ethical Corporation, October 2007, pages 20–21.

A significant proportion of any pecuniary losses due to breaches of policy can be covered by insurance. However, can the same be said of security? In recent years, protection of premises from infiltration by unauthorised people has moved up the corporate agenda. Employees, customers, subcontractors, etc. now expect some measure of security from the risk of random attack by intruders. Expenditure for minimising this risk has become a necessity and therefore has been built into budgets. It is also true of integrity risk. There are enough examples of unethical, and sometimes illegal, behaviour by individuals or groups in corporations which have severely affected the reputation, if not the viability, of a business. Some of the examples that have been cited by the IBE and are well documented. They include, for example, the collapse of Barings Bank as a result of losses made by trader Nick Leeson.

As is true of other areas of corporate governance, while it is not possible to guarantee the prevention of such unethical behaviour, it is possible to introduce preventative steps which will help to minimise (but not eliminate) behaviour which can lead to loss of corporate integrity; for example, by the implementation of an ethical policy. However, the IBE has found that:

> 'the need for such a policy is not yet widely accepted. It is still mainly the largest corporations that take business ethics seriously. One reason is, of course, the cost of developing and embedding the policy. Different approaches have been tried with varying degrees of success.'

Certain corporations have chosen to be incredibly proactive in trusting that the costs will yield positive results. This is a major focus in the technology sector, as it is truly an innovation driven market. In 2004 and 2007, IBM sponsored a large conference, The Global Innovation Outlook (GIO), the purpose of which was to invite corporations, governments, academic institutions and NGOs to explore a variety of issues and generate innovative solutions to problems that concern business and the world. In the publication issued after the GIO 2.0 conference in 2007 (available at: http://domino.research.ibm.com/comm/www_innovate.nsf/pages/world.gio2.html), it was reported that '248 thought leaders from nearly three dozen countries and regions, representing 178 organisations, gathered on four continents for 15 "deep dive" sessions to discuss three focus areas and the emerging trends, challenges and opportunities that affect business and society'. One of the most interesting examples in the report highlighted a change in research strategies to focus on decomposition rather than composition, to convert waste into value. By starting research with the end of the product life cycle and building backwards to manufacturing, one can reduce waste and increase the use of recycled or sustainable materials, while limiting the end of product life waste. This results in economic and social advancement by pursuing environmentally sound practices.

The importance of an innovative strategy when it comes to materials is apparent when looking at a few statistics that were discussed:

> 'When one compares the value of the natural resources embedded in the earth versus the ones buried in the world's landfills, the landfills win – hands down. Experts estimate

> that the amount of aluminium in North America's landfills outweighs the amount of ore that's left in the earth.''One metric ton of electronic scrap from personal computers contains more gold than that recovered from 17 tons of gold ore.
>
> ''The average American steelmaker uses 20 tons of water to make one ton of steel. Korean steel companies use just three to four tons of water.'

Another topic covered in the report was the change in 'the evolution of social structures', due to the 'proliferation of communication networks … Suddenly, it is possible to transcend physical and geographical borders more easily, and that freedom has fostered a new willingness to partner both within and outside the traditional boundaries of organisations and countries'. eBay is a perfect example of the change, where there exists a community of approximately 193 million cumulative confirmed registered users. According to a survey conducted by eBay in 2005, 724,000 Americans use eBay as their primary or secondary source of income. The evolution of social structures caused by proliferation of communication is also apparent in world politics. In relation to the recent rule of law crises and human rights atrocities in Myanmar and Pakistan, it has been impossible to completely stem the flow of information to the outside world because of the prevalence of communicative technologies, thereby increasing worldwide pressures on the regimes.

As time progresses, smaller corporations are starting to embrace business ethics more seriously because of an increased awareness of the benefits of acting ethically. For example, Mackie's, a family owned ice cream company in Scotland, was honoured by an environmental award due to its energy policies. The company produces its energy from three wind turbines that generate more than 1,500,000 kWh per year. Mackie's sells its surplus power to the utility company Good Energy. This is also an instance of collaberative innevation, that implements innovative for positive benefit.

Case study: CSR benchmarking – contaminated land illustration

By way of example, a utility that has inherited a great deal of contaminated land as part of its asset base would prioritise its environmental management programme. In view of the fact that the management of contaminated land is an increasingly important concern in the UK and elsewhere, this is considered in more depth in CHAPTER 16. For the purpose of the current example, in order to objectively assess environmental programmes relative to contaminated land, an organisation might find it helpful to engage experts to carry out the following four step benchmarking study:

1. Map the various processes and options available in a typical contaminated land site management programme;
2. Define the values and objectives of 'best practice' in the context of any environmental policy for the management of contaminated land;
3. Design a benchmarking study that will provide a consistent framework to evaluate the peer industries relative to their management of contaminated land; and

4. Carry out the study, compare the results to the programme and report the findings.

In mapping the processes the experts would look at both the business and technical aspects of decisions and actions that would be involved with the management of a contaminated site. Particular emphasis would be placed on how these decisions and actions could impact the value chain for an industry. The value chain in this context would not only be the bottom line profitability of the company, but also include other factors that impact value like reputation, public heath and welfare, risk of regulatory enforcement and risk management. This is particularly important having regard to both ongoing corporate policy and specific projects. This would then enable the organisation to define the basis of best practice. Often 'best practice' really means 'effective practice'. It is a question of where the company wants to fit (that is the best, top 10%, above the median) and with what group it is to be compared.

For example, in its policy statement prior to the merger with Transco (the gas transporter), National Grid stated:

> 'Following the principle of integrating environmental considerations into all aspects of the group's activities we will:
>
> * as a minimum, meet the statutory requirements of environmental regulations;
> * seek to keep known adverse effects on the environment to a reasonably practicable minimum; and
> * seek to achieve as high an overall level of environmental protection as is reasonably practicable.'

It further went on to compare itself using the FTSE 100 Environmental index for the Utility Sector and Business in the Environment's Index (BiE) where issues of corporate governance, sustainability and ethical investment are significant. This would appear to be an appropriate starting point for the basis of the design of the benchmarking study, that is, a comparison as to how other utilities (or possibly non-utilities) in the UK are dealing with contaminated sites. If there are more effective methods known in the EU or US spheres these could be reviewed.

However, one needs to keep in mind that National Grid is functioning within the UK regulatory context. National Grid improved its placing in the FTSE 100 table from number 44 to 24 in one year. They also came tenth out of 20 companies in the utilities sector, which has the highest average score for all the groups (compare CSR Benchmarking in India at the **Appendix** to **Chapter 12**).

In such an instance one would review the existing policies and extract from that meeting a better understanding of values and objectives that would be expected to fulfil the intent of the policies relative to the management of contaminated sites using the SERM methodology and framework by way of example.

The design of the benchmarking study could build onto the previous task. A series of questions would be developed that would extract from peer companies how they manage the values and objectives that have been identified as important to National Grid. The environmental policies, organisational structure, financial management and corporate objectives for contaminated site management would be included in the benchmarking study. It would be important to identify a list of several peer companies to conduct the survey. The companies could be all UK based or include companies based in the USA or other countries. Also, the companies could include all utilities or may include other related industries. The final benchmarking targets would be dependent on the definition of the values and objectives determined important by National Grid.

With gas site remediation projects in mind, the benchmarking programme would focus on the ways the participating companies:

- manage risk in the project environment;
- implement a risk analysis framework;
- define qualitative and quantitative risk analysis;
- discover the role of assurance providers and how they can add value;
- analyse the different tools and techniques available for project risk management; and
- create an effective risk response plan.

Once the benchmarking has been completed the data would be reduced, evaluated and reported to the organisation. The key deliverable for the final benchmarking study would be a report that summarises:

- how the companies manage the key values and objectives previously identified;
- how the business relates to the peer practices;
- a list of other effective practices that could further enhance its management programme.

Several of these issues are also relevant to the discussion in **Chapter 16** regarding environmental due diligence, as well as in the consideration of risk management and the SERM case study referred to in **4.25**. Moreover the approach to risk management has relevance to the culture of the company or business, as is noted in **Chapter 8**.

Socially and responsible investment **4.46**

Whereas SRI has been referred to above as a topic it deserves specific discussed as it is a generalised subject heading for different forms of investment strategy. SRI sometimes goes by the names of ‘sustainable and responsible investment’ and ‘ethical investment’. This goes some way to explaining the initial confusion over the different strategies. The shift in title also goes some way to explaining how and why it has developed. It is helpful to conclude this chapter with a more detailed discussion of SRI in view of the significant demonstrable links between ethical behaviour and global economic trends. Such issues – even if considered initially to be rather remote or macro – can indeed have practical micro impacts increasingly on business practice. They further endorse the need for sound corporate governance and ongoing due diligence.

What is SRI? 4.47

The flippant but tempting answer to this is many things to many people. Research has revealed no fewer than five different definitions, all of which share one common theme. That theme is investment which in some form takes into account social, ethical and environmental (SEE) issues. The problem with this definition is that it is too vague. For example, it makes it very hard to assess the size of the SRI market as under such a loose definition investors have been included who exercise their right to vote as shareholders, or write a letter to a company regarding a management practice. This constitutes engagement – central to some SRI strategy. Writing a letter to a company or exercising a right to vote is not enough to constitute what most professionals in SRI would consider sufficient to be an SRI strategy.

A single question comes to mind that is essential to understand SRI. It is simply to ask who is investing? It is surprising to think that religions, charities, individuals and institutions have been grouped together under one nice comfortable banner, yet they have. From this point begins the distinctions between some sophisticated investment strategies.

Therefore if we take this into account we can reform our definition by saying that it is action or information on social and/or environmental and/or ethical issues that inform the investment decision. The step change here is that it has in some way informed the investment decision differently than if the action or information had not taken place. An overview of some of the investment strategies are outlined in the box below.

Socially responsible investment strategies

Distinctions between types and styles of investors need to be made to understand SRI better. These distinctions include differences between:

Best in class – ranking companies according to how well they encompass environmental, health and safety, and social policies and trying to invest in the best performing companies.

Engagement – encouraging companies to implement ethical practices and improve their policies through persuasion, support and voting. Approaches may be to communicate ethical policy to companies, subscribe to a corporate governance service, or to invest only with managers who engage with companies. This approach is less exclusive as managers are able to invest in entire portfolios as long as engagement occurs, therefore minimising risk. This is viewed by some as the best way of implementing an SRI policy.

Integration – the explicit inclusion by asset managers of Corporate Governance and eESG risks into the traditional financial analysis methodology.

Pioneer screening and thematic investment – these are based on specific ESG issues, or criteria, such as an organisation's transition to sustainable development, or its moves towards a low carbon economy by investment in renewable technology.

Screening – positive screening is the creation of a list of acceptable practices to apply to companies and, from this, to choose the best performers. Negative screening can be the creation of a list of unacceptable practices and to avoid investment in companies or sectors using such techniques. *Norms-based screening* is a form of *negative screening* of companies according to their non-compliance with international standards and norms such as issued by OECD, ILO, UN and UNICEF.

The development of SRI **4.48**

In the last decade on so SRI has been growing at a tremendous rate. The tables below detail the rise of SRI in the UK and then the global rise in SRI assets. Historically SRI developed from moral issues, hence its association with ethical investments. The Methodists saw alcohol as causing social problems in the 19th century and refrained from investing in companies that they saw as promoting social harm. In the 1970s opposition to the Vietnam War saw the creation of the PAX World Funds which did not invest in companies that were profiting from the conflict. The PAX World Funds represented the financial expression of new investment independence and values. When the fund started to outperform their peer group it was realised that maybe there was more to stock selection than purely financial.

In recent years we have seen the rise of divestment movements against repressive regimes in Myanmar, Nepal, China and Pakistan. With governments worldwide becoming increasingly sensitive to making their countries attractive to investors, this movement has inspired advocacy groups to persuade shareholders of major corporations to lobby policy makers on their behalf. Owing to this cultural shift, shareholders are now increasingly likely to regard war, underemployment and civil unrest as undue risks.

Mainstream investment used to look at financial fundamentals to determine whether or not to invest in a company and by how much. However, there are strong suggestions that this was never solely the case. Investments would be made also on the belief that continued successful delivery of those financial fundamentals was possible, that the management was capable of delivering on predictions, that the business was sustainable and would still have a market for its product and finally for the belief that the business was capable of managing its potential risks. These were all measured and classed as financial risks. As business and the global economy has developed and grown ever more complicated in terms of regulation, operation and delivery these once clearly tangible business issues became broader interms of impact and market behaviour more complex.

Why and how is SRI used? 4.49

The complexity of the distinctions is furthered by the fact that none of these distinctions are mutually exclusive except for passive and active investors.

As a religious or moral investor, SRI is necessary to exercise a belief system. Typically this will take the form of screening against investment that is considered contradictory to the belief system, this is referred to as negative screening. Examples of this are green investors who choose not to invest in companies that contribute to environmental degradation, destruction of biodiversity or contributing to climate change. Religious investors tend to screen against investments in tobacco, alcohol, pornography and armaments. This represents possibly the most well-known side of SRI and also the smallest financially.

Depending on the size of investments involved, the funds will have a different risk structure. The larger the investment the more conservative the risk profile tends to be. Therefore, larger religious or moral investors tend to use a system of positive discrimination in stock selection, referred to as positive screening. For example, by only investing in companies that have International Organization for Standardization (ISO) environmental standards where appropriate, or companies that satisfy international standards.

There is also a system of selecting a best in class. In many ways this can be seen to a more risk adverse positive screen. A best in class strategy recognises the dangers of avoiding a sector entirely in terms of financial return and also the right of a business to exist in terms of satisfying legal requirements and fulfilling a market need. The financial year 2003 in the UK markets saw a strong out-performance of tobacco stocks. Nevertheless, this strategy believes that those companies that are better managed in terms of SEE issues will perform better and therefore selects quite simply a best in class in terms of SEE issues or CSR management.

As far as responsible investment goes, Hermes Pensions Management Limited (Hermes), the fund manager for the largest UK pension fund – the BT Pension Scheme – is an excellent example. In 2003 it published 10 principles committing itself to the idea of responsibility for its investments. As a large pension fund it is forced to invest across the entire stock universe of the FTSE 100, it is a passive indexed fund. This means that they do not actively pick and choose stocks to invest in, instead they are passive and they pick a stock index (the FTSE 100) and invest their money across the whole index. The reason this approach is taken is because of the size of the pension fund and the risk allocation.

Active investors will change investments according to their method of stock selection. Whereas a passive investor invests according to an index and may change how much of a particular stock is held, the investor will still hold the entire range of stocks across an index. This practice is usually adopted by funds that are of a very large size and need to adopt a low risk profile. In the USA, virtually all large private equity firms invariably include pension funds among their key investors since retirees and pensioners tend to be passive investors. Ford Motor Company's profit-sharing model also helps create a large number of passive investors in the form of employees and retirees. More recently, Citigroup expanded its micro financing efforts in Bangladesh by partnering with BRAC, an anti-poverty NGO that serves five million mostly female members in the country. By offering BRAC access to $180 million over a period of six years, Citigroup managed to secure a pool of millions of low risk, passive investors for more than half a decade.

Passive funds are much lower in risk than active funds. As a pension fund their first duty is to provide their members with adequate remuneration. Hermes, however, believes that well-managed companies will perform better; therefore, companies that pay attention to managing their environmental and social risks will make more money. With this in mind from the entire stock universe within which it invests, Hermes will make financial assessments as to how much of that particular stock they will own, some stocks being overweight, as they believe they will perform well, and some underweight (as they believe they will perform poorly). Nevertheless, Hermes, as a universal investor, believes that it ought to influence the companies within which it holds stocks to 'internalise its externalities'. By this, Hermes means that companies ought to pay attention to potential risks and rather than wait and see, deal with them before hand and appropriately, *thus* encouraging corporations to internalise any potential external risk. Hermes is very much on the periphery of the SRI universe but is nonetheless a useful example of the responsible attitude of a long-term and conservative investor.

Additionally, large pension funds do not just have a fiduciary responsibility to its members but there is an increasing examination on responsibility for the quality of life of its members. As such, the influence of large pension funds is increasingly being exerted to ensure that companies are run for the greater benefit of their stakeholders.

Trends in SRI

The continued growth of ethical and SRI 4.50

Since the mid-1990s there have been a number of changes and trends in the arena of SRI, and the type and quantity of SEE drivers made by companies, especially so in the last few years. SRI and SEE drivers are receiving increasing levels of attention from business, government and society as a whole.

There is a move towards broader and more integrated disclosure due, in part, to the general erosion of trust in big business, not least following highly publicised and documented financial and accounting scandals, such as Enron and Worldcom, and pressures from stakeholders to improve transparency. SRI, which can offer some protection for investors, is becoming increasingly valued and sought after, illustrated by the current 30% annual growth trend in the UK SRI retail market.

Global SRI figures **4.51**

Global SRI Investment Funds accounted for around US$4 trillion in 2005 with Syariah compatible funds adding a further US$300–500 billion and perhaps as much as US$1 trillion (OWW Consulting Research, 2007).

The wide definition of SRI funds within Europe has reached over €1 trillion (of which €781 billion is within the UK) and has grown over 36% in excess of the general market benchmark. The trend for the stricter category of the 'Core' SRI is stable, at only 1% real market growth above base at €105 billion. These now represent 10–15% of total European funds under management.

Global revolution, SRI assets 2001–2006 in US$ billions

	2001	2006
Australia	0.7	16.9
Europe	12.2	1,200
Japan	1.3	3.1
US and Canada	1,624.8	2,300
UK	224.5	781 (euros)*

Source: EIRIS Ethical Investment Research Services, 2002 and OWW Consulting Research, 2007 and Eurosif 2006, SRI Strategies as applied in the UK, 31 December 2005, €781 billions as broad SRI 117 billion as simple exclusion.

Even in developing markets SRI has a significant foothold. In South Africa, for example, around US$1.6 billion was invested in about 21 SRI funds in 2006.

Factors fuelling the growth in SRI? **4.52**

The key drivers of SRI are seen as:

- *Availability* – There are now hundreds of funds designed for socially conscious investors, many of which are more personalised investment vehicles than their mainstream relations. Socially screened options are increasingly being offered within retirement plans, and hundreds of asset managers now promote their ability to manage socially responsible portfolios.

- *Corporate scandals* – Recent instances of accounting fraud, corporate downfalls and other scandals have eroded trust in company leadership reporting standards. Many investors are now attracted to an investment research process which goes deeper into corporate character than just outlining financials. The impact of the scandals has also led to business and financial services regulation that requires more transparency on sustainability issues.
- *Customer demand and values* – A Mercer Investment Consulting (Mercer IC) survey reports that 75% of investors believe that environmental, social and corporate governance (ESG) factors can be material to investment performance (Perspectives on Responsible Investment, Mercers, 2006). There is also a spiritual yearning on the part of a large and growing segment of the population to integrate personal values into all aspects of life, including finance and investing.
- *Information* – Investors are significantly better educated and informed today. Social research organisations are able to provide much higher-quality information than ever before. The better-informed investors are, the more responsible their actions tend to be.
- *Institutional demand* – Investors with pension funds increasingly demanding that their asset managers incorporate sustainability issues.
- *Increased activism* – By the financial community, including strategies such as engagement on these issues and the integration of them into 'mainstream' investment decisions.
- *Performance* – The business case has increased credibility in the financial community. A wide range of academic evidence plus real-world results have refuted the contention that ESG screening will automatically result in underperformance. Investors are realising that responsibility can walk hand-in-hand with prosperity.
- *Specialised investments opportunities* – SRI is closely linked with positive investment opportunities in renewable and alternative energy, organic and natural foods, sustainable building, and alternative healthcare, providing new inspiration and expanded investment opportunities.

Shareholder activism **4.53**

One social driver is the wider community perspective on investment accountability and corporate governance, particularly with the international human rights framework governing corporations. Increasing attention is being paid to the use of proxy votes of shareholders. For example, public pension funds, religious organisation funds and labour union investment funds use the shareholder proposal process to pressure companies regarding environmental and labour-related issues. The wide distribution of company proxy statements makes them a powerful foundation for a media campaign to direct attention at the activities of multinational corporations. If there is a serious prospect that a proposal could garner a majority vote, and hence represent, at least formally, the will of the shareholders, proponents of resolutions are often in a position to seek company concessions in exchange for withdrawing the proposals. Proponents of shareholder resolutions generally make some effort to associate their proposals with increasing shareholder value, but they are often investing in the companies simply in order to qualify as shareholders in order to make their proposals.

One example relates to Baker Hughes. Baker Hughes is engaged in the oilfield and process industry segments. It also manufactures and sells other products and provides services to industries that are not related to the oilfield or continuous process industries. A recent proxy statement included a proposal to implement the MacBride Principles in Northern Ireland. The MacBride Principles, consisting of nine fair employment, affirmative action principles, are a corporate code of conduct for US companies doing business in Northern Ireland. The Principles do not call for quotas, reverse discrimination, divestment (the withdrawal of US companies from Northern Ireland) or disinvestment (the withdrawal of funds now invested in firms with operations in Northern Ireland). They are intended to encourage non-discriminatory US investment in Northern Ireland.

Another example is ChevronTexaco's resolution requesting reporting on renewable energy, and Exxon Mobil's six proposals dealing with social responsibilities issues. When activist shareholders began attempting to use this pressure technique with BP, it began including instructions for 'members' requisitioned resolutions' on its investor centre website to clarify the differences between UK law and US law, particularly the UK prohibition against shareholder resolutions which simply express opinion. Nevertheless it is clear that developments in one jurisdiction influence trends and decisions elsewhere, especially with the powerful forces of the media and technology at work.

As will be seen below, the business benefits achieved by businesses that follow proper due diligence procedures and good corporate governance can be demonstrated in bottom line performance and stakeholder confidence. It is increasingly recognised that those businesses that manage their business ethically and having regard to these concepts are the better managed businesses overall. They are also closely aligned to the other well-known goals of sustainable development and sustainability (see below and **Chapter 16**). With this in mind an organisation will need to establish whether its management programme is consistent with its best practice policy and has regard to relevant developments in risk management, as well as current practice in corporate governance (see **Chapter 10**).

Shareholder activism and engagement growth **4.54**

US corporations and investor activists appear to be finding more common ground, leading to a much larger number of shareholder proposals being withdrawn in 2007 than in 2006.

Timescale from January to mid-September	2007	2006
Shareholder proposals submitted	1,145	947
Shareholder proposals withdrawn	306	189
% of total number of proposals submitted	26.7	20

Source: RiskMetrics ISS Governance Services Unit, September 2007.

- Withdrawals were as high as 55% on the issue of majority voting for corporate board members this year, up sharply from 24% in 2006 and 23% in 2005. More companies have bowed to investor calls to adopt majority voting, meaning that directors cannot be re-elected unless a majority of votes are cast for them.
- Thirty-eight per cent of proposals to require companies to fully disclose their political contributions have been withdrawn so far this year, compared with 19% in 2006 and 17% in 2005.
- Forty proposals requesting an annual advisory vote on executive compensation were voted on and averaged about 42% support from shareholders, compared with an average of 40% at seven firms last year. (Reported by Martha Graybow, 2 October 2007. 'Reuters News US firms more open to engage with investors-study' at: http://www.riskmetrics.com/press/articles/20071002_reuters.html)

Some key drivers **4.55**

Increased investor activism demonstrates that there is mounting evidence to support the view that fiduciary duty is not compromised by a socially responsible investment stance which includes ESG considerations. There are discussions that are taking sustainability issues into account as part of the fiduciary duty of the trustees of investment and pension funds. Relevant findings are:

- Seven out of ten global investors wanted improved disclosure of corporate governance information. (The 2006 ISS Global Investor Survey www.iss-proxy.com/globalinvestorstudy).
- There will be an increase in issue-based activism; an example is the CDP, which has 225 signatory investors controlling trillions of dollars in assets, which has requested information from over 2,000 companies on the risks and opportunities relating to climate change and GHGs. The CDP has managed to raise their company response rate from 42% in 2005 to 58% in 2006.
- 71% of global investors in the 2006 ISS Global Investor Survey believe corporate governance has become more important to their firms over the last three years.
- 63% of global investors in the 2006 ISS Global Investor Survey forecast an increased growth in corporate governance issues in forthcoming years; this figure is 93% for Chinese investors, 61% for Europe but lower for the USA.

Shareholder rights 4.56

As regards listed companies, the primary exercise by shareholders of their right to participate in the governance of their corporation is in connection with election of the board of directors. Specific information is required in connection with the election of directors. This includes for each person nominated for election by the shareholders:

- their age;
- business experience over the last five years;
- directorships of other listed companies;
- any position they have had with the company;
- any understandings with others related to their selection as a nominee;
- legal proceedings where the director's interests are adverse to the company's;
- any bankruptcies of companies they were executives or partners of;
- various types of legal proceedings they have been involved in; and
- indebtedness, financial transactions or other relationships with the company.

In view of the independent review of the role of non-executive directors (NEDs), the Higgs Review (see also **Chapters 7** and **10**), the appointment of NEDs is becoming more sensitive as the level of responsibility and integrity is raised. Moreover, whereas the review was aimed at large businesses, advisers have noted that, as with other regulations and standards relevant to ongoing due diligence and good corporate governance, there are impacts also on small businesses. Bearing in mind the increased risks and the heightened vigilance of shareholders, as well as other stakeholders, a proactive approach can assist business performance, whatever the size of the organisation.

Stakeholder pressure on businesses 4.57

Locally, businesses do experience more and more pressure from stakeholders including public sector bodies and NGOs. All of the trends in the context of risk management support this and investors have begun to influence significantly the way in which businesses operate to the extent that the image and brand are increasingly vulnerable to external pressure (see Chapter 7). In addition, the requirements on listed companies to embed risk management in their corporate policy have meant that the board must be aware of and evaluate the risks and their management for communication to stakeholders. This has grown in significance in the light of large corporate scandals, a change in stakeholders' understanding of risk, and a movement away from traditional business risk theory.

It has become clear that while some aspects of corporate responsibility are measurable, for example progress towards environmental management and enhancement, many others are not. Various strategies are referred to in this chapter to raise their profile with business decision-makers. There are both corporate and government initiatives taking place. For example, adherence to the standards of the government backed ETI, which has 43 corporate members, is an extension of the idea of fair trade into other ethical procurement policies. These and other similar approaches are useful in their respective ways to help to promote high standards of business ethics within corporations and among their stakeholders.

Shareholder engagement **4.58**

Increasingly, SRI funds have taken on an attitude of engaging with companies rather than disinvesting. Fund managers have been seeking added value through dialogue and improvement in companies that they found lacking. At the very least this will mean an active exercising of the voting rights afforded to the fund manager as a shareholder. For instance Hermes engages with companies over issues of corporate governance and issues that are relevant to their two principles above. It is through such interaction that Hermes hopes to add value, or minimise potential loss, to the company that it owns shares in.

ISIS Asset Management applies an engagement overlay to all their SRI funds. This overlay is intended to add value and to mitigate risks in essentially the same way that Hermes intended. The essential difference is that ISIS does not solely believe that financial return is the only aim of investment. ISIS, like other asset managers, believe that as an owner of a company, you have a responsibility as a steward, to ensure that the actions of a company are in keeping with at the least normative behaviour.

Insight investment, the asset management arm of HBOS plc, promoted a two-fold argument as to why SRI issues must be taken into account. Their argument is expressed in demanding high standards of corporate governance and corporate responsibility, as set out below.

1. Financial benefits
   The first reason is that we believe that investment returns can be enhanced if the companies we invest in maintain high standards of corporate governance and corporate responsibility. Conversely, there are many examples where weakness in these areas has contributed to poor financial performance and even, occasionally, corporate collapse.
2. Responsibility
   Secondly, we believe that investors, especially in their role as shareholders, have moral responsibilities with regard to the companies in which they invest. It is widely accepted that individuals are responsible, not only for their own actions, but also, under certain circumstances, for the actions of those who act on their behalf. We believe this principle extends to the corporate context. As a general principle shareholders approve the composition of the board. The directors have a fiduciary duty to conduct the business on the shareholders' behalf and in their interests. Thus it is reasonable to accept that shareholders have a wider responsibility, under certain circumstances, for the actions of companies. While company law (see **4.44** above) strictly limits the legal liability of shareholders, it does not thereby limit their moral obligation.

This is not to say that shareholders' responsibility in this regard is open-ended. Effective control of companies, in law and in practice, lies with the directors. This is therefore where the main burden of responsibility for the company's actions should rest. However, given that shareholders approve board composition, the primary role of shareholders is to support, encourage and, where appropriate, challenge the directors in their efforts to achieve high standards of governance and corporate responsibility.

Some of the most effective engagements have come about through collective actions groups – in the USA, for instance, a group called the Interfaith Center of Corporate Responsibility (ICCR). They are a membership organisation representing institutional funds of religious groups. The purpose of the group is to engage companies on SEE and management issues. Their most high profile and successful engagement was bringing a shareholder resolution against the energy company Talisman Oil which resulted in Talisman selling their stake in Sudan, which had been a concern for investors because of the human rights atrocities amongst other issues.

The concept of engagement itself is somewhat confusing. It may mean to simply write a letter or exercise voting rights. However, it is often taken to mean a prolonged campaign of communication including, in all probability, face-to-face meetings. More often than not, once engagement has been started by a fund manager a company will usually agree to an examination of the issue highlighted and then, if it agrees, develop policy and implement change. Taking engagement as far as shareholder action is the strongest line any investor can take short of selling shares. It is essentially a constructive dialogue with a company in order to achieve what is seen as a mutually beneficial outcome.

In response to these pressures companies often try to engage with shareholders who submit resolutions in the hope that the proposals can be resolved without a shareholder vote and a potentially embarrassing showdown at the annual meeting. The table in the section above shows that this approach to governance is paying off as a record number of shareholder proposals have been withdrawn after engagement by the companies with the proponents of the proposals. RiskMetrics special counsel Patrick McGurn said:

> 'In many cases the board sat down with the proponents of these issues to see if there was a workable solution that was satisfactory to all parties.'

By way of concluding comment it is a fact that all of these issues will become more and more important for the management of an organisation operating in the 21st century regardless of its size or location.

Un Initiative

In 2004, the UN Environment Program Finance Initiative launched a CEO Briefing entitled 'The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing'. This study comprised of 11 reports from nine brokerage houses reflects agreement among contributors that ESG issues can affect long-term shareholder value. The studies are available from: www.unepfi.org/stocks and http://www.unepfi.org/work_streams/investment/materiality/mat2/index.html. This initiative has highlighted the fact that such issues new represent key trends and discuss for due deligace and corporate governance.

Useful web links

European Accounts Modernisation Directive 2003: http://eurlex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=2003&nu_doc=51

Eurosif – Reviews of Socially Responsible Investment (SRI) in Europe. A full report on Europe's core and broad SRI funds: http://www.eurosif.org/publications/sri_studies

International Finance Corporation (part of the World Bank Group) has documents relating to the emerging opportunities with regards to the trends we discuss in this chapter: http://www.ifc.org/sustainability

United Nations – Reports on global trends are available from: http://www.unepfi.org/fileadmin/documents/materiality2/governance_db_2005.pdf

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Appendix

Corporate sustainability and responsibility research (CSRR)

A standard has been drawn up by the Association of Independent Corporate Sustainability and Responsibility Research (AICSRR) groups, CSRR-QS 1.0, with the objective of promoting confidence in those bodies performing the research. The standard aims to improve quality management systems, to stimulate transparency, to facilitate assurance processes and to form a basis for further verification procedures and their project can be viewed at: http://www.csrr-qs.org/theproject.html

This standard covers the functions of bodies whose work may include the collection of CSR data and subsequent SRI activities on the level of research, analysis, evaluation, rating, ranking, screenings, risks and opportunities assessments, all related products, processes, work procedures, services and subsequent reporting of results of these activities to clients and other stakeholders.

Although these CSRR activities may have numerous outputs and clients, the CSRR-QS 1.0 focuses mainly on the operational requirements of SRI-related products and services. The initiation of the standard has been granted by the European Commission, Employment and Social Affairs DG as the outcome of the project 'Developing a Voluntary Quality for SRI Research'. It has been drawn up in the light of the EC's aim to build partnerships for the promotion of CSR, seen as a contribution to achieve the publicised strategic goal of becoming, by 2010, 'the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion'.

Both the Green Paper *Promoting a European Framework for Corporate Social Responsibility* and the EC's Communication *Corporate Social Responsibility, a Business Contribution to Sustainable Development* call for 'more convergence and transparency of SRI rating methodologies', request that 'quality and objectivity should be ensured, not only on the basis of the information submitted by the management, but also by the stakeholders' and suggest that 'external audit and internal quality procedures should be used to assure accuracy in the research and assessment processes'.

Prior to the set-up of the standard a detailed survey has been executed in order to make an inventory of existing practices on the level of quality management, and related clients and stakeholder demands.

5

Key due diligence and corporate governance management issues

5 Key due diligence and corporate governance management issues

CHAPTER OVERVIEW 5.1

Chapter 4 has demonstrated the evolving nature of the definitions of due diligence and corporate governance, having regard to the business environment and the extensive business drivers mentioned in that chapter. Evidently management should aim to have a clear policy that not only prioritises the positive aspects of running a successful business but also has considered the more traditional concerns that embrace such matters as:

* contracts;
* customer care;
* marketing;
* employment;
* health and safety; and
* other risks.

All of these can expose the business to potential conflict and dispute. While the better policy is to be proactive and protect the business as far as possible through careful drafting, with appropriate advisers inside and outside the business, there is no doubt that the risk of litigation is a day-to-day concern. In terms of ongoing operations, the threat of litigation looms large in the business lives of many and can devastate relationships with customers, financiers and suppliers. This has an impact upon the internal due diligence and corporate governance management issues of the business.

Since this is a potentially huge subject, for the purpose of this discussion certain topical examples have been selected to demonstrate its relevance in this handbook. The reader should bear in mind (the premise stated in **Chapter 1**) that the approach to due diligence and corporate governance being taken here is that both concepts are intended to enable the establishment and development of a sound healthy business in which sustainable decisions can be made. Accordingly, it should always beborne in mind that litigation can also in any event:

- prevent the success of a proposed deal or transaction;
- cause an unexpected blow to growth;
- affect morale;
- distract the human and financial recourses of a business, whether starting up, growing or established;
- impact upon reputation; and
- potentially cause insolvency and/or the end of the business.

Since the litigious environment of today's business world means that it is difficult to avoid confrontation, an understanding of the alternatives that are now available to mitigate the effects of such confrontation is very important. This can assist towards a 'litigation policy' so that management can aim to escape the disastrous impact on a business, small or large, through the distraction of resources. Many businesses try to avoid the reality of looming conflicts and potential legal battles. It is vital that a business ensures that someone in the business takes responsibility for this aspect of running a business from the outset and that they have a clear approach to litigation management. This is all the more true in this era of increased focus on corporate governance matters that requires transparency in all operations. For instance, since many businesses do not in fact have in-house legal expertise to assist with such a policy, a practical overview of the dispute resolution trend and alternatives should be sought through appropriate advisers or organisation. It is noteworthy that the general trend is towards dispute resolution and that in one major area of concern, employment law, there are recent regulations in many jurisdictions, such as the English Employment Act 2002 (Dispute Resolution) Regulations (due to come into force on 1 October 2004), giving rights to employers and employees, aiming to encourage both parties to resolve disputes internally through discussion, thereby reducing the need for further action and keeping the business moving. Both employer and employee must follow the minimum three-stage process in the event of dismissal, disciplinary or grievance procedure before resorting to an Employment Tribunal.

Litigation 5.2

In most jurisdictions prosecuting or defending civil litigation before the courts is an expensive business. Frequently the legal costs overtake the amount originally at stake. Costs include lawyers' fees and expenses and in some cases the opposing party's costs. Even a party awarded its costs can expect to recover less than the full amount of those costs. There may also be costs that cannot be recovered if the other party has become insolvent in the meantime, which is why it is critical to monitor the solvency of the opposing party. In limited circumstances it may be possible to obtain an order requiring the prosecuting party to provide security for the defending party's costs at risk.

The English Woolf Reforms **5.3**

In April 1999 sweeping reforms were introduced changing the way in which civil cases are prepared and conducted before the English courts. The Civil Procedure Rules (CPR), also known as the Woolf Reforms, provide a unified body of rules that apply to the County Courts, the High Court and the Court of Appeal. They were intended to ensure that the civil justice system is accessible, fair and efficient. The rules themselves are subject to an overriding objective which may be very briefly summarised as enabling the court to deal with cases justly, which includes so far as is practicable:

- Ensuring that the parties are on an equal footing.
- Saving expense.
- Dealing with the case in ways that are proportionate to the amount of money involved, the importance of the case, the complexity of the issues and the financial position of each party.
- Ensuring that the case is dealt with expeditiously and fairly.
- Allotting to it an appropriate share of the court's resources, while taking into account the need to allot resources to other cases.

The parties are required to help the court to further the overriding objective. The court may further the overriding objective by actively managing cases. Previously case management was almost entirely in the hands of the parties, or rather, in the hands of their lawyers. The courts could be asked to make orders giving directions to parties who were slow or uncooperative. Now the initiative lies substantially with the court to determine how the matter shall proceed and the pace of progress. There is now little opportunity for the parties to opt out and there is reduced opportunity for the lawyers to play games at their clients' expense. It is reasonable to expect that an average commercial dispute will take 18–24 months to come to trial from the date of issuing proceedings, often longer.

Without doubt, many of the reforms introduced by the CPR were overdue, are welcome and operate for the benefit of litigants, and in some cases for lawyers. Litigation can now progress to its conclusion quicker. It is now more difficult for the parties or their lawyers to abuse the system or delay. However, the cost of litigation remains high and the reforms seem to have discouraged a lot of litigation of smaller value.

How to reduce costs **5.4**

Costs can be reduced, or prevented from spiralling out of control, either by the client's effective management of the legal team or by finding alternatives to litigation. What is important is effective management. There is no cheap way of conducting litigation (straightforward debt collection excepted), but business people involved in disputes can take positive steps to ensure that their money is spent to best effect. The following are a few suggestions that should be helpful to any business, not necessarily in order of importance.

Using effective lawyers 5.5

At a commercial level at least, law firms generally tend to specialise. Some of the larger law firms (the majority of which, for the UK, are in the City of London) have more than 1,000 fee earners plus support staff. They often have a very wide range of expertise, all under one roof, but however much they may deny it publicly, they do tend to be more expensive than smaller firms. Nevertheless, they have certain advantages. Sometimes the required expertise is not available elsewhere. Sometimes the matter requires a team, and may even demand working 24 hours/7 days a week. Smaller firms can rarely provide this level of urgent service. If the matter does not require the expertise and service that only a major firm can provide, consider a less expensive alternative. Furthermore, many businesses find that it is not always necessary or expedient to use one firm exclusively and it can be useful to introduce a little competition (without overlooking the value and benefits of loyalty and trust).

Saving time and energy 5.6

There is a significant hidden cost of litigation which many lawyers fail to take into consideration. Complex litigation involves ongoing teamwork between the lawyers and their client. A substantial and ongoing input is often required from the client. This can take up a great deal of the client's time, a lot of the client's energy and there are cost factors involved. The client should consider whether that necessary input of time and energy might not be better spent pursuing the client's business. Critically set out a plan at the outset. The client should make clear what the litigation is expected to achieve (and at what cost) and make sure everyone has signed up to that. Ensure the lawyers explain their strategy for conducting the litigation, when they might be seeking settlement or mediation, what the costs plan is and how they will keep the client updated on progress.

Co-operation 5.7

If the matter is to be pursued, the client should ensure that his or her own input is well managed. This means making sure that staff are available or appointed to provide the lawyers with the answers to their questions and to provide all relevant documents. Documents should be presented in an understandable form and usually in chronological order. This reduces the many chances of mistakes and the time that the lawyers have to spend assimilating complex ideas, facts and evidence. One of the criticisms made of lawyers is that they have little idea of how they (and their work) are perceived by their clients. They think they have done a great job. The client thinks they have made an expensive mountain out of a molehill. Recognise these difficulties. Let the lawyers know what is wanted and expected.

Agreeing a budget 5.8

Some of the financial uncertainty of litigation can be mitigated by agreeing a budget with the lawyers in advance and perhaps during the course of the case. Although each party to the dispute may say that its objective is to seek justice, what each really means is that it wants to win. It is hardly surprising that there is seldom continuous co-operation between the opposing lawyers. The pace, direction and cost of the litigation may be largely determined by steps taken by the opposition. It is therefore difficult for lawyers to accurately estimate in advance how the opposition will react and behave and as a result what a case will cost to fight and win or to fight and lose. The best the lawyer can usually do is either provide an estimate that takes into account all of the things that might go wrong (and in doing so risk frightening the client) or provide adjusted estimates for each stage of the litigation as the matter progresses, giving likely maximum and minimum figures. If the client wants an estimate that allows for no increase, he or she must expect to cover the costs risks. This means that he or she will have paid over the odds if the litigation progresses without difficulties.

It is a little different where lawyers tender for bulk work which might involve hundreds of disputes over a period of time. They can apply the swings and roundabouts principle. It is not in the lawyer's interest to take on work that turns out to be non-remunerative and it is not in the client's interest to tie the lawyer down to a fee structure that tempts the lawyer not to spend as much time on the matter as it deserves. The lawyers should always be able to provide realistic estimates on an ongoing basis of the likely costs ahead.

Insurance 5.9

Some domestic and motor policies provide additional insurance against legal fees including fees that may have to be incurred resolving disputes. This is now known as 'before the event' insurance. Business insurances are less likely to contain such benefits. Insurance is also available, provided by specialist insurers, to cover the expenses of a particular piece of litigation. The insurance can either cover the whole of the cost or the excess over an agreed sum. It is known as 'after the event' insurance. It provides an element of financial certainty but of course it can only be bought at a price, which can be, by way of premium, up to 40% of the coverage required. The insurers do not expect to lose. The insurance can also cover the risk of having to pay the opponents' legal costs if the case is lost. Such cover is normal if the lawyer is working on a conditional fee basis, but not all cases can be dealt with in that way. Not all lawyers are prepared to work on that basis and jurisdictional rules vary.

Legal expenses insurance is a useful way to cover the risk of a costs disaster, to contain litigation costs within a budget or as a necessary adjunct to a conditional fee arrangement. One must be very careful about the terms of such policies. One key area of concern is the pyrrhic victory. This may be where a favourable judgment is given, but there are no funds to satisfy that judgment.

This is defined as a win in the terms of the policy and therefore any funds extended to cover own side costs become repayable regardless that the insured has not received any funds from the losing party. Secondly, the definition of win and lose needs to be carefully examined particularly where one is suing more than one defendant. One may lose against one defendant and have to pay their costs, but succeed against other defendants. Policies often define win as winning against any of the defendants, thereby preventing the insurer being liable to pay out against those who successfully defended the claim (which is more common than one might think). The insured nonetheless remains liable for the costs of the successfully defending party.

Litigation funders **5.10**

In England the *Access to Justice Act 1999*, coupled with a number of legal authorities, opened the market to those wishing to provide funding for pieces of litigation, which they typically do either by taking an assignment of the action outright or in return for a share in the proceeds of the action. The old legal principles of champerty and maintenance make it clear, despite the developments welcoming the role of funders in providing liquidity to good claims which fail only for lack of funds, that such funders are not entitled to interfere in the conduct of the litigation. To do so would be to invalidate the funding arrangement. This is to say, therefore, that funders may not dictate the course of the litigation: that is the role of the client as advised by its lawyers.

Typically funders will be looking for a case to satisfy three key criteria.

1. That the case has a 70% or better chance of success on the legal merits.
2. That the proposed defendant has the means to pay any judgment ordered against it.
3. That the costs of pursuing the matter are proportionate to both the size of the claim and the percentage which the funder will take by way of its return (typically 25–50% of the net proceeds of an action, which needs to equate to a 3:1 return on costs spent by the funder).

Again, clients need to check the terms of such arrangements (e.g. when any funds might be repayable, what level of uplift the lawyers are entitled to under their Conditional Fee Agreement (CFA), that adequate adverse costs insurance is provided for, that adequate indemnities are provided for in any funding agreement), but the advantage of such arrangements is that there are no costs to be paid as these will only be taken out on recovery. Of course specific rules differ according to jurisdiction.

Overseas lawyers **5.11**

International businesses can find themselves with international (or cross-border) legal problems (see the discussion at the end of **Chapter 1**). Contractual disputes may be subject to interpretation according to another country's law, and perhaps by that country's courts. Some of these problems can be avoided by taking legal advice before the contract is made, or by anticipating the problem before it arises and making sure that the applicable law and jurisdiction are agreed in advance.

When problems arise it may become necessary to involve foreign lawyers. Their costs may not be so easy to control. For a UK-based business, for example, they may be less expensive than their UK counterparts but their basis of charging may be entirely different. If another language comes into the equation, the client should expect to pay a little more for having the luxury of a foreign lawyer reporting and receiving instructions in the client's own language. If text has to be translated professionally, the cost will be significant. Unless the client already has a good working relationship with an overseas lawyer in the country in question, he or she should consider instructing UK solicitors with an international practice to instruct overseas lawyers on the client's behalf. Some of the larger firms have overseas offices. Some large and small firms belong to one of the international associations of lawyers that provide access to trusted overseas colleagues. Instructing UK lawyers will mean incurring additional fees, but the UK lawyers will have some experience of the pitfalls to avoid. They should be able to ask all the right questions on the client's behalf and prevent nasty surprises when it comes to fees and expenses. They will endeavour to be cost effective. Sometimes part of their fee can even be recovered as recoverable costs in successful foreign proceedings.

Early settlement 5.12

If the matter is capable of being settled before trial, then from the point of view of savings costs, the sooner the better. Costs tend to increase the closer the matter gets to trial. By then there will probably be increased reliance by the solicitors on the advice of counsel (barristers) and the need to instruct expert witnesses. These all add to the costs and to the costs at risk if the case is lost.

Commercial lawyers in the UK generally consider it to be part of their job to resolve the matter as quickly and economically as possible and to avoid the heavy costs of a trial whenever possible. They will usually be skilled negotiators and be able to start settlement negotiations without the risk of their doing so being seen as a sign of weakness on the part of their client. The lawyers can usually broach the subject of settlement without it necessarily being implied that they do so on their clients' express instructions. Nevertheless, it does not hurt to remind the lawyers from time to time that settlement is preferable to trial if there is no point of principle or important point of law (i.e. important to the client) to be determined. Lawyers are often accused of dragging out litigation in order to increase their fees. No doubt this happens but most commercial lawyers take the view, quite apart from their professional obligations, that there is more money to be made by having happy clients who come back again and again than by milking a case for all it is worth.

English offers to settle – Part 36 5.13

Part 36 refers to the particular section of the CPR governing the procedure described below in this paragraph. It would be unfair if a claimant were free to start legal proceedings, ignore a perfectly reasonable offer of settlement, press on regardless, be awarded less than was offered and but nevertheless recover all of his or her costs. To balance this, a defendant in litigation has always been free to make a money offer. If the right sum is offered and is backed by a payment of the offered sum into court, the claimant is put in a quandary. If he or she accepts the offer, he or she is entitled to recover the costs he or she has incurred up to the date of the payment into court. If he or she ignores the payment into court he or she does so at his or her peril. If when the matter is later resolved at trial he or she recovers less than the sum offered (making due allowance for interest) he or she will recover the sum awarded and the costs he or she has incurred up to the date of the payment into court. However, he or she will have to pay his or her own costs and the defendant's costs (at the higher, or what is known as 'indemnity' level, by way of recognition that he or she has acted perhaps rashly) incurred after the date of payment into court.

Since the costs of the trial are likely to be substantial, he or she may well lose much more than he or she stands to gain. Incidentally, the fact of the Part 36 offer and of the payment into court is not revealed to the trial judge until after the matter has been decided but before the judge proceeds to deal with the matter of costs. The CPR takes this procedure one step forward. It now enables the claimant to make an offer by stating a sum that he or she would be prepared to accept in settlement. If the defendant fails to 'beat' the offer, he or she is not only penalised in the same way as to costs, but he or she will pay a punitive rate of interest on the sum awarded. The procedure is also available in respect of non-money claims.

It is of course the lawyer's job to advise the client of the availability of this procedure, when to use it and how much to offer, but it is no bad thing for the client to be aware of this from the beginning. An early Part 36 offer focuses the other party's mind on the risks being borne and often leads to an early settlement, although not necessarily on the terms of the offer.

Early settlement with or without the assistance of a Part 36 offer will probably do more than anything to bring about a saving in litigation costs.

Legal costs consultants 5.14

The rules relating to the calculation of lawyers' costs, especially the costs that can be recovered by the successful party are complex. Not surprisingly, it has created a specialised industry for independent law costs draftsmen. Lawyers sometimes prefer to use consultants rather than keep costs draftsmen on the staff payroll. Some of them also now offer their services to larger consumers of legal services. They can help the client to reduce fees. If they are engaged as a matter of routine, rather than as a result of a disagreement about the bill, they can prevent problems arising by keeping the solicitors in check.

Summary – Hints and tips when using lawyers 5.15

Do not be too hard on the lawyers. A working relationship based on trust and respect for each other's role goes a long way to achieving the desired result. However, wherever the business is located, do:

- take steps to avoid disputes arising and treat litigation as a last resort;
- not be fooled into believing that the Woolf Reforms have made litigation more financially viable;
- choose appropriate lawyers for the job;
- not overlook the input that will be required from you as the client;
- be aware of the lawyers' problems and help to meet their requirements;
- agree a budget in advance;
- consider whether legal expenses insurance might be appropriate;
- if using foreign lawyers, consider using domestic lawyers as an intermediary;
- be alive to settlement possibilities and opportunities;
- be aware of the possible advantages of a Part 36 offer in the UK; and
- consider the use of legal costs consultants where feasible.

Since litigation is almost always expensive, particularly so if you lose and in consequence you are ordered to pay your opponents' costs, alternatives to going to court should also be considered.

Alternatives to litigation

Avoidance of disputes 5.16

It cannot be emphasised enough that in terms of due diligence and corporate governance, the avoidance of disputes is generally the best policy. This seems like obvious advice but avoidable commercial disputes occur all the time even when business on both sides is conducted in exemplary fashion. Disputes usually arise from misunderstandings. Typically the parties enter into a business venture, focusing on all the positive aspects of the venture but without much thought as to how matters will be resolved if things do not go according to plan. Carefully drafted agreements, contracts and business documents can legislate for the sort of misunderstandings or difficulties that may arise. It is usually much cheaper to pay a lawyer a fee to help draft something that will reduce the risk of problems arising, than to pay a lawyer later to sort out the mess.

Cost management by early settlement 5.17

It is surprising how often sophisticated business people who know the high cost of legal services automatically rush straight to their lawyers as soon as a dispute arises. When lawyers are seen to be involved, legal costs are incurred and the parties tend to distance themselves from each other and from reconciliation. It is worth considering for a moment what steps may be taken to bring about an early settlement. It is usually appropriate to seek legal advice on the merits of the prospective claim or defence at an early stage. It may not be necessary or appropriate to involve lawyers further in any initial attempts to achieve settlement. The client can be sure that if the first move is made by his or her lawyer, he or she will drive the other party into the arms of his or her lawyer too and the chances of an early settlement will probably be lost, at least for the time being. This is so in many jurisdictions.

Often in business, although the parties might not admit to it, there is an emotional obstacle to settlement. One party may feel that he or she has been bullied or cheated or there may simply be a clash of personalities. If this has happened and feelings are too strong to allow settlement, the matter should be taken out of the hands of the people involved (i.e. change the negotiating team).

An offer to settle a matter, or an offer to accept less than the full amount, may be perceived as a sign of weakness but not if the gesture is expressed properly. Care should be taken, however, to ensure that any settlement proposal is carefully expressed in such a way that it cannot later be used against you if negotiations fail. For example, up to a point, the negotiators can make it clear that their proposals are without prejudice. These words will generally ensure that the letters so marked or conversations expressed to be 'without prejudice', or 'off the record' will be excluded from anything placed before the court if the matter cannot be resolved. Negotiators can also hide behind the board of directors or their managers for formal authority to settle until such time as agreement in principle is reached. Lawyers can assist in negotiations and still be kept in the background. Bear in mind the value of what is sometimes called a 'commercial settlement' where the agreed debt or obligation is repaid by continuing or additional business between the parties.

Alternative dispute resolution 5.18

The term Alternative Dispute Resolution (ADR) is usually used to encompass two quite different means of resolving disputes – arbitration and mediation. Arbitration is an alternative to litigation before the courts. It is a less formal means of adjudication, and is often but not necessarily cheaper than court litigation. Mediation is a process that often takes place after litigation or arbitration has started, rather than as the first means of resolving the dispute. Mediation is directed to settlement, not adjudication. Here again the information presented is based on English circumstances: nevertheless the trends have relevance in many jurisdictions since ADR is generally becoming a more accepted and effective means of resolving disputes.

Arbitration 5.19

Arbitration as a means of resolving disputes has been employed in England for hundreds of years. Arbitration is generally understood as 'a reference to the decision of one or more persons, either with or without an umpire, of some matter or matters in difference between the parties'. Arbitration can be effectively used to resolve simple and very complex disputes. It is supported by a body of law, most recently the *Arbitration Act 1996* which sets out the following general principles (partly summarised):

1. The object of arbitration is to obtain the fair resolution of disputes by an impartial tribunal without unnecessary delay or expense.
2. The parties should be free to agree how their disputes are resolved, subject only to such safeguards as are necessary in the public interest.
3. The court should not intervene except as provided by [the Act].

Legislation such as this, together with the rules of natural justice provide an outline set of rules and principles which also generally limit the scope for interference or intervention by the courts. The courts remain in the background, to intervene only when permitted and when absolutely necessary. An arbitration award may be enforceable as such overseas in a number of countries. It may be enforced in the same way as a judgment of the court. It may be 'converted' to a court judgment if appropriate for the purposes of enforcement, for example if it is to be enforced overseas in a country where a foreign judgment but not a foreign arbitration award may be enforced. It is often easier to enforce an arbitration award overseas than it is to enforce a court judgment overseas.

Advantages/disadvantages of arbitration **5.20**

One person's advantage is often another person's disadvantage so rather than set out advantages and disadvantages it is more appropriate to set out some of the features of arbitration.

1. *Freedom of choice*: Arbitration takes place only with the agreement of the parties. That agreement may be embodied in the contract giving rise to the dispute, or the parties faced with a dispute may subsequently agree to refer the matter to arbitration. In the absence of an arbitration agreement, the parties cannot be forced into arbitration. Conversely if there is agreement, the courts (at least in the UK) will set aside court proceedings in favour of arbitration. Many business people in the UK and overseas feel more comfortable having their disputes resolved by members of their own business fraternity whom they have chosen rather than by the judiciary. Not all courts overseas are competent to deal with complex business matters.
2. *Cost*: Arbitration is generally perceived as being cheaper than litigation but that is not necessarily the case. Arbitration procedure is usually less formal than court procedure. Even when arbitration takes place under the auspices of a professional arbitration body according to that body's arbitration rules, those rules will be very much simpler and more straightforward than the courts' *Civil Procedure Rules 1998* (*SI 1998/3132*) (*CPR*) although the arbitration rules themselves may be interpreted and applied in the same way as the CPR. In more straightforward matters, it is quite normal for the parties to conduct the arbitration reference without the aid of lawyers. Sometimes

the parties will have help from lawyers, but manage without advocates. The saving in lawyers' costs may to some extent be outweighed, however, by the additional executive time devoted to the reference.

Heavy commercial arbitration can involve specialist solicitors, senior junior counsel and leading counsel briefed for the hearing together with an army of expert witnesses. The cost can be as high as the costs that would be incurred in court. Added to this the parties have to pay the daily fees of their arbitrators. It is quite common for the tribunal to consist of three arbitrators. In addition there may be the cost of hiring a room and facilities for the hearing. Although litigation in court involves the payment of fees to the court, the judge will sit for as long as the case takes to conclude, at no extra cost. No charge is made for the court room. At least one international arbitration body charges substantial administration fees in addition to the fees of the members of the tribunal. Some of the trade organisations that offer an arbitration procedure to their members (and others) make a modest charge for providing an administrative framework within which the arbitration reference can take place. Others make no charge, leaving it to the parties and to the tribunal to attend to all administrative matters, usually with some standardisation of fees. The cost of arbitration can be significantly reduced if the parties can agree to a single (sole) arbitrator. Of course when the parties are at loggerheads, they cannot always agree who should arbitrate for them. Sometimes, however, they can at least agree who shall appoint the arbitrator for them if they cannot agree between themselves and if there is no organising body with a set procedure for this event. The High Court has powers of appointment in these circumstances but even with the CPR reforms, the procedure can be fairly slow and costly when one is faced with an uncooperative opponent in a foreign country.

Some organisations provide a special procedure for small claims. The London Maritime Arbitrators Association (whose arbitrators routinely deal with complex disputes) have a small claims procedure for claims involving less than $US 50,000 (or equivalent). This procedure provides a straightforward low-cost resolution service at a fixed cost. Under this procedure arbitration awards are made on documents alone, that is without an oral hearing taking place, and the matter is decided by a sole arbitrator.

3. *Speed*: The speed with which an arbitration reference may proceed is substantially in the hands of the parties. If the reference is to a sole arbitrator and the matter is to be determined on documents alone, it can proceed to completion in a matter of weeks; sometimes less with everyone's co-operation. If the tribunal consists of three heavily booked professional arbitrators, busy counsel and solicitors, heavily booked expert witnesses and witnesses of fact with similar problems, the hearing date may have to be fixed months, possibly a year or more in advance. It is probably true to say that with goodwill on both sides, arbitration is usually quicker than litigation before the UK courts and certainly much faster than litigation before some overseas courts.

4. *Hearing*: More often than not it is for the parties to agree whether an oral hearing should take place at which witnesses may or may not be called to give their evidence. Britain has a tradition of advocacy. The advocate's role in civil litigation is an important one. In many European countries, the advocate's role in civil matters is much reduced. The written submissions of the parties and their written evidence are largely supposed to speak for themselves. British arbitration tribunals are reluctant to deny a party his or her right to be heard, but it is probably true to say that the majority of arbitration cases are decided without advocates, on documents alone, that is on the basis of written submissions and written evidence. Significant cost savings can be achieved by dispensing with an oral hearing. The saving on advocates alone will be significant as will the saved cost of expensive expert witnesses standing by. There will also be a saving of executive time as well as the cost of room hire, catering, interpreters, messengers, etc. Whether a formal oral hearing is really appropriate will depend on the nature of the case.
5. *Representation*: Some arbitration bodies exclude lawyers from any oral hearings, for example the arbitration rules of the Grain and Feed Trade Association (GAFTA). Lawyers may routinely be employed, however, in the preparation of the parties' cases, and the cost of lawyers may be recoverable by the successful party, even when lawyers are not permitted to take part in the hearing.
6. *Challenge/appeal*: As a general rule, UK arbitration awards are not subject to challenge by the courts except on the grounds of serious irregularity that has affected the outcome, or of the absence of the tribunal's jurisdiction to make the award. An award can be made the subject of an appeal to the courts but only on a question of law and then only (in the absence of agreement) with leave of the court. There is no automatic right of appeal. Some arbitration bodies provide an appeals procedure within the arbitration framework itself. This will not affect any eventual right to appeal by a court.

   From the point of view of overall cost, restricted access to an appeals procedure can cut short what might otherwise be an expensive ongoing legal procedure. The parties can set the parameters in advance.
7. *Confidentiality*: Civil court proceedings are, with very limited exceptions, public. The decisions of the courts are reported not only in the press but in the numerous law reports that line the shelves of lawyers' offices. The decisions are, after all, the law itself. Arbitration proceedings are, with limited exception, private and confidential. If the matter becomes the subject of an appeal to the court, the facts and the parties are likely to become a matter of public record.
8. *General suitability*: One of the perceived advantages of arbitration is that the arbitrators need not be lawyers. They may be drawn from the trade or profession in which the parties have conducted their business and fallen into dispute. Arbitrators can be chosen who may have spent most of their working lives in the particular trade or business concerned. They are usually chosen by the parties themselves. They will be familiar at once with the technical aspects of the matter before them. Their expertise and experience may be unsurpassed, particularly, for example, in quality disputes involving agricultural produce or

manufactured goods and in construction or shipping matters where the dispute is likely to be more one of fact (or rather facts) than law.

However, the substantial commercial knowledge of the judges of the Commercial Court of the Queen's Bench Division and of some of the county courts should not be overlooked. A judge of the Commercial Court may even be appointed to act as a sole arbitrator or as an umpire.

9. *Getting to the truth*: Where the choice whether to proceed before the courts or by arbitration remains open at the time the dispute arises, it may be appropriate to consider whether the dispute is likely to involve oral evidence from witnesses who may be tempted to be untruthful.

Arbitration is big business in the City of London. Disputes that have no connection with the UK are brought to London as a trusted neutral forum for dispute resolution. There is a good supply of competent professional and part-time arbitrators with surprising degrees of expertise. There are expert witnesses at hand with expertise in all manner of subjects. There is also a ready supply of lawyers and barristers routinely involved in arbitration work so the future continues to look bright for London arbitration. Strangers to arbitration should give the arbitration option serious thought.

Mediation **5.21**

Mediation is a facilitative process by which the parties in dispute engage the assistance of an impartial third party, the mediator, who helps them to try to arrive at an agreed resolution of their dispute. The mediator has no authority to make any decisions that are binding on the parties, but uses certain procedures, techniques and skills to help the parties to negotiate an agreed resolution of their dispute without adjudication.

Thus, mediation is quite different to arbitration. Unlike arbitration, mediation does not involve making a finding of fact or law or the rendering of a final and binding award. The mediator has no authority to make a binding decision. Unlike arbitration agreements, an agreement to enter into a mediation process will not be enforced. As yet there is no substantial body of mediation law, but that may change in time. The rules of natural justice probably have little or no application to mediation.

How does mediation work? **5.22**

Mediation takes place when the parties agree to try to resolve their differences by mediation or, perhaps more commonly, when during the course of litigation (or even arbitration) the parties are encouraged to try to reach a settlement by mediation. This applies equally to commercial disputes as, for example, family matters. The UK courts now encourage mediation by allowing adjournment of proceedings for that purpose. The court may require the lawyers for the parties to confirm that they have brought the possibility of mediation to the attention of their clients.

Mediation will not work if there is no will to settle – the skill of the mediator lies in helping both sides to reach agreement about how a dispute should be settled. Sometimes the parties will realise that at least some of the issues between them can be resolved, leaving fewer or shorter issues for the court to resolve afterwards.

There are no hard and fast rules. Different mediators have different ways of working. What often happens is that everyone involved meets in a room in the presence of the mediator. The mediator explains how the matter will proceed. It is up to the parties to decide whether they want their lawyers to accompany them. The parties then take it in turns to summarise what their case is about and to state what they are looking for. A time limit may be imposed. Then the parties go to separate rooms where they will be visited, probably several times, by the mediator who will discuss the case and try to determine where the common ground may lie or what are the underlying obstacles to settlement. The mediator will not disclose to the other party what has been discussed except to the extent that he or she is specifically authorised or requested to do so. The mediator will carry forward ideas, suggestions and, hopefully, offers. The parties are likely to be subjected to a deadline for completion of the process to make sure that their minds are concentrated on bringing the matter to a conclusion.

What happens if no agreement can be reached? **5.23**

If no agreement can be reached it is the end of the matter. Nothing that has taken place during the mediation process will be referred to in the resumed proceedings or any subsequent proceedings brought in respect of the dispute. The process is confidential. The parties may even agree to a further mediation session at a later date.

What happens if agreement is reached? **5.24**

Agreement may be reached as to the whole of the dispute, parts or aspects of it. The mediator has no powers to make any judgment or award but may assist the parties to draw up the terms of their settlement in such a way that it becomes legally binding upon both parties. If the mediation has taken place during ongoing court proceedings (or arbitration) the parties may ask the court or arbitration tribunal to make an order or award on the terms of the settlement so that it becomes enforceable as such. This may be important for enforcement overseas. If there are no underlying proceedings then the agreement will simply be of a contractual nature.

What happens if the settlement terms are repudiated or ignored? **5.25**

If the settlement has become an order of the court or an arbitration award, it can be enforced in the same way as a judgment or award, possibly overseas. If it is purely contractual then it may be necessary to sue on the agreement. To some extent this means starting all over again but the issues this time should be clear and capable of being dealt with by a court quickly and cheaply.

What does it cost? 5.26

Arbitration can cost very little, especially when compared to the alternatives. If the mediation is conducted by a court (such as the Central London County Court) or a professional mediation body, modest fees are payable to cover the services of the mediator and the provision of facilities for the mediation to take place. The service offered by the Central London County Court is extremely reasonable. If the parties appoint their own mediator (anyone can be appointed but someone with experience is more likely to achieve a result) the fee is a matter for prior negotiation. Since the process is likely to last less than a day and will not generally involve the engagement of advocates or expert witnesses, the only other cost is the cost of the panics' lawyers (if they are to attend) and the price to be put on executive time for the parties themselves. The parties are usually required to agree beforehand that each will pay half of the costs of the mediation whatever the outcome.

Does it work for commercial disputes? 5.27

The answer is yes, provided the parties enter into mediation with the intention of trying to reach a settlement. The rate of take-up is not particularly high – this may be the fault of lawyers unfamiliar with its possibilities and concerned that it might appear too soft or informal to their commercial clients. Indications are that when lawyers are present at the mediation, the success rate is lower. Perhaps this will change in time. Mediation is particularly appropriate where no point of principle is involved or where the parties may wish to do business together in the future.

Mediation should be kept in mind for all commercial disputes, if not at the beginning then during the course of litigation or arbitration. It costs little, arrangements can usually be made for mediation to take place quickly and there is really nothing to lose (other than its shared cost) if it does not work since neither party is prejudiced. Furthermore, a recent High Court decision (*Dunnett v Railtrack plc [2002] EWCA Civ.* (*303*)*, [2002] 2 All ER 850*) made it clear that the courts will penalise on costs, those parties who, having been offered mediation, deny it and then go on to win. Where ordinarily they would get their costs, if they have denied the use of mediation they will not automatically get their costs back – this is a powerful weapon for getting the parties to mediate.

The introduction of the CPR has demonstrated that the cost of court litigation will remain high at least for the foreseeable future and that there is a real need for alternatives. Whilst there is a strong tradition of arbitration in Britain, other countries are well ahead in taking up the advantages of mediation and that is good news for the lawyers. Following the CPR reform – there was a boom in meditation according to experienced mediators. This was because there was a formal realisation that mediation was here to stay and due to it being made a formal part of the system. In comparison with court proceedings, the evident advantages of mediation are that it is:

- quicker;
- relatively cheaper;
- can enable the resolution of disputes without damaging the commercial relations between the parties.

Some practitioners see mediation as a tool to be used in conjunction with – rather than as an alternative to – litigation. In any event, mediation does indeed seem to be on the increase along with the number of organisations providing mediation services.

Other ADR procedures **5.28**

The ADR procedures that are discussed in the list below are also sometimes used. There are other procedures and, no doubt in time, more will be devised.

1. In some jurisdictions the court can refer the case or aspects of it to a referee (or expert) chosen by the parties to decide some or all of the issues. This is to be distinguished from the practice by which the court appoints an expert who reports his or her findings to the court. There is nothing to prevent the parties to a dispute agreeing to adopt this procedure.
2. In some industries (in particular the construction industry) the contract will provide for the appointment of a neutral adjudicator to make summary binding decisions without following litigation or arbitration procedures. This happens in the UK.
3. Sometimes the parties may themselves simply appoint an expert to consider the issues and make a binding decision without going through the motions of an enquiry followed by adjudication.
4. Statutory (or administrative) tribunals may be appointed (as in the UK) to establish fair rents, the price of freeholds, compensation awards, social security benefits, etc. These tribunals have somewhat limited powers but they tend to be formal. A short comment on these is made in **5.30** as a result of the Leggatt Proposals.

In the UK certain sectors such as legal and financial services may be investigated with public findings by an Ombudsman who may even be able to award compensation. In some jurisdictions a ‘mini trial’ may take place at which the lawyers for the parties present their cases to the parties and a neutral appointee who helps to clarify the issues and evaluates the merits. The neutral appointee may also play the part of mediator. Although the findings are not binding, settlement sometimes follows.

There are a number of variations of these alternatives but the least exotic and therefore perhaps most attractive at the moment seems to be mediation.

Summary: A practical approach to disputes 5.29

The following is a summary list of hints and tips to be considered.

1. Reduce the opportunities for disputes. Let the lawyers earn their fees by helping to avoid disputes arising.
2. If the dispute can be resolved amicably, the sooner the better if legal costs are to be reduced or avoided.
3. Consider the benefits of involving lawyers behind the scenes.
4. Change the negotiators if appropriate.
5. Frame settlement proposals carefully.
6. Consider including an arbitration clause in contracts and agreements.
7. Always be aware of the benefits of resolving the matter at any stage by mediation. Do not rely on the lawyers to suggest it.
8. Consider whether one or mote of the other ADR procedures might be appropriate.

The role of tribunals 5.30

Another consideration for business in England and Wales is that they may be involved in tribunal proceedings. Following the Leggatt Review proposals for an overhaul and simplification of the tribunal system were submitted. For further information on this specific area it is recommended to seek expert advice since the impact of being involved in any tribunal process is again the impact on the business operations and business continuity (see further below).

The Leggatt proposals 5.31

The thrust of the Leggatt proposals was to provide tribunals with a more coherent structure. The report submitted that tribunals will only acquire a collective standing that matches the court system once all of them, that is the administrative tribunals concerned with disputes between citizen and state and those concerning private parties, are brought under one administration. Within that structure there would be first-tier tribunals, for example education, health and immigration. These would have corresponding appellate tribunals. Some argue that employment tribunals have become so significant in terms of workload, however, that they should be the subject of a separate structure. They refer to the employment tribunal system task force recommendations. Similarly education tribunals are facing an expanding role and workload in the face of issues over disability discrimination. While the Leggatt proposals would remove the perception that tribunals are not independent from their sponsor government departments there is also concern that a unified tribunal system would be too cumbersome and may lead to a dilution in expertise. This is a specialist area that should be followed up separately where required.

Points to consider **5.32**

Wherever a business is located it is advisable to fully understand the complexity of the legal framework that will apply. Management should understand the way that it can be impacted through legal or administrative rules or requirements. As part of a general due diligence when entering a jurisdiction that is unfamiliar steps should be taken by any business to understand the local system. It is generally safer not necessarily to rely upon advice of one's local partner but instead to take independent appropriate professional advice. In view of the concerns over business interruption set out below there is no doubt that being proactive in this context makes business sense (see also **CHAPTER 1**).

Due diligence and late payment issues for business **5.33**

Another key area that can impact on the business relates to payment issues and late payment in particular. Here again proactive knowledge of the local rules is crucial. For instance legislation in England and Wales has assisted with the ongoing problem of late payment of invoices and accounts and, therefore, cash flow. The *Late Payment of Commercial Debts* (*Interest*) *Act 1998* (*LPCD*(*I*)*A 1998*) came into force in August 2002. It made provision for the payment of interest at a compensatory rate on the late payment of certain debts arising under commercial contracts for goods or services. Its main provisions (summarised) are that:

- interest becomes payable on the debt at the rate of 8% over the Bank of England's official dealing rate when payment becomes overdue;
- when no payment date has been agreed, interest starts to run after 30 days from the date of performance; and
- any term that purports to contract out of the statutory right to interest is null and void in the absence of a substantial contractual remedy for late payment.

The extent and nature of the late pay problem **5.34**

It is well known that the provision of credit by suppliers to customers is an established feature of business transactions in most jurisdictions. Such a facility is essential for the efficient operation of the global economy. However, the provision of goods and services in advance of payment means, of course, that the supplier can be exposed and vulnerable to payment delays.

Debtors may be late meeting credit payments for several different reasons generally cited as including:

- deliberate unjustified delay for financial advantage;
- disputes over the provision of goods and services;
- temporary cash flow difficulties;
- administrative errors by either debtor or creditor;

- misunderstanding or uncertainty over the agreed credit period;
- 'pay when paid' contract terms;
- breakdown in payment systems; and
- inability to pay due to insolvency.

Nevertheless, whereas it is a fact that small businesses have in the past regarded and continue to regard late payment as a serious problem, any quantification of the effect of the late payment problem is difficult. Some relevant surveys have, however, been carried out over several years. By way of example, the Cork Gully Report of 1991 for the Confederation of British Industry (CBI) found that nearly 60% of businesses regarded late payment as a significant problem. A more recent survey, which was undertaken in 1996 for Intrum Justitia (receivables management services company), found that a majority of UK companies surveyed said late payment caused a problem or serious problem for their cash flow, profit, growth and/or survival. Moreover the Forum for Private Business (FPB) has particularly lobbied the government on behalf of its 28,000 members – many of whom are within the definition of micro business as defined (0–9 employees) to deal with late payment issues as a matter of priority for small business. The FPB has been extremely proactive in this area.

It should be understood that actual payment performance against contractual credit periods would appear to support the concerns of small businesses. The 1996 survey undertaken on behalf of Intrum Justitia found that in the UK commercial debts were paid on average 18 days late (i.e. after the contractual payment date). Moreover, the existence of a statutory right to interest on late payments was supported by 80% of the UK respondents in this survey.

As in many other parts of the world, small business plays a key role in the economy of the UK. The UK government has demonstrated its concerns that actions should not unnecessarily hinder the competitiveness of small business. There are countless examples that demonstrate the connection between late payment and business failure. It is therefore vital that larger businesses – as well as the smaller organisations – should keep abreast of the developments and observe their contractual obligations as part of their operational due diligence and corporate governance.

The late payment of commercial debt is recognised by most stakeholders in the business community as being a very serious problem, especially for small businesses (defined below and also in Appendix) who are least able to carry the additional costs arising from payment delays. In particular, the recovery of debts can impose further expense in terms of diverted resources and actual goals, especially where recourse to the courts is required. Delays in payment are generally more harmful to a small business than to a large business. Small businesses are often highly geared, relying on short-term loans and overdrafts for working capital. Cash flow problems caused by late payments can, therefore, have a significant negative impact on the ability to trade for many companies and businesses, especially the smaller players. Small business, particularly in supply chain situations, can be very exposed to the problems of insolvency (some of which are mentioned briefly in **5.35** below). It has been acknowledged that any late payment, like any other breach of contract, should attract appropriate sanctions.

Some international examples and comparisons – applicable law **5.35**

The problem of late payment is not, of course, limited to the UK. For example, most EU Member States report payment delays. In general, legislation in Member States of the EU tends to apply to all commercial debts. What is of obvious practical importance to business is not only the existence of a statutory right to claim but also the existence of the necessary legal systems to enable a creditor to enforce the right efficiently and effectively. As indicated above, one key reason for businesses not exercising their right to interest is the cost involved in pursuing the interest. It is evident that the more expensive and time consuming the legal process, the less likely that interest will be claimed and the less effective the legislation will be in improving the payment culture. By way of example, in Sweden, interest can be claimed automatically and, where not paid, can be pursued through the courts even if the principal debt is paid. A summary court procedure for undisputed claims exists. If disputed, the claim is referred to the court for litigation. Notice of this is sent to the debtor, seeking payment or objection/defence within eight days, in the absence of which a summons will be issued. The debtor must pay interest and compensation for the cost of pursuing the claim where a claim for interest is upheld.

It is noteworthy that the USA also introduced legislation to address the problem of late payment by Federal government bodies. The *Prompt Payment Act of 1988* provides small businesses with a right to interest on overdue payments by Federal Authorities.

The matter of applicable law is therefore also vital. The UK legislation, the *LPCD(I)A 1998* (see also **5.36**) applies to any commercial contract, including imports and exports, written under the UK law unless foreign law expressly applies. Where the choice of law is a foreign law the Act applies if, but for that choice of law, the applicable law would have been UK law in general.

Implementation of the English Late Payment of Commercial Debts (Interest) Act 1998 **5.36**

The implementation of this legislation gave rise to various practical issues for small business relating to credit management. In this connection the Better Payment Practice Group was formed in 1997 as a partnership between the public and private sectors. Its publicised aim was to improve the payment culture in the UK business community and reduce the incidence of late payment. Since the implementation of the Act and steps taken by businesses also with the assistance of advisers and their technology the recognition of the need for credit management as part of their due diligence and governance programmes has been more understood.

Some outstanding issues 5.37

Wherever the business operates it is important to take appropriate steps to understand the implications of the framework relating to late payment, as well as insolvency (see further below) especially as one can often lead to the other. This applies to the business regardless of its size or sector since they can create direct repercussions as regards business interruption and recovery.

Business interruption and recovery 5.38

As comments made in other chapters demonstrate, such as **Chapter 9** on IT (information technology), business interruption is one of the greatest risks that faces an organisation. This is even more true in the fast moving world that we inhabit: it can involve litigation, lead to insolvency and cause real business crisis. In **Chapter 9** this area is discussed from the e-commerce perspective since the repercussions are increasingly dramatic in view of the dependency on IT worldwide. Companies should invest in effective disaster recovery and business continuity plans as a priority. This is so regardless of the size of the business or its location, as with other risks. Unfortunately the Institute of Chartered Accountants in England and Wales (ICAEW) in their recent policy papers 'Entrepreneurship: the Key to Growing the SME Sector' found that small firms place too little emphasis on risk management. Although many companies focus on financial and insurable risks the approach that risk should be managed throughout an organisation remains relatively novel. Moreover, despite the fact that IT has been proven to be one of the weakest areas for businesses of all sizes, when implementing the Turnbull Guidelines (see **Chapter 10**) the Department of Trade and Industry's (DTI's) 'Information Security Breaches Survey 2004' found that two-thirds of businesses surveyed had to restore significant data from backup due to a computer failure theft. This is despite the increased reliance on business intelligence (see **Chapter 10**) and the growing sophistication of internal and external threats. See also **5.43** and the London Case Study below.

Global events 5.39

The ramifications of the terrorist attacks on 11 September 2001 to the World Trade Center in New York have been discussed extensively at many levels – political, commercial and personal – in many forums and no doubt they will continue to be debated for some time yet to come. Moreover since then it has been clear that terrorist attacks can strike anywhere at any time and business is still to recognise the full implications as is demonstrated in the Case

Study carried out by the London Chambers of Commerce (LCC) in the context of London one year on from the attack on 7 July 2005.What has been demonstrated in such discussions in no uncertain terms is the practical reality of the ‘shrinking world’ in relation to business activity. Global events impact on national activity, including security (see further US response below) and the consequences for global business impact on both large and small business. The broader implications and the increasing involvement of international law are common threads for business and initial observation should be noted here.

9/11 US economic repercussions

When considering the events of 11 September, one executive summary has noted that the incident ‘hit when the world economy was already weakened. As a result, global growth will be even weaker than formerly expected and the anticipated recovery postponed’.

Moreover since mid-2000 global growth had been on a downward trend due to:

* a collapse in investment spending;
* a tight monetary policy; and
* high-energy prices.

Even before the terrorist attacks, the economic outlook for the USA had deteriorated and the American consumer was beginning to ‘retrench’. The business disruptions due to the attacks probably expedited the process, however, and the repercussions are widespread due to the high level of interdependency in the global economy. It is now understood that the downward trends at a high level can be disastrous and can disrupt micro business, bringing about an increase in insolvencies, pending upward trends. Already 2008 has witnessed major losses.

Small business **5.40**

As this handbook aims to demonstrate that impacts can be felt regardless of size in the light of today’s business relationships, the concerns of small business must be addressed. Having regard to the global events referred to in **5.39** above, some insight is given into the recent developments regarding insolvency in the context of corporate governance. Their impact is, of course, an important issue for small business at times when the global economy is highly volatile and affects all business and the supply chain directly. It should also be noted that the contribution of a healthy small business sector is dramatic in its positive impact on the economy in view of the size of its membership. Wide scale insolvency and bankruptcy can therefore have damaging lasting effect throughout the business community as a whole.

Insolvency

Meaning of insolvency 5.41

In the UK there has been extensive debate regarding the appropriateness of its regulatory framework relating to insolvency and business failure. It is not intended to go into the present laws of insolvency (which is a vast subject) but rather to consider the meaning of insolvency and its application by some reference to other relevant countries that are driving change. What, then, is usually meant by insolvency? Generally:

- the inability to pay debts as they mature;
- under the American *Bankruptcy Act of 1898* the insufficiency of assets at a fair valuation to pay debts;
- under various other laws the insufficiency of assets at a fair saleable valuation to pay debts.

The second meaning is sometimes referred to as the balance sheet insolvency test and is the predominant meaning in civil law jurisdictions. Non-lawyers are accustomed to using the term 'insolvent' as an adjective, such as an insolvent debtor whereas lawyers sometimes use the term attributively as a noun, that is 'an insolvent'.

Also relevant is the concept of bankruptcy, which generally refers to:

- the fact of being financially unable to carry out one's business and meet one's engagements, especially to pay one's debts;
- the fact of having declared bankruptcy or having been adjudicated bankrupt under a bankruptcy statute;
- the field of law dealing with those who are unable or unwilling to pay their debts.

In this respect the relevance of the American approach has been widely debated in the UK. In the USA the phrase 'Bankruptcy Act' refers to the law of 1898, which governed bankruptcy cases filed before 1 October 1979. The phrase 'Bankruptcy Code' refers to the *Bankruptcy Reform Act of 1978* (frequently amended since then), which governs all cases filed since 1 October 1979. What is well known in American law – and increasingly understood here – is what is called '**Chapter 11**'. In American legal usage **Chapter 11** has become synonymous with corporate reorganisation to handle debts in a structured way, under the protection of a federal bankruptcy court. By way of example it has been noted that:

> 'The purpose of a **Chapter 11** filing is to give a chief executive an opportunity to reorganise a financially troubled business by putting its creditors on hold. When the money problems have been straightened out and the company restored to health it emerges from the protection of the bankruptcy courts and picks up where it left off.'
>
> (*John Taylor, 'Bankruptcy Was a Disappointment', N.Y. Times, p. 11, 10 December 1989*)

Although to 'go **Chapter 11**' does not appear to have the stigma attached to insolvency and bankruptcy evident elsewhere, the consequences for business – as well as personal consequences – may in fact be devastating. This has been witnessed in many recent cases, such as Kmart and Global Crossing and including the controversial Enron case study that has been so publicised and analysed. This led to calls to make US directors more accountable and to require a new team of managers under **Chapter 11** rather than leaving the existing management in place. In some ways the USA is moving closer to UK thinking, to make it more difficult for bankrupts to be forgiven their debts and to be rehabilitated without sanction. It is recognised that insolvency may be a result of mismanagement, misfeasance or fraud.

Nevertheless it has been noted that the stigma that attaches here, together with the ongoing practical repercussions of business interruption and failure – insolvency or liquidation – often means that a valuable contribution to the business economy is damaged in circumstances that are often beyond the control of the small business at risk and are disproportionate in effect. In some ways the UK is moving closer to the USA by attempting to make it easier for companies to be rescued and make it less of a crime for an individual to go bankrupt. This is where there is no blame involved. It can be appropriate in circumstances in which small business often finds itself, that is with cash flow problems in circumstances beyond its control through the late or non-payment of debtors.

Key areas of concern **5.42**

At an EU seminar on business failure cash flow was reputed to be the cause of 30% of insolvencies. What have emerged as key areas of concern in the insolvency debate are:

- the role of the banks;
- the appointment of an insolvency practitioner;
- the priority of debts;
- the costs of insolvency;
- the problem of cash flow and causation of insolvency.

While the debate continues, certain recommendations set out below may assist in reaching a satisfactory conclusion for stakeholders when any insolvency occurs, particularly as regards small business.

Methods applied in different jurisdictions

Again it should be mentioned that as a matter of ongoing due diligence it is helpful to consider the highlights of other approaches – both in place and proposed – in different jurisdictions based on the location of activities and operations.

Business continuity and operational risk management by D. Kaye **5.43**

Bearing in mind the above, it is appropriate to consider business continuity and operational risk management at this stage. Since business continuity can be affected for an array of reasons, as has been noted (in **5.38**), management should be prepared as part of its internal due diligence and corporate governance. One preliminary issue is whether a business does in fact consider operational risk management and business continuity as being entwined. The basis for this discussion is the experience of many organisations where operational risk management and continuity planning are considered to be two entirely separate disciplines. So often, according to risk practitioners, the two departments never really work together to any significant extent. Yet many risk advisers consider that they are one and the same. Continuity planning is simply one of the opportunities – and an increasingly important one – available to the modern risk manager.

Part of the problem, as ever, is understanding the terms. Ask a dozen people for a definition of risk and there will be at least 15 answers. We are talking here about operational risk; nasty surprises that come along and divert the organisation from its strengths and objectives (see also **Chapter 8** regarding risk management culture).

The science or art (depending on your point of view) of risk management has an unfortunate foundation in people who called themselves risk managers, but were in reality buyers of insurance programmes. Other 'risk managers', including company secretaries, treasurers, auditors, lawyers, facilities managers, continuity managers, health and safety managers, security managers and business directors, all developed their own risk approaches quite independently.

A business director could cheerfully accept an exposure of, say £10 million or even £100 million, and see doing so as a business profit opportunity – comfortably fitting within the assets and cash flows that are managed on a daily basis. The 'insurance buyer' in the same company, however, may be spending millions buying insurance for PCs and photocopiers. The lawyer may be cheerfully transferring risks to other contracting organisations without it being part of the job description to consider the residual risks on their own organisation if that party failed to meet those contracted responsibilities.

Continuity management, on the other hand, comes into the 21st century from a 20th century foundation of IT and facilities managers owning the responsibility for, and developing continuity facilities for their services. Fortunately, the science of continuity management have moved on somewhat. Increasingly, the business impact analysis is a vital tool, and there is more ownership and exercising by business managers. It is a history, however, that is still not easy to forget considering the background and the reporting lines of some continuity managers.

The evolution of risk management in practice **5.44**

Looking at risk management first, the ground has shifted noticeably under the old 'insurance buyers' and in different ways at the same time. Firstly, their employer's organisation is almost certainly undergoing such major change that the old organisation of just a few years ago, and the new, are barely recognisable as one. Following mergers, it is likely to be much much bigger, and much more international. Computerisation and communications have created different marketing, service delivery and cost saving opportunities. These developments have reduced the need for locations and people dramatically.

The focus on creating value at each individual stage of the supply chain has created new critical dependencies in third-party organisations that are less easy to supervise in detail. These dependencies have frighteningly shorter and shorter periods where delay can be tolerated before destructive damage occurs. Entirely new risks – e-commerce, internationalism, media and others – have evolved; as have customers' expectations been raised towards a seamless 24 hours/7days service (see **Chapter 9**).

E-commerce – where basic entrepreneurial instincts are fuelled by ever more powerful computers – along with telecommunication and data mining tools, is one huge area where the rewards of the first pioneer are totally disproportionate to the rest. In that atmosphere of headlong sprint and laying bets so large that they will create, or kill, careers, the risk and continuity managers asking for time and resources to plan effectively can be ignored.

Sometimes it is an 'old' risk that, because of these changes, now has a new potential for total, organisation wide and simultaneous destruction across individual business units – miles or even countries apart. What good is it being able to produce good products if the world has lost confidence in the product's name and won't buy them?

Conversely, these larger corporations have opportunities to absorb much more risk within the strength of their balance sheets and cash flows. They are large enough also to have some flexibility to keep them in their marketplaces whilst problems are being resolved without stakeholders feeling an unacceptable impact.

Challenges **5.45**

The challenges that face today's risk managers therefore include:

- making best use of the new strengths within the organisation;
- a consistency when approaching risk evaluation, risk tolerance and risk management – leading to seamless risk decision-making;
- both a bird's eye view and a detailed view across the organisation at the same time;
- managing second-hand, destructive risks or timescales in suppliers;
- risks that arc beyond the ability of the insurance industry to support;
- communication on matters of risk and thus managing diverse expectations; and
- keeping up with change.

The concept of 'killer risks' (having such an effect that it literally kills the company) is increasingly emerging. The brand and stakeholder confidence concerns (see **Chapter 7**), are such killer issues; as is insolvency (see **5.41**), and business and financial control. Dependencies on central group-wide facilities such as computerisation and communications to deliver the products on time to an acceptable standard; also the intellectual assets within the organisation (see **Chapter 9**), are just a couple more amongst others. These are all not unfamiliar to the continuity manager.

As is mentioned in **Chapters 1** and **4** – and discussed further in **Chapter 10** – the changing regulatory needs are also demanding a more 'holistic' approach to risk management. Stakeholders have no interest in internal organisational boundaries. They concern themselves only with the potential for unacceptable impact on the shareholding, or on any other relationship they may have with the organisation itself. These regulatory needs, Turnbull included, are driving organisations to consider enterprise-wide operational risks more formally. These organisations, however, are more comfortable with the clearer cut aspects of financial risk and indeed they have experiences, sophisticated strategies and controls, developed over many years. The evaluation and cost/benefit analysis of non-financial, operational risk, decision-making, however, is not as simple to quantify. Some are clearly struggling with the commercial decision-making that is being demanded (see also **Chapters 4** and **7**).

It is worth considering at this point where the insurance programme fits into this new style corporation and its 'killer' risks. Insurance is indeed extremely useful eventually but where is that value in those crucial, threatening minutes and hours after a disaster where survival of the organisation and its dependencies is the only challenge? The organisation and its most crucial dependencies need to survive first to fully gain, later, the value of its insurance programme. This is a specific area that should be referred for specialist advice as insurance cover and the role of insurance ebbs and flows with trends that require detailed consideration (see also **Chapter 16**).

Stakeholders **5.46**

The risk manager will consider that the organisation is no more than the brand value, its intellectual and free value assets together with the combined influence and support of its stakeholders. These stakeholders, with their quite different interests, are at the centre of the risk manager's thoughts. This is true of the continuity manager too. They include:

- employees;
- suppliers;
- customers and distributors;
- regulators;
- the media;
- private and quoted shareholders;
- bankers;
- the public – via their impression of the brands; and
- the environment and others.

Risk evaluation 5.47

When evaluating risk, the risk manager measures them against the agreed risk tolerance levels of the organisation itself. If the risk, and/or the potential impact, is not acceptable to the organisation, then the risk manager sets out to bring these aspects within that agreed tolerance level. It is rare that the risk manager can remove all risks or impacts altogether. In addressing unacceptable risks, the risk manager can consider the commercial realism of a range of options and the relative value of each option. They are:

- reduce the likelihood or the potential frequency;
- ensure that the impact is reduced to an acceptable level – whether that be in human, operational or financial terms;
- transfer the impact to another organisation (e.g. a counterparty, an insurer, a captive insurer, the financial market or another); and
- prepare for the incident by way of continuity planning of business critical issues.

The suggestion here, therefore, is that contingency planning is just one of the options available to the risk manager. If credible, tested plans can be in place so that the organisation can get through an incident without serious damage, then surely that is one of the options alongside risk expenditure and resources. This is especially so where risk management constrains the organisation from doing what it is best at doing and when dealing with low-frequency, high-impact exposures. Resultant expenditure incurred after the disaster can often be an insured expense – a benefit close to finance directors' hearts. What is import-ant here is to highlight credible, tested plans. This is all familiar to the continuity manager, who sets out to identify risks and evaluate them within the context of the impact on safety, and the urgencies, survival needs and responsibilities of the organisation. However, one should also include here, not just business continuity plans, wherever contingency planning is needed, for instance:

- kidnap;
- extortion;
- bomb threat;
- suspicion of major fraud;
- succession planning;
- media criticism;
- product recall; and
- others.

These have common denominators, of course, but the needs of each must be met.

It may not be cost effective, or just unachievable, to remove risk altogether by risk management. Continuity planning may be the only answer left when all that is realistically preventative can be done. All of these measures though, ones that can include business decision-making, security, health and safety, resilience in production lines, etc. are, with continuity planning, best effective when all are part of a relatively seamless process of risk and impact understanding and management.

Even the challenges to risk managers and to continuity planners, are similar. Firstly, how to get the attention of the board to the point that the right level of priority is given? How to gain resources for risk and continuity management in competition with projects that are about what is happening today not what may or may not happen sometime in the future? How indeed to get the directors to pay more than superficial attention and concede fully, that not only this thing may happen, but it may happen within the ever-shorter tenancies of that particular top job. Risk management and continuity management are both commercial business issues which incorporate the special challenges of acceptability and urgency. Each discipline is evolving within itself. There is real value in them working much more closely together and each providing valuable support for the other.

Case study 1: Priorities for business continuity management – a London case study by James Ford and James Heal (Extract from 'One Year On From 7 July' Report by LCC, 2006) 5.48

In London the Buncefield oil refinery fire, 7/7 and all the other disasters that have happened in the past few years suggest a number of priorities for business continuity management. These should be at the forefront of businesses' minds when developing contingency plans.

Protecting data and ensuring that a business can continue to function despite a major problem with their IT system has always been a priority of contingency planning amongst businesses. In fact, business continuity management as a concept largely stems from firms' plans for disaster recovery in the event of a critical failure of their IT system. Adam Laurie, technical director of secure data storage company The Bunker Ltd, said that companies are increasingly becoming aware of the need for offsite backups and data recovery: 'The focus for companies now is on getting their data out of London, as data is obviously an extremely important part of the viability of their business, and if the system is destroyed or threatened, it is important to have an offsite network which can continue their business.'

Another business continuity priority is to ensure that businesses can communicate. Telecoms are therefore an important aspect of a business's contingency plan. The example of 9/11 where mobile, landline and Internet connections all suffered from capacity problems, shows the importance of communication networks during a crisis. The McKinsey Consultancy Group's post-9/11 report showed that businesses were extremely vulnerable at choke points such as telephone switches and other information hubs. Despite this, it seems that businesses do not attach as much importance to telecoms as to data and IT, possibly due to the complexity and cost of setting up an emergency network.

According to John Goodeve-Docker of telephone back-up company Speech Solutions: 'In a time of crisis, whatever the reason, it is human nature to revert to communicating by a familiar and trusted method – the telephone. Yet the vast majority of companies with a business continuity plan, let alone those without one, tend not to include their telephone systems within their plans.'

Maintaining communications was a very important aspect of companies' experiences of the July bombings. Because the attacks occurred when many staff were travelling to work, accounting for the whereabouts of missing employees proved a difficult task for many managers and firms. A number of companies also reported that their switchboards came under pressure on 7 July, in part due to a large amount of calls from worried relatives of employees.

Another major lesson of 7/7 in terms of companies' contingency plans was that they focused on evacuating staff from premises that had suffered an attack. However, the fact that the 7/7 attacks were directed against London's transport network meant that many staff found themselves essentially stranded in central London, many of them overnight. This meant that businesses needed to provide their staff with sleeping bags, food and drink [1].

Other threats to business continuity 5.49

Business continuity management is about more than just surviving a direct terrorist attack on a company's business premises. Business survival can also be threatened by failures in other critical business areas such as power outages, failures in IT or telecommunications systems, loss of transport networks or supply chain disruption – all of which may result from natural disasters or random 'acts of God' rather than terrorism. The current UK Government's only legislation on preparedness, the Civil Contingencies Act 2004, for example, owed its genesis not to the 9/11 terror attacks in 2001 but to the period from September 2000 to Summer 2001 when the UK was beset by a fuel crisis, severe flooding and an outbreak of Foot and Mouth Disease. The variety and unpredictability of disasters that can affect communities and businesses was further proved by events in 2005, when the world witnessed the full spectrum of disasters that could befall communities and businesses, starting with the Asian Tsunami and then moving on to include the Pakistan earthquake, hurricanes in the USA, the London bombings and even the Buncefield oil refinery explosion.

Respondents to the CMI's Business Continuity Management Survey 2006 rated 'terrorist damage' as only the seventh most significant threat to their finances, alongside fire but behind utility outage (sixth), loss of telecoms (second) and loss of IT (first). Also, the seventh-placed ranking was actually down slightly on the year before, when 'terrorist damage' was rated as the sixth most significant threat. The full table of results is included below:

Source of threat to costs and revenues	Percentage of respondents identifying this threat (2006)	Ranking (2006)	Previous ranking (2005)	Percentage of organisations' contingency plans which include this (2006)
Loss of IT	67	1	1	67
Loss of telecoms	56	2	2	63
Loss of people	56	2	5	51
Loss of access to site	54	4	6	61
Loss of skills	49	5	3	40
Utility outages	45	6	8	51
Fire	44	7	3	55
Terrorist damage	44	7	6	45
Damage to brand or corporate reputation	39	9	9	26
Negative publicity	34	10	10	28
Employee health and safety incident	30	11	11	41
Supply chain disruption	28	12	11	27
Environmental incident	27	13	11	42
Flood/high winds	26	14	14	42
Customer health/product safety	26	14	15	22
Industrial action	22	16	15	20
Pressure group protest	16	17	17	16

Source: CMI Business Continuity Management Survey (2006).

More importantly, when asked to rank these factors in terms of those which had actually had an impact on their organisation during the previous year, managers placed direct 'terrorist damage' at the bottom of the list, impacting on just 3% of respondents. Loss of IT topped the poll with 38%, followed by loss of people (29%) and loss of telecoms (24%).

Nonetheless, although managers said that their business had not suffered direct damage from terrorism, many reported knock-on effects from the 7/7 bombings in London. Some 10% of respondents said the bombings had caused 'significant disruption' while 26% said it had caused 'minor disruption' and 24% said there had been a negligible effect. Just 36% of managers said their organisation had seen 'no impact' from the terror attacks. By comparison, 70% of managers said the Asian Tsunami had no effect on their business and 77% said they had seen no effect from the Pakistani earthquakes.

A number of other potential threats to businesses have risen in prominence in recent months, most notably a possible avian flu pandemic. However, despite the significant media attention the threat of a flu pandemic received, businesses remain unprepared. An LCC London Business Leaders' Panel survey in February 2006 found that just 19% of firms had a contingency plan in place to deal with an avian flu pandemic. Some 10% of London firms had updated their existing contingency plan to deal with avian flu and only 6% had tested their plans in the context of a pandemic.

In the light of increased public interest in climate change, concern over environmental disasters and extreme weather conditions have also risen in prominence (see further **Chapter 16**). A sustained heatwave in France during August 2003 did not just result in the deaths of an estimated 11,000 citizens but also threatened national power supplies and caused IT systems and data centres to shut down or overheat. An AXA Insurance survey found that SMEs cited severe weather patterns as a bigger threat to their business than poor management or competition [2].

The Hurricane Katrina disaster in the USA is estimated to have caused insured losses of $25 billion, making it the costliest storm in US history. Lost tourist revenues in New Orleans alone are said to have topped $5 billion and the Mississippi River's gaming industry was all but wiped out with the state's 12 floating casinos either severely damaged or destroyed. As a result of the storms and flooding 91% of oil production and 83% of gas production in the Gulf of Mexico was shut down, forcing petrol prices and energy costs to rise sharply across the USA. Freight transport companies lost $3–4 million a day while the region's 12 ports were closed [3]. In the state of Louisiana alone an estimated 18,750 businesses were destroyed, wiping out 240,000 jobs [4].

Buncefield – a lesson in contingency planning for business 5.50

One useful example of the need for contingency planning is the Buncefield oil refinery fire in December 2005. The Business Continuity Institute (BCI) described the Buncefield disaster as 'what business continuity management is all about'. According to Lyndon Bird, technical director at the BCI: 'It provides more messages and lessons than all of the other annual incidents put together. Firstly, it just happened 'out of the blue', with no obvious reason, warning or prior experience to suggest it might … Secondly, it happened at the most inconvenient time, two weeks before Christmas when demand for oil products was at its peak and many organisations were working at full capacity. Thirdly, it was the things that many had not planned for that caused the most concern, for example police and other emergency service access restrictions. Lack of access to their own business premises (even if not damaged) caused anger, conflict and major frustration' [5].

The Buncefield disaster had a heavy impact on surrounding businesses. Internet retailer ASOS suspended trading on their shares, the headquarters of software firm Northgate Information Solutions was severely damaged and had to initiate its contingency plan, and DSG International, the firm that owned Dixons and Currys, had to close its head office [6]. According to Geoff Howard, director of The Continuity Shop: 'After the Buncefield disaster, several companies went bankrupt which weren't even damaged by the explosion, but were just in the exclusion zone. One wholesaler of Christmas supplies was caught in the exclusion zone for a week, and due to the nature of his product, was unable to deliver to his suppliers in time for the deadlines. Clearly due to the investment made in the stock he could not wait another year, and hence went bankrupt. This illustrates the importance to SMEs especially of having some kind of business continuity plan in place, as well as some kind of insurance which covers such eventualities.'

These sentiments were echoed by Professor Jean-Noel Ezingeard of the Henley Management College, who said: 'Something like Buncefield, where businesses three miles away were affected, should bring it into focus. Every business owner should be looking at the effect an incident could have … They need to prepare for the impact on trade, turnover and stock.'

Following the Buncefield disaster, data management software designers Version One conducted research which found that 30% of finance directors did not believe that their business would survive the loss of all paper records and business documents in the event of a disaster. Some 32% would take 12 months to recover and 38% estimated a recovery period of approximately 6 months. In terms of the financial cost of losing paper records, 45% of firms estimated the cost to be at least £50,000, 32% of firms said the cost would be between £100,000 and £800,000 and 15% of finance directors said the cost to their business would be more than £1 million [7].

Barriers to developing contingency plans 5.51

A lack of adequate contingency planning is a major issue for SMEs in particular. While the latest LCC survey found that 41% of firms had a contingency plan, the figure fell to just 29% amongst firms with fewer than 20 employees. Comparatively, amongst firms with 20 staff or more, the proportion with contingency plans is 57% [8]. Research by AXA Insurance and Henley Management College found that 76% of SMEs had not 'reviewed business approaches' since the July terrorist attacks. The report concluded: 'Despite growing awareness of the problem, UK SMEs appear to have failed to be stimulated into action … With fewer resources to withstand the business impact of a major incident than larger firms, underprepared SMEs expose a significant vulnerability in terms of their own survival, and the consequential impact on their employees, their customers and their suppliers' [9].

According to Professor Jean-Noel Ezingeard of the Henley Management College: 'Too many of Britain's SME managers bury their heads in the sand when it comes to continuity planning. The fact that 40% of businesses suffer a terminal failure as a result of an incident proves that more needs to be done. Continuity planning can be a simple, practical measure whereby senior managers ask a series of "What if" questions, and for most businesses, the only cost to the business will be their time. A lot of SMEs tend to focus on the day-to-day aspects of the business but never look at risk control … Firms can have robust contingency plans with only a small amount of carefully directed effort.'

As well as size, the LCC's research found that there are also differences in business continuity management take-up rates between sectors. Some 52% of professional services firms, 50% of transport operators and 49% of 'other services' firms have contingency plans but just 34% of manufacturers and only 21% of retailers said they had a contingency plan.

One critical barrier to adopting contingency plans is that Government advice is provided through Government agencies which are not the points of contact or sources of advice that SME company directors tend to utilise. Accurate and timely information from Government is a vital aspect of effective business resilience. If the Government's civil contingencies messages are only being communicated to a small section of the business community then this could have very serious ramifications for the resilience of UK plc.

A recent survey by the Federation of Small Businesses found that only 4.4% of SME company directors take business advice from government-funded business support organisations and just 1.1% seek advice from central Government bodies (such as the DTI or the HSE). By comparison, directors were much more likely to take business advice from their accountant (53.7%), their solicitor (28.4%) or their bank (8.7%). In fact, company directors were almost 6 times as likely to take advice from a trade association, and twice as likely to seek the opinion of their local tourist board, than from the DTI [10].

Another barrier is the nature of the advice itself. While guidance from policy experts in Whitehall may be thorough and comprehensive it tends to lack grounding in the realities and constraints of running a business. For example, the Cabinet Office's *Pandemic Influenza Checklist for Businesses* recommends businesses assess their preparedness for a flu pandemic with reference to 30 tasks or activities. However, 21 of these tasks require a significant input of time and a further seven, such as more frequent cleaning of business premises or enhancing mail ordering facilities, represent considerable extra costs to businesses. Three of the tasks – finding up-to-date pandemic advice, reviewing a communications plan and testing contingency plans – must be regularly repeated and revised, representing ongoing obligation upon businesses. The Cabinet Office should also ask itself how practical or realistic it is to ask SMEs to 'establish policies for reducing the spread of influenza at the worksite [by] promoting respiratory hygiene and cough etiquette' or to always 'ensure that communications are culturally and linguistically appropriate' [11].

It is important to ensure that communication with business is practical and fit for purpose. Departments and agencies should make advice focused and relevant and avoid trying to use contingency advice to meet other policy objectives, not least because to do so suggests that the Government has failed to grasp the seriousness and scale of the threat to business.

Efforts to increase levels of business continuity management must also be targeted at the right audience. Research has shown that contingency planning within firms is a direct result of commitment from the highest levels of management. According to the Henley Management Institute: 'Without backing from the managing director or chief executive, business continuity management does not happen' [12].

Encouraging business continuity management 5.52

In the USA, business continuity management has been driven forward as an unexpected consequence of the expansion of corporate governance legislation. The 2002 Sarbanes-Oxley Act, introduced in the wake of corporate accounting scandals such as Enron, includes a requirement that organisations must understand the risks that may impact their financial reporting processes and requires them to put in place proper controls. According to the *US Disaster Recovery Journal*: 'Compliance requires companies to establish an infrastructure designed to protect and preserve records from destruction, loss, unauthorised alteration or other misuse.' The consequences of this legislation have been to force senior executives to examine the issue more closely (in order to avoid hefty fines), has prompted organisations to regularly test their contingency plans ahead of annual compliance reporting to the US Securities and Exchange Commission, and has increased business continuity management budgets [13]. However, the legislation only applies to companies of a certain size and turnover (practical resources to assist business in the USA are discussed below).

There are limitations, however, to how successful or desirable such legislation would be in the UK. Increasing the regulatory and reporting burden on UK businesses beyond current levels would not be supported by the business community. Also, any legislation is likely to either have a detrimental effect on small businesses in terms of creating additional burdens because it is too severe or else is unlikely to provide the stimulus to action needed because it cannot be applied to small and very small enterprises.

Given that the most commonly cited reasons given by SME managers for not having a contingency plan are that they lack the time and money to do it effectively, it seems contradictory to attempt to encourage contingency planning by increasing the costs on businesses. Instead, business continuity management amongst smaller businesses is more likely to be encouraged by incentives, such as tax breaks, rather than compulsion and regulation.

The LCC has previously called for a nationwide 'buddy scheme' in which larger companies partner up with smaller businesses to help develop their contingency plan. The DTI should offer financial incentives, such as a continuity management tax credit, to encourage contingency planning by businesses. For smaller firms these incentives could cover the initial cost of setting up a contingency plan while larger firms could be rewarded if they form continuity partnerships to offer assistance with business continuity management to smaller businesses from within their supply chain or in their local area. These partnerships could range from help and advice in developing a contingency plan to agreements to share premises, facilities or resources in the event of a disaster or terror attack.

Crisis management – views from the USA 5.53

As indicated above, today's business environment requires that crisis management is prioritised, especially since the terrorist attacks on 11 September 2001. Indeed events that have spanned from the threat of Y2K with the turn of the century to today's terrorist attacks mean that serious threats to business exist in many ways.

It is useful to consider the approach in the USA in terms of important business risks such as the environment and health and safety from the perspective of the external adviser.

Some checklists that the USA has evolved are also included largely to assist SMEs which are increasingly affected by all of these concerns.

Managing an environmental, health and safety crisis by S. Miano 5.54

The world collectively breathed a great sigh of relief on 1 January 2000, when the much anticipated and greatly feared Y2K bug failed to bite, and the long predicted worldwide crisis never happened. In the weeks leading up to the new millennium, even those of us who had convinced ourselves that everything was under control and that no crisis would actually occur, had quietly put aside some extra cash and had stocked up on grocery supplies, just in case. In hindsight, many questions are being asked about why we survived the stroke of midnight unscathed. Was it all just a hoax? Was it misinformation? Or perhaps, was it due to the unprecedented planning and testing of computers and computer-related equipment that had taken place in preparation for the new millennium?

Those who believe that the Y2K bug was exterminated by the enormous planning efforts of corporate America think there is a lesson to be learned from this experience; namely, there is no substitution for good planning. That concept is certainly true when it comes to planning for and managing a crisis in the environmental, health and safety (EHS) arena. Unfortunately, despite an organisation's best efforts, it is almost inevitable that somewhere, sometime, a very serious EHS accident will occur. Experience has shown that companies caught without a comprehensive EHS crisis management plan, suffer both severe public relations troubles and significant legal liability (see also **Chapter 16**).

The old adage, 'there's no substitute for good planning', is one that EHS managers must not take for granted. The world, many would argue, is a very different place than it used to be. The spectre of terrorism has created a previously unimaginable set of scenarios that, unfortunately, must be taken into consideration when planning for unintended EHS events. Further, whether or not you subscribe to the belief that global warming has forever changed our weather patterns, it is hard to ignore the fact that natural events, including tornadoes, hurricanes, tsunamis, wildfires, drought and even earthquakes have increased both in frequency and intensity. Any one of these events has the likely potential to result in significant EHS consequences.

In addition to the increased possibility that catastrophic events may cause significant EHS consequences, there is the absolute expectation, on the part of both government regulators and the public, that such events will be properly managed to avoid those consequences. Recent experience has shown that companies caught without a comprehensive EHS crisis management plan, suffer both severe public relations troubles and significant civil and criminal legal liability.

Heightened expectations **5.55**

Due to the rapid pace of technological advances, a timely response to an EHS crisis is more critical than ever. Because of the widespread availability of electronic mail, cell phones and other forms of immediate communication, there is a growing belief that there is no excuse for delayed response. Both the public and regulatory agencies, such as the Environmental Protection Agency ('EPA') and the Occupational Safety and Health Administration ('OSHA'), have raised their expectations considerably. There are a myriad of new laws and regulations that now require companies to plan for and execute proper EHS crisis management when necessary. Regulatory agencies have also stepped up enforcement activity in the wake of such accidents. It is not uncommon for companies to face huge civil penalties and criminal enforcement for failing to prevent environmental and other harm from incidents. Moreover, computer technology has assured that, not only will your company's EHS crisis make the 11 o'clock news, it will also be posted on numerous websites, complete with all the details and pictures.

Interestingly, even regulatory agencies and governmental authorities are not immune from the inevitable criticism resulting from 20/20 hindsight following events that result in environmental harm. For example, many of us recall that even in the wake of the unprecedented 9/11 attacks in New York, EPA's Administrator was the subject of intense questioning and criticism over the agency's handling of the EHS aspects of the emergency response that followed.

These reasons make it an absolute necessity for companies, governmental authorities and even regulatory agencies to have in place, well thought out, usable and responsive EHS crisis management plans. Due to the varied complex issues involved in crisis management, it is extremely important that a multidisciplinary team develop the plan. Too many companies make the mistake of having a plan developed solely by a public relations firm or engineers. Such plans are inevitably missing critical elements. Once a plan is complete, it is also important to make certain that all of the players involved in EHS crisis management, from top to bottom, are familiar with it.

How crisis leads to liability **5.56**

In order to properly prepare for an EHS crisis, it is important to understand why and how your clients can be subject to both public relations nightmares and legal liability in the event that such an unfortunate accident occurs. First and foremost, a company that is unprepared to deal with an EHS crisis, say a chemical spill or industrial accident, will very likely not be in a position to contain the spill or minimise the consequences of the accident. Obviously, to the extent the problem gets worse, the more expensive the clean-up bill becomes and the higher the agency penalties and claims in third-party law suits will be.

In addition, there are myriad requirements under EHS laws to immediately report a spill, release or an accident. For example, in the United States, both the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and the Emergency Preparedness and Community Right to Know Act (EPCRA or SARA Title III), contain provisions for immediate reporting of chemical releases, which a company knew, or should have known, are in excess of reportable quantities set out in the regulations. EPA has taken the position that reporting such a chemical release more than 15 minutes after the release occurs is a per se violation of law subject to the imposition of penalties. In fact, the reporting requirements of these statutes require that the caller provide details such as the type and quantity of the released chemical and its health effects, as well as exposure and precautionary information. In order for a company to comply with that requirement, it must have a sophisticated record keeping and reporting protocol in place, before a spill occurs. Each state has overlapping and sometimes broader reporting requirements so companies with operations in various jurisdictions cannot simply rely on a national corporate-wide plan.

In order to properly report and respond to a release, a company must be able to immediately determine the substance or substances involved, and the proper agencies that must be contacted. This may require a very sophisticated chemical inventory system at each facility. A company that is unprepared to appropriately and fully report and respond to such a release will undoubtedly incur significant penalties from an agency. Given that the standards and expectations have been raised, it is easier for governmental agencies to make a case for criminal negligence.

Moreover, history has shown that EHS crises inevitably lead to additional, and sometimes far-reaching, government regulation. Consider the track record in the US. In the 1970s, flaming rivers led to the enactment of the Clean Water Act. Love Canal led to the enactment of CERCLA in 1980. Major air releases in Bhopal, India, and Institute West Virginia, led to the enactment of SARA Title III, as well as a number of provisions in the Clean Air Act requiring companies to provide significant volumes of information to the public, as well as increased record keeping requirements. The Exxon Valdez oil spill directly led to the Oil Pollution Act, which required additional planning and, which contained many new requirements for the prevention of releases of oil to waters. Finally, the 9/11 attacks have led to the enactment of a number of laws aimed at strengthening security at chemical plants, and EHS crises management planning (see further below).

The public relations trap 5.57

Often public relations issues feed the legal liability problems after an incident such as a spill or an industrial accident. A spill that makes front page news, regardless of the actual environmental harm, will inevitably lead to more severe consequences for a company. Naturally, an injured party, or someone who believes they are injured, is more likely to bring a lawsuit when they perceive that the situation was not handled properly. A good public relations strategy is key to altering that perception. Simply responding to an EHS crisis is not enough. One must manage the crisis.

A company that is not prepared to deal with the public and that does not have senior management responding in a way that assures the public the company has things under control, is more likely to become the subject of intense scrutiny. That scrutiny can come in the form of government enforcement, including criminal investigations and prosecution, as well as third-party suits such as toxic tort and citizen suits; the latter becoming increasingly relevant to the UK as a result of the impact of European environmental legislation (see **Chapter 16**).

A crisis is no time to dust off the crisis management plan 5.58

Some companies have invested considerable sums developing EHS crisis management plans with the assistance of able public relations firms and lawyers. However, it is common for an organisation to merely take the plan and put it on the shelf, being satisfied that it is there when needed. This is a mistake. A crisis is no time to test a plan for the first or even second time. Moreover, during a crisis, there is simply no time to consult a plan, particularly a voluminous one, with which you are not already thoroughly familiar. Crisis management requires almost instantaneous reaction by companies, both plant personnel on the scene and senior management, wherever on the globe they happen to be.

Everyone involved in managing an EHS crisis, from the second shift process operator, to the chief executive officer (CEO), must be familiar with both the contents of the plan and, more importantly, their role in the crisis management process. The kind of organisation required to effectively manage an EHS crisis is something that requires careful thought, planning, testing, practice, and updating.

Updating plans 5.59

For many reasons, it is very important to make sure that the EHS crisis management plan, once developed, undergoes frequent periodic review and updating. There is the growing public expectation that companies will not miss a step during a crisis. Therefore, periodic review and updating of plans will assure that they are both correct and familiar to those who are tasked with the responsibility to execute them. Outdated data, such as contact or health, affects information, can cause serious delays and either over or under reporting of information to agencies and the public. Even sophisticated organisations with well-prepared crisis management plans end up with serious liability due to outdated data. By way of example, if the material safety data sheet (a form required to be maintained by both OSHA and EPA) for a new process chemical does not make its way into the plan this can mean an incomplete report to EPA during a process release and a significant penalty. If a release drifts to a nearby neighbourhood, the outdated information could bring about far more devastating consequences.

In addition, in these days of frequent corporate mergers and takeovers, EHS managers are often faced with responsibility for entirely new facilities and divisions. Because of personnel changes and other reasons, EHS accidents are more likely to occur during such transition periods because EHS might be overlooked for a short period. Ironically, most EHS managers are simply too overwhelmed by the integration of day-to-day EHS functions to focus on integrating crisis management plans. That can unfortunately lead to serious problems in the wake of EHS accidents.

Finally, there are many new federal, state and local laws, regulations and policies that can come into play in any EHS crisis. While most companies track new EHS requirements and incorporate them into operations, many forget to make sure those new requirements are integrated into updated crisis management plans and systems.

The lawyer's role in EHS crisis management **5.60**

As stated in **5.58**, an effective crisis management plan is the work product of a variety of professionals bringing their particular expertise to bear on the process. The experienced environmental/OSHA lawyer, particularly one who knows your business well, should be an important member of the development team. In most cases, use of specialised outside environmental/OSHA counsel for this task makes sense regardless of the in-house legal structure of the organisation.

Even though many companies have specialised in-house EHS counsel, many are already overwhelmed with day-to-day regulatory issues, briefing management on significant issues, overseeing litigation and reviewing EHS issues in transactions. Despite their best intentions, consistent participation of these individuals in EHS crisis management planning is simply not feasible. Moreover, many in-house lawyers spend significant time on the road. Therefore, even assuming they are immediately reachable during a crisis, they may be unavailable to effectively participate in the necessary efforts. Also, an experienced outside lawyer is likely to have seen a number of plans prepared by different clients and there is significant value in incorporating his or her experience into the team.

Due to the many legal issues and requirements involved in a crisis, the expertise of a lawyer is necessary in both planning and during a crisis. For example, an EHS lawyer can help assess the extent of a crisis and the applic-able legal reporting requirements (including reporting to insurance companies). In addition, the lawyer can assist in (although not participate directly in) the dissemination of information during a crisis, and help prepare statements by the company to the public and regulatory agencies. Also, the lawyer can assist in the event inquiries lead to criminal investigations. A lawyer can also assist in, and potentially protect through privilege, internal investigations of root causes and can begin to develop a record for use later. Finally, to the extent the lawyer was involved in the planning and response, he or she can be invaluable in responding to the host of government inquiries in the days following the event. Moreover, a lawyer who is respected by the responding agencies can be invaluable in assuring those agencies that the company has matters under control.

Ongoing considerations 5.61

EHS crisis management is extremely important, particularly in these days of immediate and prolonged media coverage. Such crises are, unfortunately, more and more likely to arise for most companies in the wake of terrorism and more frequent natural disasters due to climate changes or otherwise (see also **Chapters 4** and **16**). The involvement of an experienced team of professionals, including outside environmental/OSHA lawyers, in both planning and during an actual crisis, can have payoffs far beyond the costs involved. History has shown that few managers look back on a crisis and wish they had prepared less.

Security Risk Assessment as part of corporate due diligence in the USA by J. Sarracino 5.62

Since the first edition of this handbook the security industry in the USA has become a sophisticated international industry. Security Risk Assessment has as its purpose the support, the continuity of operations, for business in the face of security breaches and also involves the prevention of terrorism by the assessment, analysis and implementation of operational strategies to safeguard, property, personnel and information from infiltration of terrorist activities that have as their goal the weakening of the economy by compromising individual businesses.

Security measures are increasingly important to the due diligence exercise for businesses of all sizes. Governments continue to be concerned about the security of products and services (information) of their citizens in a global commercial environment. Nearly all modern businesses have some aspect of commerce that potentially touches on global trade. This can range from regularly hiring foreign nationals and having staff that understands complicated immigration requirements to ownership of international investment holdings such as for pension plan offerings to complicated corporate structures of multinationals. These examples merely scratch the surface on the need to consider security threats when conducting due diligence for start-up exercises or for continued maintenance of business entities.

Over the last few years, security risks within the US business community have come to hold specific meaning, depending on what sector of the economy they reside in. Continuity of Operations is vital in all sectors because it details who the vital personnel actors are and who will be essential to keeping the core business functions running in the event of an emergency. The leader in this regard has been the Federal and State governments. They have initiated studies, policies and staged mock exercises to ensure that continuity of operations will be in place for any tragedy. Business owners are now obtaining guidance that can assist them in making sure that their profit line is not affected or minimally affect in time of chaos.

(a) UK: Despite the need for improvement referred to in the London Case Study above in the UK a decided look at continuity has gained more popularity in the business sector. The government has always been sensitive to this issue due to the monarchy and long history of being geographically isolated from mainland Europe to which it identifies most. In recent years, the change over in government leaders, the 'war on terror' and also the Y2K 'scare' regarding computer outages and mistakes over the change in century have driven many businesses to allocate funds within their budgets to ensure that core *functions*, many of which include exports and of course, imports, to continue without major disruption.

(b) International outlook: India for instance, in a boom of sorts is coming of age within its economy during a time where many of the 'hard' issues concerning due diligence have been sorted out by the USA and the UK for example. Indian business owners, many of which come from higher education origins in the USA or UK come to their business enterprises in India with an increased level of sophistication. Part of this package is a deep understanding of how continuity of operations is a vital and previously non-existent component of business planning.

Assessment strategies and the purpose – practical resources for business owners **5.63**

DHS 'Ready Business' website[1]

The Department of Homeland Security (DHS) has as one of its missions the goal to help incorporated businesses of all sizes and individuals to utilise security measures (see the **Appendix**). This effort includes advice that businesses can follow without undue measures or expense. The Ready Business website includes the steps each business should take to institute a comprehensive security risk assessment. The assessment can be completed in conjunction with a Certified Professional (normally a CPP) or in-house by different personnel.

[1] Retrieved on 20 September 2007 from: http://www.ready.gov/business/plan/index.html

The first step to take is to '*Be Informed*'. Knowing the emergencies that potentially could affect your business is a vital first step in the process. DHS sets out some general possibilities, including natural and man-made. Local authorities will also have emergency information, both future and past that will apply to your location and possibility your industry. A mere list of possible disasters will begin the process to discern what will need to be further analysed.

The next step designated by DHS is '*Continuity Planning*'. This concept in due diligence and government institutional planning became a buzz word during the Y2K scare. This aspect of risk assessment is necessary to ensure that all vital functions and the personnel necessary to maintain them are planned for in an emergency. An assessment should come first to determine these core functions and core positions. Next a plan to identify and notify individuals about their roles during an emergency is necessary. The DHS website recommends looking at the functions of the business and what internal and also what external processes are core to continuing business. Reviewing such items as business flow charts, procedures in place or planned for emergency payroll and banking which may include paying vendors and other external parties and a new concept for some businesses (other than family owned: see **Chapter 18**) management succession. Management succession is vital in the event that death, injury or even kidnapping occurs. Each business will have to assess its vulnerability in regard to this item and the response will reflect this. It could be a simple as having the company lawyers hire an outside law firm or solo practitioner to act as an emergency repository for documents and vital functions in place of the owners. For mid-sized businesses with a governing board, a management succession plan may be required by the laws of the state in which it is organised. This topic not only includes identifying what are vital core functions, people and materials, but also the implementation of plans and procedures. The DHS website provides a form for businesses to use. The form itself walks business owners through a series of questions that help them identify and record information that can be retrieved in the event of an emergency.

The next item of concern during the due diligence exercise is '*Emergency Planning*'. In the event of an emergency, the most important thing is to mitigate the dangers to the humans involved in your business operation. Your employees are the most valuable asset of any business operation and can help a business recover quickly from a disaster if certain steps are taken. DHS recommends talking with and forging relationships with the local first responders. They can be a wealth of information concerning evacuation routes, other responders in the area and also give business owners an indication of the levels of emergencies and what action is recommended at each level or type.

Emergency planning can take several forms depending on the size of the company and the type of company. Emergency planning should include plans for both the 'before' and the 'after' and may include time off for employees to help family members in the community that may have also been affected, or counseling to help ease the stress of living through a disaster or loss of life of a fellow co-worker, and other anxiety-producing situations attached to an emergency. Identifying employees with special needs, based on age, disability or working conditions may be important in the planning to ensure that all employees are able to receive communications about an impending, present or recent emergency and how it affects their ability to continue their job. Physical location can have a direct effect on the safe movement of employees during work hours to a non-endangered area. The best example of this was during the World Trade Center attacks, individuals in wheelchairs were trapped due to the necessity of using the stairs during the attacks.

