CORPORATE COLLAPSES - TO WHAT EXTENT DOES FAILURE TO FOLLOW CORPORATE GOVERNANCE CONTRIBUTE

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Introduction

The global economy is witnessing a string of corporate collapses and financial crises which has shaken its foundation. Once again the question posed is, whether corporate governance has contributed towards precipitating these crises.

Economic expansion is dependent on global capital flows which require investment and the steady flow of capital into economies. Most investors, before making a decision, are mainly concerned with the safe return of their money with high profit margins; generally gain this confidence by investigating into the financial activities of the company through annual reports and financial statements. This method of assessing the success of a company has been questioned in light of many corporate collapses that have occurred in spite of the fact that their annual reports seemed to be in good order.

The OECD Observer (2000) states that: ‘In the 21st century, stability and prosperity will depend on the strengthening of capital markets and the creation of strong corporate governance systems.’ This statement clearly emphasises the importance of good governance principles and practices within an organisation leaving us with the question: To what extent do corporate governance principles and practices result in corporate collapses and contribute to the financial crisis?

The main objective of this article is, therefore, to find out whether there are other internal and external governance mechanisms that contributed to the corporate collapses apart from the failure of following good corporate governance. The article attempts to answer this question by examining two major corporate collapses, namely, Enron and Northern Rock, that took place in the recent past.

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2 Ibid.
3 OECD Observer (Summer 2000).
What is Corporate Governance

Corporate Governance is defined by the Oxford English Dictionary as: ‘good order’, by the Cadbury Report on the Financial Aspects of Corporate Governance published in 1992 as: ‘The system by which companies are directed and controlled’.4

Accordingly, it is clear that corporate governance is some form of “control of corporate affairs” and the controlling powers are not carried out by the company owners or the shareholders who contributed to the company’s capital, but in most jurisdictions, by the board of directors. Berle and Means clearly saw this separation of “Ownership and Control” in their thesis of ‘Separation of Ownership and Control of the Modern Corporation’ where they regarded control as something that distances ownership from management.5

It seems clear that corporate governance is a concept that can set standards to overcome many of these issues. Most commonly developed standards are based on “self regulation.”6 The recent corporate collapses have shown that self regulation may have limited the effectiveness thereby ensuring the urgent need for legal enforcement.7 The aforesaid link to the law which is mostly interpreted as principles or standards in the form of codes and guidelines differ from that of what is in practice.8

In addition, another aspect of the purpose of corporate governance should be policy makers giving equal attention to how a company can be socially responsible through corporate governance.

Growth & Development of Corporate Governance

The corporate governance codes and guidelines have been issued by committees, governments, professional & academic bodies and Stock Exchanges.9 For instance, today the Combined Code issued by the Cadbury Committee is implemented by the Financial Services Authority (FSA) in the UK as an appendix to the listing rules.10 OECD has developed a set of principles of corporate governance11 which has been followed by the World Bank, the IMF and the Commonwealth Association for Corporate Governance12. BASEL Committee too has developed recommendations for corporate governance in banks.13

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6 ibid, 06.
7 ibid, 06.
8 ibid, 06.
9 ibid, 21.
11 n 03 above.
In the UK, the questions of corporate governance of listed companies have been the subject of the three specific reports prepared for the Stocks Exchange. In 1992, the Cadbury Committee chaired by Sir Adrian Cadbury reinforced the tripartite relationship of directors, auditors and the shareholders without considering other stakeholders such as the employees, consumers, suppliers, and the broader community. The Code of Best Practice was recommended as a guideline to all the listed companies in the UK emphasising the principles of openness, integrity and accountability. The balancing of executive and non executive directors too was discussed where it was pointed out that there should be at least three non executive directors. The appointment of non executive directors to the audit and the remuneration committees have granted non executive directors with controlling powers, enabling them to make important contributions by way of reviewing and guiding the board in the event disputes occur between executive directors and the shareholders. The shareholders role in governance is to appoint the directors and auditors and satisfy themselves that are appropriate governance structure is in place.