Communication is key to prevent injury during an evaluation. Communication to employees regarding how to act in the event of an emergency during or before work hours should be placed in permanent, accessible formats, for instance on a website or intranet or via wallet cards. Toll-free numbers to verify operating status is also helpful. Workshops or drills also help to relieve some of the anxiety about emergency planning. Employees should have responsibilities during a disaster such as participating in phone trees to notify co-workers and external parties of business closures and the reasons why, but also as hall monitors or fire emergency assistants to be relied upon for information and action during an emergency. Identifying employees that have certifications in CPR or first aid or any medical training can be useful so that they can be responsible for helping others during an evacuation.

Ongoing conversations should occur to allow be involved in making improvements. Local responders should have a copy of the company's emergency plan, as should any neighbours that could lend assistance in an emergency, such as fellow employers within a building or on the same block. Keeping records of training and drills can also help to improve plans and also to prevent future emergencies due to more sophisticated planning after study.

Making sure that a business has '*Emergency Supplies*' is another factor to consider when assessing the vulnerability of business operations to emergency and disaster (see also **Case study 1 at 5.48**). The department urges people to, 'Think first about the basics of survival: fresh water, food, clean air and warmth.' This aspect of due diligence embodies the idea that employers may become required to provide the resources necessary to the basics of life in the event that employees or others on the physical premises cannot leave. Certain instantaneous events like some natural disasters or terrorist attacks cannot be foreseen and may leave employees 'stranded' on the worksite. The needs to be covered under this category should become more apparent if the other aspects are covered first. Planning is made easier reviewing risk assessment reports to this point and also by requesting a visit by the local fire Marshall. In the US local fire departments can come to a place of business for a small fee and help property owners determine their need for items such as fire extinguishers, exits, first-aid items, such as antibacterial ointments, portable heart defibrillators, anti-allergens, etc.

The reason why businesses are urged to assess their needs in this regard is so that employees that are trapped at work and cannot exit a building, a worksite, factory or other location, can still remain without emergency intervention. In some cases, emergencies supplies would be used when or where first responders could not get to disaster victims quickly. The aspect of '*Deciding to Stay or Go*' includes 'shelter-in-place' and 'evacuation' plans. These plans need to be very specific and detailed because they deal with factors that could contribute to death or injury or hopefully save lives in the event of an emergency.

The issue of '*Fire Safety*' is normally at the top of any corporate manager's priority list due to the fact that fires are, according to the Department of Homeland Security, 'the most common of all business disasters'. In addition, when purchasing space for purchase or lease, the fire inspection documents and escape routes are normally disclosed, making this issue one that would come up naturally.

When planning for '*Medical Emergencies*' corporate managers should look at fire safety plans and identify medical personnel on staff, in the building or campus, and of course public facilities such as ambulance units, police and fire emergency stations and nearby hospitals or health clinics. Taking the initial steps of identifying resources will allow for more specific plans to be in place. A conversation with the chosen insurance carrier is also a vital part of this aspect and all others. Determining what is covered in a disaster is important to know so that contingencies can be provided for.

Another subject of concern for businesses in the USA (but perhaps not so in Europe or Eastern countries) is the fear of an '*Influenza Pandemic*'. There are many resources available to walk managers and security personnel through the dangers, appropriate training and education for employees. An influenza pandemic would be of national concern within the US.

American Society for Industrial Security guidance 5.64

The American Society for Industrial Security or ASIS is the largest and best-known professional association of security professionals in the USA and possibly, the world. ASIS publishes numerous guidelines and materials for security professionals and businesses on how to keep their assets protected. The 'bible' for security professionals in organisations is the Protection of Assets (POA) Manual which is available for hard copy or electronic purchase. This particular guide offers extensive strategies on how to plan for, prevent and recover from a security risk 'event'. While it may be practical for larger organisations that have in-house security personnel to have this manual on hand, for smaller companies where the expense is not feasible, luckily much of the guidance can be found updated on the www.asisonline.org website.

The General Security Risk Assessment Guideline published last in 2003 by ASIS, is a resource that is accessible via the website. This particular guideline booklet offers enough solid advice to businesses of all sizes as they incorporate security risk assessment into their due diligence protocols. The simplified security assessment strategy outlined allows for business owners to adapt it to their specific needs. The steps are:

1. understand the organisation and identify the people and assets at risk;
2. specify loss risk events/vulnerabilities;
3. establish the probability of loss risk and frequency of events;
4. determine the impact of the events;
5. develop options to mitigate risks;
6. study the feasibility of implementation of options; and
7. perform a cost/benefit analysis.

These items mesh directly with the guidance given by the US Department of Homeland Security, creating an environment in the USA of consistency and increased communication among security professionals. The most significant change over the more recent years is the ability for the government and professional associations to make guidance clear, unfettered and specific so that the average business owner can implement the guidance without a significant expense or taking time consuming measures.

Continued efforts on the part of law enforcement and security professionals is evident in the increased number of multidisciplinary professional conferences, secondary education programmes, and free resources, found primarily on the Internet. Federal funding has increased these efforts as a top priority of the Bush Administration in the 'war against terror'.

Private security assessment options 5.65

Private security assessment options exist in various forms. Assessment services can be purchased as a comprehensive package from a large business consulting firm, small business or in the case of smaller operations a single consultant. Many consultants in this field are former law enforcement or military officers. They have the knowledge and know-how to identify and prevent security risks. Professional credentials in this field are varied; however the 'gold standard' is the CPP which is allocated by ASIS. Certified individuals have studied and passed a comprehensive hours-long exam covering the *POA* – a staple among security experts and a must for any in-house security officer to have.

Policies/regulation/oversight 5.66

The Department of Homeland Security was created by the Homeland Security Act of 2002. The Act establishes the department under title 5 of the United State Code and sets forth its mission as being to:

(a) prevent terrorist attacks within the United States;
(b) reduce the vulnerability of the United States to terrorism; and
(c) minimise the damage, and assist in the recovery, from terrorist attacks that do occur within the United States.

Reducing vulnerability of the United States to terrorism and minimising the damage are the two key elements important to business people. Under this purpose, the department has consolidated resources for business owners to follow in order to include security assessment exercises in due diligence efforts that maintain the security of private individuals and assets.

The Department of Justice covers areas of national concern that may be rooted in criminal activity. It has the ability to enforce and prosecute crimes that affect business everyday, such as computer fraud, intellectual property rights, extortion and kidnapping are among several other areas for which the personnel at Justice are responsible.

Other US agencies involved in security

* FTC, FDA, USDA: Mainly commercial trade issues of compliance prior to mass production and shipping. These agencies ensure that companies who manufacture or sell regulated products protect their assets by correctly labelling items, meeting all set standards for food, drugs and cosmetics.
* DOC/NIST and others, Customs: These agencies concern themselves with transboundary issues and border protection concerning the transport.

Case studies are instructive on the cost and benefits of risk assessment 5.67

The US Department of Homeland Security offers the public free case studies to illustrate the need for more intensive security measures by business owners. For instance, the case study on Equity Technologies Corporation of Mobile, Alabama points out several actions that were taken by company management to prevent, assess and deal with disasters, both natural and man-made affecting company information. The company is located in a hurricane-prone area of the United States and had plans and procedures on the book to deal with natural disasters. Examples highlight communication procedures that promoted awareness of weather threats for employees and their family members. Employees were given cards with supervisor contact information and a call-in number regarding company operating status. The advent of the Y2K threat was the main reason given for equity to begin planning more seriously about potential emergencies that could affect the business. Management identified a few employees as key contacts; created 'safety and security' teams which assessed the company's entire emergency process. After identifying that communication with clients and external partners, the company purchased several generators that would replace public generated electricity for their phone system during utility outages. The company has made plans to review emergency plans and procedures on a yearly basis.

Case study 2: Hurricane Katrina – a US case study on Sandy Whann bakery's preparation

5.68

Sandy Whann is the president of the family owned-and-operated Leidenheimer Baking Company. He is the fourth generation of Leidenheimer men to run the company which was founded in 1896 in the city of New Orleans by Sandy's great-grandfather, George Leidenheimer of Germany. The bakery produces French bread made famous by traditional local dishes like the muffaletta and po boy sandwiches that originated in the heart of the French Quarter. As a lifetime citizen of New Orleans, Sandy has experienced many evacuations and has become adept at hurricane planning.

When the hurricane alert was issued on Saturday, 27 August 2006 this veteran immediately put his family emergency plan into effect as his wife and two children prepared to leave the city. Sandy remained near the plant to keep a close eye on his 110-year-old company and keep production working at a minimal capacity. Sandy then focused on his employees and their families. On Sunday, after meeting with his upper management, Sandy uncharacteristically decided to shut the bakery down, secure its exterior, gas lines and doors and encouraged his employees to prepare their own homes and loved ones for the storm and potential evacuation. Both Sandy and the Leidenheimer management team keep home phone numbers and emergency evacuation contact information for all employees. Having an emergency preparedness plan helped him to focus on priorities in the limited time. En route, Sandy checked with his insurance provider, accountants, legal consultant and spoke with customers via cell phone to keep them abreast of the situation and the affect of his shutdown on their supply of baked goods. Sandy's business evacuation kit played a large part in his success. Fortunately, Sandy was able to return to his plant within a week of the storm hitting. When he returned, he was met with widespread damage, but without the flooding he had expected. All Sandy could focus on was getting the plant back into production as soon as possible. Despite caring deeply for his business, the most important thing to Sandy was his employees and he felt fortunate that all of the company's employees were safe. He arranged a carpool service to pick up employees at shelters to drive them to work and back each night. Sandy tried to remain supportive of his employees while staying open for business. 'The rebuilding process included a handful of things,' said Sandy. 'Number one is the employees … It is important to listen to the needs of employees'. In summing up his experience Sandy said, 'Katrina was severe enough to teach even us experienced hurricane survivors a few new things about our emergency planning.' Since hurricane Katrina, Sandy has revised his business emergency plan and gained a more extensive understanding of the importance of preparation.

Checklists and forms 5.69

The checklists and rubrics mentioned below are designed to guide business owners in their assessment efforts. These documents can be reproduced, utilised and saved along with other important due diligence documents.

The following rubric checklist was created to meld both the advice and strategy of the US DHS and the ASIS. This instrument can be used as part of a comprehensive due diligence exercise. The recorded outcome of the assessment using this rubric can be placed along with business organisation paperwork as proof of due diligence in this area. Each business must decide the point value to assign to each major category for their own circumstances and work through the factors to determine where the highest priorities exist and what action should be taken.

- Personnel considerations included, in the respective categories: whether the company has any high-profile employees or board members; whether the business operates in a high profile or inherently dangerous or vulnerable industry; what the number of employees, contractors or board members are and what the extent of exposure to each group might be. Research of past threats to employees at any level should be considered along with present employees, contractors or board members who handle or have access to classified or proprietary information. Reviewing records on regular safety drills or past security plans can help determine what risks exist and are possible for the related group of individuals.
- Geography considerations include, in the respective categories: whether the physical location(s) is inherently dangerous or vulnerable, such as being located on difficult terrain, near water or remote areas, where natural disasters tend to occur, or under aeroplane routes, or near hazardous material transport routes, etc. Are locations proximate to high profile or high risk areas of the country or located in foreign countries? Are locations at a safe travel distance for employees, or is there a telework arrangement in place when employees are not able to travel to work?
- Physical assets considerations include, in the respective areas: whether buildings or campus, plant or administrative equipment (manufacturing equipment and computers, for example), warehouses, vehicles or containers for shipping, in-bulk purchases, frequency of deliveries/shipments, are inherently vulnerable based on content or handling. Consider internal assets such as safes, filing cabinets, fireproof desks and portable safekeeping devices such as briefcases, folders and keys. Research past or existing problems with premises or systems by searching maintenance records and phoning local law enforcement agencies.
- Information assets consideration include, in the respective areas: consideration and study of proprietary processes, intellectual property, customer or client information, employee information and more. Whether off-site back-up systems, CDs and other portable storage of electronic data have been used or can be. Whether locked and fireproof storage on site are aged or

outdated due to use or new existing technology. Consider potential risks for both electronic and hard copy data, especially access.

Rubric for security risk due diligence	Personnel point value	Geography point value	Physical assets point value	Information assets point value
Work flow considerations				
Existing emergency plans/fire				
Identify past, present, potential risks				
Assess probability of each risk and prioritise				
Identify and develop ways to mitigate risk in order of priority				
Assess implementation requirements, including cost and permissions				
Identify key internal and external individuals that will take responsibility responding to events				
Identify key internal and external individuals that will take responsibility for continued assessment exercises				

The second checklist is based on a review of several consulting firm websites, allowing for a quick run through of items any business should consider during the initial due diligence process. Some points are more important that others depending on the scope of the business – local, regional, domestic, international, etc. and can be used in conjunction with, or alternatively to, the rubric above. This particular style allows for a quick listing of already identified risks and helps business owners the ability to rank risks and implementations so as to be most cost effective. See the example below.

List risk	Level of importance to core business purpose	Current protections (plans, documents, alliances)	Priority at this time (based on available resources or level of risk)
Located in flood plane (example)	High	Escape Route document and assessment produced in 1991	Medium

The third rubric is based on the ASIS items to consider when conducting a security assessment. See the identified ‘levels of priority’ as: ‘Keep in Records Only’, ‘Appoint Internal Responsibility/Point of Contact’ and ‘Seek

Out External Vendor/Certified Professional'. When conducting a due diligence exercise on security risks facing the company, this checklist will help owners to prioritise the risks that the company is most vulnerable to and will allow for a simplified manner to discuss funding priorities with stakeholders. Place an 'X' in the appropriate column and write notes on deadlines, resources needed, etc.

Element	Keep in records only	Appoint internal responsibility/point of contact	Seek out external vendor/certified professional	Notes
1. Understand the organisation and identify the people and assets at risk				
2. Specify loss risk events/vulnerabilities				
3. Establish the probability of loss risk and frequency of events				
4. Determine the impact of the events				
5. Develop options to mitigate risks				
6. Study the feasibility of implementation of options				
7. Perform a cost/ benefit analysis				

Security risk overview 5.70

Existing and potential business owners need to consider several aspects of their operations with regard to security risks. This is not a trend to be disregarded, but is rather a requirement to do business intelligently in the new age. When considering the profits saved or salvaged in the event of an emergency, including security risk assessment during upfront due diligence makes sense. Once a full assessment is conducted and an ongoing strategy to re-assess has been agreed to several options exist for business owners. These options then might take the approach of how to make individual employees feel more secure within their workplace environment. This can take the form of employee-friendly perks such as on-sight day care (to have dependents nearby), on-sight cafeterias or other food vending services (to reduce security leaks via conversation or documents during off-sight lunch hours). In addition, these two items can help to maintain a sense of community and will also provide a location for employees to gather in an emergency, not to mention having food stock on the premises will allow for a sustained existence in the event of a shelter-in-place situation.

Additional benefits can be in the form of insurance policies, such as life, disability, theft, kidnapping and extortion, etc., depending on the level and exposure of employees. Securing phone lines and providing technology for information transfer on and off premises, such as secure laptops, PDA's or cell phones can also be a perk from an employee standpoint, but offers peace of mind to owners and management. Private planes or other transportation vehicles may also apply depending on the situation. Offer reimbursed training or higher education is also a perk to employees, but can help to minimise internal leaks by teaching employees the importance of security at all times regarding proprietary information, but also, location and travels of senior executives, especially foreign travel, personnel information.

The rubrics will assist any small business to determine how their operations are vulnerable and will help assess a priority of what is necessary to focus on when resources and/or personnel are scarce. These tools, while instructive to the process, cannot take the place of educated and experience judgment that each business owner has. These are guides, helpful instruments and suggestions regarding this wide spread and important aspect of due diligence prior to beginning business. The important thing that business owners should remember is that, no matter where they do business, a security assessment must be made in order to insulate and isolate profit losses in different situations. Even non-profits can benefit. Non-profits benefit in a unique way by decreasing risk to board members including functions that affect the safety, well-being or education of the public and employees (see also **Chapter 17**).

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Appendix

US Department of Homeland Security's Sample Business Continuity and Disaster Preparedness Plan

PLAN TO STAY IN BUSINESS

Business
Name____Address______________________
______________________________City, State____________________________________
____Telephone Number

If this location is not accessible we will operate from location below:
____Business
Name____Address_______________
___________________________________City, State ______________________________
____________________Telephone Number

The following person is our primary crisis manager and will serve as the company spokesperson in an emergency:____
Primary Emergency Contact ____
Telephone Number ____
Alternative Number ____
E-Mail ____

If the person is unable to manage the crisis, the person below will succeed in management: ____
Secondary Emergency Contact ____
Telephone Number ____
Alternative Number ____
E-Mail ____

EMERGENCY CONTACT INFORMATION

Dial 9-1-1 in an Emergency
____Non-Emergency Police/Fire
____Insurance Provider

BE INFORMED

The following natural and man-made disasters could impact our business:
____
____
____
____

EMERGENCY PLANNING TEAM

The following people will participate in emergency planning and crisis management.

WE PLAN TO CO-ORDINATE WITH OTHERS

The following people from neighbouring businesses and our building management will participate on our emergency planning team: ______

OUR CRITICAL OPERATIONS

The following is a prioritised list of our critical operations, staff and procedures we need to recover from a disaster. Operation Staff in Charge Action Plan

SUPPLIERS AND CONTRACTORS

Company Name: ______
Street Address: ______
City: ______ State: ______ Zip Code: ______
Phone: ______ Fax: ______ E-Mail: ______
Contact Name: ______ Account Number: ______
Materials/Service Provided: ______

If this company experiences a disaster, we will obtain supplies/materials from the following:
Company Name: ______
Street Address: ______
City: ______ State: ______ Zip Code: ______
Phone: ______ Fax: ______ E-Mail: ______
Contact Name: ______ Account Number: ______
Materials/Service Provided: ______

If this company experiences a disaster, we will obtain supplies/materials from the following:
Company Name: ______________________________
Street Address: ______________________________
City: __________State:__________Zip Code: __________
Phone: __________Fax:__________E-Mail: __________
Contact Name: __________ Account Number: __________
Materials/Service Provided: ______________________________

EVACUATION PLAN FOR __________ LOCATION (Insert address)

We have developed these plans in collaboration with neighbouring businesses and building owners to avoid confusion or gridlock. We have located, copied and posted building and site maps.o Exits are clearly marked. We will practice evacuation procedures ____ times a year. If we must leave the workplace quickly:

____

____

1. Warning System: ______________________________ we will test the warning system and record results ____ times a year.
2. Assembly Site: ______________________________
3. Assembly Site Manager & Alternate: ______________________________
   (a) Responsibilities Include:______________________________
   ____
   ____
4. Shut Down Manager & Alternate:______________________________
   (a) Responsibilities Include:______________________________
   ____
   ____
5. ____________________is responsible for issuing all clear.

SHELTER-IN-PLACE PLAN FOR __________ LOCATION (Insert address)

We have talked to co-workers about which emergency supplies, if any, the company will provide in the shelter location and which supplies individuals might consider keeping in a portable kit personalised for individual needs.o. We will practice shelter procedures ____ times a year. If we must take shelter quickly______________________________

____

1. Warning System: ______________________________
   We will test the warning system and record results ____ times a year.
2. Storm Shelter Location: ______________________________

3. ‘Seal the Room’ Shelter Location: ________________________________
4. Shelter Manager & Alternate:
   (a) Responsibilities Include:____
   ____
   ____
5. Shut Down Manager & Alternate:
   (a) Responsibilities Include:____
   ____
   ____
6. _______________________is responsible for issuing all clear.

COMMUNICATIONS

We will communicate our emergency plans with co-workers in the following way:

____

____

In the event of a disaster we will communicate with employees in the following way:

____

____

CYBER SECURITY

To protect our computer hardware, we will:

____

To protect our computer software, we will:

____

If our computers are destroyed, we will use back-up computers at the following location: ____

RECORDS BACK-UP

______________________ is responsible for backing up our critical records including payroll and accounting systems. Back-up records including a copy of this plan, site maps, insurance policies, bank account records and computer backups are stored onsite ____.

Another set of back-up records is stored at the following off-site location:____

If our accounting and payroll records are destroyed, we will provide for continuity in the following ways:____

EMPLOYEE EMERGENCY CONTACT INFORMATION

The following is a list of our co-workers and their individual emergency contact information:

____

____

____

____

ANNUAL REVIEW

We will review and update this business continuity and disaster plan in _____

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6

Commercial due diligence case studies

6 Commercial due diligence case studies

CHAPTER OVERVIEW 6.1

In a traditional due diligence exercise commercial due diligence forms the practical aspects of the transaction, some of which have already been considered in **Chapters 1** and **2.** The target or candidate company is assessed in the context of:

* its competitors;
* the market;
* brand value;
* product image;
* the integration of the workforce and their interaction at different levels;
* business goals and objectives.

As a matter of ongoing due diligence and prudent commercial practice a business must, of course, constantly monitor its competitors and the market in general. Media headlines are often filled not only with stories of failure in this respect but also likely acquisition moves, as well as sensitive sector comment. This handbook as a whole deals with ongoing commercial due diligence and corporate governance, having regard also to the management of risk – this chapter focuses on the latter by way of practical case studies in selected sectors. Many of the issues are, of course, relevant for many business sectors. Nevertheless, it must be emphasised that this chapter does not intend to address how a business should deal with the competition. Instead it approaches the topic by considering sectors that are both highly competitive and risk driven as illustrative case studies.

It has been noted in earlier chapters, specifically in **Chapter 5** that in today's fast moving business world a business can be set up, grow, be acquired or fail in a short period of time. A vivid illustration is the information technology (IT) sector, which was the subject of so many 'boom and bust' stories and examples. Some sector specific comments regarding e-commerce are made in **Chapter 9.** Moreover, in **Chapter 7** consideration is given to the reputation risks that can affect business as a result of decisions taken, having regard to the sector in which they operate. For the purpose of this chapter, the sector case studies that have been selected demonstrate a more modern area of extensive business interest and a very old traditional industry. Sensitive topics that increasingly attract business risks and opportunities (in terms of innovation, etc.)in the context of commercial due diligence are also considered. They show that whatever the sector, this is clearly the age of risk management, internal due diligence and corporate governance. With this in mind an attempt has been made to consider relevant macro and micro issues in this chapter in accordance with the theme of the handbook.

The choice of the two main case studies is also topical since both often attract the attention of the media, non-governmental organisations (NGOs) and the public in general. In order to compete successfully, businesses operating in such sectors need to demonstrate a sensible approach to due diligence, corporate governance and legal risk management. While the first case study highlights, in particular, the importance of legal risk management, the second emphasises the need for the implementation of good governance to enable this sector to be more competitive, while all examples illustrate the need for best practice and due diligence as explained earlier.

Case study 1: The biotechnology industry by Z. Hamzah

Introduction 6.2

Managing legal risk exposures is an area that all businesses face throughout their life cycle. Given the unique nature of the biotechnology business with its very long product development cycle, high financial investments and multifaceted risk environment, legal risk exposures are accentuated. The need to evolve a structured and proactive legal risk management framework is an imperative that stakeholders in biotechnology ventures cannot ignore.

The process that a biotechnology company goes through from initial venture funding to product release and facility expansion is long drawn and fraught with risks. This case study seeks to provide an understanding of the legal risk management process and the tools available for identifying, managing, controlling and ideally eradicating, if not, mitigating such risks for biotechnology ventures at different stages of development from the start-up to the market roll-out phase.

The biotechnology industry has seen rapid technological advances over the last two decades, often led by small start-up companies that focus on innovative, early-stage technologies (see also **Chapter 8**). While the returns in investing in these companies can be lucrative, the risks are equally high. When investors are confronted with a decision as to whether they should fund an early growth company, a very thorough risk assessment on the investment proposition offered by early-stage technology companies is critical in the investor's decision-making process.

What is biotechnology? 6.3

Biotechnology can be defined as any form of technology that makes use of the natural biological processes or products of living things to modify and advance human health and the human environment. Although biotechnology has reached a key position on the corporate agenda in more recent years, the concept of biotechnology is not new at all. Traditional forms of biotechnology include brewing, bread making and cheese making. These processes use natural fermentation processes of micro-organisms to either preserve food produced through agriculture or create new tastes and textures. Advanced or modern day biotechnology, for example in the area of genetic engineering, attempts to achieve the same goals of producing new or better products but in a more technologically advanced and efficient manner. Today these same processes of micro-organisms are used for a wider range of applications, to produce valuable products such as antibiotics or enzymes for medicine or industry.

Areas of biotechnology 6.4

While, as noted in **6.3**, biotechnology embraces processes that are very old, from the point of view of due diligence and corporate governance it is the more modern applications that attract controversy and more risk. Modern or advanced biotechnology today encompasses broad areas of the life sciences and includes both products and processes. Examples of relevant products and processes are:

- products that include genes (including modified genes, expression vectors and probes); proteins (including modified proteins, monoclonal antibodies and receptors) and other chemical compounds;
- processes or methods that include a new method of using a known compound and methods of medical treatment.

Biotechnology today, therefore, covers a wide range of industry sectors and typically involves the following areas of technology:

- medical biotechnology which uses micro-organisms (such as bacteria or fungi) to make antibiotics or vaccines;
- industrial biotechnology which uses micro-organisms to make enzymes (e.g. to add to biological washing powders), or to produce beer, cheese or bread;
- environmental biotechnology which uses micro-organisms or plants to clean up land or water that is polluted with sewage or industrial waste;
- agricultural biotechnology which aims to produce better crops, ‘natural’ fertilisers, or feed additives.

The life cycle of biotechnology companies 6.5

Comment has already been made in **Chapters 4** and **5** regarding the extensive issues involved in establishing and maintaining a healthy business. For example, some consideration has been given to business interruption and continuity management, credit management, disputes and their avoidance, as well as other business issues bearing in mind the demands of good corporate governance. This consideration sought to address the concerns of a business throughout its life cycle, from idea stage, start up, operations, expansion and so on. Biotechnology companies typically go through the following stages in its business life cycle:

- conception of idea;
- research and development (R&D);
- sourcing of funds (including corporate finance);
- incorporation of business entity or formation of alliance (e.g. a corporation or partnership or joint venture);
- conduct of clinical trials;
- application for approvals, licenses and permits;
- early product roll-out in the market;
- market review;
- expansion of facilities and scale up of marketing; and
- ploughing back of commercial returns into further R&D to start a new or overlapping cycle.

This can be a lengthy process: the whole growth cycle typically takes between 6 and 12 years. From the M&A perspective of evidently, as with certain other sectors, biotechnology companies may be acquired at different points in their business life cycle and the risk exposures vary according to:

- the stage of development that the biotechnology company has reached, for example a start-up drug discovery company as opposed to a drug company that has generated revenue from its R&D activities;
- the type of industry segment the biotechnology venture is in and its risk profile, thus a drug company that has to carry out clinical trials in a highly regulated and strict licensing regime would have greater risk exposure in terms of compliance than one where the regulatory regime is more relaxed;
- the complexity of the transactions that the biotechnology company is involved in.

Biotechnology business **6.6**

Compared with other technology-based transactions, biotechnology ventures may be considered as unique in several ways:

1. At the heart or core of biotechnology ventures are inventions which define what the whole business is. Biotechnology business is about innovation and the quality of ideas and inventive flair will determine whether there is a potentially lucrative business to start with. Therefore the business is very much dependent on the quality of researchers and research managers. When

such inventions eventually have legal protection, typically in the form of patents and sometimes as a trade secret, due diligence in the area of the adequacy of legal protection becomes central to the whole risk management exercise. Accordingly, in managing legal risks in biotechnology ventures, due diligence relating to patents and other forms of intellectual property (IP) tend to take centre stage.

2. Biotechnology ventures are by their very nature very capital-intensive and have an extremely lengthy turnaround time from R&D to the market place. For instance, it could typically take some 12 years and over $US 30m on average to bring one medicine onto the market. Given this turnaround time, the risks are far greater compared to those found in other technology ventures. Moreover, the risks are highest when the biotechnology ventures, which are often target companies, are at their R&D or early growth stage. Such a long investment cycle also means that there are distinct challenges in evaluating existing and pending patent claims which may be made at any particular point in time in the life of the biotechnology companies.
3. The biotechnology products and services which are typically the subject of acquisitions more often than not deal with matters that affect the medical conditions of humans, such as pharmaceuticals and modified genes, or things that humans consume, such as genetically-modified (GM) food. This means that the health and environmental risk factors are accentuated. These are particularly sensitive issues that are of continuing interest to the media and the general public, as well as government agencies and traditional stakeholders. It is vital that the business monitors such risks which can impact on vital business decisions, including the choice of location, very carefully. The GM debate is one that has aroused particular concern in many parts of the world. (see also the food safety discussion below).
4. Biotechnology related data analysis relies heavily on the use of IT and this raises new risk factors (as can be seen from the discussion in **Chapter 9**). Take for example the area of bioinformatics – the marriage between biotechnology and IT. The intensive use of electronic tools and processes, such as the application of software to process the huge amount of data in genomic analysis, creates new risk exposures. As such data are far more fragile and are more vulnerable to attacks from hackers and technical piracy, acquirers must take greater effort to protect such digital assets. The loss of such digital assets in turn may mean greater potential liability or losses compared to physical assets such as land, equipment and machinery. In this respect the physical assets are relatively ‘safer’ compared to digital assets that are created out of bioinformatic transactions.

The key legal and business issues **6.7**

As is the case in other sensitive sectors, the risk exposures that biotechnology ventures face are very much dependent on what stage of development they are in. These stages include different types of activities and may be summarised as follows:

Research phase 6.8

This includes:

- conception of idea;
- planning of research;
- conduct of research;
- research breakthrough;
- development phase; and
- clinical trials.

Corporate set-up phase 6.9

This includes:

- compliance programme;
- business and deal structuring;
- financing and funding of the business;
- document structuring;
- contract management; and
- human resource activities (including the employment of researchers and managers).

Operational phase 6.10

This includes:

- IP audit;
- laboratory management practices;
- intellectual asset protection;
- IP licensing strategies; and
- IT security (particularly in relation to bioinformatics).

Marketing and product roll-out phase 6.11

This includes:

- product safety and liability;
- environmental compliance;
- health and safety requirements;
- technology transfer; and
- dispute prevention.

Ongoing work 6.12

This includes:

- audit functions;
- audit assessment;

- corporate governance practices; and
- use of IT and its attendant legal risks.

Business and legal risk factors 6.13

As is the case with all major commercial transactions, there are a range of legal and business risk issues that should be taken into account. In biotechnology ventures, the major transactional risk factors may be summarised and include:

- financial risks (for example where there is a huge investment in a research programme involving GM crops where the market response is uncertain);
- compliance risks (for example some jurisdictions have laws that ban human stem cell research);
- asset creation, protection and exploitation risks (for example the failure to register an invention as a patent or failure to commercially exploit patents or to maintain a trade secret);
- legal liability risks including contract enforceability (for example there may be non-performance of ongoing contractual obligations for clinical trials of new drugs);
- operational risks (for example the inability to obtain live samples of micro-organism such as viruses in order to carry out R&D);
- business model risks (for example a biotechnology venture may be dependent on critical data from other parties thereby increasing their risk exposures);
- ethical and reputational risks (for example the failure to abide by public sentiments on moral issues of patenting living organisms);
- alliance formation risks (for example the teaming arrangements between private companies and university research institutions);
- third-party risks (such as an overdependence on third parties for critical technologies);
- privacy risks (such as the protection of personal data of individuals involved in research projects);
- IT security risks (particularly in bioinformatics-related activities);
- product liability risks (for example when a GM crop poses potential or actual health risks); and
- health and occupational risks (including employees and staff).

In managing a biotechnology venture, the above risks must be recognised, addressed and managed. As is the case in other businesses the board of directors and senior management of biotechnology ventures are usually responsible for:

- developing the organisation's business strategy; and
- establishing an effective management oversight over risks.

Having regard to the demands of good corporate governance also, the board and senior management can therefore be expected to take an explicit, informed and documented strategic decision about the organisation's overall risk management framework.

Legal risk management 6.14

In **Chapter 1**, legal due diligence was considered as part of the traditional due diligence process. In the course of that discussion risk management was mentioned (this is also examined in **Chapter 8** in the context of reputational issues and in **Chapter 10** when considering corporate governance issues). Moreover, the connection between due diligence, risk management and corporate governance is a general theme of the handbook.

Legal risk management is a process designed to help organisations identify, quantify, and control their legal risk exposures with the ultimate aim of protecting the organisation and creating greater value to the shareholders and other stakeholders. Legal risk management can be a complex undertaking. The failure to adequately address legal risks can subject businesses and organisations to virtually unlimited financial liability. In other words, risk management can be simply seen as a process to help an organisation protect its bottom line. The risk management process is significantly more difficult in the biotechnology sector than other industries due to the huge investment amount and the long turnaround time from ideas to the market place.

As has been stated earlier in this chapter that this is the age of risk management, therefore all organisations should adopt and uphold high standards of risk management and for those businesses operating in sensitive sectors such as biotechnology this is a priority. In developing this legal risk management framework, primarily biotechnology ventures are expected to:

- establish a sound and robust risk management process;
- strengthen their intellectual asset management programme; and
- establish their risk management programme as part of the organisation's good corporate governance practices.

Depending on the quality of corporate management, the risk profile of the biotechnology company would vary from company to company and requires a tailored risk mitigation approach. There is therefore no ‘one size fits all’ approach to risk management in biotechnology transactions. Moreover, if the intention is to dispose of the business, a careful grooming exercise should be carried out. This may also be the case in the event of corporate financing. As a general principle, biotechnology companies differ in their stage of development, size and their risk management approach. It is important that businesses operating in the biotechnology sector should have in place risk management processes which are appropriate for their:

- individual risk profile;
- operational structure; and
- corporate governance practices.

In biotechnology transactions, the people or ‘brains’ factor behind the technological products and processes tend to be more important than technology assets. Indeed in many of the biotechnology companies, the company would not have any valuable assets if it were not for the people behind the inventions, unlike companies that are rich in physical assets such as land, minerals or equipment. Therefore the board of directors and senior management in biotechnology companies and research institutions should establish rigorous and effective risk management systems and standards in their business operations to safeguard their human as well as technological assets. As part of this process, they need to continually monitor the adequacy and effectiveness of their risk management functions as well as implement compliance and audit procedures to ensure that their business and legal interests are protected.

In view of the varied business and legal risk exposures that the board of directors and senior management of biotechnology companies face, it is also important to establish a holistic and integrated risk management framework at the corporate level. The absence of such a framework suggests that the overall risk management approach is weaker and the stakeholders of the biotechnology venture should address this aspect of the corporate framework carefully. This should be considered in the context of the overall approach to due diligence and corporate governance.

The legal risk management process **6.15**

A legal risk management framework at the corporate level that contains the key priority elements for the business is a necessary tool that every organisation should evolve, have and use. The absence of such a framework may weaken the organisation's capacity to better manage its risk liabilities and to transfer its risks to other parties, wherever possible. The overall intention of the risk management process is to minimise the financial impact of losses on the company's bottom line and the strategies and techniques must all be geared towards this goal.

The process of legal risk management may be summarised here and involves:

- identification of legal risk events (for example dangers of an unprotected biotechnology invention);
- analysing and weighing the gravity of legal risks and analysing their consequences (for example non-compliance with the laws banning test on human stem cells is far more serious than a weak indemnity provision in a licensing agreement);
- taking proactive, preventative, responsive or reactive steps – depending on the scenario – to prevent the problems from either taking place or worsening (such as entering into legal agreements or requiring parties to comply with legal obligations in ongoing projects); and
- reviewing the efficacy of the legal measures introduced to counteract against a problem or a potential problem in the future.

Governance aspects **6.16**

Biotechnology ventures should play a proactive role in educating the researchers, business executives and partners on the benefits and risks of biotechnology services and products through a structured and enterprise-wide risk management framework. Once an organisation has effectively managed its legal risks exposures and the attendant financial risk liabilities through such a framework, it would then have a better frame of mind to pursue its corporate strategy and other regular business activities in a manner that would enhance its growth, having regard also to the more recent trends and drivers referred to in earlier chapters as well as the regulatory and other frameworks in the chapters that follow.

Case study 2: The shipping industry by M. Dance 6.17

Another example of a sensitive sector in today's business world is the shipping industry. The shipping sector can be exposed to usual commercial risks, as well as sensitive ethical issues and concerns of governance and sustainability. Indeed the shipping industry can affect the performance of many other business sectors and, in turn, this affects the economy and society as a whole. Bearing in mind the age of this industry it is most important that it monitors the trends of good corporate governance and fulfils modern day responsibilities. Moreover, since this industry has to deal with both macro and micro issues shipping can provide a useful case study that addresses, many aspects of risk management and due diligence and complements the earlier one. In order to operate a successful business in this area a company should not only carefully take account of the commercial and contractual issues but also be aware of the broader concerns to which it is exposed. This is intended to be a practical case study that:

- considers some of the main day-to-day business risks;
- offers some business hints and tips; and
- proposes some governance strategy for the sector.

Loss, damage and expense to cargo – avoiding and reducing the risks 6.18

When goods are moved by road, rail, inland waterway, sea or air in the course of trade, they are inevitably exposed to a wide range of risks of loss or damage. Below the usual and less usual risks are summarised.

Usual risks 6.19

Goods in transit are a target for opportunists and thieves. Fire can break out almost anywhere. More rarely, road and rail accidents occur. Goods carried across water are subject to the predictable risks of loss or damage during the course of loading and of discharging, by sinking, stranding, by the ingress of water, by contamination by other goods, sweating and damage through shifting, etc. Perishable goods suffer if delayed. Some cargoes, especially bulk cargoes, suffer a measure of inevitable loss due, for example, to natural shrinkage or to the difficulties of accurately measuring or assessing their true weight on loading and discharge. Cargoes carried by air tend to suffer less damage but as non-perishable air cargo is often of high value, air cargoes are a magnet for thieves. International carriage can involve partial carriage by sea, road and rail with trans-shipment and consolidation for the purposes of making up full loads. Each operation increases the risk of goods going astray or becoming damaged. The above are examples of just some of the many risks to which goods in transit are exposed.

Less obvious risks **6.20**

There are some less obvious risks that fall upon the owners (whether shippers or receivers) of goods carried by sea. The following are examples.

General average **6.21**

General average may arise when goods are saved from loss or damage by sacrifices made by the ship or by other cargo interests for the common good. For example, the sacrifice made by a shipowner who incurs emergency towage and repair costs when the ship's engines fail at sea or by the owners of other cargo jettisoned to make continuation of a voyage safer in bad weather. The owners of the ship and the owners of the cargoes on board and even freight at risk (freight that will only be earned if the cargo is delivered) will be required to contribute rateably to the cost of the sacrifice. Contributions are determined by a general average adjustment made by an average adjuster, much later. Cargo interests will be required to deposit security for their contribution before being allowed to take delivery of their cargo.

Marine salvage **6.22**

When a ship in difficulties or distress receives assistance from another vessel or from a professional salvor, the salvor is usually entitled to a reward for his services. The salvor's reward will be based substantially upon the value of property salved. Professional salvors are awarded substantial sums as an encouragement to them to keep their expensive salvage vessels, equipment and crews on constant standby in busy waters. Cargo interests will be required to bear their rateable proportion of the salvor's reward. In practice the salvor (especially the professional salvor) will usually require the master of the vessel requiring salvage services to enter into a ‘Lloyd's Open Form’ written salvage contract. The salvor will have a supply of forms on board the salvage vessel. The ‘Lloyd's Open Form’ contract terms enable the salvor to take over control of the ship for the purpose of the salvage operation without discussion being necessary about terms and the price of the job. The price is determined much later in London, by specialist salvage arbitrators. The salvage operation can therefore usually take place without the risky delays that are likely to result from negotiation. Cargo interests will be required to provide immediate security for the eventual salvage arbitration award as a pre-condition of being permitted to collect their cargo or continue the voyage.

Unexpected taxes and charges **6.23**

Taxes or other charges, direct or indirect, may be levied by acquisitive or desperate governments, without warning, at ports, airports and entry points. An import licence may be required. The importation of certain goods or commodities may suddenly be made unlawful with the result that goods may have to be surrendered or forwarded to another country for sale, or returned. The associated costs may well exceed the profit expected from the original sale.

Cash crisis **6.24**

Sometimes the sea carrier or contractor simply runs out of money or claims to have done so and is unable (or unwilling) to pay the crew and pay for fuel and provisions to continue the voyage. If there is cargo on board, trans-shipment to another vessel, if indeed possible, is usually risky and always expensive. If the voyage is to continue, the cargo interests may have to pay the voyage costs all over again or risk losing their goods. Carriage, by any means, may be delayed. Markets may be lost. Perishable cargo may suffer. Similar problems might arise in relation to other means of transport.

Liens **6.25**

Where either a shipowner or charterer who has sub-let their chartered vessel have not been paid, the unpaid shipowner or charterer may be able to exercise a lien on the cargo to cover the unpaid freight or hire. A cargo owner may promptly pay freight or hire due, only to find that payment has not been made up the line to the head-owner or head-charterer who then purports to exercise a lien for unpaid freight or hire on the innocent cargo owner's cargo. That the lien may not be effective according to English law is no guarantee that it will not succeed overseas.

Delay – demurrage **6.26**

Demurrage is compensation in the form of liquidated damages payable to the shipowner when the charterer exceeds the time permitted by the charter contract for the loading and discharging of the cargo. The seller of the cargo (who may also be the charterer) may make the buyer similarly liable for delay in discharging his cargo at destination. Similar provisions may apply to other means of transport.

Dishonesty/fraud **6.27**

Documents, especially bills of lading or other documents of title to goods on board ship or conveyance, may be forged, tampered with or may simply misstate the nature or condition of the goods or the date of loading. Such events are likely to affect the sellers' right to payment and are likely be to the sellers' ultimate loss.

Absence of justice **6.28**

Justice, or the means to resolve problems quickly and effectively may not be available in the country where the problem has arisen. Even if justice is available, it may be slow or uneconomic. Local courts may be persuaded to seize jurisdiction to resolve disputes despite a contract stipulating that the courts or a tribunal of another country shall have exclusive jurisdiction.

Avoiding and reducing the risks **6.29**

As is the case when operating any business, some of these risks (and there are others) can be avoided altogether or reduced in a number of ways. Some suggestions follow by way of a practical guide that offers some hints and tips since it is not possible to go into extensive detail.

Avoid the risks altogether **6.30**

Certain methods of risk avoidance may be summarised as follows:

1. If goods intended for ultimate delivery to a place overseas are sold on ex-works (EXW), ex-factory terms or free carrier (FCA), free alongside ship (FAS) or free on board (FOB), the buyer will carry most if not all of the risks associated with carriage.
2. Will the seller necessarily make any more profit or will the seller necessarily gain an elusive sale by selling goods on delivered terms or similar? If not, the seller could end his responsibilities either at the factory gate or at delivery on or alongside the buyer's nominated ship or other means of transport.
3. Does the transaction justify the risks, and will the profit justify the cost of insuring against risks that cannot be passed on directly to the buyers? If the seller sells on cost and freight (CFR) terms or cost, insurance and freight (CIF) terms, risk in the goods will usually pass to the buyer on shipment. If the sale terms are CIF, the seller has to take out only the minimum insurance cover.
4. If the seller's skill lies in producing or procuring goods of a certain description, it may not be appropriate for the seller to get involved in the wholly different business of organising and carrying the risks of international carriage of those goods. Chartering ships is not for the faint-hearted and will require dedicated management. The profit potential can be substantial, but so can the risks.
5. Much of the burden of organising international carriage (but few of the risks) may be taken from the seller's shoulders by competent freight forwarders who can, for example, arrange a 'door to door' service.

Insurance 6.31

All of the risks associated with carriage of goods can be insured, including provision for periods when, in the course of transit, the goods are likely to be stored. Of course the broader the insurance cover, the more it costs. The cost of insurance can vary according to the state of the insurance market at any one time. The cost of truly comprehensive cover can cut deep into the envisaged profit margin, particularly in relation to low profit bulk commodities.

Shippers of bulk cargoes often insure subject to Institute Cargo Clauses Form C or free of particular average (FPA). Such insurance is much cheaper because cover is limited to catastrophes. The cargo owner's liability to contribute in salvage or in general average is covered, but partial loss or damage is not covered. The insurers will take care of any general average or salvage security that has to be deposited.

Form B insurance provides extended catastrophe cover, but restricts the perils insured against. It costs more than Form C cover, but less than Form A, which is 'All Risks' cover.

If the seller requires the buyer to insure the goods (therefore saving the seller the possibly heavy cost of doing so) it is unlikely that the insurance will insure for the benefit of the seller. Until both property and risk in the goods pass to the seller (an event usually determined by the terms of the contract of sale) the seller is at risk and must consider whether to incur the expense of insuring against that risk. A good insurance broker will be essential.

Sale terms 6.32

In terms of the usual carriage-of-goods risks, what cannot be adequately covered by cost effective insurance can usually be covered by sale terms that place the risk elsewhere. If there is a straightforward contract sale, the sale terms will determine when both property and the risk in the goods pass to the buyer. However, even well used standard form contracts can be vague about such matters. Property and risk pass when the sale contract so provides, which is when the parties intend that property and risk shall pass. The reality is that the intentions are often not clearly expressed.

The sale terms will identify with whom the risks lie. As is the case with all business dealings, careful drafting of contracts and the use of well tried and tested models are advisable. The party who takes the lead in drafting the sale terms is usually best placed to draft to advantage. If a lot of money is involved, or if there are likely to be multiple contracts on the same or similar terms, it may be appropriate to seek assistance from specialist solicitors.

Payment provisions 6.33

These provisions are, of course, perhaps the most important part of all the agreement. The payment terms should be made very clear in the contract terms. If payment is to be by documentary letter of credit, care should be taken to ensure that so far as is possible the documents that trigger payment are in order before shipment is made. Careful thought should be given to what documents will be needed. Is there likely to be any problem about their coming into existence? Are they actually relevant to proper execution of the contract? The letter of credit should be confirmed by the sellers' own bank (preferably at the buyer's expense) if there is any doubt about the paying bank.

It the payment terms are not tied up carefully, the buyer may seize the opportunity to avoid payment. Recovering payment in a foreign country may be fraught with problems. It is likely to be expensive.

Documents **6.34**

Vigilance should be exercised to ensure that the documents required to trigger payment under the letter of credit (or other means of payment) will not only be available but that they are genuine. The buyer should always have in mind that the documents that will trigger his or her payment should, so far as possible, evidence due shipment of goods corresponding with the contract terms. The seller should make sure that the required documents will be readily available. The necessary documentation to allow import and export of certain goods should be obtained.

Superintendence **6.35**

It may be necessary or advisable for bulk cargoes (especially) to be subject to specialised superintendence by recognised superintendence companies. They will oversee the loading process (perhaps also the discharging process) and issue certificates certifying the quantities shipped and discharged. This will help to avoid fraud and disputes. Banks or even insurers may insist on it. The loading superintendence certificate would then be included amongst the documents required to obtain payment under the letter of credit.

Early action **6.36**

If something appears to be wrong or shipment or delivery seems to be delayed, early action should be taken. Action will usually be supported by the cargo insurers, who will arrange for expert surveyors to investigate, attend and report. Sometimes it may be appropriate to instruct lawyers to become involved at an early stage, but first on the scene is usually the cargo surveyor. If goods are at risk, any delay usually compounds the risk.

Supervision **6.37**

Sometimes the cost of engaging a surveyor (as opposed to a cargo superintendent) to supervise loading and discharging operations will be justified, even though the cost forms no part of the price of the goods exported or imported.

Apart from reducing risks of damage by bad stowage and bad handling, the surveyor can sometimes reduce time spent loading and discharging, reducing the potential demurrage bill.

Summary: Hints and Tips 6.38

The following is a list of hints and tips for risk avoidance:

- identify the most likely risks;
- where appropriate, ensure that the sale terms pass responsibility for carriage risks to the other contracting party;
- insure, recognising the limitations of less expensive cover. There is little or nothing that the shipper or receiver can do to avoid a liability in general average or salvage, but marine insurance will take care of the financial and administrative consequences;
- the small risk of unexpected taxes or import restrictions in the country of destination is avoided if property in the goods has passed to the buyer;
- the occasional risk of falling into the hands of impecunious shipowners or charterers is difficult to avoid as the risk is often unpredictable. The risk may be reduced by avoiding sub-charterers altogether;
- be especially careful to ensure that the payment provisions are effective. The bank should be able to give some assistance;
- exercise vigilance to avoid fraud. Dishonesty appears in so many different forms that the best approach is probably to trust no one;
- consider whether superintendence and the issue of superintendence certificates is appropriate;
- appoint cargo surveyors to arrange supervision of loading and/or discharging if the cost can be justified. Keep in mind that demurrage can be substantial, and is usually difficult to recover from the buyer/receiver; and
- take prompt action if something appears to be wrong.

Macro issues and the shipping industry 6.39

Many of the business risks associated with the shipping industry have been summarised above in **6.19–6.28**. This discussion has largely considered the risks form a micro perspective. Yet, as was mentioned at the beginning of this case study at **6.17**, there are also macro issues that the shipping industry should address. In this case study, therefore, the discussion proceeds to consider global governance concerns.

Ship demolition – environmental consequences 6.40

Fortunes are made and lost in shipping. Freight rates are pulled in different directions by differing national economies – they seldom remain constant. When freight rates are high, ships command high values. When values are high, some shipowners may even feel confident enough to order the construction of new ships. As new ships are constructed, old ships are sold for demolition.

Governance trends and ship breaking **6.41**

In recent years there has been a steady reduction in the volume of surplus over age tonnage. There has been increasing pressure on and from the maritime nations to make ships safer to navigate and environmentally safer. In the long term this makes for more profitable and stable freight rates, and rids the seas of ships that are either unseaworthy or in danger of becoming unseaworthy.

When ships reach the end of their economic or safe life, they can be disposed of in much the same way as an old car. They can be delivered to the breaker's yard or they can be dumped and abandoned.

Some parts of the ship can be salvaged for use on other ships, but the greater function of the breaker's yard will be to reduce the ship to her basic metal components, the most important being steel. The value of a ship for demolition is determined by the current market price of her steel. Anything else on board that can be salvaged is a bonus for the breaker.

As an alternative to breaking, a ship may be abandoned at sea, sunk, run aground or stranded in shallow waters. She may then become a danger to navigation, a source of pollution (she will have significant fuel and lubricant residues on board) and perhaps an eyesore. Fortunately the sheer size of ships means that even as scrap ships can be worth millions of dollars, so the majority are scrapped for profit rather than abandoned.

The greater the number of ships scrapped, the cleaner and safer the seas are likely to become. The construction of safer and cleaner ships is likely to reduce the number of environmental disasters to which our seas and coastlines are at risk. Ship breaking, however, has an ugly side that is likely to remain for years to come. Ship breaking is a dirty and labour intensive business. It cannot be neatly confined to a small industrial area. No significant ship breaking takes place in Europe, including Eastern Europe. Ship breaking cannot be undertaken profitably outside third world countries where labour is cheap and where health and safety and environmental controls are non-existent or primitive, unenforced and unenforceable.

Not surprisingly, ship breaking has become an almost exclusive third world industry, with India and China leading the world as the major ship breaking nations. Given the tightening regulations governing waste management generally (such as the recent WEEE framework referred to in **CHAPTER 16**) companies often seek to dispose of the waste in what they perceive to be the most cost effective manner in less developed regions. For instance in China electronic goods are often dismantled and disposed of just as in India the same applies to ships. The operation is often conducted in the most appalling health and safety, as well as environmental, conditions.

A ship to be broken is likely to be more than 20 years old, perhaps built in a country not too sensitive at the time to the dangers of certain types of asbestos. The asbestos will be stripped by hand. The ship will be stripped with bare hands (and feet) sledge hammers and gas torches. Heavy metals and poisons will be released, contaminating the workers, the beach on which the operation takes place and the sea that washes it. Asbestos fibres will also be airborne. Partially empty fuel tanks may be explosive. Metals may be reclaimed by the process of burning and raking the ashes. Further air pollution will take place.

Governance – macro issues **6.42**

Whereas awareness is growing regarding the environmental and health risks associated with the shipping industry, largely through the pressures from the media and NGOs such as Greenpeace, the solution to these problems must be considered by the industry itself as a matter of good governance. The traditional approaches did not consider these issues and the responsibility for solving such problems has been ignored. It is a matter of importance not only for the shipping industry but also other sectors since the discussion also illustrates well the importance of earning the licence to operate in today's shrinking business world. Greenpeace has tried to highlight these concerns, particularly in the context of the scrapping of ships in India and has emphasised that while the international community has recognised that the environmental pollution from ship breaking is a serious concern it fails to address the issue seriously. End-of-life-ships are waste and this means that their export is regulated under the Basel Convention (see further below). The Greenpeace Rainbow Warrior vessel went to India on a Corporate Accountability tour, in a bid to expose corporations that are committing crime against nature and humanity. The first phase of the tour was focused on the ship-breaking at Alang, Gujarat where many breaches were found: recently there have been some suggestions that in view of India's emergence as a major global player some of the more serious corporate players in this sector are taking some initiatives towards improving their reputation and that of the sector as a whole. (see also **Chapter 12** on corporate governance in India).

Environmental issues (Source: http:// www.stellamaris.net) 6.43

The lives of the People of the Sea are closely bound to their environment. Pollution of marine and coastal areas harms their health, sources of food and quality of life. Below some of the key issues are cited in **6.44** and **6.45**.

International obligations 6.44

According to the 1982 United Nations Convention on the Law of the Sea (UNCLOS), 'States have the obligation to protect and preserve the marine environment.' **UNCLOS, Art 192**. UNCLOS further states that, within their territorial waters, states should take measures to 'prevent, reduce and control pollution of the marine environment from any source' **Ibid. Art 194**.

Territorial waters are usually defined as lying within a radius of 12 nautical miles from the shore. However pollution of the high seas is a global problem.

Pollution Sources

Sources from the United Nations Environment Programme (UNEP) identify land-based pollution as the most significant threat to the maritime environment.

'The major threats to the health, productivity and biodiversity of the marine environment result from human activities on land – in coastal areas and further inland. Some 80% of the pollution load in the oceans originates from land-based activities. This includes municipal, industrial and agricultural wastes and run-off, as well as atmospheric deposition.

Source: 'UNEP Global Programme of Action for the Protection of the Marine Environment from Land-Based Activities.

Atmospheric pollution is generally caused by road vehicles, aviation and industry. Pollution caused by the maritime industry is comparatively low. Both the International Maritime Organisation (IMO) and the International Chamber of Shipping claim that shipping is the least environmentally dam-aging form of commercial transport.

According to figures quoted by the IMO, the years 1988–2004 saw a massive 80% increase in sea-bourne trade. This was mainly due to the increase in the carriage of oil and petroleum products. In 2004 over two billion tonnes of oil were transported by sea. Estimates of the quantity of oil spilt over the same period have steadily reduced. But major accidents, although rare, have a devasting effect on the environment.

During the unloading of cargo, water is pumped into the holds of large ships to stabilise them. When ships are reloaded, this water is pumped out. If ballast water is pumped out in a different part of the world, eco-systems can be harmed by the introduction of non-native species. Both ballast and bilge water, i.e. waste water collected in the hull, can carry human pathogens and toxins which, on discharge, can pollute coastal waters. Outbreaks of cholera have been attributed to ballast discharge.

The term 'recycling' is usually associated with concern for the environment. However ship recycling, also known as 'ship breaking' at its worst represents the dumping of toxic waste by rich countries on poor ones. When a ship comes to the end of its life, some of the materials used in its construction, for example steel, can be recycled. However older ships may contain substances now considered dangerous. These include asbestos, paints containing lead, heavy metals such as cadmium and arsenic, and even radioactive substances. Strict regulations regarding the handling of such materials, and the added cost of insurance, make ship breaking economically unviable in the West. Therefore most operations now take place in less developed countries where labour is cheap and regulations lax.

In 2005, pressure groups Greenpeace and the International Federation of Human Rights Leagues produced a report 'End of life: the human cost of breaking ships'. They found that workers employed in ship breaking were often poor, unqualified and easily exploited. Despite a lack of documentation on the part of employers, they found evidence of frequent casualties, often fatal, and high rates of cancer and asbestos-related conditions among workers in addition to atmospheric pollution in shipyards and on beaches where ship breaking takes place.

The report recognised that ship breaking provides an important source of income and employment to developing countries. It calls on governments of the countries where ship breaking takes place to do more to protect workers. In addition, shipowners and governments of rich industrialised countries are urged to take responsibility and ensure that decommissioned ships are safe for dismantling before they are sent abroad.

Regulations and Implemention Concerns 6.45

The shipping industry, like many others, is subject to the pressures of public opinion. Positive attitudes to environmental protection make good commercial sense. The IMO cites improvements in energy efficiency, fuel quality and the use of ships with larger cargo-carrying capacities as contributing factors to a more environmentally friendly approach.

The International Convention for the Prevention of Pollution from Ships, known as the MARPOL Convention, entered into force in 1983. It has been signed by 136 countries, representing the owners of 98% of the world's shipping tonnage. In 1997 an Annex was adopted on the Prevention of Air Pollution. Ratification was required by 15 states representing not less than 50% of the world's merchant fleet. This took 8 years, with the Annex entering into force in 2005.

The problem of ballast water was specifically addressed by the IMO in the 2004 Ballast Water Convention. This requires ratification by 30 countries representing 35% of world's shipping tonnage in order to enter into force. By December 2006, only six countries, representing 0.62%, had ratified it. The IMO acknowledges that ratification of its instruments is too slow. Less developed countries may lack the technology to meet the requirements. There is a need to support the development of national maritime administrations.

Some regulation of ship breaking is covered by the Basel Convention, an international agreement on the movement and disposal of hazardous waste which entered into force in 1992. In 1995 an amendment was adopted with the aim of prohibiting the export of hazardous waste from industrialised countries to less developed countries. Ship breaking was cited as an area of special concern. Despite opposition from certain industry groups and nations, the EU has implemented the amendment.

How can the dangers to health and the environment be avoided? Without the intervention of vast amounts of capital to subsidise the ship breaking industry and corporate governance drivers this is a global problem that must be resolved. Who will provide the capital or subsidy? If scrapping is not made economically attractive to the shipowner, there will be a disincentive to dispose of older ships. If a shipowner cannot be guaranteed a return after taking into account the running costs of getting the ship to a scrapping destination (which may be many thousands of miles away) the shipowner may be tempted to dump or scuttle the ship. Even ships forming part of a fleet tend to be owned by individual and often extremely anonymous companies based offshore. The companies will have no assets, from the moment they dispose of the ships. Individual persons can escape personal liability for the consequences of dumping or scuttling. Higher profile shipowners, anxious not to tarnish their reputations, can avoid any association with the messy business of scrapping by selling the ship to a third party. The third party will then in turn sell to the breaker leaving no connection between breaking and the original owner.

Since ship owning is a truly international business the imposition of, for example, a tonnage tax to provide the subsidy necessary to clean up the business of ship breaking will simply drive owners to register their ships in a different jurisdiction where no tonnage tax (or any other tax) is imposed. Shipowners have long since abandoned countries where taxes are levied.

If the imposition of safety controls on the demolition process had the result that ship breaking in India, for example, became more expensive (thus reducing the scrap value of the ship to be broken), the industry would shift elsewhere. Many of the workers in India are migrants. They or other migrants would migrate to the new scrapping base. Even if subsidies became available to entice the business to Europe where health and safety and environmental controls are more likely to be enforceable, few European countries would want the business in their backyards. It is likely therefore to remain a third world industry.

The provision of capital resources to implement effective health and safety procedures and environmental protection may not guarantee that those procedures would be adopted or that their adoption would be enforceable, but they would certainly improve the present state of affairs.

The solution to the pollution and health and safety risks must lie in a combination of heavy subsidy, implementation of appropriate controls and enforcement of rules and regulations giving effect to those controls. The countries in which demolition takes place cannot afford to provide their own subsidies. Those involved in the business of owning and operating ships cannot (and will not) be forced to pay. Ship builders will not agree to build deconstruction costs into the sale price, nor build for safer deconstruction. If they are forced to do so, they will lose business to other countries eager to subsidise the industry, without the burdens of deconstruction. The necessary subsidies, grants or donations will have to come from governments rather than directly from the shipping industries, or from businesses willing to accept part of the responsibility for cleaner seas, safer shipping and improved working conditions in poorer countries.

Ship breaking – environmental, health and safety implications in the third world 6.46

The imperatives of corporate governance are drivers to consider the following concerns:

- the shipping industry is sometimes in crisis largely because the freight rates do not justify the cost, the risks and an deal level of investment in health and safety;
- it is in the interest of shipowners worldwide to encourage a programme of scrapping (breaking) older vessels. This would lead to better freight

rates. There would be fewer ships chasing available cargoes. It would also stimulate the construction of new and better ships. Moreover, the recycling of materials by scrapping is generally agreed to be environmentally desirable;

- a ship's value as scrap will fluctuate according to the market value of steel. Its value can be millions of dollars;
- scrapping usually takes place in third world countries where this is an ample supply of cheap labour and minimum or absence of rules and regulations to obstruct the process and to diminish the price attainable by the shipowner;
- the bulk of ship breaking takes place in India and China often in appalling conditions for the labourers and with inadequate regard for the environment, bearing in mind the presence of the following risks:
  - oil residue – sometimes explosive, always environmentally demanding;
  - asbestos – especially around pipe work stripped manually without any or adequate protection for the labourers or environment;
  - dangerous metals and chemicals that are used in the construction of ship's equipment; and
  - pollution of beach/land, sea and rivers.

Bearing in mind the above a cost-benefit risk analysis is summarised below.

Practical problems **6.47**

These include:

- the failure of preferred scrapping destinations to provide legislation or pressure to protect:
  (a) the workforce;
  (b) the environment;
- the necessity for shipowners to get the best price if a vessel to be scrapped;
- there is no economical alternative to scrapping in unregulated third world countries;
- the lack of social conscience in a desperate industry. The majority of the world's merchant ships are owned by one-ship companies domiciled in flag of convenience countries. This is not likely to change in the foreseeable future;
- ship owning and ship management are usually separated;
- ships tend to be registered in countries that do not charge taxes;
- offshore ship owning companies are difficult to track, trace and condemn. Legislation serves no useful effect. Penalising the shipowner will not work;
- whilst the compartments of tank ships can be rendered ‘gas free’ before delivery to the breakers, the industry does not consider it viable economically or otherwise for ships to be ‘cleaned’ prior to scrapping. Apart from cost, vessels usually use their own motive power to reach scrapping destination. Stripped of their offending parts, they would be reduced to a hazard to shipping and to the crew; and
- most ships are owned by one-ship companies, even those forming part of a major fleet. When a ship is sold the proceeds of sale generally disappear instantly and there are no other corporate assets to attack.

Positive action **6.48**

Positive action could incorporate:

- the education of breakers, improving the awareness regarding these major practical concerns;
- the co-operation of major fleets with breakers should be developed as a matter of good governance.
- an obligation on trading vessels over, say, 20 years to carry out a detailed inventory of hazardous materials used in their construction, identifying presence of hazardous materials. (This could be enforced by IMO regulations currently in force, relating to safety generally (see also extract on pertinent environmental issues refered to in **6.42–6.44** above));
- the consideration of best practice from other industries can be helpful, for example the motor car industry, in the Netherlands for instance. There should be some co-operation with manufacturers to design for hazard free deconstruction and disposal; and
- as with any other industry, financial incentives should be considered to effect change. The carrot is more likely to succeed than the stick, again as with most sectors in business.

Case Study Conclusion **6.49**

This form of industry response to collective liability can have relevance to other sectors. In the context of this case study it is important to note the risk of ships being dumped, thus polluting the sea, rather than broken and the commercial impact on the well-known companies in terms of reputation.

In view of the increased interest and awareness, relevant members of involved sectors should be proactive in considering the state of the industry that takes account and bringing it up to date, in line with the drivers of corporate governance and due diligence.

Other key case studies: Sensitive Topics

Risk management and food safety: global issues for business

Improving standards and disseminating best practice in agrifood production, domestic distribution and export businesses: N. Poole, L. Spedding and F. Marshall **6.50**

In this shrinking global marketplace one key sector that has been under scrutiny from the media and the public alike has been food production. Since this sector has impacts on many related areas of business in the context of due diligence, corporate governance and risk management – particularly for those businesses that have connections in developing markets as well as the developed markets – selected concerns in connection with the risks of food production in India as a case study has been included. While this may be more technical in the context of this handbook it is clear that there is an urgent need to raise the profile of the issues with concerned governments, and to think beyond the matter of food safety to such issues as Standards and Best Practice in food production, distribution and export businesses. The public worldwide is demanding more transparency in this sector. Key issues are:

- the creation of business opportunities in domestic and international food markets;
- labour safety standards in agricultural production (right use of agrochemicals);
- enhancing standards for export;
- enhancing the institutional framework for social responsibility in business;
- environmental protection; and
- consumer health and safety.

Recent trends 6.51

Air pollution is rapidly increasing in many urban areas of the developing world. 'Brown haze' effects on climate and respiratory effects of contamination are well known and publicised. Air pollution also reduces both the yield and nutritional quality of crop plants, and is a major source of particulate contaminants that can accumulate at toxic levels in the edible portion of crop plants grown in urban and peri-urban (*UPU*) areas. The impacts of UPU environmental pollution case study on the safety of vegetables in India is a relevant in terms of the global marketplace for social responsibility, transparency and accountability. It explores appropriate public and private quality assurance initiatives and suggests that wholesale markets be adopted as an entry point for improved quality assurance (QA).

According to UNEP about half (47%) of the world's population now live in urban areas, and the percentage is expected to reach 65% by the year 2050. Most of the growth in the world's population is taking place in developing countries, and most of the projected increase of 1,000 million people between 1999 and 2010 is likely to be absorbed by their cities. The 'ecological footprints' of cities can be vastly greater than their physical area because of the demand for energy, food and other resources, and the regional impact of their wastes and emissions to air, soil and water. Among the most serious environmental problems in the developing world is air pollution, which is reaching crisis dimensions in many 'megacities', that is urban populations greater than 10 million (UNEP 1999, 2002). Climatic and respiratory hazards from air pollution in urban areas are widely acknowledged. Another reason for concern is the major threat posed by air pollution to crop production in UPU areas, where people's livelihoods are dependent on access to cheap and safe food of high nutritional quality. The contribution of UPU production to urban food demand throughout the world, particularly of perishables, can vary from 25% to 100%, and may involve a high percentage of families. The majority of highly perishable products, including many vegetables that are consumed in cities, are produced in UPU areas. This is relevant to the whole global debate over access to fresh food and nutrition.

There is currently little information on the integrity of supply chains for horticultural produce in UPU areas of developing countries. Whereas the focus here is India but there are implications for agrifood systems in other regions. The impact of air-borne contamination is not confined to these macro effects. Specific air-borne contaminants from industrial and domestic emissions are also known to have local effects on agricultural production, reducing yield and nutritional quality. It is evident that questions of food safety standards in production and handling, and of market mechanisms to enhance the integrity of the domestic food system, have broader implications than the reduction of health hazards[1] in vegetables. Food safety is known as a 'luxury' good. Thus, the demand for food safety depends inter alia on income and prices; on perceived risk (a function of the level and value of available information); on individual attributes such as age, education and risk tolerance. Where incentives and information flows are imperfect, the market alone may fail to supply the level of food safety demanded by society. Hence the need for improved governance.

It has been recognised that market failure to deliver the level of safety to meet public-health requirements and consumer demands constitutes economic grounds for public policy intervention. However, the existence of market failure does not mean that intervention can necessarily improve the performance of unregulated markets. Approaches to public food regulation range from low to high levels of intervention. Distinctions have been made between information-based incentives for private market solutions and direct 'command and control' interventions. The former may be:

- provision of information to consumers;
- lowering information costs through improved testing mechanisms;
- branding;
- labelling;
- (self-)certification schemes; and
- laws creating enforceable liability.

Reputation effects and trust are additional private mechanisms that are of considerable importance in advanced economies, and probably no less important in developing economies. For instance in India – as in most

[1] A distinction is made here between adulteration, the deliberate alteration or falsification of the composition of packaged foodstuffs, and contamination that is accidental, causing inadvertent deleterious change in the quality of fresh foodstuffs.

jurisdictions – people do business with those with whom there is prior mutual trust. In principle, interventionist regulations can take two broad forms:

1. Performance standards specify a quality level that a firm's output must meet, involving enforcement through testing, while allowing the firm autonomy over its production process.
2. Process standards specify procedures required to produce output of the desired quality.

High levels of intervention create the potential for firms to 'capture' the regulatory process and thereby attempt to co-opt the regulatory system to gain competitive advantage. This phenomenon, together with the enforcement problems that arise from a heavy regulatory approach – as in India – suggest that where the institutional framework is weak, regulation must be approached with caution.

In advanced economies there are increasing concerns about the costs to the industry of regulatory compliance. The costs to the authorities are those of the enforcement of performance measures through product testing, and to firms are the costs of conforming to industry-wide standards that may not be appropriate. Whether or not food chain stakeholders engage in private QA activities depends in part on the mix of incentives. Incentives may be positive, resulting in voluntary adoption of appropriate QA mechanisms. They may be negative, either purposive (in the form of policy-mediated sanctions for non-compliance such as fines), or consequential (in the form of declining market share and exclusion from the market). Generally, both public and private sector initiatives are necessary in enhancing the integrity of food systems. Regulatory initiatives to impose 'due diligence' requirements and legal liability cannot work alone – legislative and judicial failure. Nor can the task to secure the integrity of the supply chain be left to individual or firm initiatives in response to market forces – market failure.

It has been argued that the contrast between market- and government-based economic decision-making, particularly in India, requires a clear understanding of the context and that an effective market is one which operates freely, but within a structure of norms and legal institutions. At the state level in India, it has been proposed that three factors are essential for successful public policy implementation:

1. well-functioning public (i.e. state-provided) services;
2. public (i.e. democratic and participative) action;
3. a particular type of public action – the political organisation of deprived sections of the society.

As has also been witnessed in the UK, having regard to the BSE and foot and mouth crises, in the context of food safety, advocacy and consumer pressure are forms of public action expected to play a role in bringing about improved QA. According to the World Bank such assertions are consistent with the climate of economic adjustment that seeks to find an efficient and effective balance between intervention and regulation by the state, and private sector activity in response to incentives created by the market.

QA mechanisms
The efficient and effective transmission of private information and incentives is an important constituent of the mechanisms for QA. Information and incentives are likely to play a part in food QA mechanisms at least as important as policy, especially where the regulatory environment is weak. Even in advanced food systems, deficiencies in the flow of information through market systems have been found to be a source of market imperfection in matching market intermediaries' perceptions of quality to consumers' preferences and demand characteristics.

Agrifood standards 6.52

Having regard to the case study of India in the context of global risk management and food safety agrifood standards key five points are relevant when considering business risk:

1. The rationale underlying the food safety issues has a broader expression in the imperative for environmental protection in general. Food safety hazards are not only caused by air-borne contamination, but also soil and water-borne contaminants, and other sources, and can be found at all stages of the chain: from poor production practices, inadequate transport and storage, poor handling practices at wholesale and retail levels, to poor household practices. Specific mention should be made of the need for improved labour safety standards in agricultural production. The right use of agrochemicals is important not only for consumers but particularly so for the most vulnerable stakeholders in the food system, the farm labourers (who are likely to be poor and female). Standards and recommendations for best production practices will benefit not only consumers but also farm labourers. Moreover, major stakeholders in best production practices are the agrochemical manufacturers and distributors, whose corporate responsibility it is to advise/ensure dissemination of best practice in agrochemical application.
2. The agrifood industry is a sector with significant micro-economic outcomes. The production and postharvest handling of fresh fruit and vegetables is an important source of household incomes for peri-urban producers, traders and retailers. Among the latter group in particular are to be counted many individuals from poor households whose livelihoods are dependent on the food economy. Moreover, development of the food system has the potential for the creation of business opportunities in domestic food markets that again will increase value added to food products, better satisfy consumer preferences, and create further income and employment opportunities and contribute to poverty elimination. The development of the wider economy will be enhanced through multiplier effects by the development of an efficient, effective, and environmentally sound food system.

3. Enhancing the institutional framework for business social responsibility is relevant. Concepts of entrepreneurial and corporate social responsibility are critical for the development of the food system and the satisfaction of consumers' needs, and for fair returns to other stakeholders in the food system. The regulated markets are an example of intervention (albeit only partially successful) to create an equitable business environment and reduce high transaction costs that arise through structural market imperfections and unethical market conduct. Developing and implementing an improved regulatory framework for business conduct and social responsibility is a necessary (but not sufficient) approach to improving the business environment. One policy element must involve assessing responsibility and assigning liability for product safety. Due diligence, hazard analysis and control procedures are appropriate also for the food industry.
4. Enhancing standards for export and international trade in agrifood products is critical for the development of the agrifood industry, and macroeconomic indicators. Both international public standards (such as Codex Alimentarius) and higher level private standards (European retailers, EUREPGAP standards and private specifications) must be satisfied to ensure market access. Inasmuch as good export sector practice exists, then lessons need to be transferred to the domestic food industry through incentive (e.g. information) mechanisms and control (regulation). Food distributors in importing countries (e.g. northern European supermarkets) are also stakeholders in improving export country standards because of their own food safety frameworks and CSR policies.
5. Food safety implications of environmental contamination concern consumer health and livelihoods. Notwithstanding the lack of data on morbidity and mortality from food poisoning, the effects of heavy metal ingestion are well known, and the presence of contaminants will undoubtedly cause ill-health in current and future generations. Other types of food contamination include hazards associated with street food. The poor are most vulnerable to hazards, and are least well endowed to exert effective demand for improved food safety.

Initiatives to improve food quality assurance must be placed within a context where food security and other health hazards are (correctly) accorded greater priority. Nevertheless, action on food safety is required, and the complexity of enhancing food safety and quality in India – as anywhere else – requires a multi-faceted and integrated approach. Taking advantage of the regulated market system as a QA entry point is a necessary but not sufficient food safety and quality strategy. Having regard to the comments on agrifood standards, in conclusion a framework for identifying other necessary measures to reduce food system health hazards of which the market system initiatives constitute one element may be proposed. Thus, initiatives to improve food quality assurance can be expected to operate at three levels in India, and will range from strong intervention to implement controls on emissions and industry location, through actions facilitating improved market coordination, to information dissemination and creation of awareness:

- macro level: national or central government/state/city;
- meso level: market system from input supply and production through wholesale and retail to consumption;
- micro level: individual producers, traders and consumers.

The implementation of such a framework has relevance for the global marketplace and demonstrates the need for social responsibility, transparency and accountability in a manner that is also important for other sectors. Moreover certain aspects – such as bio-terrorism implications – have practical application in wider due diligence and corporate governance debate.

Challenges for Food Safety and Bio-safety System in India in the era of bio-terrorism by V. Sardana **6.53**

Every country is developing systems to ensure that its citizens must get safe food to eat, but the recent controversy on quality and safety of carbonated soft drinks (see **Chapter 7**), security threats due to liquid explosives, uninterrupted import of fruits and vegetables in India without pest risk analysis, entry of foods without proper labelling and content declaration, ineffective and improper actions by various state governments and concerned agencies raises the issues of seriousness and criteria in the decision-making process in the country on sensitive and complicated issues related to food safety, bio-security, food trade and public health. Appropriate sector governance is crucial (see also **Chapter 12**). Given that Parliament passed a bill on Food Safety and the purpose of this discussion is to generate a healthy debate in society on how to develop a reliable food safety system in the interest of public health in India.

The Food Safety System in India

The Indian Constitution prescribes the responsibilities of the government's three branches: executive, legislative and judicial, which all have roles that underpin the nation's food safety system. Parliament, the legislative branch, enacts statutes designed to ensure the safety of the food supply. Parliament also authorises executive agencies of national and state governments to implement statutes, and they may do so by developing and enforcing regulations. When enforcement actions, regulations, or policies lead to disputes, the judicial branch is charged to render impartial decisions. Generally Indian laws, statutes and executive orders are made public through gazette notifications by an established procedure to ensure that regulations are developed in a transparent and interactive manner with the public participation.

What should be the Characteristics of a Food Safety System? 6.54

Any effective food safety systems include the following essential characteristics:

- separation of powers among the three branches of law making, executive, legislative and judicial;
- transparency;
- science-based decision-making and
- public participation in decision-making.

An Efficient Food Safety System should be guided by the following principles:

- only safe and wholesome foods may be marketed;
- regulatory decision-making in food safety is science-based;
- the government has enforcement responsibility;
- manufacturers, distributors, importers and others are expected to comply and are liable if they do not;
- the regulatory process should be transparent and accessible to the public.

In this context, while India's system should have high levels of public confidence the reality is different.

How does an Efficient Food Safety System Work? 6.55

Precaution and science-based risk analyses are long-standing and important traditions of food safety policy and decision-making in many developed countries. Many food safety statutes, regulations, and policies are risk-based and have precautionary approaches embedded in them. The food safety agencies should enable well-qualified science and public health experts to work cooperatively to ensure the safety of food for public health. Scientists from outside government should be regularly consulted to provide additional recommendations regarding technical and scientific methods, processes, and analyses used by regulators. The cutting-edge science that informs regulators should be routinely discussed and shared internationally through interactions with organisations like the Codex Alimentarius Commission, World Health Organisation, the Food and Agriculture Organization, and the International Office for Epizootics. The food safety systems globally also routinely and effectively deal with technological advances, emerging problems, and food safety incidents. Due to the threat of bio-terrorism, currently there is a focus on early warning systems about pathogens, toxins, environmental contamination and residues of agrochemicals in food. The legislation granting authority to agencies generally enables them to revise regulations and guidance consistent with advances in technology, knowledge, and need to protect consumers. National food agencies are accountable to the head of the state, to the parliament which has oversight authority, to the courts which review regulations and enforcement actions, and to the public, which regularly exercises its right to participate in the development of statutes and regulations by communicating with legislators, commenting on proposed regulations, and speaking out publicly on food safety issues.

The Prevailing Food Safety System in India – Issues and Concerns **6.56**

In theory, the Indian food safety system is based on strong, flexible, and science-based national and state laws, as well as industry's legal responsibility to produce safe foods. National, state and local authorities have complementary and interdependent food safety roles in regulating food and food processing facilities to provide a comprehensive and effective system. Principal national regulatory organisations responsible for providing consumer protection in India are the Department of Health and Family Welfare, Department of Prevention of Food Adulteration (PFA), Department of Agriculture Marketing and Inspection, Bureau of Indian Standards, Department of Consumer Affairs, and many other agencies. The Department of Customs assists the regulatory authorities by checking and occassionally detaining imports based on guidance provided. The effectiveness of the law is directly related to its implementation. The ineffective implementation of the statutes and the food safety system over many years has resulted in very low levels of public confidence in the safety of food in India. A joint Parliamentary Committee Report also indicated dissatisfaction on the quality of food available to citizens. Unfortunately, many agencies and offices have no effective food safety missions within their research, education, prevention, surveillance, standard-setting, and/or outbreak response activities, including ICMR, CFTRI, ICAR Agriculture Universities, state supported agriculture Universities, APEDA, MPEDA, BIS, etc. The PFA department is charged with protecting consumers against impure, unsafe, and fraudulently labelled food apart from areas regulated by other acts concerning fresh produce. However they are short of manpower and run the department with retired officers due to a ban on new recruitment.

A more effective area of regulation is that no food item may be marketed legally in India if it contains a food additive or residues not permitted by PFA, a pesticide residue without a PFA tolerance rating or residue is in excess of an established tolerance. However the logic of science in many decisions regarding the permitted use of food additives is absent. Various food agencies in India are not clear regarding the use of existing food safety and environmental laws to regulate plants, animals and foods that are the results of biotechnology and so called novel products. No one knows what is coming into India, and to date no one was ever detained or prosecuted for bringing in any product which presents a quarantine or bio-security threat to Indian airports and ports. There are no warning signs for passengers and most of the checkpoints are rarely manned. The approach of agencies at the entry points is to look for valuable items but not those that can be a bio-security threat to the country. Most of the fresh fruits and vegetables coming into India dose without a proper pest risk analysis. A comparative study between the pest risk analysis method adopted in India with other developed countries and what is recommended by IPPC would be an interesting exercise. One issue is that there are many versions of pest risk analysis in India.

The Challenge of Existing Food Laws and Implementing Regulations 6.57

The three branches of government – legislative, executive and judicial – all have roles to ensure the safety of food supply in India. However the Indian food safety system has not been effective in separating regulatory powers and science-based decision-making on the whole at the cost of science.

In many cases, public participation is also not open. In fact there are restrictions imposed by various committees and authorities on open debate on various important issues within the food laws. Food issues are raised by consumer bodies or related NGOs but the prosecution rate in case of violation of food laws is minimal

Options before India to ensure food safety in the era of bio-terrorism 6.58

Food safety programmes must be risk-based to ensure that the public is protected from the health risks of unsafe foods. Decisions within these programmes should inherently be science-based and should involve risk analyses. Risk assessment is useful in understanding the magnitude of the problems faced, and it assists the government agencies in determining an appropriate risk management response. The regulatory development process should be conducted in an open and transparent manner. Regulations should be developed and revised in a public process that not only allows, but also encourages, participation by the regulated industry, consumers and other stakeholders throughout their development and promulgation. Moreover there is an urgent need for accountability of the food inspectors working in the department, including reports about how many samples were lifted, how many of them found safe and how many sub-standard or unsafe. Following the passing of the Food Safety and Standards Bill the proposed Food Safety Authority of India is an opportunity for the people of India to demand safe food from the authorities and this will impact on those businesses involved in this very sensitive sector.

The Dilemma of Toys and China: Key US Safety Concerns 6.59

The toy sector is another area of global sensitivity and public concern. Those involved must in fact – and be seen to – carry out best practice as regards due diligence and corporate governance. Yet major controversy has arisen recently as regards the way in which the toy industry often appears to prioritise economic advantages over safety. Indeed the toy industry, along with other businesses, has moved so much manufacturing to China, in order to cut costs, that it remains exposed to problems despite laws and efforts on the ground to contain them. China makes around 80% of the toys that enter the United States and is a leading exporter of products from electronics to apparel to auto parts. 2007 witnessed a spate of quality-control concerns about Chinese exports, from pet food to toothpaste to tyres, which not only alarmed consumers but also heightened existing trade tensions with Washington. The events also triggered questions about the role Western companies should play in monitoring the complex supply chain that links them to low-cost production facilities in China. Chinese-made products have come under increasing international scrutiny after a series of safety scandals. For instance a substance found in pet food made in China caused the death of a number of animals in the United States, and toxic ingredients were also found in Chinese-made toothpaste.

The Chinese government has tried to reassure consumers about the safety of its products and the Chinese Minister of Commerce has announced that more than 99% of Chinese exports are safe and of good quality. However public-health experts say Chinese manufacturers repeatedly revert to lead paint regardless of the rules because it is cheap and readily available, and helps factories meet relentless pressure to contain costs. Lead can make paint more resistant to corrosion, stabilise it and fend off mold. It also helps it dry quickly, speeding up production and reducing costs. Such violations slip through because of regulatory gaps in both nations Indeed, Chinese regulators are regarded as lax in enforcing their own lead-paint standards. While China has laws banning lead paint from consumer products a lack of regulatory enforcement means such laws are routinely ignored. Over the past 4 years, the US University of Cincinnati has tested 38 paint samples from China, representing 11 brands and found more than 25% had lead levels exceeding the US safe limit of 0.06% for paint. This has sharpened concern over whether industry or governments can stop Chinese manufacturers from using lead paint. The series of recalls involved not only Mattel (see box below), but millions of pieces of children's jewellery, Thomas & Friends trains made by RC2 Corp. and other goods. The recalls can be very costly for companies – Mattel, which had 2006 sales of $5.65 billion, said it expected to take a loss of $30 million for the second quarter because of the incident.

Headlines: Mattel Inc. Recall

Two decades ago, Mattel was one of the first US companies to move manufacturing to China. The industrial province of Guangdong in southern China now has more than 5,000 toy factories, where the majority of the world's toys are made. However, about 1.5 million toys made for Fisher Price, a subsidiary of US giant Mattel, were withdrawn from sale in 2007. Many were made by Lee Der. Meanwhile, the head of a Chinese toy firm involved in a huge safety recall committed suicide according to the Chinese media. Zhang Shuhong, who co-owned the Lee Der Toy Company, was reportedly found dead at his factory in southern China.

Mattel could face liability lawsuits over the recall, even though the toys were made by a third party.

Mattel Inc.'s recall of nearly one million lead-tainted toys shows the challenge Chinese companies increasingly pose for US partners: how to benefit from low-priced goods without getting caught by safety and regulatory risks. The Mattel recall, comprising 83 types of toys from its Fisher-Price unit, involved excessive levels of lead paint in toys – a common problem in China despite lead-paint regulations both there and in the US. Lead experts say the scale of the recall suggests the use of lead paint was not uncommon at the factory at issue in the Mattel recall. ‘From the size of the recall, we're not talking about accidental use of paints,’ said Paul Mushak, a toxicologist at PB Associates, a US risk-assessment firm specialising in toxic metals. ‘We're talking about something that's been a conventional practice.’

US retailers and toy makers, including Mattel, have attempted to devise processes to prevent products with lead contamination and other problems from reaching shelves. However the systems vary, and they have not stopped problem toys from slipping through the process. Sometimes, toys that have passed inspection more than once are later found to contain excessive levels of lead paint – indicating that Chinese companies may have been able to get around the safety inspections.

In Mattel's case, its own inspection process – praised for being an industry standard – also failed. Mattel allowed the manufacturer to perform its own tests, the company said, because it had a trusted 15-year relationship with it. Mattel said it performed monthly audits of the manufacturer's toys, which sometimes involved testing samples and other times involved reviewing the manufacturer's own testing records. Such incidents are one reason for calls to mandate independent third-party testing.

In the US, a crescendo of lead-related product recalls has encouraged demands for more rigorous, standardised product testing for toys made in China. About a third of the 967,000 toys being recalled in the US – which include popular Elmo, Dora the Explorer and Sesame Street characters – reached stores in 2007 before Mattel began the recall process. Lead is a neurotoxin that hijacks the developing brain. It causes damage by mimicking helpful metals found naturally in the body, such as calcium, iron and zinc. Lead displaces those and disrupts brain circuits critical for learning. Occasional exposure to small amounts is unlikely to have serious health effects, but repeated exposure can cause declines in IQ and, in extreme cases, severe brain damage. New research suggests there is no safe level of lead exposure, and the World Health Organisation (WHO) has tightened its guidelines over the past year.

While the recent recalls have ignited health concerns in the US, lead exposure is a major public-health problem in China, where millions of children have unsafe levels of lead circulating in their blood. One 2004 study by researchers at Peking University in Beijing found 34% of young children in China had blood-lead levels that exceed the safe limit set by the WHO, though exposure rates have improved in recent years. Meanwhile, some critics have reported that US regulators such as the Consumer Product Safety Commission (*CPSC*) are ill-equipped to police toy imports from China. 'The CPSC does not test the products in advance,' according to Ed Mierzwinski, the consumer program director at the US Public Interest Research Group. 'Even if it were ordered to, it's underfunded, understaffed and has inadequate authority to even impose recalls.'

How to prevent lead paint use has plagued US toy makers for several years. In 2003, for example, Toys 'R' Us Inc. voluntarily recalled 50,000 lead-laden sticks of sidewalk chalk. Afterwards, the company ramped up safety measures by evaluating products before full-scale manufacturing, as well as enlisting third-party labs to perform spot-checks. An internal team was also established to bring products beyond CPSC standards. Even so, lead contamination has remained an issue for the retailer. In March 2007, Toys 'R' Us voluntarily recalled about 128,700 military toys produced by Toy Century Industrial Company Ltd. of Hong Kong that were found to contain high levels of lead paint. Since the most recent incident, Toys 'R' Us says it has stepped up testing for lead and has increased its quality assurance budget by 25%.

Such issues clearly impact not only on direct costs for the sector but also the reputation of the major players within the sector (see **Chapter 7**). In this context ongoing due diligence, corporate governance and risk management, as well as best practice, are essential. In terms of commercial due diligence such concerns, that very much affect supply chain and other decisions, must be taken into account very seriously from both macro and micro perspectives.

7

Reputational due diligence and risk management

7 Reputational due diligence and risk management

CHAPTER OVERVIEW **7.1**

Since the First Edition the concept of reputational risk has gained increasingly in importance in terms of due diligence (as defined in **Chapter 1**), corporate governance and risk management. This chapter covers the elements of due diligence which contribute to the management of reputation due diligence including:

* Reputation management
* Crisis management
* Brand management
* Intellectual property management
* Corporate governance management
* Stakeholder management.

Reputation and Goodwill; Value **7.2**

Risks such as stakeholder pressure, whether it be from the financial community complaining about executive remuneration or NGOs bemoaning the lack of published policies, can impact upon the accumulated 'goodwill' or intangible asset value of a company.

The market value of a company is made up of three elements:

Market value = tangible assets (less debt) + goodwill + intangible value

Within a company's report and accounts the tangible assets are assessed and audited. The intangible value of a company is partially included in the balance sheet as 'goodwill' or 'intellectual capital', of which the corporate and product brand reputations are a large element. Intangible value is often regarded as too difficult to measure and breakdown into its constituent parts, but it constitutes an estimated 71% of market value of the UK FTSE100.

Intangible value is quite often of higher value than tangible value, according to *Interbrand* 2000, who estimated that 96% of the market value of Coca-Cola, 97% of Kellogg and 84% of American Express is 'intangible' (Quoted in Business Case for Corporate Responsibility, by Arthur D. Little and Business in the Community, 2003).

There is evidence to show that the public reputation of a listed company and its share price movement in the future have a strong correlation. This research was conducted by MORI the polling company who found that the 'favourability' rating of the analysed companies led to corresponding moves in share performance, with a lag of between 3 and 12 months (*Financial Times*, 22 August 2005).

The company's reputation, therefore, becomes a key issue in enhancing or destroying its intangible value; whether it is listed or not the same rules apply. It is not just a company's overall reputation which is important but how its reputation is aligned with, and whether it meets the expectations of, its stakeholders. If this is achieved then value will be created.

> 'The management of reputation integrity is one of the greatest corporate challenges of the new millennium. As forces of globalisation continue to gain momentum, society increasingly demands that large multinational corporations improve their performance in the areas of human rights, the environment, worker health, and other governance issues. Failure to address these demands has proved damaging to a company's most important asset – its reputation.'
>
> *(Price Waterhouse Coopers, Earning Your Reputation: What makes others respect Your Company? 1999)*

Respected Reputations

Respected reputations are built over a long time, as they are a combination of reliability, credibility, responsibility and trustworthiness, and these reputational qualities are hard won. In the context of his organisation, Ralph Larsen, the CEO of Johnson & Johnson, has aptly stated:

> 'Our image is that of a caring company. It is shaped not by great acts or great decisions, but rather the sum total of all behaviors and actions of the company over a period of time.'
>
> *(Reputation, Charles Fombrun, Harvard Business School Press, p. 69, 1996)*

As many case studies have demonstrated reputations can be rapidly damaged or even lost. In business practice this can occur through inadequate:

- corporate governance, as demonstrated in international cases including Enron, Worldcom and Tyco, among others;
- compliance with regulations and reporting requirements;
- risk management practices such as – environmental; health and safety; and socio-economic risk management, as indicated by the following examples:
  - the Exxon Valdez oil spill;
  - Firestone tyres recalls;
  - Mattel toy recalls;

  - ○ Concorde plane crashes;
  - ○ product contamination scares; or
  - ○ marketing promotions that backfire.
- stakeholder engagement procedures, including investor relations (IR).

This chapter provides a framework for reputational due diligence whilst maximising stakeholder value.

Reputation due diligence 7.3

It is now generally recognised by most organisations that without risk there is no reward and, as a general rule, the higher the potential reward the higher the potential risk. Those organisations which have struck the optimum balance between risks and rewards are the modern day heroes. Indeed many organisations are assessed upon the basis of their risk appetite and how far they are risk averse.

Achieving a balance between risk and reward is becoming more and more difficult, as there is now an increasing and often unrealistic expectation from stakeholders that reward can be delivered without risk. In order to build and retain a good reputation, these unrealistic expectations need to be expertly managed through transparency, education and inclusion.

Therefore the starting point for any company is to have a clear understanding of the key issues surrounding its 'risk versus reward' strategy:

- How could its reputation be damaged; or
- How, if managed well, could it enhance its reputation over that of its competitors?

The organisation needs to work closely with all of its stakeholders by:

- discussing with them the wider implications of their expectations, the management and deliverability of their expectations;
- ultimately, agreeing with them how their interests can be aligned with those of the other stakeholders.

In essence, the company and its stakeholders should be working together harmoniously. The issues are dynamic and need to be continuously reviewed. Expectations these days mean that even good surprises can be unacceptable.

Reputation management 7.4

The extent to which a range of intangible risk factors influence share price is vital information. These risk factors include:

- corporate reputation and individual brand values;
- regulatory regime and government reaction to public pressure;
- media and NGO interest; employee morale; and
- investor, lender and insurer confidence.

These factors are considered in the framework for this chapter which covers:

- Reputation management – the organisation's reputation: This reflects key stakeholders' perception of the company's strength and corporate governance; this is a function of size and visibility. It includes the credibility, reliability, trustworthiness and responsibility of the organisation.
- Brand management – Individual brand values – the product's reputation: This reflects the relevant customer's perception of brand name and resultant loss of sales/increases in returned goods/inventory costs; related to visibility.
- Intellectual property management – Individual brand values;
- Corporate governance management;
- Stakeholder management:
    - Academic and research organisations: vital to some sectors which need scientific approval for their products.
    - Business partners and suppliers: reflects the effect on voluntary or imposed partnering due to operational structure.
    - Customers and their representatives: not only the demand for products and services, but also brand loyalty, quality and product safety perceptions.
    - Direct action and NGO interest: reflects the likelihood of NGO campaigns against some aspect of the company's operations (e.g. Internet-based campaigns). This also includes the actions of militant action groups and reflects the adverse pressure (often unlawful direct action) against the company over perceived malpractice (such as Anti-vivisection protestors).
    - Employees and their representatives: employee morale and industrial relations are included. This reflects the damage which could occur, resulting in resignations/recruitment costs, loss of productivity and concerted trade union pressure.
    - Financial viewpoints: investor, lender and insurer's confidence.
    - Government and the regulatory regime: reflects changes to a company's operating environment beyond its control (e.g. leading to imposed restrictions, loss of licence, likelihood of government intervention, etc.). Government reaction to public pressure – reflects the extent to which perceived unethical business practices are becoming untenable (i.e. overcharging and monopolistic tendencies).
    - Government: local government pressures and permits, including planning regimes and processes which can aid or inhibit operations.
    - International governments and regulatory regimes: for example, the EU, UN and ILO.
    - Journalist and media interest: reflects the extent to which intrusive and maintained media coverage could adversely influence stakeholders' perception.
    - Key competitors: the extent to which major competitors affect the 'competitive environment' like resource and product prices, their reporting and stakeholder engagement activities.

- ○ Local communities: local communities can prove of critical importance and can pose risks of their own, from activism and objections to planning applications and business operations. They are also the source of employees and local reputation is of importance.

Reputational management 7.5

Media interest and NGOs activities work together to create public awareness. If an issue is newsworthy and a stakeholder launches a campaign about the issue, it will keep gaining momentum and lead to ever increasing public awareness.

Companies need to assess the current and potential damage or value the issue could have. How sustained could the coverage be? 'Does the story have legs?' A negative, one-off headline can be fairly damaging but a long drawn out campaign can severely undermine a company's reputation, even if it is only in the local press. The issue could potentially centre on a major accident, leading to a public enquiry and class action for compensation. The whole process will ensure maximum media coverage.

This can increase public awareness of the issues; the company should consider the public's reaction on the basis that they are aware and have an understanding of both sides of the argument surrounding the issue. Will the issue lead to anger, outrage or fear? The media and NGOs will only be able to create and sustain public awareness if the issues, which they are promoting, are likely to lead to a high level of anger and outrage amongst the general public. 'Bad news sells newspapers'. Industry lives with these issues and often comes to accept them as being part and parcel thereof. The public perspective can be very different, however, and a company should try to understand how angry the public could be if it fails to manage the issue.

It is generally the case that once a company is in the spotlight over a certain issue it remains vulnerable. Therefore a strategic option to try to limit the damage is to convince the press and public that it is a sector issue rather than a company specific issue. For instance, Shell's reporting of their known retrievable oil and gas reserves under the US Securities and Exchange Commission's (SEC) guidelines was a well-documented example. Shell appeared to be successfully turning it into a sector issue, but the subsequent disclosure of the board's damming internal e-mails turned the focus of the blame clearly back onto the company. This resulted in fines of $151 million (£83 million) to draw to a close the dispute with the SEC and UK's FSA (Financial Services Authority) over its wrongly booked reserves (*Financial Times*, 30 July 2004).

Some issues can be quickly addressed and, if carefully managed, can even enhance a company's reputation, such as in the case of product recalls if the company initiates the recall prior to media exposure of the risks (see also **Chapter 6**). Others just simply will not go away; these are issues which the company has to live with and are, therefore, an inherent part of a company's operations. General and specific examples include:

- Oil companies that are active in parts of the world where their staff and operations are at risk from saboteurs and media exposure of environmental damage.

- JP Morgan Chase setting aside an extra US$3.7 billion to cover investor lawsuits in relation to its 'alleged role in corporate scandals such as Worldcom and Enron' (*Financial Times*, 22 July 2004).

The media and NGOs have long memories and will continue to make an example of a company's poor management in relation to an issue. Once a company has entered this territory it is very difficult to reduce the onslaught of adverse publicity. For instance, in the UK Jarvis plc provided a case in point as their loss of reputation over safety incidents was then compounded by the loss of contracts and the resultant cash flow problems and redundancies.

Why does reputation matter? **7.6**

According to *The Aon European Risk Management and Insurance Survey 2002–2003* [1], the loss of reputation was seen as the second biggest threat to business (after business interruption). These findings were based on the views of risk managers, insurance managers and financial directors of over 100 of Europe's largest companies. Aon's research also showed that the top 2000 private and public sector organisations regard reputation as their biggest risk. The results of a similar survey carried out in Australia revealed a very similar picture, with loss of reputation, business interruption and brand protection topping the list. It was also pointed out that, the key causes of concern for brand management were ethics, corporate governance, compliance and product quality.

Aon risk management survey 2005

Every two years, Aon commissions a survey of the UK's top 1,000 public and private sector organisations on their risk management and financing strategies. The 2005 survey again analysed the responses from risk managers, insurance managers, finance directors and company secretaries in response to their questionnaire.

The survey was carried out independently by Consensus Research International, an independent market research company and revealed key findings in the following areas:

- Dominant risk issues
- Risk management resources
- Insurance markets
- Risk retention strategies and captives
- Outsourcing.

The 2005 report explained how risk management had come of age. In the UK legislation, regulation, corporate governance, the Combined Code and anticipated Operating and Financial Review (OFR) preparation were largely responsible for forcing risk management up the board's agenda and ensuring that it permeates the entire organisation. The survey noted good risk management to be vital to companies of all sizes. Since many of the greatest threats to business are uninsurable, or partially insurable at a cost, a major incident will inevitably put the ability and agility of senior management to the test. No company can underestimate the importance of sound risk management. Heading the 2005 list of risks that pose the greatest threat to companies is loss of reputation. This has regained its top position while business interruption, is now in second followed by failure to change. Product liability/tamper has moved into fourth place from ninth in 2003. Product recall can have a seriously detrimental effect on a company (see **Chapter 6**). The company's ability to successfully and quickly manage the aftermath will largely determine its future.

For the first time the impact of regulation/legislation has emerged as one of the greatest risks, notably in fifth place. This is particularly evident for issues such as environmental management that are rapidly being pushed to the top of the board agenda (see **Chapter 16**).

'It takes 20 years to build a reputation and five minutes to ruin it'. *Fortune Magazine* reported Warren Buffett's view in 1991, arguably the world's most successful investor. It now takes more than just good public relations (PR) and a clever advertising campaign to successfully secure financial success – ongoing reputational due diligence and corporate governance exercises are needed. If a company commits to an idea, it does so in public and will be therefore subject to public scrutiny and examination.

It is useful to refer to what reputational risk means among the investment community. Referring to reputation and share price as measured by YouGov's BrandIndex (see www.brandindex.com). Stephan Shakespeare, the co-founder and CIO of YouGov has defined reputational risk as 'the gap between perception and reality. For example, if a company succeeds in selling itself as environmentally friendly and is then discovered knowingly to be causing environmental damage, it will hurt more than if public perception and the underlying reality had been in harmony. The risk, therefore, is that a credit will be discovered to be false. Conversely, a negative story that nevertheless chimes with what was already thought will not matter so much. Early in 2006 a powerful "expose" of Ryanair in a Channel 4 documentary had a big negative effect on the budget airline's buzz scores but little lasting effect on its "recommend" scores, presumably because Ryanair has built its business on being "no frills" and the TV attack was not at variance with what consumers had already discounted' (*The Business*, 15–29 December 2007).

Consultation with stakeholders is the best way to ascertain stakeholder perceptions and expectations about building credibility.

A good corporate reputation can influence:

- investors' willingness to hold its shares;
- consumers' willingness to buy from it;

- suppliers' willingness to become its partner;
- competitors' determination to enter its market;
- media coverage and pressure group activity;
- regulators' attitude towards it;
- its cost of capital;
- potential recruits' eagerness to join;
- the motivation of existing employees.

Corporate reputation is now very much defined in stakeholder terms. One of the definitions of corporate reputation sees it as the 'aggregate perceptions of multiple stakeholders about a company's performance' [2]. A good reputation is therefore achieved when stakeholders' expectations and experiences of the company are aligned. Stakeholder expectations represent the expectations of all conceivable parties interested or in some way involved in the workings and development of a company. (The stakeholders that really matter to the private sector are invariably customers, employees and investors. Others may include regulators, strategic partners, suppliers and the local community.) It is considered good business sense to perform market surveys on relevant consumers. The rationale behind this is that these consumers will have an effect on the corporate health of a company. If consumers like a product or brand, they will purchase it. This will result in profits. This is well understood because it can be seen to have an obvious effect on the economic bottom line. However, if consumers are examined more closely, they can be seen to be swayed by fashion, values and other outside influences. The risks a company faces is having a product boycotted, found unfashionable, of poor quality or not purchased, because of bad press. To minimise these risks it is sensible to address stakeholders, concerns and interests and in that way influence the perceptions of stakeholders encouraging purchasing decisions and investment, whilst also ensuring a reduced exposure to liabilities. Furthermore, it will also give the business the opportunity to be able to recognise market trends faster, change faster and predict the social effect on the economic aspects of the business. Therefore a wider range of research undertaken with regard to stakeholder groups should take place: an example of this is the shareholder analysis that is provided below in this chapter.

The following are the most significant areas where a risk to reputation may arise:

- delivering customer promises;
- communications and crisis management;
- corporate governance and leadership;
- regulatory compliance;
- workplace talent and culture;
- financial performance and long-term investment value; and
- corporate social responsibility (CSR).

Businesses cannot afford to ignore risks related to their reputation and brand. However, as noted above, apart from business interruption, the top risks identified by the Aon survey are uninsurable. Therefore, mitigation of such business risks is largely an issue for corporate governance. The Cadbury Report [3] defined corporate governance as 'the system by which companies are directed and controlled' (paragraph 2.5) (see also **Chapter 10**). The report's findings marked an important advance in the process of establishing corporate governance.

A broader definition of corporate governance is that it ensures that the Board of Directors develops, implements and explains policies that will result in an increased shareholder value and address their concerns. It will also reduce the costs of capital and diminish business, financial and operational risks.

However, the relationship between risk and materiality is not necessarily a straightforward one. Western case law seems to have defined materiality to mean those things that would be material to shareholder interests. For example, the current US regulatory regime (see **Chapter 11** and the discussion of the *Sarbanes-Oxley Act of 2002* legislation) requires directors of listed companies to develop a system of detailed business controls that enables them to report accurately on any financial or business risks that are material to shareholder interests. In other words anything that, if the information leaked out, could lead to a material decline in the share price or value of its bonds. This is remarkably close to what investors expect the purpose of good corporate governance to be. This implies a very much wider interpretation of risks than those usually reported on by companies in their annual accounts. This can be illustrated with respect to the well-known experience of Nike and the labour practices of its suppliers in Pakistan and Vietnam. Those local companies were found to be using unregulated child labour in the manufacture of Nike sports goods. Nike, of course, was aware of this. From a financial accounts perspective, these were not material risks or issues, other than it kept manufacturing costs low (as in the case of Mattel Inc's toy policy, see **Chapter 6**). However, once the news came out Nike's shares dived as a result of the ensuing consumer backlash. That decline in the share price was definitely 'material to shareholders' interests'. Being socially responsible and engaging in stakeholder dialogue with investors and consumer groups would have helped to avoid this problem.

Reputation, transparency pressures and supply chain issues

Asma Jehangir Jillani, currently under house arrest in Pakistan, is a veteran human rights lawyer chairing the Pakistan Human Rights Commission. Her work in the 1990s resulted in the announcement on the part of Nike, Reebok and other sporting goods manufacturers to discontinue the practice of shareholders to discontinue the purchase of all soccer balls from Pakistan using child labour. Efforts such as hers stimulated the practice of shareholders to pressure their parent companies to eschew doing business with any gross violators of child labour laws. The practice is, over time, pressuring companies to be increasingly transparent regarding their supply chains.

Prior to the withdrawal of proposed regulations in the UK (see **Chapters 4** and **10**) some companies had been publishing OFRs, providing more qualitative and forward-looking information on a wider range of issues than have traditionally been covered by company reporting, for some time. In fact the Accounting Standards Board (ASB) first issued a statement of best practice for the OFR in 1993. Many listed companies do so as a matter of best practice or to enhance their reputation and profile in particular areas, such as the environmental impact of their business. A survey by Deloitte and Touche [4] reported that in 2003 over 60% of listed companies had either prepared an OFR or adopted the broad approach set out in the ASB statement, and a further 30% include some recognition of the OFR in their reporting. However, the general upward trend in the quantity of reports has not been matched by the provision of improved quality of information. The UK government's Company Law Review (see **Chapter 4**) found that the content and rigour of reporting varied widely, and that a significant proportion of large companies fell well short of meeting the ASB's recommended practice, especially outside of the FTSE 100. Only a few reports go further than explaining their 'policies' and contain any quantitative data about performance, mentioned progress on previous targets or strengthened future objectives. Moreover, only very few reports were audited by third parties. Even if this did happen reports were often mainly concerned with the methodology and not the verification of information or the even the investigation for why certain information has not been included (see further **Chapter 10**).

Although the reporting on 'intangible' issues that was scheduled to become compulsory for listed companies in the UK by means of the OFR was abandoned the expansion of company law to make it much easier for shareholders to obtain information on how companies deal with reputational risk issues was still pursued through consultation over the Business Review found in the Companies Act 2006 (see **Chapter 10**). The DTI objectives may be recalled:

> 'We expect companies to create wealth while respecting the environment and exercising responsibility towards the society and the local communities in which they operate. The reputation and performance of companies which fail to do these things will suffer … For this reason, … increased, high-quality shareholder engagement is vital to creating the modern economy that we all want. But, if shareholders are to hold the directors of their company to account for its performance, they need full and accurate information. This will allow them to act if they see a risk that a company may go in the wrong direction.'
>
> *(Department of Trade and Industry, pp. 5–6, 2004 [5])*

Reputation and corporate culture **7.7**

Reputation management is a natural extension of brand management (see below) and some rules apply to both. Aligning an organisation with its brand is crucial for managing a brand in the eyes of consumers; and aligning an organisation and its reputation is paramount for managing the reputation in the eyes of stakeholders.

Aligning the organisation, its operations and culture around its brand values brings the 'promise' that the brand makes to life (see also the discussion regarding corporate culture in Chapter 8). A corporate brand stands for the relationship that an organisation has with its employees, as much as it represents the relationship that it has with its customers through its product and service offering. For example, Starbucks' corporate culture has generated fierce loyalty from shareholders, consumers and employees, primarily due to risk management and socially responsible policies. For a brand to 'come to life' with customers, the organisation must be internally aligned to deliver the brand promise through the organisation's culture, reward systems, key success activities and structure. In other words, employees must 'live' the brand values in their day-to-day interactions. Also management must demonstrate their commitment to these values through their behaviour as well as corporate communications, demonstrating sincerity – not just rhetoric [6]. While Starbucks came under criticism for attempting to copyright a coffee-bean specific to a region in Ethiopia, it abandoned its claims rather than engaging in an expensive legal and media battle with the claimants at the risk of losing stakeholder confidence. In the United States, Starbucks offers benefits to any and all employees who work above 27.7 hours per week. Worldwide, Starbucks has been one of the leading companies to provide more transparency in its supply chain. In another example of building corporate culture, the introduction of profit-sharing for Ford employees not only brought on the desired effect of increasing production by making workers assume a vested interest in the good of the company, but also allowed for a steady new pool of shareholders coming from Ford retirees.

Internal reputation management 7.8

A good reputation helps to sell goods and services, recruit new employees and reflects positively on a company's share prices. It is needed for creating shareholder value. Delivering on a 'brand promise' is crucial for reputation management. Companies that commit themselves to this promise generally demonstrate the following characteristics:

- Effective use of internal communications to raise employee morale and commitment through shared beliefs and vision;
- Managers and staff are given a deeper understanding of the brand promise and the behaviours and values the promise demands – they are trained to adapt their behavior;
- All employees understand how their own work processes and responsibilities contribute to delivering the brand promise to customers; and
- Such company policies as recruitment, training and rewards are changed so that the organisation is also behaving in line with its brand promise. When employees understand and accept that the values are genuine, they align their attitudes and behaviour to the brand values. The result is greater satisfaction for both customers and employees, leading to employee and customer preference and loyalty.

The above approach is also consistent with the responsibility of organisations towards their employees and fits into the principles of CSR as so many reputational risk issues do (see also **Chapter 4** regarding ethics). At the same time, neglecting the human interface between the company and its stakeholders (especially customers) can destroy all the other attempts at reputation management. Implementing an integrated approach to reputation management across the organisation is thus critical to success.

The high proportion of mergers and acquisitions failures (noted in **Chapters 1** and **8**) can be largely attributed to the inability of managements to align corporate cultures. This fact supports the importance of having an integrated approach to reputation management for the creation and sustainability of shareholder value. Reputation management is necessary for protecting long-term brand value and should not be confused with creating a marketing image of an organisation's product or just a PR exercise.

Crises and reputation management **7.9**

An effective crisis and disaster management system that enables the continuation of business is a fundamental part of preserving a reputation for effective management. (see also **Chapter 4**)

A business crisis that results in the loss of reputational value, as a result of risk manifesting itself, has been defined as:

> 'Any problem or disruption that triggers negative stakeholder reactions and results in potentially damaging public scrutiny.'
>
> *(The Institute of Crisis Management, Annual Report 2002, May 2003 from www.crisisexperts.com)*

Since corporate reputation is increasingly defined in terms of the relationships that a company has with its stakeholders, transparency and accountability are vital to reputation risk management because it is not enough to *be* 'good', it is also important to be *perceived* as being 'good'. Through becoming transparent, companies engage their stakeholders in dialogue and thus become accountable. By engaging in dialogue, companies can address the concerns of their stakeholders, thus mitigating the risks that arise out of legal action, bad press and other actions taken by stakeholders that may have a negative effect on the company.

Reputation risk management differs from traditional risk management in an important respect: reputation is largely about perception. Many management teams have been criticised for the way they handled a crisis – not because their strategy was ill conceived or clumsily implemented, but because they failed to tell the outside world what the strategy was. The Exxon Corporation received relatively little comment about its recovery plans after its tanker *Exxon Valdez* ran aground in Prince William Sound, Alaska, but was criticised for its communication with the local community [7].

A highly relevant example of why companies should address the opinions of stakeholders is the well-known case in 1995 when Shell focused on the legislative aspects of disposing of its Bent Spar oil storage rig. Having assured itself that the procedure would comply with all relevant legislation, Shell decided that the best environmental option was to wreck the rig in the North Sea. Environmental activists protested vigorously but Shell paid no attention, it was content that its case was legally sound and therefore risk free. However, Greenpeace released a torrent of negative publicity against the company, based on what later proved to be an incorrect analysis of the environmental impact of sinking the Brent Spar. Nevertheless, Greenpeace's attack served to bring the proposal to the attention of the public so successfully that Shell had to back down in the face of public outrage demonstrated by a boycott of its products in Germany [8]. Addressing the opinions of the relevant NGOs in the decision-making process of the disposal of the rig would have helped to prevent the damage done by the lack of transparency and subsequent boycott (see also **Chapter 6**).

In contrast, British Midland Airways demonstrated a good example of effective crisis management after the 1989 Kegworth air disaster in which the airline's Boeing 737 crashed near East Midlands Airport. The chief executive of the airline handled media interviews in a convincing and honest manner that confronted the scale of the disaster and addressed the questions that the various stakeholders had. Not only did the airline avoid a decrease in sales, but it actually saw a short-term increase in sales after the disaster.

After 25 years of NGO campaigning, Nestle, is still the target of boycotts over its policies in promoting infant formula over breast milk. In the 1970s, when the company was accused of selling infant formula in developing countries at prices that could not be afforded and where clean water was unavailable, the company ignored allegations of irresponsible behaviour and contravening the WHO's code. Nestle suffered reputational and commercial damage by refusing to debate the issues in public. By the time the company was prepared to negotiate with campaigners and other stakeholders, no amount of attempts to align with the WHO code made a difference.

Accusations of false advertising can also have a severe impact on damage to brand reputation. While Cadbury Schweppes is well known for their attention to CSR, especially in regard to the environment, the company is currently facing a lawsuit for misleadingly claiming that its 7UP drink contains all natural ingredients. Public interest group CSPI, the claimant in this proposed lawsuit, pointed to the presence of high-fructose corn syrup in 7UP. Meanwhile the reputation of various key players in the soft drinks and water industries have been impacted in many jurisdictions, including India (see case study below). Similarly the costs of such crises as the product recall by Mattel Inc and others referred to in Chapter 6 can be extremely damaging and costly to the business. Product recalls, disaster and business continuity due diligence and risk management techniques are discussed further in The Handbook of Risk Management: A Sustainable Approach by the author and Adam Rose. Some of the more high-profile examples are outlined in the table below:

The cost of crisis

Corporation	Event	Cost ($ million)	Year
JP Morgan Chase	Corporate scandals lawsuit set aside	3,700	2004
Shell	Fine for mis-booking of reserves	151	2004
Ford/Firestone	Product recall	5,000	2000
Coca-Cola	Product recall	103	1999
TotalFinaElf	Oil spill	100	1999
Monsanto	GM crops	2,000–3,000	1999
Barings	Financial collapse	1,200	1995
Shell UK	Brent Spar	150	1995
Perrier	Product recall	263	1990
Exxon	Valdez oil spill	16,000	1989
Pan Am	Lockerbie	652	1988
Occidental	Piper Alpha disaster	1,400	1988
P&O	Zeebrugge	70	1987
Union Carbide	Bhopal	527	1984

Source: Larkin, J., Strategic Reputation Risk Management, *Palgrave Macmillan (2003) and SERM Rating Agency Analysis (2007).*

For example, the Co-operative Bank's estimate losses at Esso, due to the boycott of their parent company Exxon Mobil Corporation, ran into the hundreds of millions of pounds each year. Exxon Mobil Corporation was one of two companies found to have lost the most ground as highlighted in a study on reputations by Harris Interactive and the Reputation Institute, reported in the *Wall Street Journal*, 19 February 2004.

> 'Exxon Mobil is financially robust, but its continuing fight over punitive damages in the 1989 Exxon Valdez oil spill keeps the Alaskan disaster fresh in people's minds and lowers its rating for environmental responsibility.'

Journalists focus on these companies and their continual negative commentary acts as a magnet for them to be sent additional information by whistleblowers and other aggrieved stakeholders. As indicated above once a journalist is in this envious position it is very difficult to shake them off.

Case study in India: Environmental and water resources crisis – society and Coca-Cola's reputation

Water scarcity is an increasingly worrying problem for all sectors of the Indian economy, not only the agricultural sector. Water supplies are already under severe stress and in 2005 the World Bank warned that India's demand for water could exceed all sources of supply by 2020 unless action is taken now. Effective water management in both urban and rural areas is crucial. According to the World Bank, 70% of India's irrigation water and 80% of its domestic water supplies comes from groundwater, which is being rapidly depleted. In many states, water from shallow wells is often badly contaminated by agricultural pesticides and other pollutants (see also case study in **Chapter 6**). Deeper wells typically have cleaner water, but require electricity or diesel and installation of a water tank. The capital and operating costs are significantly higher and, given the high variability of electricity supply, reliability is poor. The protection of water supplies is a very sensitive issue in India when it comes to corporate responsibility: Coca-Cola's plant in the southern state of Kerala was shut down when it was found using a lot of water for soft drinks, leading to depletion in groundwater levels in the state. Groundwater pollution is a corporate responsibility requiring mechanisms to be in place and a major environmental concern in India.

The issue of controversy fact is that bottled water is often no different from water that should come from the taps. The only difference is it is packed in plastic and not conveyed in pipelines. Yet, while the Indian rich can afford to buy bottled water, the poor cannot. The rich have the choice and they opt out of the failing municipal systems. What NGOs have noted is that Indian water systems are failing because the rich in the country – who can afford bottled water – are still supplied water at a tenth of what it costs the municipality. Moreover, wastewater is conveyed and pumped from homes and even treated (at times). None of this cost is recovered. NGOs have concerns that it is the public subsidy which is leading to poorer and poorer delivery from water agencies. It is the rich, who have options to drink bottled, who are failing the system.

A study by Knight and Pretty [9] (pp. 275–279) revealed further implications that catastrophes have on the share price of companies. In their research they focused on 15 major corporate disasters, similar to the ones in the above table, and traced their effects on stock returns and trading volumes. The selection of catastrophes was based on five criteria, which also made this research relevant to reputation risk management:

- man-made as opposed to natural disasters;
- involved publicly quoted companies;

- received headline coverage in the world news;
- occurred since 1980;
- the organisation had to be affected on a symbolic level as well as on a physical level.

In all of the cases studied, the catastrophe was found to have had a significant negative impact on the share price – on average amounting to 8% of stock value. However, after just over 50 trading days some stocks experienced an apparent full recovery with the exception of the non-recoverers whose initial drop in share price amounted to 11% and up to 15% one year after the catastrophe.

What also became apparent from the research was that for the first six months after the catastrophe, the stock market tended to judge the companies on the impact of the financial loss on its average market capitalisation and the number of deaths arising as an immediate consequence of the catastrophe. However, after six months the market paid more attention to whether the company was perceived to be responsible for the disaster. Investors' perceptions of managerial responsibility were the most important ones.

The negative impact of the catastrophes on the companies' cash flows was usually reduced by the extent of insurance recoveries, and the stock market usually formed a collective opinion regarding the cash flow impact when the exact figures were not known in the immediate aftermath. However, a lot more depends on management's abilities to deal with the consequences.

> 'Effective management of the consequences of catastrophes would appear to be a more significant factor than whether catastrophe insurance hedges the economic impact of the catastrophe … Evidence suggests that managers' immediate, honest and efficient disclosure of relevant information to all parties helps secure share price recovery … The lessons for managers are clear. They must do all that is reasonably possible to prevent catastrophes from happening.'
>
> *(Knight and Pretty, pp. 278–279, 2001 [9])*

Brand management

Value of brands and their importance to reputation 7.10

Brand management is a natural extension of overall reputation management as an extensive part of the value of an organisation can be its brands in certain customer sensitive sectors.

When the FTSE 100 index was first calculated on 3 January 1984, the value of the 100 largest companies (by market capitalisation) listed on the London Stock Exchange was £100,145 million. Exactly 20 years later this figure stood at £1,110,838 million. According to research carried out by a major branding consultancy, Interbrand, over 70% of this value is accounted for by goodwill, or, in other words, reputation and brand. In 1994 goodwill, according to the same organisation, accounted for 44% of total value. The above facts suggest that the 11-fold growth in the value of FTSE 100 companies is largely attributable to their reputation or brand.

The widescale use of brands started in the late 19th and early 20th centuries. Improvements in manufacturing and communications allowed mass marketing of consumer goods. Consumer brands like Coca-Cola, Quaker Oats, Shredded Wheat, Kodak, American Express and Heinz date from this period. Trademark legislation was introduced to allow the owners of these brands to protect them in law. Since then, brand protection was little more than a legal issue.

Trademark law prohibits a company from using the same or similar names logos, or marks if they are already in use by another company. However, brand is much more than a name or a logo.

> 'Today's brand strategists say brands evoke distinct associations; they ascribe human personality traits to brands; they speak of long-term relationships with customers, rather than transactional exchanges. Brands carry emotional attachments; brands are your neighbours, your colleagues, and your friends. In short, brands have the potential to provide customers with a variety of pleasant, or unpleasant, experiences.'
>
> *(Schmitt, p. 236, 2001 [10])*

Considering this view of the brand and the value of brands to their owners, there is a need for more than just legal protection and protection from competition (see further below). Companies need to manage brands in an integrated manner across the entire company. Brand is reputation, which has to be managed in the eyes of all of the company's stakeholders and the public at large. Via the Internet and other new media, consumers, concerned citizens and NGOs can mobilise powerful campaigns against corporate behaviour of which they disapprove. Anything a company does or says can add to, or destroy brand value and reputation.

> 'Brand owners are accountable for both the quality and the performance of their branded products and services and for their ethical practices. Given the direct link between brand value and both sales and share price, the potential costs of behaving unethically far outweigh any benefits, and outweigh the monitoring costs associated with an ethical business … The more honest companies are in admitting the gap they have to bridge in terms of ethical behaviour, the more credible they will seem.'
>
> *(Brands and Branding, 2003)*

To many companies, brands are their most important assets despite being intangible. According to research carried out by Interbrand in 2002, the contribution of such brands, such as Coca-Cola and McDonalds, to shareholder value are 51% and 71%, respectively. Hence the significance of an adverse publicity, especially in respect of a failure to carry out best practice, due diligence, risk management and corporate governance activities as in India (see below). In fact, it is possible to argue that the majority of business value is derived from intangibles like brand and reputation. This is certainly supported by the attention that they have been receiving from management in the recent decades. Other research shows that companies with strong brands generally outperform the market in respect of several indices.

However, despite all of the above, a number of large brand acquisitions in the 1980s have revealed the inability of most accounting standards to deal with goodwill in an economically sensible way. The purchase of Rowntree by Nestle for £2.5 billion, which was 2.5 times the pre-bid price and 8 times the tangible net asset valuation, sparked off the debate about the inadequacy of the accounting standards for such transactions.

In the UK, France, Australia and New Zealand companies can put acquired brands on their balance sheets as identifiable intangible assets; however, they are not encouraged to do so. Nevertheless, the recognition of acquired brands by a number of companies led to a similar recognition of internally generated brands as valuable financial assets within companies. In 1988, Rank Hovis McDougal, a leading UK food conglomerate, defended itself from a hostile takeover by Goodman Fielder Wattie, by demonstrating the value of their brand portfolio and later accounting for it on the balance sheet. This was the first brand valuation in the UK and it established that it was possible to value brands not only when they had been acquired, but also when the company itself had created them. Since then there has been a number of accounting standards changes on the topic of treatment of goodwill on the balance sheet, including the introduction of FRS 10 and 11 by the UK ASB in 1999, and the IAS 38 by the International Standards Board.

Since the late 1980s, a number of brand valuation models have emerged. According to Jan Lindemann, the Managing Director of Global Brand Valuation at Interbrand the two main categories of these models are:

- research-based brand equity evaluations;
- purely financially driven approaches.

Research-based brand equity evaluations are usually insufficient for assessing the economic value of brands unless they are integrated into a financial model. This is due to their heavy reliance on consumer research and relative performance of brands. Financially driven approaches, can be further subdivided into four categories (see the table below):

Brand value assessment approaches	
Cost-based approaches	These define the value of a brand as the aggregation of all historic costs incurred or replacement costs required in bringing the brand to its current state: that is, the sum of the development costs, marketing costs, advertising and other communication costs and so on.
Comparables	Another approach is to arrive at a value for a brand on the basis of something comparable. But comparability is difficult in the case of brands as by definition they should be differentiated and thus not comparable.
Premium price	In the premium price method, the value is calculated as the net present value of future price premiums that a branded product would command over an unbranded or generic equivalent.

(*Continued*)

Brand value assessment approaches	
Economic use	Approaches that are driven exclusively by brand equity measures or financial measures lack either the financial or the marketing component to provide a complete and robust assessment of the economic value of brands. The economic use approach, which was developed in 1988, combines brand equity and financial measures, and has become the most widely recognised and accepted methodology for brand valuation.

Interbrand's own approach to brand valuation, is one of economic use. According to *Business Week* (4 August 2003) it values brands the same way analysts value all other assets – on the basis of how much they are likely to earn in the future and then discounting these projected earnings to a present value based on how risky they are.

Intellectual property management **7.11**

It should be mentioned that any business involved in building its reputation also has to consider whether it has any intellectual property (IP) or brand to protect. This is true wherever it operates and all the more so in today's global marketplace. It is also true of other organisations. Indeed, with regard to due diligence, taking steps to protect the future of key assets should be a natural process for any business and actually seen as an investment.

Protecting IP safeguards the growth of a business as well as protecting it from theft. IP protection can help businesses of all sizes:

- raise finance;
- improve company performance;
- legal protection against poor quality imitations;
- build brand awareness; and
- improve customer loyalty.

However, despite these clear benefits, many do not see this as an important area of risk management. Indeed, only 26% of UK businesses, and even fewer small- and medium-sized enterprises (SMEs) either recognise or know how to take full advantage of this growing area of opportunity (see also **Chapter 6**).

Surprisingly, 98% of worldwide patents are granted for 'across-the-board' technology – for design advances, and in everyday fields in the engineering and computing sectors – not for the key, breakthrough inventions profiled in the media.

Categories of IP **7.12**

IP falls into three broad categories: patents, trademarks and design protection.

Patents: protect inventions by giving the owner of the patent the right to stop anyone from making or using the invention without the owner's permission. This is a legal right, for example, in the UK granted by the Patent Office, lasting up to 20 years. This right to stop competition is only legal in the country for which a patent has been granted. Practical tips include:

- Keep the details of your invention secret until you have filed a patent application. To get a patent, your invention must not have been disclosed publicly anywhere in the world before you apply-even by yourself.
- Ignorance that you are infringing someone else's patent is no defence.
- Contents of patents are published; they do not remain a secret.
- A national patent only gives you rights in that country.
- The European single market does not override national patent systems.
- You have to police your own patents, or get someone to do it for you.
- Always obtain professional advice – it is easy to go wrong.

Trademarks: are signs which are used to distinguish the goods or services of one business from those of another. Most trademarks are words or logos or combinations of the two, but other forms, such as three-dimensional shapes, combinations of colours and even sounds, may also be used as trademarks. Protection lasts initially for 10 years and then, on payment of a fee, it can be renewed in 10-year blocks for an indefinite period.

Having a registered trademark gives brand recognition and helps guarantee the origin, quality and consistency of the goods or services. Not only does this help avoid confusion with others in the same line of business, it also allows action to be taken against anyone counterfeiting or copying a trademark for similar goods or services. This is key in the era of increased counterfeiting and economic crime.

Products sold under a particular trademark may vary but the trademark remains unchanged. Trademarks are an important means of protecting the reputation and goodwill that a business has built up. Trademarks are, for many businesses, the single most valuable marketing tool that they possess.

Design protection: is very important. It is often the reason that a particular product is chosen or desired. A significant amount of work may be involved in producing a design, and it is therefore important wherever possible, to provide protection for this design work. Design protection can be very important in preventing competitors from using the same or a very similar design. It can also be used in licensing a design to third parties and therefore potentially providing an additional income source.

The EU definition of design is the appearance of the whole or part of a product resulting from features such as the lines, contours, colours, shape, texture or materials of the product or its ornamentation. Such products can include graphic symbols, screen displays, logos, typefaces and packaging. Accordingly the scope of what is meant by 'a design' is very broad, and principally falls into two categories, whether the design is two or three dimensional.

Three types of protection are potentially available:

1. Registered Design is obtained by registration, and can protect the appearance of new two- or three-dimensional designs.

2. Copyright is a right associated with a particular 'copyright work' and is a right to stop unauthorised copying of the work. Copyright is largely applicable to two-dimensional designs, but can provide protection for some three-dimensional designs.
3. Design Right is an automatic type of protection which provides protection for a limited period for most three-dimensional designs.

The pros and cons **7.13**

In the context of reputation due diligence there are many positive reasons for taking steps to protect the IP of an organisation from as early a stage as possible. IP can be useful to raise vital finance. Intangible assets, such as registered patents and trademarks, are increasingly being used as security to borrow cash. They also provide new revenue streams from licensing and franchising activities. They may also have a residual value so that even if the company stops trading, the IP may continue in existence and can be sold on to others. Companies that protect their IP often undertake a wider range of performance enhancing activities, such as research, design and development. Trademarks and patents also enable their owners to command a premium price in the market that is reflected in their financial performance.

The IP protection process, however, has never been a cheap or straightforward journey. Traditionally, the IP profession existed surrounded by an air of mystique. It involved highly skilled attorneys, sitting in distant offices, corresponded by letter to businesses large and small, using unintelligible jargon and attaching reams of complicated information. They charged significant sums of money for work that offered no clarity to their client. This led to many start-up businesses and SMEs making little use of formal methods of protection requiring registration, such as patents. They preferred informal methods because they were cheaper and within the control of the company. The principal method of maintaining confidentiality was through working with customers, suppliers and employees who could be trusted. They saw the greatest threat to their IP as loss of key people, far more than the threat of copying by the competition.

However, there have been key developments and advances in the IP sector of late. In the UK, for example, the volume of IP has grown enormously, and gets greater and greater each year. A much larger proportion of technology patents are being applied on a global scale.

Inventors, and indeed most SMEs, now seek more and more practically angled advice, especially advice that is tailored around the commercial hopes of the business, its customers or end-users. In the past, patent agents operated much like solicitors: the provision of patent law advice, but little more. All that has now changed dramatically and IP protection is a much more accessible method of managing risk to the brand. Moreover, what may become the biggest long-term change, is that a much broader range of commercial and corporate clients are harnessing the IP system, with much of it funded by third parties such as investors of venture capital firms.

Corporate governance management 7.14

This issue is covered in many chapters as good corporate governance is one of the foundations of due diligence management practice and is critical to reputational matters. Its significance is embedded in each chapter although **Chapter 4** reviews trends in this field and **Chapter 10** explores the main issues relating to corporate governance due diligence. Elements of CSR Management are also explored in other sections of the book and have an impact upon reputation.

Corporate governance
A company will have certain issues such as corporate governance that are specific to the company as they are under the company's control. These are the issues that, if managed well, will help enhance a company's reputation, or, if mismanaged, could ultimately destroy its reputation.

As regards risk management and good corporate governance procedures, including non-financial risk in particular, of key importance as a reference tool is the Combined Code (revised) on corporate governance, that resulted from the merging of recommendations offered by the Derek Higgs review (released in January 2003) as well as those offered by the Turnbull, Cadbury, Greenbury and Hampel committee reports. The Code has been incorporated into the listing rules for all UK listed companies and applies for reporting years beginning from 1 November 2003.

Sites that offer guidance on the most appropriate corporate governance best practice for UK companies are the Institute of Chartered Accountants in England & Wales (www.icaew.co.uk), and the ABI's Institutional Voting Information Service (IVIS) website at www.ivis.co.uk

Stakeholder due diligence 7.15

An organisation needs to consider the range of stakeholders and the currency of the issues they face by asking the following questions:

- How current is the issue and is it of growing relevance or concern to the stakeholders?
- Is it an old issue which is lying dormant and could suddenly take off?
- Is it a new emerging issue?
- What are the dynamics of the issue and the stakeholders involved?

Stakeholder assessments and engagement will enable a company to see in a new light the relationship between itself, its stakeholders and the issues. It will give a company its overall view as to which stakeholders to target for engagement and to enter into dialogue with, in order to see how their common interests can best be aligned.

The link between the companies and their key stakeholders are the issues that the company has the ability to manage/influence and thereby improve the position for the stakeholder. For each of the stakeholders the company should consider the pertinent issues that could enhance or destroy their relationship. The issues impact varies from stakeholder to stakeholder as their expectations are not necessarily the same.

A starting point for a company to assess reputational risk and how it interacts with the intangible value is to list its key stakeholder groups. These can be broken down under several main categories as set out in the stakeholder review section below.

As is mentioned further below, the list should then be expanded to show the key individual stakeholders under each category. Agreeing exactly who their key stakeholders are can be a challenge to most boards. The key stakeholders' trust and high regard for the company are paramount to the company's sustainable growth. As is illustrated below, stakeholders can have a direct impact upon the value of a company:

- Actual and potential shareholders of a listed company will decide what they think the value of a company is with the prices they are willing to buy and sell at.; and
- Regulated industries can have their prices set by government departments or regulators, or are taxed by the Government, thus affecting the demand for their offerings (e.g. alcohol, tobacco, oil, etc.).

There are numerous indirect risks and stakeholder pressures which can damage an organisation's reputation. These can include changes to the company's operating environment through regulation; for example, imposed restrictions, loss of licence, likelihood of government intervention, etc. These may also be closely related to environmental, health and ethical concerns.

It has already become evident that, to be complete, an institution's operational risk profile should reflect intangibles such as reputation which are acknowledged to be central to the success of an institution. Listed companies in particular are under increasing pressure from external ratings agencies, indexers, investment advisers and others, over their safety, environmental and social performance. Poor communications or communicators can attract media interest or outrage. As part of a reputational risk analysis it is necessary to capture stakeholder sentiments about the organisation. This is part of the reputational risk assessment reviewed in the following sections. (see the **Appendix**)

Stakeholder review **7.16**

Corporations are often said to have obligations to shareholders and other constituencies, including employees, the communities in which they do business and government, but these obligations are best viewed as part of the paramount duty to optimise long-term shareholder value which necessitates good management of stakeholders in the long term as well.

The following section reviews the main stakeholder groups that should be considered for your assessment. The trends and drivers that emanate from these stakeholder groups have also been covered in **Chapter 4**.

A stakeholder analysis template

* Academic and research organisations.
* Business partners, suppliers and trade bodies.
* Customers and their representatives.
* Direct action groups and NGOs.
* Employees and their representatives.
* Financial institutions (banking, investor and insurance criteria).
* Governmental organisations.
* Local and regional governmental organisations.
* International governmental organisations.
* Journalists and media organisations.
* Key competitors.
* Local communities.

A – Academic and research organisations 7.17

Academia research and government scientific research councils often conduct research into risk. They contribute through the assessment of risk, the development of responses, and prediction of future risk and monitoring of the effect of preventative actions. By way of example, research organisations have raised the level of awareness of the dangers posed by man-made chemicals (pesticides, fungicides, endocrine fertility disrupters) and other influencers of human health. They can also prevent a company's products reaching the marketplace on health and safety grounds, for example, or they are likely to be the source of research which has a damaging effect on an existing product.

B – Business partners, suppliers and trade bodies 7.18

Businesses are being encouraged to become more responsible, moral and ethical as the public and Government become frustrated by the end results of business self-regulation. There are concepts of CSR, responsible leadership, corporate accountability, sustainability, business durability, suppliers' auditing and management systems, and moves to account for greater supplier governance and due diligence systems being in place.

C – Customers and their representatives 7.19

These risks are explored in more depth in marketing theory or analysis, as customers are mostly silent and usually vote with their purchasing patterns. If customers are dissatisfied with an organisation the business will tend to be unaware until sales start to plummet. Brand reputation is also important here, as customers are prepared to pay a premium for quality, reliability and durability.

Some companies confuse reputation management with PR, corporate 'green washing' (where the environmental management systems and claims are part of the PR, or IR departments, and are not embedded into the corporate culture of an organisation), or putting a false picture of an organisation into the world. In truth, the general public and NGOs place trust in a brand (which translates into sales) if they believe that an organisation is honest. The financial sector also places a premium on transparency, as they prefer a planned disclosure of risks and bad news instead of sudden surprises.

D – Direct action groups, including NGOs **7.20**

NGOs want to fight campaigns which they can win, attract new members and gain sponsorship. High-profile NGOs, such as Greenpeace (see also **Chapter 6**), like to win people and they focus their attention on major multinationals and their suppliers. Smaller but focused NGOs can run effective campaigns on a single issue; their members are passionate about the issue and will fight on tirelessly.

E – Employees and their representatives **7.21**

It is in an organisation's best interest to treat employees fairly and equitably and in order to facilitate this communication, engagement and understanding are helpful.

It is self-evident that employees are easier to attract and retain if the organisation portrays a professional image. Employees can also be an effective source of environmentally beneficial suggestions. Good industrial relations with employees and their representatives (trade unions and committees) reduce the incidence of lost production time and some case studies even indicate an increase in overall productivity levels. It has also been noted that organisations with the Investors in People (IiP) recognition are, on average, 1% more profitable than those without the recognition. It helps if organisations:

- communicate honestly with their employees about corporate operations, goals, financial performance and policies;
- communicate policies and practices that are relevant to employees such as retirement, healthcare, insurance, compensation and other benefit plans since employees should be fully informed of the terms of those plans; and
- have in place and publicise mechanisms for employees to seek guidance and to alert management and the board about potential or actual misconduct without fear of retribution (i.e. 'Whistle blowing' arrangements).

F – Financial institutions – investors, insurers and lenders

Shareholders **7.22**

Organisations have a responsibility to communicate effectively and candidly with shareholders. The goal of shareholder communications should be to help shareholders to understand the business, risk profile, financial condition and operating performance of the corporation and the board's corporate governance practices.

Organisations should:

- Communicate with investors and other constituencies not only in proxy statements, annual and other reports, and formal shareholder meetings, but also in many other ways.
- Have effective procedures for shareholders to communicate with the board and for directors to respond to shareholder concerns. The board, or an independent committee such as the corporate governance committee, should establish, oversee and regularly review and update these procedures as appropriate.
- Have procedures for shareholder communications and its governance practices and these should be readily available to shareholders.
- Provide information about the board's structure and operations, committee composition and responsibilities, corporate governance principles and codes of ethics should be widely disseminated to shareholders.
- Consider issues raised by shareholder proposals that receive substantial support and should communicate its response to proposals to the shareholder–proponents and to all shareholders. The corporate governance committee should assess the reasons for the vote and recommend to the board the action to be taken with respect to the vote, which should be communicated to the corporation's shareholders.

Investors **7.23**

In brief this means that more shareholders will become proactive in engaging with companies. In **Chapter 4** there is an exploration of the emerging investment (SRI) strategies that are gaining prominence in the marketplace.

Insurers **7.24**

Major adjustments are occurring in the insurance world as the insurers respond to the new and often unprecedented level and scale of some claims from risks which materialise like: environmental catastrophes and hazards; flooding and corporate governance risks (see also **Chapter 16**).

Lenders **7.25**

Lending criteria is becoming more aware of these risk issues as the banks and other lending agencies can also receive indirect reputational damage for supporting a contentious project (e.g. banks which fund road or dam building in ecologically fragile areas). The main global banks have also developed a code of conduct, the 'Equator Principles', which will seek to set a global standard of what is acceptable to their sector. The 'Equator Principles' are used to analyse banks' risk to investments arising from damage to the environment amongst other factors. They are:

> 'A financial industry benchmark for determining, assessing and managing social and environmental risk in project financing.'

G – Governmental organisations **7.26**

In most jurisdictions a variety of government departments and agencies are responsible for the establishment of standards seeking to reduce the level of harmful substances entering the environment and harming the public by:

- imposing penalties;
- prosecuting offenders;
- issuing enforcement notices;
- raising and enforcing taxes and subsidies.

Companies or corporations, like all citizens, must act within the law; these laws are in a state of change and are regularly altered. The penalties for serious violations of law can be extremely severe, even life-threatening, for corporations. Compliance is not only appropriate, it is essential. Management should take reasonable steps to develop, implement and maintain an effective legal due diligence systems programmes that track existing and emerging legislation in each country of operations.

H – Local and regional governmental organisations **7.27**

Again in most countries, local authorities can directly regulate some elements of business activity, such as:

- Planning consent for the expansion of business operations, activities or works access.
- Planning consent for developments, which is especially important for some sectors like house building, construction and sectors which require substantial land capital (for example out of town retailers).

I – International governmental organisations **7.28**

There are a wide range of international bodies that can affect organisations' due diligence systems. There are bodies like the UN, WHO, ILO and a myriad of others that make recommendations on industrial sectors. They can recommend advertising bans, launch crack downs on industries and even pronounce products dangerous (for example WHO stating that passive smoking is deadly).

Within the EU the European Commission and Parliament hold increasingly large legislative power over a wide range of issues. The impact of the EU on the environmental agenda has been dramatic, and it has been responsible for a range of environmental measures including the preferred instrument, the directive. (see further **CHAPTER 16**).

J – Journalists and media organisations **7.29**

Media interest activity works to create public awareness. If the issue is newsworthy and a major stakeholder in a company raises an issue (for example an NGO's campaign launch or a shareholder revolt), that issue will keep gaining momentum and lead to ever increasing public awareness.

K – Key competitors **7.30**

The review should determine the extent to which major competitors affect the 'competitive environment' like resource and product prices, their reporting and stakeholder engagement activities.

L – Local communities **7.31**

Local communities can prove to be of critical importance and can pose risks of their own from activism and objections to planning applications and business operations. They are also the source of employees and local reputation is of importance. Where possible a corporation should be a good citizen and contribute to the communities in which it operates by making charitable contributions and encouraging its directors, managers and employees to form relationships with those communities.

Stakeholder reporting **7.32**

For extra-financial reporting there is an increasing number of guidelines and reporting frameworks for organisations to become immersed in; the main ones in the UK are the Turnbull Code, the Corporate Governance Combined Code (the Code) and the *EU Accounts Modernisation Directive* that is the basis for the Business Review discussed in **Chapter 4**. There is a trend towards the internationalisation of Accountancy Standards with the introduction of the IFSB *et al.* (see **Chapter 9**).

Management of these reporting issues sets the company apart from its competitors and helps answer the question 'What makes you different?' The ultimate goal is to be ahead of the field and align the company's policies and operations with its stakeholders' growing expectations. This is facilitated by reporting effectively through the appropriate channels as set out in the outline that follows.

Stakeholder reporting channels **7.33**

The following reporting channels are seen of primary importance in engaging with stakeholders:

- Academic and research Organisations:
  - Collaborative research papers
  - Grants and sponsorship

- Business partners and supply chain:
  - Tender document
  - Supplier meeting
- Customers and industry partners:
  - Corporate responsibility or sustainability report
  - Purchasing
  - Guidelines
- Direct action groups and NGOs:
  - Corporate responsibility or sustainability report
  - Face-to-face meetings
- Employees:
  - Corporate responsibility or sustainability report
  - Internal magazine
  - Intranet
- Financial investors:
  - Annual report
  - Briefing
  - Press release
  - Questionnaire
  - Road shows
- Governmental organisations (local, national and international):
  - Briefings
  - Corporate responsibility or sustainability report
  - Regulated disclosure
- Journalists and media organisations:
  - Briefings
  - Corporate responsibility or sustainability report
  - Press releases
- Key competitors:
  - Sector journals and sector quality standards
  - Industry trade bodies
- Local communities:
  - Site newsletter
  - Local press article
  - Cause related marketing channels

Integrated reputation risk management 7.34

The above paragraphs demonstrate the extent of damage that can be done to an organisation once its reputation is damaged. Reputation damage can harm organisations of all sizes and activities; however, it is the most misunderstood and ill managed of all enterprise risk management activities. Once an organisation has done something that reveals or even suggests a possibility that its products or services are unsafe or unreliable, that the management was incompetent or corrupt, no amount of immaculate crisis response and highly paid PR consultants can prevent the damage. Therefore, Reputation risk management can only be effective if it operates in an integrated manner – not as a specialist function to be activated in an emergency but as a major influence on the organisation's actions, behaviour and standards. The key to this is to understand your reputation, matching its management to its needs.

The potentially catastrophic consequences of not managing a crisis properly often becomes apparent only when a reputation incident has already severely damaged the credibility of an organisation or one of its brands, or its standing in the eyes of its stakeholders. Many organisations make the mistake of assuming that all that is needed is crisis planning. However, a reputation crisis exposes to public and media scrutiny not only the organisation's competence at crisis handling, but also the values, standards and shortcomings that existed beforehand. Reputation risk management should have two main objectives: to prevent the causes that could damage reputation; and to minimise the impact if, despite best efforts, a reputation crisis still occurs.

Strategic Reputational Risk Management
In her book on the subject [11], Judy Larkin argues that there are six steps to successful reputation risk management:

1. Establish early warning and monitoring systems – the reputation risk 'radar'.
2. Identify and prioritise risks (and opportunities).
3. Analyse the gaps; identify response options.
4. Develop strategies and action plans.
5. Implement strategies and action plans.
6. Keep the 'radar' tuned.

Early warning and monitoring systems 7.35

Establishing early warning and monitoring systems or surveillance systems designed to scan commercial, political/regulatory, social, economic, technological and other trends that may have an impact on business strategies is the first step. This may involve stakeholder profiling in relation to a specific risk issue, examination of look-alike and legacy issues, quantitative and qualitative stakeholder opinion polling and assessment of websites, chat rooms and scientific, public health, consumer and other relevant databases. The need for a finely tuned 'radar' that can scan for threats and track individuals, groups and organisations that may have an interest is critical. Discerning and monitoring cases of faulty demand forecasting, for instance, can be useful in identifying abuses of mandatory overtime laws and falsification of time sheets and record books by managers scrambling to meet inflated production goals. Ford, for instance, has a rigorous Employee Involvement (EI) programme in which employee grievances help maintain the quality of goods needed to keep Ford competitive with the increasingly automated Japanese manufacturers.

Prioritisation of risks 7.36

The identification and prioritisation of risks provide the basis for developing and validating risk issue management strategies. This may involve facilitated scenario planning, auditing and benchmarking as well as gathering qualitative and quantitative data that can assist planning. The aim is to identify all risk issues that may have an impact on the business. It is essential to factor in the reputational risk dimension into integrated risk management and internal audit procedures (e.g. include in operational 'risk register').

Gap analysis and response options 7.37

Analysing the gaps and developing response options involve the analysis of any gaps between current performance and stakeholder expectations. This provides a basis for determining anticipatory or response options that can contribute to closing the gap. Questions to ask are:

- Is there a gap between performance and expectation? If so, what is it and why is there a gap?
- Is the risk evaluation effective?
- Does the company really deliver the standards and values it claims?
- Which people determine how the company behaves?
- Which stakeholders can influence the company's reputation and performance on these issues?

Asking these questions helps a company realise the differences between how it sees itself relative to the perceptions of its key stakeholders.

Strategy development and action plans 7.38

Developing strategies and action plans involves selecting the most appropriate response options, deciding on the company's position, assessing resources, identifying stakeholders to be targeted and developing an action plan. The action plan would need to consider steps to be taken, responsibilities, timelines and measurement criteria.

A standard, bullet point template which describes the risk issue alongside a risk assessment, objectives, potential scenarios, strategic approach, key messages and summary operational, and communication actions can help to filter out all but the most important information for implementation purposes. In the case of partnerships and outsourced operations, for instance, this strategic approach communicates ethical values associated with a company's brand reputation to partners and subcontractors. For example, Nike is still dealing with production issues in Pakistan, because of unauthorised outsourcing of Nike products to unmonitored home workers, including underage labourers. (see also **CHAPTER 6**). This poses a major threat to Nike's efforts to improve its image as a corporate citizen. In the case of most industrialised economies, a template designed to ensure good corporate standing would include registered full-time employees with access to healthcare and other social benefits.

Implementation 7.39

Implementation is about putting the approved strategy into action and communicating the response effectively to relevant stakeholders. Testing position statements and engagement techniques may be a necessary first step. Building a support base and using trusted third parties for stakeholder research, and communication are also important considerations. The implementation phase will also require the preparation of supporting materials, which may include position papers, question and answers, press statements and websites. Throughout this process, the reputation risk 'radar' must be tuned to track media, Internet, and trend and event data influencing the issue. Internal communication is also essential.

Keeping the 'radar' tuned 7.40

Keeping the 'radar' tuned involves evaluation and ongoing vigilance. Answering the following questions may be useful:

- Has the issue become more serious in terms of its reputational impact and/or likelihood?
- Is there support among key stakeholder groups?
- To what extent has the issue faded from the radar?
- Can the company fulfill its objectives more effectively?
- What input can be proved to future strategies?
- What learning can be disseminated and built upon as part of this process?

Closing Comment 7.41

All of the above analyses together with the approaches discussed in the Appendix provide a sound practical starting point as regards reputational due diligence and risk management.

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Appendix

Examples of reputational risk management

In-house teams for multinational companies have begun to try and establish systems to satisfy these points. At the Institutional Investor Group on Climate Change meeting in London November 2003, Lord Browne, CEO of BP, announced that for an initial £20 million investment they had a return of £650 million. Other major companies have not been so adept at measuring these values and have turned to specialist rating agencies. The SERM Rating Agency, based in London, specifically rates companies on social, ethical, and environmental risk and reputational risk. They do this solely from the point of view of the external stakeholders' perceptions and express the risks as a percentage of market capitalisations. Their ability to quantify and measure these risks is becoming ever more popular amongst the FTSE 350 companies who are increasingly being forced to examine them not just from a reputational risk perspective but also from a legislative one (see **Figure 7.1**).

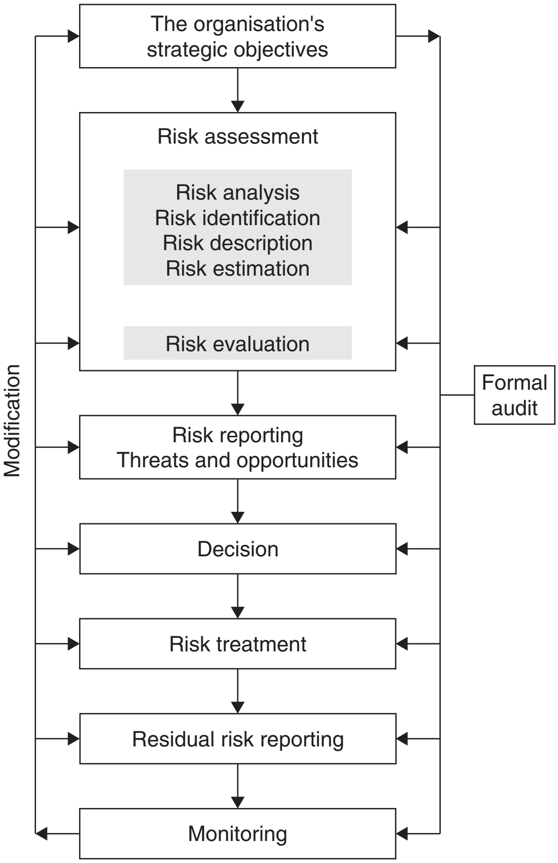
The organisation's strategic objectives
Risk assessment
Risk analysis
Risk identification
Risk description
Risk estimation
Risk evaluation
Risk reporting
Threats and opportunities
Decision
Risk treatment
Residual risk reporting
Monitoring
Modification
Formal audit

Figure 7.1: Suggested risk management process. *Source*: Reproduced with the kind permission of the Institute of Risk Management, the Association of Insurance and Risk Managers and the Association of Local Authority Risk Managers.

The above diagram, taken from the UK *Risk Management Standard* [12], represents the suggested risk management process and broadly corresponds to the six steps to successful reputation risk management proposes by J. Larkin. Indicating that reputation risk can be managed just as any other risk facing organisations today.

Reputation risk management, the Turnbull Report and the Combined Code

Following a series of relatively recent high-profile corporate disasters such as Enron, Worldcom, Maxwell, BCCI, etc., and controversy over directors' pay, the general trend towards risk awareness as an integral part of corporate governance has been supported by such guidelines as the *Cadbury Report* (1991) [3], the *Greenbury Report* (1995), the *Hampel Review* (1998), the *FSA Listing Rules*, the *Turnbull Guidelines* (1999), the *Higgs Report* (2003) [13] and the *Smith Report* (2002) [14] that were all incorporated into the *Combined Code on Corporate Governance* in July 2003. All of these recognise the importance of risk, management in safeguarding and enhancing the investments of shareholders as an integral part of corporate governance. The relevant sections of the *Cadbury Report* [3] states that:

> '4.23 The basic procedural requirements are that the board should meet regularly, with due notice of the issues to be discussed supported by the necessary paperwork, and should record its conclusions … Boards should have a formal schedule of matters specifically reserved to them for their collective decision, to ensure that the direction and control of the company remains firmly in their hands and as a safeguard against misjudgments and possible illegal practices. A schedule of these matters should be given to directors on appointment and should be kept up to date.
>
> 4.24 … such a schedule would at least include: risk management policies
>
> Boards should lay down rules to determine materiality for any transaction …
>
> 4.31 Directors are responsible under *s 221* of the *Companies Act 1985* for maintaining adequate accounting records. To meet these responsibilities directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimise the risk of fraud. There is, therefore, already an implicit requirement on directors to ensure that a proper system of internal control is in place.'

The Hampel Review (1998) states that the board should maintain a sound system of internal control to safeguard shareholders' investments and the company's assets not only by means of financial controls, but also risk management. The above principles have also been confirmed by the *FSA Listing Rules*, which require listed companies to supply the following information in their annual reports and accounts:

> '12.43A(a) a narrative statement of how it has applied the principles set out in Section 1 of the Combined Code, providing explanation which enables its shareholders to evaluate how the principles have been applied.'

Company directors increasingly have a corporate responsibility to identify risk and to ensure that adequate risk mitigation measures are in place. The *Turnbull Report* requires company directors of Stock Exchange listed companies to demonstrate a sound system of internal control to safeguard shareholders' investments and company assets. The Report recommends a regular programme to assess and evaluate all risks to the business – both internal and external. Historically internal audit procedures have concentrated almost exclusively upon confirmation of financial veracity, a position that is then verified by external auditors. The *Turnbull Report*, however, defines business risk in a much wider sense and requires that a company should consider and monitor its overall exposure to risk. Reputation is now so important that the *Turnbull Report* on corporate governance advises companies to treat it in the same way as all other assets.

The Turnbull Guidelines (1999) were produced to provide guidance to companies on what is required to comply with the *Combined Code* (1998):

> '17. In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board's deliberations should include consideration of the following factors:
>
> - the nature and extent of the risks facing the company;
> - the extent and categories of risk which it regards as acceptable for the company to bear;
> - the likelihood of the risks concerned materialising;
> - the company's ability to reduce the incidence and impact on the business of risks that do materialise; and
> - the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.'

The above document also states that the board's statement on internal control should disclose that there is an ongoing process for identifying, evaluating and managing significant risks. The **Appendix** of the *Turnbull Guidelines* provides a list of possible questions that should be asked in order to assess the effectiveness of the company's risk control process.

Questions related to risk assessment include:

- Does the company have clear objectives and have they been communicated so as to provide effective direction to employees on risk assessment and control issues?
- Are the significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis? (Significant risks may, for example, include those related to market, credit, liquidity, technological, legal, health, safety and environmental, reputation and business probity issues.)

Questions related to control environment and control activities include:

- Does the board have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks?
- Does the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?
- Are authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the company appropriately co-ordinated?
- Does the company communicate to its employees what is expected of them and the scope of their freedom to act? This may apply to areas such as

customer relations; service levels for both internal and outsourced activities; health, safety and environmental protection; security of tangible and intangible assets; business continuity issues; expenditure matters; accounting; and financial and other reporting.

Questions related to information and communication include:

- Do management and the board receive timely, relevant and reliable reports on progress against business objectives and the related risks that provide them with the information, from inside and outside the company, needed for decision-making and management review purposes? This could include performance reports and indicators of change, together with qualitative information such as on customer satisfaction, employee attitudes, etc.

Questions related to monitoring include:

- Are there ongoing processes embedded within the company's overall business operations, and addressed by senior management, which monitor the effective application of the policies, processes and activities related to internal control and risk management?
- Do these processes monitor the company's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, its business and its external environment?
- Are there specific arrangements for management monitoring and reporting to the board on risk and control matters of particular importance? These could include, for example, actual or suspected fraud and other illegal or irregular acts, or matters that could adversely affect the company's reputation or financial position.

The above questions do not purely relate to reputation risk management but to risk management generally as an integral part of corporate governance. However, the recognition of reputational risk issues mentioned earlier is clearly apparent.

Some argue that following the recommendations of the *Turnbull Report* regarding boardroom responsibility for risk management and accountability for intangible assets such as reputation; and the Higgs Review of corporate governance recommending a more active and independent role for non-executive directors (NEDs). NEDs should be appointed as reputation guardians for the corporation – in much the same way as they now sit on audit, nomination and remuneration committees. This recommendation was given added weight by the proposed implementation of the OFR in 2004, which was to embed reputational enhancement and protection in corporate reporting. Whereas the Business Review that has been introduced through the Companies Act 2006 is not so detailed generally, NEDs should use a powerful strategic management tool (stakeholder audits) to ensure that they can perform this task properly. They will also need the support of an experienced communications function, which will be critical in conducting, interpreting and advising on appropriate courses of action arising from any stakeholder audit (see also **Chapter 10**).

8

Cultural due diligence

8 Cultural due diligence

CHAPTER OVERVIEW 8.1

There are many lengthy publications, manuals and books that address the vital matter of corporate culture. Whereas it is important to touch upon this issue it is not intended to examine it in depth. Moreover throughout this handbook it is referred to in related topics, such as in the context of governance in the family business discussed in **Chapter 18**. Therefore, in this chapter selected aspects will be considered in accordance with the theme and discussion of due diligence, risk management and corporate governance as set out in **Chapter 1**. Since the earlier edition cultural due diligence (CDD) has become more acknowledged. For instance, having regard to the trends in favour of outsourcing, for example (see also the **Appendix**), it is important that businesses should make it clear whether or not this is part of their corporate culture. Through CDD the human side of transactions and operations can be given the same scrutiny that has traditionally been applied to the more quantitative assets of companies. This also has ramifications for the success of a transaction such as a merger or acquisition as it goes to the heart of the business decisions and can involve broader international considerations. If they do not do so misunderstandings within business relationships can arise. Indeed the approach of an organisation to, for example, diversity, gender, employment practice, the environment, health and safety and other key issues can all form part of the corporate culture. According to various experts and practitioners CDD (see further below) includes:

- leadership: vision, mission, values, ethics, etc;
- communication;
- infrastructure;
- involvement and decision-making;
- finance;
- change management;
- cultural descriptions including predetermined values to reflect the values of the organisation;

- overall corporate climate to listen and encourage suggestions from workforce; and
- sharing.

It should also be noted that much of what has been covered in most of the earlier chapters could be described in terms of ongoing CDD.

The success or failure of a business depends very much on the quality of the decisions it makes. Decisions are made by everyone within the organisation at all levels and range from those involving strategic direction, major investments or acquisitions to those evidently simple tactical judgments made on the shop floor of the business. For instance, as regards the development of the brand it has already been seen that a brand is more than a product – it is a promise. No matter how globally aware consumers become they will always want to carry out business with brands they know and trust – brands that fulfil an actual or implicit promise made by the company. The key to the promise is the most powerful word in branding today – trust.

Building and nurturing brand trust have never been more important than in the current climate of suspicion of corporate behaviour. For example, in 2004 in the retailing sector Gap Inc was developing strategies to fend off any sweatshop image in its use of factories in places such as China, Taiwan, Saipan, Cambodia and sub-Saharan Africa by spending resources on training and helping factories develop their own compliance programmes. Gap has been working with NGOs and local authorities on labour policies. Meanwhile in the banking sector Merril Lynch has been accused of having a culture of sexual discrimination. On the other hand, in 2004 the oil giant BP announced its commitment to diversity that has its roots in a larger cultural shift. The then CEO stated that he intended to create a positive culture of ‘inclusiveness’. In addition, competing marketing messages, brand pollution and consumers’ propensity to shop around for the best price mean that familiarity and brand awareness are ever more precious. They are critical to building and maintaining sustainable success. Recently, valuing human resources has been described as crucial not only in general policy but also in daily office practices. The approach to all of this reflects the culture of the business.

Since the first edition of this handbook significant trends in favour of innovation have occurred that have obvious links with corporate culture and human resources. In the UK, for instance, the Department for Business Enterprise and Regulatory Reform (BERR) has encouraged a culture of innovation in order to improve competitiveness. Experts have noted that companies that innovate successfully tend to get right what have been termed the six ‘P’s’: planning, pipeline, process, platform, people and performance. Innovation is of course more common in small and medium-sized enterprises (SMEs) and start-ups where a single idea, product or individual may comprise a large part of the assets. As the organisation grows management structures and the need to formalise processes can limit creative growth. This can often mean that employees become removed from the innovation initiatives and they become less likely to offer innovative ideas. Building a culture of innovation relies a great deal upon the example set by a company's leaders, and, as with the factors referred to above, the following useful pointers can assist:

- foster trust and openness;
- encourage openness;
- set innovation goals;
- minimise bureaucracy;
- encourage brainstorming;
- take risks and allow failure;
- give constructive feedback:
  - discard irrelevant or ineffective ideas; and
  - reward carefully and appropriately to maintain the team spirit.

A managed risk culture 8.2

All decisions present different levels of risk: sometimes the risk will be obvious and the decision-maker will consider the risk formally or intuitively. At other times the risk will not be so evident and therefore will not be taken into account or prioritised. Clearly in the context of CDD one challenge is how to get risk management integrated within the decision-making process so that risk is considered as a normal part of business and its internal due diligence. In this discussion of CDD, it is intended to focus on the importance of risk management being part of that culture to enable successful business alliances. Creating a culture with the objective of 'no surprises' does not mean that the company becomes risk averse. Rather, it is free to take risky decisions with comprehensive and intelligent knowledge of what the risks are.

According to many risk managers a managed risk culture can be defined as creating an environment that:

- enables people to take more effective decisions;
- allows risks to be fully understood so that calculated risks can be taken;
- encourages employees to consider the consequences of decisions and actions that they take.

It is true to say that such a risk management culture can be positive for the generally perceived culture of the business, as well as its brand/s and its reputation.

As has been discussed in the discussion of reputation in **Chapter 7**, a risk management tool is of particular use to the director of corporate communications because it provides a comprehensive and scientific basis on which to argue for increased focus on reputation management strategies. Given the constituent parts of the overall reputation story – brand, vision, values, media, public affairs and public policy, compliance, governance, regulation, corporate responsibility – a framework for improved co-ordination of the reputation management strategy is important. The tool is also valuable to the risk director since it provides hard data for inclusion in the company risk register, where it is possible that no entries have been made before, either in terms of categorisation or value. It will also become more important to the company secretary for business review reasons referred to in **Chapter 10**. A value for intangible assets, and related values for the component parts, is of tremendous importance in today's business climate. The brand and the culture of a business are intangible assets that are of utmost value, yet rarely taken into account. Taken together, the increased visibility which results from the valuing of intangible assets, and the improved understanding of what is necessary to control, mitigate and eliminate the risks associated with a decline in asset values, should lead to strengthened risk management, reputation management and financial modelling procedures. The innovative approach that takes account of intangible assets beyond goodwill alone also presents the opportunity to refresh and redefine key parts of business process such as:

- improved techniques for risk and reputation management;
- the mitigation of threats/disaster recovery planning and crisis management;
- the supply value chain and other partnerships;
- alignment and incentives for all betterment initiatives including good corporate governance.

More powerful applications of the tool relate to issues such as:

- the implications for strategy;
- articulating and communicating the corporate character and 'personality' of the company;
- stakeholder engagement and management by the alignment of internal behaviours and external expectations; and
- change management programmes (see **8.3**).

Whereas **Chapter 7** has discussed brand and reputational risk issues in more detail, here the connection between brand and corporate culture should be specifically noted. In this respect, broadly speaking a brand is regarded as a particular product or a characteristic that identifies a particular producer. To be a successful brand one of the most important issues facing the board – and the marketing director specifically – is to establish a customer-driven corporate culture. As has been noted above companies can decide upon positive strategies as regards their culture. This is particularly important when they are acting globally and deal with external concerns such as location, which involves language, regional and other cultural differences. Even the regulatory culture has to be considered, and flexible internal cultural policies implemented accordingly, along with some demonstration of, for example, a sensitive corporate social responsibility (CSR) strategy along the lines proposed below. Cultures can motivate and stimulate companies and increase productivity and profit while balancing any stress factors. This is also clear from the study of outsourcing in the case of India. A positive culture – especially one that espouses CSR and many of the features described in the context of enlightened corporate governance – can be invaluable (see also case study in **Chapter 12**).

Human resources and cultural due diligence

All of these cultural issues are increasingly linked with attracting talented human resources. According to recent trends prospective employees like to conduct due diligence on their prospective employers and culture is a key deciding factor. For instance the Great Place to Work Institute (GPTW) has developed a due diligence tool in this regards to explore a potential job offer. GPTW has developed pillars of trust that evidently have proved to be accurate in 30 countries. These are: credible management practices; respectful relations between managers and employees; fair treatment and processes; pride and a sense of camaraderie in the following checklist.

Credibility

What are the core values that guide executive decision-making and how are managers held accountable for living the values?

What do the values and vision say about employees' contributions to business success?

Respect

How are employees' contributions recognised, developed and encouraged?

Do workers have a voice? Does the climate allow employees to speak openly about mistakes and learn from them?

Fairness

What commitment do executives make and what concrete actions has the company taken to foster a work environment free of discrimination and favouritism?

How equitable and balanced is the distribution of perks, recognition, rewards and training opportunities *at* the organisation?

Pride

What is the basis of the company's reputation as an employer, and how does this play out for employees? Do its claims about being a top employer have substance in the eyes of employees?

Do employees express genuine pride in their job and company?

Camaraderie

How are new employees at any level welcomed and made to feel part of the workplace community?

Do employees from the front lines to the executive suite actually enjoy their co-workers and have fun at work?

Source: Cultural due diligence by Graham Lowe, *Canadian Business*, 23 April 2007, pp. 60–61.

Creating a sustainable marketing culture has been described as one of the hardest tasks facing business. It requires:

- proper training and education;
- sharing good practice;
- awareness and commitment on all levels;
- excellent corporate communications.

Marketers of a business also have to think and act as 'brand champions'. Brand strategies include consideration of the following questions:

- Has a clear philosophy on the corporate brand evolved?
- Has there been a thorough investigation of the brand portfolio?
- Has it been established which brand needs boosting – perhaps by buying brands – which brand requires development and which should be pruned or sold?
- Has the management of the brands been incorporated into the organisational structure?
- Is there a logical system for brand naming?
- Has the company tried to establish a financial value for its brands?
- Have the local nuances in new markets been thoroughly investigated to try to decide which brands can travel?

In terms of corporate culture certain questions can form an initial checklist that can impact on several departments:

1. Is there a defined strategy for changing the corporate culture?
2. Has a corporate identity programme been carried out in place of noticeable corporate cultural change?
3. Is there real communication in the organisation or do employees tell superiors what they want to hear?
4. What is the first impression given by reception when calls are answered?
5. What is the role of the marketing director?
6. What is the role of marketing beyond spending on advertising?
7. Has restructuring been considered to integrate marketing with sales?
8. Do the various departments know what the others do?
9. Is there a philosophy of moving staff around to perform different functions?

Change in culture must be focused on:

- employees;
- leadership style; and
- organisational processes and functions.

Change management 8.3

This is another vital aspect of corporate culture that requires ongoing monitoring in the context of ongoing due diligence and good corporate governance. As has been emphasised in earlier chapters change has become the only real constant in everyday business life. All kinds of changes take place: social, technological, political, economic and cultural. These changes develop at an accelerating pace. Every day we witness different products, new markets and different customers. Some of the resulting significant challenges have been referred to as the five 'C's':

- competition;
- change management;
- complexity of business;
- control needs; and
- creativity.

The business has to try to cope with the changes by initiating:

- new organisational structures;
- re-engineering;
- re-structuring;
- alliances;
- mergers;
- hostile takeovers;
- acquisitions;
- joint ventures; and
- other potential arrangements.

As has been seen above, changes in the organisation and its priorities are becoming an integral part of the global business scenario. The business has to be alive to all changes to meet them effectively. Management has to anticipate and meet effectively the challenges in order to align their business with changing markets and customer needs, and implement this proactive approach into its culture. In this context it is helpful to consider the role of what are often described as strategic alliances.

Strategic alliances **8.4**

Bearing in mind the issues of brand and culture that have developed over the last few decades, the business world has witnessed many strategic alliances as a way to:

- secure competitive advantage;
- share costs;
- leapfrog into new markets; or
- protect existing ones.

Such strategic alliances can appear in a variety of forms, from full-blown mergers and acquisitions or joint ventures to co-operation agreements in areas such as:

- licensing;
- technology and research, technology and development agreements;

- long-term buyer–seller agreements;
- market alliances.

They can provide positive advantages, by helping companies to:

- gain competitive advantage with less risk and expense than going it alone;
- gain economies of scale from partners in the same sector;
- share development costs;
- swap technical know-how;
- gain a wider presence – this being useful when takeover targets are scarce;
- overcome cultural and language barriers;
- enter complementary product lines;
- enlarge distribution reach.

In this respect too change management is another significant area that requires ongoing business focus. Not only should business therefore develop a proactive culture as part of its ongoing CDD, but also it should seek a similar approach in the area of potential business partners and business transactions.

Culture clash in mergers and acquisitions – risk mitigation 8.5

In **Chapter 1**'s consideration of transactional and operational concerns, some comment was made regarding the high failure rate of merger and acquisition that occurs post-completion. This is the case in spite of the traditional due diligence processes. The research data on why some 55–77% of mergers and acquisitions fail in meeting their intended results is absolutely clear. This is the case in many parts of the world. Many experts have found that the failures are overwhelmingly attributable to 'culture clash' that occurs as attempts to bring the two organisations together are made. The problem is that this makes merging the two organisational cultures or establishing a new culture for the merged organisation extremely difficult, if not impossible. The inevitable result is the expensive demerger. In this connection it is important to understand how to avoid the culture clash and what to do post-merger when expected results have not occurred.

In those instances where the organisations are merged, the ongoing direct and indirect costs of unresolved 'culture clash' issues are high, and require the merged organisation to focus on internal issues and problems rather than on the marketplace, the customers and the competition. In this connection a full and appropriate CDD exercise can make a huge difference (see **8.6**). Moreover, in this era of global merger and acquisitions that involve regions with very different approaches to doing business, one key issue that impacts on the success of the transaction is whether or not the organisations involved are family run businesses (see also box below and **Chapter 18**).

The family versus professional corporate culture and regional developments

Family firms – and values – still impact hugely on global business life and they are especially important in the emerging markets of Asia and Latin America (see also **Chapter 18**). One such firm in the USA, Cargill, has grown into a giant multinational corporation employing 70,000 people, with sales of $50 billion, and remains a private family firm. Even among industrial countries there are major differences. Germany, Japan and the USA were quick to adopt the corporate form of organisation as they industrialised in the late 19th and early 20th centuries, and today their economies are hosts to giant, professionally managed corporations like Siemens, Toyota, Ford and Motorola. By contrast, the private sectors of France, Italy and capitalist Chinese societies like Hong Kong, Taiwan and parts of the People's Republic of China (PRC) have been dominated by smaller, family owned and family managed businesses. Experts have indicated that these societies have had difficulties in institutionalising large-scale private corporations; their relatively small companies, while dynamic, tend to fall apart after a generation or two, whereupon the state is tempted to step in to make possible large-scale industry. India has also been dominated by small, family owned and family managed businesses (see also **Chapters 12** and **18**). According to various experts, with few exceptions, there has been a cultural resistance among Indian firms to institutionalise themselves. As a result, until recently there have been relatively few large, hierarchical, professionally managed corporations of the kind that have developed in Japan and the USA. Evidence suggests that large autonomous corporations are needed to exploit the economies of scale in capital-intensive, complex manufacturing processes or extensive distribution networks. Smaller, family style companies tend to be better at more labour intensive activities, which demand flexibility, quick response and innovativeness. Traditionally, large corporations have gravitated towards semi-conductors, automobiles and aerospace, while smaller businesses have created clusters in fashion apparel, software, machine tools and furniture.

The difficulty experienced by Indian (and Chinese) businesses in institutionalising themselves into large professionally run corporations may historically have kept them out of certain sectors which demand scale and certain strategic types of technology. The success of the Italian, French and Chinese small enterprises suggests that being a family firm per se is not necessarily a disadvantage. However, a successful family firm must be able to professionalise. It must be capable, for example, of recruiting and retaining outside professional talent. In a competitive world, it must be able to get the best person to run the company. If the family member is not the best person, then it must be willing to hand over the management to an outsider (see also **Chapter 18**).

The CDD process in mergers and acquisitions 8.6

As has been emphasised above the cultural direction of managers and their decisions are noted by stakeholders, both direct and indirect. It is important to bear in mind that organisational culture is critical to organisational effectiveness. Also, managing the culture is vital to successful business operation. This is particularly important in times of large-scale change, such as an acquisition or alliance. Fiduciary responsibility and due diligence require careful examination of the cultural aspects of any acquisition as a major component of the ability to actually run the operation and achieve the potential synergies.

The cultural audit

The first step in managing the human aspects of a merger or acquisition (M&A) requires undertaking a cultural audit in order to develop an understanding of each company's culture and how the combining of culture affects the success of the M&A. Surveys are recommended to solicit feedback regarding: organisational culture; core values and philosophy; commitment to vision and strategy; leadership practices; respondents' desired culture; organizational norms such as methods of communication, decision-making, etc. Through the audit decision-makers can systematically address potential threats and take necessary steps to deal with them before they severely impede the transition following M&A.

The CDD process can be described as a systemic, systematic and research-based methodology for significantly increasing the odds of success of mergers, acquisitions and alliances. Until recently it has been an overlooked parallel process to the traditional financial and legal due diligence that is considered absolutely essential to any merger or acquisition (see comments on environmental due diligence by way of comparison in **16.1** in **Chapter 16**). As with other forms of due diligence the CDD process is proactive and problem solving in advance of the transaction, the merger and acquisition or deal.

By assessing the characteristics of both organisations' cultures as soon as possible in the merger process, potential culture clash problems can be predicted, prioritised and focused on in a comprehensive cultural integration plan. Such a plan will guide the integration of the two cultures, or the building of a new culture for the merged organisation in full consideration of the cultural issues and 'landmines' that are a part of the terrain. Bearing in mind the failure rate and the costs involved in every way, CDD is at least as vital and necessary as traditional legal and financial due diligence in providing an informed basis for executive decision-making and planning, and perhaps more so in increasing the odds of success of the merger or acquisition.

CDD involves sound leadership and management. It offers decision-makers in both organisations:

- comprehensive, data-based predictions of culture clash problems that will occur within the merger process;
- the relative priority of those problems;
- recommendations on how to eliminate their cause or minimise their impact before they occur.

The results of the research in this regard are clear: CDD is overlooked at the peril of the success of the merger or acquisition. It is therefore also important that a business develops a positive proactive culture as part of its ongoing due diligence and corporate governance practice before any transactional issues are raised.

As in the case of any sound organisational research the CDD process employs both qualitative and quantitative data collection, and includes:

- interviews;
- focus groups;
- workplace observations;
- documentation reviews;
- web-based CDD surveys.

One approach to analysing and organising CDD data is to group the findings within 12 domains of the CDD process, although the data can be organised around the key elements of the business plan, or in a manner that will be of greatest value to the two organisations.

The CDD model 8.7

When performing CDD during, for example, a merger or acquisition, it is necessary to gather operational and behavioural data on the relevant domains in both organisations: the one acquiring and the one acquired. Once data is collected from both organisations, this can be contrasted and compared, having regard to potential areas of conflict and/or misunderstanding and of synergy and leverage.

The 12 domains of the CDD process 8.8

A brief description of each of the 12 domains follows. These descriptions provide a general sense of each area and are not meant to be definitive. They enable an understanding of the key issues that fulfil the broad requirements of good corporate governance.

The 12 domains generally cover the relevant issues of corporate culture. However, at least two areas commonly mentioned in discussions of corporate culture may appear to be overlooked:

- values and beliefs;
- myths, legends and heroes.

In actuality, data on these issues are embedded in the 12 domains. By analysing each domain, underlying values and beliefs are uncovered. This is far more effective than simply asking a representative 'what are the values and beliefs around here?'

The same is true of myths, legends and heroes. These are simply the anecdotal versions that give more direct and immediate meaning to the belief systems operating in a company. Myths, legends and heroes will present themselves when the 12 domains are considered, but only if qualitative data gathering techniques are used.

1. Intended direction/results **8.9**

It is important to ascertain, from the top of the organisation to the bottom, what the company intends to accomplish. Key questions that should be raised are:

- What is the business plan about?
- What is the intent and purpose of the organisation?
- What results are expected from the business activity of the organisation?
- How are these issues discussed and communicated?

2. Key measures **8.10**

This domain encompasses what the company measures, why and what happens as a result. The key measures demonstrate a great deal about the manner in which the company and its executives and staff are driven, particularly when the consequences for each measure are also considered. A comparison of key measures across the two companies is an important consideration and cultural indicator.

3. Key business drivers **8.11**

This demonstrates how the company views its industry and its subsequent efforts within the industry. If one company defines success in terms of total market share while another defines it as net profit margin, there is considerable room for disagreement around such matters as what actions are appropriate to correct unacceptable results, or decisions on appropriate new product offerings. Questions to be raised include:

- What are the primary issues driving the business strategy?
- Is the focus on competitive edge? and if so, how is that defined, for example by price differentiation, quality, market share, service, reliability, etc.

4. Infrastructure **8.12**

Under this heading relevant questions are:

1. How is the company organised?
2. What is the nature of the reporting relationships?

3. How do the staff systems interface with the line systems?
4. What is the nature of the relationship between groups and units in the organisation?

5. Organisational policies and practices **8.13**

This domain raises such issues as:

1. What formal and informal systems are in place?
2. What part do they play in the daily operations of the business?
3. How much flexibility is allowed – at what levels and in which systems?
4. What is the relationship between political reality and business reality?

6. Leadership/management practices **8.14**

While there are clear behavioural differences between management and leadership functions, both are clearly important in running a successful business. The issue is around which approach is predominant in each area/department of each company. This domain relates primarily to the middle management group but has obvious impact on the next area. Questions to consider are listed below:

1. What is the balance between leadership and management approaches with staff?
2. What basic employee value systems, such as the degree of supervision or delegation, are in place?
3. How are employees treated and why?
4. How is the business plan implemented through the management system?
5. How are decisions made?
6. Who is involved in what, and when?

7. Supervisory practices **8.15**

Supervisory practices have a major impact on employees and their feelings about the company and the work they do. The nature of the interaction between the employee and their immediate supervisor is one of the primary tone-setters for the culture of the company. The main issue is what is the degree of delegation, level of trust and responsibility between the supervisor and the employee?

8. Work practices **8.16**

The manner of work practices is also a vital area of concern, especially considering overseas cultures and their differing practices. Sample questions are:

- How is the actual work performed?
- Is the emphasis on individual responsibility or group responsibility?
- What degree of control, if any, does the individual worker have on the workflow, quality, rate, tools utilised and supplies needed?

9. Technology utilisation 8.17

This is an important domain both in relation to internal systems and equipment, as well as the services and products provided to customers (see also **Chapter 9**). Key questions are:

- How current is the technology being utilised?
- What are people used for in relation to technological support/resources?

10. Physical environment 8.18

Many aspects of the physical environment can have a bearing on how people feel about work and the company. Changes in these areas, particularly if it is perceived as arbitrary, can result in bad feelings for years. Useful questions are:

- How do the workplace settings differ?
- What are the differences between:
  - open work spaces versus private offices;
  - high security versus open access, buildings, furniture, grounds?

11. Perceptions/expectations 8.19

This is another crucial domain affecting governance of the business. Questions for consideration are:

- How do people expect things to happen?
- What do they think is important?
- What do they *think* should be important, versus what they believe the company feels is important?

12. Cultural indicators/artefacts 8.20

This domain covers the following key issues:

- How do people dress and address each other?
- What is the match between formal work hours and actual hours spent working?
- What company-sponsored activities exist and what are they like?

CDD deliverables 8.21

All of the data collected by means of the CDD process is carefully analysed and organised into a number of extremely valuable management tools to be used by executive and senior management in planning the integration of the two organisational cultures into a desired new culture of the merged organisation. These tools include:

- detailed cultural profiles of both organisations;
- perceptions of various departments of both organisations;

- assessments concerning the current culture and the merger;
- specification of cultural similarities within the 12 cultural domains;
- specification of cultural differences within the 12 cultural domains;
- prediction, specification and prioritisation of 'culture clash' problems and their impact on the merger;
- specific recommendations on avoidance and/or minimisation of culture clash problems;
- integrated road map for implementation of recommendations.

Given this information and these management tools, key decisions can be made early in the merger process that will:

- minimise culture clash problems;
- facilitate the optimum integration of the two cultures;
- greatly increase the probability of success of the merger.

CDD and other activities **8.22**

The extent to which legal and financial due diligence are performed competently plays a significant role in determining the successful integration of two organisations. Exclusively focusing on these concerns, however, understates the reality that a merger is similar to a marriage if two people who may have very different personalities. Therefore the human side must not be ignored.

Moreover it should be noted that the points raised above in the discussion of the CDD process in conjunction with mergers and acquisitions are also relevant to a discussion of CDD relating to an organisation's ongoing operations especially bearing in mind the trend in favour of the use of CDD to attract quality human talent and resources noted above. Also the points raised are discussed in other chapters in relation to best practice and corporate governance.

Appendix

Outsourcing and offshoring – the Indian case study

Introduction

For some time the world has been talking about the 'Indian BPO (business process outsourcing) success story' – a story of an industry that is growing at a phenomenal pace of 59% year-on-year and contributing nearly a quarter to the total IT exports revenue. Many strategy experts attribute this growth to the inherent advantages that India possesses, for example low cost base, vast English-speaking population and a highly skilled manpower. Undoubtedly, cost savings due to labour arbitrage continues to be one of the most compelling factors for offshoring processes to India. In addition to this, rising vendor sophistication, improved process and project management skills and quality standards have given India a pre-eminent position in the US$275 billion global outsourcing market. However, the real challenge before India lies in its ability to maintain its strengths and build newer capabilities to tackle increasing competition from countries like Ireland, China and Israel, for example.

With the objective to chart a strategic road map for unhindered growth of this industry and to gauge the perception of Indian BPO service providers on various issues, ASSOCHAM (The Associated Chambers of Commerce and Industry of India – one of the leading Indian corporate representative bodies) conducted the 'First BPO Industry Confidence Survey' in the months of May to June, 2003. Coincidentally, this was also the period when domestic and international media highlighted the outsourcing backlash in the USA, Australia and European countries and the possible impact it could have on the Indian BPO industry. This nationwide survey evinced a huge response, especially from the BPO SMEs, and gives some view from the Indian perspective while so much media coverage has dealt with the issues form the developed world. In India, leading companies like eFunds International, Bhilwara Infotech, 24/7 Customer Access, Transworks, HCL BPO, ITI Limited and Indigo Lever also participated in this opinion poll. Overall, 160 CEOs responded to this survey.

Research methodology

In planning this survey, the ASSOCHAM BPO research team implicitly accepted the potential, opportunity and drivers of the trend to outsource processes to India. The questionnaire survey was specifically modelled to study the underlying issues that could become future threats for this industry. Accordingly, the questions covered the following aspects:

- Short and long–term impact of:
  - slow pace of regulatory reforms;
  - infrastructure bottlenecks;
  - lack of streamlined approach for branding Indian BPO services;
  - increasing competition from other countries with similar capabilities;
  - increasing service level requirements;
  - geo-political situation in sub-continent;
  - rising attrition rates/other human resource issues;
  - US and European backlash against outsourcing;
- Level of satisfaction on the human resource and telecom infrastructure in India.
- Acceptability of the government policies/initiatives in this field.
- Future direction of the government's BPO agenda.
- Overall confidence on the future prospects of this industry.

Findings of the survey

Short- and long-term impact analysis

Slow pace of regulatory reforms: the members of ASSOCHAM BPO Steering Committee have recognised regulatory issues as one of the major concerns for

Indian companies in this area. While the government has increased support to the IT/ITES (information technology enabled services) industry, many industry experts point to the tardy pace of these reforms.

Industry opinion:

- short to medium term (0–2 years) – moderate impact (50%);
- long term (2–5 years) – serious impact (54%).

The survey clearly showed that industry is concerned over the long-term implications of slow pace of regulatory reforms. Broadly, the policies/acts pertinent for this industry are:

- Information Technology Act 2000;
- Software Technology Park policy;
- Foreign investment policy;
- Venture Capital investment policy;
- overseas investment policies (mergers and acquisitions, American depository receipts/global depository receipts (ADR/GDR), remittance of profit, for example); and
- other fiscal incentives.

The government in consultation with industry associations should chalk out a time-bound plan that covers the various loopholes in the above-mentioned policies. Significantly, very recently it has been reported that India's IT outsourcing sector is heading for crunch time in 2008, as a rising currency and increasing wage and real estate costs force the industry to rethink how it does business. It has also been reported that while multinationals continue to view the country as one of the most viable outsourcing destinations, competitive pressures are making other countries look attractive. Indian IT outsourcing companies earn most of their revenue in foreign currencies, particularly dollars, but they incur most of their costs in rupees. Much of the negative sentiment concerns the stronger rupee, which hit Rs 39.16 against the dollar in late 2007, its strongest level since March 1998. India's IT outsourcing companies have been among the worst performing on the stock market in 2007. The sector has underperformed the MSCI India index by 47%. This has in turn created additional stress (see further below) in many respects.

Leading companies in this sector, such as Infosys Technologies and Tata Consultancy Services, have so far largely maintained their margins. Measures they have used to keep margins up include moving more work onshore and hiring cheaper graduates from disciplines other than engineering. They have also employed hedging. Analysts believe, however, that a longer-term shift in strategy is necessary if India's IT companies are to prevent more work going overseas to emerging centres such as Vietnam, China and Brazil. Gartner, the research group in a 2007 study of outsourcing destinations, found that India accounted for 28% of the estimated workforce available globally for offshore work. That makes the country the largest such labour pool in the world. However the study also found that costs were rising fast. Salaries are climbing an average 14.5% a year, almost double the rate in China and the Philippines, and the rate of attrition is 20–25%.

‘The attrition [rate] leads to the challenge of consistency and therefore of quality for buyers of these services’, said Ian Marriott, Research Vice President at Gartner. ‘And so the whole appeal of India is starting to just lose a little bit of the gloss. It’s still very appealing for a whole variety of reasons but it’s starting to get people thinking: should we investigate other locations as well, probably not as an alternative necessarily but in addition to India’. According to him, Indian companies need to move away from thinking that more demand means more hiring and extracting greater productivity out of existing workforces. Moreover while the larger companies were also trying to become more global and were setting up centres in other offshoring locations, this was not an option for the SME outsourcers. These smaller companies had to become more specialised. ‘They’ve got to be very niche by design and very focused on specific markets, specific services, specific kinds of customers’, Mr Marriott said.

Meanwhile ASSOCHAM has recently also found that work-related stress and mental fatigue – mainly blamed on expectations of better performance, deadlines and competition – is taking a toll on Indian employees in sectors like construction, banking, media, shipping and small-scale industries. A survey has revealed that ‘the menace of stress and mental fatigue has intensified in recent times at the top and middle positions of sectors comprising construction, shipping, banks, government hospitals, trading houses, electronic and print media, courier companies, small-scale industries, retail and card franchise companies’. These sectors are becoming high-stress zones like BPO, call centres and IT companies due to:

- deadlines;
- demand for high performance;
- shortage of staff; and
- threats from competitors.

Working conditions are also a factor which contributes to the stress level of employees, the survey shows. The survey of nearly 200 Indian employees revealed that top executives such as civil engineers, architects, contractors, marketing managers, quality controllers, editors, reporters and copy writers brave stress and take home its adverse impact. While professionals like chartered accountants, lawyers, tax consultants and those in sectors like automobiles, infrastructure, advertising and NBFCs enjoyed better working conditions, others were not so lucky.

In the case of construction companies, employees have to execute their work in a scheduled period, keeping in mind cost and time factors. Those working in the banking sector – both public and private – tend to get stressed as they have to attract a large pool of customers for various schemes besides ensuring timely recovery of loans. Government hospitals in India face acute shortage of trained staff and professionals, coupled with large inflow patients, which cause stress to the employees. Employees of media organisations work under pressure for long hours, causing insomnia and other stress-related problems, the ASSOCHAM survey has found. Employees of small-scale industrial units in India have to work 15–16 hours, adversely affecting their mental health and leading to depression. In contrast, the stress level among employees in ministries, central and state government offices, institutions and bodies funded by central and state governments is very low owing to limited working hours, surplus staff and lack of competition. ASSOCHAM has suggested that rest rooms be set up in offices and relaxation techniques like meditation, deep-breathing or yoga be practised during working hours, which can help reduce stress.

Infrastructure bottlenecks

Availability and reliability of infrastructure facilities is still cause of serious concern. However, the government is attempting to strengthen telecom infrastructure and build fibre-optic networks in city centres of software activity, as well as providing uninterrupted power supply. Much of these efforts have drastically improved power availability and telecom density.

Industry opinion:

- short to medium term (0–2 years) – serious impact (86%);
- long term (2–5 years) – very serious impact (47%).

An overwhelming 86% of the respondents view infrastructure as a serious cause of concern in the short term. In the long term, majority felt that poor infrastructure would have a very serious impact.

Lack of streamlined approach for branding Indian BPO services – recommendations

Industry experts have often suggested that India should have an ‘umbrella brand’ for IT and ITES industry. The marketing of India as a BPO destination until now has been mostly at the behest of service providers themselves. The industry–government partnership in this field needs to be strengthened. There has been a lack of a streamlined approach on branding Indian BPO abroad: some of the issues raised above should be integrated as regards the future of the sector.

9

Information technology and e-commerce: issues of due diligence, risk management and corporate governance

9 Information technology and e-commerce: issues of due diligence, risk management and corporate governance

CHAPTER OVERVIEW

9.1
As the business world continues to reel from corporate scandals in many jurisdictions, companies also have to cope with more stringent regulatory frameworks. Compliance with a whole range of new legislation and standards has become a major concern and, increasingly, companies are looking to technologies such as business intelligence to offer some solution. As the discussion in **Chapter 11** demonstrates, the *Sarbanes-Oxley Act of 2002* (*SOX*) legislation has provided much of the pressure in the USA in that it requires companies to strengthen their internal controls and increase levels of financial disclosure. As noted, while the US framework is primarily aimed at US business, SOX also applies to companies from other countries that are listed on the US stock exchanges. As a matter of corporate governance, US companies will expect suppliers to conform to the same standards regarding the retrieval and retention of records. Meanwhile in Europe the International Financial Reporting Standards (IFRS) came into force on 1 January 2005. IFRS is intended to make it easier to compare the performance of listed companies in different European Union (EU) countries. Its adoption demands greater transparency from companies' financial reports such as the requirement to account for certain financial instruments at market level.

Whereas the UK's proposed operating and financial review (OFR) requirements were withdrawn the Companies Act 2006 which has been passed includes a business review. Moreover experts have generally agreed that what remains is the requirement for companies to include a fair review of their business in their Directors' Report, in accordance with requirements introduced by the European Accounts Modernisation Directive. The key requirements of the business review are largely similar to, though more flexible than, those of the proposed OFR: they represent a significant enhancement in narrative reporting from previous requirements.

Advisers have pointed out that, like the OFR, the business review requires:

- a balanced and comprehensive analysis of the development and performance of the company during the year and the position at the end of the year;
- a description of the principle risks and uncertainties; and
- an analysis using financial and non-financial key performance indicators (KPIs) including those relating specifically to environmental and employee issues.

Companies will also need to consider:

- disclosing information on trends and factors affecting the development, performance and position of the business where this is necessary for a balanced and comprehensive analysis; and
- providing an indication of likely future developments.

It has been suggested that compliance with the OFR statement will remain best practice and both strategic and forward-looking information will continue to be much appreciated by shareholders. Further useful comments on the OFR and the Companies Act are found in **Chapters 4** and **10**.

While all of this legislation may seem overwhelming, the overall intention should be recalled: to enable stakeholders to see financial statements clearly and accurately. The regulations require businesses to be able to produce, when requested, both financial information and records of how decisions were made.

In practice data must be accurate and accessible rapidly so that:

- auditors are able to see a company's financial statements; and
- auditors are able to look in detail at the data that was input into those statements.

The presence of a good business intelligence solution system is becoming increasingly important. It should have a data warehouse that ensures that all reports are based on the same information. It should provide a solution that allows users to follow an audit trail by 'drilling down' from the high level into more detail. For instance commentators have remarked that had Shell been compliant with *SOX* they would not have been able to state that they thought that they had one-third more oil reserves than they actually had. One of the requirements of *SOX* is for real-time reporting so that if a major event takes place that has an impact on a company's financial statements then the company must respond quickly by making updated financial reports available. This requires:

- having a very agile infrastructure;
- being able to capture information in relative real time;

* having the tools to assess it very quickly; and
* assessing the implication for the profit-and-loss account or balance sheet.

Some experts warn that many firms implementing solutions are losing sight of the need for a holistic view by considering, for example, the regulations separately. For instance initially the Basel II Convention (which revised the international capital framework and caused enterprise risk management in banking to align adequacy assessment with underlying credit risk, market risk and operational risk) and IFRS requirements on reporting losses were not compatible. Although the issue has been resolved, such conflict demonstrates the need to take a high level view. In addition, by taking a short-term view that solves current problems, businesses fail to protect themselves against possible merger and acquisition issues. To deal with the constant increase in new demands, solutions should provide a coherent view across the organisation and the functions that are in place within it.

Therefore, it is clear that in today's complex business world companies that use the right business intelligence should be more successful in handling all of the issues in a more holistic way. However, it also means that many of the complex concerns related to information technology (IT) and e-commerce should also be considered as a priority. As a result of the growing reliance upon technology more risks must be managed both as regards the internal use of technology in monitoring business concerns and as regards the handling of external relationships and matters. Many smaller businesses, for example, cannot afford to protect themselves in an ideal way. Therefore in this chapter an overview is provided of some of the developments that have occurred – and current issues – in the context of the IT debate. This is such a broad subject that spans both macro and micro issues (from handling the above requirements to dealing with everyday email nuisance such as spam) that it requires a manual in itself.

Data handling risks

Intercepting communications 9.2

For some time, monitoring communications (such as email, telephone calls and Internet use) has been possible without any legal restriction. However, rules have been introduced in many parts of the world to deal with communications. Whereas this discussion focuses on the UK it should be understood that similar issues are likely to be faced in most jurisdictions. The UK's legal requirements are included in the *Telecommunications* (*Lawful Business Practice*) (*Interception of Communications*) *Regulations 2000* (*SI 2000/2699*) as amended by the Privacy and Electronic Communications (EC Directive) Regulations 2003. Further guidance is contained in the publication '*Electronic Communications at Work: What You Need to Know*' published by the e-Government Unit and available from www.e-envoy.gov.uk. Further guidance, albeit contradicting some of the advice above, is available in the publication '*The Use of Personal Data in Employer/Employee Relationships*', which was issued by the office of the Information Commissioner in October 2000 (available from www.dataprotection.gov.uk).

Whilst this is a controversial area and discrepancies have appeared between the statutory instrument and the guidance published by the Information Commissioner, business must ensure monitoring continues for one of the reasons set out in the statutory instrument:

- to establish the existence of facts;
- to conform with regulatory compliance;
- to determine quality control; and
- to provide training.

Interception has been authorised only if it is for the purpose of monitoring or recording communications that are relevant to the business, and the business has made all reasonable efforts to inform all users that communications may be intercepted. Failure, for instance, to inform or make aware to users other than employees that their communications may be intercepted may cause serious problems in the future. Additionally, getting the agreement of employees to monitor communications may also be difficult. There is a dividing line between an employee accepting that their communications will be monitored and the company informing the employee that they cannot remain an employee (or be employed) unless they agree to the monitoring of their communications. If a company decides to monitor communications, the board must take an active role in deciding whether to monitor and how to implement the policy, otherwise the company could face action from several sides: employees, customers and suppliers.

Protecting data **9.3**

Recently in the UK there have been some high level data protection incidents that have been reported in the media and created extensive loss in confidence and reputation damage for the organisations concerned, as well as trauma for the victims. Whereas these have concerned public sector data handling (such as the loss of child benefit data records and National Health Service data records) they have highlighted the crucial importance of a well protected data management framework for all organisations.

UK Legislation
The Data Protection Act (DPA) 1998 entered into force in stages, involving transitional periods and enabling longer established businesses to remain exempt until October 2001. The DPA established important legal principles that apply to the holding of personal data. Since there are few businesses that do not hold details either about their employees or customers it is useful to recap the principles of the DPA. Therefore all small businesses – and their advisers – should bear in mind the regulatory framework that applies and keep abreast of any changes that may take place in connection with the requirements.

Indeed there are eight generally well established principles of data protection and anyone processing personal data must comply with them. These state that data must be:

- fairly and lawfully processed;
- used for limited purposes;
- adequate, relevant, not excessive;
- accurate;
- not kept longer than necessary;
- processed in accordance with the data subject's (e.g. the customer) rights;
- secure; and
- not transferred to countries without adequate protection.

A more comprehensive definition of these principles is available on the website of the Information Commissioner's Office (see www.dataprotection.gov.uk). In view of the fact that many small and medium-sized businesses (SMEs) hold such date it is most important that they grasp the issues as part of their ongoing due diligence and corporate governance. As a guide, business websites such as www.is4profit.com has offered advice to the effect that when managing customer data companies should consider the following areas:

1. Make sure there is an understanding of the DPA 1998.
2. Check whether there is a need to register.
3. Understand the principles.
4. Identify the type of information that must be stored and why.
5. Look at the format to be used to store information.
6. Develop confidentiality procedures to maintain data security.
7. Establish a retrieval system to access stored information.
8. Back up or copy essential data.

Whereas these appear to be common sense or logical suggestions surprisingly they are not always followed. Moreover, it is also vital to make sure that staff understand and are trained in managing data in accordance with the regulatory framework. Such requirements impact on organisations of all sizes. Any failure to deal with personal data under the terms of the *DPA 1998* may damage the reputation of many companies in the future (see above and **Chapter 7**).

Survey on the Data Protection Act and small business – impact of regulatory frameworks

Another instance that demonstrates the need to understand the regulatory framework relates to IT security. When web hosting provider Hostway UK released results of its report in 2005 it indicated over 50% of UK SMEs could be in danger of breaching the DPA 1998. The report surveyed 121 UK SMEs and showed that although 94% of respondents understood the importance of IT security in compliance with the 1998 Act, 59% were still at risk from non-compliance because of the security risks associated with poor server configuration. Additionally, 59% of businesses said they were using default configurations when setting up servers, while nearly 47% of SMEs admitted to not regularly auditing the services they have running on their servers.

Since most SMEs store personal data on their servers, they should follow the eight principles of the DPA cited above that were enforced to ensure that data is handled correctly. The seventh principle of the DPA calls for SMEs to set processes and procedures in place to protect the personal information they hold about individuals, including information kept on websites and related servers. In the survey report the conclusion of the CEO Rob Lovell was: 'By installing and leaving services running that are not being used, businesses are essentially leaving doors into the server open, therefore compromising data security, With personal details residing on most servers, you can easily see how so many SMEs are at risk of breaching the DPA. This simply isn't acceptable, if an SME is found guilty of breaching the act not only will its reputation suffer but it could also suffer financial penalties'.

The Information Commissioner has greater powers to enforce the provisions of the *DPA 1998* than previously granted under the *DPA 1984*. Boards can expect to be put under pressure to treat this matter seriously, especially with the advent of e-business. For instance, in the summer of 2000, PowerGen was required to respond to an alert by a customer who stumbled upon the names, addresses and bank card details of approximately 7,000 customers who paid their electricity, gas and telephone bills online. Several points emerge from this event:

- The company clearly breached their duty of confidentiality to each customer.
- Various sources have estimated that this incident cost PowerGen about £35,000 in payments to customers, amongst other expenses.

- The company demonstrated that it was not looking after data properly under the terms of the *DPA 1998*.
- Adverse publicity resulted because of the breach itself, unfounded threats that suggested that the person finding the breach did not do so innocently, and because this incident will be used time and again to remind people that such incidents will occur unless you have a proper security policy in place.

Protecting personal data is part of the wider problems relating to risk management. The risks are both internal (PowerGen seemed to have failed to put adequate security measures in place) and external, which includes hacking, computer viruses and actions of ex-employees (CD Universe, a US company, was hacked by a teenager in 2000 and the personal details of thousands of customers and their credit card details were released on the Internet after the company refused to pay a sum of money). Directors are expected to ensure that personal data is managed properly, which means both technical and organisational measures must be implemented to prevent the unauthorised or unlawful processing of data or the transfer of data outside the EU.

Best practice for business – practical tips 9.4

It is also possible to obtain more detailed hints and tips by way of best practice from public domain sources, such as relevant official and secure guides on the Internet, as well as to seek advice from small business or sector organisations. By way of example, to highlight some of the numbered points cited from the websites that are referred to above:

- Identify the type of information you need to store and why

You must be clear regarding the type of information you wish to store on customers or potential customers and why, for example name, address, any personal details. This includes information taken electronically, for example from e-commerce transactions. Make sure that you take the data protection principles into account when storing customer data.

- Look at the format you will use to store information

You need to ensure that any customer information is stored securely. Manual (paper) data is vulnerable to accidents such as fire or flood and, if stored in a basement, can be damaged by rodents, damp or vandals. Electronic information stored on floppy disks, CD-ROMs, etc. are easily stolen, fire damaged or can corrupt. Practical security should be considered. For example, it is pointless storing sensitive documents in a safe if the keys are left lying around or anyone has access to the information stored.

- Develop confidentiality procedures to maintain data security

Risk evaluation should be carried out to ensure that security systems are in place to protect data. For example, if it is decided not to give out client details over the telephone, part of the security system would be in ensuring all staff are aware of this policy.

- Establish a retrieval system to access stored information

Since the storing or archiving all of the business correspondence and documentation can be time consuming and make retrieval difficult, you must have systems in place to manage data storage and retrieval. Make sure there is minimum duplication of customer information between, for example, the accounts system and a customer database. This helps manage the customer data and comply with data protection law.

- Back up or copy essential data

Businesses should always back up or copy essential data as damage to files can mean the loss of essential information, including data on sales and market predictions or the financial records of the business.

- Ensure that staff understand and are trained in managing data

As noted, as a priority the staff should receive training in the business data protection policies and understand the reasons behind confidentiality procedures.

Small business support
As emphasised it is important for small business to keep abreast of regulation such as the 1998 Act and to establish a best practice approach that enables the members of staff to be fully aware of both their rights and duties. If there is any doubt on this some key suggestions that have been recommended are as follows:

* Contact the Information Commissioner's Office if you have any questions regarding registration requirements under the Act.
* Security of information should be treated with the same level of seriousness as that of premises or cash.
* The storage and retrieval system should be monitored to ensure it continues to meet the needs of the business whilst complying with legislation.
* Business association advisers will be able to help you identify the information you need to retain and how to establish data management systems.

The principles of the DPA 9.5

To recap, the DPA applies to the processing of all data, both information processed by computers and manual data if it consists of a set of information that is structured so that specific information about an individual is readily accessible.

By way of example one can cite personnel files in a filing cabinet in alphabetical order. In the UK there are eight important principles to comply with:

- Personal data must be processed fairly and lawfully and one of a number of specified conditions must be fulfilled, including that:
  - ○ the individual has given their consent;
  - ○ the processing is necessary for the performance of the contract with that individual;
  - ○ the processing is necessary for the legitimate interests of the business.

  It should be noted that sensitive personal data, such as data as to a person's racial origin or political opinions, can only be processed with the explicit consent of the individual or if it is necessary for the employer to perform any legal rights or obligations.
- Data must be obtained for specified purposes and should not be used otherwise.
- Personal data must be adequate, relevant and not excessive.
- Personal data must be accurate and kept up to date.
- Personal data used for a purpose should not be kept longer than necessary for that purpose.
- Individuals have certain rights in respect of their data that businesses must respect, for instance the right to be given details about their data upon request and to require processing to stop.
- Appropriate steps must be taken against the unauthorised or unlawful processing of data and accidental loss or destruction, for example steps to prevent hackers.
- Personal data should not be transferred to a country outside the European Enlargement Area (EEA) unless that country ensures an adequate level of data protection for individuals (see further below).

Those who are processing personal data – other than manual data – must register that they are doing so with the Information Commissioner (previously known as the Data Protection Commissioner) for an annual fee. However, most of the Data Protection rules will not apply to manual systems kept by a business since October 1998 until October 2007. Also a business registered under the DPA 1984 need not register until the expiry of that registration and other limited exemptions apply.

The DPA – compliance procedures **9.6**

Although the DPA entered fully into force in November 2001, it has been noted that many businesses are still not complying properly with the legislation that, to date, covers businesses with computerised systems recording personal data.

In practice almost all businesses will process personal data, especially in relation to the maintaining of staff records and client/customer information. As with other areas of regulatory requirements and compliance risk management, businesses have to establish and implement procedures for compliance, in this case with the eight principles set out above. Essentially compliance with these requires the following steps to be taken:

- The organisation should undertake an audit of all personal data that is collected and the uses of such data;
- The organisation should obtain the individual consent of the individual regarding the use of the data, where necessary;
- The individual should be informed of the purposes for which the information is being used;
- Any information that is no longer current should be updated or discarded;
- Personal data should not be released to a third party or outside the UK unless this is permitted; and
- Ongoing procedures for compliance and training of staff for in those compliance procedures must be put into place.

Outside the EEA **9.7**

As has been mentioned above, one of the key principles enshrined in the DPA is that personal data should not be transferred to a country outside the EEA unless that country ensures an adequate level of data protection for individuals. One important jurisdiction and UK trading partner that could be affected by such a principle is the USA. Directive 95/46/EC is the underlying European legal instrument that prohibits the transfer of personal data to a third country that does not have an adequate level of protection. In order to resolve this matter for those businesses or multinational companies that hold personal data on their employees that may be transferred between the EU and the USA what have become known as the 'Safe Harbour Principles' were adopted by the USA. Their full title is the US Safe Harbour International Privacy Principles. On 26 July 2000 the European Commission in Brussels decided that the US Safe Harbour Principles provided an adequate level of protection for the transfer of personal data.

Unlike the EU's Data Protection regulatory system, which is legislation based, the US Safe Harbour Principles are a combination of legislation, regulation and self-regulation. In consultation with the EU Commission the US Department of Commerce developed Safe Harbour Principles that an organisation must comply with. In addition businesses have been provided by guidance produced by the US Department of Commerce in consultation with the Commission. These are in the form of 15 Frequently Asked Questions (FAQs) and Answers relating to the Safe Harbour Principles.

US Safe Harbour Principles **9.8**

The key principles are as follows:

- Notice

An organisation must notify individuals about the purposes for which the personal data would be held and to whom it will be disclosed.

It must also provide information about how an individual can contact the organisation with any queries or complaints.

- Choice

An organisation must allow individuals the opportunity to choose the purposes for which the personal data can be used and whether the personal data they have provided can be disclosed to third parties.

- Onward transfer

In the absence of the individual's consent personal data given to an organisation cannot be transferred to third parties. In circumstances in which an organisation employs an agent to process the data it must ensure that the agent subscribes to the Safe Harbour Principles.

- Access

Any individual who provides personal data to an organisation must have access to that data, as well as the right to be able to correct, amend or delete any information held by the organisation that is inaccurate.

- Security

An organisation must ensure that the personal data that it receives is kept secure and it must take all reasonable steps to protect personal data from:
  - loss;
  - misuse;
  - disclosure;
  - unauthorised access;
  - alteration; or
  - destruction.

- Data integrity

An organisation must offer a readily available and affordable mechanism to handle complaints. This includes:
  - a clear procedure whereby disputes may be resolved;
  - procedures for verifying that they are complying with the principles;
  - obligations to remedy any problems arising out of the failure to comply with the principles.

Membership of the Safe Harbour **9.9**

Membership of the Safe Harbour is completely voluntary. If an organisation wishes to join it must comply with the Safe Harbour Principles and publicly declare that it does. This means that an organisation must either join a self-regulatory privacy programme that adheres to the Safe Harbour Principles or it must develop its own self-regulatory privacy policy that conforms to the Safe Harbour Principles.

In order to ensure that it maintains the benefits of Safe Harbour an organisation must:

- self-certify that it adheres to the principles of Safe Harbour; and
- state in its published privacy policy statement that it adheres to Safe Harbour.

The US Department of Commerce maintains a list of organisations that file self-certification letters and make both the list and the filed self-certification letters publicly available.

Practical information **9.10**

Information relating to the Safe Harbour Principles, including the 15 FAQs, can be found on the website of the US Department of Commerce as follows: www.exports.gov/safeharbor

For businesses operating in the UK that wish to check whether businesses that they deal with are registered for Safe Harbour this is a useful site.

For more information about the DPA introductory material can be found on the website as follows: www.dataprotection.gov.uk

Online transactions **9.11**

Security breaches on the Internet, such as the breach at CD Universe (see **9.3**), are not the only sources of potential embarrassment and liability to a company. The electronic environment has a wide range of risks that directors are only just beginning to be made aware of. The types of attacks by electronic means that have occurred or can occur include:

- The interception of confidential information such as user names or passwords by the use of what has been referred to as a ‘packet sniffer’.
- Hackers obtaining rights of access to a system by hiding behind, for instance, email addresses that the system is configured to trust, this is known as ‘IP spoofing’.
- Attacks on a website by bombarding the server with queries and messages until the server stops working because of the sheer volume, known as ‘denial-of-services attacks’.
- Attempts to gain access to the system by ‘brute force’, where the hacker submits repeated login information in an attempt to guess a correct password to gain entry.
- Successful access to a server by exploiting known weaknesses in application level software.
- The use of viruses, worms and ‘Trojan horses’ to wreak havoc to the system in a variety of other ways.

For some time it has been clear that external threats are not the only risks that can cause extensive damage, as John Leaver of PrestigeCars.com reported in the *Financial Times* in an article published on the 23 October 2001. A rogue piece of code designed to manage the deletion of advertisements caused thousands of new adverts to simultaneously disappear from the website two days before the launch of a marketing campaign. With the help of a dedicated team and extra help, the problem was resolved, but it was a close call for a fledgling company.

A similar internal problem occurred to Ikea's website in 2000. Customers who requested catalogues on the company's website received an error message containing the name of a database. If the customer used the name of the database as a web address, they would obtain access to the names, mailing addresses and telephone numbers of people who had previously requested Ikea catalogues.

These two examples indicate how the protection of personal data and the security and technical framework of the computer system interact. Many commentators cite the perceived lack of security on the Internet as a reason why people do not buy goods and services online. Clearly buying online can be more secure if personal details are transferred by means of encryption. Indeed it does not matter which method is used by the customer to provide personal information, whether by telephone, post, facsimile transmission or by email. Invariably the information is put on a database, which in turn is held on a computer. The key issue is the security that is in place to prevent unauthorised people from obtaining access to the database. If that database can be hacked into from the outside, no matter how the data was obtained, it was never placed in a secure environment from the day it was received. As a result, the risk is within the company as a consequence of poor procedures and inadequate security. In the UK, a hacker can be liable under the terms of the *Computer Misuse Act 1990* (CMA) for committing a criminal act, but, of course, they cannot be held liable for the poor risk control mechanisms of the organisation. The Act has become a model which other countries, such as Canada and the Republic of Ireland, have referred to when subsequently drafting their information security laws. In 2004 the UK All Party Internet Group published its review of the law and highlighted areas for development. Their recommendations led to the drafting of the *Computer Misuse Act 1990 (Amendment*) *Bill*, which was ordered to be printed on 5 April 2005 and which sought to amend the CMA to comply with the European Convention on Cyber Crime. Under its terms, the maximum sentence of imprisonment for breaching the Act was amended from six months to two years. It also sought to explicitly criminalise denial-of-service attacks and other crimes facilitated by denial-of-service. The Bill did not receive Royal Assent, however as Parliament was prorogued.

As has been emphasised, directors of boards are custodians of the company they lead. They have responsibilities for the reputation of the company, and duties to shareholders and stakeholders. In today's business climate it is foolhardy to ignore many of the obvious risks that should be identified, analysed and dealt with in accordance with the adverse effect such a risk could have on the business. Directors should be aware of the benefits of managing risk. If other members of the board refuse to consider the issue seriously, or the culture of the board and senior management does not allow for the problem to be treated with the gravity it deserves, the individual director might, perhaps, look to their own future with the company. There is only so much an individual director can do to counteract a culture or environment that does not acknowledge the responsibilities of the board (see also **Chapters 7** and **8**).

There are benefits to managing risk, and any process introduced to the company that seeks to bring risk to the attention of every employee can be regarded as a healthy procedure that can reap positive rewards through better performance and higher sales. Consider the process of risk management as an asset which, when analysed, may well produce higher profits and better internal procedures, thereby helping to bring about a virtuous circle.

Contract risk in e-commerce 9.12

In an e-commerce environment, the survival of a business should include an analysis of contractual obligations and liabilities. By examining the legal issues and understanding its contractual duties and rights, a business will be better placed to ensure valuable legal relationships are not put at risk. This discussion of the issues relating to e-commerce illustrates how such an analysis can be beneficial.

In the e-commerce environment a considerable number of problems can occur if something goes wrong. For instance, if a business operates a website selling goods or services, the following types of problem can occur:

1. The entire plan for the development of an e-commerce website can be seriously jeopardised if the web designer does not deliver the website on time, or the Internet service provider fails to keep the website up and running when the e-commerce site is generating a substantial and sustained income from regular sales every day.
2. A hacker can cause serious disruption. For instance, the content of the front page could be replaced with racist or pornographic images, sensitive files could be opened and customer credit card details downloaded, or the prices posted on the website altered. Whichever action is adopted by a hacker, the affect on the business would be similar: not only will the company have to devote valuable resources to dealing with the police, national press and the concerns of customers, but there may also be a beach of the provisions of the *DPA 1998*, which could lead to action by the Data Protection Commissioner.
3. Internal failure can occur, as it did for the retailer Argos, when television sets were offered at £2.99 each in the summer of 1999, rather than the full price of £299.99.

When assessing risk, the failure to focus on contractual liabilities can be construed as poor risk management. This is because the business needs to consider what, if any, action it is contractually obliged to take if it faces a disruption. As has been noted in **Chapter 5** any disruption to the smooth running of the business can be caused due to factors that are both internal and external.

In both instances, where there are written contracts in place or the use of standard trading terms, the contract will invariably include a term relating to *force majeure* or the occurrence of unforeseen circumstances. These terms are drafted to incorporate events that might occur which are beyond the control of either party. The inclusion of such clauses absolves the party affected of carrying out their obligations under the terms of the contract – especially if they are not able to fulfil their contractual responsibilities.

Any business should aim to assess what, if any, potential legal challenges it might face and consider what action to take to avoid the expense and uncertainty of litigation (see also **Chapter 5**). In the process of dealing with disruption, the action that it takes and how it deals with the situation may not only affect its ability to trade, but whether its reputation is damaged or enhanced. If the business faces a serious disruption, it is crucial that all trading partners and customers are kept informed. By keeping suppliers and customers up to date with a regular flow of relevant news, they will be far more likely to assist by providing technical or financial support.

By looking at its contracts, a business will be able to assess its most important legal relationships. In so doing, it can determine which are crucial to it and, as a result, where relationships are affected by a problem, for whatever reason, it will be in a better position to deal with the crisis.

The information gathering exercise **9.13**

When looking at its contractual obligations, the business will need to consider:

- the rights, obligations and liabilities relating to it;
- any future inability to fulfil contractual obligations.

In carrying out this exercise, it will inevitably want to focus on the principal areas of its e-commerce operation. However, it is also worth considering the full range of business activities. Identify the areas of the business that will suffer if something goes wrong. A business only needs one vital supplier to fail to deliver, for instance, and it could find itself in a very difficult position.

The following list, which is not exhaustive, provides some idea of the breadth of contracts that should be taken into account: contracts with customers (if any), suppliers, distributors and wholesalers' utilities, Internet service providers and web designers.

Questions relating to suppliers

Parties to the contract **9.14**

For each contract the legal identity of the other party should be established. In some instances, a business may have agreed with a web designer to provide it with a website, and may not be aware that they are a sole trader or operate within the identity of a limited company. By establishing the precise identity of the other party, it will be able to assess the risk to the business if, for instance, the web designer fails to produce the website on time or at all (see also **Chapter 4**).

When planning for the first website, or for a re-design of the present website, a business will invariably accept that the process will probably take longer than originally agreed. No doubt it will provide for a flexible timetable for the development of its e-commerce site. For instance, it may have established a flexible timetable with suppliers, the warehouse operator and the Internet service provider. Although it can resist entering into legally binding agreements for a period, it will have to commit itself at some stage. It may well be that it has to enter such contracts before the website is finished. As a result, any failure to have the website ready on time may lead to rising costs, because of the commitments necessarily entered into for the successful implementation of the website.

In such circumstances, not only should the business ensure that it knows with whom it has entered a contract, but it should also set out to establish a timetable and the consequences of failure to adhere to the timetable. The higher the value of the project, the greater its concern should be in identifying who its future partners are and the greater degree of attention it should give to any trading terms that might apply to the contract.

Pre-contract representations and issues **9.15**

Quite often, when a person tries to effect a sale, they make comments to assist a decision to buy. Such comments are usually made orally. They can also be made in writing, for instance, on literature provided about the product. In both cases, representations will have been made that might cause the purchaser to enter into the contract.

In the context of IT, it is wise to discuss some of the issues set out below with a number of Internet service providers before deciding which company to place one's business with. Therefore some or all of the following practical issues should be incorporated into a contract with an Internet service provider and steps taken:

- Establish the power of the servers.
- Ask whether the temperature of the room in which the server is located is temperature controlled.
- Seek to negotiate a service level agreement that suits the needs of the business.
- Ask the following questions:
  - Does the company offer hardware maintenance?
  - Does the company provide software that can balance the load?
  - How much spare network capacity can be relied on? and
  - If the business website suddenly becomes busy, will the Internet service provider allocate more bandwidth?

While each Internet service provider will discuss the issues raised above (the list is not meant to be exhaustive) and careful attention must be paid to the points below about such representations. The Internet service provider should set out their answers in writing their responses should be included in the terms of the contract.

Although a service provider may try to prevent any representation, whether made orally or in writing, becoming part of the contract, the representation made, whether by the person selling something, or if written in company literature, can still form part of the contract. This is a general statement, and the position will depend on the precise circumstances relating to the contract. Any comments noted down at the time a sale was effected might be important in the future. If comments were made prior to the contract, they should be noted down at the time they were made. They can then be confirmed, together with the affect the comments have on the agreement, by setting them out in writing to the other party prior to the contract.

If a company has a set of trading terms, one clause might refer to representations. The clause usually seeks to avoid responsibility for any oral representations made by employees or agents. In addition, an attempt might be made to refuse liability for any written representations. Such clauses might, depending on the circumstances, be effective. Whether a clause can prevent the purchaser from relying on a representation will depend on a number of factors that are beyond the scope of this chapter. In any event a business is strongly advised to consider whether any representations were made, whether oral or written, for all contracts. By doing so, it will heighten the awareness of this issue. Further, its contractual rights might be strengthened if the representations, if any were made, were incorporated into the contract. All of these issues need to be considered in the context of IT and e-commerce: some practical tips are set out further below.

Analysis of agreements **9.16**

Evidently the paper trail can determine the method by which a business entered the contract. How it entered the agreement will have a bearing on rights, and therefore the strength of any negotiating position. For example, if it uses its own purchase order, the probability is that its terms of trading, if any, will apply to the contract. If this is the case, in the event of a dispute, the other party to the contract is likely to argue that their terms do not apply to the contract if their terms are generous. This is an issue that should be considered carefully. It is better not to assume that one's own trading terms are advantageous. Consider trading terms carefully because they seek to apportion risk and attempt to negotiate changes if necessary. It is not always possible to negotiate changes with a bigger and more powerful company. However, if a dispute occurs, it does not necessarily follow that the bigger company will succeed in having all their limitation clauses accepted by a judge. This is a complicated area and a business should be aware that onerous clauses limiting liability can be challenged.

The purpose of a purchase order is usually to provide evidence of the intention to enter a legally binding contract. If a business is willing to accept the trading terms of the organisation it is buying from, it is important to ensure, when it provides a purchase order number, that the provision of the purchase order number is merely evidence of the acceptance of the offer to enter into a legally binding contract on their terms of trading.

If goods or services are purchased without a purchase number, the probability is that the terms of the supplier will apply to the contract and a copy should be requested. It is in the interest of good practice to establish whose terms apply to the contract. Failure to do so might mean the need to litigate to establish the position, which is costly and time consuming (see **Chapter 5**). Moreover, whether the supplier can enforce the terms of the agreement might also depend on answers to the following questions:

1. Did the purchaser know the terms before it entered into the contract?
2. Were the terms on the invoice?
3. Were the terms, or mention of them, on any literature or other documents sent to it?

It is important to know whether the literature or other documents were sent before or after buying the goods or service. The terms of trading accompanying goods, for instance, will only apply to the contract if a business knew they existed before it entered into a contract.

Many companies erroneously print their terms of trading on the back of invoices. This is a waste of money. Terms that are presented to the customer after the contract has been concluded do not have any affect.

If the contract is not governed by any terms – whether that of the purchasing business or that of the supplier – then in the UK it can rely on the statutory rights provided by Parliament. When planning for continuity, therefore, it should try to establish an answer to this question. By being aware of its legal position, a business is better informed. As a result, it can more readily determine the strengths and weaknesses of its predicament, should an issue arise.

Online practical contractual issues

Administering the website effectively **9.17**

Issues relating to copyright and trademarks must be carefully considered. Ensure the web designer (or employee, if the website is administered in-house) does not use the trademarks of competitors in meta-tags, for instance. Meta-tags are the hidden indexing system that help search engines to find websites. For example in the UK, Road Tech Computer Systems successfully applied to the High Court for a summary judgment against Mandata, where Mandata wrote trademarks belonging to Road Tech into their meta-tags 27 times. Mandata was ordered to pay £15,000 damages and the costs of both sides, which amounted to £65,000.

Consider having an administration process in place to ensure that all changes to the content of the website are checked before the replacement goes live. Paying a person to undertake a quality check can be cheaper than resolving the adverse publicity and increased costs associated with mistakes on websites. Consider having trading terms drawn up: an added contractual problem for Argos (see **9.12**) related to the legal position of the price. Clearly, customers may have thought the price somewhat low, but they could legitimately argue that it is possible that Argos could have been offering a short, one-off sale as a marketing gimmick. Alternatively, Argos would say that the price was so low as to be a clear mistake.

An additional complexity to add to the legal analysis is whether the website is termed an invitation to let a customer think about buying from the business, or an offer to sell an item at the price noted on the website. If the website can be construed as an offer, it may find itself liable for every order made by each customer electronically. This is a very important point. If a business fails to establish the precise nature of its website, and if demand outstrips the ability to supply goods ordered, it could be embarrassed by the national press as yet another online trader that fails to live up to the promises that e-commerce is supposed to bring to traders and customers alike.

It is important to try to minimise the risks when trading online, as the Argos example illustrates. It is important to avoid unlimited liability to deliver thousands of items at very low prices. The contractual position with a potential customer should be considered very carefully, and provision should be made in a specifically designed set of trading terms to ensure the business can quickly resolve such a problem, if it were to occur. Moreover a recent US court ruling has confirmed that unless customers are given sufficient notice of changes to online contracts (e.g. subscriptions, website terms of use, conditions of sale) the changes will not be binding. The courts in many other countries, including the UK, apply the same notice rule. Websites frequently attempt to satisfy the notice rule by including the following terms in their online contracts:

- changes can be made at any time without notice;
- customers must regularly check the website for any changes to the contract terms. However, this type will not always be sufficient.

Indeed a US court recently invalidated changes to an online contract for the provision of long distance telephone calls even though the changes had been made four years previously. When the customer had entered into the original contract he had also authorised regular automatic payment from his credit card. Subsequently changes were made to the online contract by the telco provider without notifying the customer. The court concluded that as the customer had no reason to re-visit the website it could not be assumed that he was aware of the changes. The customer was therefore only bound by the unamended original contract terms. It is possible that the UK courts would have reached a similar conclusion.

In the UK, consumers (i.e. individuals contracting for non-business purposes) are also given additional protection by the Unfair Terms in Consumer Contracts Regulations 1999. The regulations invalidate 'unfair' terms in contracts with consumers. Several recent UK decisions have stated that a seller having the right to make changes without notice is 'unfair' and therefore unenforceable. Any changes to such contracts with consumers will only be enforceable if sufficient notice of the changes has been given.

As a practical point, the recent US and UK decisions confirm that business may be at risk if any of the following factors apply:

- some customers are consumers;
- some customers will not be visiting the website regularly; or
- the changes are to key terms or place additional obligations on customers.

Retail website owners should not, therefore rely solely on terms such as those set out above. Instead they should be proactive and take positive steps to alert customers of the changes, for example, via prominent alerts on the website and via individual emails/letters to customers.

Business interruption 9.18

It is probable that most businesses with an online presence will not suffer from the attacks of hackers. However, the activities of hackers are not the only problem businesses face in relation to e-commerce. The proliferation of viruses and similar unpleasant electronic attempts to make computer systems inoperable can all affect the smooth operation of the business (see also **Chapter 5**). In such circumstances, it is imperative that the business scrutinises any contract it has with its Internet service provider and any other relevant service provider, to ensure that it understands the provision, if any, in relation to the security system. If it is not given sufficient assurances in writing about the ability of a service provider to keep the e-commerce site running 24 hours a day, 7 days a week, the business should either consider an alternative provider or the services of a good quality electronic security company.

Analysing the contractual obligations when running an e-commerce website can pay dividends. By assessing the strength of the contractual position, the business can plan more effectively. If it has good relations with customers and suppliers, it may consider incorporating clauses into contracts relating to risk and continuity. It should not allow tight deadlines to force it to gloss over the conditions of important contracts. By establishing an accurate picture of its contracts, the business is in a better position to take steps to minimise those risks that it has taken the care to identify (see also **Chapter 5** regarding business continuity and operational risk management).

Technology due diligence managing legal risk exposure 9.19

In earlier sections comment has been made about the handling of IT and data as part of the ongoing due diligence and operations of the business. Another issue concerning the use of IT relates to technology due diligence in so far as it is often one key aspect of the overall due diligence process performed by those wanting to acquire or invest in companies. In this context it is primarily an exercise about managing both commercial and legal risks. It is about managing risks in a way that will enable the parties involved in the business transactions ultimately to maximise their respective commercial returns or to minimise bottom line losses. Technology due diligence is about assessing the quality of technology assets and any attendant risks that an acquirer would assume in acquiring such assets. In this spectrum of risks, legal risk exposures probably rank among the top concerns of senior management.

In the era of Internet-based business, one of the key assets of corporations is its intellectual asset. Acquiring intellectual assets is often one of the key objectives in mergers and acquisitions, and they are also increasingly exploited for strategic advantage. In this discussion 'intellectual assets' cover those generic cluster of intangible assets which, when narrowly defined within a precise legal context, emerge as rights which are protected or can be protected by law. Such intellectual property rights typically include patents, copyrights, trademarks, design and trade secrets. They are often intangible and come in the form of technology or know-how which can be software or hardware driven or simply business processes driven by technology.

Companies typically want to acquire technology from others for any one of the following reasons:

- the technology is useful in itself;
- the technology may enhance the acquirer's own product range, service offerings or technology development cycle;
- the acquisition of the technology will enhance the acquirer's corporate branding;
- the acquirer sees long-term investment value by acquiring the technology at what the acquirer regards as fair market value;
- the acquirer sees benefits in terms of positive public perception of the acquisition that would result in better market price for its shares.

Investors typically insist on having a very clear view of the strength and weaknesses of the technology in the overall corporate and industry context. Research and development houses may also use technology due diligence to assess or validate their performances while technology start-ups may use the result of technology due diligence for their own self-assessment or evaluation for the purpose of fundraising. The ultimate aim of any technology due diligence exercise is to use it as a management tool that helps increase the probability of a successful investment, a partnership or a merger and acquisition. As with all due diligence exercises, a risk assessment has to be made.

In a technology due diligence process, the purchaser or investor typically would want to achieve one or more of the following objectives:

- to identify technology asset strength and weaknesses that would help in closing the deal successfully;
- to remedy any identifiable flaws in a way that will be conducive to further negotiations but often in the hope that it will reduce the acquisition cost for the acquirer or purchaser and secure better terms in general;
- to ensure the eradication or minimisation of all if not most legal risk exposures from the acquisition of that technology.

The main assessment that an adviser has to make typically arises from the following scenarios:

- an acquirer intending to purchase a technology company; or
- an investor taking up an equity stake in a technology company; or
- parties to any transaction with a technology component.

The questions to be asked cover:

- whether the technology that is the primary asset of the company being acquired does in fact do what it is supposed to do: its capabilities must be evaluated and verified;
- whether the acquirer can verify that it would be able to extract business value from acquiring the technology: in particular whether the management team responsible for the creation of the technology can in fact deliver what the technology purports to be able to do for businesses, in short, the commercial prospect of the technology;
- whether the owner of the technology does in fact legally own all the rights to the technology;
- the nature and magnitude of legal risks that the acquirer would be assuming if the acquisition is made; and
- what the true measure of the value of the technology being acquired is, that is, its strengths, weaknesses and therefore its real worth.

Given the primacy of intellectual assets in the Internet-based economy and the essence of such assets being the technology itself, the issue of protection of such assets is of paramount importance. In a technology due diligence, managing legal risk exposures in relation to the intellectual property rights of the company is always one of the primary concerns of parties. Therefore this central aspect of technology due diligence, that is, the evaluation of and the risk assessment of intellectual property rights issues, both internal and external to the company or individual owning the technology, is considered below.

Management of intellectual property issues 9.20

The proper management of the intellectual property issues, in particular, the management of any legal risk exposures to the acquirer, may often make or break a deal. Even if the technology is valuable, the danger of legal risk exposure over a mismanagement of intellectual property issues could unravel business deals. In any technology due diligence, the identification of the nature of assets or more specifically intellectual property rights is often the first step. In most jurisdictions around the world, the class of intellectual property rights would typically include:

- patents;
- copyrights;
- trademarks;
- designs; and
- trade secrets.

Some rights arise automatically, such as copyrights, in most jurisdictions. Other types of rights, for example patents, must be applied for and the examination process is rigorous. One major issue that arises in cross-border technology due diligence is the question of the applicability of different laws which affects the creation of intellectual property rights. Most intellectual property laws are territorial in nature and any sound technology due diligence should adequately address this issue to ascertain with some precision the existence or non-existence of intellectual property rights. For example, in most countries patent protection is secured from the date of first filing with the exception of the USA which uses a mix of first to file and first to invent system. Also the test for patentability of technology varies from country to country and this would have a major impact on the value of technology which is to be used across multiple jurisdictions.

A particular technology being acquired in turn may have multiple intellectual property rights. In a typical e-commerce site, the text, the layout and the 'look and feel' of the site accompanying music and the software codes are the subject of copyrights, while logos, prominent marks or signs are subject of trademark. The process of electronic payment which could be software driven and which has a demonstrable technical effect could be patented. An investigation into the nature of the property would therefore require a thorough analysis of the nature of legal rights of that class of assets to ensure that any overlap could be positively exploited for the benefit of the purchaser or investor.

Another aspect in addressing the nature of the technology asset is the question of legal compliance. The development of any technology must comply with the prevailing laws and regulations in which the operating company is domiciled. Thus if a particular country prohibits a particular type of technological endeavour, for example cloning of human cells, any patenting of such technology is likely to be against public policy and this sort of issues should be uncovered during the technology due diligence process.

Ownership issues **9.21**

The next issue relates to the ownership of assets. Rights which are registrable such as trademarks, patents and in which there is some kind of searchable governmental registry should be the first line of enquiry in any technology due diligence. This can be done comprehensively. Nevertheless, issues of the territorial nature of intellectual property laws must be borne in mind. So if a technology-based company uses Internet technology across multiple jurisdictions for its business operations, searches in different jurisdictions must be made.

However, ownership issues become murkier when such intellectual property rights are not yet registered or are not capable of being registered. Thus an employee in a research and development department may have obtained source codes for software development (i.e. copyrighted materials) that rightfully belong to the employee's former employer. Any technology due diligence must therefore uncover such legal risk exposures for the acquirers of such technologies.

Assets can be owned or be verified to be owned by a particular entity but the legal protection itself is weak owing to gaps in legal drafting. While warranties and other forms of representation complete with indemnity provisions would clearly help the legal position of a purchaser or an investor of companies, there is nothing more reassuring than a thorough background check including physical examination to ensure that nothing – whether in hard or soft copies – of any form of property that belongs to someone else is being used at all by the staff or management of companies in which the technology is purportedly owned.

Other ownership issues that should be addressed during technology due diligence include:

- identities of all parties involved in the development of that technology;
- when the technology was developed – for example it could have a prior existence in a different legal entity;
- whether there are any third party rights that attach to the property;
- whether the registration of rights (e.g. granted patents) can be challenged and subsequently revoked;
- whether the documentation evidencing ownership (if not registrable in governmental search agencies) exist or clear enough for avoidance of doubt;
- whether all legal compliance requirements have been fulfilled for purposes of evidencing ownership;
- whether all renewals and payments have been made (even if the governmental authorities have not issued any reminders or warnings of expiry).

Duration of protection 9.22

Different types of intellectual property rights have different life spans. For example, a trade secret can last forever while trademarks can last forever subject to fee renewals. Patents in turn typically last for 20 years or so depending on the jurisdiction. Therefore the technology due diligence process should elicit a very clear position on the duration of such rights as this will have an impact on the commercial value of such technologies.

Rights involving other parties 9.23

A sound technology due diligence should also be able to ascertain whether the key features and functionalities of the technology are dependent on any licensed component. Are there, for example, third party relationships with contractors and other service providers in which the successful exploitation of the technology being acquired are dependent? These issues would determine the quality of technology assets.

Ascertaining the risk of infringement of the intellectual property rights of others is probably one of the most difficult parts of any technology due diligence. Again tightly drafted representations and warranties to cover all forms of contingencies are necessary.

Sufficiency of legal documentation 9.24

The technology due diligence must also review all available legal documentation to ensure the eradication or minimisation of legal risk exposures. So in a high risk transactions, for example, where the ownership issue is in question, there has to be legal provisions typically in the form of legal rights that must be included in the agreement to protect the interests of the purchaser or investor. Representations, warranties and indemnity provisions in legal documentation must be carefully scrutinised in this part of the technology due diligence process.

Technology due diligence is but one critical aspect of the whole due diligence process (as discussed in **Chapter 1**). Investors or purchasers interested to acquire enterprises in which the intellectual assets are one of its quality assets are well advised to evolve a systematic way to manage its technology due diligence process and focus on intellectual property rights issues and the minimisation of any attendant legal risk exposures. This would maximise the chance of a successful acquisition or investment.

Legal risk issues in Internet commerce 9.25

There are several characteristics of Internet commerce that require legal risk issues to be assessed in a different light.

UK economic crime case study 9.26

Almost daily there are reports of criminal activity that is causing problems for both private and corporate citizens alike. This damaging trend is clearly relevant to Internet commerce. Crimes against businesses have cost the UK a staggering amount over the last few years. Therefore, increasingly companies are finding that developing a more positive relationship with public agencies, particularly the police, can offer a healthy way forward if business is to become really organised in its fight against organised crime. Business should indeed be more innovative in dealing with these concerns and keep abreast of developments as far as possible. Running a business in today's economy can prove to be a complex matter that requires an alert and multidisciplinary approach to issues that were traditionally not relevant or were handled by others. Thus the use of IT can be regarded both as a threat and an opportunity in the context of due diligence and corporate governance.

Costs of economic crime

It has been calculated that crimes such as embezzlement, money laundering, fraud and dishonesty cost British businesses more than £40 billion in 2005, the equivalent of £110 million a day or some 4% of the UK's domestic product. Indeed, some £32 billion was lost to the criminals, while £8 billion was spent on prevention. It is largely because crimes against businesses are often construed as 'victimless' that industry groups have had to campaign for many years to press the authorities to take the problem seriously.

A survey by RSM Robson Rhodes also found as follows:

- there is a stigma attached to crime which prevents companies from reporting it to external auditors or industry regulators;
- for this reason, just 14% of respondents said they shared information on criminal activities with local firms;
- six in ten respondents expected the problem to get worse in the next three years; and
- while nearly all respondents agreed that responsibility for tackling the problem should be held at board level, only 57% claimed to have extensive knowledge of the problem.

As with other areas of emerging risk, it has been found that businesses must also take the risks posed more seriously. Whilst there is no set time for how long boards should spend tackling the issue, in order to achieve a proper understanding and response to the concerns they need to research the level of economic crime in their industry sector. They then have to put in place effective systems and controls to:

- prevent economic crime;
- identify material losses; and
- take action to recover those losses.

Clearly there are certain key sectors that are particularly vulnerable to economic crime. By way of example the Financial Services Authority (FSA) has warned that organised crime groups are attempting to place staff in financial services firms to commit fraud and steal customers' identities. The FSA has advised that:

- firms must vet the background and identity of their staff more carefully before confirming their appointment;
- they also should be aware that devices such as Personal Digital Assistants (PDAs), USB pens and Smart phones can be used to steal corporate information or act as sources of virus infection;
- firms could do more to address the potential risks rather than responding to attacks once they have occurred; and
- in particular, senior management needs to take on responsibility for information security which includes the need for firms' defences to be continuously reviewed and updated to keep on top of the increasingly sophisticated methods used by criminals.

The warnings come in a recent report by the FSA that demonstrated how financial firms are managing their information security in the fight against fraud and other financial crime. Some findings have indicated that whilst some major firms, particularly in the banking sector, have built some practical defence in response to potential targeting by hackers and fraudsters, other sectors and SMEs are less well prepared (see also comments on these issues in **Chapter 5** regarding business interruption).

Police initiatives

In London the Metropolitan Police Service (MPS) at New Scotland Yard has prioritised the issue of global economic crime and the impact on the UK, particularly in the context of its Operation Sterling. London is viewed as a centre for economic crime. Yet there is an identifiable concern over the sharing and partnership regarding intelligence. In general business does not like to share information. Accordingly the police are re-engaging with business to enable a single office to consider the trends and tackle the concerns. Since there has been a migration across sectors there needs to be an expanding partnership with business that crosses traditional boundaries and sectors to enable more proactive and dynamic intelligence. This has meant a more proactive prevention team. By way of example (see also below) in 2005 the Police in London warned that gangs of organised criminals were infiltrating Britain's banking industry and blackmailing employees to obtain customer account details. The problem was exacerbated by the use of unvetted temporary staff. Firms should follow a preventative approach rather than reacting to a situation once it has happened which can be costly and damaging to reputation according to the police. Having been the target of criminals in recent times, as noted, via the Internet and other such technologies, the major banks tend to have strong defences in place. However there is no room for complacency and criminals will seek to exploit vulnerable points where they can find them, including in other sectors or smaller firms.

Here again the SME sector is very vulnerable and it was reported in 2004 that nearly 60% of SMEs become the victims of crime every year. A Federation of Small Businesses (FSB) survey of 18,000 firms has revealed that while 58% of small businesses experience criminal acts, less than half of these are reported. The report highlighted the crucial fact that businesses are twice as likely to fall victim to criminal acts as households, and criticised the Home Office for failing to prioritise business crime. According to reports David Croucher of the FSB has said, 'There is a perception amongst business owners that the UK is experiencing a crime epidemic and that no one cares. Sentences are lower for commercial burglaries than domestic burglaries, and criminal damage and theft from commercial premises have effectively been de-criminalised'. Evidently, the business group has called for a number of measures to be put in place to help tackle the problem, several of which highlight again the need for a partnership approach with the police, including the following:

- business crime to be recorded as a distinct category from domestic crime;
- crime against business to be made a KPI by the Home Office;
- businesses to report all crimes to the police;

- sentencing guidelines to be revised, to ensure that crimes of a similar nature are treated equally;
- a business crime compensation scheme to be established, to prevent otherwise viable businesses from closing down.

In this area corporate identity theft has also blossomed. Indeed the MPS also launched a major initiative to advise businesses how they can take simple preventative measures to minimise the risk of their company's identity being hijacked. Again the statistics cause concern. The crime works in much the same way as personal identity theft. Criminals change the details of UK registered firms by filing fake documents with Companies House. Having done that, the criminals can then impersonate the companies and use their credit lines to obtain goods. The police have said that criminals are so well organised that they have even diverted lorries when they are mid-transit to a new address. Meanwhile Companies House has warned that it could not check every one of the seven million or more documents it receives every year relating to changes of company details. Yet statistics show the rising crime figures: fraudsters who steal the identity and then trade under a legitimate company's credit and name are thought to cost industry in excess of £50 million a year. The MPS's 'Sterling' initiative is a long-term partnership strategy which takes a proactive partnership approach to reducing opportunities for, and combating, economic crime. Part of its aim is to dispel the myth that fraud is 'victimless' crime. Therefore, working together with Companies House under the 'Sterling' initiative, the MPS has warned or advised companies to take four simple steps, which will protect their company from being cloned by a fraudster that is to:

- check your company's registered details are correct at Companies House and that they have not been fraudulently changed;
- sign up for Companies House electronic filing, by which information is filed online with an electronic password – registration details can only be changed electronically with correct security codes. Companies House electronic customers can then subscribe to 'PROOF', the protected online filing service that reduces the possibility of fraud even further. PROOF customers tell Companies House that they will only file electronically, and that paper that claims to come from them should be rejected;
- sign up to Companies House 'Monitor', an email alert system, which will warn the password holder when any future changes to your company details are made. The alert system sends an email every time someone tries to change a firm's registered details; and
- take the precautionary measure not to rely solely on Companies House records in determining whether to lend goods or offer services on credit. Companies House is a public record registry and not a credit reference agency or crime prevention service. It is therefore recommended that you satisfy yourself that your customer is legitimate through additional means.

For more details see http://www.met.police.uk/fraudalert and for more details on how you can protect your company's identity, see www.companieshouse.gov.uk

The findings of the surveys and the initiatives mentioned above show that economic crime is a growing area of concern that extends beyond the business community to the general public who suffer its negative effects. Thus there is a clear link with a risk to reputation for those organisations that cannot demonstrate to their stakeholders that they are dealing appropriately with the concerns. The belief that white-collar crime is a victimless crime must be overcome; the negative effects of economic crime are actually suffered by all. The statistics are striking and reinforce the need for further collaboration between state and industry bodies and consumer groups. Furthermore, as seen above, economic crime is not confined to specific industries or regions and knows no limits or geographical boundaries. In an age of technological advancement, it is vital that the issue of economic crime is discussed within industry forums and closer collaboration between industry bodies and consumers occurs to raise general awareness of the problem. In most cases, the trust that businesses place in their staff is rewarded by hard work and loyalty but since employee disaffection by one member of staff alone can cause a great deal of harm this must be considered a priority. For instance, software piracy and music piracy are huge concerns. Moreover, whilst educating employees and management in methods of prevention is crucial, it needs to be combined with strong and effective regulation.

In view of the rising trend in economic crime globally, there is no doubt that the cost of crime and of crime prevention is a substantial cost to business. Firms see the cost of crime directly, for example, in terms of goods that are stolen, but also indirectly through increased security and higher insurance costs. In order to become more organised in the face of organised economic crime improved risk management is paramount for all businesses, regardless of size and location. There is no doubt that greater co-operation is needed among all interested parties and that this is an area that should be monitored and on which professional advice should be sought as part of the governance of the organisation.

Northern Rock crisis – role of IT

Commentators have stated that the crisis at Northern Rock appears to be an example of bad planning on many levels. However, of interest here is the criticism that the bank's use, or possible neglect, of technology could be at the root of many of its problems. Whereas the bank borrowed money from the Bank of England to ensure its own solvency in the face of increasing financial turmoil abroad what it then failed to do was to manage its customer relationships effectively to calm the fears of its account holders. Every bank has the information- and presumably the resources- to reassure each of its customers that their money is safe. Northern Rock appears not to have done this, preferring instead to shout the message out of the branch doors at queues in the street. Meanwhile the bank's website was brought to its knees by the weight of online customers trying to get out of Dodge. The site was so slow that it proved difficult even to get the customer services number, let alone access an account. A Northern Rock spokeswoman insisted the poor site performance was purely due to an unexpected increase in traffic, as if that were a reasonable excuse. As some commentators have asked, if some of the bank's branch buildings fell into the street, would it now be blaming the brickwork? Surely the bank had a duty to provide online customers with access to their accounts and should have laid on emergency capacity to cope with an unexpected spike in traffic. Experienced website operators know this.

There is perhaps a more fundamental aspect to this apparent lack of planning. Banks are known to be highly risk averse. They generally have systems in place to analyse and predict areas of potential risk. If such systems existed at Northern Rock and were heeded, surely the bank would have moved its business model out of danger before it had to go to the Bank of England. At least it could have educated the market to prepare for rough waters. What it did instead was set off a chain of events that created more crisis while the authorities attempted to play down the significance of their intervention.

Digital and other information assets **9.27**

Internet commerce deals with hitherto new types of digital and information assets. Such assets in a way define what Internet commerce is all about for the traditional brick and mortar enterprises. In cases where the enterprise itself is a 'pure' Internet company, that is, one without a physical presence, the Internet-based business model is actually the very business itself. These digital and information assets are particularly vulnerable to attacks which can threaten the commercial viability of the business. The interception of data and breach of confidentiality can create specific legal risks that have focused the minds of many organisations in terms of risk management, especially since the Turnbull Report requirements and the importance of embedding risk management into core corporate policy at board level (see further **Chapter 10**). The legal risks are considered in more detail below.

Borderless and global activities **9.28**

Internet commerce is by definition a borderless and global activity. The Internet is a global network of networks. Internet connectivity itself crosses political boundaries with no hindrances so long as the networks in two different jurisdictions are connected. Business methods that are effective and in compliance with the laws and regulations in one enterprise's home market may not work in markets that operate in a totally different legal environment, and might even expose the enterprises to unexpected legal liability. An example would be a US online bank trying to offer its services to citizens of other countries located in different legal jurisdictions. This kind of a business model would probably be affected by the laws affecting such citizens in their respective home markets.

Timing for product and service roll-outs 9.29

In Internet commerce, the 'go to market' time for a new project is much shorter compared to brick and mortar commerce. This reduced time frame means that legal issues must be addressed much earlier than it is traditionally expected to.

Managing legal risk issues in Internet commerce 9.30

As a result of the more Internet-intensive commercial environment, technology-related legal risk management is now becoming an increasingly familiar concept to the board and senior management of all enterprises. If it is not, it should be.

If the legal risks that flow from technology risks are serious enough to threaten the legal and commercial interests of the enterprise, senior management needs to ensure the establishment of a legal risk management framework to identify these risks and take adequate measures to address them. The company's board of directors, for instance, have a fiduciary duty to protect the organisation from security attacks and other forms of cyber crime and security risks which may have a critically negative impact on the organisation's reputation, assets and commercial viability.

Enterprises should ensure that adequate steps are taken to protect themselves legally. Apart from liabilities for breaches of contractual obligations, the failure to take reasonable and adequate steps to provide security measures may possibly lead to an enterprise being liable for negligence, either in not taking sufficient steps to protect data and information where it has a duty of care to protect, or in being used as a platform or a channel to mount an attack against another party. Preparatory steps should therefore be taken in advance in planning the procedures to handle security breaches.

The board and senior management should therefore review and approve the organisation's legal risk management policies taking into account technology risks and the capacity of the organisation to deal with such problems. Legal risk management in this new technology-intensive environment cannot be a task that is merely carried out periodically, that is, yearly or half yearly. In today's accentuated security risk environment, legal risk management has to be regarded as an oversight process undertaken by senior management on a continuous basis. This process involves legal risk identification, assessment, control and mitigation. Also the scope of legal risk management should embrace a broader horizon which incorporates proactive legal risk management. A key component in this legal risk management framework is the protection of digital assets.

Protecting digital assets 9.31

To protect its Internet-based business, enterprises should first begin by identifying the assets to be protected before it begins to do its business. This will avoid any potential loss of time, resources and when the enterprise finds itself losing control of these assets. Potential assets at risk are described below.

Data 9.32

This includes customer information, financial data, equity and market index data online and other proprietary data.

Applications or software 9.33

Such applications or software includes those which run corporate IT systems and its workflow (e.g. an Internet commerce software or an enterprise resource planning software which may cost millions of pounds).

Digital products and services 9.34

Information products sold by the enterprises such as financial planning software, e-toolkits or e-guides and business information. Legal advisers should help ensure that the enterprise has the right to sell these assets and can help improve the chances of successful litigation against digital asset violators and pirates.

Intellectual property rights 9.35

Such intellectual property rights could include those that are in digitised form (e.g. copyrights in e-commerce software or trade secrets stored in a digital format). The enterprise's business identity in turn can be embodied in its trademarks, logos and its domain name. These assets should be protected by registration in commercially important jurisdictions, to ensure the highest level of protection for the enterprise.

Websites 9.36

As has been touched on above (see **9.12–9.15**), the enterprise's information website and its transactional site or portal itself needs to be protected through effective contracts governing its formation and enforcement. Such websites should also be monitored and controlled as well through effective contracts involving users of the site such as the enterprise's customers and other third parties. Pre-emptive action should be taken against users who violate the enterprise's intellectual property rights and other digital assets.

Contractual obligations 9.37

From the business perspective, the legal risk exposures that result from major service disruptions are to be given greater priority. Such legal risk exposures usually arise out of contractual obligations in the following two situations:

- Where there is service disruption affecting their customers, which, if not clearly regulated in legal terms, may expose the enterprise to potential legal suits for non-performance of its contractual obligations.
- In the event of service disruption to the enterprise's partners or other third parties who rely on the enterprise technology infrastructure to fulfil other transactional requirements.

Compliance relating to business continuity 9.38

Another legal issue that enterprises have to address in the provision of Internet commerce services relates to compliance requirements in relation to business continuity planning. Enterprises such as banks and financial institutions typically operate in a legal environment that is very tightly regulated. The regulatory authorities may require legal compliance in terms of having a sound business continuity plan or disaster recovery that is subject to regulatory review and penalties for non-compliance. Such regulatory non-compliance is one form of legal risk exposure that the enterprise's legal advisers must address.

A business recovery and continuity plan is essential for every business that owns any mission critical application or system. To ensure adequate availability, enterprises typically provide for contingency backup systems to mitigate denial-of-service attacks or other events that may potentially cause business disruptions. As has been mentioned in **Chapter 5**, a business continuity plan or disaster recovery plan is an essential part of the overall risk management framework of the business. Such a risk management framework typically also includes issues pertaining to data confidentiality, system and data integrity and security practices in general. The board of directors have a fiduciary duty to ensure that in the event of system failure for whatever reason, there is continuity of service for the enterprise's clients and partners.

Relationship with technology providers 9.39

Most commercial enterprises are not in the business of providing technology solutions and they rely greatly on external parties such as Internet commerce technology service providers to provide the technology infrastructure to enable them to provide Internet commercial services. This is another dimension in the legal portfolio that senior management must handle.

As has been discussed above (see **9.14–9.15**) a vitally important aspect of the legal protection framework in Internet commerce is the use of effectively drafted contracts with third party vendors and solution providers to ensure the enterprise's potential legal liabilities are adequately managed. These are contracts that typically manage the relationships that enable the enterprise to provide secure and continuous services, covering such matters as:

- web hosting;
- development of applications (e.g. Internet commerce software);
- access services provided typically by infrastructure providers such as telecommunication and Internet service provider companies;
- security services including the supply of security products such as firewalls and encryption software.

Since the provision of technology services are typically not part of a commercial enterprise's core competencies, such services are typically outsourced to external providers. However, the enterprise's primary responsibility to its customers is to provide an accessible, secure service direct. In the event of the failure of the enterprise's service provider, the enterprise itself would still be accountable to their customers. There is therefore a need for enterprises to ensure sufficient counter-indemnity arrangements are entered into between themselves and the third party technology providers.

Therefore when there is a major service disruption which is caused by technology or system failure, the issue that often arises is the extent to which the enterprise is able to pass on or share any legal risks to the technology ser-vice providers. This typically takes the form of indemnity provisions which require the technology service providers to indemnify the enterprise for losses that result from the service provider for failure to ensure business continuity.

Managing liability issues **9.40**

The task of a business and its legal advisers in an Internet commerce business is to ensure that once the types of technology risks have been identified, the legal ramifications are clearly understood and analysed. Any potential economic loss should be quantified wherever possible. With this information, the enterprise would then be able to prioritise the legal risks and make legal risk mitigation decisions. As has been indicated above in **9.12–9.15**, enterprises can minimise, if not eradicate, such legal risk exposures by designing terms and conditions in their service agreement that exclude or limit their liability in the event of system failure that causes non-delivery of essential services.

As is also seen above, by the very nature of enterprise being in 'big businesses', it is not uncommon to see 'pro-company' terms being imposed on the customers. While customers might simply accept such terms that exclude or limit the liability of the enterprise, particularly when they are not in a strong negotiating position, it makes a lot of sense for enterprises to focus on managing their relations with their customers in other more productive ways such as in the form of client education.

Consumer interests 9.41

For most consumers transacting over the Internet, the primary concern when a transaction fails is usually whether he suffers a pecuniary loss, for example payment made but the goods or services are not received, or when the wrong or unsatisfactory goods or services are delivered. From the perspective of the customers, confidence is about knowing what the customers can expect from the enterprise when there is a disaster or an attack that affects their commercial transactions. Individuals and consumers also need to understand the available remedies of a failed transaction over the Internet, regardless of whether it is attributed to a merchant that was a target of hacking or the action of fraudulent third parties. In general customers think in legal terms only when there is a major economic loss on their part (although the trend in society is towards more litigation). In any event, the way to manage possible legal risk exposures that might result from contractual obligations is an assurance programme that is sound, well publicised and that engages the clients of the enterprise in times when there is no disaster.

While taking the legalistic approach of protecting one's interests by defining and controlling legal risk through 'small print' might serve its purpose, a better strategy is therefore to focus on assurance and effective communication to parties that may potentially sue the enterprise in the event of major service disruptions.

Evidential issues 9.42

In any cases involving breaches of security, companies must have in place work policies and procedures to ensure that evidence can be properly presented to the prosecuting agencies and the courts. If proper steps are not taken in relation to digital evidence, the chances of proving one's case or to disprove the other side's case will be much less. Given the fragility of digital evidence and the need to collect, preserve and present evidence to the prosecuting agencies in a criminal legal proceedings, enterprises should ensure that digital evidence can be properly detected, preserved and presented in a manner that legally complies with the local laws of the country. Also, given the transient nature of digital evidence, time is of the essence in all cases involving information security breaches. In general, companies should have in place policies and procedures to include the following:

- steps to isolate or quarantine the evidence;
- recovery of evidence;
- reproduction of evidence;
- processing and analysis of evidence; and
- preparation of report by an expert for use in the courts.

In the event that digital evidence and data are not properly secured or preserved, such evidence may subsequently be found inadmissible in court for the purposes of criminal or civil proceedings. Therefore, as part of the enterprise's post-incident operation procedure in areas of disaster recovery and business continuity planning, there is a need to ensure that legally compliant procedures be pre-established so that they can be activated expeditiously when the incident happens.

Businesses should also seek legal advice on how to determine whether a crime has been committed and the possible courses of action that can be taken based on the evidence available. Digital forensics work will invariably have to be undertaken together with legal personnel to identify the crime, the offender, and to collect and reconstruct the necessary evidence which are typically found on disks, logs and other media. Legal advice should be sought on issues such as preservation of evidence, issues of admissibility and the overall presentment of such evidence to the prosecuting agencies in a manner that not only comply with the law, but also are managed in a manner that would make a strong case for the prosecution. Aside from criminal proceedings that the Public Prosecutor may take against the perpetrator for the offences committed, the victim of the crime may also consider filing civil claims for damages and other losses that may have been suffered as a result of the attack.

Designing a risk management framework 9.43

In designing the overall legal risk management framework, businesses should, as a general rule, have a proactive and structured programme of action involving the following elements:

- An overall system to identify, classify, measure, prioritise and assess legal risks that are relevant to the enterprise's operations;
- A plan that is documented in the form of an operation manual (both hard copy and embedded into the system in the form of web-based documents containing policies, practices and procedures that addresses and controls these risks). Such a plan must specify the responsibilities of all parties involved in the whole risk management process from the operational level right up to the CEO;
- A regular test plan that when implemented approximates all possible worst-case scenarios for the purpose of testing the system to its fullest potential;
- A monitoring programme to assess all types of technology and other operational risks and the evaluation of the effectiveness of such programmes;
- The regular updating of such plans in the light of developments in the technology, law and business practices;
- Post-incident recovery procedures which must incorporate digital evidence collection, preservation and presentment techniques which are legally complaint;
- The fulfilment of legal compliance requirements as specified by the regulatory bodies; and
- A security awareness programme that will help nurture a more security conscious environment.

Legal audit 9.44

In designing this legal risk management framework, it is best to begin with an audit. This phase involves the senior management in the enterprise and the legal team conducting an audit on the adequacy of legal strategies, legal documentation and work procedures and guidelines that affect the day-to-day legal management of Internet commerce services. Examples of issues that are usually addressed during the audit include:

- The overall legal strategy to handle legal risks that are technology driven and the objectives and plans currently guiding the business in the area of technology risk management.
- An assessment of the legal compliance environment as well as the developments in the legal standard of care in providing security services to protect the business from intrusions or such other forms of attack.
- The form and effectiveness of the legal standard operating procedures and guidelines of the business, as well as the general organisation and administration of legal matters.
- Legal cost and economics, for example the cost–benefit analysis of getting external lawyers to advise on the legal issues that the enterprise is currently addressing.
- Legal department resources and capabilities, that is, strengths and weaknesses relating to resources, reputation, services and legal market position. Issues that need to be addressed include whether existing lawyers who are competent in the traditional type of commercial activities such as loan document preparation are competent to handle IT-related legal liability issues for example in the area of security breaches in Internet commerce.

A forecast of the technology and security risk environment and the legal consequences that flow from it will affect the legal position of the enterprise and its clients.

Enterprises involved in Internet commerce should address and manage legal issues in a manner that is structured and proactive. In Internet commerce it is imperative that not only is the physical security be assured, but a sound legal protection regime that protects and secures the enterprise's other commercial interests should also be in place. If planned and executed in such a structured and proactive manner, such a legal protection regime would bolster the enterprise's overall corporate governance framework.

Conclusion 9.45

Bearing in mind all of the above, a business should be aware that the value of its digital assets could surpass that of its physical assets. Moreover, given the unique nature of digital assets, legal risk exposures can be particularly accentuated. A structured and proactive legal risk management approach has to be one of the central pillars of an organisation's management of its digital assets. The elements of such a management framework can be dealt with by a corporate digital asset management policy (see the **Appendix** below). This may help organisations better manage their legal risk exposures when they create, protect and exploit digital assets and assist them to fulfil the need for ongoing due diligence and good corporate governance as considered in this handbook.

Appendix

Checklist for implementing a corporate digital asset management policy

Developing a corporate digital asset management policy

- Have you identified all digital assets in your workplace?
- Has an audit of your company's digital asset been conducted? Is there a digital asset inventory?
- Have you registered all of your digital assets that can be registered as intellectual property rights?
- Do you have a corporate digital asset policy?
- Is there a separate operating procedure to complement the company digital asset policy?
- Is your company's digital asset policy regularly reviewed or updated? How often?
- Do you have in-house expertise to review your digital asset policy and procedures?
- Is your company's digital asset policy documented (manual and in soft copy)?
- Is there a digital asset management procedure that your employees must comply with?

Communicating digital asset policies

- Have you communicated the company's digital asset policy to all employees?
- Are employees required to acknowledge in writing that they have read and understood the company's digital asset policy?
- Is your workplace designed in a manner such that signs or notices about the need to protect digital assets are clearly visible?
- Do you regularly remind your employees about your company digital asset policy?
- Do you have a hire and exit procedure that takes into account digital asset policy matters and are these adequately communicated to all employees?
- Do you have a digital asset compliance officer that ensures that all employees abide by the company's digital asset policies?

Implementation of company digital asset policy

- How is the company's digital asset policy implemented?
- Is there a company officer in charge of implementation or execution?

- Do you have a pre-agreed criterion to assess the success of your company's digital asset management programme?
- Are there both quantitative and qualitative aspects in the assessment criteria?

Documentation

- Is your legal documentation for all your digital asset rights complete?
- Have all contracts and agreements been reviewed to ensure compliance with the company's digital asset policies?
- Do you have a procedure for clearing publication of professional papers for presentations at industry or trade shows that meets the requirements of your company's digital asset management policy?

Violation of digital asset management policy

- Do you monitor your digital asset rights for possible violation?
- Have you ensured that your employees have not violated the digital assets of their previous employers?
- Have you ensured that employees who leave the company have not violated the company's digital asset policy and procedures?
- Are there measures to restrain key personnel from violating digital assets, for example restrictive covenants?

10

Corporate governance issues

10 Corporate governance issues

CHAPTER OVERVIEW **10.1**

This chapter is intended to give an overview of key points that have come together to demonstrate where we are today with specific focus on UK developments. In the earlier chapters, such as **Chapter 4**, some comment has already been made as to the meaning and drivers of corporate governance and in the chapters that follow international comparisons are made (see **Chapters 11–15**). Moreover, the term governance is considered in various additional contexts in **Chapter 18.** In order to reduce the potential for duplication it should be emphasised that in this chapter the more recognised definitions are referred to. In addition, the main developments towards today's understanding of what is meant by corporate governance issues are reviewed bearing in mind that it is an evolving area. In this chapter, the UK framework is discussed having regard to the approach that has evolved through a series of codes leading to the revised combined code that affects listed companies in particular. Since the management of risk is very relevant to the development of corporate governance, risk management is also considered later in the chapter (see **10.8–10.15**). Clearly the way in which a business manages risk is closely interlinked with its corporate governance.

Corporate governance definitions and drivers

Definitions **10.2**

There has been considerable discussion regarding the meaning of the concept of corporate governance since the first edition of this handbook. On one hand it can be understood in a more limited sense that covers financial controls. On the other hand it can be taken to extend to all of the responsibilities and policies of the business that include such matters as environmental concerns (see also **Chapter 16**). Between these two approaches there are, of course, many variations. What is increasingly clear is that the trend is in favour of widening the scope of the term. As with previous debates over such issues as sustainability, it is recognised that the role of business in today's global economy is profound and that accountability should be extensive. The responsible partners are both the public and private sectors. The stakeholders, including members of the public – and not only those with a direct interest in the company – are demanding more transparency and evidence of responsible behaviour.

Another important matter concerns the repercussions of the corporate governance debate for smaller business. As with the demands of other regulatory frameworks including product liability, the environment and health and safety, the corporate governance framework affects small business. In addition to the supply chain pressures there is the consideration that today's small growing business can become a big business very quickly.

As has been noted throughout this handbook the concept of corporate governance has been attracting public attention for quite some time in many parts of the world and the practical developments and responses have been gaining momentum. Therefore some attention is given to selected jurisdictions, such as India, Hong Kong, China and Australia (see further in **Chapters 12–14**). The topic is no longer confined to the halls of academia and is increasingly finding acceptance for its relevance and underlying importance in the industry and capital markets. Progressive firms in many places have voluntarily put in place systems of good corporate governance. The focus on corporate governance and related issues is an inevitable outcome of a process, which leads firms to increasingly shift to financial markets as the pre-eminent source for capital. In the process, more and more people are recognising that corporate governance is indispensable to effective market discipline. This growing consensus is both an enlightened and a realistic view. Corporate governance can enable a company to have its systems in place and give it sufficient freedom to operate within a framework of accountability. It helps to enhance transparency and responsibility while maximising long-term wealth of investors.

However, the concept of corporate governance is defined in several ways because it potentially covers the entire array of activities having direct or indirect influence on the financial health of the corporate entities. As a result, different people have recommended different definitions, which often reflect their special interests in the field.

To start with it would be useful to recall the earliest definition of corporate governance by the economist and Nobel laureate Milton Friedman. According to him, corporate governance is to conduct the business in accordance with owner or shareholders' desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs. This definition is based on the economic concept of market value maximisation that underpins shareholder capitalism. At first sight Friedman's definition might be assumed to be narrow in its scope, but as the 'basic rules of the society embodied in law and local customs' are dynamic and have evolved rapidly over recent times to embrace the well-being of nearly all, then Friedman's definition holds good today and is likely to in the foreseeable future. It is now generally accepted that a company is not only responsible to its shareholders but to, amongst other things, its employees, customers, suppliers, the public at large and the environment.

The great challenge for a company now is in aligning and managing the complexities of the various stakeholders' interests, values and expectations.

According to some experts corporate governance means doing everything better, to:

- improve relations between companies and their shareholders;
- improve the quality of outside directors;
- encourage people to think long term;
- ensure that the information needs of all stakeholders are met; and
- ensure that executive management is monitored properly in the interest of shareholders.

Experts at the Organisation for Economic Co-operation and Development (OECD) have defined corporate governance as the system by which business corporations are directed and controlled. According to them, the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set, and also provides the means of attaining those objectives and monitoring performance.

It is helpful to compare definitions in other jurisdictions. For example, according to the relevant report in India – the Report of the Kumar Mangalam Birla Committee on Corporate Governance:

> '... in an age where capital flows worldwide, just as quickly as information, a company that does not promote a culture of strong, independent oversight, risks its very stability and future health. As a result, the link between a company's management, directors and its financial reporting system has never been more crucial. As the boards provide stewardship of companies, they play a significant role in their efficient functioning.'

This report goes on to state that:

> 'Studies of firms in India and abroad have shown that markets and investors take notice of well-managed companies, respond positively to them, and reward such companies, with higher valuations. A common feature of such companies is that they have systems in place, which allow sufficient freedom to the boards and management to take decisions towards the progress of their companies and to innovate, while remaining within a framework of effective accountability. In other words they have a system of good corporate governance.
>
> Strong corporate governance is thus indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high-quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure. Without financial reporting premised on sound, honest numbers, capital markets will collapse upon themselves.'

For further comment on corporate governance in India see **Chapter 12**.

According to some economists, corporate governance is a field in economics that investigates how corporations can be made more efficient by the use of institutional structures such as contracts, organisational designs and legislation. This is often limited to the question of shareholder value – that is how the corporate owners can motivate and/or secure that the corporate managers will deliver a competitive rate of return. In brief, therefore, corporate governance calls for three factors:

- transparency in decision-making;
- accountability which follows from transparency because responsibilities could be easily established for actions taken or not taken; and
- the accountability to safeguard the interests of the stakeholders and the investors in the organisation.

For the purposes of this discussion it is also useful to cite the important definitions of corporate governance found in the Cadbury Report [1] (see **10.4**) and the Hampel Combined Code as follows:

- 'The system by which companies are directed and controlled';
- 'The greatest practicable enhancement over time of their shareholders' investment. All boards have this responsibility and their policies, structure, composition and governing processes should reflect this'; and
- 'Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants, such as board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance'. See also **CHAPTER 7**.

Summary of corporate governance drivers **10.3**

Bearing in mind the matters referred to throughout the handbook, particularly in **CHAPTER**S **1** and **4**, there are clear drivers that have resulted in:

- the establishment of committees to assess best practice;
- the main reports that have been published; and
- the regulatory and voluntary frameworks that now exist.

It may be said that we live in a climate of corporate governance that has largely come about through the series of high profile corporate disasters in the 1990s, for example BCCI, major recent financing scandals such as at Enron, the ongoing controversy over directors' pay and an overall trend towards risk awareness and management.

Whereas many of the developments are referred to elsewhere, such as **CHAPTER 7**, it is useful to set out and understand the chronology of events.

The Cadbury Report **10.4**

In 1991 the Cadbury Committee was set up by the Financial Reporting Council (FRC), the London Stock Exchange (LSE) and the accountancy profession.

Following the consultation period the Cadbury Report [1] was published in December 1992. The main terms of reference of the report were:

- the structure and responsibilities of boards of directors;
- the role of auditors;
- the rights and responsibilities of shareholders; and
- a code of best practice.

The relevant highlights of the report were:

- boards should have a formal schedule of matters specifically reserved to them including risk management policies (paragraph 4.24);
- directors need to maintain a system designed to minimise the risk of fraud (paragraph 4.32); and
- the prime responsibility for the prevention and detection of frauds is that of the board (paragraph 5.23).

The stated objective of the Cadbury Committee was 'to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them'.

The Committee investigated accountability of the board of directors to shareholders and to society. It submitted its report and associated 'Code of Best Practices' in December 1992. In its findings it spelt out the methods of governance needed to achieve a balance between the essential powers of the board of directors and their proper accountability.

The resulting report, and associated 'Code of Best Practices', published in December 1992, was generally well received. Whilst the recommendations themselves were not mandatory, the companies listed on the London Stock Exchange were required to clearly state in their accounts whether or not the Code had been followed. The companies who did not comply were required to explain the reasons for that.

The Cadbury Code of Best Practices had 19 recommendations. Since it may be described as a pioneering report on corporate governance, it would be in order to make a brief reference to them. The recommendations are in the nature of guidelines relating to the board of directors, non-executive directors, executive directors and those on reporting and control.

As regards the board of directors, the Cadbury Code of Best Practices made the recommendations that are summarised below:

- The board should meet regularly, retain full and effective control over the company and monitor the executive management.
- There should be clearly accepted division of responsibilities at the head of a company, which will ensure balance of power and authority, such that no individual has unfettered powers of decision. In companies where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognised senior member.
- The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions.

- The board should have a formal schedule of matters specifically reserved to it for decisions to ensure that the direction and control of the company is firmly in its hands.
- There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.
- All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of company secretary should be a matter for the board as a whole.

Regarding the non-executive directors the recommendations are:

- Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
- The majority should be independent of the management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgement, apart from their fees and shareholding. Their fees should reflect the time, which they commit to the company.
- Non-executive directors should be appointed for specified terms and reappointment should not be automatic.
- Non-executive directors should be selected through a formal process and both, this process and their appointment, should be a matter for the board as a whole.

For the executive directors the recommendations in the Cadbury Code of Best Practices are:

- Directors' service contracts should not exceed three years without shareholders' approval.
- There should be full and clear disclosure of their total emoluments those of the chairman and the highest-paid UK directors, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.
- Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

As regards reporting and controls the Cadbury Code of Best Practice stipulates that:

- It is the boards' duty to present a balanced and understandable assessment of the company's position.
- The board should ensure that an objective and professional relationship is maintained with the auditors.
- The board should establish an audit committee of at least three non-executive directors with written terms of reference, which deal clearly with its authority and duties.

- The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.
- The directors should report on the effectiveness of the company's system of internal control.
- The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

Corporate governance – the Cadbury Report and beyond 10.5

The emphasis in the Cadbury Report is on the crucial role of the board and the need for it to observe a code of best practices. Its important recommendations include the setting up of an audit committee with independent members. The Cadbury model is one of self-regulation. It was recognised that in the event British companies failed to comply with the voluntary code, legislation and external regulation would follow.

It is interesting to note how the corporate world reacted to the Cadbury Report. The Report in fact shocked many by its boldness, particularly by the code of practices recommended by it. The most controversial and revolutionary requirement – and the one that had the potential of significant impact on the internal auditing – was the requirement that 'the directors should report on the effectiveness of a company's system of internal control'. It was the extension of control beyond the financial matters that caused the controversy.

Accordingly, the Paul Ruthmann Committee was constituted later to deal with this controversy and watered down the proposal on the grounds of practicality. It restricted the reporting requirement to internal financial controls only as against the 'the effectiveness of the company's system of internal control' as stipulated by the Code of Best Practices contained in the Cadbury Report.

It took another five years to get the original Cadbury recommendations on internal control reporting reinstated. Meanwhile public confidence in UK continued to be shaken by further scandals and Ron Hampel was given the task of chairing the Committee on Corporate Governance with a brief to keep up the momentum by assessing the impact of Cadbury and developing further guidance (see **10.7**).

The Greenbury Report 10.6

The Greenbury Report [2], which was submitted in 1995, addressed the issue of directors' remuneration. This Report was largely in response to increasing concerns over huge pay increases for directors, share option gains and directors' contracts. It was published in 1995 and made these issues the main focus of the report since directors' pay issues had been of growing interest and concern to stakeholders and the media as a matter of public interest. The Greenbury Report set out a Code of Best Practice that covered:

- remuneration committees;
- reporting to shareholders; and
- service contracts and compensation.

The Report made it clear that remuneration for directors should be aligned with corporate objectives and bonuses should be paid for the achievement of challenging targets.

The Hampel Review and the Combined Code 10.7

The Final Report submitted by the Committee chaired by Ron Hampel [3] had some important and progressive elements, notably the extension of directors' responsibilities to 'all relevant control objectives including business risk assessment and minimising the risk of fraud ...'

The Combined Code was subsequently derived from Ron Hampel Committee's Final Report, from the Cadbury Report and the Greenbury Report. The Combined Code is appended to the listing rules of the LSE. As such, compliance is mandatory for all listed companies in the UK.

The stipulations contained in the Combined Code require, among other things, that:

- the boards should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets;
- the directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so; and
- the review should cover all controls, including financial, operational and compliance controls and risk management.

Therefore the Hampel Review and the Combined Code demonstrated a change of emphasis and the positive contribution that corporate governance can make. Principle AIV, for example, stated that the board of a company should be supplied with information to enable it to discharge its duties. This was bearing in mind that the board consists of an active or dynamic group of people charged with running the company as opposed to a passive body. In addition:

- Principle DII stated that the board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets;
- Hampel recommended that guidance notes should be prepared to expand upon and clarify what is meant by 'internal controls'.

The system of internal control was intended to cover not only financial controls, but also operational and compliance controls and risk management.

The culmination of the above was the publication of the Combined Code – published in June 1998. It was the result of the work and recommendations of Cadbury, Greenbury and Hampel and covered:

- principles of good governance;
- the role of the board;
- the role of shareholders;
- directors' remuneration;
- accountability and audit; and
- the public reporting or risk.

The Combined Code 2003 superseded the previous Combined Code issued by the Hampel Committee in 1998.

The revised Code derived from a review of the role and effectiveness of the non-executive director by Derek Higgs and a review of audit committees by a group led by Sir Robert Smith (both reviews published in January 2003). They had reported simultaneously on 20 January 2003. The final Higgs report contained many recommendations relating to:

- the structure of the board;
- the role and other commitments of the chair;
- the role of the non-executive director;
- the recruitment and appointment procedures to the board;
- induction and professional development of directors;
- board tenure and time commitment;
- remuneration;
- resignation procedures;
- audit and remuneration committees;
- board liability; and
- relationships with shareholders.

Higgs recommended that the FRC and the FSA should process the review's proposals rapidly. The FRC announced that it would progress the recommendations of both the Higgs and the Smith reports for changes to the Combined Code by 1 July 2003. The FRC was the body charged with incorporating the Higgs recommendations into the Combined Code – its consultation on the Higgs recommendations resulted in 181 submissions. After much controversy, particularly regarding the prescriptive nature of the recommendations, the FRC concluded that:

- the chairman should be allowed to chair the nomination committee;
- no limit should be placed upon the re-election of non-executive directors;
- the companies outside the FTSE 350 should not have to have at least half independent directors; and
- some of the provisions in the draft were more like principles.

These changes were included in the new Combined Code published in 23 July 2003, by the FRC. They were due for implementation in company reports from 1 November 2003 and were at last accepted with widespread support.

The FSA (see the heading 'London Stock Exchange listing rules') has also replaced the 1998 Code with the revised Code. The 2003 Code applies to reporting years beginning on or after 1 November 2003.

The 2003 Code included guidance on how to comply with particular parts of the Code:

- 'Internal Control: Guidance for directors on the Combined Code', produced by the Turnbull Committee, which relates to Code provisions on internal control (C.2 and C.3 of the Code).
- 'Audit Committees: Combined Code Guidance', produced by the Smith Group, which relates to the provisions on audit committees and auditors (C.3 of the Code).

In both cases the guidance suggests ways of applying the relevant code principles and of complying with the relevant Code provisions. In addition, it includes suggestions for good practice from the Higgs Report.

The Combined Code includes the corporate governance principles which the LSE listed companies are expected to adhere to as part of their listing rules.

> 'Listed companies have to describe how they apply the Code's main and supporting principles and either confirm that they comply with the Code's provisions or provide an explanation to shareholders.'
>
> *(FRC Press Notice 75, 23 July 2003) (see also* ***10.8****)*

The Combined Code reflects the principles developed in and following the Cadbury Report (see 1**0.3**).

The 2003 Code does not include material in the earlier Code on the disclosure of directors' remuneration. This is because the *Directors' Remuneration Report Regulations 2002 (SI 2002 No 1986) have* entered into force and supersede earlier provisions in the 1998 Code.

London Stock Exchange listing rules **10.8**

Mention has already been made of what are referred to as listed companies (see **CHAPTER 4**). In order to apply to be a member of, and remain listed on, the London Stock Exchange companies must comply with the FSA listing rules. The FSA listing rules require listed companies to supply the following information in their annual report and accounts under Section 12.43A:

- A narrative statement of how it has applied the principles set out in Section 1 of the Combined Code, providing an explanation that enables its shareholders to evaluate how the principles have been applied;
- A statement as to whether or not it has complied throughout the accounting period with the Code provisions set out in Section 1 of the Combined Code. A company that has not complied with the Code provisions, or complied only with some of the Code provisions or, in the case of provisions whose requirements are of a continuing nature, complied for only part of the period, must specify the Code provisions with which it has not complied and, where relevant or applicable, for what part of the period such non-compliance continued. The company must give reasons for any non-compliance; and
- A report to the shareholders by the board that must contain a statement of the company's policy on executive directors' remuneration.

The rules require detailed discussion of financial issues such as:

- share options;
- long-term incentive plans; and
- service agreements.

The Turnbull Report 10.9

Subsequent developments with regard to corporate governance in the UK led to the guidance of the Turnbull Working Party on Internal Control, known as the Turnbull Report, in September 1999. This required the board of directors to confirm that there was an ongoing process for identifying, evaluating and managing the key business risks. Shareholders, after all, are entitled to ask if all the significant risks have been reviewed and whether appropriate actions have been taken to mitigate them. They are also entitled to question why any event causing financial damage was not anticipated and acted upon.

In this context, it was observed that the one common denominator behind the past failures in the corporate world was the lack of effective risk management. As a result, risk management subsequently grew in importance and is now seen as highly crucial to the achievement of business objectives by the corporate world.

It was clear, moreover, that boards of directors were not only responsible for, but also needed guidance on, reviewing the effectiveness of internal controls and for providing assurance that all the significant risks had been reviewed. Furthermore, assurance was also required that the risks had been managed and an embedded risk management process was in place. In many companies this challenge was being passed on to the internal audit function.

Therefore, in terms of the framework for corporate governance in the UK, the Turnbull Report represents a major key document to enable an understanding of the key steps in the background to corporate governance. It provides guidance on all of the controls as opposed to only internal financial controls. The final date for compliance with the Turnbull Report was 23 December 2000. In setting out internal control guidance notes it has regard to the following:

- in Principle D2 of the Combined Code it is stated that the board ‘should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets’; and
- guidance was sought to enable companies to establish what was required to comply with Principle D2.

In accordance with the above, the Working Party stated that in determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control, the board should consider:

- the nature and extent of risk facing the company;
- the extent and categories of risk which it regards as acceptable for the company to bear;
- the likelihood of the risks concerned materialising;
- the company’s ability to reduce the incidence and impact on the business of risks that do materialise; and
- the costs of operating particular controls relative to the benefit thereby received.

It is helpful to summarise the Turnbull Report for the purpose of the discussion on risk that follows. Regarding the review of the effectiveness of internal control it states that:

- the board should receive and review reports; and
- the board should undertake an annual assessment to the effect that it has considered significant risks.

As regards the board's statement on internal controls:

- evaluating and managing significant risks; and
- the disclosure should provide meaningful, high level information.

A series of questions to assess the effectiveness of the company's risk and control processes include:

- a risk assessment;
- a control environment and the control of activities;
- information and communication; and
- monitoring.

Developments post-Turnbull **10.10**

Since the guidance was published in 1999 and as a result of the Report, there have been many media reports, conferences and workshops to highlight the growing importance of risk management. Since then there has been an increased awareness of risk management and, together with the ongoing scandals that have been the subject of media headlines globally, it has become true to say that risk management is the key issue for business in terms of its internal due diligence and corporate governance.

Relevant matters that have been under discussion have included:

- how far companies have changed their approach to risk in practice;
- which issues have been singled out as priority concerns;
- to what extent listed companies simply pay lip service to the review of internal processes in their annual report; and
- how far risk management is embedded in the management of the business in accordance with the Turnbull requirements.

This has also meant that businesses have had to change their approach to risk management in order to:

- align their risk management structure to follow the Turnbull requirements;
- define and disclose the optimal structure for their risk management framework;
- assess and explain their risk controls to promote shareholder confidence;
- assess responsibilities with regard to their risk management function;
- identify risk management tools; and
- ensure that their organisation is able to respond quickly to the ever-changing nature of risks.

Optimising the impact of new requirements **10.11**

Developments concerning the role of the audit committee and the risk manager in the business, together with their relationship with the board, have led to the optimising of corporate governance, business risk assessment and the internal control framework. Companies have had to consider:

- linking their corporate governance framework with their internal control framework to achieve the best value;
- whether internal audit and risk management should be merged or form an alliance;
- using their governance and control framework to embed risk management into their organisation;
- ensuring that they implement a dynamic internal control framework; and
- determining and embedding responsibilities and accountabilities for governance risk management and internal control.

The commitment of the board **10.12**

In order to obtain the involvement and commitment from the board of directors to an improved risk control framework, risk management and control advice has been important for all relevant staff across the organisation. In addition the role of the audit has had to be considered to fulfil the Turnbull requirements. Companies have needed to provide independent and objective assurance through the audit to the board about the adequacy and effectiveness of key internal controls and other risk management activities across the organisation. The auditors can act effectively as risk and control educators to all relevant staff in the business. In order to do so steps should be taken to:

- educate the board to the benefits and opportunities of the Turnbull recommendations for improving the management of risk, providing transparency and clarity of controls and improving business performance and shareholder value;
- determine the priorities of the board and identify the risk areas that affect shareholder value;
- communicate the internal control failures and necessary actions, using business – rather than risk – language to enable improvements to the existing internal control framework; and
- gain sponsorship from the board.

Risk management and shareholder value **10.13**

When considering the impact of the Turnbull Report on risk management and shareholder value over the last few years companies have worked to:

- analyse the impact of greater disclosure of risk management processes on shareholder value;
- manage all aspects of risk effectively;

- address the possibility of insurance as a relevant strategy to identify whether risk transfer addresses the correct risks and is desirable in a modern economic model;
- assess the level of technical expertise among the directors and identify the new issues that they need to address such as the efficacy of the information supply lines, the need to appoint new directors and the expectation of shareholders; and
- understand how the failure to provide the right people with the right skills can lead to executive errors.

When reviewing board issues, companies have also had to address:

- how the board should be structured to compensate for shortcomings;
- the extent to which directors need effective training;
- the way in which the risk of material misstatement can be mitigated effectively;
- the identifying of the role of directors and auditors in providing assurance;
- complying with the requirement to separate critical boardroom roles and establish clear responsibilities between the chairman, chief executive and the independent senior non-executive director.

Embedding the risk management processes **10.14**

The business world has improved risk awareness in order to:

- embed risk management processes in the organisation to meet the requirements;
- improve business performance; and
- gain competitive advantage.

The goals are to:

- establish best practice, using the Turnbull Report to create an embedded risk management process;
- establish a business risk exploitation programme;
- identify and evaluate the significant risks;
- deal with exposures and exploit opportunities;
- integrate the process within any existing risk management framework;
- monitor key risks;
- co-ordinate assurance activities across the organisation;
- refocus the function of internal audit;
- create a continuous embedded process; and
- measure benefits.

Legal risks **10.15**

As has been indicated in other chapters (such as **Chapters 1, 6 and 8**) the management of risks has evident implications for legal risk management and internal due diligence.

In order to minimise legal risk, a company must:

- understand the legal challenges if directors exercise judgement in areas in which they have not done before and things go wrong;

- identify the specific types of proceedings to be concerned about, such as potential exposure to negligence claims or the potential for litigation of US shareholders;
- review the role of the in-house lawyer to enable a dynamic growing business;
- grasp the connection between risk management and legal relationships with customers, suppliers, regulators, employees and consumers;
- adopt a legal risk management approach that is flexible enough to identify the changes in risk; and
- achieve an active embedded cultural concept of legal risk management.

It is also important to relate the above to the company's corporate governance approach.

Reporting Turnbull compliance **10.16**

There is no doubt that the reporting trend is here to stay. Companies that have become compliant with the Turnbull requirements have had to consider:

- what to write in their disclosure in the annual report in order to optimise the wording disclosure and reporting of their risk management structure;
- identifying which information is 'meaningful' or 'high level' and should therefore be disclosed;
- ensuring that transparency is promoted and misleading statements are avoided;
- implementing a risk management strategy to assess the probability and impacts of key risks on the company's finances and reputation; and
- providing reasonable assurance to executive management and the board about the adequacy and effectiveness of the risk management and control framework.

Recent developments **10.17**

As has been indicated earlier the reporting of major corporate scandals has led to a rapid regulatory response in many countries that has in turn impacted hugely on the way companies do business. One of the main examples of such regulatory response has been the enactment of the *Sarbanes-Oxley Act of 2002 (SOX)* in the USA. This legislation, known as the *SOX* legislation, has had such ramifications for business that the legislation is assessed in depth in **Chapter 11**.

For the present purposes it is important to bear in mind that the *SOX* legislation:

- relates to all US listed companies, including overseas companies with US listing;
- introduced a huge change as regards the accountability of the board; and
- brought about a 'sea change' in audit practice.

Other major developments have been the review in the UK of the role and effectiveness of non-executive directors known as 'the Higgs Report' and the audit committees Combined Code Guidance known as 'the Smith Report' (referred to also above). The former considered the role of non-executive directors in depth and proposes changes to the Combined Code and the latter deals with the role of the audit committee.

Practical corporate governance 10.18

Having regard to the definitions referred to in the heading 'Definitions' and the interaction with risk management that has been highlighted, certain steps may be identified to establish a system and structure of corporate governance. The key steps of a system that has regard to the requirements referred to in **10.9–10.16** can be proposed. These key steps are to:

- establish and implement a risk management framework;
- ensure the full commitment and support of the board and the chief executive officer (CEO) to best practice as regards corporate governance standards and activities;
- establish an audit committee;
- establish a remuneration committee that fulfils the Greenbury requirements;
- establish a nomination committee;
- organise the board agenda to cover standing items that deal properly with corporate governance;
- devise a programme of shareholder communication;
- prepare an annual timetable to ensure effective preparation for the annual general meeting (AGM);
- monitor changes in the context of corporate governance and plan appropriate responses; and
- ensure that there are adequate resources for corporate governance and risk management functions.

All of these steps can be taken following some of the suggestions below.

Risk management framework 10.19

Bearing in mind the Turnbull Guidelines in particular, in today's business world it is now imperative for companies to establish:

- an internal risk management structure using a formal risk management methodology, including:
  - risk identification techniques;
  - quantitative and qualitative risk assessment;
  - cost effective methods for risk reduction and transfer;
- a process such as the UK Risk Management Process contained in the Standard (see **10.34**);
- a review process by internal audit to ensure the effective operation of the risk management framework.

Board commitment 10.20

Without top to bottom commitment the introduction of most policies will not succeed. This is certainly true of corporate governance where, as has been seen, many of the issues are directed at the board in particular. Therefore the CEO and the board must be fully committed to good standards of corporate governance and must support and promote all related corporate governance activities. Without the full commitment of the board any system will fail. To assist the implementation of a practical system the board should agree and sign off the risk management activities through, for example:

- the engagement of a risk manager and support staff;
- the financial resources to enable the undertaking of risk control activities; and
- proper disaster recovery planning.

It is vital that the board creates the culture of commitment to good corporate governance by demonstrating an example and expecting effective risk management and corporate governance from senior management and staff.

The audit committee 10.21

It is important that the company establishes an audit committee as part of the corporate governance system and structure. The Smith Report, which was a major report entitled 'Audit Committees – Combined Guidance: A report and proposed guidance by an FRC-appointed group', should be examined carefully by the chairman of the audit committee. In any event:

- the company should aim to have an audit committee or explain in the annual report why it does not have one and review the need for one from time to time;
- the audit committee should consist of at least three non-executive directors and have clear terms of reference and authority and duties; and
- the audit committee should keep the work of the internal audit function and the results of the external auditors findings under review.

The remuneration committee 10.22

In view of the sensitivity of the remuneration of directors and the manifold problems that have occurred in this regard, strict and clear guidance has emerged for companies, as follows:

- the company should establish a remuneration committee;
- the remuneration committee should consist of non-executive directors who are free from any business or other relationship that could materially affect or interfere with their judgement;

- all bonuses that are payable to directors should be based on performance and designed to enhance the business;
- the remuneration committee should establish levels of remuneration for directors that are sufficient to attract and retain the directors needed to run the company successfully, having regard to the external market and relevant benchmarks;
- a stated policy on remuneration should be prepared for communication to the shareholders; and
- the statement of actual salaries of directors and the remuneration report should be prepared for the annual report.

The nomination committee **10.23**

The establishment of a nomination committee also helps to endorse the commitment to corporate governance. Certain points should be borne in mind:

- a nomination committee should be set up to make recommendations to the board in connection with all appointments to the board unless the board is small;
- the nomination committee should mainly consist of those non-executive directors that are most suitable for the task; and
- the board should be ready, willing and prepared to respond to shareholders' questions regarding why a particular director has been nominated or has been approved.

The board agenda **10.24**

It cannot be overemphasised that the board must be positively engaged in risk management in an ongoing manner. It is also important for the board to be guided on these issues with an appropriate agenda. Therefore the company should consider that:

- the company secretary should draft board agendas and set aside appropriate time in order that meetings regarding corporate governance matters receive full and proper attention;
- the meetings should occur on a regular basis, generally monthly, so that standing items on the agenda can be dealt with including:
  - the risk management report, with details of any breaches of internal financial controls;
  - proposed new business activities; and
  - any new risks that are material;
- the items that are periodic would generally cover:
  - reports – usually quarterly – from the audit committee;
  - the remuneration report, usually annually or as required; and
  - board nominations, at least annually or as required.

Shareholder communication 10.25

Many of the recent concerns have shaken stakeholder confidence in companies and can be addressed only by appropriate communication. Key points on appropriate communication are listed below:

- The Combined Code gives a clear expectation that institutional investors should use their voting powers with discretion;
- Boards of companies should be ready to enter into a dialogue with institutional investors;
- In accordance with the Code boards should use the AGM to communicate with private investors and encourage their participation, by voting on resolutions, expressing opinions and asking questions; and
- The board should consider the best way forward for a programme of communication.

The annual timetable 10.26

As part of the commitment to demonstrate best practice and good corporate governance, the company should have an appropriate annual timetable that fulfils the requirements of the regulatory framework. Such a schedule ensures proper preparation for the AGM. With this in mind the schedule should:

- ensure that all board meetings are set a year in advance;
- confirm regular dates for reports from the risk management team, audit committee, nomination committee and remuneration committee; and
- ensure that directors are provided with all relevant information in good time to enable them to conduct a review of the effectiveness of the system of financial control and sign off of the report to shareholders that they have done so.

Monitor changes and plans 10.27

It should always be borne in mind that this is a dynamic subject and that it has practical repercussions on the day-to-day operation of the company. Therefore any changes in corporate governance should be followed up and appropriate responses developed. In particular it should be recalled that:

- since 1992 the development of the corporate requirements of listing authorities has taken place;
- meanwhile the expectations of shareholders have been developing and higher standards of management are required now;
- the Higgs Report and the Smith Report have endorsed the expansion of corporate governance; and
- the new Combined Code is showing the way forward.

Resources for risk management and corporate governance 10.28

The allocation of resources is always a sensitive issue. There is no doubt that, as with other policies, the success of a strategy for corporate governance depends on the resources allocated to it. Therefore:

- successful risk management and corporate governance strategies depend on the qualifications, experience and commitment of the organisation's staff;
- as this may be a new, and fast growing, area of corporate activity there should be an ongoing assessment of the numbers of staff required; and
- as a result of the link to the audit function it should be noted that there is a trend for accounting personnel to be selected into risk management positions even though this is not always appropriate.

The role of risk management 10.29

In many contexts, particularly in events following the Turnbull Report in 1999 risk management was regarded as a threat to business. Risk management should not only be considered to be a threat – it should also be recognised as an opportunity. With this in mind a company should consider that:

- the role of risk management is a function to optimise outcomes such as profit objectives, return on investment and performance measures, that is value creation;
- there are strong loss prevention implications;
- effective and comprehensive risk management facilitates improved risk taking analysis to improve decision taking;
- this is a role that has grown from insurance and health and safety, as well as accounting; and
- it is very closely related to corporate governance.

The development of risk management is a subject that requires extensive comment. While it is not the place to comment in great detail in this handbook, some of the developments that are relevant to corporate governance should be touched upon in the interests of clarity. A brief discussion is set out below in the following paragraphs.

The risk manager 10.30

In order to fulfil the corporate governance requirements it is proposed that there should be a risk management round table. The members of the round table would carry out their tasks while the risk manager would undertake facilitation and administration. The round table would consist of representatives from the following departments:

- legal/secretarial;
- finance;

- treasury;
- IT;
- corporate communications and branding;
- health and safety;
- human resources;
- security;
- quality; and
- procurement.

Senior management 10.31

The matter of commitment has already been pointed out on several occasions. In order to ensure change it is vital that senior risk management members of staff support the risk management strategy. Senior management can ensure:

- authorisation for the risk manager's function by the senior management team;
- top level sponsorship, which usually provides the most effective way to open doors and build networks;
- identify and prioritise necessary changes through risk analysis;
- enable best practice reports for the board as they bear ultimate responsibility for decision-making; and
- recognition and value for the function.

Periodically the corporate governance and risk management activities of the organisation should be assessed externally. Advice from external auditors should be taken by the board on their performance to understand whether they are effective in what they do. It has been recognised that peer group reviews as well as major investors' views should be sought.

The future 10.32

Bearing in mind the evolving approach to corporate governance and risk management in the future, the focus of the role of the risk manager could include:

- risk financing as a vital balance sheet management tool;
- a strong interest in risk reduction rather than avoidance;
- an emphasis on profiling and mapping;
- stewardship of the risk management and corporate governance framework;
- selling the agenda for the risk management round table;
- undertaking research and keeping or storing risk information; and
- assisting completion reports to senior management;

It seems clear that the demand for the traditional risk manager will continue to expand in today's demanding business world, as well as the role or function of systems and methodologies.

Systems and methodologies for risk management 10.33

In order to address risk management in practice and having regard to the Cadbury Report's definition of corporate governance (see **10.1**), the meaning of methodologies and systems should be also considered.

According to the Concise Oxford Dictionary a system is 'a complex whole, a set of connected things or parts'. A method is defined as 'a special form of procedure; the orderly arrangement of ideas'. Whereas risk management can be generally understood as the management of inherent risk, thereby leaving 'residual risk' for the business, risk management methodology can be defined as 'a set of connected ideas that are applied in practice as an orderly 'arrangement of actions'. Risk managers and practitioners, however, often have very different views on the order of actions and the terminology that is applied in the area of risk management can vary considerably. Nevertheless for the purpose of this discussion a practical approach to risk strategy is helpful. As can be seen elsewhere in this handbook (such as **Chapters 4, 6–8**) as well as in other legal and business publications, a risk strategy can, for example, cover:

- ethical, social and reputational risks;
- new and emerging risks;
- developments in directors' liabilities;
- Turnbull and its practical implications; and
- exploiting risks as opportunities.

Therefore a risk management framework might cover:

- types of product liability/recall;
- intellectual property, licensing;
- reputation;
- environment;
- health and safety;
- business interruption; and
- ethical issues.

As is mentioned in the discussion of Turnbull in particular, it is most important to achieve the commitment of the board and buy-in for business risk management. It is vital that the board is convinced that risk management is good practice and that it:

- can be used to demonstrate a level of corporate governance that complies with the requirements of the Combined Code and associated Turnbull Report;
- will avoid a poor audit report;
- will help mitigate health and safety issues;
- will combat directors' criminal liabilities (including corporate manslaughter charges);
- is a value-adding, profit-related exercise.

With this in mind, a risk manager has to apply a risk management methodology that maximises efficient use of the board's time when addressing risk control measures. They should build the confidence of the board that all significant risks have been identified and are being controlled so that the impact of embedding risk management into the framework of the business reaps clear results.

Accordingly, risk management standards have been introduced to provide a methodology for risk management that can be referred to and be adapted to the needs of the business.

Below **10.34** highlights the main aspects of such standards – set out as a practical overview. One useful approach is to base the organisation's methodology on the risk management standard (below in **10.35**).

Risk management standards **10.34**

In 1995 the first comprehensive risk management standard was published in Australia after a consultation process administered by academics. This was updated in 1999. This Standard was published by the Australia and New Zealand Standards Authorities (for further discussion of corporate governance in Australia see **Chapter 14** and www.standards.com.au). In 2002 the UK Risk Management Standard was published after a joint initiative was undertaken by the Institute of Risk Management (IRM), the Association of Insurers and Risk Managers (AIRMIC) and ALARM (see www.irm.org). This received input from the Association of British Insurers (ABI) and the Institute of Internal Auditors (IIA) in the UK but is yet to be adopted by the British Standards Institute (BSI).

The main features of the Australasian and British Standards are:

- the concept of 'flow process' risk is promoted by both;
- both contain definitions of risk terminology;
- the UK Standard incorporates the International Organization for Standardization (ISO) Guide 73 risk management vocabulary; and
- neither Standard is compulsory or prescriptive.

The UK Risk Management Standard **10.35**

The UK Risk Management Standard sets out a risk management process. The key characteristics of the process that form part of the audit process and modification are:

- setting the organisation's strategic objectives;
- risk assessment;
- risk analysis;
- risk identification;
- risk description;
- risk estimation;
- risk evaluation;
- risk reporting;
- threats and opportunities;
- decision;

- risk treatment;
- residual risk reporting; and
- monitoring.

For more detail regarding the elements of the Standard see www.theirm.org and the ISO Risk Vocabulary. In accordance with the Standard, the approach an organisation has towards risk management will be guided by its strategic objectives such as:

- the risk environment including financial and political issues;
- the nature of the business, that is the sector, for example chemicals or healthcare, and the high risk activities as in the airline, shipping or construction business; and
- the effect of external influences such as regulatory framework and listing requirements.

As a matter of best practice, risk management should take into account the legal, regulatory, moral and contractual limitations or constraints.

Following is a summary of a selection of the key characteristics of the process.

Risk assessment 10.36

Risk assessment is the first stage of the process and is defined by the ISO Guide as 'the overall process of risk analysis and risk evaluation'. Since the identification of risks is vital for the treatment of risk, risk evaluation is part of the risk analysis. The risks should be set out or be noted down. The estimates of the potential likelihood and impact of the risk event must be made.

Risk analysis 10.37

Risk analysis forms the second stage, in the following manner:

- risk identification;
- risk description; and
- risk estimation.

Risk identification 10.38

Risk identification is the 'process to find, list and characterise [describe] elements of risk according to the Risk Management Standard'. While it is possible to identify risks without formal processes this is unlikely to be so effective. Therefore it should be approached in a structured way in order to ensure that all significant activities within the organisation have been captured and the risks flowing from these activities are identified. The results must be co-ordinated and centralised. There are very well established formal risk identification techniques and these include:

- the brainstorming of risks through workshops at different organisational levels including the board, management and operational staff, as well as across different departments, subsidiaries and geographical regions;
- business process and scenario analysis;
- flow process analysis;

- incident investigation;
- auditing and inspection;
- hazard and operability studies (HAZOPs);
- fault trees; and
- statistical analysis.

In terms of quantitative and qualitative risk analysis each risk that is identified and described must be measured, either using quantified techniques or qualitative views. There are various known quantitative techniques such as Monte Carlo simulation, which randomly generates values for uncertain variables over and over to simulate a model; commercial software is also available, for example @Risk and loss trend forecasting.

The brainstorming period is crucial since it enables input from across the organisation. During the brainstorming and risk identification workshops subjective views and financial impact can be gathered. The brainstorming session should be facilitated by someone who is familiar with risk management. This will help direct the debate and identify relevant risk issues. Nevertheless all comments are valid and all ideas noted for later discussion. When the risks have been captured they can be grouped according to type, such as:

- strategic – long-term objectives;
- operational – day-to-day activities;
- financial – internal and external financial risk factors;
- knowledge management – control and protection of knowledge resources; and
- compliance – legal or regulatory.

Risk description and estimation 10.39

The purpose of risk description is to display the identified risks in a structured format, for instance through a risk map (see **10.40**). As regards the estimation of risk, this can be quantitative, semi-quantitative or qualitative in terms of the probability of occurrence and potential impact. The estimate of impact may relate to threats or downside risks and opportunities or upside risks. The estimated probability and impact is over-laid on the risk map and can be finite or grouped by consequence and risk. By way of example as regards fire risk:

- probability of fire: low, medium or high or one in 5, 10 or 25 years, etc.;
- potential impact of fire: low, medium or high: up to £l million, £l–5 million or over, £5 million.

Risk prioritisation and risk mapping 10.40

The advantages of risk prioritisation are that an agenda for action is produced and cost–benefit judgements can be made. There are some tips that can be referred to by the business such as:

- each risk will have some probability and frequency rating attached to it;
- the current risk control status will reduce a ‘gross’ risk to a ‘net’ or ‘current’ risk;

- the risks can be listed according to the greatest financial impact; and
- the listing will never be final as it is so hard to accurately quantify exposures.

Risk mapping is the identification, quantification and prioritisation of risks that enables a clear risk profile or risk map to be constructed. A risk map enables a central focal point for risk treatment activities and to record gross and net risk. Based on the risk map summarised reports to the board can be prepared. Risk mapping is therefore a process that is a key part of monitoring and review of the risk management process.

Risk treatment 10.41

Corporate governance practices require directors to have good risk management information. According to the Cadbury Report [1] 'Boards should have a formal schedule of matters specifically reserved to them including … risk management policies' (Cadbury, paragraph 4.23). In order to comply with this requirement the organisation's upward reporting structure should be such that the right people are informed of the risk profile. In addition risk treatment activities should be properly assigned so that 'risk owners' are noted in the risk profile schedules. Risk treatment is the process of selecting and implementing measures to modify the risk. The key elements of risk treatment are:

(a) Risk control – it is quite clear that risk control is the core function of risk management; its objective is the reduction or removal of the underlying risks of the business. Risk controls can of course cover a wide range of activities, such as:
   - ○ internal financial controls;
   - ○ good contract management;
   - ○ product efficacy and safety;
   - ○ health and safety of employees and the public;
   - ○ sprinkler and other fire protection;
   - ○ construction standards; and
   - ○ security.

(b) Risk transfer other than insurance – can be achieved by several methods, other than insurance, the most usual being by contract conditions and outplacement or joint venture structures:
   - ○ contractual risk transfer includes statements in the contract regarding who has responsibility for any loss events, known as indemnity and 'hold harmless' clauses (see also **Chapter 1**); and
   - ○ risk transfer by outplacement has the effect of moving responsibility for risk control to another party.

   Despite such methods the risk transfer alone does not control or reduce the 'gross' risk.

(c) Risk financing including insurance – also involves several methods that do include insurance. The various sources of finance include:
   - ○ insurance;
   - ○ cash flow;

- ○ bank lines of credit;
- ○ reserves in the bank; and
- ○ shareholders funds.

Generally insurance is acquired when there is a legal requirement and when the organisation decides that the premium payable – the price – is worth the transfer of the risk.

(d) Risk avoidance – can occur through strategic decisions such as withdrawing from a market sector or region such as the manufacture of chemicals and being in the volatile film industry or the sale of products in the USA. Apart from such withdrawal other risk avoidance strategies include the purchase of forward contracts for the supply of raw materials or for the sale of the organisation's product. One caution is that there may be very limited scope in practice to avoid risks since the avoidance of one risk can often mean exposure to other risks.

Residual risk 10.42

It is important to recall that the above exercise is intended here to enable a risk management strategy to fulfil the requirements of corporate governance. Part of a good risk management structure is the presence of contingency planning to address the effects of adverse events as and when they occur. Since effective risk management involves the continuous assessment of both the risk environment and the operation of the identification, analysis and treatment process monitoring should take place. Risks are always changing and the response should be effective and rapid. Therefore an external review or audit of the overall process is necessary to enable the senior management to be confident that good risk management is in place and that the residual risk really reflects good corporate governance practice.

The OFR and the Companies Act 2006 10.43

As has been referred to in earlier chapters, the 'Company Law Review' (Department of Trade and Industry (DTI), July 2002) identified the fact that company accounting and reporting was backward looking and based on financial indicators. There were few statutory requirements to report on the main qualitative factors which underlied past and future performance, in particular on intangible, and the so-called 'soft' assets (which may contribute significantly to success but are not well captured in traditional financial statements); and on key business and wider relationships. Yet a good reputation is considered central to every company in its acquittal of its responsibilities (see also **Chapter 7**). As explained previously, the legal requirement to produce an operating and financial review (OFR) was due to apply to 1,290 companies in the UK (see also **Chapters 4** and **7**) but was withdrawn by the then UK Chancellor Gordon Brown. Instead the Companies Act 2006 has set out duties for directors (see below). Preparations for the OFR led directors to explore and understand the agendas not only of shareholders, but also of other stakeholders – employees, customers, suppliers, non-governmental organisations (NGOs), local communities, society – that are likely, directly or indirectly, to influence the performance of the business and its value. A further proposed requirement was to include appropriate performance indicators, where directors were to include quantitative data wherever they could. Therefore, by way of preparation for the OFR several companies had begun to address anticipated events, and include an assessment of non-financial issues that could have significant consequences for future performance and value. In this context:

- Directors may have also addressed the link between their strategy and the key attributes upon which the company's reputation was built (see the **Appendix** to **Chapter 8**); and
- Directors may have considered the approaches adopted by others in the same industry to see whether any consistent approaches might be appropriate in their own case.

In terms of process, the OFR recommended mapping, that is, audit trails, and references to best practice. Account had to be taken of actual and potential sources of value creation in the business as well as the factors that might prejudice value creation. There could have been an incentive for special work to be done or advice obtained on a particular issue or topic that the board considered important but that did not fit readily into existing management structures, in the social and environmental areas for example. Businesses with significant groups of stakeholders were likely to benefit from the results of consultations with these groups to ascertain their view of the key issues, and the potential effect on business reputation. Boards may have needed to decide on an appropriate approach for 'new' information. This process – along with the requirements referred to above – has been changed by the introduction of the business review introduced by the Companies Act 2006 (the Act) and referred to further below in the overview set out in key bullet points: it is recommended that specific advice should be obtained on the Act's details.

The Companies Act 2006 received the Royal Assent on 8 November 2006 and is being brought into force through a series of instalments between November 2006 and October 2008. This type of phased introduction is largely due to the fact that the Companies Act 2006 is one of the longest Acts of Parliament in British history, consisting of nearly 1,300 sections and 16 schedules. The length of the Act reflects the ambitious objective to codify and regularise huge corporate case law materials. The Company Law Reform White Paper (2002) stated that the proposals for change were intended to:

- ensure a 'greater transparency and accountability within a company's operations';
- provide shareholders with 'greater opportunity … to play an informed part in company business'.

The codification of company case law will bring an estimated £30–105 million in savings to companies per year, as directors would require less advice on how to run their organisation. At its core, the Companies Act 2006 aims to promote four general themes (referred to below) and to benefit business in the following key ways, that is to:

- Clarify the position on directors' general duties and bring them into conformity with modern business practice;
- Make greater use of electronic communication with shareholders;
- Clarify the position on liability for reports to the market;
- Enable directors to have the automatic option of filing a service address at Companies House (rather than their private home address);
- Improved the rules for company names;
- Remove the requirement to specify the company's 'objects';
- Clarify that the company memorandum should become a formal document recording the position at the point of registration, with the articles being the continuing constitutional document;
- Enable shareholders to agree limitations on the liability of auditors; and
- As a result general duties for directors (Sections 171–177) were introduced, that is to:
    - Act in accordance with the company's constitution and only exercise powers for their proper purpose;
    - Promote the success of the company for members benefit ('enlightened shareholder value'): this means directors must have regard to:
        - the likely consequences of any decision in the long term;
        - the interests of the company's employees;
        - the need to foster business relationships with suppliers, customers and others;
        - the impact of the company's operations on the community and the environment;
        - the desirability of the company maintaining a reputation for high standards of business conduct; and
        - the need to act fairly as between members.
    - Exercise independent judgement;
    - Exercise reasonable care, skill and diligence: this duty codifies the common law rule of duty of care and skill. Section 174(2) states that a director is expected to use care, skill and diligence that would be exercised by a reasonably diligent person with:
        - the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and
        - the general knowledge, skill and experience that the director has.
    - Avoid conflicts of interest (comes into force in October 2008) (Section 175).
    - Refuse benefits from third parties (comes into force in 2008) (Section 176): this duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.
    - Declare any interest in any proposed and existing transaction or arrangement with the company (comes into force in October 2008) (Sections 177 and 182).

As regards additional provisions that directors need to comply with, the following provisions took effect on 1 October 2007:

- Directors' service contracts: members' approval for contracts in excess of two years;
- Directors' loans: all companies can make loans to directors with shareholder approval and a public company or companies associated with public company may make a quasi-loan to a director with shareholder approval;
- Natural persons: companies must have at least one director who is a natural person from 1 October 2008 – proposed grace period until October 2010 for companies which did not have a natural person as director on 8 November 2006;
- Age limit: there is no longer an upper age limit for public company directors (there will be a lower age limit of 16 from 1 October 2008);
- Loss of office: extended members' rights of approval; and
- Substantial property transactions:
    - Members' approval required;
    - Companies may enter into arrangement conditional on shareholder approval being obtained; and
    - The de minimis threshold for the meaning of substantial raised from £2,000 to £5,000.
- Directors' liabilities:
    - The law under 1985 Act largely remains but there are new provisions allowing companies to provide qualified pension scheme indemnity provisions (QPSIPs); and
    - Shareholders decision to ratify acts of directors amounting to negligence, default, breach of duty or trust must be taken without reliance on the votes of the directors concerned.

Derivative actions **10.44**

From 1 October 2007 there are a wider range of circumstances for a shareholder to bring a derivative claim, including claims:

- as a result of a director's negligence; and
- for a breach of a director's duty even if the director has not benefited personally.

There is no requirement to show that the directors who carried out the wrongdoing control the majority of the company shares.

Resolutions and meetings **10.45**

From 1 October 2007 the following apply:

- Enhanced rights of proxies: for example the right to attend, speak and vote at meetings on a show of hands or on a poll. Members are also allowed to nominate one or more non-members to receive a copy of all notices, reports and accounts.

- Written resolutions: less bureaucracy;
- Short notice: 90% for calling a general meeting on short notice (private companies);
- AGMs: no longer required for private companies;
- Notice period for general meetings: generally reduced to 14 days (AGMs will require 21 days notice); and
- Register of members: new measures modifying the right to inspect and be provided with a copy of the Company's Register for requests made on or after 1 October 2007:
  - Inspection by non-members must be for a 'proper purpose'.
  - Company may refer a request to court if they think it has not been made for a proper purpose.

Other changes **10.46**

- Institutional disclosure of voting: the Secretary of State has a reserve power under the Act to make regulations requiring institutional investors to disclose information about the exercise of voting rights attached to shares in which they have an interest of 75%.

Business Review Overview **10.47**

In view of the debate that took place in the context of the withdrawal of the OFR and the inclusion in the Act of the need for a Business Review this is considered in separate bullets and headings below. Essentially Section 417 of the Act states that unless a company is subject to the small companies' regime (Note (i)) the Directors' Report within the annual report and accounts must contain a Business Review.

The purpose of the Business Review

To inform members of the company and help them to assess how the directors have performed their duty to promote the success of the company.

The requirements

A balanced and comprehensive analysis of:

- the development and performance of the company's business during the financial year; and
- the position of the company's business at the end of that year, consistent with the size and complexity of the business.

Content specifics

To the extent necessary for an understanding of the development, performance or position of the company's business, the Review should include:

- a fair view of the company's business;
- a description of the principal risks and uncertainties facing the company;

- an analysis using financial key performance indicators (Note (ii));
- where appropriate, an analysis using other key performance indicators (including information relating to environmental and employee matters) (Note (iii));
- where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

There is no requirement for the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

Quoted company requirements

The Business Review must include:

- the main trends and factors likely to affect the future development, performance and position of the company's business;
- information about
  - ○ environmental matters;
  - ○ the company's employees; and
  - ○ social and community issues, including information about any policies of the company in relation to those matters and their effectiveness; and
- information about persons with whom the company has contractual or other arrangements which are essential to the business of the company (Note (iv)).

Omissions

The Business Review must state which of the above kinds of information are not contained within it.

Group directors' reports

The Business Review has effect as if the references to the company were references to the undertakings included in the consolidation.

Directors' liability

Directors are liable to the company for the contents of the Directors' Report (and any Remuneration Report), including summaries thereof, for losses resulting from knowingly or recklessly providing untrue or misleading information.

Business Review Overview Notes

(i) A company satisfying two or more of the following conditions in a financial year qualifies under the small companies' regime:
  - ○ Turnover – not more than £5.6 million.
  - ○ Balance sheet total – not more than £2.8 million.
  - ○ Number of employees (average in the year) – not more than 50.

(ii) 'Key performance indicators' = factors by reference to which the development, performance or position of the company's business can be measured effectively.

(iii) Where a company qualifies as medium sized in relation to a financial year, the directors' report for the year need not comply with these requirements so far as they relate to non-financial information. A company satisfying two or more of the following conditions in a financial year qualifies as medium sized:
- ○ Turnover – not more than £22.8 million.
- ○ Balance sheet total – not more than £11.4 million.
- ○ Number of employees (average in the year) – not more than 250.

(iv) No disclosure is required of information about a person if the disclosure would, in the opinion of the directors, be seriously prejudicial to that person and contrary to the public interest.

Action points: Practical hints and tips
Directors need to consider their approach to:

- analysing the development, performance and position of the business;
- identifying and describing principal risks and uncertainties;
- identifying financial and non-financial key performance indicators;
- analysing and reporting on key performance indicators.

Quoted company directors also need to consider:

- trends and factors likely to affect the future development, performance and position of the business in addition to;
- information regarding environmental matters, employees and social/community issues – including details of related company policies and their effectiveness;
- disclosure of contractual or other arrangements which are essential to the company's business;
- which, if any, of the above information is not contained within the Business Review.

Conclusion **10.48**

Today there are already several issues relevant to corporate governance such as, company law reforms, director's compensation, self-regulation and the role of audit committees. However, several additional business imperatives will drive the move towards high levels of corporate governance in the 21st century, including section key questions such as;

- What are the pressures or fears that force business leaders to make decisions detrimental to the company?
- How can they be helped to be more integral to their own organisations?
- How can the board of directors play a more useful role?

The owners have to bring about an attitudinal change and identify more with the aspirations of each stakeholder. One way in which organisations can improve their standards of corporate governance in the future is by focusing on how they choose external directors – they should be selected mainly on the basis of their experience and expertise.

Modern corporate governance also emphasises the role of shareholders and financial institutions. Shareholders should be involved in all major decisions and financial institutions should appoint functional experts to represent them on the boards of companies in which they have substantial holdings.

Effective corporate governance requires a clear understanding of the respective roles of the board, of senior management and their relationships with others in the corporate structure. The relationships of the board and management with shareholders should be characterised by candour; their relationships with employees should be characterised by fairness; their relationships with the communities in which they operate should be characterised by good citizenship and their relationships with government should be characterised by a commitment to compliance.

The corporate environment elsewhere, such as India and Australia, has not remained indifferent to the developments that were taking place in the UK. In fact, as indicated earlier in **10.1**, the developments in the UK have had tremendous influence on the developments in other countries. In places such as India UK development inspired the process that has led them to laying down their own ground rules on corporate governance (see **Chapter 12**). For example, as a result of the interest generated in the corporate sector by the Cadbury Committee's report [1], the issue of corporate governance was studied in depth and dealt with by the Confederation of Indian Industry (CII), the Associated Chambers of Commerce and Industry of India (ASSOC-HAM) and the Securities and Exchange Board of India (SEBI) through Kumar Mangalam Birla Committee Report (cited in **10.1**). With this in mind it is interesting to look upon the corporate governance model in other countries (see **Chapter 12–15**).

References

1. Committee on the Financial Aspects of Corporate Governance, *Report with Code of Best Practice (Cadbury Report)*, Gee Publishing, London, 1992.
2. Confederation of British Industry. The Greenbury Committee. *Directors' Remuneration – Report of a Study Group* (chaired by Sir Richard Greenbury), July 1995.
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11

The Sarbanes-Oxley Act of 2002

11 The Sarbanes-Oxley Act of 2002

'The Sarbanes-Oxley Act is arguably the most sweeping and important US federal securities legislation affecting public companies and other market participants since the SEC was created in 1934.'

Ethiopis Tafara, Acting Director, Office of International Affairs,
US Securities and Exchange Commission (10 June 2003)

CHAPTER OVERVIEW

11.1 The last several years have seen an unprecedented upswing in reports of accounting and other irregularities at public companies. There was a time, a few years ago, when every day seemed to bring with it a new report that a public company was in the process of re-stating its earnings, seeking bankruptcy protection, fighting criminal indictments or sometimes all of the above. In the wake of these developments, it was hardly a surprise when the US legislature took action. On 30 July 2002, President Bush signed into law the *Corporate Accounting Reform and Investor Protection Act of 2002*, which is now almost universally referred to as the *Sarbanes-Oxley Act of 2002* (*SOX or the Act*) (Pub. L. No. 107–204 116 Stat. 745). Despite its swift drafting and passage, *SOX* has had and will likely continue to have profound implications not just for public companies, but for all companies doing business in the USA.

It is important to first acknowledge the scope *of SOX*. While the scope of the Act may seem, at least on its face, to be quite limited, the more accurate answer may be that only time will tell the true reach of the Act. By its own terms, *SOX* applies only to public companies and the accounting firms that audit them. In the long run, however, the changes to corporate governance and accounting imposed by *SOX* may gradually become institutionalised as series of best practices that are adopted by non-public companies as an appropriate baseline. Furthermore, it is certainly possible that states, and indeed the USA itself, may ultimately decide that the principles enunciated in *SOX* should be equally applicable to private companies.

At its core, *SOX* has five primary areas of focus: the Act:

- establishes a Public Company Accounting Oversight Board (sometimes referred to as the PCAOB or the Board);
- sets forth new and revised standards for auditor independence, many of which are carryovers from the auditor independence rules adopted by the Securities and Exchange Commission (SEC) in 2002;
- promotes revised corporate governance guidelines addressing audit committees, conflicts of interest for officers and directors and enhanced financial disclosure;
- authorises numerous studies and reports to assess various concerns that gave rise to the Act; and
- imposes new and strengthens existing criminal penalties for violations of the Act and the securities laws.

See generally summary of SEC actions and SEC-related provisions pursuant to *the SOX*, issued by the SEC (30 July 2003), summarising SEC-related aspects of the Act.

In so far as this US legislation has had such extensive ramifications globally, it is important to examine the details of this regulatory framework.

Basic goals of the Act

Public Company Accounting Oversight Board 11.2

SOX established the (PCAOB as an oversight body for accounting firms (*SOX § 101, 15 USC § 7211*). Given the historical focus on self-regulation in the accounting industry, the concept of any type of external regulatory body was tremendously contentious. Ultimately, the compromise reached by the drafters of the Act was that the PCAOB, unlike the SEC and other regulatory bodies, would be a non-profit corporation, not an agency or establishment of the government. Accordingly, the PCAOB embodied a compromise and something of a hybrid – neither a part of the government nor of the accounting industry.

> 'The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress … The Board shall not be an agency or establishment of the United States Government, and, except as otherwise provided in this Act, shall be subject to, and have all the powers conferred upon a nonprofit corporation by, the District of Columbia Nonprofit Corporation Act' (*SOX § 101(a)–(b), 15 USC § 7211(a)–(b)*).

The PCAOB is not, however, entirely autonomous and is subject to a certain degree of SEC oversight (*SOX § 107(a), 15 USC § 7217(a)*).

The PCAOB has three primary responsibilities which may be generalised as registration, promulgation and regulation. Under the Act, all accounting firms that prepare or issue, or participate in the preparation or issuance, of audit reports for public companies were required to register with the PCAOB within 180 days of its creation (*SOX § 102(a), 15 USC § 7212(a)*). The registration fee ranges, depending on how many public company clients the registrant has, from $250 to $390,000 (*SOX § 102(f), 15 USC § 7212(f)*) (authorisation of PCAOB to charge fees), PCAOB Rule 2103 (stating that the PCAOB will, from time to time, announce the amount of the registration fee).

The PCAOB also has the duty of establishing auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports (*SOX § 103, 15 USC § 7213*). On 14 May 2004, the SEC approved the PCAOB's first auditing standard: *Auditing Standard No. 1*, References in auditors' reports to the standards of the PCAOB; addressing auditing, attestation, quality control, ethics and independence standards, SEC Release No. 34–49707. Since that time, the SEC has approved the following auditing standards:

- *Auditing Standard No. 2*, An audit of internal control over financial reporting performed in conjunction with an audit of financial statements.
- *Auditing Standard No. 3*, Audit documentation.
- *Auditing Standard No. 4*, Reporting on whether a previously reported material weakness continues to exist.
- *Auditing Standard No. 5*, An audit of internal control over financial reporting that is integrated with an audit of financial statements.

Auditing Standard No. 5, approved by the SEC on 25 July 2007, replaced the PCAOB's previous internal control auditing standard, *Auditing Standard No. 2* listed above http://www.pcaobus.org/news_and_events/news/2007/07-25.asx. All of the PCAOB's rules are available in a compiled form on the PCAOB's website at http://www.pcaobus.org/rules/RulesOfTheBoard.pdf.

Finally, in order to 'police' auditing companies, the Act authorised and empowered the PCAOB to investigate registered accounting firms and to impose sanctions on them (everything from censure to monetary penalties), *SOX §§ 104–105, 15 USC § 7214–15*. The PCAOB has submitted rules to the SEC for approval which would allow the PCAOB to:

> 'conduct investigations concerning any acts or practices, or omissions to act, by registered public accounting firms and persons associated with such firms, or both, that may violate any provision of the Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards' http://www.pcaobus.org/pcaob_enforcement.asp

The PCAOB's rules would also:

> 'require registered public accounting firms and their associated persons to cooperate with PCAOB investigations, including producing documents and providing testimony … [and would] permit the PCAOB to seek information from other persons, including clients of registered firms' http://www.pcaobus.org/pcaob_enforcement.asp

In order to close a potential loophole for foreign public accounting firms, the Act provides that any such firm that prepares an audit for an issuer must be subject to the Act and the jurisdiction of the PCAOB in the same manner and to the same extent as a public accounting firm that is organised and operates under the laws of the USA or any state, *SOX § 106(a)(1), 15 USC § 7216(a)(1)*. Moreover, the PCAOB is empowered to subject foreign firms to registration and oversight requirements if the firm plays a 'substantial role' in the preparation of audits, *SOX § 106(a)(2), 15 USC § 7216(a)(2)*. By the same token, the SEC or the PCAOB (with SEC approval) may exempt foreign firms from some or all of the requirements of the Act, *SOX § 106(c), 15 USC § 7216(c)*. Note that a foreign firm's registration with the PCAOB does not, by itself, subject that firm to unlimited Federal and State Court Jurisdiction, *SOX § 106(a)(1), 15 USC § 7216(a)(1)*.

The PCAOB is governed by five PCAOB members, *SOX § 101(e)(1), 15 USC § 7211(e)(1)*, two of whom must be or have previously been certified public accountants, *SOX § 101(e)(2), 15 USC § 7211(e)(2)*. PCAOB members may serve up to two five-year terms, provided that the first terms of the initial PCAOB members are staggered over a four-year period, *SOX § 101(e)(5), 15 USC § 7211(e)(5)*. The current members of the PCAOB are: Mark W. Olson (Chairman), Kayla J. Gillan, Daniel L. Goelzer, Bill Gradison and Charles D. Niemeier. The PCAOB's website, http://www.pcaobus.org, contains information about various aspects of the PCAOB's activities, including registration information and the PCAOB's standards documentation.

Auditor independence **11.3**

One of the most significant perceived problems addressed by the Act was the inherent conflicts in the relationship between auditors and their clients. In an effort to prevent future conflicts, the Act set forth new and revised standards for auditor independence, many of which are carryovers from the auditor independence rules adopted by the SEC in 2002, but are even more restrictive.

Under the Act the following non-audit services, if provided to an audit client, would impair an accounting firm's independence and are therefore prohibited:

- bookkeeping or services related to accounting or financial statements;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contribution in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser or investment banking services; and
- legal services and expert services related to audit *SOX § 201(g), 15 USC § 78j-l(g)*.

In addition, an auditor may only provide tax services to a client if those services were pre-approved in advance by company's audit committee, *SOX § 201(h), 15 USC § 78j–l(h)*; *SOX § 202, 15 USC § 78j–l(i)* (describing pre-approval process).

In addition to audit committee pre-approval of tax services, the SEC adopted final rules requiring disclosure of the amount of fees paid to the accounting firm for tax services, *17 CFR § 240.14a-101*. As with many provisions of the Act, the PCAOB may grant exemptions to the above described rules, *SOX § 201(b), 15 USC § 7231(b).*

The Act also acknowledged that the relationship between an audit partner and the corporation he or she audits may, over time, become too close and thus inhibit the auditor's necessary objectivity. Accordingly, an audit partner can only serve in that capacity for five fiscal years; after that, a new audit partner must be appointed, *SOX § 203(j), 15 USC § 78j–l(j).*

Revised corporate governance guidelines **11.4**

The Act promoted revised corporate governance guidelines addressing:

- audit committees;
- conflicts of interest for officers and directors;
- enhanced financial disclosure.

For example, the Act makes it unlawful for an accounting firm to serve as the company's independent auditor if any of the following officers of the company were employed by that firm and was involved in the company's audit during the one-year period prior to commencement of the audit: chief executive officer (CEO), controller, (CFO), or chief accounting officer or any person serving in an equivalent position, *SOX § 206, 15 USC § 78j–l(l).*

Studies and reports **11.5**

In order to determine what additional legislative and regulatory measures might be necessary and appropriate, the Act authorised the undertaking of numerous studies and reports. Among the studies to be undertaken pursuant to the Act are studies on:

- special purpose entities to determine the extent of off-balance sheet transactions, and whether Generally Accepted Accounting Principles (GAAP) result in financial statements of public companies reflecting the economics of such transactions, *SOX § 401, 15 USC § 78m* and *15 USC § 7261*;
- the consolidation of public accounting firms to identify factors that led to consolidation and resulting reduction in number of firms capable of providing audit services to large businesses; affect on capital formation; ways to increase competition and number of firms capable of providing services, *SOX § 701*;
- the role and function of credit rating agencies in the operation of the securities markets, *SOX § 702*;
- the number of securities, lawyers practicing before the SEC who have aided and abetted a violation of the federal securities laws but not been sanctioned, or who have been primary violators, *SOX § 703*;
- enforcement actions by the SEC involving violations of reporting requirements and restatements of financial statements, *SOX § 704*;

- investment banks and financial advisers, *SOX § 705*; and
- the potential effects of requiring mandatory rotation of accounting firms, *SOX § 207, 15 USC § 7232*.

Many of the studies are available on the SEC website at www.sec.gov.

New and enhanced criminal penalties **11.6**

An integral element of the Act is forcing high-ranking corporate officers to take greater responsibility for financial irregularities of their companies. In order to accomplish this, the Act created a number of new criminal penalties and strengthened various existing penalties for violations of the Act and the securities law, *SOX §§ 801–807*, codified at *18 USC § 1348, 1514A, 1519, 1520, 11 USC§ 523(a)*, *28 USC § 994, 1658, SOX §§ 901–906*, codified at *18 USC § 1341, 1343, 1349, 1350, 29 USC § 1131, SOX § 1106, 15 USC § 78fff(a)*, and *SOX § 1107, 18 USC § 1513(e)*.

Beyond the addition of new criminal penalties and the enhancement of existing criminal penalties, the Act also attempts to make such actions more difficult to avoid. For example, the Act expressly provides that debts of a company are non-dischargeable in bankruptcy if those debts were incurred in violation of the securities fraud laws, *SOX § 803, 11 USC § 523(a)*. Similarly, the Act amended existing statute of limitations law by allowing suits for, among other things, violations of securities laws, to survive for the earlier of:

- two years after the discovery of the facts constituting the violation; and
- five years after such violation, *SOX § 804, 28 USC § 1658*.

When *SOX* was signed into law, the US Attorney General circulated an internal memorandum acknowledging the powerful new tools for criminal enforcement provided by the Act:

> ‘The President this week signed into law the Sarbanes-Oxley Act of 2002 *(*the ‘Act’). The Act provides tough new tools to expose and punish acts of corporate corruption, promote greater accountability by financial auditors, and protect small investors and pension holders.’

Memorandum from the Attorney General (1 August 2002). As of the date of this chapter, however, there have been only a few significant prosecutions involving alleged violations of the Act, most notably:

- The information and subsequent plea by a former officer of HealthSouth Corporation to violations of a number of criminal laws including, but not limited to, the Act;
- The arrest of an accountant in California for, among other things, violation of the Act and obstruction of justice;
- In 2005, the PCAOB initiated its first enforcement actions against several accountants who were alleged to have concealed information requested in a forthcoming PCAOB inspection of their firm; and

- Separately, the PCAOB's Division of Enforcement and Investigations has commenced several investigations of audits of subsequently restated financial statements.

It is likely that more arrests, prosecutions and enforcement actions under the Act will follow in the coming years.

Specific aspects of the Act

CEO/CFO certificates **11.7**

Following the Enron hearings, there was a general trend towards requiring CEOs and CFOs to certify their periodic filings. Prior to the adoption of the Act, on 14 June 2002, the SEC issued a Proposed Rule on the Certification of Disclosure in Companies' Quarterly and Annual Reports, which was subject to public comment until 19 August 2002, SEC Release No. 34–46079. On 27 June 2002, the SEC issued an order requiring that CEOs and CFOs file a sworn statement with the SEC that to each executive's knowledge, no 'covered reports' contain an untrue statement of a material fact, or omit to state a material fact necessary to make the statements contained in the report not misleading, SEC File No. 4–460. Sworn statements were required to be filed by 14 August 2002 for fiscal year-end filers.

The Act contains its own unique certification requirements found in *§ 302* and in *§ 906* of the Act, *SOX § 302, 15 USC § 7241; SOX § 906, 18 USC § 1350*. Initially, there was much consternation over whether these were two separate requirements, or whether *§ 906* simply contained the penalty provisions for a violation of *§ 302*. Section 906 certification was effective immediately, and therefore required on the Form 10-Qs that were being filed for the period ending 30 June 2002 (due by 14 August 2002 in most instances). The CEO and the CFO were required to certify that:

- the periodic report containing financial statements fully complies with the requirements of *Section 13(a)* and *15(d)* of the *Securities Exchange Act of 1934*; and
- the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer, *SOX § 906(b), 18 USC § 1350(b)*.

The Section 906 certification contains no knowledge qualifier and signatories are subject to criminal penalties for knowing or willful false certifications up to $5 million and 20 years in prison, *SOX § 906(c), 18 USC § 1350(c)*. In implementing the Section 906 certification, the SEC has not inserted a knowledge qualifier, and also has not specified the exact text of the certification.

Effective on 29 August 2002, the *§ 302* certification was required following the issuance of final rules by the SEC on 28 August 2002. This certification differed slightly from the Section 906 certification in that it did contain a 'knowledge' qualifier ('based on my knowledge, this report does not contain any untrue statement ... '), *SOX § 302(a)(2)* and *(3)*, *15 USC § 7241(a)(2)* and *(3)*. This certification also required a more extensive certification about the company's internal controls and disclosure controls and procedures. Notably, the *§ 302* certification makes no reference to the financial information being presented in accordance with GAAP, in light of the view that such disclosure should meet a standard of overall material accuracy and completeness that is broader than financial reporting requirements under GAAP. Additionally, senior officers are certifying that required material non-financial information, as well as financial information, is included in the periodic reports through the certification of the company's 'disclosure controls and procedures'. The SEC prohibited modification of the language required in the *§ 302* certification other than deletion of certain language with respect to internal control over financial reporting (ICFR) during the interim period before effectiveness of Section 404 of *SOX*. The text of the *§ 302* certification is codified at *17 CFR § 229.60l(b)(31)*.

Congress anticipated that the Act could encourage some public companies to 'seek greener pastures' and attempt to shift their primary domicile outside of the USA to evade the reach of the Act. To forestall such corporate domicile shopping, the Act made clear that a company could not avoid the *§ 302* reporting requirements by simply reincorporating or changing the domicile of the company to a country other than the USA, *SOX § 302(b), 15 USC § 7241(b)*.

On 21 March 2003, the SEC issued additional proposed rules on the *§ 302* and *§ 906* certifications, requiring that they be included as exhibits to periodic reports. The *§ 302* certification is 'filed' with the report, while the *§ 906* certification is simply 'furnished' with the report.

A final note on the subject of CEO reporting and certificates – although Section 1001 of *SOX* is not binding, Congress used it as an opportunity to opine that 'Federal income tax return[s] of a corporation should be signed by the chief executive officer of such corporation', *SOX § 1001*. It goes without saying that the enhanced focus on reporting violations has significantly increased the workload for CEOs and forced them to take a hard look at corporate disclosures, with a view towards protecting themselves against personal liability as well as protecting the corporation.

Prohibition on personal loans to officers and directors **11.8**

Section 402 of the Act severely limits an issuer's ability to make personal loans to executive officers and directors, *SOX § 402, 15 USC § 78m(k)*. Personal loans maintained on 30 July 2002 are grandfathered so long as there are no material modifications to the terms of the loan or any renewal of the loan after 30 July 2002, *SOX § 402(k)(1), 15 USC § 78m(k)(1)*. The Act also permits an issuer to make loans to executive officers and directors to the extent that such loans are:

- made in the ordinary course of the issuer's consumer credit business;
- generally made available by the issuer to the public;

- made on market terms that are no more favourable than those offered by the issuer to the general public, *SOX § 402(k)(2)(A)–(C), 15 USC § 78m(k)(2)(A)–(C).*

The prohibition also does not apply to insured depository institution loans where the lender is subject to the *Federal Depository Insurance Act (12 USC § 1813)* insider lending restrictions of the *Federal Reserve Act (12 USC § 375b), SOX § 402(k)(3), 15 USC § 78m(k)(3).*

Until guidance is issued under the Act with respect to personal loans, issuers face many unanswered questions concerning common practices with respect to officers and directors. Issuers should act to examine benefit plans and programs to determine where there are potential extensions of credit in violation of the Act. Commonly used practices include:

- split-dollar life insurance arrangements;
- cashless option exercises;
- personal loans from 401(k) plans;
- loans in connection with recruiting new executives (including loans to purchase a residence pending sale of an old residence or forgivable loans to replace unvested benefits);
- company assistance with third-party lenders which may include company credit cards; and
- expense and other advances to be reimbursed by the officer or director.

In the absence of further guidance, the grandfather provisions for extensions of credit maintained on 30 July 2002 do not address loans to an employee who subsequently becomes an executive officer or binding arrangements in effect on 30 July 2002 that provide for future draw-downs. In particular, split-dollar life insurance arrangements typically contain a binding agreement for future advances for premium payments. Under recent IRS guidance, split-dollar insurance established with a collateral assignment is taxed under the theory of a loan from the employer to the employee. However, a loan theory is not applied to endorsement split-dollar insurance arrangements. Many public companies have chosen to terminate such arrangements in the light of this uncertainty.

Forfeiture of certain bonuses and profits **11.9**

If an issuer is required to restate its financial statements 'as a result of misconduct', the CEO and the CFO must reimburse the issuer for any of the following amounts received during the 12-month period following the first public issuance of the document containing the financial statements which are restated:

- any bonus or other incentive- or equity-based compensation received by the CEO or CFO from the issuer;
- any profits realised from the sale of securities of the issuer, *SOX § 304(a), 15 USC § 7243(a).*

The SEC may, in its discretion, exempt an officer from the *§ 304* forfeiture provisions, *SOX § 304(b), 15 USC § 7243(b).*

Although this section was effective on 30 July 2002, the Act provided little guidance as to what constitutes 'misconduct'. The courts appear to be the venue in which this term shall be defined, with much debate as to its meaning in the interim. As with the prohibition on loans, the SEC is not required to engage in any additional rulemaking with respect to this provision although it is permitted to do so.

Audit committee independence 11.10

Under the Act, all audit committee members of a public company must be 'independent', *SOX § 301(m)(3), 15 USC § 78f(m)(3).* The Act defines 'independence' as follows: a board member may not, except in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

- accept any consulting, advisory or other compensatory fees from the issuer;
- be an affiliated person of the issuer or any subsidiary thereof.

The Act allows for national securities exchanges to adopt more rigorous definitions of independence, *SOX § 301(m)(3)(B), 15 USC § 78f(m)(3)(B).* The SEC has the ability to exempt a particular audit committee member from the general independence requirements, *SOX § 301(m)(3)(C), 15 USC § 78f(m)(3)(C).*

The SEC adopted a final rule directing the exchanges to prohibit listing of the securities of any issuer that does not have an independent audit committee by the earlier of:

- their first annual shareholders meeting after 15 January 2004; and
- 31 October 2004, *17 CFR § 240.10A-3.*

Audit committee financial expert 11.11

Section 407 of the Act requires the SEC to issue rules requiring the disclosure of:

- whether or not the issuer's audit committee had a member who was a financial expert, as such term was defined by the SEC;
- if not, the reasons for not having such a financial expert, *SOX § 407, 15 USC § 7265.*

A 'financial expert' must have:

- an understanding of generally acceptable accounting principles;
- experience in the preparation or auditing of financial statements of generally comparable issuers and the application of such principles in connection with the accounting of estimates, accruals and reserves;
- experience with internal accounting controls; and
- an understanding of the audit committee functions, *SOX § 407(b)(1)–(4), 15 USC § 7265(b)(1)–(4).*

The company's board of directors must make the determination of whether a director qualifies as an audit committee financial expert.

On 22 October 2002, the SEC issued proposed rules requiring each issuer to disclose: the number and names of persons that the board of directors has determined to be the financial experts serving on the company's audit committee; whether the financial expert or experts are 'independent', as that term is used in *Section 10A(m)(3)* of the *Exchange Act*, and if not, an explanation of why they are not; and if the Company does not have 'financial expert' serving on its audit committee, the Company must disclose that fact and explain why it has no financial expert, SEC Release No. 33–8138.

On 15 January 2003, the SEC voted to adopt rules implementing the new financial expert rules, SEC Release 2003–2006 (15 January 2003). The final rules significantly expand the types of experience and background that will satisfy the definition of financial expert from the definition previously proposed.

The rules define 'audit committee financial expert' to mean a person who has the following attributes:

- an understanding of financial statements and GAAP;
- an ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions, *17 CFR § 229.401(h)(2).*

Under the final rules, a person can acquire such attributes through any one or more of the following means:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience, *17 CFR § 229.401(h)(3).*

The final rule also provides a 'safe-harbour' (see earlier discussion on the US Safe-Harbour Rules) to make clear that an audit committee financial expert will not be deemed an 'expert' for any purpose, including for purposes of Section 11 of the *Securities Act of 1933*, and that the designation of a person as an audit committee financial expert does not impose any duties, obligations or liability on the person that are greater than those imposed on such person as a member of the audit committee in the absence of such designation, nor does it affect the duties, obligations or liability of any other member of the audit committee or board of directors, *17 CFR § 229.401(h)(4)*.

The SEC's final rule requires that companies include disclosure on whether they have at least one audit committee financial expert serving on the audit committee and, if so, the name of the audit committee financial expert and whether the expert is independent of management in their annual reports on Form 10-K or 10-KSB, *17 CFR § 229.401(h)* and *17 CFR § 249.310, Item 10*. Since the information would be included in Part III of Form 10-K, issuers would have the option of including the disclosure on financial experts in their proxy statements, as long as the proxy statement was filed with the SEC no later than 120 days after the end of the fiscal year covered by the Form 10-K or 10-KSB. A company that does not have such a financial expert will be required to disclose this fact and explain why it has no such expert.

Code of ethics **11.12**

On 23 January 2003, the SEC issued final rules which required issuers to disclose:

- Whether they have adopted a 'code of ethics' applicable to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and
- if the issuer has not adopted such a code of ethics, the reasons it has not done so, SEC Release No. 33–8177; *17 CFR § 229.406*.

The SEC utilised a broad definition of 'code of ethics', defining it as written standards that are reasonably necessary to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely and understandable disclosure in reports and documents that a company files with, or submits to, the Commission and in other public communications made by the company;
- compliance with applicable governmental laws, rules and regulations;
- the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
- accountability for adherence to the code, *17 CFR § 229.406(b)*.

Under the SEC's final rules, companies are required to disclose in their annual reports whether they have a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, *17 CFR § 229.406* and *17 CFR §249.310, Item 10*. Companies which have not adopted such a code of ethics must explain why they have not done so.

A company will be required to make available to the public a copy of its code of ethics, or portion of the code which applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, *17 CFR § 229.406(c)*.

The company may do so by: filing the code as an exhibit to the annual report; providing the code on the company's Internet website (provided that a company choosing this option also must disclose its Internet address and its intention to provide disclosure in this manner in its annual report on Form 10-K); or undertaking in its annual report to provide a copy of its code to any person without charge upon request, *17 CFR § 229.406(c)*.

A company is also required to disclose in a Form 8-K filing or through posting the disclosure on its Internet website (but only if the company disclosed in its most recent Form 10-K: (a) its intention to disclose these events on its Internet website and (b) its Internet website address):

- The nature of any amendment to the company's code that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and
- The nature of any waiver, including an implicit waiver, from a provision of the code granted by the company to one of these specified officers, the name of the person to whom the company granted the waiver and the date of the waiver, *17 CFR § 229.406(d)* and *17 CFR § 249.308, Item 10*.

In each case, the Form 8-K must be filed or the disclosure posted on the company's website within five (business days of the amendment or waiver, *17 CFR § 249.308*, General Instruction B.1.

Assessment of internal controls and procedures **11.13**

As part of the *§ 302* certification, an issuer's principal executive officer and principal financial officer are required to certify that they are responsible for establishing and maintaining 'disclosure controls and procedures' and that such disclosure controls and procedures have been designed to ensure that material information is made known to them, *SOX § 302(a)(4)(B), 15 USC § 7241(a)(4)(B)*. Furthermore, they must certify that they have evaluated the effectiveness of the company's disclosure controls and procedures as of the end of the period covered by the periodic report, and have presented their conclusions about the effectiveness of such controls and procedures in the periodic report, *SOX § 302(a)(4)(C)–(D), 15 USC § 7241(a)(4)(C)–(D)*. Finally, the certifying officers must confirm that they have disclosed any deficiencies in the design or operation of ICFR, and any fraud involving management or employees who have a significant role in the company's internal control over financing reporting to the company's auditors and the audit committee of the board of directors, *SOX § 302(a)(5), 15 USC § 7241(a)(5)*.

'Disclosure controls and procedures' is a newly defined term meaning controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted by it under the *Securities and Exchange Act of 1934* is recorded, processed, summarised and reported within the time required by the SEC, so that appropriate information is disclosed in a company's periodic filings, SEC Release No. 33–8124 (29 August 2002). The SEC has not required any particular procedures for conducting the required review and evaluation, but instead expects each company to develop a process that is consistent with its business and internal management and supervisory practices. The SEC did recommend the creation of a 'disclosure committee' with the responsibility for consideration of the materiality of information and determining disclosure obligations on a timely basis. 'Internal Control' is a pre-existing term relating to a company's ICFR, *15 USC § 78m(b)*; AICPA Professional Standards AU Section 319.06.

Section 404 of the Act furthers the increased focus on internal control mechanisms, *SOX § 404, 15 USC § 7262*. In accordance with Section 404, each annual report filed by an issuer must now contain an 'internal control report' (or 'internal control assessment') containing certain information specified by the Act, *SOX § 404(a), 15 USC § 7262(a)*. The auditor must attest to and report on the internal control report, *SOX § 404(b), 15 USC § 7262(b)*.

On 5 June 2003, the SEC adopted final rules implementing Section 404 of the Act, SEC Release No. 33–8238. (The final rules define ('ICFR' and require management to:

- annually assess the effectiveness of the company's ICFR; and
- to include a report on the effectiveness of the company's ICFR in the company's annual report, *17 CFR § 229.308*.

Additionally, the company's independent auditor must attest to management's assessment of the company's ICFR, and the attestation must be included in the company's annual report. Companies which are 'accelerated filers' as defined by the SEC must comply with the report and attestation requirements in their annual reports for their first fiscal year ending on or after 15 November 2004, and all other companies must comply for their first fiscal year ending on or after 15 July 2005.

Due to the high costs many companies experienced in the implementation of Section 404, the SEC formed an Advisory Committee on smaller public companies to review the application of Sarbanes-Oxley to companies which do not qualify as 'accelerated filers'. On 23 April 2006, the Advisory Committee delivered its final report to the SEC. The report included 33 separate recommendations to the SEC concerning smaller public companies, including the following primary recommendations:

- Establish a system of scaled or proportional securities regulation for smaller public companies using determinants defined by the Advisory Committee;
- Until such time as a framework for assessing ICFR for such companies is developed that recognises their characteristics and needs, provide exemptive relief from the Section 404 requirements to microcap companies with less than $125 million in annual revenue and smallcap companies with less than $10 million in annual product revenue;
- Again, until a framework that addresses smaller public company needs is in place, provide exemptive relief from external auditor involvement in the Section 404 process to certain companies;
- Implement cost-effective standards for the implementation of Section 404's external auditor requirement;

- Incorporate the scaled disclosure accommodations available under *Reg. S-B* into *Reg. S-K* for all micro cap companies, and cease prescribing separate disclosure forms for smaller companies;
- Incorporate the scaled financial statement accommodations available under *Reg. S-B* into *Reg. S-K* or *Reg. S-X* for all microcap and smallcap companies;
- Allow all reporting companies listing on a national securities exchange, NASDAQ or the OTC Bulletin Board to be eligible to use Form S-3, if they have been reporting under the Exchange Act for at least one year and are current in their reporting at the time of filing;
- Adopt policies that encourage and promote the dissemination of research on smaller public companies;
- Adopt a new private offering exemption from the registration requirements of the *Securities Act of 1933* that does not prohibit general solicitation and advertising for transactions with purchasers who do not need all of the protections of the Securities Act's registration requirements;
- Spearhead a multi-agency effort to create a streamlined NASD registration process for finders, M&A advisors and institutional private placement practitioners;
- Develop a Safe-Harbour protocol for accounting for transactions that would protect well-intentioned preparers from regulatory or legal action when the process if appropriately followed;
- In implementing new accounting standards, FASB should permit micro cap companies to apply the same extended effective dates applicable to private companies;
- Consider additional financial guidance for all public companies with respect to materiality related to previously issued financial statements; and
- Implement a de minimis provision in the application of the SEC's auditor independence rules.

The SEC has not yet acted to adopt rules addressing any of the Advisory Committee's primary recommendations.

When the SEC adopted final rules with regard to Section 404 in June 2003, two broad principles were emphasized:

- That management's evaluation must be based on procedures sufficient both to evaluate the design and to test the operating effectiveness of ICFR; and
- That the assessment, including testing, must be supported by reasonable evidential matter. Instead of providing specific guidance regarding the implementation of these two principles, the SEC expressed its belief that the methods of conducting evaluations of ICFR will, and should, vary from company to company.

Since the adoption of these requirements, however, because of the lack of guidance initially provided, many companies sought to hire outside consultants to aid in the ICFR assessment process. Consequently, on 13 December 2006, the SEC voted unanimously to take action to improve the cost-effectiveness of the implementation of Section 404 of the Act, and to once and for all emphasise that management must be involved in and bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides reasonable assurance for its assessment, SEC Release Nos. 33-8762 and 34-54976; File No. S7-24-06.

One of the Commission's actions was to propose interpretive guidance to assist management in planning and performing its annual evaluation of ICFR. The proposed interpretive guidance is intended to enable management to conduct a more effective and efficient evaluation of ICFR by focusing on a top-down, risk-based approach, and making it clear that the authoritative literature for management's evaluation lies with the SEC's interpretive guidance and not with the literature written for auditors. Furthermore, the SEC eliminated the auditor's opinion on management's assessment of ICFR in the auditor's attestation report, hoping to significantly lessen, if not eliminate, the pressures that managers have felt to look to the auditing standards for guidance in performing their evaluations. Management should determine those areas that are both material and pose a risk to reliable financial reporting, and then identify the controls that address those risks, including the risk of material misstatement due to fraud.

The comments included by the SEC in the interpretive guidance make clear the notion that the assessment of risk of pervasive throughout the entire evaluation process. Management must determine whether any identified control deficiencies should be considered 'material weaknesses', defined as 'a deficiency, or combination of deficiencies in ICFR such that there is a reasonable possibility that a material mis-statement, or the company's annual or interim financial statements will not be prevented or detected a timely basis by the company's ICFR'. Whether or not a mis-statement has actually occurred is not germane to the assessment. The proposed guidance also provides management flexibility in determining how much documentation is required to support the evaluation, SEC Release Nos. 33-8762 and 34-54976; File No. S7-24-06.

Audit committee responsibilities **11.14**

Section 301 of *SOX* requires the audit committee to have certain responsibilities:

- The audit committee shall be directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by the issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such public accounting firm shall report directly to the audit committee;
- The audit committee must establish procedures for: (a) the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters and (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;

- The audit committee must have the authority to engage independent counsel and other advisers as it deems necessary to carry out its duties; and
- Each issuer must provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation (a) to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report and (b) to any advisers employed by the audit committee, *SOX § 301, 15 USC §78f(m)*.

On 9 April 2003, the SEC issued final rules which require national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee independence and other responsibility requirements contained in Section 301 of *SOX*, SEC Release No. 33–8220. Under the final rules:

- Each member of the audit committee must be independent according to specified criteria;
- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of the issuer's outside auditor, and the outside auditor must report directly to the audit committee;
- The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;
- The audit committee must have authority to engage independent counsel and other advisers as it deems necessary;
- Each issuer must provide appropriate funding for the audit committee; and
- Listed issuers must be in compliance with the new listing rules by the earlier of: (a) their first annual shareholders meeting after 15 January 2004 or (b) 31 October 2004, *17 CFR § 240.10A-3(a)*. Certain other issuers must be in compliance by 31 July 2005, *17 CFR § 240.10A-3(a)(5)(i)(A)*.

Insider trading during pension fund blackout periods **11.15**

One of the most disturbing tales that was told after the collapse of Enron and other high profile companies concerned the company employees who had poured their savings into the purchase of company stock only to see the value of that stock fall to virtually nothing. During those same periods, the story went, corporate 'insiders' were able to quickly liquidate their stock to avoid a similar cataclysmic decline in its value. To prevent the recurrence of such perceived inequities, the Act established 'blackout periods', so that during times when employee stock plans could not sell company stock, officers and directors would also be unable to sell their stock in the company, *SOX § 306, 15 USC § 7244, 29 USC § 1021, 29 USC § 1132*.

On 22 January 2003, the SEC issued final rules prohibiting insider trading during pension fund blackout periods, SEC Release No. 34–47225. The rules create new Regulation BTR (Blackout Trading Restriction) and are designed to prevent the inequities that arise when directors and executive officers trade-in company securities when rank and file employees are prohibited from doing so due to a pension fund blackout period, *17 CFR Part 245*. The regulation covers trades in any equity or derivative security of an issuer, other than an exempt security (as defined in *Section 3(a)(12) of* the *Securities Exchange Act of 1934*).

Regulation BTR prohibits trading-in issued securities by executive officers as defined in *Exchange Act Rule 16a-1(f)* and directors (as defined in *Section 3(a)(7)* of the *Securities Exchange Act of 1934*) of an issuer during a pension fund blackout period, *17 CFR § 245.101*. Regulation BTR defines 'issuer' as:

- an issuer whose securities are registered under *Section 12* of the *Securities Exchange Act 1934*;
- an issuer that is required to file reports under *Section 15(d)* of the *Securities Exchange Act 1934*; or
- an issuer that files, or has filed, a registration statement that has not yet become effective under the *Securities Exchange Act of 1934*, and that the issuer has not withdrawn, *17 CFR § 245.100 (k)*.

Some limitations are imposed where Regulation BTR might otherwise apply to directors and officers of foreign private issuers.

Regulation BTR prohibits directors and executive officers of an issuer from acquiring equity securities or derivative securities of an issuer during a blackout period if the acquisition is in connection with his or her service or employment as a director or executive officer, *17 CFR § 245.100*. In addition, the regulation also prohibits directors and executive officers of any issuer from disposing of equity securities or derivative securities of an issuer during a blackout period if the disposition involves issuer securities acquired in connection with his or her service or employment as a director or executive officer.

The rules define pension fund 'blackout period' as any period of more than three consecutive business days during which 50% or more of the participants in all company pension plans (e.g. 401(k) plans, profit-sharing and savings plans, stock bonus plans) that permit participants to acquire company equity securities are restricted from trading-in company securities held in plan accounts by the company or by a fiduciary of the plan, *17 CFR § 245.100(b)*. Note that certain blackout periods imposed in connection with mergers or acquisitions to allow persons employed by the acquired entity to change their participation are exempted from the rules, *17 CFR § 245.102(b)*. The following types of individual account plans would be included:

- plans that permit participants or beneficiaries to invest their plan contributions in issuer equity securities;
- plans that include an 'open brokerage window' that permits participants or beneficiaries to invest in the equity securities of any publicly traded company, including the issuer;

- plans that match employee contributions with issuer equity securities;
- plans that reallocate forfeitures that include issuer equity securities to the remaining plan participants, SEC Release No. 34–47225.

Companies must provide timely notice of pension fund blackout periods to directors and executive officers and to the SEC. *17 CFR § 245.104.* The notice must include:

- The reasons for the blackout period;
- A description of the transactions affected;
- A description of the class of equity securities affected;
- The actual or expected dates of the blackout period; and
- The name, address and telephone number of the person designated by the company to respond to inquiries about the blackout period. Notice is given to the SEC by filing a Form 8-K on the same date that notice is given to directors and executive officers. Finally, advance notice to directors and executive officers is not required if circumstances beyond the company's reasonable control prevent the company from providing such notice, so long as notice is provided as soon as reasonably practicable, *17 CFR § 245.104(b)(2)(ii).*

Violations of Regulation BTR will subject a director or executive officer to potential SEC enforcement actions and possible criminal penalties. The rules also establish a private right of action under which the company is entitled to recover, from a violator, any profits realised from prohibited trading, *17 CFR, §245.103.*

Implementation of standards of professional conduct for attorneys **11.16**

Section 307 of the Act mandates that the SEC prescribes minimum standards of professional conduct for attorneys appearing and practicing before the SEC, in any way in the representation of issuers, *SOX § 307, 15 USC §7246.* Not surprisingly, Section 307 and the regulations promulgated to implement, it have been the subject of intense scrutiny and debate in the legal community. In fact, the controversy surrounding the proposed rule was so intense that the final rule issued by the SEC was significantly modified in light of the comments received by the SEC.

The SEC has made it clear that it believes that the final rules adequately address the 'up-the-ladder' reporting requirements mandated by the Act. Generally, the final rules require that, in the event that an attorney has credible evidence based on which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation of any US law or fiduciary duty has occurred, is on going, or is about to occur, the attorney has a duty to seek to remedy to the problem by 'reporting up the ladder' within the issuer, SEC Release No. 33-8186. This standard, developed from the SEC's attempt to make objective rather than subjective to the test of when a lawyer must report a violation, has a lower threshold than a 'more likely than not' standard. An attorney's duty is not confined to matters as to which the attorney has formed a legal conclusion that there has been a material violation, SEC Release No. 33–8186.

Section 205(1) of the Act establishes minimum standards of professional conduct, intended to supplement applicable jurisdictional standards, *SOX § 205(1), 15 USC § 7245(a).* These standards are not intended to limit the ability of any jurisdiction to impose additional obligations, but this part governs any conflict between the two. Jurisdictions are free to impose stricter rules, but to the extent state ethical rules impose a lower obligation, they will be preempted. As an aside, the Washington State Bar Association issued an Interim Formal Ethics Opinion indicating that attorneys licensed in Washington 'cannot as a defense against an RPC [Rules of Professional Conduct] violation fairly claim to be complying, in "good faith" with the SEC regulations', if they took actions pursuant to Section 307 Rules that were contrary to the Formal Ethics Opinion. The Washington State Bar takes the position that if Section 307 Rules authorise, but do not require, an attorney to reveal client confidences and secrets, a Washington attorney may not do so unless authorised by the provisions of the RPC. The Corporations Committee of the Business Law Section of the State Bar of California has also issued a public letter to the SEC questioning the ability of the SEC to adopt regulations governing attorneys, which purport to preempt state professional responsibility laws.

The attorney conduct rules apply to all attorneys, whether inside counsel or outside counsel and those in foreign jurisdictions, appearing and practicing before the SEC, *SOX § 307, 15 USC § 7246.* The SEC intends that the issue of whether an attorney–client relationship exists for purposes of Section 307 rules will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer, *17 CFR § 205.2.* Thus, whether the provision of legal services under particular circumstances would or would not establish an attorney–client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under Section 307 rules.

Under the Act, the client of an attorney representing an issuer before the SEC is the issuer as an entity and not the issuer's individual officers or employees with whom the attorney regularly interacts. The proposed rule said an attorney 'shall act in the best interest of the issuer and its shareholders', which suggested that the attorney also had a duty to shareholders which might form the basis of a private right of action, SEC Release No. 33–8150. This language was removed in the final rule.

At the crux of the debate regarding the Act's attorney rules is the imposition of a duty on lawyers to report evidence of a material violation. The Act provides that if an attorney becomes aware of evidence of a material violation by the issuer or any officer, director, employee or agent of the issuer, the attorney shall report such evidence to the issuers chief legal officer (CLO) (or the equivalent thereof) or to both the CLO and its CEO (or equivalent thereof), *SOX § 307(1), 15 USC § 7245(1).* Such reporting does not affect privileged or otherwise protected information, *17 CFR§205.3(b).* The SEC proposed a number of documentation requirements in the proposed rule, but withdrew these in the face of concerns that it would impede an open and candid discussion between attorneys and their clients, and could create a conflict of interest between lawyer and client, SEC Release No. 33–8185.

A company's CLO must enquire into the evidence of the material violation and if he or she determines no material violation has occurred, is ongoing, or is about to occur, he or she must advise the reporting attorney of the basis for such determination, *17 CFR § 205.3(b)(2)*. Unless the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she must take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof, *17 CFR §205.3(b)(2)*. In lieu of conducting an enquiry, the CLO may refer a report of evidence of a material violation to a qualified legal compliance committee (QLCC), *17 CFR §205.3(b)(2)*.

If the reporting attorney does not believe the CLO has provided an appropriate response within a reasonable time, the attorney must report the evidence of a material violation to 'up the corporate ladder'. Specifically, the lawyer must report the evidence to:

- the audit committee of the board of directors;
- another committee of the board consisting solely of independent directors; or
- the entire board, if the board does not have any independent committees, *SOX § 307(2)*, *15 USC § 7245(1)*.

Additionally, if an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's CLO and CEO, the attorney may by-pass them and report the evidence directly to an appropriate committee of the board, *17 CFR §205.3(b)(4)*.

It should be noted that any attorney retained to investigate a material violation is also appearing and practicing before the SEC and is bound by this rule, *17 CFR §205.3(b)(5)*. Also, the officers and directors who caused the company to retain an attorney to investigate remain obligated to respond to the attorney who initially reported the suspected material violation, *17 CFR §205.3(b)(5)*.

There are certain limited situations in which a lawyer does not have to report a material violation. Specifically, an attorney need not make a report if:

- the attorney was retained or directed by CLO to investigate evidence of a material violation;
- the attorney reports the results of such investigation to the CLO and (unless both the attorney and the CLO reasonably believe no violation has occurred) the CLO reports the results of the investigation to the company's board or an independent committee thereof; or
- the attorney was retained by the CLO to assert a 'colourable defence' on behalf of issuer, and the CLO provides reasonable and timely reports on progress to the company's board or an independent committee thereof, *17 CFR §205.3(b)(6)*.

If the attorney receives what he or she reasonably believes is an appropriate and timely response, he or she needs do nothing more, *17 CFR §205.3(b)(8)*. If, however, the attorney does not reasonably believe he or she has received an appropriate response, he or she must explain her reasons to the CLO, the CEO and the directors to whom she reported the evidence of a material violation, *17 CFR §205.3(b)(9)*. An attorney employed by an issuer who has reported evidence of a material violation and reasonably believes he or she has been discharged for so doing may notify the issuer's board or any committee thereof that he or she believes, he or she has been discharged for reporting evidence of a material violation, *17 CFR §205.3(b)(10)*. Discharging an attorney for reporting under Section 302 of the Act would violate the whistleblower protections afforded by Section 806 of the Act.

If an issuer has previously formed a (QLCC, an attorney may report to the QLCC in lieu of reporting to the CLO, *17 CFR §205.3(c)*. The attorney does not need to assess the issuer's response in such a situation. Likewise, a CLO may refer a report of a material violation to a QLCC and must inform the reporting attorney of such, *17 CFR §205.3(c)*. The QLCC then becomes responsible for responding to evidence of a material violation, *17 CFR §205.3(c)*. Note that the QLCC must have been previously formed, and not formed simply to respond to a specific incident, *17 CFR §205.3(c)*.

Under the Rules as originally proposed, an attorney who did not receive an 'appropriate response' from the issuer was required or in certain circumstances, was permitted to make a 'noisy withdrawal' from the representation, SEC Release No. 33-8186. 'Noisy withdrawal', in some cases, would have required an attorney to withdraw from his or her representation of an issuer and report directly to the SEC, SEC Release No. 33-8186. After the SEC issued the proposing release on 'noisy withdrawal', the flood of comments from the professional community requesting the SEC to defer adoption of final rules relating to noisy withdrawal prompted the SEC to put forward an alternative proposal, SEC Release No. 33-8186. The alternative proposal contains three primary provisions as discussed below:

- First, the alternative proposal requires an attorney to provide written notice of withdrawal to the issuer when the attorney does not receive an appropriate response to his or her report of a material violation. This proposal requires an outside attorney to withdraw from representing the issuer and to notify the issuer, in writing, that the withdrawal is based on professional considerations. An insider attorney is required to cease participating or assisting in any matter concerning the violation and to notify the issuer, in writing, that he or she believes the issuer has not provided an appropriate response;
- Second, the alternative proposal requires an issuer to report an attorney's written notice of withdrawal. An issuer who has received notice from an attorney under the first part of the proposal would be required to report the notice and the circumstances related thereto in an appropriate filing with the SEC; and
- Third, the alternative proposal permits the attorney to inform the SEC when an issuer has not complied with the issuer reporting requirements.

> This attorney notification is permissive, instead of mandatory, in light of the numerous comments received by the SEC which were critical of 'noisy withdrawal'.

As of the date of this writing, neither the original proposal nor the alternative proposal for 'noisy withdrawal' has been adopted by the SEC.

An attorney supervising or directing another attorney who is appearing and practicing before the SEC in the representation of an issuer is a 'supervisory attorney' and is required to make reasonable efforts to ensure that a subordinate attorney that he or she supervises or directs conforms to Section 307 Rules, *17 CFR § 205.4.* Supervising an attorney in the representation of an issuer in non-SEC-related matters, or overall management of a law firm, would not result in an attorney being considered a 'supervisory attorney' for Section 307 purposes, *17 CFR § 205.4.* A supervisory attorney is responsible for complying with the reporting requirements when a subordinate attorney has reported to the supervisory attorney evidence of a material violation and may report evidence of a material violation from a subordinate attorney to the issuer's QLCC, *17 CFR § 205.4.*

An attorney who appears and practices before the SEC in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's CLO) is a 'subordinate attorney' and is obligated to comply with Section 307 Rules notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person, *17 CFR § 205.5.* A subordinate attorney complies with Section 307 Rules if the subordinate attorney reports to his or her supervising attorney evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the SEC, but may 'report up the ladder' if the subordinate attorney reasonably believes that the supervisory attorney to whom he or she has reported evidence of a material violation has failed to comply with Section 307 Rules, *17 CFR § 205.4.*

A violation of the attorney reporting requirements subjects an attorney to the civil penalties and remedies for a violation of the federal securities laws available to the SEC, along with other disciplinary measures such as censure or denial of the privilege to appear or practice before the SEC, *17 CFR §05.6.* An attorney who complies in good faith with the regulations will not be subject to discipline because of inconsistent standards imposed by a state or other US jurisdiction. Furthermore, the Act clarifies that the attorney-disclosure provisions do not create a private right of action and that enforcement is vested exclusively in the SEC, *17 CFR §205.7.*

State jurisdictional issues **11.17**

As discussed below, the precise impact of the Act on state regulators is unclear. In the Act itself, however, Congress expressed a clear intent that states consider the Act as guidance when considering how to regulate certain accounting firms.

In supervising non-registered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking in consideration the size and nature of the businesses of the accounting firms they supervise and the size and nature of the businesses of the clients of those firms. The standards applied by the Board under this Act should not be presumed to be applicable for all purposes of this section for small and medium-sized non-registered public accounting firms, *SOX § 209, 15 USC § 7234*. It is still too early to tell how states will react to this 'advice'.

Communicating with auditors 11.18

One common defence raised by auditors in cases of public company accounting fraud is that the officers or directors of the company have purposefully provided false, misleading or inaccurate information to the auditors. In order to address this perceived problem, the Act specifically makes it unlawful:

> 'for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading', *SOX § 303(a), 15 USC § 7243(a).*

Enforcement of this provision is vested exclusively with the SEC, *SOX § 303(b), 15 USC § 7243(b).*

Standardisation of financial reporting 11.19

While most accounting firms already prepare reports using basic agreed upon principles, the Act went further and codified the fundamental standardisation of accounting reports. Specifically, the Act now requires all financial reports to be prepared in accordance with GAAP, *SOX § 401(a)(i), 15 USC § 78m(i).* In addition, the Act mandated the preparation of Commission rules designed to cull misleading, untrue, and inaccurate information from pro forma financial information, *SOX § 401(b)(1), 15 USC § 7261(b)(1).*

Enhanced SEC review 11.20

As discussed previously, the Act arose largely from a series of embarrassing and catastrophic bankruptcies of public companies. Although the companies that declared bankruptcy were 'private' (in that they were non-governmental entities), they were also subject to regulation and oversight by the SEC. The Act increased the SEC's oversight of public companies by requiring a 'regular and systematic' review of public companies' disclosures 'for the protection of investors', *SOX § 408(a), 15 USC § 7266(a).* The exact scope of the review is unclear from the Act, but it clearly includes the company's financial statements, *SOX § 408(b), 15 USC § 7266(b).* As an example, the Act requires the SEC to review the periodic reports filed by an issuer at least once every three years, *SOX § 408(c), 15 USC § 7266(c).*

Real time issuer disclosures **11.21**

It is axiomatic that information is power. In the context of publicly traded companies, information is not only power but also, in a very real sense, money. Accordingly, any type of timing gap in the communication of relevant information creates the possibility of inappropriate leveraging of that information – of 'anticipating' value changes based on advance information. To minimise the likelihood of such gaps, the Act requires the dissemination of information, 'on a rapid and current basis', *SOX § 409(1), 15 USC § 78m(l).* The SEC adopted amendments to the form of current reports on Form 8-K that require most material developments to be reported on Form 8-K *(*or Form 6-K for foreign companies) within four business days.

Whistleblower protection **11.22**

The debate over whistle blowing and the protection of whistleblowers has affected commercial and non-commercial organisations across the world. It has been seen that on the whole a worker who blows the whistle on an employer can expect to feel the full force of institutional anger and discrediting with the following repercussions:

- criticism;
- poor performance evaluations;
- punitive transfers;
- job loss;
- ostracism from colleagues;
- blacklisting; and
- stress and health damage.

Over the last few years the world has witnessed both real and alleged whistle blowing on organisations both in the private and public sectors, such as Merrill Lynch and the European Commission, as well as in the profit and not for profit sectors. Historically, whistleblowers have found that they have made a decision that entails all risk and no reward.

A detailed discussion of whistle blowing is clearly not possible or appropriate here as it is a subject that deserves much more comprehensive treatment. However, it should be noted that the issue of whistle blowing has arisen, of course, as a major factor in the well-documented corporate scandals. Indeed, one of the lessons of the last 10 years in the corporate fraud arena is that, more often that not, corporate fraud is generally detected from within rather than without. So-called corporate whistleblowers are, accordingly, an integral part of maintaining corporate integrity and such activities must be encouraged and protected. Section 806 protects whistleblowers from termination and allows them a right of action if they are discharged, demoted, suspended, threatened, harassed or discriminated against, *SOX § 806, 18 USC § 1514A*. It should be noted that the Act does not provide for the award of punitive damages to a successful whistleblower. Title XI, which deals with corporate fraud and accountability, goes further than Section 806, imposing criminal penalties on anyone who retaliates against a whistleblower who provides truthful information to the government, *SOX § 1107, 18 USC § 1513*.

Environmental issues under *SOX*

Introduction **11.23**

Before getting further into the specifics of *SOX* and its impact in the environmental arena, it is probably helpful to summarise briefly how environmental issues were handled pre-*SOX*. Under prior SEC guidance, environmental liabilities were generally addressed under three specific rules:

- *Item 101 of Regulation S-K, 17 CFR,* Section 229;
- *Item 103 of Regulation S-K*;
- *Item 303 of Regulation S-K.*

Regulation S-K, of which all three of the items listed above are a part, provides the basic requirements applicable to the content of the non-financial statement portions of certain securities filings made by public companies with the SEC (e.g. Form 10-K, Form 10-Q, Registration Statements, etc.).

Item 101 of Regulation S-K (Reg. 229.101) requires companies to provide a narrative description of the company's business which must include:

> 'the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material' *(Section 229.101(c)(xii))*.

Item 103 of Regulation S-K (Reg. 229.103) addresses generally the disclosure of 'Legal Proceedings'. The basic rule of *Item 103* is that 'material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject' must be disclosed in the filing. Moreover, *Instruction 5* to *Item 103* specifically addresses environmental matters and states that:

> 'an administrative or judicial proceeding (including, for purposes of A and B of this Instruction, proceedings which present in large degree the same issues) arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment shall not be deemed "ordinary routine litigation incidental to the business"'.

In other words, if the criteria set out in *Instruction 5* are met, the public company must disclose the environmental proceeding to which it is a party.

Finally, *Item 303 of Regulation S-K (Reg. 229.303)*, which addresses management's discussion and analysis of financial condition and results of operations, also can be impacted by environmental issues. Although *Item 303* is not directed specifically at environmental matters, *Section (a)(1)*, which addresses liquidity generally, requires the public company to:

> '[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way.'

The same concept – trends, demands, etc. – recurs a number of times in *Item 303*. The SEC has specifically indicated an increased emphasis on disclosure of known trends.

SOX implications **11.24**

Although the SEC has not yet amended any of the Items described above, *SOX* will still have a significant impact on how public companies deal with potential environmental liabilities.

In addition to the certification requirements, the SEC has:

- proposed rules which would require 'upstream' reporting of material violations of law (including environmental law) by company lawyers';
- proposed rules addressing various disclosure rules which could impact the disclosure of environmental violations.

Outside of the SEC, signs of change abound – in 2002 the American Society of Testing and Materials adopted two new standards for assessing and describing environmental liabilities, and the Senate Committee on Environment and Public Works has asked the General Accounting Office to review current environmental disclosure practices.

While the basic impact of *SOX* on environmental disclosures is clear, the precise steps a company should take in response to the impact is somewhat less clear. The nature and extent of the changes which need to be implemented by a particular company in response to the Act depend on the size of the company, the nature of its operations and how it currently handles environmental issues. Nevertheless, three basic principles can be enunciated:

- Companies should be mindful of how new regulations or specific compliance deadlines may impact the company's overall financial performance. One way of handling this issue is to specifically delegate it to a particular individual or committee. By doing this, the company will be able to disclose information about up-coming regulatory impacts and, from an operational perspective, prepare the company for those impacts;
- Ensure that lines of communication are established and fully functional. As noted above, with regard to the Section 906 certificates, lack of knowledge is no excuse. Accordingly, it is critical to make sure that information known by environmental professionals is being communicated to the officers who

will be signing the appropriate certificates. The SEC has suggested the use of a disclosure committee; and

- To the extent that potential impacts are being quantified, make certain that a member of management is participating in those discussions to ensure that the estimates are being done correctly.

Key due diligence issues **11.25**

The impact of *SOX* on due diligence depends greatly on the nature of the company being investigated. Where a public company due diligence effort is being planned, an important part of the process will be identifying what steps the company has taken to comply with the Act and what violations of the Act the company may have committed historically. Among the questions which should be considered are the following:

- Disclosure controls
  - Does the target have effective disclosure controls and procedures in place to capture all information required to be disclosed under the Exchange Act?
  - Have the disclosure controls and procedures been followed consistently when drafting the target's public disclosure?
  - Does the target have a Disclosure Committee, and what function has the Disclosure Committee played in reviewing the target's public disclosure?
  - Does the Disclosure Committee have governing principles or a charter to guide its operations? Are minutes or agendas of meetings retained?
  - What is the target's outside auditor's role in the disclosure process? (Many buyers are moving towards having their external auditors review the target's financial statements and communicate with the target's external auditor outside of the presence of management.)
  - Has the target's audit committee overseen the operation of the target's disclosure controls and procedures?
  - If the target's disclosure controls and procedures are deficient, the buyer will need to assess the personnel and financial costs of establishing appropriate disclosure controls and procedures prior to the next quarterly certification date.

- Internal controls
  - Does the target maintain effective ICFR?
  - Does the target have any significant deficiencies or material weaknesses in its ICFR? If so, the due diligence process must be sufficient to provide a basis for the disclosure of the company's conclusions regarding the effectiveness of its ICFR.
  - What process has target management followed in assessing ICFR? Has it been consistently followed? Is appropriate documentation in place? Have controls been properly tested?
  - What process will be required to integrate the target's internal controls with the buyer's?

- Certifications
  - Have the CEO and CFO provided the Sections 302 and 906 certifications required by *SOX*?
  - Will the CEO and CFO of the buyer be in a position to make the required certifications concerning the combined company following consummation of the acquisition?
  - if a private company, will the target and buyer have sufficient time prior to consummation of the acquisition to create the processes necessary for the buyer's CEO and CFO to have the ability to make the required certifications?
  - Will the CEO and CFO be able to certify that they have 'designed' the disclosure controls and procedures to ensure that material information is made known to them?
    - Will the CEO and CFO be in a position to draw conclusions about the consolidated company's disclosure controls and procedures?
    - Are the typical representations and warranties of the target with respect to its historical financial statements sufficient in light of the certification requirements of *SOX*?
    - Review copies of all previously filed Sections 302 and 906 certifications of target.

- Financial due diligence
  - What off-balance sheet transactions or arrangements has the target entered into?
  - What are the target's critical accounting policies and estimates and how do they align with the buyer's?
  - What are the principle transactions, liabilities and obligations of the target that affect the target's financial condition and results of operations?
  - Are there any issues relating to the target's financial statements that are significant enough to interfere with certification by the CEO and CFO following consummation of the acquisition?
  - What related party transactions has the target entered into? Have they been appropriately disclosed? Has the target's audit committee reviewed and approved such transactions?
  - Have any whistleblower complaints been received by the target's audit-committee or general counsel and, if so, how were they handled? By whom?
  - What impact will acquisition-related charges, including write-downs, have on the buyer's future financial statements?
  - Identify the company's auditor (including audit partner). How long has the audit partner served in that capacity?
  - Identify whether any officer or director of the target has been employed by the buyer's auditor within the last three years.

- Corporate governance
  - At a minimum, the buyer should review the following corporate governance documents:
    - principles of corporate governance;
    - charters of audit, compensation and nominating/corporate governance committee;
    - codes of compliance, conduct or ethics;
    - board evaluations, if available;
    - corporate governance ratings from third-party agencies;
    - whistleblower complaints;
  - It the target is listed on an exchange or national securities market, do its corporate governance practices meet the standards of such exchange or market?
  - Have there been any waivers or amendments to the target's code of ethics?
  - Are the code of ethics and, if applicable, corporate governance principles being enforced? What is the enforcement mechanism?
  - Assess the strength of the corporate governance policies and practices, and whether the target is actually following the policies and procedures documented in its corporate governance documents.
  - Have the target's executives set the appropriate 'tone at the top'?
  - Does the company have an 'employee hotline' or similar mechanism whereby concerned employees can report problems to management? Have any such complaints been received? What follow-up actions were taken by the company to investigate those complaints?

- Director independence
  - If persons affiliated with the target are expected to fill roles as directors of the buyer, their independence must be analysed under both *SOX* and the listing standards of the buyer's exchange or market.
  - All relationships (including current and historical business, charitable, familial and personal relationships) between each person who will become a director of the buyer and the buyer will need to be explored.
  - Explore relationships between the independent directors of the buyer and the target to determine whether the acquisition of the target might change the independence status of the buyer's current directors.
  - Do the target's audit committee members meet the higher independence standards required of them?

- Officer and director loans
  - Are there any loans or extensions of credit to the target's officers and directors in violation of *SOX* Section 402? What are the terms of the loans? What documentation exists documenting those loans?
  - Will any loans 'grandfathered' by *SOX* lose that status should the executive officer or director become an executive officer or director of the buyer?

  - ○ Big red flag area for an acquisition of a private company – any loans made to a private company executive officer or director after 30 July 2002 will become unlawful of the executive officer, or director becomes an executive officer or director of a public acquirer.
  - ○ Are any benefit plans or arrangements of the target structured in a manner that could result in the creation of a loan following consummation of the acquisition?

While the list above is not intended to be exhaustive, it does highlight some of the critical information that should be obtained during the course of due diligence.

As more fully discussed above, private companies are not directly subject to the provisions of the Act. Nevertheless, investigation of the issues listed above may well provide a window into the company's internal control mechanisms. Accordingly, some limited form of *SOX* due diligence may be appropriate even if the company being investigated is not a public company.

Corporate governance issues **11.26**

From a corporate governance perspective, the mandate of the Act is clear: it will no longer suffice for high level corporate executives (particularly CEOs and CFOs) to simply adopt an ostrich approach whereby they remain aloof from corporate malfeasance. Indeed, such upper level executives now bear an affirmative burden to investigate the corporations that they serve. From the top down, each corporation must ensure that:

- it has in place a framework designed to gather the information covered by the Act;
- its audit committee is empowered to probe possible problems which may need to be addressed in publicly filed reports;
- such committee is, in fact, using those powers; and
- problems suspected or detected are being correctly communicated within the corporation and swiftly rectified.

As of the date of this chapter, each public corporation should have conducted a comprehensive internal review to ensure that it is not in violation of any of the applicable provisions of the Act. As discussed previously, it is likely that many larger private corporations have undertaken similar review.

International impact of *SOX* **11.27**

From the inception of *SOX*, the US regulators have been acutely aware that the Act has an inevitable and profound international impact. Moreover a certain amount of controversy has been reported as a result of the US approach in the related area of the Extradition rules, including the coverage of the renowned Nat West Three. In recognition of the need to work, in a co-operative way, with the international community, the SEC has consistently provided international authorities the opportunity to comment on proposed regulations. Despite this spirit of co-operation, the international community remains deeply sceptical regarding the long-term impact and repercussions of the Act. Listed below are some of the primary international impacts of the Act:

- Although foreign accounting firms that audit the USA public companies must still register with the PCAOB, such firms have been provided a number of accommodations by the SEC such as:
  - not having to provide registration information to the board where such disclosures would violate home country laws; and
  - having an addition six months to register with the PCAOB;
- With regard to audit committee requirements, taking in account foreign corporate governance schemes, while preserving the intention of the Act to ensure that those responsible for overseeing a company's outside auditors are independent of management;
- Allowing foreign accounting firms to provide tax services despite their local definition as legal services, which are among the enumerated list of services prohibited by the Act;
- Excluding most foreign lawyers not licensed to practice law in the USA from coverage under the attorney conduct rules; and
- Allowing a financial expert to become qualified not just by learning US GAAP, but also by developing an understanding of an issuer's home country GAAP.

Indeed, even beyond the direct impact of the Act on international markets, there is increasing indication that some other countries (including the European Union) may be looking to their own corporate laws to determine whether they should be conformed to comply with the US. The Act clearly will have a ripple effect as the years pass and other companies (and countries) move to comply with the standard set in the Act.

Corporate governance in Europe – impacts of *SOX* **11.28**

It was always tempting fate to say that Enron was an American problem and that European rules would prevent similar corporate collapses here. Now, of course, Europe has seen its own corporate scandals, such as Parmalat, and the European authorities are responding with draft new rules of their own. The European Commission published a press release on 16 March 2004 announcing their proposal revising the existing EU audit Directive. The 8th Directive or Directive on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC (PDF, 42 pages 263 KB) aims 'to ensure that investors and other interested parties can rely fully on the accuracy of audited accounts and to enhance the EU's protection against the type of scandals that recently occurred in companies such as 'Parmalat and Ahold'. The difference, say the rule-makers, is that the European proposals are not a 'knee-jerk' response, but the result of careful scrutiny over many years. Knee-jerk or not, some of the proposals bear a striking similarity to those pushed through in the USA in 2002.

The draft rules issued by the European Commission would underpin the independence of auditors and regulate their fee structures to ensure that they are not dependent on other services provided by the same firm. Companies would also have to disclose any other services provided – although the proposals stop short of banning firms from taking on other engagements for their audit clients. Audit partners would have to change at least every five years, or the firm would have to change every seven. There would also be a legal requirement for publicly traded companies to establish an audit committee, including at least one member competent in accounting or auditing, to select the auditors. Other measures would strengthen the oversight of accountants (ending self-regulation) and require registration of firms from countries outside the European Union to ensure consistently high standards of regulation.

European accounting firms have welcomed some of the proposals, but all are strongly opposed to auditor rotation, arguing that it damages audit quality. Businesses have reacted against a rules-based approach, saying that, for example, the requirement for audit committees should come from codes of conduct and not from legislation. The UK particularly prides itself on outstanding model codes rather than descriptive regulation that can mean more of a checking box mentality.

Whatever the outcome, the Commission's draft rules have fuelled the debate within Europe. They are some way away from finalisation, let alone from becoming law. However, it is certain that something will emerge which moves further towards the US approach; indeed, in some countries, changes are proceeding ahead of European-wide reforms. In the UK, for instance, a bill is currently going through Parliament that will strengthen the oversight of auditors and improve their powers of investigation. Whether *SOX* provided the impetus or not, there is no doubt that stricter regulation is coming. The robust defence of the European system by some immediately after the collapse of Enron may therefore have been premature.

12

International dimensions and corporate governance: the Indian perspective

12 International dimensions and corporate governance: the Indian perspective

CHAPTER OVERVIEW 12.1

The legal expression, corporate governance has acquired significance in India during the last few years. After the collapse of the Soviet Union and the end of the Cold War in 1990, it has become the conventional wisdom all over the world, including India, that market dynamics must prevail in economic matters.

This has also coincided with the thrust given to globalisation because of the setting up of the World Trade Organization (WTO) and every member of the WTO trying to bring down the tariff barriers. Globalisation involves the movement of four economic parameters, namely:

- physical capital in terms of plant and machinery;
- financial capital in terms of money invested in capital markets or in foreign direct investment (FDI);
- technology;
- labour moving across national borders.

The pace of movement of financial capital has become greater because of the pervasive impact of information technology (IT) and the world having become a global village (see N. Vittal, *Ethical Issues in Corporate Governance*, Central Vigilance Commissioner, Inaugural Address delivered at NBCC Seminar on 22 March 2000, New Delhi. *Source*: http://cvc.nic.in/vscvc/cvcspeeches/march2k5.html).

When investment takes place in emerging markets like India, the investors want to be sure that not only are the capital markets or enterprises with which they are investing run competently but that they also have good corporate governance. Corporate governance represents the value framework, the ethical framework and the moral framework under which business decisions are taken. In other words, when investments take place across national borders, the investors want to be sure that not only is their capital handled effectively and adds to the creation of wealth, but the business decisions are also taken in a manner which is not illegal or involving moral hazard (N. Vittal, *Ethical Issues in Corporate*

Governance, Central Vigilance Commissioner, Inaugural Address delivered at NBCC Seminar on 22 March 2000, New Delhi. *Source*: http://cvc.nic.in/vscvc/cvcspeeches/march2k5.html). Given the importance of this area, in this chapter the discussion is extended to other parts of the SAARC region (see further below).

The real genesis of corporate governance lies in the business scams and failures in India and abroad. The junk bond fiasco in the USA and the failure of Maxwell, BCCI and Polly Peck in the UK resulted in the Treadway Committee in the USA and the Cadbury Committee in the UK on corporate governance. After 20 years of such incidents, the corporate world had witnessed similar corporate collapses such as Worldcom, Xerox, Enron, etc., leading to the US legislation, the *Sarbanes-Oxley Act of 2002 (SOX)*, as is discussed in **Chapter 11**. Similarly, the Kumar Mangalam Birla Report and the Naresh Chandra Report were published in India by way of response to the crises in corporate governance.

History of governance in India 12.2

The concept of governance is not new to India. The principles of governance were discussed at length in 'Arthashastra' which was written in the 4th century BC. This treatise on government is said to have been written by Kautilya, the Prime Minister of India's first great emperor, Chandragupta Maurya.

In the context of Indian management, corporate governance can be drawn from the following: Kautilya's Arthashastra and Mulyas (values).

There is a famous quotation from Kautilya's Arthasastra (Sanjiv Agarwal, *Corporate Governance: Concepts and Dimensions*, 1st edn, Snow White Publications, p. 17, 2003):

> 'Praja sukhe sukham rajyaha prajanamcha hitehitam
> natma priyam hitam rajnaha prajanam cha hitam piryam.'

This means:

> 'In the happiness of his subject lies the king's happiness, in their welfare his welfare. He shall not consider as good only that which pleases.'

There are four principles of governance:

- Raksha – Protection
- Vridhi – Enchancement
- Palana – Maintenance
- Yogakshema – Safeguard.

Arthashastra also describes the concepts of 'well being' as: 'it is the duty of the king to protect the wealth of the state and its subjects, to enhance the wealth, to maintain it and safeguard it and the interests of the subjects' (Sanjiv Agarwal, *Corporate Governance: Concepts and Dimensions*, 1st edn, Snow White Publications, p. 17, 2003). It is interesting also to consider the term 'governance' from the philosophical and family wealth perspectives described in **Chapter 18**. Moreover, the history of the concepts of corporate social responsibility or CSR in India are relevant, as well as the comparison made between the past and modern India as regards corporate behaviour. Reference may be made to the recent CSR survey by Karmayog regarding their findings in terms of ratings of Indian companies, as well as to the ITC Chairman's speech to shareholders at the 2007 AGM demonstrating the value to shareholders (see the **Appendix**). Some suggest that there has also been a growing importance recently attached to karma in corporate governance due to the links to ethics: the karmic rules would automatically prevent them from deceiving investors. The grossly unethical conduct of Enron executives highlighted the importance of ethics in executives who should work for the benefit of the company and not in their self-interest. It has been suggested that while giving shape to corporate governance policy in India the law makers should pay attention to the basic need of inculcating karmic values in young business executives while they are in business schools so that they develop strong resistance to temptations and do not succumb to make money at the expense of investors. In curricula, business ethics should be balanced with moral philosophy so that in times to come the would be managers can become ethical role models in their corporation. Similarly elite US business schools have introduced 'self-mastery classes' in which Indian methods are used to assist executives to attain inner serenity. Therefore the relevance of the Indian philosophical approach to karma, whereby you experience or pay for the fruit of your actions, could affect global business trends as regards corporate governance and business management.

Corporate governance in India 12.3

In India, despite a long corporate history the phrase 'corporate governance' remained unknown until 1993. It came to the fore due to a spate of corporate scams and fraudulent practices during the first phase of economic liberalisation in the early 1990s and thereafter in successive recurrence. These led to the prominence of corporate governance within:

- the corporate body/sector;
- financial institutions;
- enlightened business associations;
- the regulating agencies;
- the government.

Good governance is imperative for edge in competition and critical to economic and social progress. In an ever-increasing globalised economy, firms need to tap domestic and international capital markets for investment, but capital providers have a choice and the quality of corporate governance is increasingly becoming a deciding factor for investment and lending.

Enlarging and deepening the capital pool for developing or emerging economies requires full attention to corporate governance standards. This sets the imperatives for reform (excerpts from the *Report on the Committee on the Companies Bill, 1997,* Department of Company Affairs, Ministry of Finance and Company Affairs, Government of India, New Delhi, September 2002).

A new era of good corporate governance has been put in place with the enactment of the *Companies* (*Amendment*) *Act, 2000*. The latter is in line with the changing needs of the corporate sector in the wake of globalisation. With the emphasis being on good corporate governance, the *Companies* (*Amendment*) *Act 2000* aims to make the Indian corporate sector as a whole and its corporate bodies respected globally so that they enjoy the confidence of investors and other stakeholders including consumers *(Report on the Committee on the Companies Bill 1997,* Department of Company Affairs, Ministry of Finance and Company Affairs, Government of India, New Delhi, September 2002).

The legal and regulatory framework regarding corporate governance in India 12.4

The *Companies Act 1956* is the principal legislation providing a formal structure for corporate governance. Akin to this, the *Monopolies and Restrictive Trade Practices Act 1961*, the *Foreign Exchange Management Act 2000*, the *Industries Development and Regulation Act 1951* and other economic legislation also govern corporate activities. The Securities and Exchange Board of India (SEBI) has assumed a greater role in recent years, particularly after the implementation of the Industrial Policy of 1991.

The government of India, has, in conformity with the above policy, tailored various laws and enacted new legislation with a view to providing a conducive atmosphere for the corporate sector to operate effectively, with the necessary safeguards. Increasing corporate activities, together with an interaction with multinationals, have raised various new issues requiring urgent attention. The legal and regulatory framework in India, pertaining to corporate governance comprises the following laws.

The Companies Act 1956 12.5

This is a monumental piece of legislation which *inter alia* sets out the requirements concerning the board of directors, meetings, management, conduct of meetings, appointment or removal of auditors or directors, directors' responsibility, corporate restructuring, mergers, inter-corporate activities, audit committee, accounting standards, shareholders directors and postal ballots.

The Monopolies and Restrictive Trade Practices Act 1969 12.6

The *Monopolies and Restrictive Trade Practices Act 1969* (*MTRP 1969*) regulates the control of monopolistic acts, restrictive and unfair trade practices and protects the interest of consumers. The *MRTP 1969* is gradually in the process of being replaced by new Competition Law. The latter (i.e. the new Competition Act) needs to be notified in the Official Gazette, whereupon it will become law.

The Foreign Exchange Management Act 2000 **12.7**

The *Foreign Exchange Management Act 2000* (*FEMA 2000*) regulates the control and monitoring of activities concerning the foreign flow of funds, investments and investors. The object of *FEMA 2000* is to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of the foreign exchange market in India.

The Sick Industrial Companies (Special Provisions) Act 1985 **12.8**

The main objective of the *Sick Industrial Companies* (*Special Provisions*) *Act 1985* (*SICA 1985*) is to determine sickness and expedite the revival of potentially viable units or closure of unviable units (the word, 'units' refers to a sick industrial company). It was expected that by revival, idle investments in sick units would become productive and by closure, the locked up investments in unviable units would get released for productive use elsewhere. *SICA 1985* was enacted with a view to securing:

- the timely detection of sick and potentially sick companies owning industrial undertakings;
- the speedy determination by a body of experts of the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies;
- the expeditious enforcement of the measures so determined and for matters connected therewith or incidental thereto.

The Securities and Exchange Board of India Act 1992 **12.9**

The *Securities and Exchange Board of India Act 1992* (*SEBI 1992*) provides for the establishment of a board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto. The Rules and Regulations, made thereunder relating to unfair trade practices, insider trading, takeover and mergers, raising money from the market, regulation of secondary market, etc., all bring within their ambit various aspects of corporate governance.

The Securities Contract (Regulation) Act 1956 **12.10**

The law governing securities in India is regulated, among others, by the *Securities Contracts* (*Regulation*) *Act 1956* (*SCRA 1956*). *SCRA 1956* was enacted by the Parliament of India to prevent undesirable transactions in securities dealings. According to *Section 16(1)* of *SCRA 1956*, the central government has the power to issue notifications, preventing or restricting securities transactions, which, in its opinion, are rife with speculation.

The Depositories Act 1996 **12.11**

The Depositories Act 1996 was enacted to enable the creation of the National Securities Depository Limited (NSDL) to modernise India's antiquated settlement system, primarily by enabling dematerialised equity trading. Measures were taken to promote investor security by establishing a comprehensive system of margins, intra-day trading and exposure limits, capital adequacy norms for brokers and trade/settlement guarantee funds for each exchange. Unlisted companies with a net profit in each of the last three years were given free access to the market.

Corporate governance – Indian practice **12.12**

In India, corporate governance is being observed and implemented in the spirit and the law and corporates have begun realising that it is the observance and implementation of good corporate governance practices which will lead to corporate excellence. This is also evident from the various legislative changes that have been introduced in the last couple of years in relation to corporate legislation and in the law relating to capital markets. Important changes were made in 1999 and 2000 to the *Companies Act 1956* and which are outlined below.

Buyback of shares **12.13**

Section 77A of the *Companies Act 1956* (inserted by the *Companies* (*Amendment*) *Act 1999*) permits companies to buy back their own shares. This has been supplemented by the *SEBI* (*Buy Back of Securities*) *Regulations 1998* (published in the Gazette of India, Extraordinary, Part iii – Section 4, Bombay, 14 November 1998), which allows a company to buy back its shares directly from its shareholders or through the stock markets. The extent of shares to be bought back and the buyback price have to be approved by the shareholders. The stringent guidelines set out by the market regulator require a company to maintain an escrow account, besides extinguishing the shares bought back. The rationale behind introducing the *SEBI* (*Buy Back of Securities*) *Regulations 1998* was to return the surplus cash to the shareholders, avoid hostile takeovers and promote corporate good governance.

Issue of sweat equity shares **12.14**

The Securities and Exchange Board of India has notified the *SEBI* (*Issue of Sweat Equity*) *Regulations, 2002* (published in the Gazette of India, Extraordinary, Part ii – Section 3 – Sub-section (ii), Mumbai, 24 September 2002), for the issue of sweat equity by listed companies. A company whose equity shares are listed on a recognised stock exchange may issue sweat equity shares in accordance with *Section 79A of the Companies Act 1956* (inserted by the *Companies* (*Amendment*) *Act 1999*) to its employees and directors. Further, *Section 79A* of the *Companies Act 1956* permits a company to issue sweat equity shares of a company subject to the guidelines to be issued in this regard. Accordingly, the Department of Company Affairs has notified the *Unlisted Companies* (*Issue of Sweat Equity Shares*) *Rules 2003*, which have to be complied with by an unlisted company proposing to issue sweat equity shares.

Nomination of shares **12.15**

The Companies (*Amendment*) *Act 1999*, has, for the first time, laid down the law in respect of the nomination of shares, debentures and fixed deposits. The relevant sections are *ss 109A, 109B* and *58A(11)* of the *Companies* (*Amendment*) *Act 1999.* Earlier, the position was that to avoid the problems of succession one had to hold the shares in joint names. On the death of one of the joint holders, the shares continued to be held in the name of the holder who had survived. But the matter did not end there. It transpired that the legal heirs of the deceased joint-holder could make a successful claim on the shares. The matter was finally settled by the Company Law Board (CLB) in the case of *Kana Sen and others v C K Sen and Co*(*P*) *Ltd and another, 1997, 27, CLA 82 CLB* where it was held that in case the articles of association of a company provided that the survivor of joint holding alone will have a right to the shares on the death of the joint-holder, it is only that survivor who will be recognised by the company as having a tide to the shares.

Transmission of shares **12.16**

Members can sell, their shares to any person, either directly or indirectly. This can be done through a duly executed share transfer deed.

Pursuant to the provisions of *s 108* of the *Companies Act 1956*, a company shall not register any share certificates received for transfer unless a proper instrument of transfer duly stamped is executed. There is a common share transfer form prescribed (Form No. 7B in accordance with Rule 5A5 of the *Companies (Central Governments) General Rules and Forms 1956*) for transfer of securities. This form has to be duly filled in by the transferor and the transferee.

Unpaid dividend account **12.17**

In order to make the legal position beneficial and convenient to the investing public, and also for protecting the rights of the public, *s 206A* of the *Companies Act 1956* (inserted by the *Companies (Amendment) Act 1988*) was made, with effect from 15 June 1988. Clause 28 of the Notes on the Clauses of the *Companies (Amendment) Bill* is appended below:

> 'With a view to providing protection to the investing public, this clause introduces a new section providing for payment of dividend and allotment of bonus and rights shares, to the transferee on a mandate in this regard from the transferor and in the absence of such mandate, also imposes an obligation on the company to transfer the dividends accruing on such shares to the Unpaid Dividend Account and to keep in abeyance any offer of rights or bonus shares, till the title to shares is decided.'

Investor education and protection fund **12.18**

Pursuant to the provisions of *s 205C* of the *Companies Act 1956* (inserted by the *Companies (Amendment) Act 1999*) the Central Government [of India] has notified the establishment of a fund called the Investor Education and Protection Fund with effect from 1 October 2001. The fund shall be credited with the following amounts:

(a) Amounts in unpaid dividends accounts of companies.
(b) The application moneys received by companies for allotment of any securities and due for refund.
(c) Matured deposits with companies.
(d) Matured debentures with companies.
(e) The interest accrued on the amounts referred to in clauses (a) to (d).

Small depositors **12.19**

The *Companies Act 1956* contains various provisions for the protection of small depositors/investors who are usually the most vulnerable minority group in a corporate body. The amendments in the *Companies Act 1956* have provided considerable powers to the majority shareholders. However, the principles of good governance have enunciated that every shareholder, whether he is a majority or a minority shareholder has to be protected. The newly enacted s *58AA* of the *Companies Act 1956* provides guidelines to protect the small depositors.

For the purposes of s *58AA*, a 'small depositor' (the explanation to *s 58AA* as inserted by the *Companies (Amendment) Act 2000* which came in force from 13 December 2000) means a depositor who has deposited in a financial year a sum not exceeding Rs. 20,000 (approximately US$445, the currency conversion rate for the purpose of calculation is US$1 = 45 Indian Rupees) in a company and includes his successors, nominees and legal representatives.

Section 58AA further requires that every company that accepts deposits from small depositors to inform the CLB of any default made by it in repayment of such deposits or part thereof or payment of any interest thereon, within 60 days from the date of default furnishing full particulars of the name and address of each such depositor and the principal sum of deposit and interest thereon due to them. The CLB, on receipt of such information from the company, will exercise on its own motion the powers conferred upon it by *s 58A* [Clause 6 of 58A explains the punishments imposed on the company in default of inviting deposits without issuing an advertisement] and pass an appropriate order within 30 days from the date of receipt of information. The CLB may also pass the order after the expiry of 30 days on giving the small depositors an opportunity of being heard. For this purpose it is not necessary for the small depositor to be present in person at the CLB hearing.

Under the new amendment, no defaulting company will at any time accept further deposits from small depositors unless each of the small depositors had been paid the amounts due. Where companies that have defaulted in repayment of principal and payment of interest to small depositors, had obtained funds by taking a loan for the purpose of its working capital from any bank, they will first utilise the funds so obtained for the repayment of any deposit and interest to small depositors before applying such funds for any other purpose. Failure to comply with *s 58AA* and any order passed by the CLB will be punishable with imprisonment up to three years and also a fine not less than Rs. 500 (approximately US$12) a day during the period of non-compliance.

Powers of SEBI **12.20**

The amended *SEBI Act (Section 11C* of the *Securities and Exchange Board of India Amendment Act 2002)* gives more powers to the market regulator (i.e. SEBI) including search and seizure power. The decision to give more powers to SEBI flows from the 'limitations' in the stock market regulator's ability to check malpractice and market manipulation. Consequently, apart from expanding the SEBI board to nine from the present six (including the chairman), the regulator will now have powers of 'search and seizure' of company premises and records but only after a magistrate permits it. Secondly, the penalties which can be imposed have been considerably hiked, from Rs. 5 lakhs (approximately US$11,110) to Rs. 25 crores (approximately US$5,555,555) or three times the undue profit made, whichever is higher *(s 15G* of the *Securities and Exchange Board of India Amendment Act 2002).* All the money realised by SEBI by way of penalties or fines would go into the Consolidated Fund of India *(s 15JA* of the *Securities and Exchange Board of India Amendment Act 2002).* (*Note*: 1 lakh = 100,000 (one hundred thousand); 1 crore = 10,000,000 (ten million).)

To enhance the enforcement powers of SEBI, the *SEBI (Amendment Act) 2002* clarifies and defines offences such as insider trading, fraudulent and manipulative trade practices and market manipulation *(**Chapter 5A*** of the *Securities and Exchange Board of India Amendment Act 2002).* SEBI would also have the powers to call for records from banks and other authorities to facilitate investigations *(Section 11 [2][ia]* of the *Securities and Exchange Board of India Amendment Act, 2002).*

Representation of small shareholders on company boards **12.21**

The *Companies (Amendment) Act 2000* has given small shareholders mandatory representation on the board of companies above a certain size, in order to protect minority interests. *Section 252* of the *Companies Act 1956* (inserted by the *Companies Amendment Act 2000*) for the first time, stipulates the requirement of the small shareholders' director. The amendment provides that a public company having a paid-up capital of Rs. 5 crores (approximately US$1,111,110) or more, 1,000 or more small shareholders may have a director elected by such shareholders in the manner as may be prescribed.

Introduction of postal ballots **12.22**

The *Companies (Amendment) Act 2000* also expands the notion of corporate democracy by permitting postal ballots (*s 192A[1]* of the *Companies Act 1956* was inserted by the *Companies Amendment Act 2000* which came into force with effect from 13 December 2000). The provisions of *s 192A[1]* of the *Companies Act 1956* provide all listed companies with an option of passing shareholders' resolutions through postal ballot. Further, the listed companies are necessarily required to get certain businesses notified (vide notification number GSR.337 E dated 10 May 2001) by the Central Government to be passed through postal ballot. *The Companies (Passing of the Resolution by Postal Ballot) Rules 2001* (notified on 10 May 2001), mentions the transactions which have to be transacted through postal ballot.

Director's responsibility statement **12.23**

The board report should also include the Directors' Responsibility Statement requiring the disclosure of various information and making the directors responsible for the disclosures. *Section 211 [2AA]* of the *Companies Act 1956* (inserted by the *Companies Amendment Act 2000* which came into force with effect from 13 December 2000) stipulates that the board's report shall also include the Directors' Responsibility Statement indicating therein that:

- in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanations relating to material departures;
- the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;
- the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
- the directors had prepared annual accounts on a going concern basis.

Audit committee **12.24**

Section 292A of the *Companies Act 1956* (inserted by the *Companies Amendment Act 2000* which came into force with effect from 13 December 2000) states that every public company having a paid-up capital of not less than Rs. 5 crores (approximately US$1,111,110) shall constitute a committee of the board knows as the audit committee which shall consist of not less than three directors and such number of other directors as the board may determine, of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors. Every audit committee constituted shall act in accordance with the terms of reference to be specified in writing by the board. The members of the audit committee shall elect a chairman from amongst themselves. The annual report of the company shall disclose the composition of the audit committee. The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the audit committee but shall not have the right to vote.

The audit committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the board and also ensure compliance of internal control systems. The audit committee shall have authority to investigate any matter in relation to the items specified in this section or referred to it by the board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary. The recommendations of the audit committee on any matter relating to financial management including the audit report, shall be binding on the board.

If the board does not accept the recommendations of the audit committee, it shall record the reasons therefor and shall communicate such reasons to the shareholders. The chairman of the audit committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit. If a default is made in complying with the provisions of this section, the company, and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to Rs. 50,000 (approximately US$1,110) or with both.

Accounting standards **12.25**

Section 211 [3A] of the *Companies Act 1956* (inserted by the *Companies (Amendment) Act 1999*) provides that every profit and loss account and balance sheet of the company shall comply with the accounting standards. For the purpose of *Section 211 [3A]* of the *Companies Act 1956*, the expression ‘accounting standards’ means the standards of accounting recommended by the Institute of Chartered Accountants of India (a statutory body constituted by the *Chartered Accountants Act 1949*) as may be prescribed by the central government in consultation with the National Advisory Committee on Accounting Standards (established under *Sub-section 1* of *Section 210A(1)* as inserted by *Companies (Amendment) Act 1999*).

Secretarial compliance certification **12.26**

The amended *Companies Act 1956* has vested various responsibilities on company secretaries in order to maintain good governance of the companies.

Every company having a paid up share capital of Rs. 25 lakhs (approximately US$11,110) or more shall have a whole-time secretary and where the board of directors of any such company comprises only two directors, neither of them shall be the secretary of the company (*Section 383A(1)* substituted by the *Companies (Amendment) Act 1988*). The *Companies Act 1956* makes it mandatory (*Section 383 A(1)* inserted by the *Companies Amendment Act 2000*) for a company having a paid up share capital of Rs. 10 lakhs (approximately US$22,220) or more to file with the Registrar of Companies a certificate from a secretary in full-time practice in such form and within such time and subject to such conditions as may be prescribed, as to whether the company has complied with all provisions of the Act and the copy of such certificate shall be attached with board's report (as referred in *Section 217* of the *Companies Act 1956*). On the failure to comply with these rules, the company and the secretary will be punishable (*Section 383A(1A)*, as inserted by the *Companies (Amendment) Act 1988*).

Capital market regulations

Introduction of depositories 12.27

Depositories (i.e. a system of organisation which keeps records of securities deposited by its depositors) was introduced in India in 1996 to increase the investor security and the transparency of the Indian capital markets. The *SEBI (Depositories and Participants) Regulations 1996* (published in the Gazette of India, Extraordinary, Part ii – Section 3 – Sub-section (ii), Mumbai, 16 May 1996) provide for the establishment of depositories subject to registration with SEBI. SEBI will prescribe conditions to be met before the 'Certificate of Commencement of Business' can be issued. Investors will have the choice of continuing with their existing share certificates or opting for a depository. Investors opting to hold their securities in the depository mode will be required to get in touch with a 'participant' in the depository system (who will be registered with SEBI). The 'participant' will be agencies like banks, financial institutions, custodians of securities and stockbrokers. Upon entry into the system, share certificates will be 'dematerialised' and names of beneficial owners would be registered in the books of the depository. The Code of Conduct is prescribed by SEBI for the protection of the investors *(regulation 20A* of the *Securities and Exchange Board of India [Depositories and Participants] Regulations 1996).*

Regulation of insider trading 12.28

SEBI has notified the *SEBI (Prohibition of Insider Trading) Regulations 1992* (published in the Gazette of India Extraordinary, Part II – Section 3 – Sub-section (II), Bombay, 19 November 1992) (the SEBI (Insider Trading) Regulations) dealing, *inter alia*, with the buying and selling of securities of the company by employees/directors. A plain reading of the *SEBI (Insider Trading) Regulations* appears to indicate that two conditions need to be fulfilled to hold somebody guilty as an insider:

- The 'insider' must be a connected person by virtue of his position in the company such as director, officer or employee with a professional or business relationship with access to unpublished price-sensitive information. Otherwise, he is deemed to be a connected person such as a company under the same management or subsidiary, member of stock exchange or merchant banker or others acting in a similar capacity.
- The 'insider' has traded in those securities on the basis of unpublished price-sensitive information.

Regulation of collective investment schemes **12.29**

The SEBI *(Collective Investment Schemes) Regulations 1999* (the Gazette of India, Extraordinary Part ii – Section 3 – Sub-section (ii), Mumbai, 15 October 1999). Henceforth, no person other than a Collective Investment Management Company which has obtained a certificate of registration under the *SEBI (Collective Investment Schemes) Regulations 1999*, can carry on or sponsor or launch a collective investment scheme. Also, no existing collective investment scheme can launch any new scheme or raise money from the investors even under the existing schemes, unless a certificate of registration is granted to it under the said regulations.

Every Collective Investment Management Company shall be responsible for managing the funds or properties of the scheme on behalf of the unit holders. It should take all reasonable steps and exercise due diligence to ensure that the scheme is managed in accordance with the provisions of these regulations; offer document and the trust deed. A collective management company should exercise due diligence and care in managing assets and funds of the scheme. It should also be responsible for the acts of commissions and omissions by its employees or the persons whose services have been availed by it. It is incompetent to enter into any transaction with or through its associates, or their relatives relating to the scheme *(Regulation 14 of the SEBI (Collective Investment Schemes) Regulations, 1999).*

Takeover code **12.30**

The procedure for takeovers is enshrined in the *SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997* (published in the Gazette of India, Extraordinary Part ii – Section 3 – Sub-section (ii), Bombay, 20 February 1997), as amended in 2002. These make it compulsory to give a public announcement before a takeover deal. No acquirer shall acquire shares or voting rights which (taken together with shares or voting rights, if any, held by him or by persons acting in concert with him), entitle such acquirer to exercise 15% or more of the voting rights in a company, unless such acquirer makes a public announcement to acquire shares of such company in accordance with the regulations (*Regulation 10* of the *SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997* as inserted by *SEBI (Substantial Acquisition of Shares and Takeovers) Amendment Regulations, 1998* published in the Official Gazette of India dated 28 October 1998). The takeover code also contains various disclosure mechanisms like the disclosure of the acquirer to the stock exchanges and continual disclosures (*Regulation 7(3) and Regulation 8* of the *Securities Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 1997*, respectively). In addition to the disclosures, SEBI has the power to call for information from the stock exchanges and the company *(Regulation 9 of the Securities Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 1997).*

Fraudulent and unfair trade practices **12.31**

SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations 1995 has been amended by the *SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations 2003* (published in the Gazette of India, Extraordinary, Part ii – Section 3 – Sub-section (ii), Mumbai, 17 July 2003) to control the unfair trade practices in the security market and by this amendment. The policing powers of the SEBI have also been increased as a result of this amendment.

Setting up of the Securities Appellate Tribunal **12.32**

Regulation 15K of *SEBI* transferred the appellate function of the central government under three different Acts to the Securities Appellate Tribunal (this provision has been inserted by the *Securities Laws (Second Amendment) Act, 1999* vide Gazette Notification dated 16 December 1999). The objectives of these Acts are to prevent undesirable transactions in securities and depositories by regulating the business of dealing and protecting investors interest. The Securities Appellate Tribunal shall not be bound by the procedure laid down by the *Code of Civil Procedure 1908*, but shall be guided by the principles of natural justice and, subject to the other provisions of this Act and of any rules, the Securities Appellate Tribunal shall have powers to regulate their own procedure including the places at which they shall have their sittings *(Section 15U(1) of the Securities Laws (Second Amendment) Act, 1999).*

Governance through listing agreement **12.33**

SEBI had convened a meeting of all the stock exchanges on 17 January 2001 to discuss various issues relating to secondary market including the compliance of the provisions of corporate governance. On the basis of the discussion in the meeting, the stock exchanges are directed to implement the following things outlined below.

Setting up a separate monitoring cell 12.34

The stock exchanges shall set up a separate monitoring cell with identified personnel to monitor the compliance with the provisions of the corporate governance. This cell shall obtain the quarterly compliance report from the companies who are scheduled in the first phase and shall submit a consolidated compliance report to SEBI within 30 days of the end of the quarter, commencing from the quarter ending March 2001.

The companies who are listed in the first phase of the Clause 49 of the listing agreement will be required to submit a quarterly compliance report to the stock exchanges within 15 days from the end of the quarter. The report shall be submitted either by the compliance officer or the chief executive officer (CEO) of the company after obtaining due approvals (see the revised Clause 49, Circular dated 26 August 2003 Ref.: SEB1/MRD/SE/31/2003/26/08. *Source*: http://web.sebi.gov.in/circulars/2003/eir2803anl.html).

Clause 49: Listing agreement – significant changes by SEBI

On 29 October 2004, SEBI issued a circular SEBI/CFD/DIL/CG/1/2004/12/10 directing all stock exchanges to amend the listing agreement by replacing the existing Clause 49 of the listing agreement. The circular 29 October 2004 provided that companies complying with the provisions of the existing Clause 49 issued by virtue of circulars dated 21 February 2000, 9 March 2000, 12 September 2000, 22 January 2001, 16 March 2001 and 31 December 2001 shall continue to do so until the revised Clause 49 of the listing agreement is complied with or until 31 March 2005, whichever is earlier.

However, noticing that a large number of companies were still not fully complying with the requirements of the revised Clause 49 of the listing agreement, SEBI, by its Circular SEBI/CFD/DIL/CG/1/2005/29/3 dated 29 March 2005 allowed more time to companies to conform to Clause 49 of the listing agreement and extended the date for ensuring compliance with the revised Clause 49 of the listing agreement until 31 December 2005.

One of the most significant aspects of the revised Clause 49 is the requirement that the Annual Report of the company must contain a separate section on Corporate Governance.

The revised Clause 49 lays down tighter qualification criteria for independent directors (see http://www.clause49.com/clause49.htm). The new Clause 49 disqualifies material suppliers and customers from being independent directors. It disallows a shareholder with more than 2% stake in the company from being an independent director as well as a former executive who left the company less than three years ago. Partners of current legal, audit and consulting firms, as well as partners of such firms that had worked in the company in the preceding three years, too, cannot be independent directors.

A relative of a promoter, or an executive director or a senior executive one level below an executive director, too, cannot be an independent director.

Another important difference is that while the original clause gave the board the freedom to decide whether a materially significant relationship between director and the company affected his independence, the new clause takes this discretionary power away from the board. In the original clause, the maximum time gap between two board meetings could be four months. The new clause has reduced this time gap to three months. The original clause had stipulated that the audit committee must meet at least 3 times a year and at least once every six months. The new clause makes it mandatory for the audit committee to meet a minimum of 4 times in a year with a maximum time gap of four months.

Moreover, unlike the previous Clause 40 which was silent with regard to the qualifications of audit committee members, the new clause states that all members should be financially literate and at least one should have financial or accounting management expertise.

The revised Clause 49 also gives a definition of 'financially literate' and 'accounting or related financial management expertise'. The revised Clause also strengthens and widens the role and responsibility of audit committees.

Nominees of institutions that have invested in or lent to the company shall be deemed to be independent directors.

The major new provisions included in the revised Clause 49 are:

1. The board will lay down a code of conduct for all board members and senior management of the company to compulsorily follow.
2. The CEO and CFO will certify the financial statements and cash flow statements of the company.
3. At least one independent director of the holding company will be a member of the board of a material non-listed subsidiary.
4. The audit committee of the listed company shall review the financial statements of the unlisted subsidiary, in particular its investments.
5. If while preparing financial statements, the company follows a treatment that is different from that prescribed in the accounting standards, it must disclose this in the financial statements and the management should also provide an explanation for doing so in the corporate governance report of the annual report.
6. The company will have to lay down procedures for informing the board members about the risk management and minimisation procedures.
7. Where money is raised through public issues, rights issues, etc., the company will have to disclose the uses/applications of funds according to major categories (capital expenditure, working capital, marketing costs, etc.) as part of quarterly disclosure of financial statements. Further, on an annual basis, the company will prepare a statement of funds utilised for purposes other than those specified in the offer document/prospectus and place it before the audit committee.
8. The company will have to publish its criteria for making its payments to non-executive directors in its annual report.

Who is an independent director?
The Indian definition of independent directors as given in the recently amended Clause 49 of listing agreement is an inclusive definition. Clause 49 of the listing agreements defines independent directors as follows: 'For the purpose of this clause the expression "independent directors" means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the directors.'

The definition of the term 'independent directors' has been amended to mean a non-executive director who:

- does not have a pecuniary relationship with the company, its promoters, senior management or affiliate companies;
- is not related to promoters or the senior management;
- has not been an executive with the company in the immediately three preceding financial years;
- is not a partner or executive of the auditors/lawyers/consultants of the company;
- is not a supplier, service provider or customer of the company;
- does not hold 2% or more of the shares of the company.

Further, there is certain minimum information that is required to be made available to the members of the board prior to the board meeting which ranges from annual operating plans and budgets to labour problems. In addition, a company is also required to lay down a code of conduct for members of its board as well as the senior management.

Report on corporate governance **12.35**

There should be a separate section on corporate governance in the annual reports of a company, with a detailed compliance report on corporate governance. Non-compliance of any mandatory requirement, that is, which is part of the listing agreement with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given below. The report shall be submitted either by the compliance officer or the CEO of the company after obtaining due approvals (see Part IX of the Revised Clause 49, Circular dated 26 August 2003 Ref.: SEBI/MRD/SE/31 /2003/26/08. *Source*: http://web.sebi.gov.in/circulars2003/cir2803anl.html).

Listing of Initial Public Offerings **12.36**

According to the schedule of implementation of corporate governance specified by SEBI Circular No SMDRP/Policy/CIR-10/2000 dated 21 February 2000, all the entities seeking listing for the first time are required to comply with the provisions of corporate governance at the time of listing.

The stock exchanges shall ensure that these provisions have been complied with before granting any new listing. For this purpose, it will be satisfactory compliance if these companies have set up the boards and constituted the committees such as the audit committee, shareholders/investors grievance committee, etc. Before seeking listing, a reasonable time to comply with these conditions may be granted only where the stock exchange is satisfied that genuine legal issues exists which will delay such compliance. In such cases while granting listing, the stock exchanges shall obtain an undertaking from the company. In case of the companies failing to comply with this requirement without any genuine reason, the application money shall be kept in an escrow account till the conditions are complied with (Circular No. 48/2001 dated 3 March 2001 issued by SMDP, SEBI. *Source*: http://web.sebi.gov.in/circulars/2001/CIR482001.html as on 31 April 2004).

Electronic Data Information Filing and Retrieval System 12.37

EDIFAR is an Electronic Data Information Filing and Retrieval System. This would involve electronic filing of information in a standard format by the companies. This system has several benefits by way of dissemination of information to various classes of market participants like investors, regulatory organisation, research institutions, etc. This would also be useful to companies and stock exchanges.

SEBI in association with National Informatics Centre (NIC) has set up an EDIFAR to facilitate filing of certain documents/statements by the listed companies on line on the website to be maintained by NIC. This system is being introduced in a phased manner and would be applicable to 200 companies (vide circular dated 3 July 2002 issued by SEBI, Ref.: SMD/POLICY/Cir-17/02. *Source*: http://web.sebi.gov.in/circulars/2002/cir232002.h). Initially, the following statements/information would be filed online:

- Financial statements comprising the balance sheet, profit and loss account and full version of annual report; half-yearly financial statements including cash flow statements and quarterly financial statements.
- Corporate governance reports.
- Shareholding pattern statement.
- Action taken against the company by any regulatory agency.

Committees on corporate governance 12.38

India has also formulated codes of corporate governance through various committees, more important ones being:

- Confederation of Indian Industries (CII) Code of Desirable Corporate Governance (1998).
- Unit Trust of India (UTI) Code of Governance (1999).

- Kumar Mangalam Birla Committee on Corporate Governance (2000).
- Naresh Chandra Committee on Corporate Audit and Governance (2002).
- N.R. Narayan Murthy Committee (SEBI, 2003).

Report of Kumar Mangalam Birla Committee on Corporate Governance 12.39

This report should be commented upon as a precedent.

The SEBI appointed the Committee on Corporate Governance on 7 May 1999 under the chairmanship of Shri Kumar Mangalam Birla, a member of the SEBI Board, to promote and raise the standards of corporate governance. The detailed terms of reference are as follows:

- To suggest suitable amendments to the listing agreement executed by the stock exchanges with the companies and any other measures to improve the standards of corporate governance in the listed companies, in areas such:
    - as the continuous disclosure of material information, both financial and non-financial;
    - the manner and frequency of such disclosures;
    - the responsibilities of independent and outside directors.
- To draft a code of corporate best practices.
- To suggest safeguards to be instituted within the companies to deal with insider information and insider trading.

The Committee also took note of the various steps already taken by SEBI for strengthening corporate governance, some of which are:

- Strengthening of disclosure norms for Initial Public Offers following the recommendations of the Committee set up by SEBI under the chairmanship of Shri Y.H. Malegam.
- Providing information in directors' reports for the utilisation of funds and variation between projected and actual use of funds according to the requirements of the Companies Act 1956; inclusion of cash flow and funds flow statement in annual reports.
- Declaration of quarterly results.
- Mandatory appointment of compliance officer for monitoring the share transfer process and ensuring compliance with various rules and regulations.
- Timely disclosure of material and price-sensitive information including details of all material events having a bearing on the performance of the company.
- Despatch of one copy of complete balance sheet to every household and abridged balance sheet to all shareholders.
- Issue of guidelines for preferential allotment at market-related prices.
- Issue of regulations providing for a fair and transparent framework for takeovers and substantial acquisitions.

The Committee has identified the three key constituents of corporate governance as the *shareholders*, the *board of directors* and the *management* and has attempted to identify in respect of each of these constituents, their roles and responsibilities as also their rights in the context of good corporate governance.

Fundamental to this examination and permeating throughout this exercise is the recognition of the three key aspects of corporate governance, namely; accountability, transparency and equality of treatment for all stakeholders.

The recommendations of the committee **12.40**

This report is the first formal and comprehensive attempt to evolve a code of corporate governance, in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets. While making the recommendations the committee has been mindful that any code of corporate governance must be dynamic, evolving and should change with changing context and times. It would therefore be necessary that this code also is reviewed from time to time, keeping pace with the changing expectations of the investors, shareholders, and other stakeholders and with increasing sophistication achieved in capital markets.

Corporate governance – the objective **12.41**

Corporate governance has several claimants – shareholders and other stakeholders – which include suppliers, customers, creditors, the bankers, the employees of the company, the government and society at large. This report on corporate governance has been prepared by the committee for SEBI, keeping in view primarily the interests of a particular class of stakeholders, namely, the shareholders, who together with the investors form the principal constituency of SEBI while not ignoring the needs of other stakeholders.

The committee therefore agreed that the fundamental objective of corporate governance is the 'enhancement of shareholder value, keeping in view the interests of other stakeholder'. This definition harmonises the need for a company to strike a balance at all times between the need to enhance shareholders' wealth whilst not in any way being detrimental to the interests of the other stakeholders in the company.

In the opinion of the committee, the imperative for corporate governance lies not merely in drafting a code of corporate governance, but in practising it. Even now, some companies are following exemplary practices, without the existence of formal guidelines on this subject. Structures and rules are important because they provide a framework, which will encourage and enforce good governance; but alone, these cannot raise the standards of corporate governance. What counts is the way in which these are put to use. The committee is of the firm view, that the best results would be achieved when the companies begin to treat the code not as a mere structure, but as a way of life.

The central problem in corporate governance in India today is sociological. Mr Rahul Bajaj, Chairman, Bajaj Auto, epitomised the problem. He said at a seminar on corporate governance in Mumbai in November, 1996 that:

> 'All of us know what boards and managements should do, but are doing what we should not do. We have done things that are questionable – legal but questionable. Why should we need a committee to tell us what to do?'

Mr Bajaj was the chairman of the task force of the Confederation of Indian Industry (CII) entrusted the task of preparing a code of corporate governance. The corporate governance problem in India crystallises into the following questions:

- Why do business leaders do things they know should not be done?
- What are the pressures or fears that force them to do so?
- How can they be helped to be more integral to their own beings?
- How can the board of directors play a more useful role?

The owners have to bring about an attitudinal change in them and identify with the aspirations of each stakeholder. One way in which organisations can improve their standards of corporate governance in the future is by focusing on how they choose external directors who should be selected mainly on the basis of their experience and expertise.

Corporate governance – drivers for change in India

The dramatic improvement of corporate governance in India is a consequence of:

* the post 1991 economic reforms;
* the challenges of globalisation resulting in enhanced competitiveness;
* changes in the shareholding pattern, growing importance of institutional investors and public financial institutions;
* events such as the securities scam (involving a large number of banks) leading to the stock market crash in 1992.

This was followed by:

* the consolidation of equity ownership by multinational companies listed on the stock markets;
* the stock market bubble in 1993;
* the crash of the ‘disappearing companies’ in 1994, which devastated the primary market until the end of the century.

These led to the formation by the Confederation of Indian Industry (CII) of the Bajaj Committee on corporate governance in late 1995, well before the East Asian financial crisis. In addition, the Indian capital markets had reached a crisis-point where the accumulated distortions of decades of restrictive state policies and of corporate control had highlighted the need for urgent capital market reform.

Corporate governance in the 21st century also emphasises the role of shareholders and financial institutions. Shareholders should be involved in all major decisions and financial institutions should appoint functional experts to represent them on the boards of companies in which they have substantial holdings.

Other corporate laws of India 12.42

The administration of affairs of companies in today's competitive environment is entrusted to persons of professional standing. The requirements of public accountability and social responsibility have become a prominent feature of law, making it necessary to pay due attention to the generally recognised principles of equity, shareholders' democracy, prudent governance and transparent accounting.

Apart from the laws that have been analysed above, the Indian regulatory framework concerning corporate governance for companies covers legislation such as the *Banking Regulation Act 1949, the Income Tax Act 1961,* the *Indian Stamp Act 1899, the Insurance Regulatory and Development Act 1999, the Information Technology Act 2000* and various Acts covering the labour laws of India.

Trends in India 12.43

Although the subject of corporate governance has been receiving explicit attention in India only in the last few years, the institutional and regulatory framework for corporate governance has been in place for a long time. The legal framework for regulating all corporate activities including governance and administration of companies, disclosures, shareholders' rights (i.e. the *Companies Act*) has existed since 1956 and has been fairly stable. The stock exchanges have been executing listing agreements laying down ongoing conditions and continuous obligations for companies.

During the last few years, greater attention is being focused on the subject and there has been a discernible growth in awareness about corporate governance being an intrinsic part of companies' best practices and obligations. The lack of it, or, the inadequacy of corporate governance among companies, has been featuring in the media, in the boardrooms of financial institutions who are the block holders in many companies, and in academic debates as one of the reasons for the 'present disenchantment' of small investors. The boards of enlightened companies – even those belonging to the business families – financial institutions and other large institutional shareholders, investors and regulators are increasingly becoming aware of the need for disclosures, open and transparent management concepts, continuing obligation to put out material information, better accounting standards and for establishing standards of best practices to be pursued by the directors, managers and employees of companies. The protection of the interest of the shareholders and the preservation and enhancement of shareholder value and wealth are concepts, which are being widely recognised in the industry and assuming greater importance.

Several factors have helped drive this change. They are:

- The economic reforms of 1991, which have allowed the growth of free enterprise and given private enterprise its rightful place alongside the public sector.
- The increased domestic and foreign competition to domestic private and public sector companies which has multiplied choices for the consumers, compelled increases in efficiency.

- The growing reliance placed by private and public sector companies on capital markets, underpinning the need for better disclosures.
- The consequential changes in the shareholding pattern of private and public sector companies, FDI caps and disinvestments.
- The growing awareness of investors and investor groups of their rights.
- The rise of institutional investors, with the public financial institutions gradually asserting themselves and transforming themselves into their new role as active shareholders rather than as lenders.
- The stock exchanges becoming gradually conscious of their roles as self-regulatory organisations and exploring the possibility of using the listing agreement as a tool for raising standards of corporate governance.
- The role of SEBI as the statutory regulatory body for the securities market to protect the rights of investors and to regulate the securities markets.

Other South Asian countries corporate governance profiles 12.44

In view of the growing importance of the South Asia region as regards global business practice, it is helpful to provide an overview of selected jurisdictions in the SAARC region. This is particularly the case given India's trade relationship with neighbouring countries, as well as co-operative initiatives.

Bangladesh 12.45

In Bangladesh, there have been no serious corporate scandals that have been so significant as to send shock waves to undermine confidence in the financial system, nor has the country found that it has reached the limits of conventional corporate financing mainly through bank lending. The relatively low level of international investment in Bangladesh does not provide a sufficient motivation for improving corporate governance, nor are there many traditional domestic motivations for improvement in corporate governance practices. Nevertheless, good corporate governance practices will help develop and stimulate better business management, strategic management and risk management, which, in the long term, will make Bangladeshi businesses more competitive. The lessons from the experience of the neighbouring countries in South Asia are such that Bangladesh can deploy good corporate governance to prevent the problems that have afflicted other countries rather than to solve them after the event.

The principle legal instrument for enforcing governance in Bangladesh is the Companies Act 1994 which is administered by Registrar of Joint Stock Company (RJSC) and the Ministry of Commerce. In that respect the Securities Exchange Commission (SEC) has limited jurisdiction of enforcement of corporate governance. SEC is concerned with publicly limited companies only, the numbers of which are very insignificant (some estimates put this at only 5% of all companies). Close monitoring of leading companies is a disincentive for going public as there is a perception that this will create and raise unnecessary difficulties for companies to supply information as and when requested. Although RJSC has registered thousands of companies, vigilance is very weak; indeed their rules do not permit them to undertake close monitoring.

Lack of appropriate training, information and knowledge about company laws are key challenges. Ignorance of regulatory requirements is one of the main detrimental issues. A recent seminar in Dhaka highlighted the need for services from people with adequate knowledge of the principles of corporate governance as well as security laws and regulations that are required for practicing these issues.

The legal system is generally weak and awareness even less so. Even a CEO of a company may not know enough about the company rules and regulations and this often hampers companies from taking a rule-based decision. This may depend on the whim of the chairperson, a situation made worse by the combination of CEO and Chair position. However, progress is being made. In 2006 Apex Footwear, one of the country's leading textile and clothing exporters became the first-listed company in Bangladesh to appoint an independent director in line with the corporate governance guidelines set by the SEC; with the new appointment, the size of the board stands at six.

Key gaps in corporate governance centre on:

- directors failing in their oversight function;
- regulators lacking competent professionals;
- ownership policy being absent for state-owned enterprise (SOEs).

Major initiatives on corporate governance include work by the Bangladesh Enterprise Institute and the Commonwealth, Bangladesh Bank directives on corporate governance, a National Taskforce, the establishment of a Code of Corporate Governance for Bangladesh (2004) and SEC Guidelines on Corporate Governance (2006).

The way forward includes:

- co-ordination among regulators;
- capacity building, the ownership policy for SOEs; and
- donor co-ordination.

There is also a need for a small- and medium-sized enterprise (SME) focus – 'many would benefit if they are interfaced with the corporate governance issues of the big companies' as one business leader has proposed. Moreover, with increasing investment in Bangladesh and South Asia there is an opportunity to develop and sustain interest about the prospects for corporate reform and good practice in corporate governance. The drive for better corporate governance can come from:

- shareholders;
- investor associations;
- institutional investors; and
- the financial press.

Each of these potential actors should be strengthened, given that:

- First, the financial press and the constituency for detailed financial reporting is limited. Furthermore, the information provided by companies and regulatory bodies is often inadequate.
- Second, public shareholders do not join together in shareholder associations to demand better company performance or to assert their shareholder rights. Even in cases where the public holds a majority of shares, the treatment of shareholders is poor. Given that majority shareholders have not asserted their rights, minority shareholder rights are not a priority to most public corporations.
- Third, there are only a few institutional investors in the country and they often do not exercise the power that they hold. In most capital markets, institutional investors like insurance companies, pension funds and mutual funds hold power over substantial sums of investment capital and demand strong performance and transparent corporate governance. In Bangladesh, there are only a few institutional investors, most of which are SOEs. State-owned institutional investors have no performance motivation to force companies to improve performance, voluntarily disclose information or improve corporate governance. The few private investors do not have enough clout to force large-scale changes in the corporate sector. As a corollary, the venture capital industry also does not exist.

Most companies do not think they are candidates for foreign investment, so there is no push from the international economic community for better corporate governance. In 2005 Beximco, the pharmaceutical company, became one of the first Bangladeshi companies to be listed on an exchange outside the country (on London's AIM market). However, Bangladesh does not have a Sovereign Credit Rating (SCR) provided by any of the international rating agencies. Multinational companies have emerged as a positive force in the general business environment creating pressure for others to conform. For instance, companies like British American Tobacco and Lever Brothers Bangladesh have proactively come forward with their own findings and statistics on tax evasion by competitors in their respective sectors. Driven by their own self-interests, they have succeeded, though, in bringing about redress at the National Board of Revenue.

A recent survey of the Dhaka Stock Exchange (Faizul Haque, 2006) found that better corporate governance enhances both the firms' ability to gain access to equity finance and firm value, and thus contributes to the process of capital market development. The evidence has specific policy implications in relation to the significance of better firm governance in enhancing financial sector development, and avoiding potential vulnerability in the financial system. The strong governance role of the legal and regulatory institutions appears to be imperative to remove mass malfunctions at both the firm and operational level of the capital market in Bangladesh.

Nepal 12.46

Nepal has a small but active equity market. At the end of 2005 there were 124 companies listed on the Nepal Stock Exchange (NEPSE). Nepal's family owned business houses play an important role in corporate ownership (see the role of family business in **Chapter 18**). Most government and market institutions lack efficiency, predictability, transparency and accountability. The legal framework governing capital markets contains large and significant gaps. Critical institutions, including the securities board and company registrar, have few resources and little authority. The industrial activity of the country is concentrated in a small number of powerful families who own and control about 27% of total private sector assets in the country. In addition, a number of enterprises are still in the public sector and operate at a very low efficiency level. The country has experienced a sharp economic downturn since mid-2001, with GDP growth slipping mainly due to political uncertainty, escalating insurgency and social unrest.

The government has adopted a market economy and has a liberal policy towards foreign investors. However, FDI in the country is still very low. Weakness in corporate governance also accounts for one of the reasons.

Awareness of the importance of corporate governance is growing in Nepal. The government has adopted good governance as one of the pillars of its five-year plan, recognising its critical importance in achieving poverty reduction and economic development targets. The central bank has introduced higher corporate governance standards for banks and other financial companies as part of a wider programme of financial sector reform. Accounting and auditing standards are being developed. Also a number of draft laws have been prepared that, if passed and implemented, should deepen and accelerate the reform process.

Nepal has initiated corporate governance reform in the financial sector and draft legislation has been prepared to spread reform to other companies. Fully tapping the potential of capital markets and professionalising boards and management will require this legislation be passed and implemented and overall reform efforts continue.

Key issues

1. *Investor protection*

- There are a number of weaknesses in the corporate governance framework that limit investor confidence.
- Shareholders can participate in the governance process, however, for some shareholders participation involves demanding money and other benefits at the AGM.
- Share registration is cumbersome and prone to abuse. Information on companies can be hard to access.
- Change in control is not common. Related party transactions take place which are sometimes disadvantageous to the minority share holders.

Minority protection is a problem when owner–managers solicit funds and then abscond or mismanage the company. Minority shareholders do not have easy access to legal protection in Nepal. The courts in Nepal are ill-equipped to deal with business problems. Judges and lawyers have not been trained to analyse the kinds of legal issues generated by a capital market. Judges should be further educated to respond to new demands, but that is a long-term solution.

2. *Disclosure*

- Disclosure is poor especially for non-financial companies.
- Ownership disclosure is limited.
- Standards for auditing and accounting are still being developed.

Poor disclosure of information is one of the impediments for gaining investors' confidence at a high level. The issuers publish over-optimistic forecasts of future profits and they often fail to publish annual accounts or hold annual general meetings, and even pay no dividends.

3. *Effectiveness and ethics of the board members*

- Boards and management are under family control.
- Directors have limited guidance on their duties or powers.
- Basic rules of conflict of interest are in place, but enforcement is limited.

Because of the relationship-based system in Nepal, most boards do not satisfy any of the conditions that accompany the principle of independent oversight. Although there is a clear distinction between full-time directors and non-executive board members, there is no legal definition of independence. Moreover, the non-executives are family members or nominees from the government or institutional shareholders. It is common for prominent persons to serve on the boards of several corporations simultaneously.

Management shares very little substantive information with the outside directors. Most of the nominee directors fail to understand that they are fiduciaries of the company. Most Nepali companies are driven by their management and not by their boards.

4. *Enforcement*

- Key corporate governance institutions lack resources and authority.
- Enforcement is largely left to the NEPSE, District Court and the Central Bank.

The affiliated company board, part time court like body, hears a steady stream of cases, but these are regularly appealed. The standards developed by ICAN and the Accounting and Auditing Standards Boards remain voluntary, and only a fraction of registered accountants and auditors have been licensed by the body.

Recommendations

1. *Strengthen capital markets*

- Nepal should continue the reform process and draft more effective company and security legislation.

- Strengthen the institutions which are in-charge of enforcing the legislations and regulating the capital markets.

2. *Protect shareholders' rights*

- Stress should be given on strengthening shareholders rights and more productive AGMs.
- Establish transparent procedures for major and related party transactions.

3. *Enhance transparency*

- Ensure that high standards for accounting and auditing are introduced and enforced.
- Improve disclosure of ownership and control.

4. *Increase the effectiveness and objectivity of boards*

- Increase the effectiveness of boards through change in legislature and introduction of 'Code of Corporate Governance'.
- Specify the directors' duties and powers and introduce new codes for directors to behave ethically and be responsible to legitimate stakeholders.
- Encourage the development of independent directors.
- Training for board members and creation of institute of directors or corporate governance.

Pakistan **12.47**

Pakistan commenced its corporate governance programmes later, following:

- the Securities and Exchange Commission of Pakistan (SECP) Act in 1997;
- the commencement of operations by the Commission in 1999;
- the introduction of the national Code for Corporate Governance in early 2002.

However, despite the later start, initiatives in Pakistan were driven by homegrown realities, in particular the recognition that the traditional structures and operations of the capital market, especially lending from state-owned banks, could no longer sustain the financing needed for growth. This has led to a realisation of a critical need for reform of the capital markets in order to mobilise domestic savings and foreign portfolio investment (as there had been in India a decade earlier).

In fact, despite the later start with formal national policies, it could be said that Pakistan focused on corporate governance earlier than many countries in the world, not just the region. By way of example it is useful to note the importance of the 1984 Companies Ordinance Act, which introduced a number of key features of good corporate governance, at a time when the very term 'corporate governance' had only just been coined and was still effectively unknown outside very specialised academic circles. Furthermore, during the mid-1980s there were some significant policy and training programmes to strengthen corporate control, board direction and chairmanship in both the state enterprises and the private sector, through the Expert Advisory Cell of the Ministry of Industry and the Lahore University of Management Sciences and Institute of Personnel, supported by USAID. Although these programmes were not described as 'corporate governance', they could be said to form part of the corporate governance heritage of Pakistan.

Assessment of corporate governance in Pakistan can be examined both in relation to listed companies and SMEs.

Listed companies

There have been a number of achievements. Reform to improve corporate governance has been significant, including the introduction of a code of corporate governance and increased vigilance by regulators. Regulators, industry associations, academic institutions and non-governmental organisations (NGOs) have raised awareness of the value of good corporate governance practice, and have established the Pakistan Institute of Corporate Governance (PICG), which aims to build understanding and provide training in an innovative public–private partnership. The PICG is a dedicated centre established in Karachi, the business and financial centre. This is supported by regulators such as the SEC and the private sector such as Citibank as well as an international professional accountancy body and aims to provide training and act as a centre for sharing best practice nationally. Crucially it also has strong links to the leading research centre for corporate governance based one of the country's leading business schools (Lahore University of Management Sciences).

Amongst multinationals, corporate governance benchmarks, internal reporting and disclosure requirements are set out by the parent company and this translates to practices that go beyond regulatory requirement. Such companies though few are becoming effective drivers for corporate governance.

Basic shareholders' rights are in place. Changes to company articles, increasing authorised capital, sale of major corporate assets all require shareholders approval. The regime for related party transactions and conflict of interest is developed in the law and requires audit committees to concur with any departures from arm length pricing and super majority of shareholders in case of investment in an associated company or an associated undertaking. Quality and timely financial disclosure have improved over the past few years. Shareholders owning 10% or more of voting capital must disclose their ownership and the annual report includes the pattern of shareholdings. The Code of Corporate Governance (2002) strengthens the role of non-executive directors, restricting the percentage of executive directors to 75% in non-financial companies.

There are a number of enforcing institutions in part reflecting the government's strong commitment to economic reform:

- The Securities and Exchange Commission of Pakistan (SECP) is committed to enforcing corporate governance regulations.
- The State Bank of Pakistan (SBP) has also been instrumental in improving corporate governance in the banking system, by requiring non-listed banks to adopt the Code of Corporate Governance.

- The Pakistan Institute of Corporate Governance (PICG) has been created with the goal of training directors and building more awareness.
- The Institute of Chartered Accountants of Pakistan (ICAP) has been an important force for corporate governance reform in Pakistan. It has some self-regulatory functions and stock exchanges are responsible for overseeing listing requirements.

Key obstacles include:

- highly concentrated control by significant shareholders which has limited the objectivity of boards; and
- reduced the impact of some of the recent reforms.

More generally, many smaller and family-owned companies have a limited awareness of the potential benefits of improved corporate governance. Remuneration paid to directors has traditionally been token.

SMEs

Almost 90% of businesses in Pakistan are SMEs, mostly working in the undocumented sector. They are run as family businesses lacking standard entrepreneurial and managerial skills. Concerns about 'standards of financial reporting', 'effective accountability' and 'transparent management and business conduct' are increasing. In this regard the SECP has laid down a specific code of conduct to be followed by the corporate sector to improve the state of corporate governance in the country. As per prevailing guidelines one of the non-executive directors on the board of a company should be the professional lawyer/legal adviser but many SMEs have been avoiding this clause for some time.

Geopolitical factors also have an impact. As one business leader noted in 2006, 'the law and order situation due to the US led war on terror is also impeding corporate governance and is a risk factor to our corporate sector. The advent of Reconstruction Opportunities Zone (ROZs) a US sponsored mechanism to quell poverty is a program which will try to encourage economic stability for the individual thereby digging out poverty, the root cause of terrorism [and] the corporate sector of our region will definitely be improved'.

Corporate governance reform needs to percolate throughout the corporate sector – listed companies and unlisted companies/SMEs, including family-owned businesses (see **Chapter 18**). Further steps need to be taken to protect shareholder rights, including disclosure of beneficial ownership. Boards must become more effective, with stronger fiduciary duties, and more capable independent directors.

Compliance needs to be improved in three areas – disclosure of beneficial ownership and control by shareholders; reporting of related party transactions and compliance with regard to the AGM. Independent oversight for accounting and auditing should be introduced to enhance credibility. There should be enhanced provisions for majority board independence (currently voluntary).

Institutional investors should adopt and disclose their corporate governance and voting policy. The move towards a central registry should be accelerated. Provisions for independent directors are relatively weak; in practice only direct ownerships are reported, although law requires disclosure of direct and indirect. The requirement for shareholders to disclose indirect ownership should be clarified. Distance voting for the AGM, by post or electronic means, should be introduced. Companies should disclose significant shareholders in their annual report and all shareholders agreements. Thresholds for shareholder action should be lowered (the threshold for filing lawsuits of 20% is high). The companies ordinance (CO) could be amended to include the concept of independent directors as opposed to non-executive directors, making it a requirement to have up to 25% certified directors with a minimum of one independent director.

Sri Lanka 12.48

In Sri Lanka, the concern for corporate governance originated in the numerous company failures, especially finance companies, in the late 1980s and early 1990s, which caused investors to lose faith in the regulatory and semi-regulatory frameworks, as well as the standards of financial reporting. Accordingly, the Institute of Chartered Accountants of Sri Lanka set up a task force in 1992 (about the same time as the Cadbury Committee in the UK) to enforce Sri Lankan accounting standards, and then extended this initiative in 1996 (again before the East Asian financial crisis) to set up a committee, to make recommendations on the financial aspects of corporate governance.

Many Sri Lankan publicly listed companies have subsidiaries in which the directors of the holding company have significant shareholdings. Some of the subsidiaries purport to perform management services, computer ser-vices and similar types of services. Because of the significant financial interest of the directors in these subsidiaries, it is possible for the boards of the holding companies to make decisions in favour of the subsidiaries to the detriment of the other shareholders of the holding company. Non-executive directors are often not effective in controlling such practices, as the board appoints them.

The Sri Lankan equity market does not have active independent shareholders. Unit trusts and other forms of fund management have not developed to a significant degree sufficient to influence the decisions of the management. As shareholdings of most companies are concentrated in few shareholders who are also directors, the directors are able to make decisions which are favourable to themselves and unfavourable to minority shareholders. Therefore, the minority shareholders are largely at the mercy of the directors, and it is unlikely that the market forces would change the situation.

Minority shareholders who participate in general meetings often feel that they do not have a significant voice at these meetings. There is little shareholder participation in important decisions, and in particular on material-related party transactions. In the plantation sector most companies have delegated management to other companies in which directors of the plantation company are the shareholders and directors. The delegated company enjoys substantial management fees. Most minority shareholders feel that this arrangement is disadvantageous to the company and its shareholders and have been done to benefit the directors.

Company legislation, in addition to accounting standards, requires disclosure of related party transactions. However, Sri Lankan accounting standards – as well as international accounting standards on which the Sri Lanka standards are based – exclude inter-company transactions between members of a group of companies from this disclosure requirement. Many minority shareholders feel that the directors of companies use this exclusion to avoid disclosing transactions with companies of the group in which directors have large financial interest.

The 2003 Revision to the Corporate Governance Code of 1997 contained several key enhancements:

- The Voluntary Code of Best Practice was updated to be in line with the Combined Code of UK.
- Clearly defined functions of the board were set out.
- The 'Lead Director' concept was introduced if the Chairman is also the CEO.
- There was guidance on non-executive directors, independent directors' and board balance.

Other areas covered included:

- appraisal of the board and CEO;
- disclosure of directors' remuneration;
- constructive use of the AGM; and
- disclosure of major transactions.

In the 2004 Guidelines for Listed Companies on Auditor and Audit Committees, the Voluntary Code of Best Practice took into consideration certain provisions of the SOX Act. The guidelines are now focused on two areas:

- Auditors of listed companies (their qualifications, appointment, powers, audit partner rotation, independence of auditors, disclosure of fees for other services, restricted and permissible non-audit services).
- Audit Committees of listed companies (their composition, objectives, powers and duties).

Most recently the 2006 Revisions to the Code of Best Practice on Corporate Governance several further steps were taken. Mandatory rules were introduced in 2007 to the effect that:

- There is enhanced guidance on non-executive directors, independent directors and disclosures relating to directors.
- The role and responsibility of the Remuneration Committee, Audit Committee and Nominations Committee is further set out with the appraisal of the board and board committees.

- There is a definition of independence and self-declaration of independence required of non-executive directors.
- The Code of Business Conduct and Ethics and Whistleblower Policy are introduced.
- There is a Voluntary Code of Best Practice formulated by a select committee, taking account of Corporate Governance standards in several jurisdictions including the UK (Combined Code) and New York (New York Listed Company Manual).

In October 2005 the Asian Development Bank 'found accounting and auditing in Sri Lanka to be of a generally good standard with the exception of public sector entities'. It noted that 'there are two major challenges to establishing effective financial sector governance in Sri Lanka. One is the significant role played by state-owned institutions, and the second is the prevalence of complex and interrelated corporate groups in the private sector'.

Appendix

Summary of the Karmayog CSR Ratings of India's 500 largest Companies (15 December 2007)

www.karmayog.org is a unique free platform for concerned citizens – for social and civic issues – that has been available since June 2004. Karmayog provides a networking platform for ordinary citizens and NGOs to engage with government organisations and media, as it believes that citizen's viewpoints are necessary for holistic and doable solutions for social and civic problems. (Url of this note is www.karmayog.org/redirect/strred.asp?docId=11691)

1. Introduction

Every company harms the environment and people!

CSR is thus just about two aspects:

1. The steps taken by a company to neutralise, minimise or offset the harmful effects caused by its processes and product-usage.
2. The further steps a company takes using its resources, core competence, skills, location and funds for the benefit of people and the environment.

CSR thus helps to define the contribution of a company beyond economic value and creating employment, and weighs this contribution against the damage done by the company through its products and processes.

This is the basic premise for Karmayog undertaking a rating of the CSR activities of India's 500 largest companies (by sales).

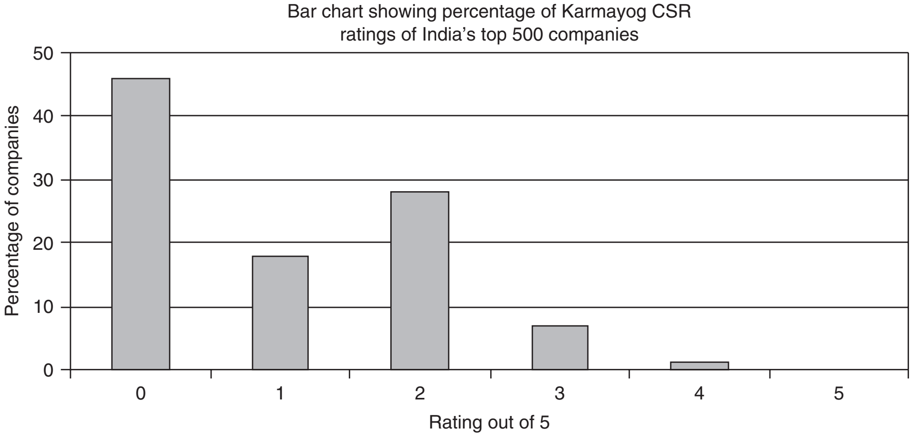
This is the first time that such an exercise has been done in any country (according to the website).

2. Results of the Karmayog CSR rating of India's top 500 companies

The results of the Karmayog CSR rating are extremely disappointing. They are as follows:

Karmayog CSR rating	Number of companies	Percentage of companies
0	229[a]	46
1	91	18
2	139	28
3	37	7
4	4[b]	1
5 (highest)	0	0

[a] *Companies doing no CSR as per information from their websites and annual reports.*
[b] *The four companies with a 4 out of 5 rating are HDFC, infosys Technologies, Tata steel and Titan Industries.*



3. Observations from the Karmayog CSR ratings

Observations from the Karmayog CSR Rating of India's 500 largest companies:

1. Most companies are not doing any CSR.
2. Many companies are only making token gestures towards CSR in tangential ways such as donations to charitable trusts or NGOs, sponsorship of events, etc.

3. Most companies believe that charity and philanthropy equals to CSR; very few companies are using their core competence to benefit the community.
4. Most companies use CSR as a marketing tool to further spread the word about their business. For instance, donation of a token amount to some cause on purchase of a particular product. The fact that companies are hiring advertising agencies for their CSR further highlights this.
5. Only five Indian companies (from this study) publish a Corporate Sustainability Report to measure and assess the impact of their business on the environment.
6. Very few companies openly state the processes followed by them, the damage caused by these processes and the steps taken to minimise this damage.
7. Very few companies state how much they spend on CSR. There is no mention of the amount spent in any of their balance sheets or annual reports. Most companies just list and describe their CSR activities and seem to be spending minimal amounts on CSR.
8. Very few companies are engaged in CSR activities in the local communities where they are based.
9. Very few companies have a clearly defined CSR philosophy. Most implement their CSR in an ad hoc manner, unconnected with their business process.
10. Most companies spread their CSR funds thinly across many activities, thus somewhere losing the purpose of undertaking that activity.
11. Most companies appear reluctant to themselves fulfil their CSR unless it is mandatory by law.
12. Generally speaking, most companies seem either unaware or don't care about CSR. However, all companies can be considered to be an upward learning curve with respect to CSR and it is expected that the situation will improve.

4. About the Karmayog CSR Ratings

- The Karmayog CSR Ratings are from 0 to 5 (5 being the highest).
- The CSR rating and reach of every individual company is given in www.karmayog.org/redirect/strred.asp?docId=9041 along with the CSR focus areas, specific CSR activities, sales, profit and recommended amount to be spent on CSR. See **Annexure 1** at the website for an extract from the table of the Karmayog CSR rating of India's top 500 companies.
- A note on the parameters for the Karmayog CSR Rating of India's top 500 companies is available at www.karmayog.org/CSR/CSR_9860.htm
- The list of 500 companies is taken from Dun & Bradstreet's 2006 edition of *India's Top 500 Companies*.
- Ratings are based on information from the company's website and latest annual report.

- All companies were emailed about their CSR activities and their rating as posted on Karmayog and invited to respond.
- We know that some ratings may be incorrect due to insufficient information available at the sources of our research. The need, value and learnings from the rating exercise remain unaffected by this.
- The Karmayog CSR Rating of an individual company will be reviewed whenever new information will be available from the company or other sources.
- Sector-wise analysis of CSR (such as automobiles, banking, cement, etc.) has also been done for the top 500 companies that have been rated. This shows examples of companies in each sector which are doing effective CSR activities. See www.karmayog.org/sectortablesofcsr/
- Details of the CSR activities of more than 200 other Indian companies (outside the top 500) have also been collated to show that companies of any size can do considerable and effective CSR activities. See www.karmayog.org/csrothercompanies/

5. Karmayog's demands from corporates and government for CSR

The insights and learnings gained from the rating exercise have resulted in the following recommendations. It is important for all stakeholders to introspect and adopt these recommendations.

(a) **Begin adopting industry guidelines**

The first step is to begin adopting international guidelines, as these are comprehensive and well researched. Two types of international guidelines and norms exist:

- ○ Common guidelines that are applicable to most industries (e.g. Minimum Environment, Health and Safety (EHS) Guidelines for companies).
- ○ Industry-specific guidelines that are linked to the processes of that sector (e.g. sector-specific guidelines) that include technical reference documents for different sectors such as forestry, manufacturing, power, etc. (available at www.karmayog.org/internationalguidelinesforcsr/).

Both kinds of guidelines identify methods that companies can adopt to minimise environmental damage caused by products and processes.

It is imperative that companies state in their Annual Report where they are on this path, and also for government, in consultation with industry associations and experts, to set timelines for the adoption and implementation of these guidelines.

(b) **Sustainability reporting**

It is recommended that every company should publish a separate Corporate Sustainability Report (as per the Global Reporting Initiative (GRI) framework) along with their Annual Report.

At the very least, every company must include a Corporate Sustainability section in its Annual Report (similar to the mandatory section on Conservation of Energy, Technology Absorption and Foreign Exchange Earnings and Outgo).

(c) **CSR philosophy to be defined and articulated**
Every company must clearly define its own CSR philosophy and objectives, stating which issues it intends working on or contributing to. It is recommended that a company first takes up areas that directly concern its business processes, and thereafter any other related or unrelated issues. These can also yield strategic benefits to the company.

(d) **Minimum annual CSR expenditure**
Every company must spend a minimum of 0.2% of its annual income on CSR activities. The CSR spending of a company should not be linked to the profit made by the company because this would vary from year to year and the CSR activities would thus not be consistently maintained.

The scale of operations of a company and its impact is connected with its sales, and not with its profits. The larger the company, the greater is the damage it is doing to the environment. Conversely, the greater is the company's ability to do good.

(e) **Protection and restoration of the environment**
Every company must be engaged in CSR activities that minimise its harm to the environment, and which help restore damage done to the environment because of the company. For example, all companies should use energy-efficient technologies for their factories and offices, and adopt rainwater harvesting irrespective of the production process they are engaged in.

(f) **Employment for marginalised groups**
Every company should provide inclusive employment opportunities and include the physically challenged and marginalised groups in their workforce. The number of employment opportunities offered to such groups should be stated in the Annual Reports as is done by public sector undertakings.

(g) **Local community development**
It is recommended that a company first undertakes projects in the places where it functions, and helps those local communities and environments that are affected by its work.

(h) **Use of core competence**
Every company should use its core competence to benefit its stakeholders and society. For instance, banks can use their expertise to identify and counsel debtors who are likely to run into financial trouble.

(i) **Extending profile and area of businesses**

A company should attempt to stretch its business beyond its existing profile and into areas where it does not normally work so as to reach out to under-served groups and populations. While this may sometimes mean smaller profit margins or marginal losses for the company, it will invariably result in valuable business learnings as well as effective CSR for the company.

(j) **Developing internal CSR implementation systems**

A company may choose to develop an in-house CSR team or division that undertakes the CSR activities for the company. This is desirable as it leads to greater sensitisation and awareness within the company about its processes, responsibilities, role, etc., and leads to the internalisation of the company's CSR philosophy.

Instead of contributing to the trust of the CEO or the promoter family, a company should set up its own trust/foundation as a matter of proper business ethics.

The company may also choose to partner with one or two NGOs or other organisations for its CSR activities.

It is recommended that a company set up a committee that includes an external director, an NGO and local stakeholders for selecting, monitoring and evaluating its CSR activities.

(k) **Focused CSR activities for greater impact**

It is recommended that a company identifies few issues for its CSR activities and works on these areas for a sustained period of time so that measurable results and improvements can be achieved, rather than undertaking or supporting several small initiatives across several areas thereby reducing effective impact.

6. Importance of the Karmayog CSR ratings

Every stakeholder has a role to play to make CSR effective and sustaining. Accordingly, this rating exercise hopes to achieve the following objectives vis-à-vis various stakeholders of a company.

(a) **For companies**

- To sensitise their directors and their employees about their responsibility towards society.
- To identify CSR activities they can and should undertake.
- To understand the various international guidelines and norms for CSR, and to effectively implement these.
- To learn about and from the CSR initiatives of other companies.

(b) **For industry and trade associations**

- To get a snapshot of the state of CSR in India.
- To set benchmarks of CSR for companies to follow.

- To prepare case studies and highlight best practices of CSR.
- To provide consultation on CSR.
- To work with government and NGOs and international organisations to upgrade and improve CSR activities in India and to set milestones for companies.
- To recognise companies doing good CSR activities by instituting awards based on these parameters.
- To understand the huge scale and magnitude of the benefits that are possible if an entire sector spends at least the recommended minimum amount on CSR. See www.karmayog.org/sectortablesofcsr/for comparison between income and recommended CSR spend.

(c) **For government bodies**

- To make industry-wise guidelines and to introduce legislations that cause companies to work effectively towards reducing environmental damage, and restoring damage done (in the areas of raw material sourcing and usage, by-product and waste disposal, product-usage and end-disposal).
- To make legislation that rewards CSR and penalises damage to the environment.

(d) **For NGOs and consultants**

- To know about the areas of CSR work undertaken by companies, thus enabling partnerships with them.
- To be able to identify companies which are not doing CSR or doing so in a token manner, so as to approach these companies to initiate meaningful projects.
- To assist companies to formulate CSR objectives, implement CSR activities, and monitor and evaluate their CSR activities.

(e) **For media**

- To stop eulogising corporate leaders whose companies are damaging the environment and harming lives.
- To present a clear view of CSR that is separate from philanthropy, charity, marketing, advertising or expanding business scope and to sensitise the public about this.
- To highlight companies which are practising good CSR, and to negate those companies which are actually engaged in marketing or advertising of their products or services under the guise of CSR.
- To encourage and enable business publications to have a regular feature or column dedicated to CSR initiatives along with feedback from NGOs and other stakeholders.

(f) **For researchers**

- To study CSR practices and results.
- To influence the shaping of CSR policy and regulations.

(g) **For students and colleges/institutions**

- To become sensitised about the role and responsibility of companies and to understand the impact and consequences of everyday processes and actions.
- To develop a holistic view of life and living.

(h) **For citizens, shareholders and investors**

- To understand that as consumers and stakeholders of companies, we can and need to influence companies to change harmful polices and adopt CSR practices, due to the huge impact and power that companies have on people and the environment.
- To ensure that through our purchase choices, we get desirable values for society to be reflected in how companies do business.

> 'There are stakeholders who can voice their concerns today while we engage them. There is another category of stakeholders like flora, fauna and physical environment, whose voices we cannot hear, but who are affected by anthropogenic impacts of global population. The future generation is another important group of stakeholders that does not exist today but will be impacted by our activities …'
>
> (*Jubilant Organosys Limited, Corporate Sustainability Report, FY 2007, see www.karmayog.org/redirect/strred.asp?docId=9955*)

(Jubilant Organosys, a pharmaceutical company, while acknowledging the harm caused in manufacturing its chemicals, actively works to minimise the damage. It is one of the five Indian companies that publish a Corporate Sustainability Report.)

7. Closing statement

Enlightened businesses worldwide, small and large, have begun to realise that responsible practices enhance profitability and ensure long-term survival. For those which disrespect the environment or living beings, we, as responsible citizens, need to individually and collectively, reward or penalise them through our voices and our wallets.

Karmayog, on its part, has created a framework for comparing CSR across industries, and via the ratings has attempted to give a snapshot of the situation as it stands today. Karmayog has put together a comprehensive, one-of-it-kind resource section on CSR on the Internet to enable companies and all stakeholders to understand and enhance CSR, thus improving the quality of life for all people.

Contents of the CSR section in Karmayog (including methodology) at www.karmayog.org/csr:

- Karmayog view of CSR
  - ○ Announcing the Karmayog CSR ratings of India's top 500 companies.
    - Note on the Karmayog CSR ratings of India's 500 biggest companies.
    - Annexure 1 to Note: Extract from Table of Karmayog CSR rating of India's top 500 companies.
  - ○ Views of citizens/NGOs/corporates/experts.

- Karmayog CSR rating
  - Parameters of the Karmayog CSR rating.
  - Karmayog CSR rating of 500 biggest Indian companies – (xls).
  - Karmayog CSR rating of 500 biggest Indian companies – (pdf).
  - List of companies from top 500 with 5/5, 4/5 and 3/5 Karmayog CSR rating – (xls).
  - Sector-wise extract from compiled table of top 500 companies.
  - Compiled table of locations (head offices and regional offices) of top 500 companies in India – (xls).
  - Karmayog CSR rating of over 200 other Indian companies – (pdf).
- CSR activities of corporates
  - Details of CSR of the top 500 companies.
  - Details of CSR of other Indian companies.
  - CSR opportunities offered by corporates.
- Various international guidelines/standards/principles for CSR
  - Standard Guidelines – International Finance Corporation – World Bank Group.
  - GRI of the UN – Sustainability Reporting Guidelines.
  - Other Guidelines/Principles for CSR.
  - Related Documents on CSR.
- Newspaper and magazine articles about CSR
  - 30+ newspaper and magazine articles about CSR.
- Various CSR websites/organisations
  - 10+ CSR websites/organisations.

Methodology/parameters of the Karmayog CSR rating (7 December 2007):

1. *Products and services*: The subjective rating (0–5) is based on the company's main products/services.
2. *Need of Society*: If the product/service offered is not needed by society, then the Karmayog CSR rating = 0.
3. *Zero-rated products*: Companies which make the following are given a Zero Karmayog CSR rating:
   - Cigarettes- and tobacco-based products
   - Liquor companies.
4. *Must – do CSR*: Every company degrades the environment, just as every individual does. Hence, every company must be working to reduce environmental degradation, and to rejuvenate the source/place from where it uses resources or operates. To get a Karmayog CSR rating of even 1, a company must be engaged in environmental work that rejuvenates and restores the damage done.
5. *Least harmful process*: The process followed in the making of that product or delivery of that service is considered while assigning the rating of a company. The process followed should be one that does the least harm (apart from the mandatory regulations and laws in place).

6. *Impacts of usage*: The implications of the usage of the product/services is considered while assigning the rating of a company (pollution, environmental degradation, waste generation, etc.).
7. *Harmful products*: Companies which make the following extensively damage the environment. Hence a Karmayog CSR rating of not more than 2 can be given to them, even if they are doing extensive work under CSR.
   - Chemicals (such as fertilizers, paints, plastics).
8. *Harmful processes*: Companies which engage in the following processes extensively damage the environment. Hence a Karmayog CSR rating of not more than 2 can be given, even if they are doing extensive work under CSR.
   - Mining
   - Aviation
   - Thermal power generation
   - Cement manufacture
   - Automobiles, auto parts, tyres manufacture
   - Paper, forestry-based products manufacture
   - Iron and steel manufacture.
9. *Minimum CSR Spend*: A company must spend an amount equivalent to at least 0.2% of its sales for CSR activities. Such an amount provides an idea of the magnitude of CSR that can be done by a company. If a company does not spend this minimum amount, then a zero or low Karmayog CSR rating would be given.
10. *Employee participation and volunteerism*: This factor has not been a deciding factor in the Karmayog CSR rating as it is more important for the company as a whole to have a defined CSR philosophy which it practises. Within such a set-up, each employee will be a more sensitised participant, and will hence be contributing towards the CSR objectives of the company. This is a far more effective, and long-lasting method of practising CSR as compared to employee pay-roll giving and volunteerism, which is often not voluntary and is usually also temporary.
11. *Reach of CSR activities*: A second rating has also been carried out simultaneously to determine the extent of impact that a company's CSR activities has. Accordingly, a company would be assigned either 'a', 'b' or 'c' where a = CSR activities involving employees only, b = CSR activities in the immediate physical vicinity of the company's operations and c = CSR activities involving the larger community and society as a whole.
12. *Social banking and social responsibility*: Banking, insurance and finance sectors tend to get rated higher because of the nature of their work. However, engaging in micro finance and rural banking does not automatically mean good CSR practice, as often what is termed as 'social banking' is just a simple extension of the customer base and business, and is also part of the priority sector lending that is mandatory.

Examples of some socially responsible and committed companies in India:

- HDFC Ltd
- Infosys Technologies
- Tata Motors
- Titan Industries.

Objectives of rating:

(a) Companies: To sensitise companies and their employees about their responsibility towards society. To help them identify CSR activities they could undertake, and learn about the CSR initiatives of other companies.
(b) NGOs: As they would be able to know about the companies and their areas of CSR work, thus enabling partnerships between them.
(c) The NGOs can also use this data so to identify those companies who are not doing enough under CSR, and these can be approached to initiate projects, etc.
(d) This module aims to be a comprehensive database for researchers, social work students and others working on CSR and related issues.
(e) This module can also help the various stakeholders like the local communities, employees, buyers, shareholders, independent directors, and nominee directors of financial institutions, advocacy groups and others to know and pressurise companies to fulfill their responsibilities.
(f) We would like Business Publications to have a regular feature/column dedicated to CSR initiatives of companies along with feedback from NGOs and other stakeholders.

13. Examples of some similar initiatives that assess a company's business practice methodology:
(a) Fair trade: That lists principles and practices for trading (creating opportunities for economically disadvantaged producers, transparency and accountability, capacity building, payment of a fair price, gender equity, working conditions, environmental protection (www.ifat.org).
(b) Equator principles: A financial industry benchmark for determining, assessing and managing social and environmental risk in project financing (www.equator-principles.com/documents/Equator_Principles.pdf).
(c) Global compact programme: That lists the UN's global compact prin-ciples on human rights, labour standard, environment and anti-corruption for signatory companies to adopt (global compact 10 principles: www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html).
(d) Council for fair business practices (www.cfbp.org).

Summary of CSR ratings of top 500 companies (see list at website annexure)

Karmayog CSR rating	Number of companies	Percentage
0/5	231	46
1/5	92	18
2/5	138	28
3/5	35	7
4/5	4	1
5/5	0	0
Total	500	100

Summary of CSR reach of top 500 companies

Karmayog CSR reach	Number of companies	Percentage
None	10	3
'a' = (CSR is for employees only)	124	25
'b' = (CSR is within the vicinity)	14	2
'c' = (CSR is for society at large)	113	23
'b' and 'c' together	239	48
Total	500	100

Note: 'y' = yes (i.e. the company conducts this CSR programme

Case Study of ITC – The First Triple Bottom Line Company in India and the importance of a CSR and a chairman who is champion

Key extracts of the speech by Mr Y.C. Deveshwar to AGM 2007

Making markets work for CSR

It is a matter of satisfaction for me to report yet another year of robust growth and strong performance encompassing all the business segments of your company. The foundations that we have laid over time by investing in R&D, technology and innovation for international competitiveness, supported by a robust governance structure, continue to drive growth in your company's multiple businesses, providing a strong momentum for a secure future.

Financial performance

Gross turnover for the year grew by 20.2% to Rs. 19,505 crores. *Net turnover at Rs.12,369 crores increased by 26.3%* driven by the non-cigarette FMCG businesses, higher agri-business revenues and the continuing strong performance by the Hotels business. *The non-cigarette portfolio* grew by 37.6% during the year and *now accounts for 52.3%* of the company's net turnover. Pre-tax profit increased by 20.1% to Rs. 3,927 crores, while *Post-tax profit at Rs. 2,700 crores registered a growth of 20.8%*. Earnings per share for the year stands at Rs. 7.19. *Cash flows from operations stood at Rs. 3,402 crores during the year.*

The ITC Group's contribution to foreign exchange earnings over the last 10 years amounted to nearly US$2.8 billion, of which agri exports constituted nearly 65%. Earnings from agri exports is an indicator of your company's contribution to the rural economy by effectively linking small farmers with international markets.

You, the shareholders, can draw even greater satisfaction from the fact that these financial results rest on a strong foundation of trust earned by your company's diverse brands, products and services and the enduring relationships formed with millions of farmers in rural India over several years. It is on this bedrock of trust, competencies, innovation and rural partnerships that we have built our aspiration to be a leader in every business segment we are engaged in.

Sustainable and inclusive growth

Last year, I had spoken to you on the fundamental pillars of vision, values and vitality that have powered the transformation of your company over the past decade. I reiterated that envisioning a larger societal purpose has always been the hallmark of your company. Indeed, this 'commitment beyond the market' is a compelling vision that motivates us to enlarge our contribution to the Indian society, even as we attain new milestones of excellence in sustainable wealth creation.

We have, over the years, pursued relentless innovation to forge unique business models that synergise long-term shareholder value enhancement with the superordinate purpose of creating greater societal capital. *We take pride that your company is defined by its deeply 'Indian' character that aligns corporate strategy to national priorities.*

It is for this reason that we measure our accomplishments not only in terms of financial performance but also by the transformation we have consciously engendered to augment the natural and social capital of the nation. *This approach towards achieving Triple Bottom Line benchmarks is key to our resolve to contribute to the national goal of sustainable and inclusive growth.* It is my firm belief that business enterprises can and must make a difference towards achieving greater social equity.

It is through a fundamental and unwavering commitment to Triple Bottom Line objectives that long-term sustainability of business enterprises can be ensured, unleashing in the process, strong drivers that can make national progress more inclusive and equitable.

ITC has received global recognition as an exemplar of Triple Bottom Line performance. *For five years in a row, we have achieved and sustained our status as a 'water positive' organisation. We have also been 'carbon positive' for* *the last two years. We continue to strive towards achieving a 'zero solid waste' discharge status, having recycled over 90% of solid waste produced during the year.* This makes us, to the best of my knowledge, the only business enterprise in the world, of our size and complexity, to accomplish these three dimensions of environmental excellence – an extremely challenging task given the fact that we are continuously growing our manufacturing operations.

In addition, through a concerted effort to develop innovative value-chains across our diverse business segments, your company today is instrumental in creating and sustaining livelihoods for nearly 5 million people, many of whom represent the weakest sections in rural India.

Our deep commitment in ensuring sustainability and competitiveness have given us the confidence to voluntarily publish an annual Sustainability Report with independent reputed third-party verification. *The 2006 Sustainability Report of your company, the third in the series, is the first in India and among the top 10 in the world to be presented in accordance with the latest G3 guidelines of the GRI.*

Indeed, these achievements reinforce our commitment in making a meaningful contribution towards sustainable and inclusive growth of the Indian society.

A social charter for business

A few weeks ago, the Hon'ble Prime Minister Dr Manmohan Singh presented a 10-point 'Social Charter' sharing his vision on the responsibility of corporates for sustainable and inclusive growth. He said, and I quote, '*Indian industry must rise to the challenge of making our growth processes both efficient and inclusive. This is our endeavor in Government. It will have to be yours too and I seek your partnership in making a success of this giant national enterprise. If those who are better off do not act in a more socially responsible manner, our growth process may be at risk, our polity may become anarchic and our society may get further divided. I invite corporate India to be a partner in making ours a more humane and just society,*' Unquote.

To my mind, the Hon'ble Prime Minister's clarion call is not only a responsibility that we, in Indian business and industry, must commit ourselves to but a crying need that we cannot afford to neglect any longer. While we can justifiably be proud of India's stellar performance in GDP growth, the growing inequity in sharing the fruits of success is indeed a millstone that impedes the nation's true potential. Business corporations draw heavily on societal resources. Therefore, it is in the enlightened self-interest of business to engage constructively in enlarging its contribution to the broader social and environmental agenda.

Competitiveness of firms can be severely threatened by unsustainable environments and a lopsided social structure that creates islands of affluence amidst a sea of poverty. A constructive public–private partnership for socially responsible growth is imperative and must occupy a larger space in the future business strategies of India's corporate sector.

You are indeed aware of the enormous importance of our rural engagement in the future growth of your company. We have constantly strived to meaningfully blend our social responsibilities with business competitiveness, so that we can continue to create shareholder value even as we enhance the benefits that accrue to rural communities. We recognise that this is the path we must pursue to ensure sustainable and inclusive growth – a philosophy that is central to the vision articulated by Prime Minister's Social Charter for business.

I take immense pride that the vision enunciated by the Hon'ble Prime Minister echoes the core values that your company has enshrined in its management philosophy and governance structure. We have indeed been 'practitioners' of this vision for many years now. It gives me immense satisfaction that your company has executed, on a substantial scale, innovative business strategies which result in 'mainstreaming' the disadvantaged sections of rural India.

Your company's pioneering e-Choupal initiative today comprises 6,400 choupals transforming the lives of over 3.5 million farmers in 38,500 villages in nine States of India. We hope to reach out to 10 million farmers in 100,000 villages in the not too distant future. The Social and Farm Forestry Programme of ITC covers 65,000 hectares providing over 28 million person days of employment among the disadvantaged. In the process, we have also helped sequester over 2,000 kilotons of carbon dioxide as a firm commitment to combating climate change. Your company's Integrated Watershed Development programmes in rural areas cover nearly 27,000 hectares providing critical irrigation to water stressed areas.

This year, we have also forged a milestone partnership with the Government of Rajasthan for an integrated watershed development project covering 5,000 hectares. Your company's initiatives to provide opportunities for non-farm incomes through economic empowerment of women, supplementary education and integrated animal husbandry services continue to make significant strides in rural empowerment.

As a nation, we face today a multi-dimensional challenge to chart a growth path that will transform the lives of almost a third of our billion population who live at the margin. Surely, it is not a task that any single segment of society – be it government or responsible business – can hope to accomplish in isolation. It is true that sustained high rates of GDP growth is one of the surest ways of creating livelihoods for the disadvantaged. However, if such growth impulses do not envision or contain conscious efforts to enhance social value, it is not necessary that high growth rates alone will ensure social equity. In fact, there is a danger that competitive pressures may not actually lead to development and growth in areas that need it the most.

There is also a significantly large cost involved in implementing value-chains that are socially inclusive. While commensurate returns may flow over the longer term, there are indeed cost barriers, over the short to medium term, that inhibit investments in such socially inclusive initiatives. In the absence of strong fiscal or financial incentives, business enterprises would hesitate to raise such investments and commit physical and human resources over a longer term. Therefore, it is important to examine how market drivers can creatively facilitate such long-term investments which have larger societal benefits.

Corporates will be able to support a much larger social involvement in their business strategies, if market forces facilitate such investments and returns.

How do we then create a market that will support such corporate action for social development? If we are to transform the Hon'ble Prime Minister's vision into reality to its fullest potential, we need to find answers to this critical question.

Mobilising CSR for economic growth with equity

Over the years, progressive organisations have demonstrated several laudable examples of responsible corporate action for social development. Unfortunately, many of these efforts have not been able to reach a level of scale and dimension that can make an impactful difference on a nation as large and diverse as ours. Why is it, that despite possessing rich and diverse managerial capability, a tradition of entrepreneurship, economic resources and the right consciousness, corporates are still unable to participate more meaningfully in building natural and social capital?

The reasons are many and complex. These relate to the lack of a conducive external environment as also to organisations' vision, values, leadership and competitive capability. *However, if there is one common thread, it is the unassailable fact that markets have failed to reward CSR.* They do not adequately provide the drivers required to sustain a level of intensity of long-term engagement necessary to produce results in the vast social fabric. As Prof. David Vogel says, in his recent work titled 'Market for Virtue', and I quote:

> 'CSR is sustainable only if virtue pays off. The supply of corporate virtue is both made possible and constrained by the market … while there is a place in the business system for responsible firms, the 'market for virtue' is not sufficiently important to make it in the interest of all firms to behave more responsibly.'

It is sometimes argued that the 'reputational asset' that CSR attains is an adequate reward in itself, and therefore, does not need any further market incentives. However, at the present stage in India, such a reputational asset has so far not led to any significant consumer support, persuaded sizeable investor interest, or resulted in meaningful preference in government policies.

Therefore, given the ambivalent market response, CSR initiatives, by and large, tend to attempt the minimum, often defined by compliance to regulations, and do not ignite creativity and innovation to accelerate social benefit.

There are also apprehensions amongst many that investing in CSR would put them at a disadvantage vis-à-vis their competitors who do not choose to carry such social overheads. Nevertheless, there are worthy exceptions, where organisations have displayed sustained commitment and are certainly the harbingers of social change and an inspiration to others. *However, it is only when market forces make CSR a crucial component of shareholder value creation that new competitive forces will emerge in favour of responsible corporate* *action*. It is then that CSR will assume a new dimension – one that is defined by market forces, and not inspired by corporate conscience alone.

I am of the firm belief that private enterprises are well placed to play a much larger role in augmenting natural and social capital. Corporates have created assets and facilities that span the length and breadth of the country, and therefore, constitute the front line of engagement with civil society. The physical presence in communities around their catchments gives them an opportunity to directly engage in synergistic business activities that can create livelihoods and add to preservation of natural capital.

More than financial resources, private enterprises possess the more crucial managerial capability to ensure efficient delivery of social projects. In that sense, CSR can lead to optimum utilisation of national resources, given that far higher social benefits will accrue to every unit of incremental cost incurred by the organisation. Thus, given the right market incentives, Indian corporates can significantly add to government efforts in pursuing growth with equity in constructive public–private partnerships.

The key to corporates sustaining a meaningful strategy for constructive social action therefore lies in the ability to create strong market drivers that incentivise CSR. Civil Regulation, including pressure groups, act as strong drivers to ensure socially responsible action. Government regulation and public policy are also influential drivers. However, these again tend to deliver the bare minimum interventions. Besides, over reliance on regulation can stifle corporate creativity and innovation. A perceptible augmentation of societal capital will take place when market drivers spur innovation and a sense of competition to deliver CSR in ways that positively impact financial results.

CSR initiatives then become a part of the balance sheet deliverables, are quantified by the market and provide a direct incentive to the company to enhance socially responsible behaviour.

Can we, therefore, make markets work for CSR? Are there compelling market drivers which would give a positive reinforcement to corporates to focus on Triple Bottom Line performance? Can these powerful drivers energise innov-ation by companies, so that CSR becomes an integral part of the marketing mix and a competitive differentiator?

Fortunately, there is an answer. The most potent force that can trigger a complete rethink of corporate strategy and bring about transformational change lies in the *power of consumer franchise*. I use the term ‘consumer’ here in a broader sense to also encompass other market participants including government – both as a buyer and regulator, investors, employees, job-seekers and other segments of civil society.

An enlightened consumer, by exercising a choice in favour of ‘socially responsible’ enterprises, can unleash a powerful force of incentives. A ‘positive vote’ for socially responsible companies, exercised through preference for a company’s products and services, would change the context and dimension of meaningful CSR, create strong economic multipliers and enhance shareholder value. The implications of such consumer franchise for business will be wide ranging.

- *Consumer preference* will spur a massive movement in corporate innovation to integrate business goals with the building of societal capital.
- CSR can also emerge as a distinctive *market differentiator* and help position progressive companies more strongly in the marketplace.
- Companies will vie for consumer spend by positioning *CSR as a compelling value proposition*.
- Gains would accrue to the company and its shareholders with *increasing revenues and goodwill*.
- Where consumers go, investors will follow. Investors will increasingly find such *socially responsible companies attractive*, given the larger market gains.
- Potential employees would also seek opportunities in such successful companies and the enterprises themselves would be *better positioned in the war for talent*.
- Competition amongst CSR exemplars would lead to a perceptible *augmentation of natural and social capital* and this would create a more sustainable future.

Thus, powerful market drivers will emerge to encourage CSR as an integral part of business strategy. In the course of time, stakeholders will build a more enduring relationship with such companies, continuously creating value for the organisation, for its shareholders and the nation.

Enlisting consumer support

The key, therefore, lies in mobilising market participants – the most potent being the consumer – and enhancing awareness amongst them, so as to empower their decisions. We will need to ramp up consumer education substantially, so that they are made aware of the power they possess to transform society and bring in enduring social change. Government, industry and civil society will need to join hands in this endeavour to give it more body, scope and reach.

Your company made a beginning in this direction by creating a high visibility 'cause marketing' campaign involving our popular brands – *Sunfeast* and *Aashirvaad* – and highlighted the link with some of our CSR initiatives. *It was our endeavour to educate the consumer that with every spend on those brands, they would, in effect, be contributing to the Social Forestry and Watershed initiatives of your company. You are aware that your company's 'Classmate' brand contributes significantly towards the education of the underprivileged by earmarking a portion of its proceeds for this cause.*

I am given to understand that school children actually prefer Classmate products not only for their superior quality, but also for their association with a noble cause. We are committed to enhancing these awareness campaigns, and it will be our endeavour to continuously make the consumer aware of the choice that she possesses to support such social programmes by making informed buying decisions.

It is heartening to note that worldwide, consumers are already demonstrating their preference for socially responsible products and services. In 2006, an estimated €1.6 billion worth of Fairtrade products were sold across the world, growing annually by almost 50%. This independent consumer certification mark guarantees that disadvantaged producers are getting a better deal. Today, more than 7 million people – farmers, workers and their families – across 59 developing countries benefit from the international Fairtrade system.

In some cases, consumers have also demonstrated that they are willing to pay more for a product or service if it contributes to social good. These are certainly welcome developments although they occupy, as of now, a small proportion of global trade. If these individual efforts of consumers get escalated into collective action, they will certainly have a distinct impact on corporate thinking and action.

Unfortunately, the 'market for virtue' in India is practically non-existent. However, a small beginning has been made. With concerted action from policy makers and civil society, a significant force can be created by enlightened consumer franchise to spur industry into innovative thinking for social action.

India's young demographic profile will also support this trend. In late 2006, a Cone Millennial Cause Study in the USA found that, amongst the youth, nearly nine out of ten surveyed stated that they were likely or very likely to switch from one brand to another (price and quality being equal) if the second brand was associated with a good cause. *This goes to indicate that with greater awareness through education and exposure, the future generation will tend to exercise a 'vote' for companies with higher social accountability.*

This is now getting to be a worldwide trend, and with increasing connectivity through the Internet, widespread media and new tools for communication, I can see the emergence of a young global community, who share common views, common concerns, and common hopes and aspirations. This is a force that is lying dormant amongst India's confident new young generation, and once unleashed will be a formidable catalyst for change.

Aligning forces of franchise

Given the power of consumer franchise, how do we align forces amongst all the market participants to support a new movement for innovative CSR?

To make 'consumer choice' a compelling market driver we would need to create a supportive *institutional framework* to facilitate the process of making an informed choice by market participants. Let me briefly elaborate on some of these enablers.

First, the policy and institutional framework:

- Market participants would need an effective tool to make an informed choice in favour of a Responsible Corporation. *I would suggest that government support the development of a 'CSR Sustainability Trustmark', or a series of Trustmarks* defined by industry segments, which could be displayed on products and services to convey to the consumer that the enterprise follows a strong commitment to building natural and social capital. Voluntary in nature, these Trustmarks, crafted on sound scientific and market principles, will stand for the positive impact a company has made on the environment and the society. The Trustmarks could also be supplemented with Ratings, based on the extent of the individual company's involvement in creating societal capital.

- *The Trustmarks need to be administered by a reputed and independent body or bodies*, much like the financial rating agencies. An institutional framework and appropriate guidelines can be created by a government–industry partnership to provide organisational support and credibility.
- *A major impetus can emerge out of government's consideration to extend fiscal and financial concessions, priority clearance* and other incentives to organisations that attain sustained high ratings. Government and its agencies could also give purchase preferences to suppliers with highly rated Trustmarks.

Second, the role of industry:

- In championing a sincere commitment to a vision that embraces contribution to society as a key component of business strategy.
- In moving towards *voluntary disclosure of Triple Bottom Line performance* in the company's Annual Reports, verified by independent reputed third-party organisations.
- In making a strong effort *to attain the CSR Sustainability Trustmarks*, and displaying the same on their products and services.
- In enlarging the company's contribution by giving preference to vendors with a strong CSR and sustainability orientation.
- In developing a model *code of responsible conduct* by industry bodies and associations for its members.
- In encouraging modern retail outlets to develop special sections that display and sell products with Trustmarks.
- In providing *support to the creation of awards* that recognise outstanding sustainability performance. This would provide a tremendous reputational asset and incentivise CSR significantly.
- *In strengthening reporting on sustainability* based on guidelines such as the GRI. I am sure that the Indian operations of multinationals, not listed on Indian bourses, would also want to make such public disclosures and demonstrate their contribution to the Indian society. I envisage a future where sustainability reporting will form an integral part of a firm's public disclosures, and will be valued by stakeholders in equal measure to the established practices of financial reporting.

Third, the role of investors:

- *Investors play a critical role in encouraging social accountability in corporate behaviour*. Globally, there are today hundreds of funds that invest in socially responsible enterprises. These funds rely on sustainability indices such as Dow Jones Sustainability World Index, FTSE4Good, Domini 400 Social Index and others to guide investment decisions. These funds have already channeled large amount of investors' savings into companies that have high social brand capital.

- *India has witnessed some welcome developments in this direction in recent years*. The ABN Amro Bank launched a Sustainable Development Fund as India's first Socially Responsible Investing Fund. Recently CRISIL, S&P and KLD have announced that they would develop an Environmental, Social and Corporate Governance (ESG) Index of Indian companies. The Institute of Chartered Accountants of India is also reported to be working on developing a similar evaluation.
- Individual investors, while seeking to maximise returns from their portfolio holdings, could exercise a powerful choice for companies with high Triple Bottom Line performance.
- Banks and financial institutions could ask for voluntary disclosures and *factor the rating in their lending evaluations*.

Fourth, the role of civil society organisations:

- Consumer awareness will benefit immensely *if civil society organisations and consumer bodies actively advocate the usage of Trustmarks*. They could also promote awareness amongst constituents to support products and services of companies with higher sustainability ratings.
- *Schools and educational institutions could also promote awareness on responsible corporate behaviour* and its association with the Trustmark ratings on products and services, and design elements in their curriculum to groom citizens of tomorrow as enlightened consumers.
- And finally, *the Media*, as one of the most powerful forces of shaping public opinion, *can make a multi-dimensional contribution in this direction*.

It is my strong belief that by aligning such powerful forces, *we will see the emergence of a new consciousness where CSR will transcend from corporate philanthropy to a competitive value proposition*.

Your company has been instrumental in setting up the *CII-ITC Centre of Excellence for Sustainable Development*, which is a unique institution that seeks to address the void in developing requisite capability on sustainability issues among Indian industry. The centre endeavours to bring about transformational change in Indian businesses by providing thought leadership, promoting awareness and building capacity. One of the major initiatives of the CII-ITC Centre is to recognise excellence in sustainability practices by presenting awards to industry, based on a rigorous process of selection.

This attempt to recognise outstanding sustainability initiatives is designed not only to celebrate individual corporate action, but also to inspire others to follow.

I am convinced that in today's enlightened India, more and more companies will respond to the appeal made by the Hon'ble Prime Minister to forge partnerships for social action, and achieve growth with efficiency and inclusivity. Making markets work for CSR will indeed provide the compelling foundation for such initiatives.

Making a difference

The essence of what I have presented to you today is a considered response to enhancing corporate participation in societal development. Your company has been at the forefront in providing both thought leadership and action in creating a more secure, sustainable and inclusive future. It is true that no single organ of society will be able to make a significant difference based on their individual action. However, the efforts made by your company demonstrate that with innovation, commitment and by forging enduring partnerships, we can all make a difference.

Indeed, the challenges seem daunting when we witness the scale of inequity and poverty. The good news is that never before in world history have we possessed so much knowledge, technology and resources to deal with this apparently hopeless situation. *It is indeed heartening to witness a growing corporate consciousness to ensure that the future generations are more secure*. I hope this ground swell of effort will continue to grow and become a committed movement for a better tomorrow.

I firmly believe that corporates in India have the capability, the vision and the entrepreneurial skill to forge a more prosperous future for the nation, even as they sharpen their competitiveness and grow their businesses globally. Mahatma Gandhi said, and I quote: *The difference between what we do and what we are capable of doing would suffice to solve most of the world's problems.* We need to heed this message to realise our fullest potential.

To be able to stand tall amidst adversity, to live your convictions and know that your actions and beliefs have transformed the lives of millions is at once a humbling and enriching experience. *Your company is indeed privileged to be able to make a difference, and be recognised for the contribution it makes. Our abiding vision, the strength of our outstanding human capital and our commitment to creating enduring value will continue to inspire us as we strive to achieve even greater success in the future*.

On this occasion of your company's 96th AGM, I would like to once again thank all of you – our valued shareholders – for your unstinted support in our shared journey to create one of India's most valuable corporations. In this journey, I look to you, as always, for your continued support and encouragement.

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International dimensions: corporate governance in Hong Kong special administrative region and the People's Republic of China

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Background to corporate governance in Hong Kong 13.1

Since the collapse of the Peregrine Group in 1997 and the Akai Group in 1999, Hong Kong has been spared from any major corporate failures such as those suffered more recently in the United States with Enron, Worldcom and Tyco, and elsewhere, such as Parmalat in Italy. However, in July 2006, Ocean Grand Holdings Limited and Ocean Grand Chemicals Holdings Limited, the listed public companies in Hong Kong, were alleged to be involved in the activities of misappropriation of funds; and their directors and senior employees were charged with conspiracy to defraud, theft and making false statements. Hong Kong's public companies, however, continue to be characterised by the predominance of family controlled businesses with their associated problems for minority shareholders and outside lenders. To satisfy the requirement of the Hong Kong Main Board Listing Rules (the Listing Rules) for an open market, a 'public' listed company must maintain at least 25% of its ordinary shares freely traded in the market. Consequently, this is the structure of a very large proportion of Hong Kong listed 'public' companies – a reality mandating even more importantly the observance of corporate governance principles for protection of those significant minorities who are in fact 'the public'.

After a succession of reforms during the 1990s which were mainly in response to the Cadbury Report from the UK, the pace of corporate governance reform has continued at a steady pace. Many of the ongoing reforms stem from external influences such as the Organisation for Economic Co-operation and Development (OECD) rather than in response to Hong Kong related issues. There is no doubt also that the lessons learnt from the Enron and Worldcom experience have had a profound effect on how the boards of public companies in Hong Kong conduct business, particularly regarding the role of auditors, independent directors and audit committees.

Conversely, the corporate governance in respect of private companies in Hong Kong should be of equal or even more importance than the corporate governance for public companies in Hong Kong because of the often overlooked fact that the number of private companies in Hong Kong is far greater than the number of public companies in Hong Kong and this is all too commonly ignored by the commentators. According to the statistics of the Government of Hong Kong Special Administrative Region, as at 28 February 2007, the Register of Companies held 600,589 companies which were formed and registered locally in Hong Kong, comprising 592,134 private companies and 8,455 public companies. Of the latter very few are among the 1,240 Hong Kong listed companies which are typically Bermudian or Cayman companies.

In mid-2006, the Government of Hong Kong Special Administrative Region launched a major and comprehensive exercise to rewrite the Companies Ordinance (CO) with the view to conduct public consultations in 2007–2008, publish a comprehensive White Bill for public consultation in mid-2009 and introducing the new Companies Bill into the Legislative Council in the third quarter of 2010.

Indeed, the community in Hong Kong has been very responsive to the corporate governance issues. In December 2007, the business community in Hong Kong invited the eponymous gurus Paul Sarbanes and Michael Oxley to visit Hong Kong to present a seminar on the topic of 'The Impact of Compliance on World Financial Markets'.

Furthermore, the Hong Kong Institute of Directors was incorporated in Hong Kong on 1 February 1996 with the missions of 'representing professional directors working together to promote good corporate governance and to contribute towards advancing the status of Hong Kong, both in China and internationally'. The corporate governance work of the institute in organising courses and recognition of director discipline has been good.

The purpose of this overview is to briefly highlight the main legislation and codes affecting corporate governance in Hong Kong.

Directors' duties

Private companies

Standard of care 13.2

Directors should meet the standard of care required by law in performance of their duties. In the performance of their duties, directors should exercise reasonable care commensurate with the standard required by the law. This standard of care is one which 'an ordinary man might be expected to take in the circumstances on his own behalf' (*Re City Equitable Fire Insurance Co Ltd [1925] Ch 407; Law Wai Duen v Boldwin Construction Co Ltd [2001] 4 HKC 403*).

Duties and requirements **13.3**

Directors can make reference to the 'Non-Statutory Guidelines on Directors' Duties' issued by the Companies Registry (June 2006) when acting for the company. These provide that directors have a duty:

- to act in good faith for the benefit of the company as a whole;
- to use powers for a proper purpose for the benefit of members as a whole;
- not to delegate powers except with proper authorisation and duty to exercise independent judgment;
- to exercise care, skill and diligence;
- to avoid conflicts between personal interests and interests of the company;
- not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law;
- not to gain advantage from use of position as a director;
- not to make unauthorised use of company's property or information;
- not to accept personal benefit from third parties conferred because of position as a director;
- to observe the company's memorandum and articles of association and resolutions; and
- to keep proper books of account.

One point that should be emphasised here is that under common law principles, a director should act honestly and in good faith for the benefit of the company as a whole. Therefore, although the above 'Non-Statutory Guidelines on Directors' Duties' are expressed as 'non-statutory' in nature, any deviation from it may be a breach of the director's duty under common law principles.

Directors must observe duties of disclosure and prohibitions under the *CO (Cap 32)*. Disclosure in the annual directors' report on the audited accounts is required by *s 129(D)(3)(j)* of the CO of significant facts relating to any contract relating to the company's business and *s 162* and *Sch 1 Table A, Article 86* require a director to disclose to the earliest practicable board meeting his interest in any such contract in which the director has any direct or indirect interest. *s 157H*, CO prohibits direct or indirect loans/guarantees to directors or other connected persons; and *s 157HA* relaxes the prohibition of *s 157H* in cases where a loan is made to a director for the purposes of the company or in the performance of the director's duties.

Concerning loans to directors, various amendments in *s157H, 157I, 157J and 161B of CO* have taken effect in February 2004 which relate to prohibition, with limited exceptions, against a company making a loan to, or providing security for a loan to a director and to the obligation to report thereon. They also extend the meaning of a loan to cover more modern forms of credit and make consequential changes to the related reporting requirements.

The Hong Kong Institute of Directors also publishes the 'Guidelines for Directors', to which all directors should make reference. This guidelines are divided into three parts, namely the company and its board; directors' legal status, powers and duties; and the directors as individuals.

Additional requirements for listed companies

Duties and requirements **13.4**

Directors of listed companies must ensure that they are in compliance with the requirements and obligations of Rule 3.08–20 of the Listing Rules, including:

- Every director must:
  - act honestly and in good faith in the interests of the company as a whole;
  - act for proper purpose;
  - be answerable to the company for the application or misapplication of its assets;
  - avoid actual and potential conflicts of interest and duty;
  - disclose fully and fairly his interests in contracts with the company; and
  - apply such degree of skill, care and diligence as may reasonably be expected of a person of his knowledge and experience and holding his office within the company.

Similarly, under common law principles, a director should act honestly and in good faith in the interests of the company as a whole. Therefore, any deviation from the above Listing Rules is not only a breach of the Listing Rules, but may also be a breach of the director's duty under common law principles.

- Every director must satisfy the stock exchange that he has the character, experience and integrity and is able to demonstrate a standard of competence commensurate with his position as a director of the company.
- Every director shall comply with **Appendix 10** of the Listing Rules which sets out the 'Model Code for Securities Transactions by Directors of Listed Issuers' ('Model Code'). The company may adopt its own like code in lieu of the Model Code but its own code must be of a strictly equivalent standard.

Absolute prohibitions **13.5**

The following are a list of absolute prohibitions which directors of a company must comply with and as set out in the section 'Rule A' (Rules 1–7) of the Model Code:

- A director must not deal in any securities of the company at any time when he is in possession of unpublished price-sensitive information in relation to those securities, or where clearance to deal is not otherwise conferred under the Model Code.

- A director must not deal in the securities of a company when, in relation to those securities, he is, by virtue of his position as a director of another company, in possession of unpublished price-sensitive information.
- During the period commencing one month immediately preceding the earlier of the board meeting for approval of the company's results and the deadline for the company to publish an announcement of its results for any year, half-year, quarter or any other interim period, and ending on the date of the results announcement, a director must not deal in any securities of the company unless the circumstances are exceptional.
- Where a director is a sole trustee, the Model Code will apply to all dealings of the trust as if he were dealing on his own account unless the director is a bare trustee and neither he nor any of his associates is a beneficiary of the trust.
- Where a director deals in the securities of the company in his capacity as a co-trustee and he has not participated in or influenced the decision to deal in the securities and is not, and none of his associates is, a beneficiary of the trust, dealings by the trust will not be regarded as his dealings.
- The restrictions on dealings by a director contained in the Model Code will be regarded as equally applicable to any dealings by the director's spouse or by or on behalf of any minor child (natural or adopted) and any other dealing in which for the purposes of Part XV of the Securities and Futures Ordinance (Cap 571) (SFO) which treats extensively with disclosure of interest he is or is to be treated as interested. It is the duty of the director, therefore, to seek to avoid any such dealing at a time when he himself is not free to deal.
- When a director places investment funds comprising securities of the company under professional management, discretionary or otherwise, the managers must nonetheless be made subject to the same restrictions and procedures as the director himself in respect of any proposed dealings in the company's securities.

Notification 13.6

The following are a list of circumstances when the Model Code requires a director to advise others of his intentions with regard to his dealings:

- A director must not deal in any securities of the company without first notifying in writing the chairman or a director (otherwise than himself) designated by the board for the specific purpose and receiving a dated written acknowledgement. In his own case, the chairman must first notify the board at a board meeting, or alternatively notify a director (otherwise than himself) designated by the board for the purpose and receive a dated written acknowledgement before any dealing. The designated director must not deal in any securities of the company without first notifying the chairman and receiving a dated written acknowledgement.

- The minimum procedure of the company must provide for there to be a written record maintained by the company that the appropriate notification was given and acknowledged pursuant to the Model Code, and for the director concerned to have received written confirmation to that effect.
- Any director who acts as trustee of a trust must ensure that his co-trustees are aware of the identity of any company of which he is a director so as to enable them to anticipate possible difficulties. A director having funds under management must likewise advise the investment manager.
- Any director who is a beneficiary, but not a trustee, of a trust which deals in securities of the company must endeavour to ensure that the trustees notify him after they have dealt in such securities on. behalf of the trust, in order that he in turn may notify the company. For this purpose, he must ensure that the trustees are aware of the company of which he is a director.
- s 352 of SFO requires the listed company to maintain a register of directors interests and short positions which should be made available for inspection at every meeting of the board.
- The directors must as a board and individually endeavour to ensure that any employee of the company or director or employee of a subsidiary company who, because of his office or employment in the company or a subsidiary, is likely to be in possession of unpublished price-sensitive information in relation to the securities of any listed company does not deal in those securities at a time when he would be prohibited from dealing by the Model Code if he were a director.

Exceptional circumstances **13.7**

The following are the exceptional circumstances under which a director can be exempted from the strict prohibitions under the Model Code on dealing with the securities of the company. They are set out in the section 'Rule C' (Rule 14) of the Model Code.

If a director proposes to sell or otherwise dispose of securities of the company under exceptional circumstances where the sale or disposal is otherwise prohibited under the Model Code, the director must comply with the Code, inter alia, regarding prior written acknowledgement. The director must satisfy the chairman or the designated director that the circumstances are exceptional and the proposed sale or disposal is the only reasonable course of action available to the director before the director can sell or dispose of the securities.

The company shall give written notice of such sale or disposal to the stock exchange as soon as practicable stating why it considered the circumstances to be exceptional. The company shall publish an announcement in the newspapers in accordance with Rule 2.07 C of the Listing Rules immediately after such sale or disposal and state that the chairman or the designated director is satisfied that there were exceptional circumstances for such sale or disposal of securities by the director. An example of the type of circumstances which may be considered exceptional would be a pressing financial commitment on the part of the director that cannot otherwise be satisfied.

Disclosure 13.8

The following are the disclosure requirements as set out in the section 'Rule D' (Rule 15) of the Model Code.

In relation to securities transactions by directors, the company shall disclose in its interim reports (and summary interim reports, if any) and the corporate governance report (see **13.10**) which APPENDIX 23 of the Listing Rules requires to be contained in its annual reports (and summary financial reports, if any):

- whether the company has adopted a code of conduct regarding securities transactions by directors on terms no less exacting than the required standard set out in the Model Code;
- whether its directors have complied with or whether there has been any non-compliance with, the required standard set out in the Model Code and the company's own code of conduct regarding securities transactions by directors; and
- details of any non-compliance and an explanation of the remedial steps taken by the company to address such non-compliance.

Independent non-executive directors 13.9

A non-executive director is a director of a company who has no executive or management responsibility. An INED (independent non-executive director) is independent of management and does not receive any benefits from the company other than the director's fee.

As many public companies in Hong Kong are family-controlled businesses, the function of INEDs is to supervise the management independently so that the interests of all the shareholders, not only the interests of a group of shareholders, shall be taken into account. In other words, the role of INEDs is seen as somehow protecting the minority interests of a public company.

A company must ensure that every board of directors must include at least three INEDs (Rule 3.10(1) of Listing Rules). At least one of the INEDs must have appropriate professional qualifications or accounting or related financial management expertise gained in significant public company positions in such responsibilities (Rule 3.10(2) of Listing Rules). An INED must also satisfy the stock exchange that he has the character, integrity, independence and experience to fulfill his role effectively (Rule 3.12).

Rule 3.13 of the Listing Rules sets out a non-exhaustive list to assess the independence of a non-executive director. The independence of a non-executive director is more likely to be questioned if the director:

- holds more than 1% of the total issued share capital of the company;
- has received an interest in any securities of the company as a gift, or by means of other financial assistance, from a connected person or the company itself, except as part of his director's fee or pursuant to the share option scheme in the Listing Rules;

- is a director, partner or principal of a professional adviser which currently provides or has within one year immediately prior to the date of his proposed appointment provided services, or is an employee of such professional adviser who is or has been involved in providing such services during the same period to the company, its holding company, or any of their respective subsidiaries or connected persons, or any person who was a controlling shareholder, chief executive, director (other than an INED) of the company within one year immediately prior to the date of the proposed appointment, or any of their associates;
- has a material interest in any principal business activity of or is involved in any material business dealings with the company, its holding company, or their respective subsidiaries or with any connected persons of the company;
- is on the board specifically to protect the interests of an entity who interests are not the same as those of the shareholders as a whole;
- is or was connected through a wide range of blood or family relationship with a director, the chief executive or a substantial shareholder of the company within two years immediately prior to the date of his proposed appointment;
- is, or has at any time during the two years immediately prior to the date of his proposed appointment been, an executive or director (other than an INED) of the company, of its holding company or of any of their respective subsidiaries or connected persons of the company;
- is financially dependent on the listed issuer, its holding company or any of their respective subsidiaries or connected persons of the company.

The Hong Kong Institute of Directors also published the 'Guide for Independent Non-Executive Directors', and 'Guide for Remunerating Independent Non-Executive Directors' to both of which the INEDs should make reference.

Code on Corporate Governance Practices/ Corporate Governance Report 13.10

The 'Code on Corporate Governance Practices' ('Corporate Governance Code') is set out in Appendix 14 of the Listing Rules. The Corporate Governance Code sets out the principles of good corporate governance and there are two levels of recommendations, namely code provisions, and recommended best practices. The company is expected to comply with, but may choose to deviate from the code provisions. The recommended best practices are for guidance only. The company may also devise its own code on corporate governance practices on such terms as it may consider appropriate.

The Corporate Governance Code has specific fields dealing extensively with:

- directors;
- remuneration of directors and senior management;
- accountability and audit, delegation by the board; and
- communication with shareholders.

The following are some of the key provisions, inter alia, of the code provisions of the Corporate Governance Code:

- The board should meet regularly and board meetings should be held at least 4 times a year at approximately quarterly intervals. A regular meeting does not include the practice of obtaining board consent through the circulation of written resolutions (Art. A.1.1).
- Notice of at least 14 days should be given of a regular board meeting to give all directors an opportunity to attend (Art. A.1.3).
- Minutes of board meetings and meetings of board committees should record in sufficient detail the matters considered by the board and decisions reached, including any concerns raised by directors or dissenting views expressed. Draft and final versions of minutes of board meetings should be sent to all directors for their comment and records, respectively, in both cases within a reasonable time after the board meeting is held (Art. A.1.6).
- If a substantial shareholder or a director has a conflict of interest in a matter to be considered by the board which the board has determined to be material, the matter should not be dealt with by way of circulation or by a committee, but a board meeting should be held. INEDs who, and whose associates, have no material interest in the transaction should be present at such board meeting (Art. A.1.8).
- The role of chairman and chief executive officer should be separate and should not be performed by the same individual. The division of responsibilities between the chairman and chief executive officer should be clearly established and set out in writing (Art. A.2.1).
- Directors must comply with the Model Code, and the board should establish written guidelines on no less exacting terms than the Model Code for relevant employees of subsidiary or holding companies of the issuer in respect of their dealings in the securities of the company (Art. A.5.4).
- In respect of regular board meetings, and so far as practicable in all other cases, an agenda and accompanying papers should be sent in full to all directors in a timely manner and at least three days before the intended date of a board or board committee meting (or such other period as agreed) (Art. A.6.1).
- The company should establish a remuneration committee with specific terms of reference which deal clearly with its authority and duties. A majority of the members of the remuneration committee should be INEDs (Art. B.1.1).
- Management should provide such explanation and information to the board as will enable the board to make an informed assessment of the financial and other information put forward before the board for approval (Art. C.1.1).
- The directors should acknowledge in the Corporate Governance Report their responsibility for preparing the accounts, and there should be a statement by the auditors about their reporting responsibilities in the auditors' report in the financial statement (Art. C.1.2).
- The board's responsibility to present a balanced, clear and understandable assessment extends to annual and interim reports, other price-sensitive assessments and other financial disclosures required under the Listing

Rules, and reports to regulators as well as to information required to be disclosed pursuant to statutory requirements (Art. C.1.3).

- The directors should at least annually conduct a review of the effectiveness of the system of internal control of the company and its subsidiaries and report to shareholders that they have done so in their Corporate Governance Report. The review should cover all material controls, including financial, operational and compliance controls and risk management functions (Art. C.2.1).
- When the board delegates aspects of its management and administration functions to management, it must at the same time give clear directions as to the powers of management, in particular to the circumstances where management should report back and obtain prior approval from the board before making decisions or entering into any commitments on behalf of the company (Art. D.1.1).
- The chairman of the board should attend the annual general meeting and arrange for the chairman of the audit, remuneration and nomination committees (as appropriate) or the duly appointed delegate of such committees to be available to answer questions at the annual general meeting. The chairman of the independent board committee (if any) should also be available to answer questions at any general meeting to approve a connected transaction or any other transaction that is subject to independent shareholders' approval (Art. E.1.2).

The company must state in its interim reports and annual reports whether the directors have complied with the code provisions in the Corporate Governance Code for the relevant accounting period.

Where the company deviates from any of the code provisions, the company must give considered reasons in the case of annual reports, in the Corporate Governance Report, in the case of interim reports, either by giving considered reasons for each deviation; or to the extent it is reasonable and appropriate, by referring to the Corporate Governance Report in the immediately preceding annual report, and providing details of any changes together with considered reasons for any deviation not reported in that annual report.

In the case of the recommended best practices in the Corporate Governance Code, a company is encouraged, but is not required, to state whether it has complied with them and give considered reasons for any deviation.

On the other hand, Appendix 23 of the Listing Rules sets out the requirement of 'Corporate Governance Report'. A company shall include a report on corporate governance practices prepared by the board of directors in their summary financial reports (if any) and annual reports. The Corporate Governance Report shall contain all the information set out in paragraph 2 of 'mandatory disclosure requirements' in this Appendix 23. The mandatory disclosure requirements shall include the Corporate Governance Code, director's securities transactions as per Model Code, board of directors, chairman and executive director, non-executive directors, remuneration of directors, nomination of directors, auditors' remuneration, audit committee. Further, paragraph 3 of this Appendix 23 also sets out the 'recommended disclosures', including share interests of senior management, shareholders' rights, investor relations, internal controls and management functions.

Audit committee 13.11

An audit committee comprising only non-executive directors needs to be established with a minimum of three members, at least one of whom is an INED with appropriate professional qualifications or accounting or related financial management expertise. The majority of audit committee members must be INED, and the audit committee must be chaired by an INED (Rule 3.21 of the Listing Rules).

Pursuant to Art. C.3.3 of the Corporate Governance Code, the terms of reference of the audit committee should include at least the following duties:

- To be primarily responsible for making recommendations to the board on the appointment, reappointment and removal of the external auditor, and to approve the remuneration and terms of engagement of external auditor, and any questions of resignation or dismissal of that auditor.
- To review and monitor the external auditor's independence and objectively and the effectiveness of the audit process.
- To develop and implement policy on the engagement of an external auditor to supply non-audit services.
- To monitor the integrity of financial statements of the company and the company's annual report and accounts, half-year report and quarterly reports, and to review significant financial reporting judgments contained in them. For this purpose, members of the audit committee must liaise with the company's board of directors, senior management and company's qualified accountant and the audit committee must meet, at least once in each year, with the company's auditors. The audit committee should also consider any significant or unusual items that are, or may need to be, reflected in such reports and accounts and must give due consideration to any matters that have been raised by the company's qualified accountant, compliance officer or auditors.
- To review the company's financial controls, internal control and risk management systems.
- To discuss with the management the system of internal control and ensure that management has discharged its duty to have an effective internal control system.
- To consider any findings of major investigations of internal control matters as delegated by the board or on its own initiative and management's response.
- Whether an internal audit function exists, to ensure co-ordination between the internal and external auditors, and to ensure that the internal audit function is adequately resourced and has appropriate standing within the company, and to review and monitor the effectiveness of the internal audit function.
- To review the financial and accounting policies and practices of the company and its subsidiaries.

- To review the external auditor's management letter, any material queries raised by the auditor to management in respect of the accounting records, financial accounts or systems of control and management's response.
- To ensure that the board will provide a timely response to the issues raised in the external auditor's management letter.
- To report to the board on the matters set out in the Corporate Governance Code.
- To consider other topics, as defined by the board.

The board must approve and provide written terms of reference for the audit committee which clearly establish the committee's authority and duties (Rule 3.22 of Listing Rules).

The stock exchange must be informed immediately and an announcement published in accordance with Rule 2.07 C of the Listing Rules containing the relevant details and reasons why the company fails to set up an audit committee or at any time has failed to meet any of the other requirements under Rule 3.21 (Rule 3.23 of Listing Rules).

Notice of the responsibilities and guidelines for the holding of meetings by an audit committee suggested in *A Guide for Effective Audit Committees* published by The Hong Kong Society of Accountants must be taken.

Transparency and disclosure

Private companies 13.12

Statutory returns on corporate information must be filed with the Companies Registry in compliance with the *CO*. The statutory returns are available to the public by public search at the Companies Registry. Some examples of statutory returns are set out below:

- Statement of revision of accounts or reports (*s 141E(3) CO*).
- Annual return (*s 107(1) CO*).
- Notification of removal of auditor (*s 131 (6) CO*).
- Notification of first secretary and director/notification of change of secretary and director (*s 158 (4) and (4A) CO*).
- Notification of resignation of secretary and director (*s 157D (2) CO*).
- Notification of situation of registered office (*s 92(2) CO*).
- Notification of location of registers (*s 74A(3), 88(3), 89(3), 95(3), 119A(2) and 158A(2) CO*).
- Mortgage or charge details (*s 80(1), 81(1), 82(1) and 91(3) CO*).
- Memorandum of satisfaction or release of property from charge (*s 85 CO*).
- Notification of mortgagee entering into possession of property (*s 87(2) CO*).
- Notification of mortgagee going out of possession of property (*s 87 (4) (b) CO*).
- Notification of appointment of receiver or manager (*s 87(1) CO*).
- Notification of receiver or manager ceasing to act (*s 87 (4) (a) CO*).
- Return of allotments (*s 45 (1) CO*).
- Notification of increase in nominal share capital (*s 55 (1) and (2) CO*).

- Notification of appointment of liquidator or provisional liquidator (*s 195(a), 228A(10) and 253 (1) (b) CO*).
- Notification of liquidator or provisional liquidator ceasing to act (*s 228A(11) (b) and 253 (2) (b) CO*).
- Special resolutions (*s 117 CO*).

The minimum disclosures required by the *CO* to be made in financial statements needs to be complied with but it is important to note that unlike the position in the UK and other common law jurisdictions, the financial statements of a private company are not required to be filed on any public records. Some examples are set out below:

- *s 123*: General provisions as to contents and form of accounts.
- *s 128*: Particulars to be shown in company's accounts in relation to subsidiaries.
- *s 129*: Particulars to be shown in company's accounts in relation to companies not being subsidiaries whose shares it holds.
- *s 129A*: Particulars to be shown in subsidiary company's accounts in relation to its ultimate parent undertaking.
- *s 129D (3)*: Content of the director's report.
- *s 161*: Particulars in accounts of directors' emoluments, pensions, etc.

The mandatory disclosures as specified by Hong Kong Institute of Certified Public Accountants' Hong Kong Accounting Standards ('HKAS') must also be made. Some examples are set out below:

- *HKAS 24*: Related Party Disclosures
- *HKAS 28*: Investments in Associates
- *HKAS 31* Interests in Joint Ventures
- *HKAS 32*: Financial Instruments: Disclosure and Presentation.

Additional requirements for listed companies

Price-sensitive information **13.13**

Rule 13.09 (1) of the Listing Rules also provides that a company shall keep the stock exchange, members of the company and other holders of its listed securities informed as soon as reasonably practicable of any information relating to the group which:

- is necessary to enable them and the public to appraise the position of the group; or
- is necessary to avoid the establishment of a false market in its securities; or
- might be reasonably expected materially to affect market activity in and the price of its securities.

The stock exchange publishes the 'Guide on Disclosure of Price-Sensitive Information' for the general reference.

Notifiable transactions/connected transactions/ continuing obligations 13.14

Disclosure of notifiable transactions (including share transaction, discloseable transaction, major transaction, very substantial disposal, very substantial acquisition and reverse takeover) and arrangements as required under CHAPTER 14 and connected transactions and continuing connected transactions under CHAPTER 14A of the Listing Rules and issuance of circulars to shareholders or obtaining approval from shareholders when required must be carried out. CHAPTER 13 of the Listing Rules also set out extensive continuing obligations of the company for reporting and compliance.

Disclosure of interests 13.15

Notifications of shareholdings or changes in shareholdings required by *Part XV* of the *SFO* need to be made, that is a person who acquires, disposes of, or make changes to an interest in the share capital of a listed company has a duty of disclosure if the interest is notifiable. The Securities and Futures Commission issued the 'Outline of Part XV of the SFO (Cap. 571) – Disclosure of Interests', and Section 2.7.1 sets out the situation when a substantial shareholder should notify; whereas Sections 3.1.1 and 3.9 set out the situations when a director or chief executive should notify.

A substantial shareholder should notify when:

- he first becomes interested in 5% or more of the shares of a listed company;
- his interest drops below 5%;
- there is an increase or decrease in the percentage figure of his holding that results in his interest crossing over a whole percentage number which is above 5%;
- he has a notifiable interest and the nature of his interest in the shares changes;
- he has a notifiable interest and he comes to have, or cease to have, a short position of more than 1%;
- he has a notifiable interest and there is an increase or decrease in the percentage figure of his short position crossing over a whole percentage number which is above 1%;
- he has an interest in 5% or more of the shares of a corporation that is being listed, shares of a class that is being listed, or shares of a class which are being given full voting rights;
- on the commencement of the SFO, if he has an interest in 5% or more of the shares of a listed corporation, or if he has notifiable interest and a short position of 1% or more, which has not previously been disclosed;
- if the 5% threshold is reduced or the 1% threshold for short positions is reduced.

A director or chief executive needs to notify when he has:

- interests and short positions in any shares whatsoever of any class or right of the listed corporation of which he is a director;
- interests and short positions in shares of any associated corporation of the listed corporation;
- interests in debentures of listed corporation of which he is a director;
- interests in debentures of any associated corporation of the listed corporation of which he is a director.

Please note that there is no disclosure threshold and he has to disclose all dealings even if he has an interest, or a short position, in a small number of shares or debentures.

Executive pay

Private companies 13.16

Directors must ensure that accounts laid before the company in general meetings contain the aggregate amounts of the directors' emoluments, directors or past directors' pensions, and any compensation to directors or past directors in respect of loss of office (*CO, s 161*).

No payment must be made to any director or past director by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, unless the particulars relating to the proposed payment are disclosed to the members of the company and approved (*CO, s 163*).

The remuneration of directors shall be determined from time to time by the company in general meeting where *Sch 1, Table A, Article 78* is applicable.

Additional requirements for listed companies

Directors' fees and any other reimbursement or emolument payable to an INED must be disclosed in full in the annual report and accounts.

Shareholders' protection

Approval from shareholders 13.17

Approval from shareholders needs to be obtained on the matters required by the *CO* or its Articles of Association, including the following 10 important matters relating to the company:

- Alteration of articles and objects (*s 8 and 13 CO*).
- Reduction of company's share capital (*s 58 CO*).
- Increase or alternation of company's capital (*Sch 1 Table A, Article 45 and 46*).
- Powers to dispose of the company's fixed assets (*s 155A CO*).

- Appointment and removal of auditors (*s 131 and 132 CO*).
- Appointment and removal of directors, directors' salaries and approving payments for loss of office (*s 116A, 157A, 157B, 163 and 163A CO*).
- Variation of class rights (*s 63A CO, Sch 1 Table A, Article 4*).
- Matters relating to dividends (*Sch 1 Table A, Article 115*).
- Winding up (*s 177 (1) (a) and s 228 (1) (b) CO*).
- Non-pro rata allotment of shares by directors (*s 57B CO*).

Meetings **13.18**

The company must hold in each year an annual general meeting. This should be held within 15 months of the previous annual general meeting (but within 18 months from the date of incorporation in case of the first annual general meeting) (*s 111 CO*). Extraordinary general meetings must be convened when they are called by shareholders (*s 113 CO*). The requirements on notice periods for shareholders' meetings must be complied with in accordance with *s 114(2), s 161BA(6), s 161BA(5), s 114A(2)(a), s 114(3)(a), s 114(3)(b)* of the *CO.*

Every company shall cause minutes of all proceedings at general meetings and at meetings of its directors to be entered in books kept for that purpose (*s 119 CO*).

Shareholders' remedies **13.19**

Shareholders have personal rights to enforce provisions of Memorandum and Articles of Association of the company (*s 23* of the *CO*).

Shareholders can petition to the court for an appropriate order if the affairs of the company have been conducted in a manner which is unfairly prejudicial to the interests of the shareholders (*s 168A* of the *CO*).

Derivative action can be brought against a wrongdoer who is in control of the company.

Various amendments in the CO have taken effect in July 2005 which have enhanced the remedies available to shareholders receiving unfair treatment, including:

- s 152FA to 152FE of CO provide that the court may, in application, make an order to inspect any records of a specified corporation, if the application is made in good faith and for a proper purpose by any number of members representing not less than 2.5% of the total voting rights; any number of members holding shares in the specified corporation on which an aggregate sum of not less then $100,000 has been paid up; or not less than five members.
- s 168A of CO provides certain improvements to the unfair prejudice provisions. For example, the court may award damages and interest to any members whose interests have been unfairly prejudiced. A past member may commence action for unfair prejudice if the unfair prejudice conduct complained of arose when he was a member, etc.

- s 168BA to 168BK of CO introduces a new statutory right to commence a derivative action.
- s 350B(1) of CO introduces a statutory right to apply to court for injunctions if a person engaged, is engaging or is proposing to engage in conduct that constituted, constitutes or would constitute a contravention of; an attempt of contravention of; aiding, abetting, counseling, procuring, inducing another person for contravention of; being in any way knowingly concerned in or a party to a contravention of; conspiring with others for contravention of CO; a breach of his fiduciary duties in any capacity other than as a director; or a breach of his fiduciary duties or other duties as a director, etc.

Access to information **13.20**

Shareholders have a right to inspect the register of debenture holders, register of charges, register of directors and secretaries, minute books of general meetings, register of members, management contracts at general meeting under the CO (*s 75, 90, 98, 120, 158, 162A of the CO*).

Copy of balance sheet, directors' report and auditors' report should be sent to shareholders not less than 21 days before the Annual General Meeting (*s 129G* of the *CO*).

Corporate governance in the People's Republic of China (PRC) **13.21**

It is appropriate to consider simultaneously the status of corporate governance in mainland China.

Background to corporate governance in the People's Republic of China **13.22**

In order to understand corporate governance in China, the transition from a planned economy to a market-oriented economy must be considered. Corporate governance reform in China began in an environment where most of the elements of a well-functioning financial market were not in place and the progress made is quite remarkable. Over the past few years, the Chinese economy has been experiencing rapid growth. For instance it has been reported that investors in shares have trebled the value of their investment on average in China in 2007. To develop a well-functioning financial market, the government put the reform of the corporate governance of Chinese companies as a top priority on its agenda.

Chinese businessmen are seeking to expand their business internationally and are becoming aware that companies with good corporate governance are more attractive to investors and more profitable. Good governance is a key factor when seeking to list on foreign stock exchanges. It has been reported by commentators that 2007 will be remembered as a milestone year for China's overseas acquisition and investment: together Chinese government and state-run corporations have reportedly spent $29.2 billion to acquire foreign companies.

The spectacular collapse of the Guangdong International Trust and Investment Corporation (GITIC) in 1999 leaving over US$2 billion of unrecoverable loans highlighted some of the deep-rooted problems of corporate governance in the People's Republic of China (PRC) and the need for urgent reforms. Among the reasons for GITIC's failure were:

- poor management;
- rash investments;
- lack of risk management systems; and
- inefficient operations.

The GITIC collapse also ended the myth that Chinese companies were backed by government guarantees and governance and good management were irrelevant to protect investors.

The story published on 2 August 2001, highlighting that the Guangxia Industry Company Limited (Yinguangxia) had been fabricating profits for several years, (see Ling Huawei and Wang Shuo, 'Yinguangxia Trap', *Business & Finance Review*, August (2001), pp. 18–37) created new concerns both inside and outside China about the governance and credibility of Chinese companies. The price of Yinguangxia's shares had risen about 800% in one year as a result of:

- falsified contracts;
- exaggerated technologies;
- forged customs returns;
- fraudulent announcements; and
- distorted financial statements.

The following day the China Securities Regulatory Commission (CSRC) suspended dealings in Yinguangxia's shares and began an investigation into the company.

The CSRC has criticised or disciplined several companies for corporate governance violations. Frequent corporate scandals not only brought corporate governance into the newspaper headlines in China – like elsewhere – but also prompted investors and regulators into thinking that the time had come to reform the corporate governance system in China, especially corporate governance in listed companies. This was particularly because of the grave impact of such scandals in the securities market.

Many of the systemic problems came about because most listed companies were re-structured state-owned enterprises or were majority controlled by government agencies. Directors and managers were chosen by bureaucrats who had little incentive to appoint the most suitably qualified candidates and often there was collusion between them to misappropriate funds for their own benefit. There were problems in removing non-performing directors and independent directors were rarely appointed. Because so many shares were non-tradable, there was little incentive to senior management or the board to improve performance or pay attention to the interests of minority shareholders.

In addition to the above matters the PRC corporate governance system has been hindered by various interconnected issues, such as:

- the absence of effective implementation mechanisms of laws and regulations;
- the lack of necessary incentive for management;
- the absence of appropriate rights protection for small/public shareholders.

The lack of efficient corporate governance that caused corporate failures, financial difficulties, fraud and other scandals meant that reform was a priority for the Chinese legislative agenda. As a result, related government authorities and agencies have issued various laws, regulations and standards. Different aspects were addressed in published CSRC, Guidelines, such as 'The Guideline Regarding Independent *Article 3, Guiding Opinions* sets out the circumstances under which persons will be disqualified from acting as independent directors.

Material associated transactions (over RMB300 million) are required to be sanctioned by the independent directors and submitted to the board of directors for discussion (*Article 5(1)1, Guiding Opinions*). Independent directors are entitled to express their independent opinions on material matters (*Article 6, Guiding Opinions*).

Listed companies must set up an appropriate insurance system for the independent directors in order to lower the risks of independent directors being exposed to litigation (*Article* 7(6), *Guiding Opinions*).

Corporate governance reforms by the government

Conversion from non-tradable shares to tradable shares 13.23

In 2005, the CSRC announced the initiative to convert non-tradable shares into tradable shares. With a view to standardising the work relating to the split share structure reform of listed companies, boosting the reform and opening-up and steady growth of the capital market, and safeguarding the legitimate interests of investors, the Administrative Measures on the Split Share Structure Reform of Listed Companies ('Measures') has been enacted, in accordance with the Company Law of the PRC, Securities Law of the PRC, Provisional Regulations on the Administration of Share Issuance and Trading, Guidelines of the State Council for Promoting the Reform and Opening-up and Sustained Development of the Capital Market and the Guidance Opinions on the Split Share Structure Reform of Listed Companies jointly promulgated by the CSRC, State-Owned Assets Supervision and Administration Commission of the State Council, Ministry of Finance (MOF), People's Bank of China and Ministry of Commerce (Article 1, 'Measures').

Revisions of Company Law 13.24

Recent revisions of Company Law strengthen the corporate governance framework of the country. Improvements can be attributed to the strengthening of minority shareholder rights and clearly defining the board structure, in particular, specifying the role of the supervisory board and chairman.

New accounting standards 13.25

The new accounting and auditing standards in China both took effect on 1 January 2007 in a bid to meet the needs of its market economy. The MOF said the standards including 39 for corporate accounting applied among listed firms and 48 for auditing used by registered accountants.

Information disclosure by listed companies 13.26

The Regulations on Information Disclosure of Listed Companies, approved by CSRC on 13 December 2006 took effect from 30 January 2007. According to Corporate Law and Securities Law of PRC and administrative bylaws, these regulations provides the ground rules on the information disclosures of stock issuers, listed companies and other disclosure obligors, to strengthen the management of information disclosures and to protect the legitimate interest of investors. Information shall be disclosed to all investors at the same time. Companies listed both home and abroad shall disclose any information revealed in overseas markets to Chinese markets as well. The directors, supervisors and senior managers of the issuers and listed companies shall faithfully and assiduously fulfill their obligation of information disclosure. People with access to inside information shall not disclose or divulge or trade on the information before it is available to the public.

Corporate governance for private companies in the PRC 13.27

The main corporate governance provisions applicable to private companies are set out in the PRC Company Law and are summarised below.

Shareholder accountability 13.28

A shareholder must contribute their capital into the company in accordance with the articles, otherwise they will be held liable for breach of contract (Article 25). Capital contributions must be verified by an approved verification authority (Articles 27 and 91) and shareholders must not withdraw their capital contribution after the company is set up (Article 209).

Board of directors and directors 13.29

The board of directors is accountable to general meeting (Articles 46 and 112).

Subject to re-election, the duration of office for a director must not be longer than three years (Articles 47 and 115), and a director may not hold a concurrent post as supervisor (Articles 52 and 124).

Directors' duties 13.30

Article 57 sets out the circumstances under which persons will be disqualified from acting as a director and a civil servant may not hold a concurrent post as director (Article 58). The following are a list of directors' duties:

- Directors must discharge their duties faithfully, uphold the interests of the company and not seize a company's properties, etc. (Article 59).
- A director must not misappropriate company's funds or lend company's funds to a third party (Article 60).
- A director must not run his own business or work for other businesses which will be likely to compete with the company (Article 61).
- Subject to the requirements of relevant laws and the approval of a general meeting, a director must not disclose any confidential information of the company (Article 62).

If a director during the course of discharging their duty violates the laws, administrative regulations or the Articles. They are required to compensate the company for any damages suffered (Article 63).

Supervisory board and supervisor 13.31

Articles 57, 58, 59, 62 and 63 quoted above are also applicable to supervisors (Article 123). Subject to re-election, the duration of an office for a supervisor must not be longer than three years (Articles 53 and 125). A supervisory board must consist of representatives of shareholders and representatives of workers (Articles 52 and 125). Articles 54 and 125 set out the authorities of a supervisory board. A supervisor must discharge his duties faithfully (Article 128).

Corporate governance for listed companies in the PRC 13.32

There are additional requirements as to corporate governance for listed companies. Apart from laws and regulations relating to corporate governance, there are also many regulatory notices, codes and guidelines which have been issued by regulatory bodies, including the National People's Congress Standing Committee (NPCSC), State Council, Ministry of Finance (MOF), the Chinese Securities Regulatory Commission (CSRC), the Chinese Institute of Certified Public Accountants (CICPA), the China Accounting Standard Committee (CASC), the State Economic and Trade Committee (SETC), the China National Audit Office (CNAO), the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE).

It should be noted in particular that, based on the OECD Principles of Corporate Governance, the CSRC and SETC jointly issued the 'Codes of Corporate Governance for Listed Companies' in January 2002.

Key principles **13.33**

From the various published laws, regulations and other regulatory documents, the following can be summarised as the five key principles for corporate governance in the PRC:

- shareholder accountability;
- directors' duties;
- the external audit must be independent and penetrating;
- disclosure and transparency are crucial to market integrity; and
- there must be an appropriate regime of regulatory discipline to back these obligations.

The article numbers quoted below refer to the 'Codes of Corporate Governance for Listed Companies' unless otherwise stated.

Shareholders **13.34**

Corporate governance must ensure equal status amongst all the shareholders, especially the minority shareholders (Article 2).

Shareholders are entitled to rely on legal channels to protect their lawful interests (Article 4).

Guidelines for general meetings **13.35**

Listed companies must ensure that they provide in their Articles for the principles of authority from members in general meeting to the board of directors (Article 7). Listed companies must also provide in their Articles procedures for general meetings, including convening meetings, voting, notices, registration and putting motions, etc. (Article 5).

Associated transactions **13.36**

Rules on the disclosure of associated transactions are set out in Article 12. Listed companies must use effective measures to prevent shareholders and other associated parties from taking possession of and transferring company's funds and assets, etc. (Article 14).

Guidelines for controlling shareholders **13.37**

Controlling shareholders owe other shareholders a duty of loyalty (Article 19). The controlling shareholders must support labour reforms and improvements of human resources and remuneration systems of listed companies (Article 18). Major issues of the company must be decided by general meeting and the board of directors. Controlling shareholders must not intervene in decisions of companies, their lawful operation and business activities (Article 21).

Directors' selection process 13.38

Listed companies must provide at their general meeting detailed particulars of candidates to be elected as directors (Article 29). During the process of electing directors, the opinions of minority shareholders must be fully considered (Article 31). Listed companies must enter into contracts with the directors clearly setting out their rights and obligations (Article 32).

Directors' duties 13.39

Directors must act in the best interests of the company and the shareholders and have duties of honesty, loyalty and diligence (Article 33). Directors must ensure they have sufficient time and commitment to discharge their duties (Article 34). Directors involved in any decision-making process which is in violation of laws, regulations and Articles of the company are required to compensate the company for any damage suffered (Article 38). Listed companies may buy indemnity insurance for the directors if this is approved in general meeting (Article 39). The board of directors must consist of a reasonable percentage of persons from different professions (Article 41). The board of directors is accountable to the general meeting (Article 42).

Rules of procedure for board meetings 13.40

Listed companies must provide in their Articles for the rules of procedure for board meetings (Article 44), and directors of listed companies must observe the rules of procedure strictly (Article 46). Minutes of board meeting must be complete and accurate (Article 47). The board of directors may delegate some of its functions to the chairperson of the board when the board is not in session (Article 48).

Two-tier board structure 13.41

China adopts a quasi two-tier structure of board governance, with a board of directors and a supervisory board. The board of directors is the main decision-maker and work closely with the management of the company. The supervisory board is an independent board that monitors the management and the board directors.

CSRC guidelines require that at least one-third of the directors are independent The Guideline on Establishment of Independent Director System in Listed Companies, issued by CSRC in August 2001, provides specific rules on the definition of independence and more power has been given to the independent directors in all companies listed in the Chinese stock exchanges.

A supervisor is entitled to know the operations of the company and owes the company a duty of confidentiality (*Article 60*). A supervisor must report to the board, general meeting and securities regulatory authorities the acts of directors, managers and other senior officials which are in violation of laws, regulations and the Articles (*Article 63*).

A supervisor must possess professional knowledge and relevant working experience such as legal and accounting knowledge (*Article 64*). Further Articles set out the duties of the supervisory board.

Executive incentive compensation 13.42

Listed companies must establish a mechanism linking the managers' remuneration with the company's performance (*Article* 77).

The Chinese government is promoting equity-based pay as one component of compensation to encourage growth in the capital market.

Corporate disclosure and transparency 13.43

In case of serious loss of a company's assets, the investigation and responsibility of relevant personnel shall be disclosed (*Article 36*, Contents and Format of Public Disclosure by Listed Companies (Standard No. 2) – Contents and Format of Annual Report (Rev 2003)).

The full names of the 10 largest shareholders, their shareholdings and types of shares (A, B, H shares) held at the end of each year shall be disclosed (*Article 25*, Contents and Format of Public Disclosure by Listed Companies (Standard No. 2) – Contents and Format of Annual Report (Rev 2003)).

Conclusion 13.44

Hong Kong remains an important gateway to China and the Far East region with its highly developed financial infrastructure, common law tradition, independent judicial system, freedom of movement of capital and strong professional support services. Corporate governance standards in Hong Kong have definitely improved and such improvement will no doubt continue steadily.

China has become one of the world's largest economic powers. The PRC Government recognises the need to show its commitment to good governance and the rule of law and has clearly demonstrated its awareness of the need to improve the climate of transparency and certainty for foreign investors, particularly those involved in foreign direct investment, joint ventures and privatisation of state-owned enterprises.

Corporate governance reforms in the PRC have already been an essential part of the PRC's rapid economic, and much progress has been made in respect of the rights of shareholders; the duties, responsibilities and independence of board directors; greater information disclosure and transparency; and strengthening the role of the auditor. Corporate governance improvements will further secure China's place as a global player in today's business world.

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14

International dimensions: corporate governance in Australia

14 International dimensions: Corporate governance in Australia

CHAPTER OVERVIEW 14.1

In Australia corporate governance has become a major issue in the last couple of years and to a large extent, has displaced the quest for quality accreditation under ISO and similar standards during the 1990s.

The reasons for this change in focus are obvious from the discussion in earlier chapters regarding the headline stories of corporate collapse, such as Enron and Worldcom in the USA, HIH Insurance in Australia and the Parmalet scandal in Italy. The HIH Insurance case that has had such a dramatic impact in Australia is explained in more detail below (see **14.11**). While this chapter explains the position of corporate governance in Australia the lessons learned from this discussion and the practical hints and tips set out have international relevance.

While the direct causes of these corporate crashes continue to be the subject of extensive investigations by liquidators, regulatory authorities, and have provided a catalyst for focus on governance, the collapses themselves are a symptom of poor governance practices rather than the cause.

As has been mentioned in earlier chapters, the recent corporate collapses have provoked a considerable amount of activity by governments with the Sarbanes-Oxley Act in the USA, the Corporate Law Economic Reform Program (CLERP) in Australia and similar legislation in many other western countries, as well as in Asia.

There has been a heavy focus on increasing penalties applied to directors and officers of companies and clearly a desire to prove that the legislative and regulatory structures are effective by meeting out harsh punishment to those involved in the collapses.

In the USA lengthy jail sentences have been given to those convicted in high profile collapses such as Enron. In contrast in Australia, there has been some disquiet at the relatively short custodial sentences arising from plea bargains, and the effectiveness of orders banning those convicted from participating in the management of business for lengthy periods is yet to be tested.

Whereas the boom and bust cycle of business has been around since human beings first began to trade, it was probably the celebrated collapse of the South Sea bubble in the 18th century that first saw some attention being focused by government to regulate business practices to protect stakeholders.

The initial approach to regulation and issues of governance was a minimalist one. It was argued that the inherent risks in any business helped to create an environment where large profits could be generated and that no government can regulate risk out of business activities, as regulation would stifle economic growth. This was largely the approach in most jurisdictions.

The attitude of the courts tended to support this minimalist approach. In 1892, the Marquis of Bute was sued by a liquidator for neglecting his duties as the President of the Cardiff Savings Bank.

The Marquis' family had a long history with the Bank that was originally established by his father in 1819 who became the President of the Bank. After he died in 1848 his son, then only six months old, inherited the position of President of the Bank. Notwithstanding the family's close association with the Bank, in the period from when he inherited the Presidency of the Bank until it collapsed in 1886, a period of 38 years, he attended only one Board meeting.

Justice Stirling absolved the Marquis from any responsibility holding the 'neglect or omission to attend meetings is not, in my opinion, the same thing as neglect or omission of a duty which ought to be performed at those meetings', clearly, times have changed.

The expectations of directors by shareholders and creditors and the obligation imposed on them by regulatory authorities and underlying legislation would not enable the Marquis of Bute to escape personal liability today by simply ignoring the affairs of the Cardiff Savings Bank.

Spectacular corporate failures make it easier for governments and regulators to add legislation to increase controls and supervision of corporations and those who govern them.

A very large proportion of the electorate in many countries have become shareholders often through privatisation, and the sale of state owned utilities including telephone companies, roads, airports and railway lines. This adds to the pressures on governments to regulate business more closely.

Undoubtedly, governments see some shareholders as consumers in need of many of the traditional consumer protection rights and remedies, more commonly involved in the purchase of goods and services.

The heavy focus on governance has seen the end of multi-disciplinary practices (combining accounting and legal service providers under the one roof), a greater role for auditors and in some jurisdictions a positive obligation on legal and accounting advisers to become whistle-blowers.

What is good corporate governance? 14.2

It has been noted in **Chapter 10** that the corporate governance framework of the UK has influenced developments elsewhere. In Australia, Royal Commissioner Justice Neville Owen in his report on the collapse of HIH suggested that corporate governance is not a term of art and his Honour preferred the principles set out in the Cadbury Report (Committee on the Financial Aspects of Corporate Governance Report (1992)) which refers to characteristics of good governance using words such as 'openness', 'integrity' and 'accountability'.

A similar approach was taken by the Core Group on Corporate Governance established by the Pacific Economic Co-operation Council (PECC), in their Guidelines for Good Corporate Governance launched at the 14th general meeting of PECC in Hong Kong in November 2001.

That committee dealt with the issue in the following way:

> 'Corporate governance principles indicate that business enterprises seeking to remain competitive in free and open markets should ensure that the powers, rights and resources invested in them as corporations are exercised for the benefit, profit and sustained competitiveness of the corporate enterprise.
>
> Moreover, as corporations, with their autonomous standing and separate personality before the law, they are set apart and distinguished from their owners, directors and managers.
>
> There is a need for some distance, defined and protected by professional ethics, to be kept between the corporation on one hand, and the owners, directors and managers on the other.
>
> The relations between owners, directors and managers and with the corporation should be governed by principles whereby each of these groups, in the proper exercise of their rights and duties, promote the best interest of the corporation as a whole.'

In May 1999, the Australian National Audit Office (ANAO) published a paper on Better Principles and Practices – Corporate Governance in Commonwealth Authorities and Companies. The ANAO paper noted:

> 'Definitions of corporate governance are many and varied. Broadly speaking, corporate governance refers to the processes by which organisations are directed, controlled and held to account.
>
> It encompasses authority, accountability, stewardship, leadership, direction and control exercised in the organization. For CAC bodies, key elements of corporate governance include the transparency of corporate structures and operations; the implementation of effective risk management and internal control systems; the accountability of the Board to stakeholders through, for example, clear and timely disclosure; and responsibility to society.'

Concepts of good corporate governance 14.3

As has been noted corporate governance is not a new concept; indeed, the underlying principles of good corporate governance have been long established through the Westminster system of government.

The principle of separation of power between the executive government, the judiciary and the Parliament underpin many of the concepts being put into place to improve the quality of corporate governance in many jurisdictions around the world.

The convention that the Prime Minister of the day should surrender the seals of office at any time when that person loses the confidence of the Parliament is a practice, which can and should translate easily into the corporate world.

The basic concept of ministerial responsibility for matters within a minister's portfolio also sits comfortably with basic principles of good governance and can also be translated into the corporate environment.

As has been seen in **Chapter 10**, many of the definitions and models put up to improve the quality of governance in the corporate world seek to define corporate governance by reference to structures and processes. For example, it has been said that good governance requires the establishment of an audit committee and once this is done, a corporation can tick the box and feel comfortably satisfied that it has met one of the criteria for good governance.

While undoubtedly legislators and regulators may seek to define corporate governance by reference to form and structure to make it easier to set benchmarks for accountability and prosecution of wrongdoers, this does not necessarily lead to good governance in a real and substantial way.

In Australia a major scandal occurred within the National Australia Bank when traders were operating outside guidelines, resulting in a loss of over AUD$300 million to the bank from these trading activities.

The bank had in place the structures for corporate governance including audit and risk management committees. The independent review, however, found that the processes and structures failed to prevent and detect these serious problems, the forms and structures said to be a sign of good governance had in fact, no real substance.

The chairperson and the chief executive officer (CEO) resigned from the Bank to atone for the failure in governance. The chair of the Audit Committee refused to resign. Clearly, if this scandal has occurred in a government operating under the Westminster system, the chairperson of the Audit Committee as a minister would have resigned immediately, even though under the Westminster system there is no written rule or legislated process to remove a minister in those circumstances.

Good governance in substance and in fact is defined by reference to the culture of a corporation, based on the principles referred to in the Cadbury Report of openness, integrity and accountability. The adoption of such core principles at every level in a corporation will then ensure that the form and structures of the governance model within the corporation have real substance.

The establishment of a prison with the highest level of security can never absolutely prevent an escape, and corporations with the strongest culture supporting good governance cannot guarantee that there will not be some person or persons who will seek to subvert the system and damage the corporation.

As has been mentioned in **Chapter 8**, the culture of the organisation is very relevant to good corporate governance. The existence of a strong culture supporting good governance, principles of integrity, openness and accountability will, however, make it harder for those who wish to subvert the process, more likely that they will be detected and ultimately minimise the damage such persons can cause to a corporation.

Corporate governance and risk 14.4

One complaint from the corporate world is that corporations, their directors and officers must take risks if they are to deliver growth and profits to shareholders and that an undue focus on good corporate governance may cause a corporation to become risk adverse and ultimately to stagnate and fail. People who advance such arguments misunderstand concepts underlying the principles of good governance.

The doomsayers who argued against the increased focus on governance have been proved wrong, and there is no objective evidence that growth has been stifled or that good governance caused a significant increase in costs and created a shortage of people willing to serve as directors of corporations.

Whilst for some directors and boards their focus on governance has driven by self-preservation or personal protection rather than the interests of the company and its stakeholders which is bad governance, fortunately they are in a minority.

Good governance is not about avoiding risks or stifling ideas and strategies. Rather, good governance ensures that risks, challenges and strategies are properly evaluated and assessed rather than driven forward by self-interest under a veil of secrecy with little accountability.

While perhaps simplistic good governance requires those responsible for managing corporations to ask the question: 'Why are we doing this, is it within our power and authority, is this the right thing to do?' Of course the lawyers will immediately respond by asking what 'right' means. The oath of office (prepared by lawyers) taken by judges in New South Wales is:

> 'I will do right to all manner of people, after the laws and usages of the State of New South Wales, without fear or favour, affection, or ill-will.'

'Right' in that context has been clearly understood to include transparency, integrity, openness and accountability having regard to all stakeholders and people that may be affected by the actions of the judge.

Corporate governance makes good economic sense 14.5

There are many issues being debated in contemporary society which people complain are influenced by 'political correctness'.

One such example is the concept of affirmative action as it relates to increasing the number of women in key positions in the workplace. There is much more to the concept of affirmative action than simply political correctness.

A strong economic argument and business case can be made for a policy which encourages using to the full, the intellect, training and experience of women in the workplace. There is a substantial cost to businesses and the community if policies are not developed to create work practices around family responsibilities and these resources are lost.

The same is the case in relation to corporate governance and the economic consequences resulting from any failure or mismanagement of or by large corporations with the inevitable loss of confidence. The economic repercussions create a very strong business case for corporate governance, apart from the fact that good governance is required simply on ethical or moral grounds. Good corporate governance therefore makes good economic sense.

The ramifications in Australia of the collapse of HIH spread far beyond the creditors and shareholders of HIH, they were felt in remote communities who could no longer obtain public liability insurance to operate a pony club gymkhana or to allow an ANZAC day march.

The problems arising from the Sub Prime Mortgage market in the USA and Europe in 2007 are yet to be fully examined in the context of corporate governance, but have already sent shock waves through global stock markets and required an urgent reduction in the US interest rates to calm markets.

The wider ramifications of poor governance practices were recognised by the Core Group on Corporate Governance in preparing their guidelines for good corporate governance for the PECC.

The chairperson of that committee noted in the foreword to the guidelines:

> ‘Developments in East Asia since the 1997 financial crisis have underscored the critical importance of structural reforms in the governance of the business enterprise. PECC noted that these reforms are necessary for the strengthening of the micro-economic base for the economies in the region.’

A key driver for economic development and investment, more so than the strength of any corporate balance sheet is a feeling of confidence, engendered by transparency and those three principles enunciated in the Cadbury Report: openness, integrity and accountability.

In Asia, good governance is not just an interesting legal theory for businesses in developed economies, but is a critical factor necessary to ensure sustainable development and social stability, and can assist in reducing regional tensions by improving living standards through economic growth.

The absence of good governance and institutions to ensure enforcement creates a high level of risk and clearly limits or discourages investment and sadly, this often occurs in regions and countries that need most economic growth.

The importance of good governance was recognised and was a key item on the agenda of the Asia Pacific Economic Co-operation (APEC) ministerial meeting in Bangkok, Thailand, in October 2003.

Every government represented at the APEC meeting recognised that irrespective of the state of economic development in their own economy, they must strongly support the principles of good governance for both government and business, as this will make their markets more attractive, increasing the number and size of investment opportunities available and the pace of development.

The importance of good governance was also recognised at a key conference of senior government, judicial and business leaders in Hyderabad, India, in November 2002. The lack of good governance practices was seen as being a significant factor slowing the process of economic reform and development in India. Good corporate governance, therefore, is not an intellectual luxury, but an economic necessity.

Key issues needed to establish good governance **14.6**

Good governance is not a matter of form and structures. If it is to be effective it must have substance by driving/encouraging/facilitating a culture within an organisation that is determined to do the right thing.

This requires a process of education and leadership, which involves those in senior positions living good governance principles rather than simply delegating the task of establishing structures to create an appearance of good governance, that is 'walk the talk'.

Regulation and punishment may drive out those who are dishonest, but only after the event and they represent a small part of the corporate world. Most corporations, directors, CEOs and managers are not dishonest, but they still need to ensure they have a culture of good governance in their organisation. There are many elements that need to be considered in relation to governance and these are outlined below.

Checks and balances – separation of power and responsibility **14.7**

As discussed earlier, see **14.3** above, a tried and tested model of good governance is the Westminster system, which has at its core, the separation of powers.

In a corporate sense, this means there have to be clearly defined roles and responsibility for the board, the chairperson, corporate executives and the auditors.

The Sarbanes-Oxley Act of 2002 in the USA and similar legislation in countries, such as Australia, have reinforced the need to ensure that auditors are independent to avoid the debacle at HIH where one former partner of the audit firm (who had also been the audit partner) was on the board, another was the chairperson of the company and the financial controller had also previously been a partner of the audit firm. See further discussion of the Sarbanes-Oxley Act of 2002 in **Chapter 11**.

HIH is an example where it became impossible to create any separation of power because of the dominant personality of the chief executive who was also founder of the company.

Clearly, this can be a dilemma for any corporation where there is a strong individual who is a driving force in creating a successful company, but who forgets that the company is not their own private domain, they are not an absolute monarch and must be held to account in terms of transparency, reporting and decision-making.

It is one thing for the legislators to impose obligations on directors, but this may not overcome the real-world challenges in a boardroom debate heavily dominated by one or two individuals. A characteristic of most corporate failures has been the involvement of one or two dominant personalities in key positions.

There is no doubt, given the complexity of corporate life, that it is important to have specialised committees to focus on specific areas of a company's operation in order to ensure accountability transparency and openness, and that the members of those committees should have sufficient expertise to ensure that they can be effective.

The example of National Australia Bank demonstrates that the existence of structures alone is not enough. In that case, the Bank did have audit and risk management committees, but plainly, those committees were ineffective and apparently had no idea of the problems of the rogue traders, did not know that the regulator had already warned the company of the problem and clearly were faced with a culture of concealment rather than openness.

One has to be cautious in making committees responsible for governance issues to ensure they have sufficient authority, autonomy and resources to carry out their responsibilities.

The PECC guidelines (see **14.2** above) in relation to the separation of powers are a useful model particularly as they have been developed in a region where some may have thought that the diversity of culture and legal systems would render it impossible to develop any guidelines for use throughout the region.

It is important that in the separation of powers and setting up board committees that one does have regard to the realities of the particular corporation. Consideration must be given by boards to ensure that the structure not only addresses the needs of good governance, but is also workable and practical, having regard to the needs and risks inherent in that corporation.

Conflict of interest **14.8**

Some conflicts of interest are obvious and easily recognised, some however may be difficult to identify and may be rationalised as no more than a perception of conflict of interest.

Having been both chair and managing partner of a very large law firm for nearly 10 years, the issue of conflicts of interest and how to deal with them have regularly arisen for the contributor because of the nature of the special responsibilities lawyers have with their client's to ensure that their counsel is impartial.

Plainly, in a corporate sense, there is a clear conflict of interest to have independent auditors represented on the board, and legislation such as the Sarbanes-Oxley Act in the USA has recognised that there is also a clear conflict of interest if the audit firm is providing other services to the corporation whether they be accounting, consulting and more recently, legal services.

Some would suggest that the management of conflicts of interest is a complicated and difficult task. This doesn't have to be the case. People generally recognise that there is an actual, potential or perceived conflict of interest by simply asking the question or trying to rationalise a way a conflict of interest situation may arise.

The contributor has had partners speak to him on many occasions when wanting to take on a matter, and the conversation will open with the line '*I don't think this is a conflict of interest but ...*' The response given is usually along the lines that having asked the question, you obviously feel that there may be a conflict, if not actual at least perceived, and in those circumstances, really need to back out.

Another simplistic test used has been the Sydney Morning Herald test. That test is to ask oneself the question when considering whether there may be a conflict as to how it would look on the front page of the morning papers.

As has been discussed above, one of the reasons for having good governance is to engender confidence that there is transparency and openness. The failure to properly manage situations where there is an actual, potential or perceived conflict of interest, strike at the heart of engendering confidence in the operations of any corporation.

Some corporations seek to deal with the issue of conflicts of interest by establishing rules excluding people from voting, requiring them to leave meetings and so on. Such rules often do not really address the issue of substance in relation to a conflict of interest.

Just because a director withdraws from a meeting at which there is a discussion about engaging a company in which that director has an interest, does not resolve the conflict of interest problem. The question still remains whether or not the director participates in the discussion as to whether it is the right thing to do to give a significant contract to an entity, which will give a director, directly, or indirectly, a significant financial advantage.

More significantly as good governance is about confidence and transparency, how will such a decision look on the front page of the morning papers or the nightly television news and impact a feeling of confidence in the governance and operations of the corporation.

The issue of conflict of interest can often come up without thinking when there is discussion about appointing a particular person who is a director of a corporation. The issue is not necessarily whether it creates an actual conflict of interest, but rather, whether it creates a potential or perceived future conflict of interest, which diminishes a feeling of confidence in the corporation.

Often, boards may debate the appointment of a person and seek to rationalise away potential or perceived conflicts of interest having regard to some extraordinary skill that the individual may have only to face a barrage of criticism five years later for the appointment, a fall in the share price because of lack of confidence in the stock market and possibly an investigation by one of the regulators.

Some argue that if one adopts a policy of absolutely avoiding potential conflicts of interest on appointment of directors, it may reduce the available pool of people with relevant experience and expertise, in my view, this argument is overstated.

One advantage of absolutely avoiding conflicts of interest would be to push the search process for new directors out beyond the usual 'network' from which directors are obtained, which of itself adds new and independent thinking to a board and reinforces good governance.

Changes in accounting practices 14.9

Whilst the causes of corporate failures are many and varied, they usually emerge because of a financial crisis and the company cannot pay its debts.

The classic defence by most directors following a serious corporate collapse is that there were misled by the information provided to them, often the most critical information about which they complain is the accounting or financial information.

Legislators and regulators have endeavoured to address this issue by working with the accounting profession to tighten up the use of international accounting standards and practices, and to ensure that the need for compliance with internationally accepted accounting standards is more than simply to ensure compliance with rules of an accountant's professional body but has become law and the failure to comply with accounting standards renders officers of corporation and the auditors who acquiesce in non-compliance liable to prosecution.

In almost every large corporate collapse, one can identify problems in the accounting systems of the corporation and manipulation of financial material either to conceal fraud from being detected or simply to enhance the financial justification for a particular strategy or proposal and to make things look better than they really are.

There are often good reasons within accepted accounting standards for changing the way in which a corporation may account for a transaction, and accounting concepts are not static and will continue to evolve just as the corporate world itself evolves and becomes more complex.

There are the traditional scams as evident in companies such as Enron and Worldcom where expenses are capitalised to improve the bottom line or assets are included in balance sheet inflated values to preserve the perception of underlying value for the corporation.

There are also more subtle approaches such as avoiding writing down assets, which may have entered the accounts of a corporation at a real figure, but which have lost value over time.

In the HIH Royal Commission, Justice Owen made reference to 'Aggressive Accounting Practices' within HIH (Volume 1 at xivii) he commented:

> 'Put bluntly, HIH management recognised that the group was underperforming at a level that could not be sustained. But it failed adequately to respond to the underlying causes of poor performance. Instead, it used and relied on questionable accounting transactions giving rise to doubtful accounting entries, which disguised the seriousness of the situation and the consequences of leaving it unchecked. The process was fatally flawed.'

A common theme in relation to major corporate failures in recent years is that they have all occurred after a period of significant growth (or at least perceived growth). Often these corporations move into new markets, which create difficulties for the corporation. The directors then find it hard to control or manage that growth process, and combined with a lack of accurate financial data don't know whether the growth is producing real profits or whether there is sufficient underlying funding to sustain it.

AMP is one example where it sought to rapidly grow its business in the UK. It entered into a process of acquiring a number of businesses utilising initially high levels of cash reserves. The process ultimately proved a disaster and only the considerable underlying strength of the company enabled it to survive.

Most growth initiatives are announced by boards and management with great gusto. Problems of management and control are often swept aside or concealed to avoid loss of face. Sometimes management will simply change overhead allocations in management accounts or expense the costs of the new venture against an existing profitable division when providing information to audit committees and boards.

While one cannot expect an audit committee to carry out the role of the external auditors, one area where an audit committee must be extremely vigilant, particularly during a period of rapid growth, is to ensure that it obtains clear and transparent explanation for any changes in accounting practices.

It is often the case when an enthusiastic new CEO comes to a company that after embarking on the usual cost cutting regime which seems common to most new chief executives, they will then put to the board a strategy for growth and put in place a number of new senior executives who that person perceives will be their allies in supporting the new CEO strategy and providing information which justifies that strategy.

This issue particularly arises where the new CEO comes from outside the organisation, often with a brief from the board to implement a change of direction. That person will report to the board a need to change senior executives because they may not be aligned with what the new CEO perceives to be the brief.

A new CEO shortly joined by a new chief financial officer appointed by that CEO and changes in the management accounting system and reports is something which an audit committee and board should treat with extreme caution.

The audit committee may lose the capacity and information because of changes in the management accounts and reporting systems to compare financial data under the new regime with what they received before. Often a new CEO will seek to justify changes, including changes in a chief financial officer on the basis that they are necessary to move the organisation forward, and existing senior management is unwilling to embrace change.

An audit committee and a board will often have some reservations to see the departure of a long-standing chief financial officer known for producing timely, informative and accurate information, but will be faced with a new

CEO who they have hired and who if they resist the proposed changes will assert:

> 'These are management issues. If you tie my hands there is no point in giving me the job or the brief set for me on my original appointment.'

Often new CEOs will, through this pressure, secure acquiescence of the board, and the consequence will be that the first step has been taken which causes the board and audit committee to lose the capacity to properly compare the results of the corporation under the new strategy with the old.

These issues are difficult to deal with. Boards must ensure that the corporation does not stagnate, that it is infused with new people and new ideas. In this process, some will not embrace change, and there will be staff turnover often at levels close to the new CEO.

Boards, consistent with the concept of separation of powers, must avoid becoming embroiled in day-to-day management, the new CEO, if that person is to succeed must be given an opportunity to bring about change and put forward new strategies.

A board and particularly an audit committee in order to effectively deal with these matters need to have people with appropriate technical experience if they are to manage the risks inherent in the change process or will lose control over their capacity to understand the financial position of a corporation during the period of change.

It is not good enough for an audit committee to simply leave this task to the external auditors. Many of the changes in accounting and reporting which can cause future problems will be perfectly acceptable under ordinary accounting standards (e.g. changing overhead allocation), and it should be noted that in all cases of a major corporate failure there was a signed audit report.

The most devastating comment one can hear from an audit committee or a director of any corporation when considering management reports is that they don't understand the report.

As has been mentioned in **Chapter 8**, good governance requires that boards of directors insist on management making themselves understood so that the board can make an informed and considered decision.

It is appropriate for a board to send back to management any material they do not understand, which is given to them for approval or to justify any strategy or proposal put up by management particularly the financial aspects of the proposal.

External advice to assist in good governance **14.10**

As with organisations elsewhere, many corporations in Australia, as part of their governance process, specifically provide for directors to obtain external advice and assistance when examining material put to them. This is a good concept to incorporate into any governance structure, but careful thought must be given as to how it is put into place in practice, in particular, the problems created by the individual directors all seeking independent advice on issues put before them.

As indicated above, it is important that boards ensure that what is put to them for consideration is presented in such a way so that they can understand the issues, the financial data and the risks.

External advice should not become a substitute for directors exercising their own mind and coming to their own views or worse a device to pass their obligations to a third party. A board of directors is a body not unlike a cabinet, and cabinet solidarity is important. There is nothing more destructive to any organisation both internally and from an external perception than to have a divided board.

The chair has a heavy obligation to ensure that there is a free flow of discussion and that the chair is not seen as a servant of the CEO or management or taking the place of a very dominant CEO, as occurred in the case of HIH.

Undoubtedly, there will be issues, which come before a board from time to time where there is very vigorous debate and strongly held views by directors. At the end of the day, notwithstanding the personal views any particular director has, it is critical that the board comes to a decision and any individual director, whose views have not been accepted, must either live with the decision or resign from the board.

A process where disaffected directors as individuals can use the capacity to obtain external device to overturn what otherwise may be a clear majority decision is bad in terms of governance, bad for the corporation and ultimately bad for all stakeholders including creditors and shareholders.

On the other hand, if a governance policy which enables directors to obtain external advice is to have any substance, there must be a process for examining issues carefully and preferably for the board, even those members of the board that may disagree with a director to come to a view that the director's wishes to obtain independent advice should be respected. In that case, it would be the board as a whole which seeks the independent advice before moving forward.

Plainly, the role of the chairperson in facilitating this process is critical, and it is vital that the chairperson exercises their authority in a way consistent with the judicial oath which requires judges to determine cases without fear or favour, malice or ill-will and most importantly, having regard to the interests of the corporation and all stakeholders as a whole.

HIH: a case study of a catastrophic failure in corporate governance

Brief history of HIH 14.11

HIH began in 1968 with Ray Williams and Michael Payne setting up an agency arrangement for two Lloyds of London Syndicates. The main business was workers' compensation, particularly in Victoria followed by Tasmania and other states.

A pattern of growth began in 1971 when the company then known as M.W. Payne Liability Agencies Pty Limited acquired C.E. Heath PLC, a public company based in the UK and the group's name changed to C.E. Heath Underwriting Agencies Pty Limited, Ray Williams continued as a director and chief executive, becoming a member of the Board of C.E. Heath PLC in 1980.

Core business was workers' compensation insurance until changes in the statutory insurance schemes in the States of Victoria and South Australia reduced indeed, in many ways virtually eliminated that class of insurance in those states and it was then decided to try and enter off-shore markets in Hong Kong in re-insurance and workers' compensation in California.

The Australian company acquired all of C.E. Heath PLC's Australian business in 1989 and as part of the arrangement, 10% of shares in the Australian company were held by management including Williams. In 1992, additional non-executive directors were appointed to the Board, which included a former partner at Andersen's, then auditor of the company becoming chairman.

The company was listed on the Australian Stock Exchange in 1992 and became a public listed general insurer with local executives holding approximately 11% of the issued capital of the company and the balance being held by C.E. Heath PLC, and the public holding about 45% of the issued shares.

In 1993, the new listed company sought new business in the UK Payne, one of the original founders, having been appointed as chief executive of a newly established UK subsidiary, Heath International Holdings (UK) Limited.

After 1995, there was a change in the company's core business to public liability and professional indemnity insurance, and the period of rapid growth began with the acquisition of CIC. Winterthur became the major shareholder in place of C.E. Heath PLC, but Winterthur did not exercise its entitlement to take control of the board.

In May 1996, the company changed its name to HIH Winterthur International and it had become the second largest general insurance underwriter in the Australian market and moved ahead with further acquisition including Colonial Mutual.

In January 1998, Winterthur disposed of its interest in HIH, which saw a dramatic change in the profile of the HIH Share Registry, by October 2000, the vast majority of HIH shares were held by people with a holding of fewer than 5,000 shares, which meant that the only dominant block of shareholders was the senior executives.

In 1998, HIH acquired FAI (with virtually no due diligence), and overseas operations in the USA and the UK continued to expand.

In March 2001, HIH went into liquidation with a shortfall of between $3.6 billion and $5.3 billion. So great where the consequences, the Australian Federal Government had to establish a support scheme for hardship cases which by February 2003 had received 11,400 applications for assistance.

HIH lessons learned: key factors and risk indicators 14.12

There are many lessons that can be learned from the collapse of HIH and applied by boards and board committees to ensure good governance. Some are blindingly obvious and have been the subject already of action by the government and regulators, others more subtle noting HIH had all the 'forms' of governance, but they had no 'substance'.

The underlying causes of the collapse of HIH are not unique and can been seen in nearly every major corporate failure, and if recognised and understood do provide practical guidance for those responsible for corporate governance to ensure the same mistakes are not repeated, they include:

- Do not be seduced by ambitious proposals that focus on growth, growth is important for the survival and prosperity of every business, but it must be manageable and profitable or it will kill the company.

  Warning! – Many CEOs and executives have contracts, which focus heavily on bonuses for growth. Proposals must be examined with rigour by boards and audit committees to ensure they are good for the company and not just the executives' ego or remuneration package.
- Be wary of growth outside core business. HIH's move into different areas of the insurance market and different geographical markets took it outside its existing skills and knowledge base.

  Warning! – Boards must test proposals and be satisfied that any move outside core business or geographical markets is supported by analysis from people with the requisite knowledge and expertise which will often have to come from outside the company.

  If the project proceeds the board needs to be satisfied that the company can put in place the required skills and systems to manage the project and the costs of these additional resources are properly included in any cost–benefit analysis and not left out to make the project appear more attractive.
- A board which comprises executives who can dominate the decision making process is high risk from a governance perspective.

  Warning! – The role of the board is to provide the primary checks and balances on the CEO and senior executives. It must be robustly independent. It is high risk to have a board, which can be dominated by a strong-willed CEO, backed up by senior executives.
- The FAI acquisition by HIH was an example of a total failure in governance. Neither the board nor the audit committee played any significant role in laying down due diligence requirements. The reality is that there was no proper study of FAI, and the CEO and senior executives pushed it through the board.

  Warning! – Management may pressurise a board on an acquisition because of the threat, someone else will get the deal and put aside due process. Often this factor is exaggerated.

  Boards will inevitably be asked to consider acquisitions. It is vital for good governance to establish basic processes and procedures to evaluate future acquisitions before being placed under pressure by management to approve a specific deal.
- Boards should set clear guidelines, procedures and information required for management, which must be complied with when bringing proposals to the board. Whilst there may be a need and good reason to make an exception, then

at least everyone knows to be more careful because it will be treated as an exception. Directors after the event will claim that when a decision was made there was a lack of information or they did not fully understand the deal.

Warning! – Most bad decisions that haunt boards and destroy companies do not involve day-to-day matters, but acquisitions or deals, which turn an otherwise successful company into a financial wreck.

- If the board does not understand, it must not allow itself to be bulldozed by threats of resignation by CEOs. The proposals must be sent politely back with a request that it be reviewed and management must explain, so that the board does understand and is convinced. This only has to be done a couple of times to firmly establish the right culture and is a good discipline for management and readily accepted by good quality executives. HIH had a high risk that it could not develop a culture of good governance as a public company because those who really controlled the company had no checks or balances to ensure that the changes were made from when it was essentially a private company owned and run by Payne and Williams both of whom were strong personalities.

  The core team remained the same and the addition of several external directors by the invitation of those in control entrenched this problem, which was confirmed as early as 1995 in an independent due diligence report on HIH. An opportunity for change was missed when Winterthur did not take a role on the board as a major shareholder and when they sold out any prospect for the public shareholders of someone outside the management team exerting any influence or control was lost and from then until liquidation the worst decisions were made.

  Warning! – Whilst good governance is vital, in every organisation it is a critical issue to consider when a closely controlled company becomes a public company.

- Governance was hopelessly compromised in HIH in relation to the only potentially independent check on the activities of the company by appointing partners of the audit firm (originally appointed before listing in 1973) to the board and one becoming the group finance director. The Royal Commissioner heard evidence of how attempts were made by management to influence the work of the auditors.

  Government and regulators have addressed the most obvious conflict of interest issues preventing auditors from being appointed to boards and key positions, but this does not remove the more subtle actions which can compromise independence.

  Warning! – Boards and their audit committees must be uncompromising in ensuring that the auditors are not only independent, but see themselves as reporting to the board and audit committee and guard against the prospect influence by meeting with the auditors without management and changing auditors on a regular basis or appointing another firm to review the auditors from time to time.

- At the heart of the operation of any company, is its financial and reporting systems and their capacity to report in an accurate, understandable and timely fashion on how the company is going today and where it is travelling. The integrity of this information is critical to the board and the audit committee.

These systems are used to generate management accounts and reports used to manage day-to-day operations, and are in many respects much more important than annual accounts whose value is largely an historical perspective. Good previously stable accounting, reporting systems and processes can often fail during periods of rapid growth particularly geographical growth remote from head office and require special attention during times of rapid change. There were no controls on or questions asked as to whether the process of growth was profitable, management accounting was unreliable and the company was adopting a fire-fighting approach in dealing with cash flow and day-to-day operations, at the same time trying to absorb new acquisitions.

Whilst accounting standards exist for annual accounts, in many companies' management may not follow these standards on day-to-day reporting (sometimes for very sound and legitimate reasons).

As accounting practices at HIH became more aggressive to cover up problems and to keep the regulator at bay, some of those involved may be convicted of offences under the Australian Corporations Law. The real problem was not so much one of deliberate fraud, but rather a situation where no one had any idea of the true financial position of the company.

Warning! – Boards must through the audit committee, ensure that proper processes and procedures are in place to ensure the integrity of management accounts.

- Board must be vigilant when management makes changes to reporting and timeliness of management accounts. New projects must be evaluated in accordance with existing reporting so the outcomes can be properly compared with current operations or prior years.
- Allocation of overheads in divisional reporting must be watched as it can be used to cover problems or make a new project look more attractive, and one must look critically if it is suggested that profitability for a new venture should be examined on a special or different basis from that normally followed in the company.
- Whilst the arrival of a new CFO or CEO will often see suggested changes in reporting, be cautious to ensure comparability is not lost, and financial results they claim credit for are not enhanced or exaggerated by the change in reporting.
- Be cautious when suggestions are made to develop or introduce new accounting systems for internal accounting. The introduction by HIH of the GEN+ system introduced in 1997 was said by the Royal Commissioner to have significantly impaired the ability of management and the board to operate HIH's business.
- In the accounting and reporting area do not be seduced by enthusiastic management pushing 'leading edge' concepts. Like most technology, the first user is the guinea pig used to iron out the bugs, it is dangerous especially if such change is made during rapid growth, or changes mean the risk of losing the capacity to obtain financial information needed to manage the company.

Whilst it is easy to ascribe all the blame for the collapse of HIH to Ray Williams who was clearly a major force in the company because of his role as a founding father and his strong personality, the failure in governance is also a reflection on those who were supposed to be watching over the interests of all shareholders and policy holders, that is to say the other senior executives and non-executive directors.

The culture of HIH ignored any concept of governance. In spite of having structures creating an appearance of a governance system, the reality is there were no checks and balances at HIH to make those responsible for the operations of the company stop and think about the impact on the company of proposed acquisitions and force them to demonstrate whether the proposed acquisitions would in reality add real profit and growth to the company, rather than simply mass.

Mr Justice Owen standing back from his work as the HIH Royal Commissioner expresses the view at page 133 of his report:

> ‘For me, the key to good corporate governance lies in substance, not form. It is about the way directors of a company create and develop a model to fit the circumstances of that company and then test it periodically for its practical effectiveness. It is about the directors taking control of the regime they have established for which they are responsible. These concepts do not lend themselves easily to specification in something such as a code of best practice. That is why I have not made any formal recommendations.
>
> One thing is clear, though. Whatever the model, the public must know about it and how it is operating in practice. Disclosure should be a central feature of any corporate governance regime. Shareholders, potential shareholders and the wider public are entitled to real, meaningful detail about the way the directors say they are carrying out their stewardship roles.’

Emerging issues: going international 14.13

Increasingly corporations are moving out of the traditional jurisdictions and geographical markets to take advantage of opportunities in new markets. For Australian companies Asia is seen as a key ‘new’ market in particular China and India.

These markets in emerging economies create new challenges for corporate governance as their legal systems and business cultures can be outside the skills and experience of many directors.

The recent Royal Commission into AWB Limited, the company responsible for selling Australia’s annual wheat harvest, has highlighted the challenges and problems of corporate governance operating in an emerging market. AWB management was keen to sell wheat to Iraq after the first Gulf War, the United Nations had imposed sanctions to preserve this market. AWB management had to pay ‘facilitation’ fees and sought to hide these fees by inflating transport costs.

The Royal Commissioner’s findings resulted in senior management being dismissed the credibility of the company being seriously damaged, a significant decline in the share price and the Australian Government being pressured to remove the monopoly held by the AWB as the sole trader of the entire Australian wheat crop, this right being a major asset of the company.

Whilst many countries have put in place legislation to enable their nationals and companies to be prosecuted for corrupt practices in international markets, the real effectiveness of this legislation has not been fully tested, and the AWB Royal Commission really for the first time highlighted the risks and governance issues which must be considered by directors of companies operating in these markets.

Issues which must be considered include:

- Whilst price and profits may be attractive, should a company as a general principle contract with parties known to be corrupt?
- Can directors who insist strict compliance with all aspects of the law in their own jurisdiction justify, excuse or ignore compliance in a foreign market or jurisdictions?
- Can/should directors accept from management when questioned about a foreign deal that 'it's the way they do business' don't worry it's not like Australia?
- How do directors critically evaluate proposals put forward by management if the market, legal concepts and business culture is outside their knowledge and experience?

There are countless examples of a management team identifying what is described to the board as a new or unique opportunity in a foreign market, persuading the CEO or a chairman to travel to this market and meet people who they are assured are 'well connected' and can by-pass red tape and other procedures (how is not explained nor the legality).

Once buy-in is secured from a CEO or chairman, the management (because of their perceived special knowledge and connections) are left to run the project, and often the project is not subject to the normal controls and evaluations processes applied to a similar domestic project, reporting is not as transparent and one day a crisis emerges as happened to AWB.

Whilst often a board will ask management to provide copies of legal advice on a project confirming compliance with local law, this is not the case with many deals in emerging markets sometimes a request for written advice is dismissed on the basis there is no rule of law other times on the basis 'do you really want to know'.

Companies have purported to invest in land deals in some emerging markets without telling directors that under local law foreigners are not entitled to buy land and in fact there are a series of 'side' deals to by-pass local laws. Prestigious law firms have sought to open offices in countries where foreigners are not entitled to practice law or require a foreign lawyers licence, but describe themselves quite falsely as 'business consultants' in that jurisdiction and in their home country marketing material refer to their 'office' overseas.

Often the first knowledge a board has of problems is when a large long-term debtor appears and only then is it explained that because the deal is not totally legal, there is some convoluted arrangement to facilitate payment because proper approvals do not exist.

Much has been written about the importance for good governance of having within boards a diversity of skills, professional qualifications and practical business experience. The challenges in dealing with business in emerging markets highlight the need to continually review the composition of the board to ensure that there is the right mix of skills having regard to the current or proposed business of the company and, if that is not found within a board, either seeking directors to fill the gap or securing for the board independent external advice to assist the board.

The board of a company proposing, for example, to invest in China should give serious consideration to appointing a director with Chinese knowledge and experience and briefing themselves on issues relating to good governance and good business so they can critically review proposals from management.

Based on an independent briefing from people with relevant expertise, boards need to clearly articulate to management the policies and processes which management must follow in developing project and bringing them forward for board approval.

Good governance policy requires boards to ensure not only compliance with local law, but also that there is compliance with the law in the foreign jurisdiction. Failure to do so can expose them to prosecution in their own jurisdiction, but as with the case of AWB can seriously expose the company in the foreign jurisdiction.

Conclusion 14.14

It is impossible to canvass every possible aspect of good governance in this chapter. The concept of good governance is one which evolves, as does each corporation, on a daily basis. The establishment of forms and structures will not create good governance; there are many examples of organisations that have successfully operated without a set of rigid rules for hundreds of years.

The constitution of the UK was never written down unlike the constitution of the US or Australia, and yet there is a process of good governance under the Westminster system that has worked effectively for hundreds of years.

Good governance will not prevent cheats and charlatans from taking advantage of an organisation, but will discourage them and, when they have a go, help to identify the problem faster and minimise the potential damage they can cause to an organisation.

Good governance is not a committee or a set of rules, but a culture which works effectively if people responsible for corporations recognise the economic value and basic morality of doing the ‘right’ thing. The structures of governance will only be effective if this culture or set of basic beliefs is embraced by the corporation.

Good governance requires a regular review to ensure that there are policies and practices in place which are relevant to both the current and future operations of the company. Moreover special care needs to be taken when considering proposals to operate outside the home market where the rule of law and legal principles may not be as well developed.

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15

Corporate governance in Japan

15 Corporate governance in Japan

CHAPTER OVERVIEW **15.1**

In the aftermath of World War II, Japan experienced miraculous economic growth that averaged around 10% a year from the mid-1950s until the oil crisis of the early 1970s. Following the bursting of the economic bubble in the early 1990s, Japan entered a period of economic stagnation which some commentators have dubbed the 'lost decade'.

Once again Japan's economic expansion appears to be on a firm footing led by robust corporate growth. The risk of renewed deflation and flat wages, though, present real issues. However, the shrinking labour market due to a rapidly ageing society may lead to wage increases, growth in consumer spending and healthy inflation.

In view of current trends it is important to include an overview of the approach to business in Japan, bearing in mind its traditional culture, as well as the clear needs of due diligence, risk management and corporate governance required by the global regulatory framework.

The core problems of corporate governance in Japan 15.2

One school of thought has long held that Japan is a trust-based society rather than a contract-based one. A by-product of this is that bureaucratic informalism has often been seen as being supreme over law. In the words of one commentator:

> 'The avoidance of legal regulation and coercive state control must be viewed as among the most prominent characteristics of governance in postwar Japan.'
>
> (*John O. Haley, Authority without Power, p. 166, 1991*)

As a result of the system of cross-shareholding among major Japanese corporations, a lack of independent directors and a legal system that discouraged shareholder derivative suits, minority shareholders in Japan had little recourse against directors of corporations until the early 1990s. The collapse of the economic bubble forced Japan to re-evaluate its economic model, which led to several substantial revisions of the Commercial Code ('Code') and, ultimately, enactment of the new Corporation Act ('Act').

In a landmark decision in 2000, the Osaka district court ordered 11 current and former directors of Daiwa Bank to pay approximately US$775 million in a shareholder derivative action for failing to adequately supervise a rogue trader in the bank's New York office who lost more than one billion dollars. Of particular relevance was the fact that the court disregarded the informal consultations that the bank had had with the government and instead chose to focus on the fiduciary duties of the directors. The decision had a significant impact on corporate governance in Japan. According to one long-time Japanese specialist:

> 'The resulting "Daiwa shock" had a far-reaching effect in Japan similar to the combined impact in the U.S. of the leading Delaware cases of *Van Gorkom and Caremark'.* (Bruce E. Aronson, *Reconsidering the Importance of Law in Japanese Corporate Governance: Evidence from the Daiwa Bank Shareholder Derivative Case*, 36 Cornell Int'l. LJ 11, 13 (2003)).

In fact, post-Daiwa, compliance and the proper method of corporate governance became hot-button issues within Japan's corporate and legal communities. The new Act was enacted on July 2005 in this environment. The Act provides a company with flexibility in choosing a corporate governance system depending on the size and type of corporation. It requires certain larger corporations to adopt a proper internal control system based on board resolution, while it allows for smaller corporations to institute a less strict governance system.

Moreover, to provide more appropriate protection to investors in securities and other financial instruments and to ensure further oversight of publicly listed companies, the Financial Instruments and Exchange Law was passed in June 2006, as an amendment to the Securities Exchange Law. This new law provides for, among other elements, regulations modelled on the US Sarbanes-Oxley Act. Consequently, the law is now more commonly known as J-SOX. The effective date of such regulations is postponed to April 2008, while other provisions of the new law have already become effective.

New corporate scandals surfaced following the Daiwa shock. The most notable scandal resulted in the de-listing of Livedoor Co. Ltd. ('Livedoor'), an Internet service provider, from the Tokyo Stock Exchange (TSE) in April 2006 and the ultimate prosecution and imprisonment of its charismatic founder Takafumi Horie on charges of securities fraud (including window dressing and share-price manipulation) in March 2007. Prior to prosecution, Horie, in a failed takeover bid, had acquired a 35% stake in Nippon Broadcasting Systems in after-hours trading by using a loophole in the securities law. He even attempted a run for Parliament, hand-picked by the then Prime Minister Junichiro Koizumi. Many commentators sensed more than a hint of satisfaction among Japan's business establishment at the punishment dealt Horie for his swashbuckling and 'un-Japanese' ways. Further types of corporate scandals followed, some involving the violation of laws and regulations on the manufacture or sale of products, such as food products and construction materials. (c.f. Chapter 7 Case Studies) Especially egregious was the fact that some of the corporations at issue continued illegal activities even with the knowledge of such violations. These series of scandals have created a keen awareness of the importance of establishing a proper system of corporate governance.

TSE criticism
At the end of 2007 the TSE President, Atsushi Saito, criticised top Japanese companies for their weak corporate governance and warned that poor financial disclosure risked undermining the country's capital markets, thereby damaging its competitiveness. Japan ranks 38 among 49 in terms of corporate governance according to Governance MetricsInternational, well behind Peru, Poland and Venezuela. Mr Saito has also criticised the lack of understanding in Japan regarding what it means to be a listed company. Tomini Yano, executive manager of the Pension Fund Association, one of the world's largest pension fund managers has agreed that Japan has been slow in taking up the issue of corporate governance and has also urged the TSE to show more leadership to encourage an improvement in corporate governance by listed companies.

Japan's whistleblowers arrive 15.3

For many Japanese consumers, 2007 was 'Annus Mislabelus', or The Year of Mislabels! Their faith in a slew of venerable Japanese producers went sorely tested as food mislabelling scandals – false expiration dates, reuse of old products and the misrepresentation of ingredients and their origin – turned into something of an exasperating 'Here we go again' spectator sport spanning the entire year. (In one extreme case, a company president went missing in the mountains, unsuccessfully attempted suicide and returned to admit his company's 10-year history of labelling misdeeds.) Yet traditional Japanese brands were not the sole transgressors (see also **Chapter 7**). Even McDonald's weathered a mislabelling scandal when one of its Tokyo franchisees sold dated salads as new.

The scandals, all violations in one form or another of Japan's stringent Food Sanitation Law or the equally exacting Law for Preventing Unjustifiable Lagniappes and Misleading Representation or both, were especially vexing to those who had habitually sought out and even paid extra for Japanese-produced name-brand delicacies – be they, to name but a few scandal-tainted products, bean-paste cakes from a 300-year-old maker in Ise, Hokkaido white chocolate cookies, a gourmet breed of chicken from Akita or a ubiquitous Yokohama-based confectioner's cream puffs.

Most noteworthy from a corporate-law perspective was the fact that the majority of scandals resulted from information received from whistleblowers. Observers with an interest in corporate governance could not help but note the whistleblowing parallels to the Enron and Worldcom corporate accounting scandals.

Whistleblowing, or *naibu kokuhatsu* (literally, exposure from within), and Japan have never been synonymous. Loyalty to one's company – regardless of its questionable practices – has long prevailed as something of an unspoken worker's motto. With the passage of The Whistleblower Protection Act in 2004, however, employees who report on the illegal activities of their employer are legally protected from termination, demotion and cuts in pay. Further, the Corporation Act's requirement of a proper internal control system is now largely understood by most corporations to include the implementation of an in-house whistleblower complaint handling system.

Competing theories abound about what is really behind Japan's burgeoning class of whistleblowers. Yes, many have been emboldened by public sentiment that is more suspicious and critical of Japan Inc. and the government than ever before. And, yes, Japan's lifetime employment system has suffered from severe erosion. Employees and employers are no longer wedded to one another forever. Moreover, interest and awareness among Japanese in food safety is at an all-time high given a number of scares involving chemically tainted Chinese products imported to Japan.

What is fundamental is that both The Whistleblower Protection Act and the Corporation Act created the legal framework in Japan that now provides the means for whistleblowers to step forward and report criminal information to the company itself or the appropriate authorities.

The remainder of this chapter seeks to provide the reader with a snapshot of the major issues under the Act focusing mainly on those relevant to large and public corporations.

General meetings of the shareholders 15.4

While the conventional wisdom used to be that a general meeting of shareholders in Japan was largely ceremonial, this is no longer the case. In fact, the current trend in Japan is towards more active shareholder participation in general meetings.

Convening general meetings 15.5

An ordinary general meeting should be convened at a fixed time within three months of the end of a corporation's fiscal year (*Articles 296(1), 124(1)(3)*). (*Editor's note*: All references to Article(s) herein refer to the Act unless otherwise indicated.)

An extraordinary general meeting may be convened as necessary (*Article 296(2)*). A shareholder who has been the owner of not less than 3% of the voting rights for at least the preceding six months may demand by request to the directors that an extraordinary general meeting be called. If the directors fail to convene a meeting within a reasonable time of the demand, the shareholder may convene the meeting with the permission of the court. The application must state the matters to be raised at the meeting and the reasons for convening the meeting (*Article 297(1)(4)*).

Each shareholder must be notified of the general meeting in writing at least two weeks prior to the meeting. The written notice should also include the meeting agenda (*Article 299(1)(2)*). The procedures noted above for convening a general meeting can be waived if all of the shareholders with voting rights agree (*Article 300*).

Resolutions of the general meeting **15.6**

The Act provides that the general meeting may only adopt resolutions as to matters provided for in the Act or by the corporation's articles of incorporation (*Article 295(2)*). Each shareholder is entitled to one vote per share, however, the corporation has no right to vote its shares (*Article 308(2)*); provided that the corporation can issue shares with different voting rights if so provided by the articles of incorporation (*Article 108(1)(2)*). Where voting is to be by unit, a shareholder has one vote per unit (*Article 308(1)*). A unit may consist of any number of shares. Where a shareholder has less than the prescribed number of shares of a unit, the shareholder is not entitled to a vote (*Articles 188, 189(1)*). A shareholder may exercise his voting rights even if he does not attend the general meeting by writing or by electromagnetic means, so long as the board of directors passes a resolution allowing him to do so (*Article 298 (1)*). In the case where the number of shareholders is one thousand or more, the board of directors must pass a resolution when a shareholder chooses to vote by writing (*Article 298(2)*). Unless otherwise stated in the articles of incorporation or elsewhere in the Act, a resolution may be passed by the general meeting if the majority of the shareholders present at the meeting, and representing over 50% of the total voting shares of the corporation, vote in favour thereof (*Article 309(1)*).

Under the former provisions of the Code, the statutory quorum requirement for a special resolution of a general meeting was a simple majority of total voting shares. A corporation was not able to relax this requirement even by its articles of incorporation. Under the 2002 amendment to the Code, a corporation may relax this requirement in its articles of incorporation to one-third of the total number of voting shares. This provision remains unchanged in the Act. In such cases, the relevant provision authorising these lesser quorum requirements must be specifically set out in the articles of incorporation (*Article 309(2)*).

When the statutory quorum is met, a special resolution is passed essentially if over two-thirds of the total voting shares of the corporation vote in favour thereof. The Act now authorises a corporation to raise the requirement of the proportion of favourable votes needed to pass a special resolution to over two-thirds.

In cases where directors or shareholders submit a proposal with respect to a matter which is the purpose of the shareholders meeting, and all shareholders agree to the proposal by writing or by electromagnetic means, the proposal is deemed to be passed (*Article 319*).

Ordinarily, it was difficult for small shareholders to place issues on the agenda at the general meeting because the agenda was decided by the board. The Act now provides that a shareholder who has for the last six months held at least 1% of the voting rights of all shareholders or 300 or more voting rights may request, at least eight weeks before the general meeting, that a specific matter be placed on the meeting's agenda (*Article 303(2)*).

Shareholders' rights 15.7

The directors, accounting auditor, auditors or executive officers are obliged to offer explanations on matters as requested by shareholders at the general meeting. The directors and auditors can refuse to provide such an explanation if there are the following reasonable grounds for doing so:

- The question bears no reasonable relation to the agenda of the general meeting;
- The explanation would harm the common interests of the shareholders; or
- In other cases prescribed by a ministerial ordinance where there are justifiable grounds.

A ministerial ordinance prescribes that the directors and auditor can refuse to provide an explanation when the explanation would require further investigation. However, where the shareholder has given reasonable notice prior to the general meeting as to the matters on which explanation is sought, or the investigation is easy, the directors or auditors cannot refuse to provide said explanation on the grounds that further explanation is needed (*Article 314*).

Under Article 358(1) of the Act, if there is cause to suspect that a dishonest act occurred or any serious fact exists constituting a breach of any law or the articles of incorporation in connection with the administration of the corporation, a shareholder who has been in possession of at least 3% of the voting rights of all shareholders or who has been in possession of at least 3% of issued shares may petition the court for the appointment of an inspector to investigate the affairs of the corporation and its assets.

Likewise, under Article 306(1) of the Act, a shareholder who has held at least 1% or more of the voting rights of all shareholders may request that the court appoint an inspector to investigate the procedure for convening the general meeting and the method of adopting a resolution.

A shareholder has appraisal rights in certain circumstances. Notably, a shareholder who opposes any of the following acts by the corporation may, by request prior to the general meeting and the presentation of opposition to the resolution at that meeting, request that the corporation purchase his shares at their value had the resolution at issue not been adopted:

- Alteration of the articles of incorporation where the articles are altered to the effect that a transfer of shares becomes subject to the approval of the board of directors (*Article 116(1)*);
- A transfer of all or a substantial part of the business of the corporation;
- The entry into, alteration of, or rescission of a contract for the leasing of the whole of the business, or giving a mandate to manage the business or sharing with another the entire profits or losses in relation to the business;
- The acquisition of the entire business of any other corporation (*Articles 467(1),469*); and
- Absorption-type demerger, share exchange for another corporation's shares or new-establishment merger (*Articles 785(1), 797(1), 806(1)*).

Finally, a shareholder who has held a share continuously for at least six months may demand on behalf of the corporation that a director who performs any of the following acts refrain from doing so:

- Any act that is not within the purpose of the corporation; or
- Any act which is against the law, and which raises the prospect of irreparable harm to the corporation (*Article 360*).

Directors may not offer benefit to a shareholder for exercise of shareholder's rights 15.8

A corporation may not offer a benefit to a shareholder for the exercise of a shareholder's rights for the corporation's own account or for the account of a subsidiary (*Article 120(1)*). Any director or auditor of a corporation who does so is liable for imprisonment of up to three years or a fine of up to Yen 3 million (*Article 970(1)*).

Sokaiya are individuals typically affiliated with organised crime who buy shares in a corporation and attempt to extort money from that corporation by threatening to disrupt its general meeting unless special payment is made. The former Code was revised to make it illegal for a corporation to make special payments to any person, including sokaiya, in return for the exercise of their shareholder rights (or silence) at a general meeting. While in the past Japanese corporations often held annual general meetings on the same day in order to diffuse the ranks of sokaiya, the situation has changed due to the illegality of special payments. General meetings have become more open and the frequency of healthy shareholder questioning is on the rise.

Alteration to the articles of incorporation 15.9

The articles of incorporation can be amended by a special resolution of the general meeting (*Articles 466, 309(2)*).

The board of directors 15.10

Until the mid to late 1990s, one of the prominent features of the Japanese corporate system was the lack of independent directors. In most Japanese companies the majority of directors were appointed from among the employees. This situation has changed and more and more companies have begun to elect independent directors.

A corporation must have at least three directors (*Article 331(4)*). All of the directors make up the board of directors (*Article 362(1)*). Directors are appointed at a general meeting (*Article 329(1)*). A director's term of office must not exceed two years (*Article 332(1)*); provided that such term must not exceed one year for the corporation providing the directors with the authority to determine dividends (*Article 459(1)*) or the corporation with committees as mentioned below.

The Act prohibits certain classes of persons from being directors, notably those who have within the previous two years been convicted of a violation of the Act (*Article 331(1)*). A shareholder may demand that the corporation hold an election for two or more of the directors by cumulative voting, except as otherwise provided in the articles of incorporation (*Article 342(1)*). The quorum of shareholders necessary to elect directors is basically half of the voting rights of all shareholders. It may be set by the articles of incorporation, but in no circumstances may it be decreased to below one-third of the voting rights of all shareholders (*Article 341*).

A director can be removed from office at any time by an ordinary resolution of the general meeting. However, if a director is removed prior to the fixed term of office without due cause, he may claim damages from the corporation for early termination (*Article 339*).

The Act charges the board of directors with the running of the corporation and supervision of the directors (*Article 362(2)*). The following matters are controlled by the board only and representative directors cannot be delegated authority to address them:

- the disposal of and acceptance of assignment of important assets;
- borrowing a significant amount;
- the election or dismissal of an important employee including managers;
- the establishment, changes to, or abolition of, important structures including branch offices, etc. (*Article 362(4)*).

Historically, most corporations delegated decision-making power to managing directors' meetings or a management committee. This is no longer a given. It is not uncommon these days for the board of directors to function as the actual decision-making body of the corporation.

A resolution must be passed by a majority of the directors present at a board meeting, and the board meeting must be attended by the majority of the directors (*Article 369(1)*). A director who has a special interest in the resolution may not participate in the vote for the resolution (*Article 369(2)*). A corporation may provide in its articles of incorporation that, in cases where directors submit a proposal with respect to a matter which is the purpose of the resolution of board of directors meeting, if all directors manifest their intention to agree to such proposal in writing or by electromagnetic means, it shall be deemed that the resolution to approve such proposal at the board of directors' meeting has been made (*Article 370*). The board of directors may by a resolution of a board meeting elect one or more particular director(s) to represent the corporation (representative director(s)) (*Article 362(3)*).

Article 354 of the Act provides that a corporation shall be liable to a bona fide third party for any act committed by a director from which it may be assumed that the director has the power and authority to represent the corpor-ation even where such director does not in fact have the power or authority to do so.

Finally, in a noted decision, the Supreme Court of Japan affirmed the validity of articles of incorporation that specify that the directors and auditors of a corporation be Japanese nationals (Judgment of the Nagoya District Court, April 30, 1971 (Kaminshu 22–3/4–549)).

Directors' duties **15.11**

Article 644 of the Civil Code (applied by the Act in *Article 330*) creates in a director a duty to manage the affairs of the corporation with the due care and skill of a good manager. The Act also places an obligation on directors to not only obey the law, the articles of incorporation and resolutions of the corporation, but also to discharge their duties faithfully (*Article 355*). As mentioned above, the board has a duty to supervise the directors (*Article 362(2)*).

Where a director intends to carry on business on his own behalf or on behalf of a third party where such business is of the type usually undertaken by the corporation, the director must disclose all material facts relating to the business to the board and must obtain the board's approval prior to entering into the business (*Articles 365(1), 356(1)*). After entering into a transaction of the type discussed above, the director is obliged to report any material matters to the board immediately (*Article 365(2)*).

Where a director wishes to enter into any transaction with the corporation (whether on his own behalf or on the behalf of a third party), the director needs to obtain approval from the board of directors (*Article 356(1)*). The same applies where the corporation wishes to enter into any transaction with a third party where a director has conflict of interest, such as the corporation's becoming a guarantor for the debts of the director (*Article 356(1)*).

Directors' liabilities **15.12**

A director may be liable to the corporation for damages if they have neglected their duties (*Article 423(1)*).

A director is liable for the losses of the corporation regardless of his own negligence in the following instances:

- Giving property benefits to any person regarding the exercise of shareholders' right (*Article 120(4)*); and
- Executing a direct conflicting-interest transaction for one's own benefit (*Article 428(1)*).

In some cases, such as illegal dividend, a director has the burden to prove that they did not fail to exercise due care in discharging their duties (*Articles 462(2), 120(4), et alia*).

A director's liability to the corporation can only be absolutely released by the unanimous consent of all shareholders (*Article 424*). Under specific conditions, the liabilities stemming from their negligence (except for gross negligence) can be waived by resolution of the general meeting (*Article 425*), by resolution of the board (*Article 426*) or by contract (*Article 427*).

As for the waiver of liabilities by general meeting, it should be noted that the unanimous consent of all of the corporation's auditors is required for the corporation to submit a proposal for such a waiver at the general meeting (*Article 425(3)*).

As for the waiver of liabilities by resolution of the board, a corporation is required to make the necessary provision in its articles of incorporation authorising the use of this method. Unanimous consent of all the corporation's auditors is required before submitting a proposal for such provision and submitting a proposal of waiver to the board (*Article 426(2)*). The corporation is obliged to issue a public notice of its intention to waive the liability of a dir-ector. Even if the board approves such a waiver in accordance with the above procedures, the waiver will not be effective if shareholders holding 3% or more of the total votes of shareholders give notice of their objection to such waiver (*Article 426(3)*).

Waiver of liabilities by contract is available only to outside directors. Further, a corporation must make necessary provision in its articles of incorporation authorising the use of this method. Unanimous consent of all the corporation's auditors is required before submitting a proposal for such provision (*Article 427(3)*). The corporation must disclose the information of the waiver at the first general meeting called after the corporation acquires the knowledge that it has suffered damages as a result of outside directors (*Article 427(4)*).

Penal provisions 15.13

The penal provisions of the Act provide for up to 10 years imprisonment and fines of up to Yen 10 million. The maximum penalty depends on the specific section of the Act (*Articles 960–974*).

Auditors, accounting auditors and accounting advisers 15.14

Auditors are elected at a general meeting and their role is to 'audit' the activities of directors (*Articles 329(1), 381(1)*). Auditors have two distinct duties: the performance of a business audit and a financial audit. A business audit determines whether or not the directors, in managing the corporation, are observing relevant laws, regulations and the corporation's articles of incorporation. A financial audit is an audit of the corporation's financial statements.

The term of office of auditors is four years (*Article 336(1)*), noticeably longer than the two-year term of directors. Auditors are obliged to attend board meetings and may express their views at those meetings if they desire (*Article 383(1), 382(1)*).

Accounting advisers are those consultants who prepare the financial statements of the corporation along with the directors. Accounting advisers must be a certified public accountant or audit firm, or a certified public tax accountant or tax accountant corporation (*Article 333(1)*).

A large corporation is defined in the Act as a corporation with a stated capital of Yen 500 million or more, or a corporation with Yen 200 billion or more of liabilities according to its latest balance sheet (*Article 2*). A large corporation must choose from the following two organisational schemes:

- Three or more directors, a board of directors, three or more auditors, a board of auditors, accounting auditors (and accounting advisers).
- Three or more directors, a board of directors, committees, accounting auditors (and accounting advisers) (*Articles 327–328*).

The board of directors of a large corporation is obligated to construct a framework of internal controls (*Article 362(5), 362(4)*).

It is important to note that the minimum number of outside auditors is at least half of the members of the board of the auditors (*Article 335(3)*).

Derivative actions **15.15**

Any shareholder who has continuously held a share of the corporation for at least six months may request in writing that the corporation institute proceedings against a director, an accounting adviser, a corporate auditor, an executive officer or an independent auditor ('Executive'), for said Executive's liability to the corporation ('Proceedings') (*Article 847(1)*). If the corporation fails to commence Proceedings within 60 days of such written request, (i) the shareholder may institute Proceedings on the corporation's behalf (*Article 847(3)*), and (ii) when the corporation receives the claim from the shareholder who requested Proceedings, the corporation must, without delay, provide notice to the person who filed the claim as to the reason for not instituting Proceedings, in writing or in another way specified by ministerial ordinance (*Article 847(4)*). Notwithstanding the above, if the corporation may suffer irreparable harm before the 60-day period above expires, the shareholder may institute Proceedings before the expiry of the 60-day period (*Article 847(5)*). In case where the shareholder institutes Proceedings, the court may demand, if the Executive has made such request and established that the institution of such Proceedings is not a proper exercise of the right of shareholder, that the shareholder post a security deposit or suitable collateral (*Article 847(7)*).

The shareholder and the corporation may intervene in the Proceedings as a co-litigant or in order to support either of the parties (*Article 849(1)*). When the corporation intervenes in the Proceedings on behalf of the director, executor or liquidator, the corporation has to obtain the consent of the corporate auditor (*Article 849(2)*). In order to provide the opportunity to intervene in the Proceedings, when the shareholder institutes the Proceedings, the shareholder must, without delay, notify the corporation of the Proceedings (*Article 849(3)*).

Although, as mentioned above, a director's liability (as with other Executives) cannot be released without the unanimous consent of all of the shareholders (*Article 424*), in the case of Proceedings, the corporation may make a settlement of the claim for alleged liabilities of an Executive without the unanimous consent of all of the shareholders (*Article 850(4)*).

Although a provision for derivative actions existed in the Code since 1950 (after being introduced to Japan from the USA), there were few cases involving it until the 1990s. It has been argued that the dearth of derivative actions was due to the prohibitively expensive cost of litigation for individual shareholders. Until the 1993 revision to the Code, the filing fee depended on the amount that the plaintiffs were seeking. Further, even if shareholders succeeded in their action, damages would be paid to the corporation. However, after the collapse of Japan's bubble economy in the early 1990s, directors were blamed for many corporate woes. Further, the number of foreign shareholders in Japanese companies increased. The issue of derivative actions was even raised at the structural impediments initiative talks between Japan and the United States. As a result, the law was changed. The fee for filing a derivative action became Yen 13,000. Shareholders who bring a successful derivative action on behalf of the corporation may now demand reimbursement from the corporation for reasonable litigation expenses (*Article 852*).

Liability of directors to third parties **15.16**

In the event that a director has, in relation to his duties as a director, been found guilty of gross negligence or bad faith, the director will also be liable to third parties for damages (*Article 429(1)*). In addition, where a director has made a false entry on material matters in a written application for shares, pre-emptive rights, the right to subscribe to new shares or in a prospectus, the director will also be liable to third parties for damages. There is one proviso, however. Liability shall not be found when the director can prove that, in performing the act at issue, he or she was not lacking in due care (*Article 429(2)*).

Special directors and corporation with committees **15.17**

The 2002 amendment to the Code, known as the *Law for Special Provisions for the Commercial Code Concerning Audits, etc.* ('Special Provisions'), added a significant new feature to Japanese corporate governance. Under the Special Provisions, large corporations, may, at their discretion, create special committees for the management of the corporation. A corporation has two options, to establish an Important Asset Committee or become a so-called Corporation with Committees. After the enforcement of the Act, Special Provisions was abolished and Important Asset Committee was changed in the Act to the provision of Special Directors. The system of the Corporation with Committees was retained by the Act.

Under the Special Directors system, the board of directors may, where six directors or more are present and one or more is an outside director, provide to the effect that a resolution of the board of directors may be made with respect to the disposition or acquisition of important assets and large borrowing. A majority of three or more directors appointed in advance who are entitled to participate in the vote must be present and the resolution must be passed by a majority of those directors present (*Article 373(1)*). Directors, other than the board of the Special Directors, need not attend the meeting (*Article 373(2)*). A corporation must register the fact that it has established the above provision, and the name of the Special Directors and outside directors, within two weeks of the provision's establishment, in the same ward as the location of the corporation's headquarters (*Article 911(3)*).

This system enables the board of directors to entrust resolutions regarding everyday business as described above to some of the directors, the so-called Special Directors, in order for the board of directors to focus on the more fundamental issues of the business.

Under the system of the Corporation with Committees, a corporation choosing to adopt the committee system is obliged to establish a number of governing bodies, including:

- a nominating committee;
- an audit committee;
- a compensation committee; and
- one or more executive officers (*Articles 2, 402(1)*).

However, such a Corporation with Committees may not have an auditor (*Article 327(4)*), and the term of office of the directors in such a corporation shall not be more than one year (*Article 332(3)*).

The duties of the board of directors of a Corporation with Committees include:

- supervising the directors, the executive officers and accounting advisers; and
- the basic management policies of the corporation.

The board of directors of a Corporation with Committees may not entrust directors of the corporation with any decisions regarding the corporate affairs of the corporation (*Article 416(3)*). However, it may delegate substantial management authority to the executive officers (*Article 416(4)*). Delegating management authority to the executive officers enables the corporation to make decision more rapidly. Affairs of the board of directors are entrusted to a large extent to the executive officers. The Act, however, limits those corporate affairs for which the board can entrust to executive officers to:

- the appointment and dismissal of executive officers;
- the power to convene a shareholders' meeting;

- the determination of the items on the agenda of a shareholders' meeting (with some exceptions); and
- the determination of the items on the reorganisation, such as assignment of business, merger, demerger, share-for-share exchange and share transfer (*Article 416(4)*).

The Corporation with Committees may not adopt the provision of Special Directors (*Article 373(1)*).

The purpose of the nominating committee is to determine the contents of the proposals appointing or dismissing directors at the general meeting (*Article 404(1)*). The audit committee is charged with a number of duties, including: the audit of the execution of duties by the directors, executive officers and accounting advisers; and determining the contents of the proposals appointing or dismissing the accounting auditor at the general meeting (*Article 404(2)*). The remuneration to be received by the directors, executive officers and accounting advisers of the Corporation with Committees is determined by the Compensation Committee (*Article 404(3)*). Each of the above-mentioned committees must consist of three or more directors, the majority of whom must be outside directors (*Article 401(2)(3)*).

The executive officers have the power to determine those matters entrusted to them by a resolution of the board of directors and the execution of the corporate affairs of the corporation (*Article 418*). An executive officer should be appointed by resolution of the board of directors and the term of office should be no more than one year (*Article 402(2)(7)*). An executive officer may be dismissed at any time pursuant to a resolution of the board (*Article 403(1)*). Directors may serve concurrently as executive officers (*Article 402(6)*). A corporation is obliged to also appoint a representative executive officer to represent the corporation (*Article 420(1)*). A representative executive officer may also be dismissed at any time pursuant to a resolution of the board (*Article 420(2)*). Where the corporation has cloaked an executive officer with the appearance of a representative executive office, for example, by giving an executive officer the title of president, senior vice-president or any such similar title, the corporation shall be bound by acts of the executive officer vis-à-vis bona fide third parties (*Article 421*).

Conclusion **15.18**

Passage of the new Financial Instruments and Exchange Law, including the regulations of J-SOX and the enactment of the Act, though somewhat in reaction to corporate scandals such as the Daiwa shock, demonstrate Japan's full-scale shift to a global model of corporate governance. This is true even though benchmarks of USA and global business such as shareholder activism are still viewed from within Japan with suspicion (if not outright derision). It remains to be seen how the corporate governance mechanisms introduced by such new legislation will function in practice.

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Environmental due diligence and risk management: sustainability and corporate governance

16 Environmental due diligence and risk management: sustainability and corporate governance

CHAPTER OVERVIEW

Macro and micro issues 16.1

The comments in earlier chapters have already demonstrated that environmental regulations and trends cover an expanding range of business activities. A comprehensive treatment of this topic would require a separate, book, but some of the key issues may be touched on here. It would be an omission to ignore the vital area of environmental issues in a book on corporate governance and due diligence. Moreover the clear overlap with concerns over climate change (cc) and greenhouse gases (GHGs) should also be considered in such an overview. Therefore considerable attention is given to the repercussions of climate change in this discussion of environmental due diligence (EDD) and risk management.

The recent trends in due diligence and corporate governance have been in favour of corporate responsibility and best practice that go beyond the regulatory frameworks. In a good practice series published by the European Commission's Directorate-General for Enterprise the publication *Responsible Entrepreneurship* (2003) it was stated (p. 32):

> 'Recent decades have seen a marked increase in awareness and public concern about the impact of productive activities on the natural environment. Environmental impacts associated with business operations include:
>
> - inefficient and unsustainable use of natural resource such as oil, gas and water;
> - emission of GHGs such as CO_2 contributing to climate change;
> - emission of pollutants contributing to air and water pollution;
> - long-term effects of hazardous chemicals;
> - the rapid loss of biodiversity;
> - a high level of waste generation and hazardous waste.

These impacts increasingly result from goods and services rather than production processes. Instruments used by business to address such environmental impacts are manifold and include amongst others:

> ‘environmental management systems, both formal (EMAS, ISO 14001) and informal, eco-design tools, cleaner production techniques and technologies and eco-labels’.

In the discussion below some of the instruments are referred to. The main headings in relation to traditional EDD and risk management may be categorised in the following summary:

- air and water pollution;
- hazardous and special waste;
- toxic substances;
- planning;
- pesticides and herbicides;
- radioactive substances;
- employee protection;
- biotechnology;
- statutory nuisances;
- marine pollution;
- environmental information;
- health and safety matters.

There is no doubt that there are many types of liability and responsibility associated with these activities since environmental law is increasingly having an impact on business transactions. The relevance of the environmental performance of a business to its core business activities is a debate that has been evolving over decades. Moreover, several matters covered by this chapter are business issues that have been on the agenda for many years. Accordingly, specific strategies have been developed to avoid or mitigate environmental damage and consequences. Indeed, in the same way as any business transaction is automatically considered from the tax angle, it is imperative to carry out a comprehensive environmental investigation as a matter of good business practice. In addition, as discussed in **Chapter 4**, a business should take account of the important risks of health, safety, social and environmental (HSSE) in the interest of good corporate governance.

The level of environmental management required for any business will depend on the nature of the business and the risks involved. Clearly, therefore, a business handling dangerous chemicals will require higher levels of environmental management than an office-based service business. Businesses may have their environmental management systems (EMS) accredited to the international standard ISO 14001 or to EMAS, the European Eco-Management and Audit Scheme. For some smaller businesses, however, accreditation may be costly and may not always be appropriate. Nevertheless, there is increasing evidence to suggest that a business with good environmental management will generally be well managed all-round.

A survey on EDD by KPMG (*Environmental Due Diligence: A Survey of major UK companies*, May 2004) has provided the following key insights:

> 'EDD has become an important feature of an increasing number of merger and acquisition (M & A) transactions. Interestingly, however, it is not automatically included in the approach many companies take to transaction evaluation, even in sectors at the greatest risk from health, safety, social and environmental (HSSE) issues …
>
> Legal and financial (capital and operating expenditure and liabilities) consequences of HSSE issues remain fundamental to most EDD investigations. But HSSE issues now also impact other business performance variables such as sales, operations, customer relations and reputation – each of which can directly impact the key transaction 'check points' of: sale and purchase agreement; valuation model (and assumptions); deal breaker evaluation; acquisition accounting; post acquisition action planning; and exit strategy (where applicable).
>
> While some companies have made the transition towards a more commercially oriented EDD process, others are part way through the transition, having adapted their assessment process to take account of the business performance issues, but not yet altering the EDD scope.
>
> One of the critical success factors is for companies to have a commercially driven scoping and assessment approach which integrated EDD findings into the legal, commercial and financial due diligence assessments, underpinned by robust technical competencies. The survey data indicates these are the companies which are suffering fewer material issues arising post acquisition and in the long run are more likely to have their M & A succeed.'
>
> Moreover, as regards management procedures and guidance the survey found that despite the availability of good management procedures and guidance many EDD teams 'work without clear internal guidance and procedures'. 'Improving the management procedures and guidance in place around EDD appears to be a clear opportunity for many companies, and may come under increasing internal scrutiny as broader corporate governance reforms come into play.'

Transactional tools 16.2

It is useful to consider the tools that have been available for some time in other jurisdictions. In corporate transactions such as acquisition/disposal of corporate assets and mergers, certain tools are employed in order to discover and make adequate provisions for potential environmental problems. Bearing in mind the above survey findings, however, it is important that the environmental and related issues are fully integrated into the business as a whole.

Pre-contract enquiries 16.3

The most useful means of creating an environmental picture of the vendor company or business is to make appropriate pre-contact enquiries in the form of an environmental questionnaire (see the example of a simple US questionnaire in the **APPENDIX**). This serves as a prompt to identify and perhaps assess the existence of circumstances which, either individually or in conjunction with other similar or linked claims, could lead to environmental liability. The acquisition or disposal of corporate assets requires a rigorous assessment of the vendor company's environmental position. Information needs to be gathered to enable the purchaser to decide on the environmental warranties and indemnities that may be required.

The environmental questionnaire would normally contain a full set of specific questions, answers to which may give an indication as to whether the land or adjoining property is contaminated or not and whether other environmental concerns are present. The following types of environmental liabilities should, for example, be disclosed in response to the questionnaire:

- liabilities which are historical, existing or potential;
- liabilities which concern civil matters such as damages, injunctions or personal injury claims relating to industrial diseases;
- compliance/regulatory matters including liabilities which concern criminal matters such as fines, prosecutions or enforcement action;
- liabilities which reveal capital or revenue cost, whether of a compulsory or voluntary nature.

In addition, the environmental questionnaire will be directed at specific sites which are to be acquired and in this regard the following matters should, for example, be covered:

- liabilities relating to existing sites, closed sites and operating sites;
- eased sites which are no longer owned or operated by the company;
- sites which may have been used by former owners;
- closed operations and practices.

It is advisable to ask the vendor to go back as far as possible – at least 15 years and more where earlier liabilities or incidents of which the vendor is aware should be disclosed. The vendor company should also be asked to give an indication of significant changes or new issues of which it is aware and which may emerge between the date of their response and the proposed date of completion.

The subject matter of the environmental questionnaire should cover:

- details of monitoring and reporting procedures of the vendor company within its own organisation – this should reveal actual and potential problems;
- details of monitoring and procedures for reporting accidents or incidents;
- details of any environmental audit carried out – both internal and external;

- whether the vendor is aware of any health and safety matters affecting its business, plants or sites or industrial diseases caused by its business or operations which could result in environmental liability;
- pending or threatened litigation matters;
- questions concerning disposal of waste produced or otherwise handled by vendor company;
- any internal guidance on landfills or other guidance relating to storage management and handling of waste, whether on or off site;
- details of any known or suspected cases of contamination of land, water or air;
- clean-up obligations in relation to contamination;
- detailed questions should be asked of the relationship with regulatory authorities and related expenditure.

Sample pre-contract enquiries cover:

- details of any litigation with neighbours;
- details of environmental liabilities which have or could be incurred under contract for example by way of indemnities or warranties given by the vendor company.

Industrial sites and their associated activities and sites used for waste disposal or waste disposal practices themselves are particularly high risk when considering environmental liabilities. The site-specific environmental questionnaire should accordingly concentrate on such matters. This would include detailed information on:

- the operations and activities of the vendor company and whether they caused (or may cause) harm to human health;
- discharges or releases into the air, water and land which could cause environmental liabilities;
- materials and chemicals used, stored or disposed of at the site;
- the vendor company should be asked to check that all conditions relating to permits licences and consents used for the business are being complied with and whether they may be revoked.

Sometimes it will be possible to issue a single questionnaire if the size and complexity of the assets/shares being acquired are relatively small. The enquiries should cover:

- the property and its historic uses;
- waste disposal policies of the company;
- usage of storage tanks, on or under the property;
- regulatory compliance and notices;
- civil liability; insurance policy on the property;
- health and safety issues;
- the historic uses of the adjoining land.

Replies to pre-contract enquiries will often indicate that there are environmental concerns that require immediate attention in the transaction. Various matters that might cause concern are discussed below by way of example. In addition suggested guidance is given, although, of course, any business should decide on the basis of the particular circumstances of the case in hand.

The product and raw materials 16.4

Although the vendor may well have a product which does not itself appear to cause pollution, the production process should be checked as it may do so. For example, toxic materials may be used as part of the manufacturing process. In such a case the purchaser is advised to:

- request sight of environmental policy adopted by the vendor;
- require information as to how it is implemented;
- enquire how the vendor company monitors compliance with its own policy.

In addition it is important to carry out investigations relating to:

- the process and previous use of the site.

The purchaser needs to find out from the vendor whether the process may cause emissions which could impose environmental liabilities. In addition previous processes need to be checked. Although they are no longer used, they may lead to current or future liabilities. Checking out the previous use of the site may alert the purchaser as to the possibility of the land being currently contaminated, with all the attendant costs for clean-up that this could bring.

Waste disposal 16.5

Whenever waste is being stored, transported or disposed of, the purchaser must be aware of its waste management responsibilities under the waste management regulations. The vendor should also be aware of its waste management activities and any problems in this connection in order to be in a position to respond to the purchaser's queries.

Environmental consents and licences 16.6

The purchaser should ask to see all environmental consents and licences which are necessary for the business being acquired. In this context, it is particularly important for the purchaser to check carefully the conditions which attach to them and also to take a view as to whether or not these conditions are being complied with, as current liability may arise out of a previous breach of conditions. Sometimes the regulatory authority which has granted a licence may review it, so it is crucial to check whether such a review is taking place. In addition, the purchaser should ask to see copies of correspondence between the vendor company and the regulatory authorities in order to consider what local opinions there are about the industry being carried on by the vendor company.

Site inspection 16.7

It is, of course, a matter of good practice for the purchaser, as well as relevant advisers, to visit the site, as issues that trigger off environmental enquiries may be discovered. For example, there may be a potential risk to groundwater caused by discharge or loss of fluids resulting in groundwater pollution. This may manifest itself in cracked concrete or soakaways. In view of the extensive impact of the contaminated land regime in the UK since its implementation in 2002, as well as the developments in the EU regarding environmental liability, as well as related developments elsewhere, it is vital to understand the implications of EDD on asset values.

Other significant potential risks for which inspection should be made relate to:

- the position of drains and the route of rain water run-off;
- local sub-surface hydro-geology;
- uses of groundwater.

The results from the site visit may lead to the appointment of specialists to carry out site inspections and to report to and advise the purchaser.

The vendor would be advised to limit his liability by:

- imposing a financial limit and a time limit on his liability in respect of the warranties or indemnities;
- demanding that the vendor should control the conduct of any claims which may be made.

Replies to pre-contract enquiries will often indicate that there are environmental concerns that require immediate attention in the transaction.

Searches 16.8

In addition to making these pre-contract enquiries, it is now common practice for the purchaser to commission an environmental search report. This often identifies the historical uses of the land and the adjoining properties for up to the previous 150 years. This may be obtained in certain public registers such as ordinance survey maps, which are often available in the relevant local authority offices. The planning history of the site should also reveal any potential problem areas, as far as the use of the site is concerned.

Where the land is found to have had contaminative uses in the past and there is no evidence that satisfactory remediation has been carried out on the site, then there may be need for a full environmental audit on the site. This would serve to determine the extent of contamination and the appropriate method of remediation.

Environmental audit 16.9

As indicated above, see **16.1**, in today's climate of increased environmental awareness, a company or lending institution involved in a company takeover or merger will ignore the environmental profile of the companies involved at its own peril (see also comment on lending below). Where a comprehensive pre-contact enquiries and search report show that the land had been used for contaminative purposes in the past, the purchaser has to commission relevant environmental consultants to carry out an environmental audit having regard to costs and the probability of the anticipated risks vis-a-vis the intended use of the property. There are environmental audits, of varying degrees of sophistication, which help to ascertain the effects of previous uses; recommend a cost-effective remedial strategy and possible alternative uses of the land. It could also be used to ensure that environmental risks are taken into account and evaluated at the stage which their importance to the transaction can be recognised and the information used with maximum effect. Since environmental audits have become increasingly important as regards corporate activities and transactions, the background to the development of auditing, as well as the current role, is detailed here.

Environmental auditing and international standards 16.10

There has been a longstanding debate over the role of environmental auditing and international standards. The 1990s were hailed as a decade of environmentalism. In 1990 there was an emphasis on:

- increased environmental awareness;
- access to environmental information;
- implementation of sound environmental principles.

Both legislative and economic incentives have placed the environment high on the agenda for businesses and government bodies, as well as consumers, shareholders, investors, etc. Some organisations have been aware of this trend and have reflected it in their growth from the beginning, others have taken it on board at a later stage. There have been some that have taken their environmental responsibilities very seriously over the years, aware of the fact that the combination of green concerns and business objectives is a must for business. This has been demonstrated in the ways that they do business as well as their approach to transactions. For example, the chemical industry has been conducting environmental audits for many years; the Chemical Industries Association has a well established set of guidelines. It is true to say that many believe that commerce can and must grow alongside an expansion in environmental awareness.

The environment is a transboundary global concern as has been vividly demonstrated in the debate over climate change. Yet much of the push towards the 'greening of business' has also come about through national initiatives of different jurisdictions where the competitive edge has been noted as well as through regional initiatives of the EU's Environmental Action Programmes, both as regards legislative and market-based tools. As has been discussed in **Chapter 4** what has emerged as a particular area of concern is that of sound environmental management.

The EU's Fifth Environmental Action Programme 'Towards Sustainability', which addressed the years 1993–2000, emphasised the importance of 'shared responsibility' for the environment which involves all sectors of society, public and private sectors, organisations and individuals alike. While accepting the importance of the regulatory approach, this Programme has highlighted a more creative approach to environmental management through the integration of voluntary mechanisms, financial incentives and central funding. Taking up the thread of the well publicised 1987 report of the World Commission on Environment and Development, *Our Common Future* (the Brundtland Report), the need to protect the environment and preserve it for future generations has been worked upon to take account of the key role that business must assume so that the concept that the 'polluter pays' is complemented by the notion that business can profit positively through an enhanced environmental sensitivity.

While the several hundred legislative instruments dealing with the environment that have emanated from Europe still have a major part to play in protecting the environment, there is no doubt that economic instruments and financial incentives also have a useful role in co-ordinating the partnership between the public and the private sectors. This is also true in the context of energy and climate change (CC) concerns.

In this discussion the intention is to consider environmental auditing in the light of the need for enhanced environmental awareness and improved environmental management standards nationally and internationally, bearing in mind the emphasis on corporate responsibility that is vital to sustainable development and having regard to the need to be proactive.

Role and objective of environmental auditing **16.11**

Environmental audits are often regarded as the best tool for bringing about environmental reform of industrial practices. This may be true provided that they are one of several mechanisms used in a much larger scheme aimed at significantly improving a company's environmental performance. It is also important that the results of that performance are regularly and readily available to the public. In the USA the US Environmental Protection Agency (EPA), the Courts and some states have all sought in one way or another to find a future for environmental audits. Under the general EPA Policy on Environmental Auditing, no company is forced to conduct an audit while the EU EMAS has also left the choice of environmental auditing to the companies or organisations who wish to participate in the scheme. Yet it is also true to say that there can be a real pressure on companies to undertake environmental audits both in respect of their success in the marketplace and in respect of the success of individual transactions.

The process of environmental auditing was first developed in the USA in the early 1970s as a method for an organisation to confirm that it was complying with legislative requirements. Specialist environmental auditors checked compliance and examined sites or plants that were being bought or sold to ensure compliance with, in particular, the superfund legislation.

After the disaster in Bhopal in India in 1984 and the liability issues raised for Union Carbide, companies became anxious to ensure that their overseas subsidiaries fulfilled similar standards, with the result that parent companies and American multinationals began auditing overseas. This brought the practice to Europe where it has assumed a different role largely because environmental liabilities have been less severe. Environmental auditing was considered a way of making a company greener and demonstrating publicly that environmental responsibilities were being taken seriously. More recently, in the USA, organisations have considered environmental auditing as a means of protecting themselves from criticism, as well as a marketing support, rather than simply a defence against legal liability. Meanwhile the ongoing discussion in Europe in connection with extending liability to impairment or damage to the environment has emphasised the role of environmental audits in due diligence exercises.

Basic objectives **16.12**

The basic objectives of an environmental audit are to:

- check a company's performance against its objectives and policies;
- report to management on any environmental concerns with suggestions for modifications or improvements;
- propose programmes for future environmental activity;
- check compliance with company wide or other standards, legislative requirements and regulations;
- specify steps required to achieve total compliance;
- recommend action for risk management.

By taking a 'cradle-to-grave' approach an audit can monitor emissions and discharges, waste and recycling efforts, with cost-effective results that can improve both the bottom line and achieve quality management in economic and environmental terms. In addition the audit can be a monitoring exercise to:

- verify training, health and safety and environmental procedures;
- check the adequacy of record keeping;
- provide a satisfactory database for use for any of several purposes;
- comment upon an analysis of information produced.

A further objective is to test the validity and quality of the audit management system in place and the adequacy of audit protocols, procedures and compliance manuals as well as to review any contingency plans. Environmental audits are often seen as management tools which are an aid to the framing of appropriate policies to support marketing and as indicators of the efficiency of the company's environmental policy. For instance, at the time of insurance review they may be helpful to obtain satisfactory insurance arrangements while compliance audits assess general compliance with existing and proposed regulatory standards, corporate standards and good practice. In addition, they perform a useful role in transactional due diligence (see also the scope of audits at **16.18**).

While environmental audits, and their results, have been voluntary rather than mandatory, EMAS, for example, does requite the independent scrutiny of the environmental impact of a company's activities and does result in a public environmental statement. Similar guidelines were developed through the BS 7750, superseded by the ISO 14001. In the UK both initiatives have had an effect on the level of corporate green activity.

Corporate environmental performance reporting **16.13**

The EU's Fifth Environmental Action Programme, as indicated, recognised that many of the present day environmental issues and threats to the world's ecological balance were posed by trends in political, economic and social life. This work has been further developed through successive programmes and evolving environmental, energy and related legislative instruments. It has been necessary to bring about substantive cultural change in these areas, which required a more flexible, imaginative approach to environmental management than had been previously adopted particularly since the recent expansion of the EU (now 27 member states). These initiatives have been developing over the last decades: yet the message has taken time to be received by business overall and therefore these developments are summarised here.

The underlying principle behind this approach was that by increasing public awareness about the environmental performance of organisations, pressure would be exerted on those organisations to ensure that their performance is 'acceptable' to the public. By way of example, in the USA, the Valdez Principles, which were evolved following the environmental accident in March 1989, caused by the spillage of an oil tanker Exxon-Valdez in Alaska, heralded a way forward for socially responsible companies. The clean-up of the Alaska coastline by the company concerned, Exxon, has to date cost over $1 billion, consumed thousands of man years of managerial effort and embroiled the company in over 150 complex lawsuits which, depending on their outcome, could add hugely to the total cost. Among other things, these Principles called for an environmentalist on each corporate board and an annual public audit of a company's environmental progress.

The message that was being sent was that eco-responsibility would be good for business. Leading corporate managers called for 'corporate environmentalism' in America and, for example, the head of Pacific Gas and Electric stressed the importance of dialogue with environmental groups and others as a way forward in an openness that was good for business. This could be seen in the context of corporate environmental policies, published commitment to environmental performance and environmental performance reports.

Organisations have in fact seen that a positive approach to environmental awareness is good for business. It has become increasingly recognised that for environmental reporting to be meaningful, it should be done on a site-by-site basis rather than by providing overall statistics relating to environmental data, such as emissions of different types. This is especially true bearing in mind the possibility of a director being buttonholed and made personally liable for any statement made in an environmental report.

Environmental issues – the environment, board and governance **16.14**

Environmental issues are on the main board agenda in a way not seen before, and in a manner that cannot be ignored, since they tie in closely with attempts to strengthen standards of corporate governance. This is evident in areas such as:

- corporate social responsibility (CSR) reporting;
- international accounting standards;
- Turnbull in the UK;
- EU Directives; and
- reputational risk.

As a result, environmental risks could represent your company's biggest (as yet, non-disclosed) off-balance sheet liability. Companies can quickly go from being financially robust to insolvency (see also **Chapter 4**), simply because they fail to seek adequate financial protection before being forced to recognise their true liabilities. It is not just larger companies that are at risk – smaller companies, municipalities and partnerships are also vulnerable. With stakeholders and regulators increasingly expecting directors and non-executive directors to know about potential liabilities, and to show they have done enough to control the financial impact, you can ill afford to ignore this issue (see below re-insurance matters).

International co-ordination **16.15**

There is no doubt that in order to improve the environmental performance of companies and to maximise the effect of this improvement, there should be worldwide co-operation by business to uphold the concept of sustainable development. This is the case, whether in developed or developing regions. Areas as diverse as business investment in Eastern Europe and the development of corporate policy in Japan and India have relied on environmental auditing as an international tool. In order that more businesses should join this effort and that environmental performance should continue to improve, the International Chamber of Commerce (ICC) established a task force of business representatives to create a business charter for sustainable development. This comprised 16 principles for environmental management. It was formally launched in April

1991 at the Second World Industry Conference on Environmental Management (WICEM 2) in Rotterdam. The last of these principles is:

> ‘Compliance and Reporting: To measure environmental performance; to conduct regular environmental audits and assessments of compliances with company requirements, legal requirements and these principles; and periodically to provide appropriate information to the Board of Directors, shareholders, employees, the authorities and the public.’

The charter was one of seven projects by European and North American Business Leaders at the Bergen Conference ‘Action for Common Future’ in May 1990. This conference was generally regarded as the main follow up event to date for the Brundtland Report. The Bergen Conference brought together at ministerial level the 34 Member Countries of the UN Economic Commission for Europe (ECE), including Canada, the US and the Soviet Union. Non Governmental groups also took part and the ‘Industry Agenda for Action’ was endorsed by business leaders at the Bergen Industry Forum and centred around the preparation of the charter and of the auspices of the International Chamber of Commerce (ICC). The charter was adopted by the ICC Executive Board on the 27 November 1990 (see box below).

The aims of the charter are still worth citing:

- ‘To provide guidance on environmental management to all types of business and enterprise around the world, and to aid them in developing their own policies and programmes.
- To stimulate companies to commit themselves to continued improvement in their environmental performance.
- To demonstrate to governments and electorates that business is taking its environmental responsibility seriously, thereby helping to reduce the pressure on Governments to over legislate and strengthening the business voice in debates on public policy.’

See Dr L. Spedding, Environmental Management for Business, Wiley, 1996, p. 8.

ICC Business Charter for Sustainable Development
Principles for Environmental Management

1. *Corporate priority*
   To recognise environmental management as among the highest corporate priorities and as a key determinant to sustainable development; to establish policies, programmes and practices for conducting operations in an environmentally sound manner.
2. *Integrated management*
   To integrate these policies, programmes and practices fully into each business as an essential element of management in all its functions.
3. *Process of improvement*
   To continue to improve corporate policies, programmes and environmental performance, taking into account technical developments,

scientific understanding, consumer needs and community expectations, with legal regulations as a starting point; and to apply the same environmental criteria internationally.

4. *Employee education*
   To educate, train and motivate employees to conduct their activities in an environmentally responsible manner.
5. *Prior assessment*
   To assess environmental impacts before starting a new activity or project and before decommissioning a facility or leaving a site.
6. *Products and services*
   To develop and provide products or services that have no undue environmental impact and are safe in their intended use, that are efficient in their consumption of energy and natural resources, and that can be recycled, reused or disposed of safely.
7. *Customer advice*
   To advise, and where relevant educate, customers, distributors and the public in the safe use, transportation, storage and disposal of products provided; and to apply similar considerations to the provision of services.
8. *Facilities and operations*
   To develop, design and operate facilities and conduct activities taking into consideration the efficient use of energy and materials, the sustainable use of renewable resources, the minimisation of adverse environmental impact and waste generation, and the safe and responsible disposal of residual wastes.
9. *Research*
   To conduct or support research on the environmental impacts of raw materials, products, processes, emissions and wastes associated with the enterprise and on the means of minimising such adverse impacts.
10. *Precautionary approach*
    To modify the manufacture, marketing or use of products or services or the conduct of activities, consistent with scientific and technical understanding, to prevent serious or irreversible environmental degradation.
11. *Contractors and suppliers*
    To promote the adoption of these principles by contractors acting on behalf of the enterprise, encouraging and, where appropriate, requiring improvements in their practices to make them consistent with those of the enterprise; and to encourage the wider adoption of these principles by suppliers.
12. *Emergency preparedness*
    To develop and maintain, where significant hazards exist, emergency preparedness plans in conjunction with the emergency services, relevant authorities and the local community, recognising potential transboundary impacts.

13. *Transfer of technology*
    To contribute to the transfer of environmentally sound technology and management methods throughout the industrial and public sectors.
14. *Contributing to the common effort*
    To contribute to the development of public policy and to business, governmental and intergovernmental programmes and educational initiatives that will enhance environmental awareness and protection.
15. *Openness to concerns*
    To foster openness and dialogue with employees and the public, anticipating and responding to their concerns about the potential hazards and impacts of operations, products, wastes or services, including those of transboundary or global significance.
16. *Compliance and reporting*
    To measure environmental performance; to conduct regular environmental audits and assessments of compliance with company requirements, legal requirements and these principles; and periodically to provide appropriate information to the board of directors, shareholders, employees, the authorities and the public.

Many companies saw the charter as a major response to governmental and activist pressures for environmental 'codes of conduct'. Moreover the code demonstrates the extent to which these issues have been considered relevant to good corporate citizenship for many years.

In addition the ICC definition of environmental auditing has been accepted generally as:

> 'a systematic, documented, periodic and objective evaluation of how well environmental organisation, management and equipment are performing with the aim of helping to safeguard the environment by:
>
> (i) facilitating control of environmental practices;
>
> (ii) assessing compliance with company policies which would include regulatory requirements.'

EU-Scheme EMAS **16.16**

EMAS, which was adopted in June 1993 and took effect in 1995, began as the draft *Eco-Audit Directive* which proposed mandatory annual audits by large manufacturing firms. It was aimed at major processes as a complement to eco-labelling which was a scheme concerned with products. As such EMAS was designed to monitor pollution and reduce the impact of large, individual facilities or sites in accordance with strictly drawn guidelines. While it still remains more suitable for manufacturing facilities in view of its site-based approach, a voluntary 'management systems approach' was proposed during negotiations and the resulting regulation establishes a voluntary scheme within which participating companies must establish an EMS. The Regulation was extended to enable Member States to include sectors such as the distributive trades and public services on an experimental basis and the negotiations also dovetailed the efforts of the British Standards Institution (BSI) which had been evolving the new Environmental Standard BS 7750 which was intended to comply fully with the EMS requirements of EMAS.

Under EMAS, a verifier will review an organisation's environmental impacts, procedures and targets in relation to its environmental policy and EMAS, and the process leads to an independent verification statement which is required to confirm compliance with the scheme. Regardless of the long history of EMAS, many businesses have not taken advantage of it despite the EU Commission's (EC) efforts to improve uptake of the scheme (see below). The EC's view is that small- and medium-sized businesses (SMEs) have a primary role to play in shifting the European economy to more sustainable production and consumption patterns, as they make up a large part of Europe's economy. They also contribute to up to 70% of all industrial pollution in the EU. Therefore, like large companies, they exert considerable pressures on the environment. For many SMEs, becoming more energy and resource efficient is also a crucial factor to increase their competitiveness. The EC is revising EMAS and the eco-label to set them as the European benchmark for enterprises to integrate environmental concerns into their business operations, either at company level (EMAS) or for a specific product (eco-label). Also their view is that the Green Public Procurement by local, regional and national authorities can be a strong driver for:

- eco-innovation;
- the promotion of sustainable production and consumption; and
- the uptake of cleaner technologies in businesses.

To further promote Green Procurement, the Commission is working on a communication on green public procurement covering targets, indicators and tender specifications and action to widen the greening also to private sector supply chains. The new instruments of the Cohesion Policy 2007–13 allow substantial funds for Member States for investments in environmental protection, especially for SMEs. One of the priority categories of expenditure for the new European Regional Development Fund and the Cohesion Fund refers to 'assistance to SMEs for the promotion of environmentally friendly products and production processes (introduction of effective environment managing system, adoption and use of pollution prevention technologies, integration of clean technologies into firm production)'. Also the new European Social Fund includes among its objectives training and information in SMEs on 'eco-friendly technologies and management skills' (see further http://ec.europa.eu/environment/emas/news/index_en.htm#207).

ISO standards **16.17**

The UK was the convenor of an International Standards Organization (ISO) International Electro Technical Commission (IEC) working group on environmental management with regard to a draft international standard. These developments also took place in the last decade. The working group was set up under the aegis of the strategic Action Group on the Government (AGE) which was established jointly by the ISO and the IEC in 1992. The intention was to design an ISO Standard from the outset and a draft document was submitted to the representatives of the working group in June 1992. The New Technical Environmental Committee (which reflected that of BSI) was based on an official proposal to produce international standards on:

- environmental management systems;
- environmental auditing;
- environmental labelling;
- environmental performance evaluation;
- an industrial mobility plan for development industrial standards; and
- life cycle analysis.

The objective was to produce an ISO Standard some one or two years after the revision of the BS 7750 Standard and the establishment of certification bodies in 1994, provided that there should be agreement on the production of an international standard. The intention was to evolve a systems approach embracing an EMS, health and safety management system and a quality management system. The ISO 14001 replaced the BS 7750. In the UK the accreditation service, UKAS, has been concerned with maintaining the implementation of the standard and has recently suggested that the accreditation should be more robust.

Scope of audits **16.18**

It is useful to consider the scope of audits by looking at the broad range of services that has developed and been offered by environmental consultants. Briefly, audits can, as noted above (see the heading 'Ongoing issues'), be transaction based, site specific or more general. The broad range of issues carried by environmental auditing evolved rapidly and provided a helpful guide to the basic types of audits available, as follows:

- *Corporate audit programmes*: to assist international corporations in the development of company-wide monitoring.
- *Due diligence audits*: to assess potential liabilities and to provide key information for negotiating parties prior to the transfer of a site as environmental liabilities can have significant impact on the value of a company's assets. The audits frequently save considerable amounts of money by helping to reduce a site's asking price or in securing warranties to cover future environmental expenditure.
- *Waste audits*: to assess all aspects of waste management from the on-site storage of materials to off-site disposal by licensed operators as required by new, more stringent legislations. Waste audits can identify opportunities for cost savings through recycling or resource recovery.

- *Health and safety audits*: to adjust working practices in response to new legislation. H & S audits in the UK and throughout the world are used to assess compliance as the basis for ongoing training and improvement programmes, and may be integrated into a health, safety and environment management approach.
- *Site audits*: A general example of a site audit could include:
  - site setting and location;
  - site history;
  - management systems;
  - raw material storage and manufacturing processes;
  - emissions (liquid, air, noise);
  - waste;
  - health and safety;
  - building materials;
  - energy;
  - security;
  - fire precautions; and
  - pest control.

Disclosure and liability under audits **16.19**

There has been a longstanding debate over disclosure and liability. While the USA deliberately avoided any public disclosure requirement as part of the EPA Policy on Environmental Audits, EMAS referred to a 'true and fair' disclosure of 'the environmental issues of relevance to activities at the site'. Nevertheless it must be recalled that this disclosure requirement only comes into play if a company voluntarily chooses to participate in the Eco-Audit Scheme. As noted above, see **16.16**, the EU is still working to encourage improved participation in the scheme, especially as regards SMEs.

In particular in the UK the audit will disclose legal risks and liabilities for which, as a matter of English law, no privilege will apply. The wide scope of the audit under EMAS for example will tend to destroy the cornerstones of privilege where the dominant purpose of the Audit was to obtain legal advice. This will, of course, vary according to the particular jurisdiction when undertaking a global audit. There has been some concern that by undertaking an audit and having results published a company may find itself vulnerable to attack by voluntary groups and enforcement agencies. Nevertheless, having regard to the general trend in favour of openness, it would be preferable on balance to select the more open approach with regard to environmental matters subject of course to specific advice.

Ongoing issues **16.20**

There is no doubt that environmental auditing can assist in the achievement of the goal of sustainable development and good corporate governance. As regards disclosure generally this has been discussed in the USA in the context of climate change.

The USA – recent developments
A 2007 petition signed by regulators in 11 states, as well as institutional investors and environmental advocacy groups, called for the Securities and Exchange Commission (SEC) to allow financial-risk proxy proposals under Regulation S-K, which requires companies to spell out material losses from unquantifiable risks, such as from climate change. Specifically, the petition seeks information on physical risks associated with climate change that are considered 'material' to a company's financial operations, as well as on lawsuits related to climate change. The business community has generally opposed efforts to quantify financial risk from climate change. 'One person's risk is another's investment', has been the issue as well as the concern that companies could be put at a competitive disadvantage if they disclose too much about their financial risk. Further, much of the information sought is already public, just not synthesised in one place. Environmental impact reports and other documents offer some insight into environmental financial risks. The SEC has not yet responded to the petitioners. However the Financial Accounting Standards (FAS) Board, which sets accounting disclosure standards, is considering tightening its FAS 5 standard to prohibit companies from claiming competitive harm from such disclosures. While FAS 5 only requires disclosure of contingent liabilities from events that have already taken place, it could be applied to lawsuits in which climate change is a factor (see also further comment in the discussion on climate change litigation and GHG legislation below).

Environmental accounting and managerial decisions – governance issues

Incorporating environmental values to improve the environmental performance of companies and to evaluate project viability 16.21

It has often been commented that traditional accounting methods do not necessarily reflect environmental costs. Because the link between environment, cost and company performance was not previously folly appreciated, cost accounting systems evolved without creating a method for identifying true environmental costs.

Traditional financial analysis also lacks the capacity to accurately predict environmental costs and savings. It has employed simple point estimates of the outcomes of future uncertain events or, at best, worst case, most, likely and best-case analyses. By collapsing continuous probability distributions of possible outcomes into point estimates, the analyses destroy valuable information that might otherwise be accessible to decision-makers. This increases the odds that bad decisions will result. Financial analysis of capital investment alternatives cannot capture the significance of environmental risk mitigation projects. Yet, environmental experts do not always have the ability to communicate to the financial analysts in the appropriate terms and framework. Environmental capital projects often compete with projects that have a more tangible cost savings equation traditionally.

Cost accounting may also be a useful tool in investment decision-making. By identifying up-front the full cost of an investment decision, companies and individuals can better select investments not only in terms of short-run profits, but also in terms of long-term sustainability. The SERM approach that was also mentioned in **Chapter 4** may be recalled in this regard.

Risk assessment and decision-making are another area where full cost accounting can add benefit to corporate planning. By having realistic figures for actual costs as well as potential costs (remediation of environmental accidents, plant closure, fines, penalties, litigation, damages, costs of bad environment decisions and cost savings from good decisions), companies can accurately predict risk, and calculate the return on investment of projects that reduce those risks.

A variety of 'green' accounting methods have been developed over several years which allow for costing out environmental costs. Because this is a different form of accounting, individual companies have to adapt these accounting systems to their own practices in order to implement them with little cost. Revamping an entire accounting system for most organisations would be a major undertaking. Nevertheless, depending on the accounting systems in place, a modified system may pay for itself by identifying costly and needless environmental expenditures.

Bearing in mind that this aspect has become increasingly relevant to the debate on climate change and corporate governance, in the USA, for example (see box below), non-governmental organisations (NGOs) have raised their voice in several quarters demanding more transparency generally. This has in turn affected corporate votes and the matter of proxy voting (see also **Chapter 4**) recently with a record number of environmental proxy proposals filed in 2007. Evidently shareholder groups are gearing up to confront companies with even more green proposals in 2008. It has been reported that in 2007, more than 80 environmental proposals were filed with public companies, 43 of them specific to climate change, compared with 31 in 2006. Environmental advocacy groups such as Ceres and the Social Investment Forum have noted an increase in shareholder support for such proposals and a growing willingness by managers to negotiate changes to a proxy vote that should continue. Evidently activity will be focused on 'large emitting' industries, such as oil and gas and timber companies. Proposals targeting the home building and auto industries are also planned, and advocacy groups will be going after the banks that finance coal and other polluting industries. Meanwhile the Senate Banking Committee has also scheduled a hearing on climate change risk disclosure.

Reported US proposal statistics

Unlike other non-binding proposals, such as shareholder say-on-pay, the US Business Roundtable considers most green proxies such as proposals that seek reduced energy costs are the right thing to do and save money. Despite the recent surge, it is still unusual for such proposals to pass: the average vote in 2007 for environmental and social issues was 15% and climate change proposals won 20% on average. Yet, support has been building recently and one proposal on GHG emissions that was filed last year at Allegheny Energy by the New York City pension fund received almost 40% support, a new record for such a proposal. Nevertheless the proposals are often viewed as just attention-grabbing tactics. Fifteen climate change proposals were withdrawn last year after companies agreed to reduce their impact on the environment, according to Ceres. Repeat proposals are also common. Under SEC rules, a proxy proposal must achieve at least 3% support in the first year, 6% in the second and 10% thereafter.

SEC rules have tripped up some attempts at filing green proposals. In 2005 the commission took the view that most proxy proposals asking businesses to quantify financial risk based on climate change would fall under the 'ordinary business' exception. The SEC has issued more than 63 no-action letters, allowing companies – mostly from the insurance and energy industries – to exclude social and environmental proposals from ballots because they are considered ordinary business matters of concern to management and not to shareholders. A January 2007 study by Ceres and money manager Calvert Group found that more than half of the companies in the S&P 500 are 'doing a poor job' disclosing climate change risks to investors. Pending further SEC guidance shareholder groups deal with the issue by rewording their proposals. Instead of asking about financial risk from climate change, shareholders will request that companies discuss efforts to reduce their carbon footprint, according to Doug Cogan, lead climate change researcher at RiskMetrics. 'It's all a matter of semantics', he said.

Another tactic that shareholders plan is to boost the number of sustainability proposals in 2008 rather than to take on climate change specific-ally. Sustainability proposals often involve many issues, ranging from human rights and social impact to whether an energy company plans to build more coal-fired power plants. In 2007, there were 39 sustainability reporting proposals: this figure is likely to grow.

Benefits of environmental accounting 16.22

Implementing environmental accounting makes environmental costs more visible to company managers, thereby making those costs easier to manage and reduce. Environmental accounting gives companies the opportunity to:

- significantly reduce or eliminate environmental costs;
- be transparent in the spirit of good corporate governance;

- improve environmental performance;
- gain a competitive advantage.

Costs to companies of environmental regulations 16.23

The following section outlines some of the ways in which companies incur environmental costs. A number of the costs, as well as potential cost savings, have traditionally been hidden from managers because of the accounting methods. In order to properly identify potential cost savings, it is important to first identify the actual costs that regulations impose on companies. Thus, once these costs are identified, it is possible to recognise when pollution prevention and environmental management activities result in cost savings.

Clean-up liability and costs 16.24

The history of the well-known Superfund, the main objective of which was to enable the clean-up of contaminated sites in the USA, provided a vivid illustration of an approach to clean up liability and costs that met with huge criticism by many stakeholders, including industry. It was estimated that if a company was named a party to a Superfund site, the immediate cost was roughly US$500,000, largely due to legal fees. Once liability was assessed, costs could run well into the millions. In addition to direct costs paid for clean-up, companies had to pay hefty insurance fees as well. These fees have sharply increased due to the costs of liability which has driven many insurers out of the environmental liability insurance market. By way of example, the cost of environmental liability in the USA was estimated over a decade ago, in 1991, to equal US$500 to US$1 trillion while the property-casualty insurance industry was only worth US$158.2 billion.

For example, Motorola, an American semiconductor manufacturer, recently worked out a Superfund settlement in Arizona that will add up to £30 million. It is worth noting that many of the 'guilty' parties for Superfund contamination in the Silicon Valley were actually complying with technology and regulatory guidelines at the time the facilities were installed. However, the technology used to store hazardous materials, etc. clearly did not do the job and contamination occurred. The debate over clean-up liability and costs continues to be very sensitive and it is vital that businesses establish their likely exposure having regard to the location.

As mentioned, in the UK there is in place a contaminated land regime, a detailed discussion of which falls outside the scope of this manual (see further the heading 'The business bottom line'). Broadly speaking, there are several important considerations in respect of the land on which a business operates. It is important to consider past uses as well as present operations. For example, where land has been previously used as a gas works, there is a high risk that the land will be contaminated. Investigations may reveal that some remediation has been carried out during previous redevelopment, but it will still be necessary to ensure that the land is in a suitable condition for its proposed use. Obviously if the land is to be used for housing, it will need to be cleaned to a much higher standard than if it were to be used for industrial purposes.

Although local authorities became responsible for identifying contaminated sites, under contaminated land regulations, most remediation of contaminated sites still generally occur through redevelopment. Anyone purchasing a site for redevelopment, therefore, should ensure that they know exactly what they are getting for their money. Proper investigation will reveal whether they are buying an asset or a liability. In addition to the site itself, it is worth considering surrounding land to assess whether there is a risk from contamination migrating on or off site.

Environmental programme administration 16.25

One significant cost associated with compliance comes from the time it takes to understand the regulations and to keep up with the details of compliance such as mandatory report generation and reporting forms. These costs are above and beyond the actual payments made, for example, to treat or dispose of waste.

Research and development for alternative processes and materials 16.26

A further cost comes from developing alternative materials and processes. Environmental laws may not require companies to invest in the development of alternatives but when a key process material is banned, companies are forced to develop alternatives in order to stay in business. By way of example, over 15 years ago in the USA, AT & T spent US$25 million on research, development and testing of substitutes for ozone-depleting substances. Moreover, in testimony to the House Armed Services Committee on 6 March 1990, IBM estimated that it would spend US$70 million in corporate-wide capital costs to eliminate use of CFC 113. IBM further estimated that it would spend about US$140 million to research and develop alternatives processes for these products. This point is further discussed in the section on legislative trends below, see **16.50**.

One advantage for manufacturers in some developing countries is that they may be spared some of these costs, because alternatives have already been developed. For companies just getting started, they can design their processes around banned substances. This means that rather than retrofit equipment or amortising costs of equipment made obsolete by bans on materials, companies can begin production with state-of-the-art processes and equipment produce few emissions.

The cost of inputs 16.27

Raw materials generally occupy the largest proportion of total production costs in any manufacturing setting. Environmental pressures that result in higher raw materials costs are generally the result of suppliers' raised costs. Prices for metals for example have been known to increase approximately 10–12% per year due to environmental pressures and related regulation.

Energy costs 16.28

Energy costs are generally a significant production cost. In heavy manufacturing, they have accounted for up to 40% of production costs. High-energy users have considered the effects of higher-energy costs, having undertaking energy audits. For example, some companies have investigated opportunities for switching to more fuel-efficient sources, especially for space heating. Plant design has been a particular constraint to moving to more energy-efficient operations. In investment decisions, plant design for energy efficiency should be one consideration for any investor. Energy efficiency will reduce production costs.

Environmental pressures impact on the technology, production and pollution control methods of companies. Most companies have had to make investments and incur costs in response to environmental legislation. Investors would be wise to assure that any company they invest in has state-of-the-art environmental technologies in place and are equipped to respond cost effectively to changes in environmental requirements.

Once a company develops a method for allocating hidden environmental costs, it will be able to realise cost savings. The next section will detail different methodologies and projects underway to further outline environmental accounting methods. The link with concerns over climate change and relevant strategies should also be borne in mind (see further below).

Environmental accounting projects and initiatives 16.29

A number of organisations in Europe and in the USA and Canada have over the years undertaken efforts to develop environmental cost accounting strategies. Investors, as well as business decision-makers, should keep apprised of relevant developments in the environmental accounting area. This is with a view to adopting and incorporating certain methodologies into the practices of their companies in the interests of transparency and good corporate governance. There have been many initiatives globally. For the present purpose a few illustrations may be mentioned.

By way of example the US EPA instituted the Environmental Accounting Project. The project was started as a response to concerns expressed by the Pollution Prevention Division that pollution prevention (practices that reduce or eliminate pollution) would not be adopted as a viable option for managing environmental concerns until the environmental costs of non-pollution prevention and the economic benefits of pollution prevention could be seen by managers making business decisions. The project had a network of over 600 members who participated and received information from the project. The main outcome of the project was the extensive gathering and sharing of information on environmental accounting. Many of the results of this project were made available through the Internet or from the US EPA. The publication of case studies detailing the experience of individual companies in incorporating environmental accounting were useful for any organisation wishing to move forward into environmental accounting. Software packages could also be purchased to help companies to incorporate environmental costs into capital budgeting decisions (see http://www.epa.gov/opptintr/library/pubs/archive/acct-archive/resources.htm).

Information on environmental accounting from the US EPA 16.30

- An Introduction to Environmental Accounting as a Business Management Tool: Key Concepts and Terms.
- Environmental Cost Accounting for Capital Budgeting: A Benchmark Survey of Management Accountants.
- Incorporating Environmental Costs and Considerations in Decision Making: A Review of Available Tools and Software.

In the UK the Association of Chartered Certified Accountants (ACCA) has also examined the question of environmental accounting and reporting and pioneered developments over many years, as well as organising annual awards on environmental reporting in an ongoing bid to engage industry broadly. This initiative has expanded to CSR and key aspects of governance: see www.acca-global.com.

In the 1990s the *International Network for Environmental Management* developed a method to give weight to the environmental impact of their activities. The tool was a decision-making tool to help management decide how to achieve the greatest environmental impact reduction per unit of investment. The report, called *Environmental Accounting for Enterprises*, also inspired practical debate. It is important to note that many of these developments originated from the 1990s yet remain foundational to this discussion. Moreover the contribution of the Global Reporting Initiative (GRI) has advanced the cause of environmental and sustainability reporting (see also **Chapter 4**) and provided a framework for adoption by business globally (see the **Appendix** at Item 2).

Environmental accounting methodologies and case studies 16.31

Environmental accounting in a company can be divided into two different areas:

- financial accounting; and
- management accounting.

Financial accounting allows companies to prepare reports for outside investors to use in looking at the risk and environmental profile of a company.

Management accounting, which is the subject of this section, is the process of identifying, collecting and analysing information principally for internal purposes. A key purpose of management accounting is to support a business's future management decisions. Management accounting can involve data on costs, production levels, inventory and backlog, and other important business aspects. Most companies develop management accounting practices as a function of their particular business needs. Business type and size, as well as customer base, can influence which methods are implemented.

Types of decisions that benefit from environmental cost information 16.32

- product and process design;
- capital investments;
- cost allocation;
- product retention and mix;
- performance evaluations;
- purchasing; and
- risk management.

Environmental insurance – reducing risk and liability

Efforts by the insurance industry to become more green 16.33

The insurance industry has an important role in the delivery of sustainable development. While globalisation and sustainable development provide prospects of gains and opportunities for the industry, very real potential losses also exist, most notably in the area of climate change. An Aon analysis of major natural catastrophes carried out by Munich Re in 1999 shows that comparing the 1960s and the 10 years from 1989 to 1998, the number of such catastrophes has risen by a factor of three, with economic losses – after adjusting for inflation – increasing 9 times and insured losses 15 times. A change in this trend is not likely and the recent floods across the UK have brought home the concept of climate change into sharp focus among the general public nationally against the reported announcements of the Intergovernmental Panel on Climate Change (IPCC) in 2007.

Therefore the insurance sector is another area where the integration of environmental issues at all levels has received attention. The industry has long been aware of environmental risks, because insurers have often had to pay for environmental damage. Companies that wish to protect themselves from exposure to environmental liability purchase a pollution insurance policy. Many banks have required such a policy before allowing certain kinds of investments and transactions. In the past, companies did not actually have insurance to protect them against liability, moreover the environmental insurance market has suffered as a result of the potential size of exposure. As a result of stringent environmental laws and the broadening of the market, the environmental insurance market matured into a billion-dollar industry. Certain initiatives that inspired positive change over the years are mentioned below. According to Aon the environmental insurance market is divided into two distinct markets: US market for US-based risk and non-US market for risk for the rest of the world (see the **Appendix** at Item 3). Moreover, there are five main types of non-US environmental policy:

- Pollution Legal Liability Cover (PLL).
- Pollution and Remediation Legal Liability Cover (PRLL).
- Clean-up/Cost Cap Cover.
- Warranty and Indemnity Wraps/Contract Cover.
- Pollution Legal Liability Accident Cover.
- Main policy exclusions.

Environmental insurance policies **16.34**

In view of the fact that many general insurance policies had an absolute pollution exclusion, the environmental insurance market developed, offering companies, both large and small, policies tailored to their particular operations and risk. Clearly, insurance is only a protection against unforeseen environmental events, and does not mean a company can take environmental risks (without repercussions).

Insurers looking to capture this growing market developed general liability policies and full pollution legal liability. These policies provided coverage for a full range of risks, covering bodily injury, clean-up of incremental pollution as well as accidents or spills. Other policies have become available that allow clients to tailor packages to what they need for their operations.

Insurance companies make environmental pledge **16.35**

Five major insurance companies in Europe began the effort to take their customers' environmental performance into account when setting premiums and to improve their own environmental record. These five companies, including National Provident Institution and General Accident of the UK, pledged to integrate environmental considerations and a precautionary principle into their business goals. The effort was sponsored by United Nations Environment Programme (UNEP). The five leading companies recruited other insurance companies worldwide to make a similar pledge. Additionally, they drafted a formal Statement by the Insurance Sector on Environmental and Sustainable Development which integrated environmental risk into casualty insurance, life and pension savings, investment management and real-estate management. They also pledged to use environmental checklists in daily operations and work with suppliers and subcontractors that demonstrate sound environmental management.

Products check environment risk 16.36

The 1990s also witnessed the arrival of new software products to support change. With concerns about enforcement of corporate environmental liability disclosure heightening, Dun & Bradstreet Information Services introduced a line of products to help users screen for potential environmental risk associated with more than 1 million commercial and industrial properties in the USA. The products, known collectively as Environmental Information Services, were designed to help perform EDD. The pre-screening was used in the early stages of a potential loan to pinpoint elevated risks, including those which would require further investigation with a more costly on-site technical evaluation. The reports also provided an estimated cost for the physical clean-up of the site based on experience at sites with similar environmental problems. One of the reports listed federal and state environmental filings located by Dun & Bradstreet on and surrounding a target property. Another report helped businesses analyse the information, translating the search into a three-level risk code. It could provide an example of the clean-up costs for other sites with similar filings. The company's Toxicheck software interpreted various sources of environmental information, including government records, questionnaire responses and visits to specific properties. The information was provided by Environmental Data Resources, Connecticut, which maintained a database of government records from more than 300 different sources. The products were developed to meet EDD standards, such as the ASTM Transaction Screen Standard, and support the FDIC's directive that lending institutions put in appropriate safeguards and controls to limit exposure to potential environmental liability.

Over the years many other software products and tools have come on to the market to identify and evaluate environmental exposures.

Business and sustainability, shared responsibility and climate change – an EU and international update 16.37

Regardless of where they operate it is imperative that every organisation, large or small, focuses on their individual role in the protection of the environment and the prevention of further climate change, irrespective of whether they are involved in a polluting industry or activity. As was noted above, see **16.13**, this ethic has been clearly supported in Europe. In its Fifth Environmental Action Programme 'Towards Sustainability', covering the period 1993–2000, the EU targeted the role of industry in implementing the principle of 'shared responsibility' to achieve improved environmental protection and preservation. This has been developed further in the Sixth Environmental Action Programme and the many publications such as *EEA Signals 2004* which is a European Environmental Agency update on selected issues. It stated:

> 'The main barriers to progress in environmental protection and sustainability are the complex, inter-sectoral, inter-disciplinary and international nature of both the problems and the solutions.'

The EC has recognised that SMEs must be equipped to participate fully in this initiative. In the Enterprise report referred to at the beginning of this chapter it is stated:

> 'Important challenges remain not least among SMEs which are often less aware of current and future environmental trends and regulations or the market opportunities available to them. SMEs tend to underestimate their environmental impacts, which may be small on a company-by-company basis but are considerable when looking at the SME sector as a whole. Internal barriers, such as a lack of skills, awareness and (human) resources, further hamper environmental responsibility … regulation and supply chain pressures seem to be the major drivers for environmental engagement by SMEs.'

The EU's EMAS exemplified the need for a practical approach by offering incentives to SMEs as is mentioned also in **16.16**.

It is also clear that in order to make business more profitable and to benefit society as a whole, organisations should aim to protect the environment by taking account of the highest standards in technology and good management practices. This is true of all of their activities, including their choice of partners in trade, investment and project finance. Management theories indicate that this is best achieved by a combination of formal and informal corporate measures including a comprehensive corporate policy on the environment and follow-up procedures such as environmental audits.

An enhanced awareness of the environmental aspects of running a business and expanding overseas entails reviewing procedures and processes not only to make them more environmentally sound, but also to improve efficiency. Businesses across the spectrum have been surprised at the cost effectiveness of measures to reduce energy consumption and minimise waste generation. The use of low-energy technology, improved insulation, the plugging of leaks, recycling of materials and energy can all lead to significant savings. Good businesses appreciate that sound environmental practice is sound business practice. For instance, every car company, every energy supplier and every supermarket group wants to win the loyalty and admiration of its customers because these are good for sales and because high environmental standards can bring operating and productivity efficiencies which help add to profits.

One major issue is, of course, climate change and the need for business to grasp the practical issues in the spirit of shared responsibility. According to the EEA Signals 2004:

> 'The climate is projected to continue changing, globally and in Europe, over the next 100 years. Evidence is growing of climate change's impacts on human and ecosystem health as well as economic viability. Substantial reductions in emissions of greenhouse gases will be required to ensure that Europe meets its short-term emission targets. Adaptation measures to manage the negative impacts of climate change also need to be put into place.'

Climate change as a policy priority EU policy on climate change, energy and competitiveness **16.38**

In October 2006 Sir Nicolas Stern's *Report on the Economics of Climate Change* concluded 'There is still time to avoid the worst impacts of climate change, if we act now and act internationally'.[1] The EU has committed itself to taking up this challenge among its Member States and at global level. Building on its EU Emissions Trading System (ETS) since 2005, in 2007 the EU has committed to curb emissions, improve energy efficiency and increase the use of renewable energy by 20% by the year 2020.[2] Other jurisdictions look to Europe as a regulatory trendsetter, and the EU is increasingly ambitious to achieve market leadership through pioneering a 'low-carbon economy'.

Pricing systems and climate change

Most economists would wish to see the price system – the principal mechanism by which resources are allocated in a market economy – at the centre of the emissions reduction policy, whether through taxation of carbon or the selling of emission permits. But there is a place for regulations and standards policies also, provided that the resulting implicit cost of abatement is reasonably uniform across sectors and economies and acceptably close to the value of the damage avoided. It is likely that some sort of global ETS, covering many of the most important sectors, will be in place in five years' time. Nevertheless a somewhat motley mixture of policies is likely to continue also.

EU regulatory developments 16.39

EU regulation regarding climate change encompasses environmental protection, waste management, emissions trading, sustainable production, energy (efficiency and renewables), and related technology R&D. Grouped under the label 'climate and energy security',[3] current and upcoming policies impacting on business operating in or trading with the EU include:

- the ETS greenhouses gases cap-and-trade system;
- the Integrated Pollution Prevention and Control Directive (IPPC);
- the Strategic Energy Technology Plan: Towards a Low Carbon Economy (SET Plan);

[1] See executive summary www.hm-treasury.gov.uk/media/4/3/Executive_Summary.pdf and full report www.hm-treasury.gov.uk/independent_reviews/stern_review_economics_climate_change/stern_review_report.cfm

[2] The targets are: (i) reduction in GHGs by 20% compared to 1990 levels; (ii) reducing primary energy use by 20% (through energy efficiency); (iii) increasing the level of renewable energy in the EU's overall mix to 20%; (iv) minimum target for biofuels of 10% of vehicle fuel. See Presidency Conclusions of the European Council 8–9 March 2007 www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/93135.pdf, also COM (2007) 354 Adapting to climate change in Europe – options for EU action, Green Paper from the Commission to the Council (etc.), June 2007.

[3] Various aspects of EU climate policy therefore come under European Commission Directorates-General for Environment, Transport and Energy, Enterprise, and Research as well as competition and trade rules.

- a forthcoming Renewables Energy Package;
- an EU commitment to build 15 carbon capture and storage (CCS) demonstration plants by 2015.

Other climate-related policy addresses air quality, CO_2 emissions from cars/fuel quality, 'carbon labelling', biodiversity, flood management, and calls for the incorporation of environmental requirements into agreements with third countries. On 23 January 2008 the European Commission published a package of proposals to implement the 20% by 2020 commitments, the revised ETS Directive, and a scheme for implementing CCS demonstrations.

The ETS 16.40

Established by Directive 2003/87/EC, the ETS provides 'a scheme for GHG emission allowance trading within the Community' to implement the Kyoto Protocol of the United Nations Framework Convention on Climate Change (UNFCCC). The ultimate objective of the UNFCCC is to achieve stabilisation of GHG concentrations in the atmosphere at a level which prevents dangerous anthropogenic interference with the climate system.

The ETS went into operation on 1 January 2005, with a forward market since 2003. After teething problems, notably due to over-allocation of emissions allowances,[4] the ETS is currently under review in preparation for its Phase III trading period from 2013. Likely changes include:

- extension to new industrial sectors – notably aviation;
- the introduction of allocation of allowances by auction (to date, allocation methods have varied between the Member States[5]);
- revised Annex III criteria for Member States' National Allocation Plans;
- setting the total emissions cap at EU level.[6]

Meanwhile, the EU and Canada are in talks to make their CO_2 emissions trading schemes compatible (see further 16.51–16.61 De: Canada).

[4] Official data published in May 2006 showed that some countries (including large polluter Germany) were left with total 44.1 million tonnes extra CO_2 allowances for the year 2005. Stern notes that the total EU-wide allocation in Phase 1 is estimated to have been only 1% below projected 'business as usual' emissions. Of the EU's major polluters, only the UK had emitted more than its quota, forcing it to buy more than 30 million tonnes extra allowances on the EU carbon market. The supply surplus sent carbon prices crashing, calling into question the credibility of the scheme.

[5] For example, the UK uses a two-stage methodology, where the total number of allowances is divided between sectors on the basis of projected emissions, and these sector totals are then distributed to installations on the basis of the historic emissions of individual installations during a 1998–2003 baseline period. Alternative methodologies (see possible future EU harmonisation) include auctioning, benchmarks, grandfathering based on different years and projections at an installation level.

[6] For example, UK (DEFRA) report on options in the ETS Review, September 2007 www.occ.gov.uk/activities/eu_ets/analysis-euets-options.pdf.

The SET Plan **16.41**

Published in November 2007, the SET Plan[7] will focus EU R & D investment on 'making the European energy system more sustainable'. In particular, it will:

- correct accumulated under-investment 'due to cheap oil' and tackle locked-in infrastructure investments;
- improve lead times for new technologies to mass market and diversify market incentives;
- help overcome the fragmentation of the European innovation base, balancing co-operation and competition across Member State boundaries.

Concrete measures will include funding through new 'European Industrial Initiatives' in solar, wind, bio-energy, electricity grids, nuclear fission and CCS.

Renewables energy package **16.42**

Legislative proposals (due to be published on 23 January 2008) will provide a framework for cross-border trading to help Member States meet their renewable energy targets. Member States will not be able to count renewable electricity produced outside the bloc towards their national targets.[8] A list of sustainability criteria for biofuels will be included, banning biofuels derived from certain kinds of 'high-carbon' and 'high-biodiversity' land. Biofuels made from cellulose, waste or residues will count double towards renewable transport fuel targets.

Climate change, energy and competitiveness in EU policy **16.43**

The Stern Report labels climate change 'the world's greatest market failure'. EU business lobbies nonetheless have critiqued the competitive costs of the EU 'going it alone' and in response to consultation on the ETS, in 2006 the European Commission set up a stakeholders *High Level Group on Energy, Competitiveness and Environment* (HLG).

The HLG reported at a conference in November 2007[9] and is expected to consider sector-specific policy proposals during 2008–2009.

EU legal bases **16.44**

The legal basis for the adoption of EU environment measures is EC Treaty Article 175. Under Article 174, EU environment policy pursues four objectives:

- protecting and improving the quality of the environment;
- protecting human health;

[7] See http://ec.europa.eu/energy/res/setplan/doc/com_2007/com_2007_0723_en.pdf.
[8] An exception could be made for the European Economic Area and Switzerland.
[9] http://ec.europa.eu/enterprise/environment/hlg/doc_07/conference_report_2007.pdf.

- prudent and rational utilisation of natural resources;
- promoting measures at international level to deal with regional or worldwide environmental problems.

The Lisbon Treaty amended the final objective, adding 'in particular combating climate change'. This will not significantly alter the legal basis, but reinforces the commitment to deliver the 20% by 2020 targets and to take a lead in UNFCCC negotiations.

Article 175 provides for 'green tax' fiscal measures adopted as a unanimous decision of the Member States. As yet, green tax measures have not been envisaged. Under Article 176, individual Member States may adopt more stringent measures than EU measures in the area of the environment.

The International Imperative and Agenda

In 2007 at the international level Dr Rajendra Pachauri, head of the UN's IPCC highlighted the need for action. The IPCC has said action to curb greenhouse emissions is needed to avert irreversible changes in climate that would threaten those living in low-lying areas that could be engulfed by rising seas, endanger food and energy security and lead to more severe and less predictable weather the world over. 'The science is very clear – it's loud, articulate and incontrovertible. On this basis I think it's time the world moved on', Dr Pachauri told Reuters a day before he and climate activist Al Gore receive the 2007 Nobel Peace Prize in Oslo. 'You will never get a more robust set of conclusions and findings than what we have provided. If this doesn't move the world to action, then I don't know what will', Pachauri said. He has referred to the issue of fairness for developing countries also when considering the regime post Kyoto.

Beyond the Kyoto framework: international considerations 16.45

Significantly at the 2007 international meeting held in Bali to consider post Kyoto (see further below and overview in the **Appendix**), developing countries without Kyoto emissions reduction targets indicated that they would consider taking on such targets if developed countries assisted in financing their adoption of climate change measures through the Adaptation Fund. They also indicated that they were willing to consider sector-specific targets or emissions cuts measured against the country's GDP.

Under the current system developed countries are obliged to provide financial assistance and to transfer clean technology to help developing countries mitigate and adapt to climate change. However some countries argue that this assistance has not been forthcoming and so developing nations are keen to integrate the issue into the negotiation of any Kyoto successor. This matter is viewed as a key concern for developing countries and the UN have identified it as crucial to discussions. The Adaptation Fund is currently sourced from levies raised via Clean Development Mechanism (CDM) projects. However many feel that the level of input needs to be increased to meet the adaptation needs of the developing world and to mitigate the impact of climate change. Some suggestions have included a levy similar to the kind imposed on CDM projects to also apply to the Kyoto Joint Implementation (JI) mechanism. As the JI system is only available as between industrialised nations the imposition of a fee to go towards the Adaptation Fund is viewed as a reasonable measure.

The role and response of the financial sector

Globalisation and sustainable development challenges for the financial services sector was recognised some time ago and was the title for the UNEP Financial Initiatives' Annual International Roundtable meeting, held in Frankfurt at the end of 2000. The event, hosted by Deutsche Bank, brought together around 300 of the world's leading financial institutions to discuss and debate the key environmental and social issues facing the financial sector and the risks and opportunities these present. UNEP launched two voluntary initiatives, the Financial Institutions Initiative, predominantly banks, and the Insurance Initiative. The discussion was that globalisation need not always be a bad thing; it provides opportunities as well as risks. In addition, risk and sustainability criteria can be judged together. The banking industry is changing rapidly as customers have greater choice and can access a wide range of services via the Internet. More than ever before, the customer is king and it is those companies that focus on meeting the needs of their customers that will enjoy the greatest success.

The Rio +10 process framed the environmental and sustainable development debate to set the agenda for the coming decades. Global networks have a very important role to play in this process to build on existing sound foundations, to develop the level of active participation by members in an ambitious work programme designed to promote sustainability throughout the sector. The impacts of globalisation on insurance, banking and asset management in particular have led to important conclusions for each discipline. Generally there has been widespread agreement that it is better for banks to engage in projects and to work with their customers to influence the integration of a sound environmental approach than to simply walk away from contentious projects. Previously several NGOs had requested the banks to identify certain sectors and projects to avoid, but the banks had responded by pointing out that such a 'negative screening' approach was unlikely to benefit the environment. The difficulty of managing reputational issues presents a challenge, as society's expectations of global players may often be based on perception as much as on fact. Management of environmental risk is not 'formula driven' and remains primarily qualitative rather than quantitative.

The sector's concerns of poverty alleviation and the need to do more for the 3 billion very poor people in the world are growing. Micro credit programmes have been increasingly highlighted as having great potential for growth, with financial institutions having a significant role in this area in the future. The case study of ICICI Bank in India is helpful.

There have been some fears that the CC issue will be used as leverage to gain support on other matters where developing countries have less of a vested interest. However the UN have made it clear that adaptation and technology transfer are critical parts of future action on climate change and are not a trade-off with developing nations.

This issue is developed further below in the important discussion of the response by North America to climate change in terms of regulatory and voluntary action and occurs throughout this handbook now that it is scientifically proven to be the major threat and challenge facing our planet which must be tackled by all stakeholders and government and industry in particular. This has led to the need to take proactive steps for usual business reasons but also to mitigate the threat of litigation (see further below).

Investor concerns and climate change

Concerns over climate change, the environment and corporate responsibility were in the forefront of investors' minds according to a survey conducted by London-based Ethical Investment Research Services (EIRIS). Investors strongly feel that environmental, social and governance (ESG) issues affect market value in over 50% of companies included in the FTSE All World Developed Index. Energy and utility companies were ranked first by investors as the sectors most affected by ESG issues.

Since the first edition of this handbook the entire debate regarding climate change and the role of business – as well as government – has become paramount. Even a conservative view is that rising temperatures have already started to alter the earth's climate. Predictions of future changes are more uncertain. Effects will depend on the degree and speed of adaptation of countries, economies and people, and differ by region. Climatologists broadly agree, however, that likely affects include:

- melting of glaciers and ice caps;
- higher sea levels;
- more frequent and violent weather events; and
- degradation of water resources.

Sectors likely to be particularly affected include: utilities; integrated oil and gas; mining and metals; insurance; building and construction; and property. Most sectors would be affected to some extent.

While a minority of sceptics continue to question the science of global warming and climate change, an increasing number of companies are putting that debate behind them, or at least to one side, and moving on. Sometimes they are moving ahead of governments, as noted further in the context of North America below. While CEOs are unlikely to regard themselves as experts on climate change they are equipped to take decisions under conditions of uncertainty, crisis and disaster management (**Chapter 5**). Therefore – particularly after the publication of the Stern Report and the reported majority view that the scientific understanding of climate change is now sufficiently clear to justify nations taking prompt action – most CEOs adopt as their starting point the probability that the scientists are right.

Such developments will probably evolve over decades. In planning, therefore, companies will regard climate change as the same sort of slow-moving but powerful force as globalisation, technical change and population ageing – forces that slowly but inexorably shape the economic environment. Indeed, climate change may cause the economic environment to alter more suddenly, particularly when EU, International and national government policy responds to the perceived threat. Evidently any change in GHG regulations on utilities, fuel economy standards for vehicles, airline taxes or building regulations can immediately affect companies' profitability and prospects. They will therefore want, at a minimum, insights not only into how climate change will affect business, but also into how policy is likely to affect it. Moreover, some companies will want or need to shape that policy.

All these suggest that companies are well advised to plan round this issue sooner rather than later – as a number are already doing. Even now, with little impact yet being felt from climate change, in most markets in developed countries a fifth of companies enter and exit each year; only 60–70% survive their first two years of activity (see also comments in **Chapter 5**). Climate change will only add to the challenges they face. Companies that prosper in an environment of changing climate and policies will tend to be those that:

- are early to recognise its importance and inexorability;
- foresee at least some of the implications for their industry; and
- take appropriate steps well in advance.

This is likely to evolve, within an overall framework of good management practice, by:

- inculcating a constructive culture of benefiting from change in senior and middle management;
- encouraging employees to embrace change and enabling them to do so through a structured programme of staff training;
- undertaking the requisite research and development, which is often highly specific to an industry or even a company; and
- translating this R&D into appropriate investment in physical and human capital.

The business bottom line 16.46

Evidently, there is no shortage of reasons why companies should pay attention to the environment. Evidence of continuing enhanced public awareness of the issues, consumer pressure and the interest of other stakeholders, as well as current or potential regulations from the UK and Europe are factors that are regularly highlighted in surveys and reports. Often environmental initiatives can often save money and improve profitability and competitiveness. This was clear both from the general approach seen nearly two decades ago in the pioneering Aire and Calder project and its daughter projects in the UK relating to waste minimisation which involved the regional teaming together of businesses into clubs and in many individual case studies. In this project eleven companies along these rivers grouped together with consultants to improve their environmental management. They reduced emissions by 25% and saved £3 million, representing a major saving at the time.

There are many initiatives which have resulted in:

- benefits to the bottom line;
- new product opportunities;
- increased market share.

For some organisations action has been motivated by compliance regarding current or anticipated regulatory requirements. Business now has substantial evidence to show that there is a huge potential to save by, in particular, good housekeeping, especially in connection with waste and energy issues. Whereas the average pay back period is often 18 months which was the target in the Aire and Calder Projects, some initiatives involve no capital outlay at all. Moreover in the UK for some time there has been an increasing interest in environmental issues in terms of lending to business and this can be seen as a useful case study.

Banks in the UK first became concerned about environmental risks in the early 1990s following the introduction of the Environmental Protection Act 1990 and the Water Resources Act 1991. At that time, there was a distinct possibility that banks may become liable for the polluting acts of their customers. This fear was fuelled by developments in the USA, in particular the case of *Fleet Factors*, a bank that was forced to pay for the clean-up of a site over which it had foreclosed. Developments in Europe also pointed towards a possibility of ‘Lender Liability’. The Lugano Convention and an early EC Green Paper added to the banks’ concern.

In 1992, The British Bankers’ Association formed an Environmental Issues Advisory Panel to inform member banks of developments in environmental issues and to lobby the UK government against the introduction of legislation which would treat the banks as a convenient deep pocket. Around the same time, individual banks began to develop their own environmental risk management systems to protect them when lending to businesses across all sectors. While the early focus was on contaminated land, not least because of the ongoing development of what was to become the Environment Act 1995, it quickly became apparent that the risks facing the banks were not just those in relation to land they might hold as security. Environmental risks for banks can be categorised into direct risks, indirect risks and reputational risks:

- Direct risks are those where the bank becomes primarily liable for the cost of cleaning up contaminated land. Such circumstances might arise where a bank takes possession of a contaminated site it holds as security for a loan. The UK Environment Act 1995, in its definition of an owner, includes a mortgagee in possession. Direct liability may also occur where a bank is held to have caused or knowingly permitted pollution to have taken place. The latter has never been tested in court and it is not thought likely that a bank would find itself in such a position.
- Indirect risks occur where a borrower incurs unforeseen costs, for example fines and/or clean-up costs for non-compliance with environmental regulations or increased expenditure to comply with new or tightening environmental regulations. In some cases, the additional burden can be sufficient to bring down the business and in most cases there is likely to be an impact on the cash flow of the business, which could affect its ability to repay the bank. At the same time, it may become apparent that land relied upon by the bank as security for the borrowing may be worth significantly less than first thought, due to contamination.
- It should also be again emphasised that lending can involve links with reputational risks (see also **Chapter 8**). Reputation and brand image are of increasing value to all companies. Increasingly, banks come under scrutiny for loans they provide where the purpose might be described as environmentally sensitive. In recent years, for example, banks have been targeted by protest groups for financing infrastructure projects, such as dams and power stations. While damage to reputation is difficult to value in such circumstances, it increasingly features in risk analysis.

In order to mitigate these risks, banks need to incorporate environmental risk analysis as part of the normal credit risk analysis undertaken when considering any loan application. Environmental risk analysis should take account of the various risks described above as a well as considering what steps the borrower has taken to mitigate those risks. A practical environmental risk assessment should encompass:

- land issues;
- the business processes carried out; and
- the level of environmental management exercised by the business management.

It is important to have an understanding of how a borrower's business operates. This is not only for risk assessment purposes, it also improves all-round understanding of the issues facing the customer and may well improve the relationship. In very basic terms, it is important to consider:

- what comes on site whether it be raw materials, chemicals or fuels;
- what happens to it, in terms of processing, storage and loading; and
- what goes off site, not only finished products but waste, effluent and air emissions.

Many processes and discharges to air and water will require a licence or consent. Additionally, all businesses have a duty of care in respect of waste. Legal compliance is very important, as non-compliance can prove very costly with serious consequences for the business and, therefore, the bank. It is also important for business managers to understand the medium- to long-term environmental implications for their business and products. In Switzerland, for example, some hotels in skiing resorts at lower altitudes are finding it increasingly difficult to obtain finance, because the impact of global warming is seriously affecting the levels of snowfall.

Environmental legislation and regulations continue to tighten. For example, the UK contaminated land regime took effect from 2000. The EC Directive on Integrated Pollution Prevention and Control was implemented across EU Member States and brought more businesses under regulation. Additionally, the introduction of the climate change levy from 2001 impacted on many businesses. It is clear, therefore, that protection of the environment is growing in significance for all businesses, not just banks. Those businesses that keep up with developments and act appropriately are likely to be well placed to take advantage of the opportunities that arise.

Meanwhile sustainable and responsible investment (SRI) is increasing, partially fuelled by government action, such as the changes to pension legislation in the UK, introduced in July 2000. These required pension companies to declare in their statement of investment principles, the extent to which they take account of the social, ethical and environmental performance of the companies in which they invest (see further **Chapter 4**). In exploring avenues to increase the level of investment in renewable energies and new energy technologies, the need for partnership between government, financial institutions and NGOs was identified. Governments need to level the playing field for renewable energy projects or even positively discriminate to make these projects more viable. In addition, a possible conflict was identified between those funds that avoid investing in the fossil fuel industry and the fact that BP and Shell are two of the biggest investors in the development of renewable energy technologies.

The influence of the financial sector

The financial sector has an important role to play in the continuing promotion of sustainable development and voluntary initiatives such as the UNEP Financial Services Initiatives have had influence (see box above).

While considerable progress has been seen since Rio in 1992 on developing environmental management within the financial sector, there is a growing demand for more action to combat social exclusion. Many financial institutions have recognised the benefits of environmental management in reducing costs, improving efficiency and in managing risk. The challenge facing the industry is to develop this and at the same time raise awareness of the social aspects of sustainable development in the boardroom.

Sustainability – economic and environmental **16.47**

All of the above endorses the fact that nowadays every business of stature – regardless of size or location – should take the environment very seriously indeed and business ignores environmental issues at its peril. Consumer pressure remains of fundamental importance, mainly because responding to what customers say they want is always good business and wise managers also listen carefully to NGOs. As has been mentioned in **Chapter 4**, there is a clear link between sustainability and good corporate governance. In addition environmental legislation and regulation around the world continues to become more stringent. Most striking, however, is the arrival of corporate peer group pressure. By way of example, the 1990s survey by KPMG demonstrated that 77 of the FTSE 100 companies discussed their environmental strategies in their latest annual reports.

Environmental reporting: This term has generally referred to the reporting of organisations on their environmental performance, typically to shareholders in the annual report, but also by way of separate reports for other groups such as employees and the general public. It is an essential requirement for registration in the EU under EMAS and at international level under the Valdez Principles. A UK initiative to assist SMEs under EMAS was set up, known as SCEEMAS.

The principle of sustainable development as endorsed by the EU's Fifth Action Programme – and further developed by the Sixth Action Programme – should be at the forefront of any corporate, environmental policy. This principle recognises that world natural resources are either renewable or finite. Renewable resources should be managed in order to provide a continuous stream for ongoing productivity. Finite resources should be used only in the most productive and efficient ways in order to allow time for the development of alternative sources once existing resources have been depleted and/ or for the development of comprehensive recycling schemes to renew these resources if practicable. The future growth and forward planning of any organisation requires crucial budgeting of available resources, the most important being financial and human resources. Management should consider projections in terms of a 'green budget' in their effort to support a credible environmental protection policy and to maintain a high marketing profile as well as to attract public support for ongoing activities. Management standards are an increasing feature of business life. For many companies, as is mentioned above, see **16.17**, the quality standard ISO 9000 as well as the environment standard ISO 14001.

Pathways to sustainability

Companies which intend to take sustainability seriously should assess their own sustainable goals. These would constitute the long-term vision of the company operating in accordance with sustainability. EMS can be converted into sustainable management systems to provide clarity about what are sustainable levels for the company's impacts, and to drive progress towards them.

There will be difficulties, the challenge of identifying sustainability goals for a particular company is complex, and in certain cases the 'sustainable level' for an existing process or product may be zero. The implication for the company may be that an alternative process or products will be required on the path to sustainability. Flexibility is a vital element. Existing EMS may improve current products and processes, but they should also identify environmental problems which can only be resolved by a lateral re-think.

The company serious about understanding sustainability will not just have an EMS, it will also have a sustainability benchmark against which to test performance and identify the sustainability gap. Unsustainable practices will be highlighted, and major strategic decisions about product substitution or process change will be planned by proactive management.

Environmental liability

The US influence **16.48**

In developing its environmental legislation, the EU considered established environmental protection legislation and policy in the USA. Liability for the clean-up costs of such sites may fall not only on the owner/operator, but also on companies who transported any waste to the site, previous owners of the site, companies whose waste was dumped on the site at any time and even lenders to those companies. The lengthy debate on environmental liability in Europe (the Commission published a Green Paper on the subject in March 1993) finally led to an environmental liability regime. What is very evident is that large organisations understand that they are judged by the higher standards that exist.

Whereas the traditional debate over environmental liability largely referred to historic liability and contaminated land, the approach in this handbook has been to develop the area of liability to the various aspects of environmental and energy management and performance as is seen throughout the publication and in this chapter in particular, that is with an ongoing approach to due diligence.

European and International Standards 16.49

While the EU is working towards harmonisation within its borders, jurisdictional differences between Member States do still exist and they maintain separate legal systems, some having imposed stricter standards than those enacted at EU level. The effectiveness of enforcement measures also varies widely. Looking further afield, there is an undoubted need to fulfil international environmental standards in order to compete globally in terms of trade, tenders and the market. Sustainable development requirements have pushed global business towards an enhanced proactive management approach.

Many developing or so-called 'third world' countries have sophisticated environmental legislation on the books and when they commence effective implementation this will have a significant impact on any business operating within their territories. For instance, India has both environmental auditing and impact assessment regulations in place. In order to minimise any impact, it is important not only to be aware of existing regulations, but also of forthcoming regulatory developments and their enforcement.

Therefore from an international point of view the ideas behind an organisation's environmental policy are vital. At the very least the aim must be to comply with minimum standards. Ideally the standards maintained should be the strictest possible, bearing in mind the cost–benefit ratio. For international companies, a single policy encompassing all the varying requirements found in the jurisdictions in which they operate demonstrates good corporate practice. The Bhopal incident in 1984 demonstrated that if high standards of management are not maintained, the consequences can be devastating. That particular incident led to American businesses being forced to maintain uniformly strict standards wherever they carry out their operations, irrespective of local regulations. Where financial constraints do not allow such an approach, a single minimum standard to be applied, with stricter standards for those jurisdictions which have enacted such standards, is a viable option for the effective management of an organisation's environmental pollution control efforts. This is true both of the developed and developing world. But by accepting higher standards before they become compulsory, it may be possible to gain market advantage. This should also be considered in the context of corporate action in relation to climate change (see further below).

Legislative trends 16.50

Despite some deregulation initiatives, the trend is towards increasing implementation of environmental legislation with stronger enforcement and tougher penalty provisions, including criminal fines imposed on those having control of the polluting operation. By way of example, the *EPA 1990* strengthened the criminal penalty provisions within the UK and gave sweeping powers to the Secretary of State for the Environment to enact comprehensive regulations for the control of everything from air and water pollution through to litter.

The re-enactments by the US Congress of the *Clean Water Act*, the *Clean Air Act* and the enactment of *Superfund Amendments and Reauthorization Act of 1986* (*SARA*) in 1986 tightened US federal laws, whilst at the same time imposing stiffer criminal and civil penalties. As the earlier discussion indicated, developments in the emerging jurisdictions in the Third World and Eastern European countries are being closely monitored by international organisations, including the UN.

The imposition of penalties for environmental crimes, moves by *inter alia* the EU to impose strict liability on companies causing environmental damage, and international monitoring of environmental protection efforts, should all be borne in mind when developing corporate environmental policy. As has also been noted, institutions such as the European Bank for Reconstruction and Development (EBRD) take into account the environmental policy of an organisation when considering an application for project finance.

Other key trends

New Zealand's parliament has recently introduced a new bill entitled 'The Climate Change (Emissions Trading and Renewable Preference) Bill' which establishes a New Zealand Emissions Trading Scheme and market with incentives for industries to reduce GHG emissions. If the bill is successful, New Zealand will be the first country in the world to pass climate change legislation of this kind. A long public consultation process will be required before any legislation passes the bill stage however.

The bill reaches across numerous business sectors and there are even proposals for helping households in reducing emissions. Industry sectors will be introduced to the scheme over five years with continuing support for adjustment through to 2025. Climate Change Minister David Parker said that talks held with various groups since announcing the scheme have focused on key issues, particularly 'pre-1990 forestry, assistance and aspects of the carbon market'. The legislation also discusses and provides for review of the ETS, which 'must consider the allocation model in the context of the emissions pricing policies of major trading partners'.

Another sector affected by the bill are electricity providers, who will be subject to a 10-year restriction on new baseload fossil-fuelled thermal electricity generation. These provisions will apply to any proposed thermal generation above 10 megawatts that uses more than 20% of fossil fuels as its fuel source. The bill will be given effect through a revised part 6A which is to be added to the New Zealand Electricity Act 1992 if the bill is successful. There is some provision to safeguard the security of the country's electricity supply which could restrict the effect of any legislation, however the move is a strong push encouraging energy generators towards the use of renewable processes. The government of New Zealand expects state-owned generators to heed the message that 'all new baseload electricity generation should be renewable'.

One of the controversial areas that has been widely reported has been the response of North America to climate change and in their management of GHGs. This issue impacts on Canada as well as USA and is becoming increasingly important in the discussions regarding steps to be taken post Kyoto. In this context the overall approach should be assessed bearing in mind the significance of the region and its contribution to climate change as well as the fact that Canada and the USA are key trading partners in the region. Therefore it is important to understand the concerns and response that are in process from both the regulatory and voluntary perspectives.

Climate change and GHG legislation: North America 16.51

Update by Gray E. Taylor and Andrew H. Macskimming.

It is often said that nature abhors a vacuum. The climate change imperative recognised so clearly by the North American public has been met by resistance to legislation at the national level in both Canada and the USA. Not surprisingly, state, provincial and municipal leaders have moved to fill that vacuum with policy initiatives and in some cases legislation to address the climate change issue. While one can easily be dismayed by the lack of federal action in Canada (Canada is on its fourth national plan with no substantive GHG legislation yet in place or on the near horizon) and in the USA (where the Executive Branch is fighting a bitter and to date successful action against numerous legislative proposals), the result has been a broad range of actions at the sub-national level, including the development of concepts and on-the-ground experiments that offer a variety of innovative mechanisms, frequently relying on markets, for dealing with climate change. This discussion touches on some of those initiatives. It also touches on the limits for such sub-national action in light of the concerns about leakage and inefficiency in isolated markets, demonstrating perhaps the need for national and ultimately global programmes and suggesting a role for voluntary markets to fill the gap.

Vacuum at the federal level 16.52

In the USA, the rejection of any effort to regulate CO_2 by the current administration has left a considerable gap. The previous two term administration was the recipient of two legal opinions by the Chief Counsel of the US EPA advising that the legal authority of the federal government to regulate GHGs could be found under the US Clean Air Act. Nonetheless, that administration chose not to introduce any regulatory measures for GHGs.

In Canada, GHG emissions have risen rapidly, despite the signing by the federal government of the Kyoto Protocol in 1998 and its ratification in 2002. Throughout this time to the present day no regulations or taxation measures have been put in place by the federal government to address carbon emissions. Both the current and previous governments in Canada have proposed emissions intensity targets. Not even the most basic infrastructure for the establishment of a GHG regulatory regime with trading, as well as participation in the Kyoto Protocol, has been put in place; most notably there are no signs of progress on a national GHG registry. Nonetheless, unlike its US counterpart, the current Canadian government has introduced a regulatory plan for GHGs which it believes establishes intensity targets rigorous enough to achieve absolute reductions from 2006 emission levels as early as 2010 and no later than 2012, notwithstanding the expected rapid growth in the energy sector. Those regulations will not, however, be effective until 2010, and intensity targets remain a matter of controversy.

State/provincial initiatives **16.53**

What follows is an overview of how states and provinces have responded to the absence of, or perhaps dissatisfaction with, federal initiatives on climate change in North America.

USA **16.54**

In the USA, there are currently 20 states that have completed climate change plans and another 15 with plans in progress; 17 states have established quantified GHG reduction targets. A handful or two of these targets are embodied in legislation, while the targets of another handful are found in executive orders (EO). Five states have caps or offset requirements for GHG emissions from power plants. To take two examples of state GHG targets that have been recently enacted:

- In July 2007 New Jersey's Governor signed into law the Global Warming Response Act which sets a reduction target for the state of 1990 levels by 2020 and 80% below 2006 levels by 2050.
- In May 2007, Washington State's Governor signed legislation establishing a target of 1990 levels by 2020, 25% below 1990 levels by 2035 and 50% below 1990 levels by 2050.

Of all the US jurisdictions, California is having the greatest impact across North America. In 2006, California's Governor signed into law the Global Warming Solutions Act which establishes a cap of 1990 levels by 2020 with enforceable penalties. California appears to have been the first jurisdiction in North America to enact a GHG reduction target expressed in absolute terms.

Under the Act, California Air Resources Board (CARB) is to adopt mandatory regulations for GHG reporting by 1 January 2008, and present a detailed plan for how reductions will be achieved from significant sources using regulations, market-based mechanisms and other actions by 1 January 2009.

GHG rules and market mechanisms adopted by CARB no later than 1 January 2011 are to take legal effect by 1 January 2012. The state is currently designing a multi-sector cap-and-trade system under the Act. At the end of June 2007, the Market Advisory Committee released its final report and recommendations to the CARB, on the design of a cap-and-trade system. The major recommendations were:

- that the programme should eventually include all major GHG-emitting sectors of the economy;
- that some share of allowances should be allocated free of charge initially, while the remaining allowances should be auctioned, with the percentage of allowances auctioned then increasing over time;
- that offsets generated both within and outside the state's borders should be recognised;
- that California should encourage linkages with other mandatory GHG cap-and-trade systems.

Two key initiatives to implement the statewide target are California's low-carbon fuel standard (LCFS), now in development, and regulatory limits on GHG emissions from motor vehicles, now legally in force, which establish targets beginning with the 2009 model year.

California's LCFS has not yet been published in detail. Rather, an EO establishes a statewide goal to reduce the 'carbon intensity' of California's transportation fuels by at least 10% by 2020. Under the EO, the LCFS, to be developed through a collaborative process between various California agencies and the University of California, will apply to 'all refiners, blenders, producers or importers' of transportation fuels, and 'shall be measured on a full fuels cycle basis'. In Canada, the latter has raised concerns that the LCFS could discourage shipments of heavier oil from Western Canada's oil sands. Two Canadian provinces, British Columbia and Ontario, have committed to adopting the LCFS.

California's GHG regulations for motor vehicles, now enacted, establish fleet average emission standards for weight-based categories of vehicles over the 2009–2016 model years, are applicable to both vehicles produced and delivered for sale in California, and are expressed on a grams per mile of CO_2 equivalent basis. By 2016, the rules will result in a 30% reduction in emissions from the 2002 fleet. A total of 14 other states have either adopted or announced that they will adopt the rules, including New York, New Jersey, Pennsylvania and Florida. The Canadian provinces of British Columbia and Quebec have announced that they will impose standards on new vehicles sold in their provinces consistent with the California rules but Ontario (the home of the Canadian automobile industry) is resisting.

California's GHG tailpipe standards are currently being challenged in US federal court. In addition, the State's regulations require a waiver of federal preemption to be issued by the US EPA's Administrator under the US Clean Air Act. California has stated that it will litigate the matter itself, if the waiver, requested on April 26th 2007 was not granted within six months and a day of that request. US Senator Boxer has introduced legislation to expedite the granting of this waiver.

Canada **16.55**

A number of interesting things are also happening on the Canadian scene. In Canada, 9 out of 10 provinces have released climate change plans[10] in addition to the regulatory plan proposed by the federal government. One of these plans, the 2005 Newfoundland and Labrador plan, does not set any quantitative targets, while the Province of Alberta sets targets on an emissions intensity basis, both for industry and the province itself. Not all provinces use the internationally recognised baseline of 1990, nor does the federal government, which may create difficulties for linking between jurisdictions within Canada and the emergence of a national system, whether driven by the federal government or provincial collaboration.

The three major hydropower producing provinces are, not surprisingly, among the provinces that have set the most stringent targets: British Columbia, Manitoba and Quebec. British Columbia, for example, has proposed reducing its GHG emissions to 10% below 1990 levels by 2020. Nova Scotia's Environmental Goals and Sustainable Prosperity Act, which entered into force 7 June 2007, sets the same target. Remarkably, despite ambitious targets, no province other than Alberta has proposed regulating GHG emissions across the main industrial and transportation sectors.

Alberta stands out as the only province and, in fact, the only jurisdiction in North America, with regulatory limits on industrial GHG emissions currently in force. Alberta's Specified Gas Emitters Regulation imposes emission intensity limits on GHG emitters in Alberta, with the first set of targets being for the six-month period between 1 July 2007 and 31 December 2007. The Alberta GHG system is innovative in many ways and includes the adoption of extended GHG reporting, emissions trading between regulated sectors, an offset system (including the adoption of protocols from the Kyoto Protocol and

[10] In the case of Ontario, the plan consists of a fairly comprehensive set of proposed GHG measures, while in the case of Nova Scotia, a target is established in legislation, the *Environmental Goals and Sustainable Prosperity Act*, which entered into force 7 June 2007, which includes principles, objectives and goals related to climate change, as well as provisions authorising the Province to enact regulations, enter into sectoral and intergovernmental agreements, and establish programmes and other measures related to climate change. The Act provides for a target of at least 10% below 1990 levels by 2020. The lone province that has not released a climate change plan appears to be Prince Edward Island (it had a climate change 'business plan' but its last effective year was 2003 and it does not appear that anything replaced it).

other systems) and the administrative arrangements needed to support such an enterprise.

In late 2001, Alberta adopted a policy to require new coal-fired power plants to meet a so-called 'good-as-gas' standard, which means that the plant must reduce its emissions intensity on a net basis to no higher than the level of a combined cycle natural gas power plant. This requirement is included as a condition in provincial regulatory approvals for new coal-fired plants. This may have been another North American first for the province.

There are two other exceptions to the statement that no Canadian province has proposed regulating industrial GHG emissions, although they are partial exceptions, because in one case, the province has not proposed regulating all major emitting sectors, while in the other, it is not clear if the measures put in place would have an effect equivalent to a regulation:

- The first is British Columbia, which is considering quite significant requirements for its power sector and some impositions on its relatively young but rapidly growing oil and gas industry. British Columbia's ambitions for its power sector include requiring all new and existing electricity produced in the province to have net zero GHG emissions by 2016, as well as reducing GHG emissions from its oil and gas industry to 2000 emission levels by 2016. Nonetheless, the only imposition on its oil and gas sector described by British Columbia as a *requirement* is the proposal for zero flaring at producing wells and production facilities. Not mentioned in British Columbia's plan are the province's vital mining and mineral processing sectors, as well as forestry.
- The second partial exception in respect of regulatory matters is Quebec. Quebec has proposed reaching agreements with industry on a sector-by-sector basis to reduce GHGs, although the legal status of these proposed agreements is not clear. Quebec is another Canadian province which has achieved a North American first. Its mark of distinction is Quebec's proposed carbon tax, which will apply to all hydrocarbons used in the province based on carbon content, effective October 1st of this year, at a rate, for example, of 0.8 cents Canadian per litre for gasoline, 0.9 cents per litre for diesel, and $8 per tonne for coal.

Significance **16.56**

In some cases, sub-national initiatives are very significant.

At the national level in North America, both the USA and successive Canadian governments have rejected the Kyoto Protocol targets, whether through words or inaction. Into this void has stepped California, whose legislated GHG target of 1990 levels by 2020 is now effectively a gold standard in North America, reflected in its adoption by Congressional proposals for regulating GHGs, including bills introduced or sponsored by Senators McCain, Lieberman, Obama, Boxer and Kerry, as well as numerous states. Canada's target for the year 2020 of 20% below 2006 levels is about 3% shy, in relation to

2006, of achieving the same result as California, perhaps due to nothing more than the irresistibility of the phrase '20 by 20'.

As can be seen from the preceding survey, state and provincial plans vary significantly in scope, the stringency of targets, and tangibility: for example, while some jurisdictions, including those in Canada, have announced targets more ambitious than California, it is unclear how they will get there in the absence of plans to regulate either industry or transportation. Another interesting study in contrasts is that of Alberta and Canada's other provinces: while the nature and stringency of its targets may not be enough for some, Alberta is in a league of its own by virtue of having the only legally effective targets for industry at present in North America. Its experience may well prove invaluable for regulators across the continent. Alberta was also the first province in Canada to enact a province-wide GHG target, a point of distinction now shared by Nova Scotia.

Regional co-operation, including in respect of registries

The Western Regional Climate Action Initiative 16.57

The Western Regional Climate Action Initiative (WRCAI) was formed in February 2006 by California, Arizona, New Mexico, Oregon and Washington State. On 24 April 2007, the Canadian province of British Columbia joined, as did Utah in May, and the province of Manitoba in June. Under the WRCAI, British Columbia, Manitoba and the six US states have agreed to set an overall regional GHG reduction goal by August 2007. The WRCAI members have also agreed to complete the design of a 'regional market-based multi-sector mechanism' by August 2008 to meet the WRCAI's regional GHG goal. In addition, the WRCAI's members will participate in a multi-state/provincial GHG registry, which will serve, according to the MoU, 'to enable tracking, management and crediting for entities that reduce GHG emissions, consistent with state GHG reporting mechanisms and requirements'. In May 2007, British Columbia became a member of The Climate Registry, along with the other 6 WRCAI members who are among 30 participating states, the province of Manitoba, several American Indian tribal governments, and the Mexican State of Sonora.

The Climate Registry 16.58

The Climate Registry will provide a common entity-wide GHG accounting, reporting and verification system to support the WRCAI and a variety of both mandatory and voluntary policies. It contemplates the development of a number of specific protocols. Quantification guidelines would include two tiers reflecting two standards of accuracy, one a preferred approach and the other a default standard. The Climate Registry was due to begin accepting data from reporting entities in January 2008. It is not proposed at present to accommodate project-based mechanisms, in other words, offsets.

RGGI 16.59

The WRCAI is unique in its wide scope. The Regional Greenhouse Gas Initiative or RGGI of the northeastern states, for example, establishes a cap-and-trade system, but only in respect of the electricity sector, and it deals with only one gas, CO_2. The programme will cap emissions at current levels in 2009, then reducing emissions 10% by 2019. A model rule has been promulgated for states to base their own legislation on. It was formed in 2005 by seven states (Connecticut, Delaware, Maine, New Hampshire, New Jersey, New York and Vermont). Three states, Massachusetts, Maryland and Rhode Island, have either now joined or committed to, bringing the total to 10. The Eastern Canadian Provinces (or 'ECP', being the four Atlantic provinces and Quebec) currently have observer status on the RGGI.

Other regional initiatives 16.60

In 2001, the New England Governors and Eastern Canadian Premiers developed the Climate Change Action Plan, a regional initiative with a target of 1990 emission levels by 2010 and 10% below 1990 levels by 2020. However, it's not clear that there has been much co-ordinated activity since that time. There are several other regional initiatives in the USA which address clean energy, energy efficiency and bio-energy, but are not focused on GHG emission reduction targets per se, as well as an initiative between New Mexico and Arizona on climate change, and an initiative between California, Washington State and Oregon on the same, which need not be discussed here due to their limited accomplishments.

Conclusion on the regional initiatives 16.61

As a multi-sector initiative, by far the most ambitious regional GHG initiative is the WRCAI. However, the initiative of perhaps the greatest practical importance is The Climate Registry which, with 30 states, 2 provinces, several American Indian tribal governments and a Mexican state among its members, has significant potential for facilitating multi-jurisdictional linkages. Such linkages will be facilitated by a common approach to measurement, reporting and verification (MRV).

Jurisdictions considering linking will also have to consider the relative level of effort reflected by a jurisdiction's GHG targets and scope of coverage, and the approach to such matters as enforcement. An issue of key importance is how each jurisdiction deals with leakage. After all, a system that allows targets to be met by increasing imports of electricity from neighbouring jurisdictions or exporting high emitting operations will be of little real value to either the environment or the economy.

A commitment to MRV, as well as the establishment of a registry, is an important sign of a jurisdiction's seriousness in pursuing GHG targets: emissions and emission reductions cannot be tracked and traded in their absence.

MRV on a common basis will facilitate inter-entity trading, as well as potentially constructive interaction between mandatory and voluntary markets. One void left by The Climate Registry is the need for standardisation of protocols in relation to offsets. The experience of Alberta which relies upon a public–private partnership called Climate Change Central to develop and provide advice on offset protocols, and the Chicago Climate Exchange or CCX, to be discussed momentarily, may be helpful in that regard.

Before leaving US initiatives, it is worth mentioning that the US Mayor's Climate Protection Agreement has brought together over 500 US municipalities around the goal of reducing their GHG emissions to 7% below 1990 levels by 2012.

The voluntary markets

Overview of the voluntary market 16.62

The voluntary markets are increasingly important.[11] Prominent providers of GHG offset credits to voluntary buyers include zerofootprint, myclimate and NativeEnergy. According to a July 2007 report by Ecosystem Marketplace and New Carbon Finance, in 2006, 23.7 million tonnes of carbon dioxide equivalent were transacted in the voluntary carbon markets. Of this, 10.3 million tonnes were transacted on the CCX, while some 13.4 million were transacted in over-the-counter trades. According to the report, as a result of the limits of the ability of their survey to capture market activity, the actual size of the market may be much larger. The North American voluntary market reaches outside the boundaries of North America. For example, some CCX offset projects have been carried out in China, Cost Rica and Germany.

Voluntary carbon credits fill a demand on the part of conscientious citizens that wish to offset the effects of their air travel and household, transportation and other emissions, as well as businesses concerned with the growing demands of customers and investors for accountability on climate change. Shell Canada is an example of a business which uses carbon offsets, specifically to reduce its carbon footprint from energy intensive oil sands operations in Western Canada.

Earlier this decade, Ontario Power Generation acquired Emission Reduction Credits registered with CleanAir Canada from Bluesource, representing up to 6 million metric tonnes of CO_2 reductions from US projects, with an option for another 3 million. Google is another example of a company that has announced very recently that it is seeking to offset its carbon emissions.

Some businesses may hope to use the market to hedge against the risk of future regulation. This would depend on new regulations either recognising the credits or allowing the underlying GHG reductions to be converted

[11] Excludes voluntary participation in offsets systems established in conjunction with a regulatory regime.

into some other recognised type of credit, perhaps as credit for early action. It would also depend on regulators allowing such credits to be carried forward and applied against obligations in a later year. Others may wish to simply play a role in building the market. Voluntary carbon markets could be seized upon to satisfy a need for a price safety valve in relation to a regulatory regime, such that CCX or other voluntary system credits could be purchased if the price of compliance were to rise above a stipulated level.

Considerations for credible voluntary GHG initiatives 16.63

The voluntary market is under increasing scrutiny by journalists and others. Much like the safeguards for credits issued under the Clean Development or JI mechanisms of the Kyoto Protocol, the presence of a sound project design, including a credible baseline, ideally validated by an independent third-party expert, sound monitoring and measurement of relevant data throughout the project, as well as ex post verification of the asserted reductions, in all cases, by an independent third-party expert, will be important.

Following these procedures are most likely to underpin credible claims when they are done in accordance with a recognised international standard, such as ISO 14064, used by the Canadian Standards Association's (CSA) CleanProjects Registry discussed below.

An additional concern in this market is to ensure a clear correspondence between the quantity of credits purchased, their price and the quantity of reductions attributable to the investment. Perhaps most important is a clear and exclusive chain of title between the generator of the reductions, the seller and the buyer, as well as anyone else involved. Carbon credits purchased to support a claim that emissions have been offset should be retired definitively and transparently to ensure public confidence.

Key players in the emerging voluntary carbon market 16.64

Voluntary systems generally take one of two forms. The first is represented by the CCX. While membership is voluntary, it requires its full members to make binding contractual commitments to achieve emission reductions, or else purchase reductions from others. Other participants act as providers of offsets without assuming their own reduction obligations. In many respects, its structure mimics that of a regulation-based ETS.

The second model for voluntary systems is one which facilitates the registration of project-based reductions that can potentially be purchased for on-sale or retirement, all in the absence of any participants that carry obligations to reduce emissions and therefore anchor demand. The CleanProjects Registry of the CSA is an example of the second model. In order to be registered, projects are required to be validated and reductions must be verified by an independent third-party expert. It permits reductions to be ultimately registered in the name of a person other than the generator of the reductions, through the serialisation of verified reductions and their 'delisting', as it is termed, to other persons or registries. The CSA will also be introducing a registry shortly at the entity level showing an organisation's complete GHG emissions inventory. Unlike the CCX which is an exchange (i.e. a location for trading), the CleanProjects Registry does not perform the exchange functions related to 'clearing' for example and leaves lots of room for the development of a Canadian voluntary credits exchange.

A number of other major voluntary initiatives have been announced. Morgan Stanley announced in August 2007 the establishment of a Carbon Bank. The Carbon Bank will service client companies that wish to assemble their GHG inventory and measure their carbon footprint. The inventory will then be verified by Det Norske Veritas (DNV), a leading verifier of emission reduction projects under the Kyoto Protocol, using ISO 14064. Morgan Stanley will then procure credits sufficient to offset the company's carbon footprint, all of which it states 'will be generated according to the standards of the Kyoto Protocol'. The Carbon Bank will then issue what is called a 'carbon zero' certificate. Very recently the International Emissions Trading Association (IETA), The Climate Group (TCG), the World Business Council for Sustainable Development (WBCSD) and the World Economic Forum (WEF) announced that they have completed work on a new Voluntary Carbon Standard, a framework containing all the methodological elements necessary to register and trade voluntary GHG reductions on a credible basis, resulting in the creation of a unit known as the VCU. This provides another option for persons that wish to realise value on their GHG reductions within the voluntary market.

GE Energy Financial Services and AES have announced a partnership to carry out projects yielding 10 million GHG offsets by 2010, primarily from methane-reduction projects. These would be sold to commercial and industrial customers that wish to voluntarily offset their emissions.

Oversight of the voluntary carbon market **16.65**

Governments are increasingly taking an interest in the voluntary carbon market. In 2007 the UK government put forward its own draft of a voluntary Code of Best Practice for carbon offsets, which it hopes will be a standard that consumers and other purchasers in the voluntary market will rely on. It could be queried whether North American governments will become more engaged in identifying the standards that should, or must, be followed in the voluntary sector. In Canada, Federal Cabinet Ministers have made statements suggesting they may be considering some form of oversight.

Perhaps most germane to voluntary carbon market offset providers in North America are the securities regulators, who could be expected to take an increasing interest in emission credits that are not created by any governmental authority or designate thereof, and which may be sold widely to the public. In Canada, where securities are regulated provincially, Ontario Securities Commission Rule 14–502 designates '[a] product based on environmental quality, including emissions or emission credits' as a 'commodity'. This suggests that, in Ontario, if emission credits are the underlying commodity for futures sold on an exchange, the futures contracts trading will generally be governed by the Commodity Futures Act, or if they are not traded on a commodities exchange, they will potentially be regulated by the Ontario Securities Act, to the extent that the credits are, or, more likely, are included in, something which is a 'security'. In respect of these issues, the securities legislation of each relevant jurisdiction will have to be considered carefully.

Private sector initiatives to spur regulation **16.66**

Some companies have taken the position that rather than expending their resources participating in a voluntary system of uncertain value, they will take it upon themselves to advance proposals that they hope will shape a future regulatory system.

The United States Climate Action Partnership or US CAP, a collaboration of major corporations and environmental NGOs, is one such example. In the context of a cap-and-trade system, its targets are: between 100% and 105% of today's levels within five years of 'rapid enactment', between 90% and 100% of today's levels within 10 years of rapid enactment, and between 70% and 90% of today's levels within 15 years of rapid enactment. If these targets were enacted this year, for example, GHG emissions could be permitted to rise by as much as 5% from present levels until the end of 2012, and be stabilised at present levels as late as the end of 2017. This is a reminder that caps and absolute reductions are not synonymous, as caps can be fixed higher than 100%.

Concluding comments **16.67**

It is clear that many jurisdictions are attempting to show that they can cut GHG emissions on an absolute basis. This suggests that from the point of view of linking systems or convergence, a cap-and-trade system is more likely to succeed. At the same time, a cap must be set at a level below 100% to be credible.

A common approach to MRV of GHG emissions enhances the likelihood of a credible and functional system for reducing GHGs, as well as any prospect of linking between systems. The Climate Registry is perhaps the most significant regional development in a North American context. Services such as the CSA's CleanProjects Registry may help to fill the gap in respect of project, as opposed to entity-based mechanisms. The Climate Registry will also facilitate the interaction of mandatory and voluntary trading systems, which may be one means to enhance liquidity and manage the price of carbon in a regulated system.

Targets in the absence of regulatory programmes for all major emitting sectors reduce the credibility of state/provincial and regional initiatives. A multi-sectoral approach implies a much higher level of effort for the economy of a potential linking jurisdiction than a jurisdiction which selectively regulates key emitting sectors or relies on a voluntary approach. Targets will be more believable as a guide to long-term behaviour where they are legislated in some form, and where they set short-, medium- and long-term targets. With some exceptions, a significant gap for many jurisdictions is the absence of any target between 2020 and 2050.

Regulatory and other initiatives should not simply lead to a reduction of emissions on paper. A credible approach will not allow for leakage, such as meeting targets by increasing imports or shifting the most polluting production to one's neighbours. In this respect, Alberta may feel some justification in not imposing more stringent absolute targets, as it is held responsible for all of the emissions from its upstream oil and gas production, while its customers bear none of the burden.

Finally, from a public point of view, as the WRCAI shows, effective action by state and provincial governments on climate change is possible where it is genuinely desired. California demonstrates further that a state or province can set the agenda for an entire country. Conversely, bold offers of action on GHGs made on a conditional basis, or an acceptance of standards imposing hardships on a neighbouring jurisdiction while rejecting those that would burden one's own industry, are unlikely to lead to co-operation and success, and are probably not intended to.

Notwithstanding the significant potential of state, provincial and regional efforts, there is no doubt that a national system would avoid the inefficiencies and potentially high transaction costs for business of a collection of divergent GHG rules. States and provinces also understandably do not wish to export jobs and investment to their neighbours. States and provinces may argue with each other over the relative merits of each other's proposals, including their relative benefits for the environment and burdens for industry. The potential for finger pointing is enormous. All of this means that despite the growing level of noise and activity on the GHG issue by states and provinces, it is not clear that they are going to succeed in establishing a strong and coherent multi-jurisdictional GHG reduction system with near complete participation, independent of the leadership of their federal governments.

To the extent that voluntary systems can seamlessly cross jurisdictional boundaries, they may well offer more universality and lower transaction costs than the large and growing number of state, provincial and regional efforts currently seen in North America. Some of these systems, such as the CCX, have found innovative solutions to problems such as the treatment of the risks associated with forestry projects. In the CCX, a 20% reserve of carbon offsets is held back for forest projects. At the same time, the growing number of voluntary GHG systems may encounter the same challenges associated with finding coherence seen among the diverse approaches of sub-national governments to climate change. There are also limits to the public's time and willingness to understand and appreciate the differences between different private sector initiatives, which may lead to their blanket rejection if some label of approval, which the public is prepared to trust, does not emerge in the near future.

It may ultimately be to the benefit of businesses participating in the voluntary carbon market if the number of voluntary systems is kept or reduced to a small number, or if a small number of voluntary systems fulfil different niches that can be made compatible with, and complementary to, each other. If the market ultimately produces this result, large numbers of states and provinces could simply sign on to the reporting, verification, registration, trading and other services of a very small number of private sector and non-governmental service providers. This could ultimately be a path to achieving the daunting task of a more or less complete North American GHG reduction system sustaining itself independently of federal leadership. The Climate Registry is the most substantial development in this respect, at least for many aspects of a multi-jurisdictional GHG system (it does not address the needs of project-related protocols, however). Yet however vital, these are nonetheless only the mechanical elements of a GHG reduction and trading system, and ultimately different jurisdictions will need to agree on fairly similar GHG reduction goals before they are likely to link to each other.

Finally, from a private sector point of view, it appears that the most essential steps for success are to recognise potential sources of GHG reductions; measure, report and verify those reductions in accordance with a recognised international standard; and register reductions with a credible registry. Clarity of the origin of GHG reductions and ensuring a clear chain of title, as well as treatment of the reductions appropriately and transparently, such as retirement towards the environment, will also be vital to ensuring the confidence of one's customers and investors. Given the uncertainty in respect of these systems, it may not be responsible to over-commit the resources of a company to reduce GHG emissions, but the taking of cost-effective measures, in accordance with the standards set by environmental leaders in one's sector, can almost certainly be justified.

Meanwhile in the USA it has also been reported that the SEC will require climate change disclosures as early as this year (see also **Chapter 11**). As a result of pressure from big institutional investors and state officials, federal securities regulators will issue guidance clarifying that certain kinds of climate-related information is 'material', meaning it involves significant business risks and must be included in corporate filings under existing law. The trend is for investors to require more information about what firms are doing – and not doing – to clean up the environment. They want to know:

- which companies are major emitters of GHGs and thus potentially liable to future lawsuits (see further below);
- what plans they have for reducing emissions and how much they will cost;
- which insurance companies are exposed to risk from climate change and to what extent.

This demand for more disclosure is being led by state pension managers from California to Florida to New York and by large investor groups and institutions that control several trillion dollars. All companies will need to report to shareholders a wide range of information on risks associated with climate change. That includes anticipated hits to earnings as well as capital expenditures due to complying with state and federal environmental laws. Evidently the corporates will also have to acknowledge when the firm's reputation could be tarnished because it's not being 'green' enough for investors. Some oil, power and insurance companies see that it's in their best interests to do so and have already begun disclosing climate change information to investors. For instance in deals agreed with environmental activists, American Electric Power, the biggest GHG emitter in the country, and Cinergy Corp. agreed to report publicly on what they're doing to cut down on carbon dioxide and other harmful emissions. Meanwhile, insurers such as Allstate and MetLife have also started disclosing financial risks tied to calamities like droughts, fires, floods, hurricanes and other climate-driven phenomena. Other sectors will be forced to follow suit, from banks to retailers to telecommunications firms. Each will also have to disclose and document in quarterly and annual statements everything from loans made to environmentally unfriendly firms to bad building practices polluting the environment.

Business ramifications **16.68**

One of the main reasons legislative developments need to be anticipated is the necessity to budget for capital items such as new plant and process equipment. It is particularly important to keep abreast of international initiatives such as the phasing out of the use of CFCs that had repercussions at regional and local level, in order for the business to remain competitive. They had to anticipate new measures and act upon them. This was evident in the early debate over the refrigeration business, as noted above.

Friendly fridges
Elstar, which supplied refrigeration to pubs and clubs, announced that it had switched its entire production to ozone-friendly chemicals. It was believed to be the first maker of commercial fridges in the world to switch to gas-cooled cabinets, some four years after the EU agreed to ban CFCs under the Montreal Protocol, because fridge coolants damage the ozone layer.

More recently the debate has been over electronic goods and legislation such as the EU's *Waste Electrical and Electronic Equipment directive* (WEEE directive). In January 2007 Europe-wide regulations regarding the disposal and recycling of waste from the electrical and electronic sector came into force. This has focused the minds of industry. Moreover the debate over the chemical regulation known as 'REACH' has extensive ramifications for the chemical industry and is a very useful recent example of how companies should anticipate and be proactive in the face of regulation in today's business world.

'"REACH" stands for "Registration, Evaluation, Authorization and Restriction of Chemicals."'

The REACH Regulation replaces over 40 earlier measures relating to chemicals produced or supplied in the EU, including legislation on existing and new substances, marketing and use restrictions, and the classification, packaging and labelling of dangerous substances. It became law throughout the EU on 1 June 2007, but deadlines for complying with its provisions vary.

REACH requires the registration and testing of all chemical substances manufactured in, imported into or used in the EU in volumes of 1 tonne per year (TPY) or more between 2008 and 2018, even those intended for export to third countries (around 30,000 chemicals). The most harmful chemicals will be phased out. Thus compliance with REACH raises major technical and scientific, product management and marketing issues, and introduces important new responsibilities not only for the chemicals industry itself, but also for manufacturers and importers of finished products ('articles') that contain chemicals.

REACH makes the manufacturers, importers and industrial or professional downstream users (DU) of all chemicals or preparations responsible for proving they are safe. DU formerly only had to provide information on chemicals classified as dangerous and supplied with a Safety Data Sheet (SDS) further down the supply chain.

REACH is not just environmental law. It also raises many other important legal matters: intellectual property rights (IPR) protection; contracts with suppliers and customers; antitrust issues; and potential customs and trade law problems.

REACH will have far-reaching effects in third countries as well as Europe, for both the chemical industry itself and for DU and manufacturers and exporters of finished products.

Basic facts about REACH

Scope 16.69

- REACH applies to virtually all individual chemical substances manufactured in, imported into or used as intermediates in the EU or placed on the EU market, on their own or in preparations or articles, whether or not they are classified as dangerous and even if they are ultimately exported.
- REACH affects EU manufacturers of substances, preparations and, in some conditions, articles, and EU importers of substances, preparations and articles produced in third countries. Third-country manufacturers are not directly affected, but they must either provide their EU importers with detailed information on the substances they supply or incorporate in their articles, or appoint a single EU-based legal representative to handle compliance with all their REACH obligations. EU-based DU also have significant obligations under REACH.

Registration and data-sharing 16.70

- All substances manufactured in the EU or imported in quantities of 1 TPY or more, dangerous or otherwise, must be registered with the European

Chemicals Agency (ECHA). Substances not registered may not be manufactured in or imported into the EU ('no data, no marketing').

- Registration of a chemical involves compiling and filing basic toxicity, exposure and other data on its health and safety factors and selecting appropriate risk management measures for it, to prove it is safe for all uses intended by any member of the supply chain or notified by an immediate DU. This will entail obtaining information from clients on how they use a chemical.
- DU should normally tell suppliers how they use a substance, so the use can be included in the supplier's risk assessment. If they want to keep their use confidential or use a substance outside the conditions described by the supplier, they must carry out their own risk assessment and notify the use separately to the ECHA. This could prove very costly.
- The timing of registration and the information required vary according to the tonnage in which a substance is manufactured in or imported into the EU and how dangerous it is. Pre-registration of (phase-in) substances listed in the European Inventory of Existing Commercial Chemical Substances (EINECS) began in 2008.
- The phase-in information will be used to organise forums where registrants of the same substance can try to agree to share data on existing studies and tests of the substance or arrange for new studies or tests.
- Operators will need to audit substances manufactured or imported in quantities of 1 TPY or more. If substantial and reliable data on the safety aspects of a substance are not available, they may have to be obtained from other registrants or scientific experts. Registration will generate substantial costs for all operators in the supply chain.

Consortia 16.71

- Manufacturers and importers of the same substance can set up consortia for joint registration ('One Substance – One Registration' – OSOR). This may save them time and money, but before joining a consortium they should take specialised legal advice on whether this is really their best option. Managing collaboration between members will require resources, and the need for generalised data-sharing will limit members' freedom to choose their partners. Other factors to consider include the consortium's opt-out rules, cost-sharing, the value of the information shared, IPR protection and the antitrust rules.

Evaluation 16.72

- The ECHA will verify that a substance dossier contains full information and complies with the requirements for registration, and will check testing proposals before any tests are performed (dossier evaluation). If the evaluation suggests the substance may cause a risk to health or the environment, the

ECHA may request further information (substance evaluation). A substance can still be marketed during evaluation, but the ECHA may decide it should be subject to authorisation or even to EU-wide restrictions.

Authorisation 16.73

- Particularly dangerous substances of very high concern ('SVHC') will eventually be subject to authorisation. Authorisation is use specific and will only be granted if it can be shown that the risks arising from the uses made of the substance are adequately controlled, or that the socio-economic benefits of using it outweigh the risks connected with its use, and there are no suitable alternative economically and technically viable substances or technologies. REACH aims to phase out SVHC, so authorisation should be considered as temporary while a safer alternative is sought.
- The ECHA will draw up a 'candidate list' of some 1,500 substances which will eventually be subject to authorisation. Although only 25–30 of them will have to be authorised each year, there will probably be market pressure to replace them with less dangerous substances before authorisation is actually required.
- Because of the risks and authorisation requirements associated with SVHC, operators must identify any potential SVHC among the substances they manufacture or import as early as possible.

Articles (finished products) 16.74

- All substances present in articles in quantities of more than 1 tpy which are intended for release from the articles during normal and reasonably foreseeable conditions of use must be registered. SVHC in articles above a concentration limit of 0.1% weight by weight (w/w) and above 1 tpy must be notified to the ECHA, unless their exposure to humans and the environment during normal conditions of use, including disposal, can be excluded.
- Manufacturers and importers of articles should verify whether the articles are subject to REACH, and whether they may need to register/notify substances in the articles so they can be sold in the EU. They will also have to monitor the work of the ECHA, particularly to identify possible categorisation of substances as SVHC.

Liability 16.75

- Operators must ensure that substances are manufactured, imported or placed on the market prudently and responsibly, so that they do not affect human health or the environment adversely under reasonably foreseeable circumstances.

Enforcement **16.76**

- Member States must introduce 'effective, proportionate and dissuasive' penalties for non-compliance with REACH, but national penalties may vary widely. REACH may also affect tort and contractual liability.

The ECHA
The ECHA in Helsinki is at the core of the REACH system. It will play a key role in providing the Commission, the Member States and other players with technical expertise and manage the technical, scientific and administrative aspects of REACH. It also has significant decision-making powers, and its appeal board provides judicial review.

Business Strategy **16.77**

Regardless of sector, therefore, in addition to proper planning, a well thought out public relations approach to increase awareness of a company's green credentials is invaluable. The UK, for example, has already witnessed the impact of organisations such as B & Q. They have effectively dictated environmental management standards to would-be suppliers for many years and, in some cases, have actually sought to assist smaller organisations in their supply chain to meet those standards. It is clear from the comments throughout this book regarding small business that they must be considered in the whole debate. Moreover, as has been mentioned above the supply chain remains a key issue. Giant companies can have as many environmental policy statements as they like, but if their suppliers do not match the same standards and have the same duty of care as the giants the consumer will realise and the credibility of business and industry will be weakened. This is clearly crucial to overseas operations and linkages and has major ramifications in terms of trade, especially in view of the offshoring or outsourcing arrangements that are prevalent in business today.

Greenness often equals quality – linked to the brand (see **Chapter 7**) – in the eyes of consumers, but consumer interest in the environmental performance of a business is no longer limited to those living in the immediate area of the company's activities. As is discussed above at **16.47**, many companies now publish details of their environmental policy in their annual report. The European Union (EU) believe that all sectors of society must be made to feel a sense of shared responsibility for the environment, and the drive to increase public access to environmental information is seen as fundamental in this context. The EU's 'eco-labelling' scheme had a similar thrust. In the UK the Department of Trade and Industry (DTI) recommended a 'cradle-to-grave approach' in relation to product stewardship, that is that the supplier of a product which has the potential for contaminating a site or causing pollution should take responsibility for it by developing environmentally sound practices covering the use of that product even when no longer within the supplier's control (e.g. when the product is being transported, used by the consumer or when it is sent for disposal). Similarly an eco-mark has been developed in other jurisdictions.

Wherever a company operates, has activities and invests, communication is vital. Workers, shareholders, the local community, green action groups and the press should be kept informed of how perceived environmental problems are being solved and, if possible, given a role in helping find solutions. Set against this background, there is a potentially overwhelming array of issues for a company to address, having regard to the need for profitable yet ethical business practice.

Business ethics **16.78**

As has been mentioned in **Chapter 4** there are various methods that have evolved and that are being evolved relating to the analysis of a company's performance in terms of its environmental performance. There is an obvious ethical link between proper environmental performance and good business performance, which is becoming increasingly clear from the point of view of shareholders, investors, banks, etc. In order to have a real picture of the assets and liabilities of a company, it must be understood that environmental liabilities are very much part of the equation. This factor was very clear in the debate in the UK over the proposed register for contaminated land proposal which was in fact withdrawn as a result of the lobbying of many property owners who considered that transactions and the market would be blighted as a result. Nevertheless the debate did raise awareness and it is true to say that most companies are likely to hold now or in the future, contaminated property. This means that, especially following the UK's Environment Act 1995, there may well be repercussions for such organisations in terms of the assessment of their balance sheet. Many aspects of environmental management can affect the finance of a company.

Costs for companies

At the international level one vivid illustration of the bad effect of perceived improper environmental management is that of the Shell case in Nigeria where business ethics came up as a major concern and involved Shell in a very expensive large-scale media exercise to recover its reputation. Shell's quoted share price fell dramatically. Shell also suffered the cost of non-compliance by paying the largest national fine of £1 million when sued some years ago and this came directly from its 'bottom line'. Shell again suffered dramatically through the misstated accounts regarding reserves, bringing about critical decisions in respect of its governance.

No activity is without some impact on the environment even if it is not subject to laws and regulations. Therefore organisations, whether manufacturing companies, retailers, service companies, multinationals or SMEs have issues that they should address in regard to the environment. In addition, the cost-effective objective applies to any business. For many of the companies that do address these issues it has been made clear that unnecessary costs and wastage occur through wastage of energy, water and raw materials and the final disposal of 'waste' products. Thinking efficiently, thinking quality, looking for new uses for materials previously considered waste, taking ideas from people at all levels in the company, working with suppliers – all these characterise the companies that have put themselves in the leadership division. This is why, for example, in the 1990s the UK's National Westminster Bank has coined the expression 'Good business management equals good environmental management' and vice versa. Moreover HSBC has encouraged environmental policies among SMEs.

The environmental balance sheet 16.79

The environmental repercussions of business activity have been considered in a debate that used to be confrontational: economics versus environment. This emphasis has shifted. If a business intends to operate a manufacturing process or own, manage such a facility and/or acquire or develop property assets, then the environmental liabilities are increasingly open to question. This applies equally to its business or trade partners or where it seeks project finance.

Largely as a result of the circumstances in the USA where the 'deepest pocket' is found to redress environmental damage, lenders, insurers, investors and employees are now much more sensitive to problem. This is true whether they arise from historical or ongoing pollution. Such interested parties will scrutinise the health of an organisation's 'environmental balance sheet' much more closely. Unfortunately, as a result of this growing sensitivity, initial estimates for liabilities or potential clean-up costs can be very high. In some cases as has been seen in the USA they can also threaten the viability of an entire business, acquisition, divestiture, development or merger. For instance the CEO of Union Carbide felt so strongly about this that he has advocated that the environment should always be considered to be a paramount business issue. He said that 'speaking from personal experience' he is in no doubt that 'environmental protection has become a survival issue for companies'. In addition, as the insurance industry has experienced to its cost, retrospective measures taken in response to enforcement action by a regulator are rarely cost effective.

Yet, however extensive or substantial liabilities may be, they become considerably more manageable when quantified accurately after thorough investigation and assessment of the issues or impacts involved. Liabilities can also be contained by a proactive and long-term strategy which uses cleaner technology and integrated waste management practices to reduce future pollution, minimise environmental impacts and improve environmental performance.

A carefully monitored and well-reported programme of effective environmental management or remedial action is vital to inspire employees, encourage investors, protect commercial interests and substantially improve the environmental balance sheet of business. Proper environmental performance is not an add-on or an after thought; it requires constant effort, commitment, attention and enthusiasm, in the same way as other key business functions.

Trends in transboundary trade and environmental standards

16.80

Certain key trends and issues – most recently regarding climate change – have been selected to demonstrate the extensive nature of relevant developments in environmental management, particularly as they apply to investment, trade and project finance activities. There is no doubt that there will be several areas to watch at international, European and national level which will impact upon how an organisation will consider its approach to environmental management.

It is quite clear from the concept of 'shared responsibility', which has been highlighted by the current Environmental Action Programmes of the European Commission and which promotes the partnership of government and industry as a team working together, that the way forward for the implementation of improved environmental standards will be through a mix of the regulatory, the voluntary and economic instruments. This fact, along with the concern that there should be a level playing field in terms of international trade, has meant that there is an ongoing comparative exchange of information both by government and by industry as regards both compulsory and voluntary standards. This is also crucial to the success of corporate governance.

Institutions in the public and private sector are aware of the need for dialogue as has been evidenced in talks of the World Trade Organization (WTO). It is clear from the WTO talks that progress on an environmental understanding is crucial. Indeed, the harmonisation of environmental standards may also occur informally as foreign regulatory models are voluntarily adopted. For example, many developing countries today may admit imported chemical products without national evaluation if the product was duly licensed in the country of origin, thereby relying on the presumed effectiveness of foreign controls. On the other hand, several European countries have borrowed from US Federal or California State standards to update their national legislation, for instance, on automobile emissions. Indeed as with the governance debate US and European environmental legislation has been on a reasonably parallel course for over 30 years. It has been commented that a veritable transatlantic policy dynamic exists.

Similarly, as seen, the concept of a pollution tax or financial charge prorated to the volume of pollutant emissions has spread. Its basic idea is to levy a disincentive charge on specified economic activities, depending on the extent of the environmental harm, and to earmark the proceeds of the charge for specific counter-measures in the form of 'effluent charges'. This concept is known throughout Western and Eastern Europe, as well as the USA. Moreover the general concept of the 'polluter pays principle' is seen to exist in different context in many jurisdictions, despite varying interpretations.

For some time there has been a debate to promote the 'environmental label', (see also 16.16–16.17). This is a system of product labelling and licensing which has been introduced in areas as diverse as West Germany, Japan, Canada and Norway. In view of the European scheme, as well as the information exchange role of the European Environment Agency, there should be a practical framework to avoid unfair trade practices in connection with such labels. It has been mooted that arrangements for the mutual recognition of national environmental labels, possibly including harmonised standards and procedures of product selection and identification will become necessary.

Simultaneously, the role of the non-governmental bodies (NGOs) (as noted in **Chapter 4**) and the likelihood of more complaints as a result of enhanced public information will be another trend that should be noted. It has already been mentioned that the concept of environmental auditing has been taken up directly by NGOs such as Friends of the Earth and by industry. Many transnational corporations – some partly in response to the Bhopal incident – carry out regular environmental audits to ensure that regulatory requirements and long-term environmental liability such as legal waste disposal duties are actively reflected in their subsidiaries' balance sheets. Since the executive board of the ICC adopted its 1988 position paper on environmental auditing for business organisations, reflecting the experience in countries and companies where the practice was already well established, the impetus for the taking up of environmental auditing by government and industry alike has developed over the last 25 years. This has sometimes been referred to as the 'eco-audit trail'.

The eco-audit trail

Throughout the operation of any business, therefore, there will be the need to demonstrate to regulators, investors, lenders, shareholders and consumers the ability of that company to meet the demands placed upon it for environmental protection. Whereas in the past the term 'audit' has referred to ensuring financial probity in business, the term is increasingly being applied in the field of demonstrating environmental probity. For example, the environmental audit has existed in jurisdictions as far apart as India and the US environmental protection legislation. The 'eco-audit' is seen as an essential tool to allow the management of a company to be appraised of its continuing environmental performance. The eco-audit provides a verifiable trail of the environmental performance of a company from the production of the raw material for its products through the manufacturing process, to the distribution, use and ultimate disposal of that product. This life cycle or 'cradle-to-grave' approach demonstrates the commitment of that business to considering the environment in all of its activities. Developments, also recognised in jurisdictions as far flung as Canada and India, include schemes for 'eco-labelling', specifying the environmental performance of products to allow an informed choice by the consumer.

However, a fundamental difference remains between the more limited scope of auditing as an internal business management technique and the idea of public review. The latter emerged as the key element of the international environmental audit procedures, which, for example, were followed by the International Labour Organisation (ILO) or in other periodic audits of compliance with agreed upon international standards that are well established. Inherent in these is public disclosure as a means of ensuring democratic control over the implementation of agreed upon international standards.

At the international level it has been mooted that, considering the evident need to make the environmental controls preventative rather than corrective, now may be the time to envisage a global auditing body that would periodically evaluate the performance of states and organisations in complying with their international obligations. There is certainly an argument for more imaginative approaches to compliance control in the field of standard setting and regulations that will require further co-ordination within the UN family of organisations. What is increasingly clear is that just as environmental problems have growing transboundary impacts so does the formulation of environmental policy. The internationalisation of policy making as governments implement Agenda 21 raised even more concerns that transcend national boundaries, necessitating new rules, UN scientists, like many NGOs, have warned this year that unchecked pollution will cause 'economic collapse'. Moreover environmentalist NGOs increasingly have a place in UN policy development activities, while, for example, the EU actively seeks their input in its policy development activities.

All of these trends, of course, have some impact on the way a company trades, invests, selects partners and generally carries out business activities wherever they operate. Those companies that gear themselves up at both compliance and voluntary levels and recognise the value of improved environmental performance in the global marketplace will have a definite advantage against this background both in private and public sector concerns. Given the increasing gravity being applied to these issues and to the licence to operate an expert review of the implications of climate change litigation is set out below by way of final comment.

Enforcing the law to combat climate change 16.81

By Peter Roderick, Climate Justice Programme www.climatelaw.org.

Climate science is now strong enough for courts. We have known for the last few years that most of the global warming since 1950 has been due to GHG concentrations as a result of human activities, mainly the burning of fossil fuel. This finding has been made with sufficient, legally relevant, scientific certainty, assessed both quantitatively and qualitatively. The need to reduce emissions promptly has been urged by the world's top scientists. There has also, since 2001, been a strengthening of the scientific evidence for human influence at sub-global levels, for example in Europe and North America. Against this background, and in the face of inadequate political and industry response, about 20 climate change legal actions have begun around the world over the last few years, using a variety of legal theories under statutes, common law and international law. Judgments and decisions are coming through. Hearings are taking place, virtually as we speak. The science of human influence has been accepted by judges, and as it continues to strengthen in legally significant ways, more cases can be expected. This overview outlines (1) the judgments already given so far in six cases, (2) one administrative determination and (3) three other ongoing legal initiatives currently underway; and provides some scientific sources in the Annex to this brief overview.

1. Judgments in six cases so far …

(1) Environmental impact assessment

Australian Conservation Foundation v Minister for Planning[12]
Held: GHG emissions from burning coal must be taken into account in a planning decision to approve a coal mine extension – that is, the use to which the coal would be put must be taken into account in determining the environmental effects.

Friends of the Earth et al., v. Watson and Merrill[13]
Held: Friends of the Earth, Greenpeace and the cities of Boulder, Oakland and Arcata had standing to sue the US export credit bodies (OPIC and the Ex-Im Bank) for funding fossil fuel projects without taking climate change into account under the National Environment Policy Act.

In dismissing the export credit bodies' motion to dismiss, and granting standing, Judge Jeffrey S. White said:

> 'The Court concludes that Plaintiffs' evidence is sufficient to demonstrate it is reasonably probable that emissions from projects supported by OPIC and Ex-Im supported projects will threaten Plaintiffs' concrete interests.'

In this case, the Department of Justice had argued that 'the basic connection between human-induced GHG emissions and observed climate change itself has not been established'[14]

The case has now been argued on its merits and judgment is awaited.

(2) Regulating GHG emissions from motor vehicles

Commonwealth of Massachusetts et al. v. EPA[15]
Held (2/1): that the US EPA need not regulate GHG emissions under Section 202(a)(1) of the Clean Air Act which provides that the EPA 'shall by regulation

[12] [2004] VCAT 2029, judgment of Justice Stuart Morris, available here: http://www.austlii.edu.au/au/cases/vic/VCAT/2004/2029.html.

[13] US District Court for the Northern District of California, 23 August 2005, summary judgment of Judge Jeffrey S. White, Case No. C 02-04106 JSW. See the judgment here: http://www.climatelawsuit.org/documents/ruling82305.pdf.

[14] Motion for Summary Judgment and Memorandum in Support, 3 November 2004, Section 2, page 15.

[15] Court of Appeals for the District of Columbia Circuit, 15 July 2005, Judges Randolph, Sentelle and Tatel, Case No. 03-1361. Judgment and other documents are available here: http://www.icta.org/global/actions.cfm?page_id = 2&section_title = Global%20Warming%20&%20Air%20Pollution.

prescribe … standards applicable to the emission of any air pollutant from … new motor vehicles … which in his judgment cause, or contribute to, air pollution which may reasonably be anticipated to endanger public health or welfare'.

The judgment is messy, and the Supreme Court has been asked to review it. One judge, Sentelle, rejected the case on standing grounds:

> 'Because plaintiffs' claimed injury is common to all members of the public, the decision whether or not to regulate is a policy call requiring a weighing of costs against the likelihood of success, best made by the democratic branches taking into account the interests of the public at large. There are two other branches of government. It is to those other branches that the petitioners should repair.'

A second judge, Randolph, assumed standing, assumed the EPA had statutory power to regulate GHG emissions from new vehicles, but, citing scientific uncertainty in particular (and on the basis of the 2001 US National Academies' climate change report), held the EPA acted within the scope of its discretion.

On 15 May 2006, 14 scientists filed an *amicus curiae* brief with the Supreme Court, stating that

> 'the Earth's climate is changing in ways that are significantly increasing the risk of adverse impacts on public welfare. Time is of the essence because delay in greenhouse gas regulation will only accelerate global climate change. EPA must begin regulating greenhouse gas emissions from motor vehicles now to slow climate change in time to reduce the risk of adverse impacts.'[16]

and saying the Judge Randolph's judgment 'significantly misrepresented the findings' of the 2001 National Academies' report, 'emphasising uncertainties in climate change science while failing even to mention the existence of fundamental areas of certainty or consensus'.

The third judge, Tatel, found standing for Massachusetts, mainly on the basis of land loss from projected sea level rise, and agreed with the petitioners. He cited extensively from the (unchallenged) affidavit of Michael MacCracken, senior scientist on global change at the US Global Change Research Program (1993–2002), stating that

> 'global warming is chiefly triggered by human-caused GHG emissions, with "the US transportation sector (mainly automobiles) … responsible for about 7% of global fossil fuel emissions," … MacCracken emphasizes that "[a]chievable reductions in emissions of CO_2 and other [GHGs] from US motor vehicles would … delay and moderate many of the adverse impacts of global warming." Elaborating, he states that "[g]iven the large emissions of CO_2 and other [GHGs] from motor vehicles in the United States and the lead time needed to economically introduce changes into the motor vehicle fleet, emission reductions must be initiated in the near future in order to significantly reduce and delay the impacts of global warming …"

[16] At pages 6/7 of the 38-page brief, available here: http://www.climatesciencewatch.org/index.php/csw/details/amici-curiae-climate-scientists/.

> [I]f EPA wants to challenge the facts petitioners have set forth in their affidavits, it has an obligation to respond to the petitioners … EPA makes no such challenge … EPA never denies the "substantial probability," see Sierra Club, 292 F.3d at 898, that injurious global warming is occurring …'

In sum, GHGs plainly fall within the meaning of 'air pollutant' in Section 302(g) and therefore in Section 202(a)(1). If 'in [the Administrator's] judgment' they 'cause, or contribute to, air pollution which may reasonably be anticipated to endanger public health or welfare', 42 USC §7521(a)(1), then EPA has authority – indeed, the obligation – to regulate their emissions from motor vehicles [most refs omitted].

The Supreme Court decision should be noted when published.

Furthermore, in April 2006, 12 US states and cities and 3 NGOs sued the EPA for not regulating carbon dioxide from power plants under the Clean Air Act, in an attempt to determine definitively whether the EPA has authority to regulate global warming.[17]

(3) Suing power companies in public nuisance

State of Connecticut, et al. v. American Electric Power Company, Inc., et al.; Open Space Institute, Inc. et al. v. American Electric Power Company Inc., et al.[18]
Held: cases brought on the basis of the common law tort of public nuisance, by 8 US states, New York City and 3 NGOs against the 5 biggest US power companies (and 1 subsidiary), were dismissed as raising 'non-justiciable political questions'. The plaintiffs' appeal hearing was scheduled for 7 June 2006.

The plaintiffs argue that the huge emissions from the defendants' power plants – some 650 million tonnes of carbon dioxide annually, making them the five largest emitters of carbon dioxide in the USA, and approximately 10% of all carbon dioxide emissions from human activities in the USA – are a public nuisance, in that:

- they are causing injury and a significant threat of injury to the plaintiffs by their emissions of carbon dioxide from burning fossil fuel in their power stations, and are knowingly, intentionally or negligently creating, maintaining or contributing to a public nuisance – global warming – injurious to the plaintiffs and their citizens and residents;
- these emissions, by contributing to global warming, are a substantial and unreasonable interference with public rights in the plaintiffs' jurisdictions, including, *inter alia*, the right to public comfort and safety, the right to protection of vital natural resources and public property, and the right

[17] http://www.oag.state.ny.us/press/2006/apr/apr27a_06.html.

[18] US District Court for the Southern District of New York, 15 September 2005, Judge Loretta A. Preska, Cases Nos. 04 Civ. 5669 (LAP) and 04 Civ. 5670 (LAP). Judgment is here: http://www.nysd.uscourts.gov/rulings/04cv5669_04cv5670_091505.pdf, and other documents are available here: http://www.pawalaw.com/html/cases2.htm.

> to use, enjoy and preserve the aesthetic and ecological values of the natural world.

They argue that each defendant is jointly and severally liable for creating, contributing to, and/or maintaining a public nuisance; and ask the court for an order requiring each defendant to abate its contribution to the nuisance by requiring it to cap its carbon dioxide emissions and then reduce them by a specified percentage each year for at least a decade. No damages are claimed.

In her judgment, the judge accepted that:

> 'Congress has recognized that carbon dioxide emissions cause global warming and that global warming will have severe adverse impacts in the United States, but it has declined to impose any formal limits on such emissions.'

But she considered that the case involved non-justiciable political questions, particularly because, in her view, of 'the impossibility of deciding without an initial policy determination of a kind clearly for non-judicial discretion'.

She said:

> 'Plaintiffs advance a number of arguments why theirs is a simple nuisance claim of the kind courts have adjudicated in the past, but none of the pollution-as-public-nuisance cases cited by plaintiffs has touched on so many areas of national and international policy. The scope and magnitude of the relief plaintiffs seek reveals the transcendently legislative nature of this litigation. Plaintiffs ask this court to cap carbon dioxide emissions and mandate annual reductions of an as-yet-unspecified percentage. Such relief would, at a minimum, require this court to: (1) determine the appropriate level at which to cap the carbon dioxide emissions of these defendants; (2) determine the appropriate percentage reduction to impose upon defendants; (3) create a schedule to implement those reductions; (4) determine and balance the implications of such relief on the United States' ongoing negotiations with other nations concerning global climate change; (5) assess and measure available alternative energy resources; and (6) determine and balance the implications of such relief on the United States' energy sufficiency and thus its national security – all without an "initial policy determination" having been made by the elected branches' (refs omitted).

(4) Violations of rights to life and dignity

Gbemre v. Shell Petroleum Development Company of Nigiera Ltd et al.[19]
Held: the flaring of gas in a Niger Delta community by Shell Nigeria is a 'gross violation' of the constitutionally guaranteed rights to life and dignity of Mr Jonah Gbemre and the Iwherekan community in Delta State.

Nigerian flaring contains a toxic cocktail which exposes residents to an increased risk of premature deaths, child respiratory illnesses, asthma and

[19] Federal High Court of Nigeria, Benin City, 14 November 2005, Justice C.V. Nwokorie, Suit No.: FHC/B/CS/53/05. The judgment is here: http://www.climatelaw.org/media/media/gas.flaring.suit.nov2005/ni.shell.nov05.judgment.pdf.

cancer – while having contributed more GHGs than all other sub-Saharan sources combined, and losing the country annually US$2.5 billion.

This was the first time a Nigerian court has applied the rights to life and dignity in an environmental case. Shell Nigeria was ordered to stop flaring in the community immediately. Justice C.V. Nwokorie found the gas flaring laws to be 'unconstitutional, null and void', and ordered the Attorney General to meet with President Obasanjo *et al.* to set in motion the necessary processes for new gas flaring legislation that is consistent with the constitution.

Contempt of court proceedings was filed in December 2005, as the flaring was continuing 32 days after the judgment without a stay of execution in place. In April 2006, in determining the stay application, the Federal High Court granted a stay on ending the flaring till the end of April 2007, and ordered the CEOs of Shell Nigeria and the Nigerian National Petroleum Corporation, and the Petroleum Minister, to appear personally before him on 31 May 2006 with a detailed, clear plan for putting out the flares within 12 months. On 23 May 2006, the Court of Appeal overturned the first instance court's order in respect of the personal appearances of the CEOs and Minister.

(5) Access to information

Bundes fur Umwelt und Naturschutz Deutschland e.V. & Germanwatch e.V., v. Bundesrepublik Deutschland, vertreten durch Bundesminister fur Wirtschaft und Arbeit[20]

In June 2004, Germanwatch and BUND (Friends of the Earth Germany) began a legal action to require the German Economic Ministry to disclose the contribution to climate change made by energy production projects supported by the German taxpayer through its export credit agency Euler Hermes AG. In a legal judgment as part of the court settlement in January 2006, the Berlin Administrative Court rejected the German government's arguments that it was not subject to the freedom of environmental information laws (derived from the EU and the Aarhus Convention) and that it did not affect climate change and the environment.

2. … as well as one administrative determination …

Endangered species

Listing of Elkhorn and Staghorn Coral as threatened species under the US Endangered Species Act[21]

On 9 May 2006, the US National Marine Fisheries Service (NMFS) published their decision to list two Caribbean coral species, elkhorn and staghorn coral,

[20] Verwaltungsgericht Berlin, 10 January 2006, Judge Gaudernack, Ref.: VG 10 A 215.04. Beschluss (judgment) in German, and an unofficial English translation, available from here: http://www.climatelaw.org/media/Germany.

[21] Federal Register/Vol. 71, No. 89/Tuesday, 9 May 2006/Rules and Regulations, page 26852.

as threatened species under the Endangered Species Act (ESA), following a petition in March 2004 from the Center for Biological Diversity. These are the first species listed under the ESA for which global warming is recognised as a primary threat: in its determination, the NMFS identified disease, hurricanes and elevated sea surface temperature as the three 'major threats' to these species, which were 'severe, unpredictable, likely to increase in the foreseeable future, and, at current levels of knowledge, unmanageable'.

The ESA requires all federal agencies to ensure that their actions do not jeopardise any listed species or adversely modify its critical habitat.

3. … and several other initiatives underway …

(1) Endangered species

In February 2005, the Center for Biological Diversity filed a petition with the US Fish and Wildlife Service to list the *polar bear* as a threatened species under the ESA. Polar bears are threatened with extinction because global warming is causing rapid environmental change in the Arctic, including the melting of the polar bears' sea ice habitat. In July 2005, Greenpeace and the National Resource Defense Council joined the petition. On 12 October 2005, the petitioners filed a Notice of Intent to Sue on the US Secretary of the Interior for failing to respond within the 90-day period required by the ESA.[22]

(2) Human rights

In December 2005, Sheila Watt-Cloutier, with the support of the *Inuit* Circumpolar Conference, filed a petition to the Inter-American Commission on Human Rights seeking relief from human rights violations resulting from global warming caused by acts and omissions of the USA, on behalf of all Inuit of the Arctic regions of the USA and Canada. Global warming violates their culture, life, food and health by melting ice, snow and permafrost, changing the weather, and radically altering every aspect of the Arctic environment on which Inuit lives and culture depend.[23]

(3) World heritage

The UNESCO World Heritage Convention safeguards outstanding and irreplaceable natural and cultural heritage for all the peoples of the world, wherever it maybe, by designating World Heritage Sites. Under that Convention, Parties have a legal duty to protect and transmit such Sites to future generations. This duty is placed primarily on the host States. It extends, secondarily, to all State Parties, whose activities are damaging or could damage Sites

[22] Petition and Notice available from here: http://www.biologicaldiversity.org/swcbd/species/polarbear/index.html.

[23] The 175-page petition can be accessed from here: http://www.climatelaw.org/media/inuit.iachr.

situated in other countries. The major GHG-emitting States are Parties to the World Heritage Convention and they will not fulfil this duty without significant cuts in their emissions.

Since 2004, 37 organisations and individuals have drawn attention to this legal duty as it relates to some of the world's most outstanding mountain areas and coral reefs facing climate change damage. They have submitted five petitions to the World Heritage Committee to add *Mount Everest, the Peruvian Andes, USA and Canadian glaciers, and the Great Barrier and Belize Barrier Reefs* to the List of World Heritage in Danger because of climate change. The World Heritage Committee decides the question of whether to give a site extra protection by adding it to the Danger List, and allocates funding.

At its 29th session in July 2005, the Committee held an unprecedented discussion on the issue of climate change and world heritage, acknowledging the petitions and the serious climate threats posed to World Heritage Sites. It asked a group of experts to report on these risks at its 30th session in July 2006 in Lithuania, and this group met in Paris in March 2006. The Paris meeting recognised the unique scale and urgency of the risks, and in considering these at its meeting in Lithuania petitioners want the 21-member committee to:

> (1) recognise that the duty on State Parties to the World Heritage Convention to protect and transmit World Heritage Sites to future generations requires significant reductions in GHG emissions;
> (2) note the need for those State Parties who are Parties to the UNFCCC and/or the Kyoto Protocol to take this duty into account when negotiating under the UNFCCC/Kyoto Protocol processes;
> (3) decide to send a mission of qualified observers to visit each petition site, to evaluate the nature and extent of the threats and to propose the measures to be taken.

The USA, voted onto the Committee in late 2005, has opposed this initiative.[24]

Annex: Human influence science – some key sources 16.82

1. Development of consensus human influence science on global temperature increase since 1990

The IPCC consensus view on human influence has strengthened over its three reports:

- Size of the warming '*broadly consistent with predictions of climate models, but it is also of the same magnitude as natural climate variability*' (IPCC First Assessment Report, 1990).

[24] More information on the US position, and the petitions, is here: http://www.climatelaw.org/media/UNESCO%20Climate%20Change%20meeting.

- The '*balance of evidence suggests that there is a discernible human influence on global climate*' (IPCC Second Assessment Report, 1995/1996).
- '*Most of the observed warming over the last 50 years is likely*[25] *to have been due to the increase in greenhouse gas concentrations*' (IPCC Third Assessment Report, 2001).

2. Acceptance of the human influence science on global temperature increase by other bodies

May 2001: statement of 16 scientific academies of Australia – Belgium, Brazil, Canada, Caribbean, China, France, Germany, India, Indonesia, Ireland, Italy, Malaysia, New Zealand, Sweden and the UK:

> 'It is now evident that human activities are already contributing adversely to global climate change. Business as usual is no longer a viable option. We urge everyone – individuals, businesses and governments – to take prompt action to reduce emissions of greenhouse gases … The balance of the scientific evidence demands effective steps now to avert damaging changes to the earth's climate.'[26]

June 2005: G8 national academies, plus those of Brazil, China and India:

> 'The scientific understanding of climate change is now sufficiently clear to justify nations taking prompt action. It is vital that all nations identify cost-effective steps that they can take now, to contribute to substantial and long-term reduction in net global greenhouse gas emissions.'[27]

3. Examples of strengthening human influence science on regional and local temperature increase since 2001

> 'The causes of twentieth century temperature change in six separate land areas of the Earth have been determined by carrying out a series of optimal detection analyses. The warming effects of increasing greenhouse gas concentrations have been detected in all the regions examined, including North America and Europe … Our results show significant anthropogenic warming trends in all the continental regions analysed.'

Stott, P., Attribution of regional-scale temperature changes to anthropogenic and natural causes, *Geophysical Research Letters*, Vol. 30, No. 14, 1728, 2003.

> 'On the basis of these results, it is likely that there has been a significant human influence on the observed North American warming in the second half of the 20th century, associated with increasing atmospheric concentrations of greenhouse gases and sulfate aerosols. Over the 20th century, this influence is manifest not only in mean temperature

[25] 'Likely' is defined as follows, in the SPM of Working Group I: 'In this Summary for Policymakers and in the Technical Summary, the following words have been used where appropriate to indicate judgmental estimates of confidence: virtually certain (greater than 99% chance that a result is true); very likely (90–99% chance); likely (66–90% chance); medium likelihood (33–66% chance); unlikely (10–33% chance); very unlikely (1–10% chance); exceptionally unlikely (less than 1% chance).' A civil court usually requires proof on the balance of probabilities, or the preponderance of the evidence, crudely 51% certainty.

[26] Statement available here: http://www.royalsociety.org/displaypagedoc.asp?id=11509.

[27] Statement available in English here: http://www.royalsoc.ac.uk/news.asp?year=&id=3226.

> changes but also in changes of the northsouth temperature gradient, the temperature contrast between land and ocean, and reduction of the diurnal temperature range.'

Karoly *et al.*, Detection of a human influence on North American climate, *Science*, Vol. 302, 1200, 2003.

> 'The summer of 2003 was probably the hottest in Europe since at latest AD 1500, and unusually large numbers of heat-related deaths were reported in France, Germany and Italy … Using a threshold for mean summer temperature that was exceeded in 2003, but in no other year since the start of the instrumental record in 1851, we estimate it is very likely (confidence level >90%) that human influence has at least doubled the risk of a heatwave exceeding this threshold magnitude.'

Stott *et al.*, Human contribution to the European heatwave of 2003, *Nature*, Vol. 432, 610, 2004.

> 'Trends in surface temperature over the last 100, 50, and 30 yr at individual grid boxes in a 5° latitude–longitude grid are compared with model estimates of the natural internal variability of these trends and with the model response to increasing greenhouse gases and sulfate aerosols … Significant warming trends are found at a large fraction of the individual grid boxes over the globe, a much larger fraction than can be explained by internal climate variations. The observed warming trends over the last 50 and 30 yr are consistent with the modeled response to increasing greenhouse gases and sulfate aerosols in most of the models. However, in some regions, the observed century-scale trends are significantly larger than the modeled response to increasing greenhouse gases and sulfate aerosols in the atmosphere. Warming trends consistent with the response to anthropogenic forcing are detected at scales on the order of 500 km in many regions of the globe.'

Karoly, D.J. and Wu, Q., Detection of regional surface temperature trends, *Journal of Climate*, Vol. 18, 4337–4343, 2005.

Appendix

Item 1: Environment, health and safety simple US company questionnaire

Please treat this questionnaire as confidential. Once completed this questionnaire should not be reproduced or handed over to third parties outside or even within the company without prior consent. The questions and your answers should only be discussed with other employees directly associated with the project. Responses to these questions can be provided in the space provided or on attached sheets. If the facility maintains a document which addresses these issues, please identify the document, note where the response can be found on the questionnaire and provide a copy of the document.

The questionnaire is organised in the following format:

1.0 General site information

2.0 Environment, health and safety (EHS) management

3.0 Production processes and raw materials utilised

4.0 Raw material and waste storage facilities
5.0 Waste materials
6.0 Waste water
7.0 Emissions (air)
8.0 Soil and goundwater quality
9.0 Worker protection for handling of hazardous materials
10.0 Fire protection for hazardous material storage areas
11.0 Safety incidents
12.0 Special health issues

1 General site information

1.1 Company or Facility Name:

1.2 Address (Street, City, Country).

1.3 Is the land or structures leased?
☐ Yes ☐ No

If yes, please identify the name, address and contact of the owner.

1.4 Name of Facility Manager.

1.5 Name of the person(s) in charge of facility EHS programmes and compliance. If more than one person is assigned to these duties, list each person and his/her respective areas of responsibility. Attach the EHS organisation chart.

1.6 Is the facility ISO 9001 registered?
☐ Yes ☐ No
Does the facility plan to be ISO 14001 registered?
☐ Yes ☐ No

1.7 Describe in general terms the products manufactured and/or services performed at this location. Also include whether the facility is primarily used for manufacturing, warehousing or office use.

1.8 Indicate the number of employees, shifts and days/week worked at this facility.

1.9 Provide in the spaces below the property size and the appropriate information concerning on-site buildings.

Property size – acres or hectares

Building designation	**Building age**	**Building area in ft^2 or m^2**	**Primary use**

1.10 List all former facility owners and/or tenants including type and duration of activities on the site.

Former owner/tenant	Type of activity and manufactured processes utilised	Duration of activity

1.11 Within what type of area(s) is the site or facility located? (check appropriate boxes):

☐ Industrial
☐ Commercial
☐ Residential
☐ Agricultural
☐ Water/Groundwater Protection Area
☐ Flood Plain
☐ Earthquake Exposure

Indicate the shortest distance between the facility and other objects (list only if within a mile or 2,000 metre radius):

Residential buildings:	feet/metres
Hospital, school or food processing company:	feet/metres
Main highway:	feet/metres
Groundwater protection zone:	feet/metres
Surface water (river, lake, marsh):	feet/metres

1.12 Airport Flight Lanes: feet/metres ....

Other: feet/metres ....

1.13 List the governmental authorities who are responsible for overseeing the company's compliance with appropriate EHS regulations. List the name of the agency, address, telephone number and responsible individual(s).

1.14 Are there any restrictions to the growth of operations or facility due to these regulations or any other government programmes or the land owner (if applicable)?

1.15 Provide a map of the facility with outlines of all buildings, roads and other significant site features.

1.16 Provide a topographical map of the site/facility and surrounding area (radius of 1 mile, or 2,000 metres).

1.17 Identify the facilities source(s) of potable and process water. If the source(s) is an on-site well(s) mark the location(s) on the map requested in Question **1.15**. Also provide other pertinent well information if available (age, depth, screened interval, etc.).

2 EHS management

2.1 Describe or provide the facility's EHS policies and EHS responsibilities.

2.2 Describe/list the facility's EHS training programmes.

2.3 Describe the facility's EHS emergency procedures.

2.4 Describe the facility's EHS monitoring and record keeping activities.

2.5 Attach a lifting of all EHS-related reports and documents prepared for the facility. (Include compliance reports, investigation and remediation projects and permit applications.)

3 Production processes and raw materials utilised

3.1 On the table below indicate if the following processes are in use today or in the past.

Process	**In use**	
	Currently	**Past**
Cleaning		
Vapour degreasing		
1,1,1 Trichloroethane		
Trichloroethylene		
Perchloroethylene		
Water		
Alkali		
Semi-aqueous		
Handwiping		
Alcohol		
MEK		
Other (list)		
Acid pickling		
Anodising		
Chromic acid		
Phosphoric acid		
Sulphuric acid		

Other		
Plating		
Nickel		
Electrolytic		
Electroless		
Chromium		
Traditional		
High speed		
Copper		
Acid		
Alkali		
Cyanide		
Electroless		
Silver		
Cyanide		
Alkali		
Cadmium		
Cyanide		
Acid		
Gold		
Other (list)		
Machining operations using coolant		
Turning		
Milling		
Drilling		
Grinding		
Other (list)		
Machining operations using oil		
Turning		

Milling		
Drilling		
Grinding		
Tapping		
Boring		
Other (list)		
Acid milling		
Titanium		
Nickel alloys		
Steel		
Other (list)		
Mass media finishing		
Ceramic		
Plastic		
Other (list)		
Shot peening		
Steel		
Glass		
Other (list)		
Stripping		
Acid		
Alkali		
Cyanide		
Welding		
Brazing		
Heat treating		
Plasma coatings		
Painting		
Electrodischarge machining (EDM)		
Electrochemical machining (ECM)		
Forging		
Casting		

Use of fixturing material		
Aluminium base		
Lead, cadmium, or bismuth based		
Plastic based		
Other (list)		
Non-destructive test (NDT)		
Fluorescent penetrate inspection (FPI)		
Oil base		
Water base		
Magnetic particle inspection		
Etch inspection		
Nital etch		
Blue etch anodise		
X-ray		
Spectroscopy		
Other (list)		
Other (list)		

3.2 List all major raw materials used in the manufacturing process, if not included in Question 3.1. Also include maintenance and treatment chemicals.

Commercial name	**Chemical name**

4 Raw material and waste storage facilities

4.1 Underground storage tanks: List and identify the underground storage tanks situated on the property, include removed and abandon UST as well. Assign each tank, or group, a number and mark each tank location on the map requested in **Question 1.15**.

Tank number	Contents	Volume units	Age	Construction material of tank (steel, fibreglass)	Tank corrosion devices

4.2 Aboveground storage tanks: List and identify all aboveground storage tanks on the property, include removed tanks as well. Assign each tank or group, a number and mark each tank location on the map requested in **Question 1.15**.

Tank number	Contents	Volume units	Age	Construction material of tank (steel, fibreglass)	Tank under roofed structure (yes/no)	Secondary containment volume (g/l)

4.3 Drum/container storage: List all the current and former storage locations of drums, including drums with new materials, solid or liquid wastes, and used oils. Also list areas where significant storage of smaller containers is conducted. Assign numbers to each storage area and mark each area on the map referenced in **Question 1.15**.

Storage location number	Number of drums/ containers	Total volume units	Contents	Secondary containment volume units	Under roofed structure? (yes/no)

4.4 Identify and describe any significant releases/spills which have occurred on the site. Include releases/spills in contained areas as well.

5 Waste materials

5.1 Complete the following table concerning wastes generated on-site.

Type of waste (office, industrial, hazardous)	**Monthly volume**	**Type of disposal (landfill, incineration)**	**Name of waste disposal Co.**	**Disposal site location**

5.2 **US only:** What is the facility's RCRA status? Attach a copy of the most recent biennial waste generation report.

5.3 Does the facility have any septic systems, dry wells, lagoons or landfills? Include units no longer in use?
□ Yes □ No
If yes, describe material and indicate quantity. Indicate the location of these units on the map requested in **Question 1.15**.

5.4 Has the facility received any Notices of Violation or Administrative Orders pertaining?
□ Yes □ No
If yes, describe briefly.

6 Wastewater

6.1 Does the facility generate and discharge industrial wastewater(s)?
□ Yes □ No
If yes continue, if no go to Section 7.0.

Are permits required for the discharges?
□ Yes □ No
If yes, attach copies of all applicable permits.

Where does the process wastewater drain?
□ Public sewer □ Surface water or ditch □ Septic system

Where does the sanitary wastewater drain?
□ Public sewer □ Surface water or ditch □ Septic system

Briefly describe the wastewater piping and identify the receiving water body, indicate the piping and discharge location on the map requested in **Question 1.15.**

6.2 Does the facility perform any wastewater treatment? (oil/water separator, coagulation/precipitation, filtration, *ion* exchange, carbon treatment, etc.)
☐ Yes, complete the following table ☐ No

Process generating wastewater	**Primary contaminants in wastewater**	**Type of treatment system**

6.3 Has the facility had wastewater contaminant exceedances above appropriate permitted discharge limits?
☐ Yes ☐ No
If yes, describe type, extent and cause of the problems.

6.4 Has the facility received any Notices of Violations or Administrative Orders pertaining to facility wastewater management?
☐ Yes ☐ No
If yes, describe briefly.

7 Emissions (air)

7.1 Describe all existing sources of air emissions from the facility

Source of emission	**Vented (yes/no)**	**Type of emission controls**

7.2 List all permits obtained by the facility for the above referenced emission sources. Attach copies if practical.

7.3 Is there an installation or process on the site which falls under a special law that regulates plants with risk of catastrophic environmental releases?
☐ Yes ☐ No

7.4 Has the facility received any Notices of Violation or Administrative Orders pertaining to facility air emission practices?
☐ Yes ☐ No
If yes, describe briefly:

8 Soil and groundwater quality

8.1 Have any soil/groundwater investigations been performed on-site?
☐ Yes ☐ No
If yes, briefly summarise major conclusions of the investigation.

8.2 If the facility has groundwater supply wells on-site has the well water been analysed?
☐ Yes ☐ No
If yes, list what chemical parameters were tested the results, and in what years.

8.3 Does the facility have any transformers or capacitors that use poly chlorinated biphenyls (PCBs) as a dielectric fluid?
☐ Yes ☐ No ☐ Do not know
If yes, indicate whether the units are located on the map requested in **Question 1.15**.

9 Worker protection for handling of hazardous materials

9.1 Identify the agency which oversees Worker Protection, their address and contact name.

9.2 According to the occupational health authorities, which safety precautions apply to the facility? (check appropriate boxes):
☐ workshop air monitoring
☐ noise protection
☐ respirators
☐ personal protective equipment
☐ other

9.3 Is the facility responsible for regular medical check-ups of the employees?
☐ Yes ☐ No

9.4 Do any building materials at the facility contain asbestos or lead water pipes?
☐ Yes ☐ No
If yes, describe the type of material (i.e. floor tiles, pipe wrap, etc.).

10 Fire protection for hazardous material storage areas

10.1 How far away is the facility from the nearest fire station? mile/kilometre

10.2 Does the facility have its own fire response team?
☐ Yes ☐ No

10.3 Notification of a fire occurs through:
Telephone..
Manually through a fire-alarm key..
Automatically...

10.4 How large is the amount of water available for extinguishing a fire:
<1,600 litres or <425 gallons/minute
>1,600 litres or 425 gallons/minute, but <3,200 litre/minute
>3,200 litres or 850 gallons/minute

10.5 Is it possible that water which was used to fight the fire can run off into surface waters, into the sewage system or infiltrate into the ground from the property?
☐ Yes ☐ No

10.6 What types of fire safety equipment are installed at hazardous material storage areas?
☐ None
☐ Automatic fire detectors
☐ Automatic gas detectors
☐ Cameras
☐ Abundant fire extinguishers
☐ Automatic or non-automatic sprinkler systems

10.7 Are employees trained for fire safety in hazardous materials locations?
☐ Yes ☐ No

11 Safety incidents

11.1 Has the facility experienced any employee work-related fatalities in the past 10 years?
☐ Yes ☐ No
If yes, describe briefly the circumstances of the accident or provide a report.

11.2 Has the facility had any serious employee work-related accidents (i.e. loss of digit or limb, injury resulting in paralysis or coma, blindness, etc.) in the past five years?
☐ Yes ☐ No
If yes, briefly describe the circumstances of each accident or provide a report.

11.3 Have there been any accidents or enquiries associated with this facility of non-employed people (i.e. general public)?
☐ Yes ☐ No
If yes, describe briefly the circumstances of the accident.

11.4 Does the facility keep a log of all work-related injuries/illnesses, if yes attach the past five years.
☐ Yes ☐ No

11.5 Has the facility been inspected by any health/safety compliance agency in the past five years? If yes provide copies of any citations and responses.
☐ Yes ☐ No

12 Special health issues

12.1 Are there any known regional or area-wide health issues?
☐ Yes ☐ No
If yes, please describe the circumstances.

12.2 Have there been any nuclear accidents near the facility (within a 500 mile radius).
☐ Yes ☐ No
If yes, please describe the event(s) and any subsequent monitoring activities.

12.3 If available, obtain and attach relevant news articles and documents related to **Questions 12.1 and 12.2**.

12.4 Does the facility currently or previously use any radioactive source materials? If yes describe the use, time period and disposal location.

12.5 Describe any equipment that generates X-rays which the facility uses.

Item 2: GRI Sustainability Reporting Guidelines – reference sheet

Source: GRI – Sustainability Reporting Guidelines, Version 3.0.

The information in this document has been extracted from its original format to provide a summary of the GRI Guidelines. The complete source document can be downloaded for free at www.globalreporting.org.

Prepared by Covive, www.covive.com

Principles for defining report content

Materiality
The information in a report should cover topics and indicators that reflect the organisation's significant economic, environmental and social impacts, or that would substantively influence the assessments and decisions of stakeholders.

Stakeholder inclusiveness
The reporting organisation should identify its stakeholders and explain in the report how it has responded to their reasonable expectations and interests.

Sustainability context
The report should present the organisation's performance in the wider context of sustainability.

Completeness
Coverage of the material topics and indicators and definition of the report boundary should be sufficient to reflect significant economic, environmental and social impacts, and enable stakeholders to assess the reporting organisation's performance in the reporting period.

Principles for ensuring report quality

Balance
The report should reflect positive and negative aspects of the organisation's performance to enable a reasoned assessment of overall performance.

Comparability
Issues and information should be selected, compiled and reported consistently. Reported information should be presented in a manner that enables stakeholders to analyse changes in the organisation's performance over time, and could support analysis relative to other organisations.

Accuracy
The reported information should be sufficiently accurate and detailed for stakeholders to assess the reporting organisation's performance.

Timeliness
Reporting occurs on a regular schedule and information is available in time for stakeholders to make informed decisions.

Clarity
Information should be made available in a manner that is understandable and accessible to stakeholders using the report.

Reliability
Information and processes used in the preparation of a report should be gathered, recorded, compiled, analysed and disclosed in a way that could be subject to examination and that establishes the quality and materiality of the information.

Standard Disclosures – Profile

Strategy and analysis

1.1 Statement from the most senior decision-maker of the organisation (e.g. CEO, chair or equivalent senior position) about the relevance of sustainability to the organisation and its strategy.

The statement should present the overall vision and strategy for the short, medium (e.g. three to five years) and long term, particularly with regard to managing the key challenges associated with economic, environmental and social performance. The statement should include:

- Strategic priorities and key topics for the short/medium term with regard to sustainability, including respect for internationally agreed standards and how they relate to long-term organisational strategy and success.
- Broader trends (e.g. macroeconomic or political) affecting the organisation and influencing sustainability priorities.
- Key events, achievements and failures during the reporting period.
- Views on performance with respect to targets.
- Outlook on the organisation's main challenges and targets for the next year and goals for the coming three to five years.
- Other items pertaining to the organisation's strategic approach.

1.2 Description of key impacts, risks and opportunities.

The reporting organisation should provide two concise narrative sections on key impacts, risks and opportunities.

Section 1 should focus on the organisation's key impacts on sustainability and effects on stakeholders, including rights as defined by national laws and relevant internationally agreed standards. This should take into account the range of reasonable expectations and interests of the organisation's stakeholders. This section should include:

- A description of the significant impacts the organisation has on sustainability and associated challenges and opportunities. This includes the effect on stakeholders' rights as defined by national laws and the expectations in internationally agreed standards and norms.
- An explanation of the approach to prioritising these challenges and opportunities.
- Key conclusions about progress in addressing these topics and related performance in the reporting period. This includes an assessment of reasons for underperformance or overperformance.
- A description of the main processes in place to address performance and/or relevant changes.

  Section 2 should focus on the impact of sustainability trends, risks and opportunities on the long-term prospects and financial performance of the organisation. This should concentrate specifically on information relevant to financial stakeholders or that could become so in the future. Section 2 should include the following:
- A description of the most important risks and opportunities for the organisation arising from sustainability trends.
- Prioritisation of key sustainability topics as risks and opportunities according to their relevance for long-term organisational strategy, competitive position, qualitative, and (if possible) quantitative financial value drivers.
- Table(s) summarising:
  - Targets, performance against targets, and lessons learned for the current reporting period.
  - Targets for the next reporting period and mid-term objectives and goals (i.e. three to five years) related to key risks and opportunities.
- Concise description of governance mechanisms in place to specifically manage these risks and opportunities, and identification of other related risks and opportunities.

Organisational profile

2.1 Name of the organisation.

2.2 Primary brands, products and/or services. The reporting organisation should indicate the nature of its role in providing these products and services, and the degree to which it utilises outsourcing.

2.3 Operational structure of the organisation, including main divisions, operating companies, subsidiaries and joint ventures.

2.4 Location of organisation's headquarters.

2.5 Number of countries where the organisation operates, and names of countries with either major operations or that are specifically relevant to the sustainability issues covered in the report.

2.6 Nature of ownership and legal form.

2.7 Markets served (including geographical breakdown, sectors served and types of customers/beneficiaries).

2.8 Scale of the reporting organisation, including:
- Number of employees.
- Net sales (for private sector organisations) or net revenues (for public sector organisations).
- Total capitalisation broken down in terms of debt and equity (for private sector organisations).
- Quantity of products or services provided.

In addition to the above, reporting organisations are encouraged to provide additional information, as appropriate, such as:
- Total assets.
- Beneficial ownership (including identity and percentage of ownership of largest shareholders).
- Breakdowns by country/region of the following:
  - Sales/revenues by countries/regions that make up 5% or more of total revenues.
  - Costs by countries/regions that make up 5% or more of total revenues.
  - Employees.

2.9 Significant changes during the reporting period regarding size, structure or ownership including:
- The location of, or changes in, operations, including facility openings, closings and expansions.
- Changes in the share capital structure and other capital formation, maintenance and alteration operations (for private sector organisations).

2.10 Awards received in the reporting period.

Report parameters

REPORT PROFILE

3.1 Reporting period (e.g. fiscal/calendar year) for information provided.

3.2 Date of most recent previous report (if any).

3.3 Reporting cycle (annual, biennial, etc.).

3.4 Contact point for questions regarding the report or its contents.

REPORT SCOPE AND BOUNDARY

3.5 Process for defining report content, including:
- Determining materiality.
- Prioritising topics within the report.
- Identifying stakeholders the organisation expects to use the report.

Include an explanation of how the organisation has applied the 'Guidance on Defining Report Content' and the associated Principles.

3.6 Boundary of the report (e.g. countries, divisions, subsidiaries, leased facilities, joint ventures, suppliers). See GRI Boundary Protocol for further guidance.

3.7 State any specific limitations on the scope or boundary of the report.
If boundary and scope do not address the full range of material economic, environmental and social impacts of the organisation, state the strategy and projected timeline for providing complete coverage.

3.8 Basis for reporting on joint ventures, subsidiaries, leased facilities, outsourced operations and other entities that can significantly affect comparability from period to period and/or between organisations.

3.9 Data measurement techniques and the bases of calculations, including assumptions and techniques underlying estimations applied to the compilation of the indicators and other information in the report.
Explain any decisions not to apply, or to substantially diverge from, the GRI Indicator Protocols.

3.10 Explanation of the effect of any re-statements of information provided in earlier reports, and the reasons for such re-statement (e.g. mergers/ acquisitions, change of base years/periods, nature of business, measurement methods).

3.11 Significant changes from previous reporting periods in the scope, boundary or measurement methods applied in the report.

GRI CONTENT INDEX

3.12 Table identifying the location of the Standard Disclosures in the report. Identify the page numbers or web links where the following can be found:

- Strategy and Analysis 1.1–1.2.
- Organisational Profile 2.1–2.10.
- Report Parameters 3.1–3.13.
- Governance, Commitments and Engagement 4.1–4.17.
- Disclosure of Management Approach, per category.
- Core Performance Indicators.
- Any GRI Additional Indicators that were included.
- Any GRI Sector Supplement Indicators included in the report.

ASSURANCE

3.13 Policy and current practice with regard to seeking external assurance for the report. If not included in the assurance report accompanying the sustainability report, explain the scope and basis of any external assurance provided. Also explain the relationship between the reporting organisation and the assurance provider(s).

Governance, commitments and engagement

GOVERNANCE

4.1 Governance structure of the organisation, including committees under the highest governance body responsible for specific tasks, such as setting strategy or organisational oversight.
Describe the mandate and composition (including number of independent members and/or non-executive members) of such committees and indicate any direct responsibility for economic, social and environmental performance.

4.2 Indicate whether the Chair of the highest governance body is also an executive officer (and, if so, their function within the organisation's management and the reasons for this arrangement).

4.3 For organisations that have a unitary board structure, state the number of members of the highest governance body that are independent and/or non-executive members.
State how the organisation defines 'independent' and 'non-executive'. This element applies only for organisations that have unitary board structures. See the glossary for a definition of 'independent'.

4.4 Mechanisms for shareholders and employees to provide recommendations or direction to the highest governance body.
Include reference to processes regarding:

- The use of shareholder resolutions or other mechanisms for enabling minority shareholders to express opinions to the highest governance body.
- Informing and consulting employees about the working relationships with formal representation bodies such as organisation level 'work councils', and representation of employees in the highest governance body.
  Identify topics related to economic, environmental and social performance raised through these mechanisms during the reporting period.

4.5 Linkage between compensation for members of the highest governance body, senior managers and executives (including departure arrangements), and the organisation's performance (including social and environmental performance).

4.6 Processes in place for the highest governance body to ensure conflicts of interest are avoided.

4.7 Process for determining the qualifications and expertise of the members of the highest governance body for guiding the organisation's strategy on economic, environmental and social topics.

4.8 Internally developed statements of mission or values, codes of conduct and principles relevant to economic, environmental and social performance and the status of their implementation.

Explain the degree to which these:

- Are applied across the organisation in different regions and department/units.
- Relate to internationally agreed standards.

4.9 Procedures of the highest governance body for overseeing the organisation's identification and management of economic, environmental and social performance, including relevant risks and opportunities, and adherence or compliance with internationally agreed standards, codes of conduct and principles.

Include frequency with which the highest governance body assesses sustainability performance.

4.10 Processes for evaluating the highest governance body's own performance, particularly with respect to economic, environmental and social performance.

COMMITMENTS TO EXTERNAL INITIATIVES

4.11 Explanation of whether and how the precautionary approach or principle is addressed by the organisation.

Article 15 of the Rio Principles introduced the precautionary approach. A response to 4.11 could address the organisation's approach to risk management in operational planning or the development and introduction of new products.

4.12 Externally developed economic, environmental and social charters, principles or other initiatives to which the organisation subscribes or endorses.

Include date of adoption, countries/operations where applied, and the range of stakeholders involved in the development and governance of these initiatives (e.g. multi-stakeholder, etc.). Differentiate between non-binding, voluntary initiatives and those with which the organisation has an obligation to comply.

4.13 Memberships in associations (such as industry associations) and/or national/international advocacy organisations in which the organisation:

- Has positions in governance bodies.
- Participates in projects or committees.
- Provides substantive funding beyond routine membership dues.
- Views membership as strategic.

  This refers primarily to memberships maintained at the organisational level.

STAKEHOLDER ENGAGEMENT

The following Disclosure Items refer to general stakeholder engagement conducted by the organisation over the course of the reporting period. These Disclosures are not limited to stakeholder engagement implemented for the purposes of preparing a sustainability report.

4.14 List of stakeholder groups engaged by the organisation.
Examples of stakeholder groups are:

- Communities.
- Civil society.
- Customers.
- Shareholders and providers of capital.
- Suppliers.
- Employees, other workers and their trade unions.

4.15 Basis for identification and selection of stakeholders with whom to engage.
This includes the organisation's process for defining its stakeholder groups, and for determining the groups with which to engage and not to engage.

4.16 Approaches to stakeholder engagement, including frequency of engagement by type and by stakeholder group.
This could include surveys, focus groups, community panels, corporate advisory panels, written communication, management/union structures and other vehicles. The organisation should indicate whether any of the engagement was undertaken specifically as part of the report preparation process.

4.17 Key topics and concerns that have been raised through stakeholder engagement, and how the organisation has responded to those key topics and concerns, including through its reporting.

Standard Disclosures – Performance Indicators

INDICATOR HIERARCHY KEY

Categories (6)

ASPECTS

XX01 *Core Indicators* are those indicators identified in the GRI Guidelines to be of interest to most stakeholders and assumed to be material unless deemed otherwise on the basis of the GRI Reporting Principles.

XX01 *Additional Indicators* are those indicators identified in the GRI Guidelines that represent emerging practice or address topics that may be material to some organisations but not generally for a majority.

Environmental

MATERIALS

EN1 Materials used by weight or volume.

EN2 Percentage of materials used that are recycled input materials.

ENERGY

EN3 Direct energy consumption by primary energy source.

EN4 Indirect energy consumption by primary source.

EN5 Energy saved due to conservation and efficiency improvements.

EN6 Initiatives to provide energy-efficient or renewable energy-based products and services, and reductions in energy requirements as a result of these initiatives.

EN7 Initiatives to reduce indirect energy consumption and reductions achieved.

WATER

EN8 Total water withdrawal by source.

EN9 Water sources significantly affected by withdrawal of water.

EN10 Percentage and total volume of water recycled and reused.

BIODIVERSITY

EN11 Location and size of land owned, leased, managed in, or adjacent to, protected areas and areas of high biodiversity value outside protected areas.

EN12 Description of significant impacts of activities, products and services on biodiversity in protected areas and areas of high biodiversity value outside protected areas.

EN13 Habitats protected or restored.

EN14 Strategies, current actions and future plans for managing impacts on biodiversity.

EN15 Number of IUCN Red List species and national conservation list species with habitats in areas affected by operations, by level of extinction risk.

EMISSIONS, EFFLUENTS AND WASTE

EN16 Total direct and indirect greenhouse gas emissions by weight.

EN17 Other relevant indirect greenhouse gas emissions by weight.

EN18 Initiatives to reduce greenhouse gas emissions and reductions achieved.

EN19 Emissions of ozone-depleting substances by weight.

EN20 NO, SO and other significant air emissions by type and weight.

EN21 Total water discharge by quality and destination.

EN22 Total weight of waste by type and disposal method.

EN23 Total number and volume of significant spills.

EN24 Weight of transported, imported, exported or treated waste deemed hazardous under the terms of the Basel Convention Annex I, II, III and VIII, and percentage of transported waste shipped internationally.

EN25 Identity, size, protected status and biodiversity value of water bodies and related habitats significantly affected by the reporting organisation's discharges of water and runoff.

PRODUCTS AND SERVICES

EN26 Initiatives to mitigate environmental impacts of products and services, and extent of impact mitigation.

EN27 Percentage of products sold and their packaging materials that are reclaimed by category.

COMPLIANCE

EN28 Monetary value of significant fines and total number of non-monetary sanctions for non-compliance with environmental laws and regulations.

TRANSPORT

EN29 Significant environmental impacts of transporting products and other goods and materials used for the organisation's operations, and transporting members of the workforce.

OVERALL

EN30 Total environmental protection expenditures and investments by type.

Human rights

INVESTMENT AND PROCUREMENT PRACTICES

HR1 Percentage and total number of significant investment agreements that include human rights clauses or that have undergone human rights screening.

HR2 Percentage of significant suppliers and contractors that have undergone screening on human rights and actions taken.

HR3 Total hours of employee training on policies and procedures concerning aspects of human rights that are relevant to operations, including the percentage of employees trained.

NON-DISCRIMINATION

HR4 Total number of incidents of discrimination and actions taken.

FREEDOM OF ASSOCIATION AND COLLECTIVE BARGAINING

HR5 Operations identified in which the right to exercise freedom of association and collective bargaining may be at significant risk, and actions taken to support these rights.

CHILD LABOUR

HR6 Operations identified as having significant risk for incidents of child labour, and measures taken to contribute to the elimination of child labour.

FORCED AND COMPULSORY LABOUR

HR7 Operations identified as having significant risk for incidents of forced or compulsory labour, and measures to contribute to the elimination of forced or compulsory labour.

SECURITY PRACTICES

HR8 Percentage of security personnel trained in the organisation's policies or procedures concerning aspects of human rights that are relevant to operations.

INDIGENOUS RIGHTS

HR9 Total number of incidents of violations involving rights of indigenous people and actions taken.

Labour practices and decent work

EMPLOYMENT

LA1 Total workforce by employment type, employment contract and region.

LA2 Total number and rate of employee turnover by age group, gender and region.

LA3 Benefits provided to full-time employees that are not provided to temporary or part-time employees, by major operations.

LABOUR/MANAGEMENT RELATIONS

LA4 Percentage of employees covered by collective bargaining agreements.

LA5 Minimum notice period(s) regarding operational changes, including whether it is specified in collective agreements.

OCCUPATIONAL HEALTH AND SAFETY

LA6 Percentage of total workforce represented in formal joint management–worker health and safety committees that help monitor and advise on occupational health and safety programmes.

LA7 Rates of injury, occupational diseases, lost days and absenteeism, and number of work-related fatalities by region.

LA8 Education, training, counselling, prevention and risk-control programmes in place to assist workforce members, their families or community members regarding serious diseases.

LA9 Health and safety topics covered in formal agreements with trade unions.

TRAINING AND EDUCATION

LA10 Average hours of training per year per employee by employee category.

LA11 Programmes for skills management and lifelong learning that support the continued employability of employees and assist them in managing career endings.

LA12 Percentage of employees receiving regular performance and career development reviews.

DIVERSITY AND EQUAL OPPORTUNITY

LA13 Composition of governance bodies and breakdown of employees per category according to gender, age group, minority group membership and other indicators of diversity.

LA14 Ratio of basic salary of men to women by employee category.

Society

COMMUNITY

SO1 Nature, scope and effectiveness of any programmes and practices that assess and manage the impacts of operations on communities, including entering, operating and exiting.

CORRUPTION

SO2 Percentage and total number of business units analysed for risks related to corruption.

SO3 Percentage of employees trained in organisation's anti-corruption policies and procedures.

SO4 Actions taken in response to incidents of corruption.

PUBLIC POLICY

SO5 Public policy positions and participation in public policy development and lobbying.

SO6 Total value of financial and in-kind contributions to political parties, politicians and related institutions by country.

ANTI-COMPETITIVE BEHAVIOUR

SO7 Total number of legal actions for anti-competitive behaviour, anti-trust, and monopoly practices and their outcomes.

COMPLIANCE

SO8 Monetary value of significant fines and total number of non-monetary sanctions for non-compliance with laws and regulations.

Product responsibility

CUSTOMER HEALTH AND SAFETY

PR1 Life cycle stages in which health and safety impacts of products and services are assessed for improvement, and percentage of significant products and services categories subject to such procedures.

PR2 Total number of incidents of non-compliance with regulations and voluntary codes concerning health and safety impacts of products and services during their life cycle, by type of outcomes.

PRODUCT AND SERVICE LABELLING

PR3 Type of product and service information required by procedures, and percentage of significant products and services subject to such information requirements.

PR4 Total number of incidents of non-compliance with regulations and voluntary codes concerning product and service information and labelling, by type of outcomes.

PR5 Practices related to customer satisfaction, including results of surveys measuring customer satisfaction.

MARKETING COMMUNICATIONS

PR6 Programmes for adherence to laws, standards and voluntary codes related to marketing communications, including advertising, promotion and sponsorship.

PR7 Total number of incidents of non-compliance with regulations and voluntary codes concerning marketing communications, including advertising, promotion and sponsorship by type of outcomes.

CUSTOMER PRIVACY

PR8 Total number of substantiated complaints regarding breaches of customer privacy and losses of customer data.

COMPLIANCE

PR9 Monetary value of significant fines for non-compliance with laws and regulations concerning the provision and use of products and services.

Economic

ECONOMIC PERFORMANCE

EC1 Direct economic value generated and distributed, including revenues, operating costs, employee compensation, donations and other community investments, retained earnings, and payments to capital providers and governments.

EC2 Financial implications and other risks and opportunities for the organisation's activities due to climate change.

EC3 Coverage of the organisation's defined benefit plan obligations.

EC4 Significant financial assistance received from government.

MARKET PRESENCE

EC5 Range of ratios of standard entry level wage compared to local minimum wage at significant locations of operation.

EC6 Policy, practices and proportion of spending on locally based suppliers at significant locations of operation.

EC7 Procedures for local hiring and proportion of senior management hired from the local community at locations of significant operation.

INDIRECT ECONOMIC IMPACTS

EC8 Development and impact of infrastructure investments and services provided primarily for public benefit through commercial, in-kind, or pro bono engagement.

EC9 Understanding and describing significant indirect economic impacts, including the extent of impacts.

Guidance for using indicators

In reporting on the Performance Indicators, the following guidance on data compilation applies:

- *Reporting on trends*: Information should be presented for the current reporting period (e.g. one year) and at least two previous periods, as well as future targets, where they have been established, for the short and medium term.
- *Use of protocols*: Organisations should use the protocols that accompany the indicators when reporting on the indicators. These give basic guidance on interpreting and compiling information.
- *Presentation of data*: In some cases, ratios or normalised data are useful and appropriate formats for data presentation. If ratios or normalised data are used, absolute data should also be provided.

- *Data aggregation*: Reporting organisations should determine the appropriate level of aggregation of information. See additional guidance in the General Reporting Notes section of the Guidelines.
- *Metrics*: Reported data should be presented using generally accepted international metrics (e.g. kilograms, tonnes, litres) and calculated using standard conversion factors. Where specific international conventions exist (e.g. GHG equivalents), these are typically specified in the Indicator Protocols.

Standard Disclosures – Management Approach

The Disclosure(s) on Management Approach is intended to address the organisation's approach to managing the sustainability topics associated with risks and opportunities.

The organisation can structure its Disclosure(s) on Management Approach to cover the full range of aspects under a given category or group its responses differently. However, all of the aspects associated with each category should be addressed regardless of the format or grouping.

Disclosures on Management Approach include:

- goals and performance;
- policy;
- organisational responsibility;
- training and awareness*;
- monitoring and follow-up*;
- additional contextual information.

*Not applicable to Economic (EC) indicators.

Decision tree for boundary setting

A sustainability report should include in its boundary all entities that generate significant sustainability impacts (actual and potential) and/or all entities over which the reporting organisation exercises control or significant influence with regard to financial and operating policies and practices.

Item 3: Information from Aon Insurance – site extract

See www.aon.com.

Environmental exposures – myth and reality

Myth	Reality
Financial protection from environmental risk doesn't exist outside the USA	It does and has developed significantly since the market started in the early 1900s.
Insurance can only cover sudden and unforeseen events, not gradual or known risks	A known 'risk' does not always turn into a 'liability': insurance now exists to protect against the actual liability crystallising.

(Continued)

Myth	Reality
	Environmental impairment liability insurance does not discriminate between gradual and sudden pollution events. Cover is now available to cap remediation costs of known risks. Protection is very expensive and provides little if any real risk transfer. Protection is very expensive and provides little if any real risk transfer. There is now a sophisticated market for environmental insurance that delivers more competitive and better products; this makes protection both affordable and effective.
To place environmental insurance I need to have detailed environmental investigations carried out. These are expensive and may find something that I do not want to know about and I may not be able to insure	The environmental insurance market has evolved. Now it is possible to place insurance, or at least get an indication of premium, cover, as well as the minimum further information needed to place the risk, with relatively little information. This information may already exist, or we may be able to acquire it from publicly available databases and archive information. Indeed, the financial management of an environmental risk may be less fraught in terms of potential financial outcome, than undertaking investigations and other forms of physical risk management. The ideal solution is to integrate both methods to achieve an appropriate balance. This way there are often savings from minimising the physical investigation element, minimising disruption to business and costs, and transferring the risk using an insurance policy. At the same time, giving the insurance underwriter adequate and appropriate information will help minimise premium costs. Aon Environmental Consulting and Solutions (ECAS) can provide a full range of technical, financial and insurance skills that ensure you achieve this balance.
Environmental risks only apply to 'dirty' industries not the service sector	With so much redevelopment of brownfield sites, this is no longer the case, particularly where past clean-ups may not meet the latest regulatory standards. New owners can incur substantial unforeseen obligations regardless of their industry sector: for instance, by simply 'buying into' a previously unidentified environmental issue.
You don't need insurance if you get sufficient warranties or indemnities when buying and selling property	Warranties and indemnities are only as good as the company that issues them – many environmental risks have longer 'lives' than the average company.

Myth	Reality
	These do not usually extend to cover potential Third Party Bodily Injury and Property damage claims.
	Many entities fail to monitor warranties and indemnities received and issued, and so fail to recognise when the risk transfers on to them.
	Vendors often mistakenly believe they can permanently transfer their total exposure to environmental issues irrespective of the legal basis behind the Polluter Pays Principle.
Investors such as Private Equity Funds are not at risk	Not so. Under the environmental legislation of many countries, an owner (or even in some cases, user) of a site can become liable for environmental impairment events. This includes a Private Equity House or a Venture Capitalist who only purchased the property, or a company owning the site, with a view to profiting from an 'on sale'.
Environmental Risk Consultants (ERCs) can evaluate risk exposure accurately	The professional indemnity cover for ERCs often constrains them to looking at their client's site in isolation. However, the problem may lie in, or be created by, neighbouring sites.
	Furthermore, ERCs will frequently limit their estimates to on-site remediation costs and typically do not consider the third-party liability exposures, either on or off site.
Risk is proportional to the apparent market value of the site	This is simply not the case – clean-up costs can extend well beyond the market value of the site.
	We have seen an accident with a litre of chemical that resulted in a US$43 million or €24 million cost for damages.
Only tomorrow's transactions matter	We believe environmental risk analysis should be retrospective as well as predictive. A past business practice could have created a potential liability that no one has yet identified and evaluated.
There are plenty of US-type insurance products that we can buy off the shelf to address environmental issues outside the USA	Not true; in many countries owners and occupiers are also liable to prosecution, and actions by effected third parties, if they knowingly let pollution cross their site and do nothing about it (even if they are not the polluter). Furthermore, environmental issues can relate to any former use of a site and the current user/owner may have unwittingly 'bought into' a legacy liability.
	Every commercial owner or occupier of property therefore has a potential environmental risk exposure.

Item 4: Summary of key decisions from COP 13/MOP 3

COP 13/MOP 3 Summary

- Roadmap
- CDM guidance
- Implementation of Article 6 guidance – joint implementation
- Decision on small-scale afforestation and reforestation clean development mechanism project activities
- Reducing emissions from deforestation in developing countries – approaches to stimulate action
- Adaptation Fund
- Development and transfer of technology
- Date and venues for COP 14/MOP 4 and COP 15/MOP 5

Roadmap

The Bali Climate Change Conference concluded on 15 December 2007 following unprecedented discussions that ran through the night. After a reported eleventh hour u-turn by the USA, which followed the EU's compromise in relation to its earlier insistence on the inclusion of mandatory targets, the Bali Roadmap or 'BRM' as it is becoming known was finally agreed.

The BRM

The BRM is the launch of a comprehensive negotiation process between all participants to secure a long-term climate change plan that will enable the 'full, effective and sustained implementation' of the UNFCCC up to and beyond 2012. Final decisions regarding the content of these global climate change measures are scheduled for completion by COP 15/MOP 5 in two years time.

Generally no decisions were adopted that impose numerical targets on nations and none of the parties accepted mandatory emission reduction targets in this session. The BRM accepted that the scientific evidence is now overwhelming. Therefore the parties have acknowledged the findings of the Fourth Assessment Report of the IPCC 'that warming of the climate system is unequivocal, and that delay in reducing emissions significantly constrains opportunities to achieve lower stabilisation levels and increases the risk of more severe climate change impacts'. The BRM states that co-operative discussions to establish the future of the UN's climate change regime is to begin without delay and the first meeting is scheduled to be held no later than April this year.

CDM guidance

The Clean Development Mechanism (CDM) process came under scrutiny during the Bali conference and several recommendations were proposed to improve the CDM. Many of these relate to the functions of the CDM Executive Board ('EB') including a request for the EB to take action so as to simplify processes where possible and ensure fair and equitable decision-making. Transparency in the processes of the EB has also been encouraged to help achieve this result. Other key decisions include the abolition of share of proceeds (cost of adaptation and registration fees) CDM projects based in least developed countries.

Implementation of Article 6 guidance – joint implementation

A decision was made to develop a new web-based interface to create a record of all JI projects (both track 1 and track 2), similar to the system used for CDM projects on the UNFCC website. This tool's objective is to provide easy access to project information for parties acting as designated focal points (the equivalent of the designated national authority in the CDM) and for information necessary for tracking of issued ERUs (e.g. project identifier codes) to be provided to the international transaction log. The JI Supervisory Committee has also been encouraged to enhance interaction with project participants to assist transparency and to expediate the approval and allocation process.

Decision on small-scale afforestation and reforestation clean development mechanism project activities

It was decided to double the limit that determines whether qualifying afforestation and reforestation CDM projects can qualify as small scale and therefore take advantage of decreased set-up costs owing to simplified procedures. To qualify as a small-scale afforestation and reforestation CDM project, it is now required that the project be expected to result in net anthropogenic GHG removals by sinks of less than 16 kilotonnes of CO_2 per year. In addition the projects must be developed or implemented by low-income communities and individuals as determined by the host party. Previously, the low limit resulted in many projects not being pursued because they were simply uncommercial given the low certified emission reduction (CER) limit.

Reducing emissions from deforestation in developing countries – approaches to stimulate action

The issue of reducing emissions from deforestation (REDD) was a priority during the conference. It was decided to analyse the topic in more detail with the aim of including it within the UNFCC. It was concluded that forest degradation and deforestation add to carbon emissions and therefore activities that seek to reduce these outcomes and maintain forested land should be incentivised through the climate change regime. The decision proposed several recommendations and called for research into the surrounding issues for consideration at future meetings. It is unclear whether REDD will be included as activities which will be able to generate carbon credits through schemes such as the CDM. However, the decision affirms the prominence of REDD and ensures that thorough research is carried out to determine whether it would be feasible for it to be included in future climate change protocols and the form in which it can be integrated into the current systems. Meanwhile the World Bank (WB) has launched its Forest Carbon Partnership Facility, simultaneously to encourage the sustainable use of forest resources through financial incentives.

Adaptation Fund

This decision determined how the Adaptation Fund should be utilised, a topic that was debated extensively in the previous COP/MOP. It was decided that developing countries who are Parties to the Kyoto Protocol and that are particularly vulnerable to the adverse effects of climate change are eligible for funding from the Adaptation Fund to assist in meeting the costs of adaptation. The Fund will be used to finance adaptation projects and programmes based on the needs, views and priorities of eligible parties. An Adaptation Board will be created and officially appointed to manage the fund and its interests. The WB has been invited to serve as trustee to the Adaptation Fund (on an interim basis). It will monetise the CERs that are issued by the CDM EB from various registered CDM projects and deducted from such projects upon issuance (by way of share of proceeds (cost of adaptation)) for forwarding to the Adaptation Fund.

Development and transfer of technology

The issue of technology development and transfer was one of the main concerns of developing countries. They argued for increased action to assist in their emissions' reduction efforts. The delegates recognised that there is 'a crucial need to accelerate innovation in the development, deployment, adoption, diffusion and transfer of environmentally sound technologies among all parties, and particularly from developed to developing countries, for both mitigation and adaptation'. It has been suggested that progress on this issue has been slow as between developed and developing countries. Therefore this decision saught to instigate action. The delegates decided to adopt the terms of reference of the Expert Group on Technology Transfer ('EGTT') and the EGTT's recommendations for enhancing the implementation of the technology transfer framework under Article 4, paragraph 5 of the UNFCC.

Date and venues for COP 14/MOP 4 and COP 15/MOP 5

The parties agreed that the 14th session of the Conference of the Parties and the fourth session of the Conference of the Parties serving as the meeting of the Parties to the Kyoto Protocol to be held in December 2008 and will be hosted by the government of Poland in Poznan. They also agreed that the 15th session shall take place from 30 November to 11 December 2009 and will be hosted by the Government of Denmark in Copenhagen.

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17

Charity considerations: issues of transparency and governance

17 Charity considerations: issues of transparency and governance

CHAPTER OVERVIEW 17.1

Just as business is now operating in an era of exacting requirements of corporate governance, as discussed in earlier chapters (see **Chapter 10**), charities are also similarly impacted. Moreover, those companies that donate to charities should ensure that the non-profit organisations that they support are following correct procedures and responsive to change. For instance, the Royal British Legion has approved radical changes in its structure following recommendations from the Combined Code on Corporate Governance created by the Financial Reporting Council in 2003 (see **Chapter 10**) and in anticipation of the legislative changes as a result of the Charities Act 2006 (see **17.4** below). Meanwhile charities should be aware that the reputation of large donors can affect their brand, image and reputation too (see **17.2** below). The interaction and influence between the commercial and non-commercial sectors can be witnessed globally.

In the UK there are over 20,000 registered charities that are also registered with Companies House. Dual registration enables them to benefit from the limited liability enjoyed by company directors to hold property directly rather than indirectly through individual trustees (see the discussion of corporate vehicles in **Chapter 4**). As the governance debate evolves so do the available vehicles or structures in addition to or in place of traditional vehicles and structures. There is a new legal form of incorporation being proposed which is designed specifically for charities, the Charitable Incorporated Organisation (CIO) to take account of this issue (see **17.4** below). Reference may also be made to the recent proposal for 'community enterprise companies' in the legislation. Indeed in the UK there is an initiative to modernise charities in many respects in the much anticipated draft *Charities Act 2006*. The full text can be found at www.opsi.gov.uk/acts/acts2006

As has been the case with topics covered in earlier chapters, the discussion of charity considerations can be the subject of another entire manual. Issues of transparency and governance include macro and micro concerns. Developments and comments can extend from the larger organisations to very small organisation in this vast sector. In this chapter, therefore, it is intended to raise awareness of selected key issues relevant to the discussion of due diligence and corporate governance and to highlight related developments. In the main this chapter covers UK developments, with some international comment as appropriate.

Accountability and corporate giving 17.2

In this age of growing accountability wherever a charity operates, clarity over donations is at issue. Corporate support is, of course, vital to many prominent areas of the voluntary sector, including aspects of the art world and other non-profit-making ventures. Meanwhile in the sports world there are often well-publicised connections that create issues of governance. For example in the UK the high-profile football sector has undergone a recent inquiry (*English Football and Its Finances* by the All Party Parliamentary Football Committee, February 2004) to address concerns over governance. Moreover, there have been questions raised regarding the appropriate vehicle for clubs and associations: the report has welcomed the initiative regarding community enterprise companies referred to above.

In all of these areas support and giving can be highly influential as well as tax efficient. While this has been true for some time in the USA, the tax implications have become increasingly important in the UK more recently. Therefore, as far as concerns both the donor and the beneficiary, transparency is most important. As in the USA, in general since the last collapse of the stock market, charities are finding that there is greater public interest from both taxpayers and shareholders in who is giving to charity and why. Moreover, there has been a heightened state of interest as a result of the global concerns regarding terrorism. Trust, once lost, is hard to regain. Just as corporate scandals, such as Enron and Parmalat, have damaged the trust of many investors, impact is felt also on the non-commercial sector (see also earlier discussions in **Chapter 7**).

One noteworthy example that illustrates the increasing connections between charities and corporate giving in the USA related to the well-documented Enron corporate scandal. The connection between Enron and the foundation associated with Kenneth Lay, the company's disgraced former chairman was controversial. The full extent to which charities favoured by Enron directors benefited from Lay and his company's patronage is unknown, due to the complexity of the arrangements and lack of information. What is clear is that much of corporate philanthropy is strategic. It is usually giving that ultimately affects a company's bottom line. It is not just about being a good corporate citizen. Bearing in mind the significance of governance both for companies and charities, even small business should ensure that it is clear about the source of donations, as well as the governance of the charity or charities being supported. Similarly the charity should scrutinise the governance of its donors and how its name is used. In the era of global business and global giving this is a transboundary concern (highlighted recently, for example, by the reference to a small charity in the complex circumstances of the Northern Rock disaster in the UK in 2007). Many companies simply do not know exactly how much they give to charity and from where because the giving is diverse – from small donations to local girl guide groups to charity functions used as marketing events. There should be clarity from both sides to ensure the trend in favour of greater transparency, such as that demonstrated by Summary Information Return (SIR) in the UK, is followed (see **17.8** below).

Fundraising and related developments 17.3

One of the most important areas of due diligence, risk management and governance relates to fundraising. There are many aspects that require careful handling. For example one of the crucial matters for the sustainability of a charity is effective fundraising that enables it to get its message across to the correct audience. This is also a sensitive area as complaints about fundraising can affect the reputation of the charity. Neil Morris, Deputy Chief Executive of the Institute of Direct Marketing in the UK has been quoted as saying:

> 'Charity fundraisers face really tough targets compared with those faced by commercial marketers.'

Charities rely on accurate lists of potential donors and up-to-date information: since the *Data Protection Act 1998* the price of such information has risen dramatically. Mailing the right material to the wrong person, is as bad as getting the message wrong in the first place. Therefore the building of sustainable relationships and strategic alliances, as well as using the right broker services that are increasingly available, are important as part of the ongoing due diligence and risk management of the charity. As with commercial organisations concerns over the increased reliance on and exposure to IT (see **Chapter 9**), operational interruption and disaster management must be addressed (see **Chapters 5** and **9**). For instance, online initiatives related to volunteering are on the increase and they can also be affected by global cyber crime. Charities have to consider:

- How to protect against internet fraud;
- Privacy and security issues;
- Problems of cyber stalking and online harassment;
- Protection against fraudulent emails;
- Different government regulatory frameworks regarding criminal activities; and
- The constitutional issues raised by intellectual property cyber crimes.

Moreover, as with commercial entities, litigation or the threat of litigation, can be devastating to small charities in particular (see **Chapter 3**) in terms of the distraction of resources and damage to reputation.

The Charities Act 2006 (see **17.4** below) moves towards a unified scheme for regulating public collections and attempts to improve the statements made by professional fundraisers and commercial participators. The pressure is on in today's climate to monitor what they say. For instance, NGOs such as WWF-UK and Friends of the Earth have been criticised for misrepresenting repercussions of climate change and the impact on species to gain more support for campaigns. There is increasing concern over the fundraising ethic and the common technique of using crises to garner support that has become prevalent here and in the USA. Since the 1980s small organisations have grown to become transnational and have adopted corporate styles of performance management. A recent paper produced by Oxford University has highlighted concerns and Paul Jepson, a former programme manager for Birdlife International, its co-author, has stated that much of the sector is still stuck in the 1980s model of fundraising:

> 'You send out a nice emotive letter and you get £10 guilt money. But then you get involved in an arms race and are forced to hype and hype the story. Ultimately this could damage the message of charities and end up with people not believing anything you say. The current state of fundraising is not good. We need a different model.'

The Charities Act 2006

Charitable purposes and public benefit 17.4

In the UK the *Charities Act 2006* is the first attempt to update charity law since Elizabethan times through statutory legislation which has attempted to clarify and update what the law regards as charitable activity. It extends the list of charitable purposes to 13 and includes a public benefit test criterion. Although there are some additions, the vast majority of these purposes has been regarded as charitable for some time, as a result of developing case law and Decisions of the Charity Commissioners. However, this is the first time all of them have been set out explicitly. The new charitable headings are:

- Prevention or relief of poverty;
- Advancement of education;
- Advancement of religion;
- Advancement of health;
- Advancement of citizenship and community development;
- Advancement of the arts, heritage or science;
- Advancement of amateur sport;
- Advancement of human rights, conflict resolution or reconciliation, or the promotion of religious or racial harmony or equality or diversity;
- Advancement of environmental protection or improvement;

- The relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage;
- Advancement of animal welfare;
- The promotion of the efficiency of the Armed Forces of the Crown, or of the efficiency of the police, fire and rescue services, or ambulance services; and
- Any other currently charitable purposes detailed in the Act.

As it stands, there will be no statutory definition of 'public benefit' as the government believes that the non-statutory approach provides flexibility, certainty and the capacity to accommodate the diversity of the sector. Nevertheless the presumption of public benefit for charities for the traditionally recognised charitable objectives for the relief of poverty, the advancement of religion and the advancement of education will be removed.

For new charities there will be the need to establish not only the recognised charitable purpose but also the provision of public benefit. It is believed that this will involve the use of case law dating back to the original Elizabethan Act. This has meant some controversy over whether campaigning organisations will want to become charities. There is a trade-off between tax advantages and the potential restrictions of charitable status. Moreover, it leaves a great deal of power to the Charity Commission (CC). Indeed the Act as a whole gives increased regulatory powers to the CC. This has alerted concerns over the potential for over policing, especially as regards the vulnerable smaller charities. The regulatory aspects will be subject to CC guidance, another area of concern due to potential problems of regulatory creep. Moreover, during the passage of the Bill before it became law several charities threatened to withdraw support unless the position regarding public benefit was clarified. However, in order to try to achieve the broadest possible acceptance of this power, the CC has been engaged in wide public consultation on this topic with the aim of developing an appropriate a public benefit test.

Independent tribunal **17.5**

The Act also creates an independent Charity Appeal Tribunal (see the reference to tribunals in **Chapter 5**). This independent adjudicator could theoretically challenge or reject the CC guidance or rulings. This initiative has been very well received.

As has been mentioned in **Chapter 5**, the government is working on wider scale tribunal reform and the charity tribunal will have to be consistent with the reformed tribunal system as a whole.

The Charity Appeal Tribunal was due to start operating in February 2008.

Liability of trustees **17.6**

The risk of personal liability can cause worry for existing and potential trustees, even though it is rare for a trustee to suffer actual financial loss. The Charities Act 2006 grants the Commission a new power to relieve trustees from personal liability for breach of trust or duty where they have acted honestly and reasonably and ought fairly to be excused. These provisions have been well received. Nevertheless, as mentioned below, the voluntary sector is generally under pressure to improve governance and, in particular, the role of trustees. A deep understanding of the trustee role enables trustees of charities, large or small, to govern well. Yet, there are concerns that very few trustees, even the most experienced, fully understand the extent of their role.

There has been some debate regarding the need for a trustee code of practice. The Enron and Worldcom scandals, as well as the subsequent Higgs Review of the role of non-executive directors (NEDs) in the private sector (see **Chapters 7** and **10**) gave this debate more urgency. Although the Higgs Review considered corporate boardrooms the Institute of Chartered Secretaries and Administrators (ICSA) has deemed the issues raised to be also relevant to charities. Since trustees are sometimes unclear about their role a single document that clarifies governance is important. Moreover, while some consider that a voluntary sector Enron would not be very likely, organisations are taking the threat seriously.

Some organisations have demanded that even charity should carry out an audit of its management structures in the interest of proper due diligence and good governance. There is no doubt that, as with commercial organisations, non-commercial organisations will be increasingly monitored by stakeholders to ensure that best practice prevails.

A sector developed good governance code – A Code for the Voluntary and Community Sector – was published in June 2005 and was endorsed by leading sector bodies and The National Hub of Expertise in Governance (the Governance Hub). The main principles of the Code are intended to be relevant to all sizes and types of voluntary and community organisations including charities.

Accountability is a key aspect of good governance and the SIR plays a key role in disseminating key information about what a charity aims to do, how it goes about it and the results that follow. Whilst there is a financial threshold of £1,000,000 (see **17.8** below) that exempt small charities from completing this return, practical impacts are being felt on the sector as a whole.

Reporting requirements 17.7

In the UK since the introduction of the Statement of Recommended Practice for Charities (Charities SORP) accounting framework in the 1990s charities have had to comply with increasingly rigorous requirements reflecting wider developments in accounting standards and reporting. The recommendations of the Charities SORP are underpinned by regulations made under the Charities Act making the 'methods and principles' of the SORP as matter of law as well as good practice. The SORP is reviewed annually and was updated in 2005, emphasising the need for charities to explain their activities and their achievements. This has of course increased the pressure on charities to be transparent in their objectives and operations. Recently SORP has focused on reporting costs and expenditure, strengthening the emphasis on achievements against objectives and encouraging equity-holding charities to declare their ethical investment policy. A sub-group of the Charities SORP Committee also considered issues raised by the Strategy Unit (SU) regarding the completion of an SIR (see **17.8** below) and helped ensure a consistent approach with the new emphasis on activities and achievement in the Trustees' Annual Report.

The government does not want charitable companies to opt out of compliance with SORP. Despite EU legislation, now adopted into UK law, to permit charities that are registered as companies to adopt International Reporting Standards company charities continue to prepare their accounts in accordance with the UK's generally accepted accounting practice.

The accounting framework provided by the Charities SORP gives charities an authoritative interpretation of how commercially developed accounting standards should be applied in the context of the charity sector. No similar framework for charities exists within International Reporting Standards and therefore the direct adoption of complex International Financial Reporting Standards would have posed particular difficulties for the UK charity sector.

The CC was opposed to the immediate direct adoption of International Financial Reporting Standard, as was the Finance Directors' Group in the UK. They both wanted to maintain SORP, not as a dismissal of international standards but rather to enable consistency while harmonisation of practice occurs. They believed that an opt out by charitable companies would have led to fragmentation.

The CC recognises that in the longer-term international charities with offices in many different places would benefit from international standards that offered a uniform manner of presenting their accounts across international borders. However, these developments need to dovetailed into the Accounting Standard Board's (ASB) plans for convergence and longer-term plans for the development of a conceptual framework that charities can apply. The Charities SORP Committee plan to develop a SORP that is compliant with International Financial Reporting Standards but this work needs to be timed to co-ordinate with ASB plans for convergence.

The CIO, whose detailed structure will be dealt with in secondary legislation, should be an option for charities in late 2008. This new structure will offer limited liability to trustees and follow the general accounting and reporting framework applying to other charities established under the Charities Act.

Summary Information Return **17.8**

A new reporting instrument was introduced in 2005 to help in the dissemination of information from charities. This return, which is made to the CC as part of a charity's annual return, is known as the Summary Information Return (SIR). The SIR was proposed in 2002 by the SU in its report on charities with a view to raising transparency and accountability in the voluntary sector. It has been agreed that the SIR will be added to the reporting requirements for charities that have an income in excess of one million pounds (£1,000,000). Therefore where donors, grant-makers or funders make a decision to give or invest in such charities they can understand better what the beneficiary organisation is trying to do, how it goes about it and what it achieves. The SIR provides a high level summary that give an introduction to a charity's work and provides an informed starting point for those who want to know more about a charity.

The SIR is a short statement that includes a range of topics, such as:

- the charity's achievements over the reporting period;
- its aims in the forthcoming year;
- information on the sources of support; and
- information on the charity's spending.

Purpose of SIR **17.9**

The intention of SIR is that donors, funding organisations and other stakeholders will be able to appreciate quickly:

- what a charity does;
- the financial base of the charity; and
- whether it is fulfilling its objectives.

The CC collects SIR data as part of the annual return process and the information will also feed into the Guidestar online charity information website. The SIR has now been a mandatory requirement since 2005 for charities with an annual income of £1 million or above. The main idea is that donors, flinders and stakeholders will be able to understand clearly and quickly:

- what a charity does; and
- how it is doing.

Considerations of the SU **17.10**

The development of the SIR followed on from The Cabinet Office's SU report 'Private Action, Public Benefit' which concluded that information about the sector was often 'inaccessible and often ill-suited to the public's needs'. The report added that it was especially difficult to find credible information about performance or outcomes. It has also expressed concerns that it has been hard to make any meaningful comparisons between similar charitable organisations (see also **17.11** below).

Concerns over SIR **17.11**

Accountants and some charities have, nevertheless, raised concerns over the new tool. Their argument is that it will be very hard to define and accurately set out the work of a charity in the small space available. This could mean rough rankings of charity performance. This could in turn bring about the possibility of league tables that the regulator might also use as a tool in its armoury to assess the performance of charities. However, these fears have not crystallised and there is growing recognition that charities need to be accountable and that a key element of accountability is explaining to stakeholders and the wider giving public the results or performance that flow from the funding charities receive.

In early 2007 the CC commissioned Compass Partnership to undertake a review the SIR, to help inform their thinking about the role of the SIR and its utility. Compass's findings will feed into a review of, and public consultation on, the SIR later in 2008.

This review will also address a recommendation made by the Better Regulation Task Force in their report *Better Regulation for Civil Society (2005)* that the CC should review the SIR, with a view to integrating it into charities' Trustees Annual Reports and Accounts.

The Compass report concludes that:

- SIRs are useful to the interested public;
- they are perceived by charities as an administrative burden, but usually take less than five hours to complete; and
- the original objectives of the SIR have not yet been fully achieved (because they are not well known, not attractively presented and do not allow users to make easy comparisons between charities).

It recommends that: SIRs should continue because:

- it would be premature to scrap them after only 18 months of operation;
- the small sample of the public surveyed appreciated the information; and
- the potential of the SIR has not yet been fully exploited.

It also recommends that: the CC should not, at this stage, incorporate the SIR into Trustees' Annual Reports because the SIR database contains precisely the information that users say they want in a much more accessible way than is currently achieved through Annual Reports. The report also recommends ways of making SIRs simpler to complete, improving their content and accessibility and publicising them more widely.

Protecting whistleblowers 17.12

As has been mentioned earlier, the debate over whistleblowers has affected commercial and non-commercial organisations across the world. A worker who blows the whistle on an employer can expect to feel the full force of institutional anger and discrediting including:

- criticism;
- poor performance evaluations;
- punitive transfers;
- job loss;
- ostracism from colleagues;
- blacklisting; and
- stress and health damage.

Historically whistleblowers have found that they have made a decision that entails all risk and no reward. A detailed discussion of whistleblowing is not appropriate in this handbook as it is a subject that deserves much more comprehensive treatment. However, it has arisen, of course, as a major issue in the well-documented corporate scandals. Moreover, it is especially relevant in the consideration of charities, bearing in mind the crucial area of professional ethics. If the public does not protect whistleblowers it tacitly accepts the risks of being denied important information. Although government ministers have been quick to condemn whistleblowers who raise awkward questions – as in the recent case of UN telephone tapping – the regulatory departments have begun to appreciate, and even encourage, whistleblowers.

Following the lead of the UK in 1998 and the USA in 2002, many governments across the world, including The Netherlands, Japan, Korea and South Africa, have drafted legislation to protect whistleblowers (see also Comment on Japan in **Chapter 15**). In 2002 the UK's Financial Services Authority established a hotline that received 276 calls from whistleblowers between May 2002 and October 2003. In the US SOX obliges all US-listed companies to establish 'confidential, anonymous' procedures for employees to submit material about 'questionable accounting or auditing practices'. It also protects whistleblowers from retaliation. Impeding a whistleblower from passing information to enforcement agencies now carries a jail sentence of up to 10 years, as well as large fines. This demonstrates a major departure for a country whose legal culture has emphasised the duty of loyalty to the employer (see also **Chapter 11**), Evidently Ernst and Young's annual survey of global fraud has rated whistleblowing above external audits as the second most effective means of detecting corruption. People are now prepared to acknowledge that whistleblowing is about good citizenship.

In the Charities Act 2006, it was proposed that auditors of charity accounts will be protected from the risk of action for breach of confidence or defamation when they communicate relevant information to the CC. Independent examiners of charity accounts will also be protected. In this respect they are protected since they are often able to identify abuse or significant breaches of trust during the audit process.

Governance issues 17.13

In the UK, governance in the not-for-profit sector has been under scrutiny. The CC has deemed existing regulations to be ineffective and has examined the role of trustees. The voluntary sector has been under pressure from all sides to consider a code for trustees to bridge the gap between law and good practice.

In March 2004 a final draft for a potential governance strategy framework for charities was produced. Simultaneously ICSA publicised its draft proposals to improve charity governance, focusing on the regulation of trustee boards. The Enron and Worldcom scandals and the subsequent Higgs Review of the role of NEDs in the UK private sector gave the debate an air of urgency. Although the review considered corporate boardrooms, ICSA has stated that the issues raised are also relevant to charities. Clearly this should not entail a box ticking exercise, practical solutions should also be reached as a result of a code of practice that covers:

- best practice;
- recruitment; and
- professional development.

There should be a set of expectations that parallels the code of the private sector, which effectively says comply or explain. In this report, and having regard to US developments (see **17.14** below) the sector is intending to be proactive so that a voluntary sector Enron does not happen. ICSA is aware of the fact that there is still a high level of public confidence in the sector but that it would take just one major scandal to set back the sector and an audit of a charity's management systems would assist.

The SIR is another indication of the growing importance of transparency and governance. While stakeholders have generally welcomed the introduction of SIR in principle, they have indicated that there are issues to be dealt with regarding the use of the SIR as a tool for comparison. It is to be hoped that in time the SIR can be implemented to the positive satisfaction of donors and donees alike. Meanwhile this is a matter of interest to organisations, including small business, and should be monitored carefully.

Trustees duties – governance for non-profits in the USA **17.14**

The corporate governance debate in the USA is also spreading from the for-profit to the not-for-profit world. There have been well-publicised controversies at organisations such as The Nature Conservancy, the American Red Cross and the James Irvine Foundation. This has even caused observers such as Eliot Spitzer, the Attorney General of New York State, to suggest that the *Sarbanes-Oxley Act of 2002* should be applied to non-profit boards. Clearly, those non-profit boards operate under unusual constraints, for example directors:

- volunteer their time;
- play an important role in raising funds; and
- in some cases are so numerous that board meetings resemble conferences rather than deliberative assemblies.

They also answer to a wide range of stakeholders who may lack a single a common goal, such as increasing shareholder value, prevalent in the commercial sector. Thus it is not surprising that a McKinsey survey of executives and directors of not-for-profit social-service organisations found that only 17% of the respondents felt that their boards were as effective as they could be. It has been suggested that to improve the governance or non-profit organisations, their boards must venture beyond the traditional focus on raising funds, selecting CEOs and setting high level policy. McKinsey's research indicates that the best boards should also:

- provide professional expertise;
- represent the interests of their non-profits to community leaders;
- recruit new talent to the organisation; and
- provide the more rigorous management and performance oversight that funders increasingly demand.

In the USA over the longer term, however, not-for-profit organisations have no choice but to reconsider the way they replace and recruit directors. Meanwhile regular evaluations can help by:

- setting out expectations;
- indicating when a change of behaviour is needed; and
- motivating underperforming directors to leave.

As regards the recruitment of new directors, a standing nominating committee should have the responsibility for creating a board on which each member brings not only the all-important fundraising capabilities but also necessary skills or relationships with community leaders, politicians or regulators. The committee should recruit candidates from as wide a range of channels as possible and recognise that sustained cultivation may be needed to get the best possible directors. This should be compared with the Higgs Review and the Tyson Report in the UK.

The Tyson Report 17.15

In the UK the Tyson Report has called for more diversity on company boards so that they included more NEDs from non-traditional backgrounds, such as the voluntary sector. It is evident that, compared with the voluntary sector, listed companies are very rigid about appointments. The voluntary sector is more flexible while commercial organisations are awaiting more guidance in order to implement the Tyson Report.

Tyson's remit was to develop the ideas raised in the Higgs Report on corporate governance. The role of NEDs is regarded as increasingly important given the high-profile corporate failures at companies such as Enron. Tyson has argued that companies would benefit from recruiting a more diverse board and that the non-commercial sector was a fertile source of NED talent for UK companies.

The Tyson Report also led to hopes that companies would take advantage of specialist registers that include top people from non-commercial sectors. Companies need to decide not only whether they want a more diverse board but also whether they would recruit other than by word of mouth or other traditional methods, thereby changing the culture. Such recommendations also emphasis the increasingly close interconnection between the two sectors in relation to ongoing due diligence, risk management and corporate governance. In any event it is essential that the independence of the voluntary sector should not be jeopardised. If involved in company boards any representatives should ensure that they keep their independence. This should not affect the ability to scrutinise companies, nor the corporate sector generally, on social and ethical issues.

Conclusion 17.16

Across the world the debate over governance has focused the minds of many in all sectors as they grapple with:

- changing models and practices;
- practical threats to their sustainability; and
- the need for positive performance for the benefit of all stakeholders.

As this chapter has attempted to demonstrate, since the commercial and non-commercial sectors interact, increasingly they must be alert to developments in both sectors. Even in the case of smaller organisations – whether in business or not – there is a duty in the interest of ongoing due diligence, transparency and governance, to meet the challenges and monitor the swiftly changing requirements and expectations of the society and the economy.

18

Governance in the family, the family business and family trusts

18 Governance in the family, the family business and family trusts

CHAPTER OVERVIEW

18.1 It can be said that the family business model has a certain longevity that contrasts with the evanescence of other business models or organisations. Indeed one expert on this subject, Professor William O'Hara, has considered whether there is any institution more enduring or universal than a family business in his book, *Centuries of Success*. He has concluded 'Before the multinational corporation, there was family business. Before the Industrial Revolution, there was family business. Before the enlightenment of Greece and the empire of Rome, there was family business'. Since the mid-1990s, research by O'Hara and his associate Peter Mandel has provided the basis for a compilation of the world's 100 oldest continuously family-owned firms. In their view, all of these firms can claim to have survived governments, nations, cities and major corporations. Those listed in the compilation are at least 225 years old; four have lasted in the same family for more than a millennium. The very oldest that they have found is the Japanese temple-builder Kongo Gumi, founded in 578.

Meanwhile India has provided a good illustration of extremely successful family business and trusts spanning generations. For a very long time Indian business was generally owned and managed by families. Yet following the economic reform and liberalisation that began in the 1990s various key issues and questions were raised that are also relevant for the wider debate over governance such as:

- Can a family-run business survive the competitive demands of the post-reform era?
- Can they overcome their historic weaknesses to deal with modern challenges?
- Even if a family firm is not at a disadvantage, it must be able to separate the family's interest from the interest of the business; have Indian firms been able to achieve this separation?
- Is a family-firm at a disadvantage versus a professionally managed firm?
- Why do Indian family-run companies have problems retaining professional outside talent?

- * Why is there a cultural resistance among Indian family-run firms to institutionalise themselves?
- * Will they be able to become professionally managed corporations similar to those found in Japan and the USA?
- * What is the best strategy suited to Indian family-run firms?
- * Will an economy based on smaller family business grow slower or be disadvantaged compared to one based on large professional companies?
- * Can India's family business firms deliver positively in today's era of globalisation where the nation's economic success is increasingly the success of its companies?

Statistics in 2001 provided by the CII indicated that family-run businesses contributed about 75% of the employment and 65% of the gross domestic product (GDP) in India (see also **18.12**) and that 71% of market capitalisation was contributed by family-run enterprises. Indeed, traditional family-run businesses have in fact grappled with the changing marketplace. Whereas competition has enabled many new corporate players to enter the marketplace, various key traditional businesses, such as the Tatas, have now become worldwide business names that are achieving tremendous success outside India (e.g. the launch of the new family car – the Nano – costing £1,000 to enable accessibility for families and safer road travel). Ratan Tata, Chairman of what has been described as 'the greying, distinguished Tata', has confirmed that more international acquisitions would help bring global visibility to his group which has been regarded as a sprawling conglomerate that makes everything from automobiles to steel and software, with a name that until recently was not well known outside India. Moreover, in view of the dynamic growth in M&A overseas by Indian companies an understanding of the approach and culture of such traditional family-run houses from India – and the trends in this context – is useful given their impact also on the global marketplace (see also **Chapter 8**).

In order to professionalise the family must make the mental leap and separate ownership and management, as well as distinguish between the family's interest and the company's interest. Most Indian companies are in a transition today. They have to cope with the problem of incompetent family members at the top of many businesses. Rahul Bajaj says, 'It is easy to get rid of an outside manager, but how do you get rid of a family member? You must either do what is right for the business or the family. Either way, you will end up with an unhappy family or a weak company' (see also 12).

Due to competitive pressures brought about by the economic reforms, Indian businessmen have realised that superior companies are built by superior people; that the success of their company depends on their attitude towards men and women of high ability and advanced training. A businessman of a Rs. 500 crore company recently admitted that, 'In the past, I was extravagantly wasteful of talent or myopic in believing that I could do it all by myself'. Today, due to competitive pressures and the rapid rate of innovation and change, it is a challenge to find talented people and then to retain them. Currently, human resources is the major issue, to find men and women of ability to manage crucial corporate positions. This is a profound change for the business world after the reforms in India.

The inability of Indian business to create large-scale non-family organisations may not, necessarily constitute a constraint on the rate of aggregate Indian economic growth. What small companies give up in terms of financial clout, technological resources and staying power, they gain in flexibility, lack of bureaucracy and speed of decision-making. Throughout the 1980s, for example the economies of Italy and other family minded Latin Catholic societies in the EU grew faster than Germany's. Max Weber, who argued that Chinese familism would impede economic modernisation was proved to be wrong. Indeed, it is feasible that small Chinese and Italian family businesses will prosper more than large Japanese or German corporations in sectors serving fast changing highly segmented consumer markets. If the objective in India is to maximise aggregate wealth, then relatively small-scale family businesses still has a place.

It is argued by experts that managerial capitalism needs social capital. Whether Indian businesses can create managerial capitalism depends partly on the Indian society's ability to build social capital. 'Social capital' refers to the way people associate with themselves in a civil society. Where people spontaneously trust each other as strangers (non-family) and co-operate with each other, there is high social capital. Alexis de Tocqueville, for instance, regarded this art of association as a key virtue of American society because it moderated the American tendency towards individualism.

Throughout this handbook ethics, trust and co-operation are promoted for all sustainable market activity. Integrity and trust can dramatically lower transaction costs, corruption and bureaucracy. In order for family capitalism to be successful in Italy, Taiwan, Hong Kong and France, it should be accompanied by education and a strong work ethic. Otherwise, nepotism and stagnation occur. Many large and successful Indian companies have also realised that educated, hard-working professionals usually outperform lazy, uneducated family members. However, the majority of SMEs, which form the core of the private economy, still struggle with this issue.

It is interesting to note that women have often found more potential in Indian family-run businesses. Evidently over the past decade, more women have gained prominence in family-run businesses as compared to professional corporate set-ups. This is in line with other positive trends in the context of governance. It has been pointed out above that since a significant component of GDP is generated by family-run companies, it is crucial to ensure that they are adequately resourced both financially and with human capital.

This debate extends to gender. Moreover attracting, motivating and retaining leadership talent in such firms is a key priority. As regards their governance, experts advise that to ensure essential value creation for family firms the family businesses need independent and 'progressive' boards that promote transparency for all stakeholders, including employees. For instance NASSCOM, India's software industry association, has confirmed that around 20,000 NRI professionals have returned from abroad to India over the last three years. Given that many experts consider that a shortage of executive talent is a serious threat to India's competitive advantage, family businesses could enjoy a significant competitive advantage in attracting individuals seeking long term, local stability and a career in their native country. The ability of family-run firms to leverage this advantage will be critical in meeting the talent shortage challenge.

Moreover, whereas private equity firms investing in India have experienced some constraints due to the predominance of family-owned businesses, on the other hand the strength of family values has been demonstrated among leading and successful family business houses in India, such as the Tatas, the Birlas, the Ambanis and the Modis. Indeed, Business Week named Arcelor Mittal as the 'best family-run business' in its 'Best and Worst of 2006' issue. The company was formed when family-owned Mittal Steel acquired Luxembourg-based Arcelor, the world's No. 2 steelmaker, in July 2006. The new company's first CEO was Arcelor executive Roland Junck, but Lakshmi N. Mittal took the helm in November 2007. 'The Mittal family, which has 43.5% of Arcelor Mittal, is once again firmly in control', Business Week reported, noting that Mittal's son Aditya is the chief financial officer. 'Its hard to argue that such family control is a bad thing when you look at Mittal's track record', the article said. 'In less than three decades he has built a global steel empire from scratch and made himself a fortune of more than $20 billion … London broker Cazenove forecasted that Arcelor Mittal would earn $11.6 billion in pretax profits (in 2006), on revenues of $82.7 billion' (*Source*: Business Week, 18 December 2006). Just as with other organisations dynamic family businesses can indeed span from micro to vast and can control tiny or massive resources globally (see **18.12**).

Governance and the family is an appropriate context in which to reflect upon the potential future of governance, as well as its scope, given that families involved in business and trusts often seek:

- more unity of purpose;
- an increasing focus on and realisation of the importance of family business;
- greater emphasis on personal development.

Currently governance tends to be defined as a function of oversight, regulation or supervision. A broader definition concerns how people communicate with one another to regulate relationships and to make decisions. In recent times, particularly with the corporate scandals that continue to be exposed, it has come increasingly to mean regulation. So, how could governance manifest in the context of best practices? For an organisation, whether business, family or family foundation, effective governance:

- Generates a sense of direction, values to live by or work by, and well-understood and accepted policies that tell organisation members how they should behave or what they should do in certain circumstances. Examples

of policies are hiring policies, promotion policies, debt policies, even fire emergency policies (see also earlier chapters such as Chapter 8).
- Brings the right people together at the right time to discuss the right (important) things.

One may consider that the world has a natural order and that governance is a tool that allows that order to unfold:

> 'Living in accordance with natural hierarchy is not a matter of following a series of rigid rules or structuring your days with lifeless commandments or codes of conduct. The world has order and power and richness that can teach you how to conduct your life artfully, with kindness to others and care for yourself.'
>
> *(Chogyam Trungpa; The Sacred Path of the Warrior)*

No organisation is effective for long without achieving these objectives. Moreover – as the case of Enron demonstrated – the effectiveness of the governance system should be measured by these achievements rather than by the boards and councils that are in place. Effective governance can be done in an informal, casual manner or through more formal structures (e.g. boards, councils) and processes (e.g. agendas, voting). As is discussed further below, in a family business a family constitution or family charter outlines the company's values, purposes and principles, and addresses a broad set of business issues. Less rigid than a shareholder agreement, a family charter can be revised and adapted as the business grows. Significantly, the governance of a family business – a company whose ownership is controlled by a single family – is more complicated than for non-family-owned companies because of the central role of the family that owns – and usually leads – the business. In a family business, the business, the family and the ownership group all require governance. In family businesses and other kinds of family enterprises, including family foundations and family investment funds, the lack of effective governance is a major cause of organisational problems. Clearly any business that is able to improve governance should reap lasting benefits.

Below are some of the questions to ask when looking for new ways of thinking, doing and being:

- How would governance develop as a field based on the vision in the quote above?
- What can we do to promote the discovery of this order, power and richness founded on a belief in mankind's tendency towards positive growth whilst at the same time being realistic about human nature with particular regard to our instinctual natures and motivation-driven behaviour such as our need for food, water and space?
- What are the processes, the fields of knowledge that have to be drawn upon, the language, the practices, the structures of governance that promote long-term thinking, planning and action, as well as the sustainability of our World?
- What framework is achievable for individuals to find meaning in their lives, among other imperatives?

In looking for answers some assumptions proposed are that:

- it is impossible to shape governance without input from the behavioural sciences;
- it is no longer enough to have to look for meaning outside of the workplace.

Leading management consultants have long recognised the need to harness individuals' passions and shortage of talent is becoming a real business issue, hence providing a strong incentive to focus on what retains employees in a business.

Having determined such guiding principles, the next step is implementation. What often gets overlooked and which leads to failing mission statements is that even if we appreciate the significance of certain values such as honesty and openness, if the culture of an organisation or the development of an individual is unable to maintain such values they cannot last. This is an essential issue to grasp and is perhaps why even though much is written about values, vision and mission statements, putting them into practice effectively often evades us.

We hear of organisations not 'walking their talk' and out of this arises scepticism and disregard for the mission statement. Arguably, it is more demoralising to have one that is not effective than not to have one in the first place. So, why is it that these mission statements cannot be carried through? One answer may to be found in Robert Kenny's assertion in 'What can Science Tell Us About Collective Consciousness' (www.collectivewisdom-initiative.org) that (where we go wrong is that) 'The external processes and systems of any collective become the sole focus. If we take a group through these processes, or structure an organisation this way, or teach these techniques, then collective consciousness will be ensured', the thinking typically goes. 'What gets sacrificed are the inner aspects of individual or collective life, issues like psychological or moral development, meditative practice, culture and so on'. If this is so, then here is some guidance as to what is needed. However, making such shifts are difficult because they require radically different ways of being on the part of individuals and corporations. This is why the existence of a family constitution or charter can be very useful.

A family constitution or family charter outlines the company's values, purposes and principles and addresses a broad set of business issues. Less rigid than a shareholder agreement, a family charter can be revised and adapted as the business grows. The key issues the charter should address include:

- leadership, management and board structure;
- share ownership, valuation and transfer, and dividend payment;
- business strategy, objectives and values;
- succession planning and management;
- the obligations of family members involved in the business;
- the appointment and involvement of non-executive directors;
- dispute resolution procedures.

Without a written agreement, disputes can leave a business in deadlock. In addition, keeping a family company on track often requires a careful balance of business strategy and personal relationship skills. Corporate issues such as share ownership and board structure become far more complex and potentially business threatening, when it is family members who disagree. In general, legal frameworks only confer basic protection to a limited company or partnership. Yet this is the basis on which the vast majority of family firms operate. What the law does not deal with are key issues such as:

- succession planning;
- non-performance of family members;
- the transfer of shares.

Family governance advisers have found that a simple solution that many family firms overlook is to draw up an agreement that can be proactive in dealing with potential shareholder problems and serve as a blueprint for the structure, management and future of the business.

Governance theories and practice 18.2

Experts tend to agree that those involved in a family enterprise must learn the basics of governance and apply the best practices that exist in family business governance. However, even non-family business leaders can benefit from consideration of the concerns of a family enterprise since power, passions and personalities are at the heart of any enterprise. Generally, good governance contributes three fundamental ingredients for family businesses to function well:

- Clarity on roles, rights and responsibilities for all members;
- Encouraging family members, business employees and owners to act responsibly; and
- Regulating appropriate family and owner inclusion in business discussions.

The governance system is flawed and should be improved – and generally needs to be made more formal – if the organisation does not:

- have a clear sense of direction, clear values and well-understood sensible policies;
- assemble the right people in a timely way to discuss and decide the big issues facing the organisation.

Wherever the business operates, a degree of formality often enables people to focus on and confront, especially, sensitive issues and to plan ahead, work towards their goals, and resolve their differences. Moreover, family enterprise can create a mixture of business, family and ownership concerns that can make governance systems more emotionally charged environments for planning and problem solving. Experts agree that in these systems individuals must manage issues within and across three overlapping groups: the family, the business and the ownership group (see further below). The overlap among these groups can result in differing points of view among individuals. For instance, the non-employed shareholders often have contrary views about the appropriate level of dividends to the relative or family owners who work in the business. Both viewpoints should be reconciled in a respectful manner to provide the needed direction for the enterprise and to preserve harmony in the family. Communication and decision-making within and across the family, the business and the ownership groups (see further below) are vital to effectively manage business, family and ownership concerns.

As regards some of the theories, practices, ways of being and thinking, which the governance theory has to embrace to support positive development, some suggestions are outlined below.

From fragmentation to relationship and systems thinking 18.3

This involves seeing ourselves as part of a system; the system of all living things, the system of human beings or the global economy, whichever system we choose.

From 'power over' to 'power from within' 18.4

Governance is also about leadership and, in line with this shift, the old hierarchical ways are being replaced with more inclusive forms of leadership, even forms of leadership that take a passive role rather than an active one.

A new language 18.5

This new language may introduce new words or revive words, placing them in new contexts. Some examples include terms such as snaring power, subsidiarity collaboration, participation, leadership from behind, servant leadership, inner leadership, consensus, creativity, acting for a greater good, compassion, openness, uncertainty, contemplation, self-awareness, self-accountability, collaboration, passion and participation.

Shifts in decision-making processes and communication styles 18.6

As well as what we talk about the way in which we talk is shifting. New processes include consensus, collaboration, dialogue, mediation, appreciative inquiry, meditation, storytelling, open space technology, world cafe and the circle.

A shift from the dynamics of 'groupthink' to harnessing the power of groups 18.7

Groupthink has tended to have a derogatory connotation, meaning that the sum of the parts is less than the whole. We need to understand and counteract its operation and learn what supports collective intelligence, the combined intelligence of a group.

Awareness, acceptance, understanding and public acknowledgement that monetary economics drives our society and that there are alternatives 18.8

New measures of progress that incorporate socially and environmentally, just measurements already exist and allow greater measurement of the qualitative rather than the quantitative and so support longer term measures. Examples include the Measure of Domestic Progress developed by the New Economics Foundation (www.neweconomics.org), the Gross National Happiness Index adopted in Bhutan and the Genuine Progress Index for Atlantic Canada (www.gpiatlantic.org). There are increasing ways of valuing the intangible assets and liabilities, as well as SERM demonstrated in **Chapter 4**.

The other side of this coin is the need to rebalance corporate power. Left to their own devices corporations are structured to pursue their self-interests. Many recognise that the balance of rights and responsibilities has to be restored, that the power of corporations, unaccompanied by social responsibility is unsustainable. Take for example the purpose of the World Business Organisation's Conference 2004 (www.worldbusiness.org).

> 'To engage participants in a deep dialogue on the role of business in the creation of a sustainable global future. In such a future, business must adopt a new form of interaction with society by: re-evaluating the responsibilities inherent in corporate governance; encouraging entrepreneurialism; and willingly contributing beyond the enterprise. Together, these activities naturally thrive in a compassionate, empowering environment. Working in such an environment strengthens the commitment of businesspeople to elevate the actualization of these goals to a high priority.'

A shift from short- to long-term thinking 18.9

An excellent example of where a failure of long-term thinking is going to have fatal effects for all of us is the global issue of climate warming, the reduction in the use of fossil fuels and a switch to what are called 'renewable' sources of energy, such as wind, water and solar power. Failure to take urgent action on this issue will lead to the destruction of our planet, so what better example to take to emphasise a need for this shift. However, other areas where short termism has acute impacts are on maintaining favourable environments for short term foreign investment and corporate valuations driven solely by market need to see cash flow.

Many of the above shifts will rely on awareness and understanding of the issues by business, lawyers and other policy makers. Only by changes in the law and policy in the short-term will some of these shifts be possible due to the power of factors such as:

- the media;
- the rewards for acting out of self-interest;
- a global lack of integrated, independent thinking and action;
- a belief that education should be structured to provide necessary skills which fails to appreciate that, if we are to create the world we want, what most fulfils

us should drive what we learn and to do otherwise just perpetuates a world lacking in personal meaning or which provides meaning for the minority;
- lack of awareness of the complexity of events;
- tolerance for a reluctance to honestly and realistically address the 'shadow' side of human behaviour.

Governance, the family and long-term wealth preservation 18.10

Wealth is about so much more than money. It is often now categorised as human, social, intellectual and financial capital and is used in this sense throughout this chapter. Human capital is arguably the most important. Certainly this is the attitude of James E. Hughes (*Family Wealth, Keeping it in the Family: How Family Members and Their Advisers Preserve Human, Intellectual, and Financial Assets for Generations*, Bloomberg Press, 2004) who has pioneered new perspectives on managing, and attitudes, towards wealth to help wealthy families preserve their wealth for reasons which go beyond a goal of simply holding onto the money. For our purposes:

- human capital refers to who the individual family members are, their health and what they are called to do;
- intellectual capital refers to how family members learn, communicate and make joint decisions;
- social capital is about how family members engage with society at large and would usually cover the philanthropic aspects of a family policy.

Governance is essential to long-term wealth preservation or, put another way, to the preservation of a healthy functioning family unit. There are those who do not want to pass on their money to their children, as they do not believe this is the right way to preserve wealth. Many are concerned that they will disempower their children by removing the incentive to make their own way. Is money without meaning sustainable? Can 'wealth without work' be sustained? (Gandhi) We do not know the answers, but it is inevitable that as one of the capitals fails so it is likely to bring down the lot. It takes enormous ongoing commitment to the family to preserve the health of all four capitals. Governance is an essential component. It provides the structure within which a family's purpose can be developed, including ongoing education regarding issues such as financial literacy, education about the nature of trusts and the responsibilities of being a beneficiary, family history, family legacy discussions and family giving, individual achievements and so on.

The family purpose and vision 18.11

As with any long-term strategy, we start with ascertainment of purpose in each of the four capitals. With relation to human capital Hughes proposes that:

> 'the purpose of a family is the enhancement of the individual pursuits of happiness of each of its members in the overall pursuit of the long-term preservation of the family as a whole.'

In helping a family to decide upon its purpose, it will make a difference whether you are talking to the creator of wealth or an inheritor and this needs to be established at the outset. Each family's purpose will vary and will have its own mix of priorities and values attributed to the various forms of capital. However, human and social capital considerations are arguably the most important. Without considerable attention to their development long-term wealth preservation has little chance of success.

In working on a family's purpose and vision, it is necessary to look at how our relationship with money – how we spend, invest, earn and save it – is an expression of ourselves, a means by which we make meaning with our lives. As such, we can learn about ourselves by understanding this relationship. By addressing their human, social and intellectual capital people can change what meaning they create with their money. Financial capital is considered in the context of the other capitals and generally is not the driver of purpose or vision.

In addition to pursuing the happiness of each individual family member what else is relevant to purpose? Why should the family stick together? Research shows that caring for a greater good such as the family, promotes psychological well-being in the form of life satisfaction, happiness, self-esteem and a sense of coherence in life. Stewardship of wealth, a term often seen in the field of wealth management means that one views wealth as being for the benefit of a greater purpose beyond oneself, maybe to be preserved for future generations or as a family which benefits the community, say in the case of undeveloped land.

Alongside discussion of values, attention needs to be given to the relationship among family members as well as their intellectual capital. Given the rate of change and the volume of information with which we live today, it has become even more important to learn how to think and not what to think, to value experience and to understand how we learn so that each can maximise what they learn. Family members have to be educated in all four capitals and much of this is set out in a worksheet developed by Bonnie Brown of Transition Dynamics in the Appendix. Lifelong learning should be adopted by every family to perpetuate and continuously recreate the family vision to stay current with best practices.

With regard to financial capital, Hughes stresses the importance of planning for the long term (also see comments in **18.1**). If one is guided by the great law of the native America Iroquois:

> 'In our every deliberation, we must consider the impact of our decisions on the next seven generation.'

This would amount to about 200 years, roughly, six or seven generations.

A powerful way to consider families is to use the following balance sheet of family assets and liabilities.

Family balance sheet

Assets minus	**Liabilities**
	Long-term family risks:
Family's total human capital including:	• Failure of family governance
• Each family member's intellectual capital	• Failure to understand that success requires a 100 year plan
• Each family member's financial capital	• Failure to comprehend and manage all forms of family capital, human and intellectual as well as financial
• Each family member's social capital	
	Intermediate family risks (internal): • Death/divorce • Addiction and other 'secrets' • Malthus's Law (the geometric increase of family members in each generation) • Creditors poor health • Poor beneficiary/trustee relationships investment programmes of less than 50 years
	Intermediate family risks (external): • Inflation • Inadequate trustee management • Estate and other forms of transfer and wealth taxes • Holocaust • Acts of God • Changes of political system • Lack of personal security
	Short-term family risks: • Income taxes market inflation • No mission statement • Lack of financial education
Equals	**Shareholder equity**
	• Are individual family members successfully pursuing happiness? • Are the family's human capital and intellectual capital increasing when measure against the family's liabilities? • Is the family as a whole dynamically preserving itself? • Is the family's governance system producing more good decision than bad by taking a seventh generational view?

Special thanks to Charlotte Beyer and The Institute for Private Investors for their invaluable assistance in the creation of this work. Copyright 1999, 2004 by James E. Hughes Jr.

In addition to the list of long-term liabilities, such global issues as peace, access to basic resources such as water and food, climate warming and the wealth/poverty divide should be added (see also the environmental considerations in **Chapter 16**). A failure to take account of these issues and use what influence each of us has is going to lead to the destruction of our planet and long-term wealth planning becomes superfluous. At a more practical level, the greater the pool of assets the greater one's leverage in the financial world to gain access to investment opportunities and to reduce transaction costs. Decisions made by groups of people have the potential to be better, made in the right conditions, than those made by one person alone.

Advisers will serve their clients by understanding and bringing to the wealth creator's attention the implications of failing to prepare heirs, whether individual family members or charitable foundations, to receive substantial wealth, notwithstanding the fears of losing control, death and conflict among heirs. It is a common assumption that beneficiaries know they will inherit substantial wealth, the reality is often quite different. Without the knowledge and the education about managing wealth and the challenges that accompany wealth, there is little chance for its long-term preservation. Any governance system must be implemented having regard to the family's purpose and vision, Socrates suggested that we find happiness by creating a life in which we honour our most cherished values.

To help families with this process, some of the 'big' questions surrounding money and its many meanings are listed in various books (Hughes, Brown, *Unexpected Wealth: A Fire Drill for Building Strength and Flexibility in Families*; Collier, *Wealth in Families*; Needleman, *Money and the Meaning of Life*). There are various assessments, tools and exercises of differing levels of sophistication that can assist with the articulation of values. As a starting point, they need to understand the different values and beliefs and preferably have determined what their values are in order to be able to facilitate such a process. There are also many ways in which the drafting of a mission statement can be facilitated. Stephen Covey in 7 *Habits of Highly Effective People* (Simon and Schuster, 1999) says:

> 'the family mission statement is a combined and unified expression of all family members of what your family is about – what it is that you really want to do and be – and the principles you choose to govern your family life.'

His mission statement reads:

> 'The mission of our family is to create a nurturing place of faith, order, truth, love, happiness and relaxation and to provide opportunity for each individual to become responsibly independent and effectively interdependent in order to serve worthy purposes in society.'

Among the processes that should be implemented, succession planning is particularly important. Research shows that failure to properly plan for succession is a key factor in this failure. A conflict resolution process is equally important as we can eliminate the scope for conflict often at times of great anxiety, particularly if a leader has died. The very presence of a process tends to minimise conflict at all other times.

Having determined purpose, mission and processes, what are the issues surrounding the governance bodies, the entities that carry out the governance? The types of bodies that may be required will be determined by factors such as:

- the number of family members and the degree of relationship among the various family branches;
- the complexity of assets;
- the health of the human capital, for example the more conflicted a family the greater will be the need for structure;
- the range of activities such as philanthropic concerns, private foundations, geographical location of assets and family members and public profile of the family.

A family council and a family committee may be formed if a family is sufficiently large, communicative and open to benefit from these more formal arrangements. One body acts like a board of directors, setting policy, facilitating the family governance process, and the other acts as the administrator or manager like a managing team in a business. Any council should address at least the following:

- the eligibility for inclusion, i.e. age, family members by marriage, advisers;
- the age of inclusion of younger generations;
- a code of conduct to manage process;
- how and who will record and circulate minutes, notices of, agendas for, calling and frequency of meetings;
- whether advisers will be appointed and terms and conditions of their inclusion;
- eligibility for inclusion in and appointment to the family council;
- reporting procedures;
- time of meeting, quotas, procedure for decision-making;
- election, duration of office, re-election, voting, removal and resignation
- compensation;
- officers such as secretary, treasurer;
- expenses;
- procedure for dispute resolution such as mediation, consensus, simple or weighted voting, for example, casting votes may be given to elders or wealth creators;
- other decision-making procedures;
- what can and cannot be decided upon by the body and what must be referred back to the family;
- member’s obligations and responsibilities;
- processes for removal, resignation, appointment;
- disciplinary procedures; and
- procedures for exiting members.

The family in business 18.12

The importance of family businesses cannot be overstated (see also **18.1**). Statistics vary, but generally in the western world they contribute over 50% of GDP and numerically exceed 80% of businesses of the country. It has also been ascertained that about 30% of businesses succeed into generation two, and about 10–15% will reach generation three. This is the same pattern as applies to family wealth, regardless of the family business, which suggests that it is not so much to do with the business itself as the family, whether succession issues, education, proper attention to the creation and nurturing of the human, social and intellectual capitals. European family businesses employ 80% of the workforce (1992). The benefits which a family-owned business can bring to the economy include greater commitment to employees and community, longer-range perspective, opportunity for family members and shared venture maintaining family unity (Dashew, *The Best of the Human Side: Managing Ourselves, Our Relationships; and Our Organisations in a Rapidly Changing World*, Human Side of Enterprise, 1997), thereby providing purpose and meaning. Family businesses also run the range from small unincorporated businesses and partnerships to publicly quoted companies.

Governance of a family business requires governance of the business, in addition to the family, and also governance of the overlap between the family and the business. Due to the additional systems and increased complexity there is more scope for conflict, lack of cohesion and greater difficulty in developing a shared vision. Often there is no diversification, the main family asset being the business. Ivan Lansberg in *Succeeding Generations*, Harvard Business School Press, 1999 summarises that:

> 'governance structures in family companies must be designed to safeguard the long-term interests of family shareholders by ensuring the growth and continuity of the enterprise and promoting the family's harmony and welfare.'

There are many issues that have to be addressed in family businesses and the following gives only a flavour of what these are. Begin by asking whether the family serves the business or the business the family? Is the family or the business the most important? This will often determine the exit strategy for the business, business strategy and operation and would be important to know to resolve conflict. Historically, family business planning centred on estates and management succession. Today, it is recognised that business families have far more needs, particularly where they see that the business can reflect the family's identity, legacy and create unity. In short, that the purpose of the family and business should be aligned. Carlock and Ward in *Strategic Planning for the Family Business*, Palgrave Macmillan, 2001 have developed a very helpful questionnaire for exploring the family business philosophy.

In addition to the foregoing section in wealth in families consider:

- Education of owners and family members about the issues that family businesses give rise to with the overlapping family, ownership and business systems.
- Learning how each system is mutually reinforcing so as one strengthens so it strengthens the other and so on in an iterative process.

- Education about the role of the board of directors, management and shareholders.
- Education about common pitfalls in family businesses, such as the need for family.
- Forum for discussion of the additional values such as those relating to return on investment, growth rates, target Family employment policy.
- Conditions for sale or purchase of shares by family members.
- Identify financial issues of ownership, such as return on investment, liquidity and exit strategies.
- Educate, inform and build understanding and consensus around:
  - need for and the role of independent directors;
  - scope, rights and responsibilities of ownership, management and employment;
  - financial issues such as compensation packages; and
  - life cycle of family members and life cycle of business.

The business introduces the need for more process because of factors such as:

- Importance of ensuring consistency of purpose, vision and goals of business and family, and of addressing family issues which impact on the business and vice versa from damaging either system.
- Motivating family members to participate in the family business, participating in the education about the business, its strategy and ownership.
- Extended conflict resolution process. Addressing the greater likelihood of family disputes spilling over into the business education.
- Greater understanding by the board of directors of family dynamics and stronger relationships with family members.
- The different roles a family member may be performing at any one time. Which hat are they wearing for example, mother or boss?
- Merging of family and business time.

Succession is once again of critical importance. Ivan Lansberg suggests that directors of a family business may have a greater responsibility to the business to address succession issues. There is increasing emphasis on succession by institutional investors.

There will be a greater need for more formality and possibly a greater number of governance structures each having a code of conduct for proceedings and a constitution. It will be useful to represent each body and each system diagrammatically to better appreciate the overlapping areas to ensure information flows where it should and adequate dissemination of information. In addition to the family bodies, consideration should be given to:

- a shareholders' council to deal with matters such as:
  - the return on investment;
  - management reports;
  - mechanisms for sale of interests and events that may have a material impact on the value of the business, and on the family's vision and values.
- additional committees for such matters as:
  - audit;
  - compensation;
  - succession;
  - strategy.

Each body should have a clear mandate and well-defined reporting processes with supporting ongoing education as to the role of each. The existence of a family business provides for more interaction between family members as the number of opportunities for interaction increase. Social capital literature suggests that when the same people are linked together via multiple overlapping roles their social ties are strengthened (Boissevain, Portes).

The additional structure will have the usual business policies and procedures. In addition consideration should be given to such matters as:

- Issues of family employees working with non-family employees.
- Compensation of all employees should be set by reference to objective standards.
- For the non-family managers a formal system for defining responsibilities, setting performance objectives reporting and evaluation.
- A board of directors which includes outside directors; appropriate outside directors can provide new momentum and a greater sense of direction which in turn can lead to greater buy in, by family shareholders.

Family trusts 18.13

The prior sections covered:

- governance in general;
- governance of wealth and families;
- governance of family businesses; and
- ownership without control.

By legal definition, irrevocable discretionary trusts are all about ownership without control. On establishment, assets are legally transferred to the trustees. It is not possible to consider issues about the validity of trusts in this overview. However, a valuable text of common and fundamental issues relating to trusts and trustees is the *Misplaced Trust* (Peter Willoughby, Gostick Hall Publications, 1999).

Discretionary trusts 18.14

The following is a list of the special issues and challenges that concern discretionary trusts and that should be taken into account in decisions revolving around governance:

- Usually part of the class of beneficiaries is made up of minors or unborn children who have no representation.
- Often trustees are professional and corporate and have no natural connection with the family.
- Beneficiaries generally do not know anything about the nature of a trust, their role and responsibilities as beneficiaries and the responsibilities of trustees.

- The use of trustees as information conduits to other members of family thereby forming triangles. This can happen wherever third-party advisers are appointed.
- Trusts are generally established for tax planning reasons, with little thought given to the consequent restrictions on dealings with the assets during the settlor's lifetime.
- Trusts have a long and sometimes perpetual duration (see in particular James Hughes, *How Family Members and Their Advisers Preserve Human, Intellectual, and Financial Assets for Generations*, Bloomberg Press, 2004, Chapter on 'Perpetual trusts'). Mechanisms that perpetuate control after the settler's lifetime should be checked carefully.
- The number of relationships involved. Assuming there is a settlor, trustees, protector, an investment committee and a body of beneficiaries there will be relationships to be managed.
- Upon creation, thought is rarely given to how the trust will play out through the generations in terms of best supporting individuals in their individual pursuit of happiness (see above). The impact of this can be as follows:
  - The settlor is more likely to defer any communication over the destination of the assets, shifting responsibility onto trustees to bear the varying reactions of the beneficiaries and future decisions as to distribution of the assets.
  - Beneficiaries inherit assets that they do not control and that they cannot control without breaching the trust. The restrictions on trustees as to how they may invest requires greater prudence than an absolute owner may exercise.
  - Beneficiaries are often unprepared to know how to 'manage' this wealth, to deal with the trustees or even to know what their options are, none of which augurs well for long-term preservation of the wealth or good relations between the various parties.
  - The assets are controlled by people who the beneficiaries may not get along with, yet have no power to change the trustees. This may be mitigated by the existence of a protector, but they may be more attuned to the values and drives of the settlor rather than the children.
  - As a result beneficiaries can have destructive attitudes, behaviour and emotions towards the trust assets, ranging from a lack of concern or interest to conflict. This can exhaust substantial parts of the trust fund in litigation.

These challenges should be met by thorough discussion in advance of the trust's formation, good governance, communication and education. Trusts can be vehicles that preserve family unity and values, facilitate succession to assets upon the death of the settlor or principal beneficiary, and minimise the likelihood or intensity of potential conflict. Trusts may also serve the valuable role of protecting wealth from events such as dissipation on divorce, taxation and irresponsible beneficiaries (see the family balance sheet above at **18.11**). The purpose, vision and goals should be addressed as set out under families and wealth, and a mission statement is as important and perhaps more so where assets are held in trusts in addition to any letter of wishes (see **18.16**).

In addition to the above, there is an increased potential for conflict for such reasons as:

- The introduction of non-family advisers into the system who control the assets.
- A lack of, or poor, communication by the settlor with the beneficiaries.
- The division of trust fund between a life and remainder interest.
- The disclosure of information concerning the existence of and extent of the trust to younger generations.

Therefore, particular regard should be given to incorporating a conflict resolution process in the family council. Also education should extend to the role and responsibilities of the trustee, the investment manager, protector and others.

Choice of adviser 18.15

As with all aspects of due diligence and governance, the choice of advisers should be given careful consideration depending on whether a private trust company, or personal or corporate trustees should be involved or any combination. In choosing trustees factors, other than those that will be dictated by tax and other legal mandates include:

- interpersonal skills;
- the scope for conflict of interest within the institution;
- an appreciation of common family dynamics; and
- the expertise or network to be able to provide appropriate support and experience of managing the assets.

Peer review, automatic retirement provisions and audits are all tools which can prevent entrenchment of anyone's position. An increasing number of families are forming family offices or using the services of a multi-family office to deal with the administration relating to the investment functions.

One of the critical aspects to address when choosing a trustee is to ascertain their willingness to work with other professionals in the field of wealth management such as family business advisers, art insurance experts, family psychologists, family group facilitators, peer groups for beneficiaries to meet to discuss common issues as wealth inheritors.

Letter of wishes 18.16

A letter of wishes, which usually sketches out when, to what extent and for what purposes a beneficiary may benefit from the trust fund, generally accompanies a trust deed. It should, in general, be supported by a well thought-through and discussed mission statement which builds in flexibility to adapt to unforeseen and changing circumstances.

Protector 18.17

A protector is usually appointed who is often a close family friend though sometimes a professional, comprises one or more persons with whom the trustee may be obliged to consult, or even be required to act in accordance with the protector's directions. This arrangement provides an alternative and is the more usual mechanism for collaborative decision-making throughout the life of the trust and, depending on the powers granted to the protector, can limit the trustee's power, thereby acting as a check and balance of power. The protector will usually have the right to remove trustees. As a matter of good governance, someone, other than the trustees themselves, should be able to remove trustees in the event they do not carry out the purposes of the trust or mismanage the assets. Of vital importance is the privacy of trust affairs and good mechanisms to manage the key relationship of trustee and beneficiaries in the interest of confidentiality.

Any number of other structures such as investment committee, advisory committee, compensation committee, beneficiary committee, can be formed. As in the other areas, governance without a proper education as to the use and benefit will render it ineffective. Effective decision-making at the trustee level (by analogy to the board of directors) can strengthen a family system and a well-governed family can reinforce the effectiveness of the trustees.

Conclusion **18.18**

It is appropriate to conclude this book on due diligence and corporate governance with some consideration of wealth management from the above perspectives. If we are to review the evolving areas of due diligence and corporate governance in the broader context of the society and the economy, this discussion also provides valuable insight into issues that highlight the need for individual responsibility, with repercussions for the quality of decisions and understanding. This should assist with a more enlightened attitude by individuals that they can bring to all aspects of their life – whether at home or in the workplace – and thereby improve the likelihood of overall sustainability and of ongoing due diligence and good governance without the need for excessive regulation.

Appendix

Building competencies information tracking grid

Arenas of learning	Formal education	Internships	Work	Volunteer	Family
Planning					
Estate					
Financial (accounting, taxes)					
Investment					
Legal					
Media and public relations					
Wealth management					
Communication					
Family well-being, roles and boundaries					
Conflict management					
Consensus building					
Family meetings					
Grieving					
Listening and negotiation					
Allocation of family assets					
Stress management					
Team building for family and boards					
Family history and legacy					
Family stories					
Genogram					
Philanthropic vision and practice					
Relationship management					
Mentor and coach relationships					
Professional adviser relationships					
Selection of advisers					
Evaluation of advisers					
Termination of advisers					
Trustee/beneficiary relationships					

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Arenas for building competencies	Formal education	Internships	Work	Volunteer	Family
	Resource contact		**Career path**	**Individual goals and evaluation criteria**	**Meetings and Training**
Financial capital					
Annual reports					
Appraisals					
Audits					
Economic theory					
Financial statements					
Investment action plans					
Stock market					
Taxes					
Social capital					
Family foundations					
Grantmaking					
Legal guidelines					
Management					
Networking					
Individual giving goals					
Other					

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Arenas	Formal education	Internships	Work	Volunteer	Family
Human capital					
Adviser relationships					
Facilitators					
Legal, accounting and investment					
Media and public relations					
Listening and negotiation					
Use of family assets					
Transport (boats, planes, RVs)					
Vacation homes					
Contingency planning (fire drills)					
Career uncertainties					
Catastrophic illness					
Sudden death					
Unexpected wealth					
Family history and legacy					
Family vacations					
Genogram					
Storytelling					
Family meetings					
Stress management					
Team building for family and boards					

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Arenas for building competencies	Formal education	Internships	Work	Volunteer	Family
	Resource contact		Career path	Individual goals and evaluation criteria	Meetings and training
Intellectual capital					
Governance structures and processes					
Adviser management					
Board management					
Code of conduct					
Conflict resolution					
Decision-making					
Financial oversight					
Meeting management					
Mission statement					
Policies and procedures for giving					
Rights and responsibilities					
Staff management					
Strategic resource management					
Action plan goal management					
Annual report preparation					
Adviser profiles					
Board chair profile					
Board member profiles					
Bylaws and board legal parameters					
Project management					
Strategic planning					
Values and ethics management					
Website creation and management					

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