The Greenbury Committee was established due to the disclosure issues with regard to the directors’ remuneration and was of the view that the directors’ remuneration should be solely based on the performance so that they are rewarded for the work they have done only.

Many changes were introduced to the Combined Code 1998 consequent to the collapses of corporate giants like Enron and WorldCom. Today the Revised Combined Code has replaced the 1998 Combined Code with 17 principles under five headings; director, remuneration, audit committee & auditors and institutional investors. An important point discussed here was the requirement of “public justification” in the event the posts of chairman and the chief executive officer are combined, thus clearly illustrating the code’s attempt of independence on the board.

What is a Financial Crisis

In the year 2007, the world economy faced yet another calamity. As a result, interbank borrowings have become hostile, stock markets have frozen, few major transactions going through capital markets, large corporations collapsing, and poor lending have reduced production in factories forcing closure of business thus increasing the unemployment rates. All this has caused instability to the international financial systems, eventually affecting the bigger framework that has led to the financial crisis.

15 ibid.
16 n 01 above,24.
17 n 10 above,332.
19 n 12 above,22.
20 n 14 above 392.
21 n 10 above,333.
22 n 10 above,334.
23 n 14 above,394.
24 n 12 above,24.
This is not the first time the world economy is witnessing a financial crisis. Its history runs back to the Wall Street collapse in 1929 and the consequent Great Depression.25 The collapse of Bretton Woods in 1971-1973 consequent on devaluing the dollar.26 The fall of Baring Bank in 1995 is a clear example of the importance of having a proper control system within an organisation and Australia’s largest insurance company, HIH went into liquidation in 2001 for not having proper planning.27 Parmalat, the Italian family owned company expanded by diversifying its businesses, collapsed due to the failure in paying the debts.28 Lehman Brothers an independent investment bank for 158 years became another large bankruptcy in the USA in 2008 with a 3.9 billion $ loss.29

The question therefore is whether the breach of corporate governance principles contributed to the above discussed collapses? Baring bank lacked effective internal control systems where it trusted one employee without properly monitoring his activities.30 Parmalat emphasised the likelihood of the board of directors of family owned companies getting influenced by family members being on the board.31 HIH pointed out the importance of having a proper risk management system, proper disclosures of risks and the directors’ duty in ensuring that such controlling systems are in place.32

Accordingly, corporate collapses all over the world, though they occurred due to specific circumstances attached to each country’s government and regulatory policies, goals and financial capabilities; there seems to be one common reason: failure to adopt good governance that has resulted in inefficient business decisions.33

What happened to Enron?

The Fortune Magazine ranked Enron as ‘America’s most innovative company for a consecutive six years from 1996 to 2001.34 One time corporate leader, Enron filed for bankruptcy in 2001 with a dramatic fall of stock price from $90 to $1 leaving thousands of employees jobless and causing its investors losses in billions.35 It was admitted by the executives that the company used accounting malpractices and so called high profits were derived as a consequence of its transactions with the

26 G A Walker, International Banking Regulation; Law, policy and Practice [Kuwer Law, 2001].
27 n 01 above, 2.
28 n 01 above, 3.
29 n 25 above.
30 n 01 above, 4.
31 ibid.
32 n 01 above, 3.
33 R. Tomasic, ‘Corporate rescue, governance and risk taking in Northern Rock: Part 2’ Company Lawyer [2008]
35 ibid.
The firm’s practice of creating SPV to hide losses, avoid taxes and gain profits out of businesses gave the management and its directors a free hand to make decisions at their discretion thus misleading investors. The top executive and their families got heavily involved in insider dealing activities especially when they started to sell shares to the public at the edge of company fall.

All the facts considered above show that the business models and techniques used by Enron were highly misleading. The board decisions revolved around profit maximisation. In order to achieve this purpose, as shown above, the company used market to market accounting technique where the income of its online trading could be forecasted at the management’s discretion. Moreover, the company made use of SPV’s and limited partnerships to make off balance entries to most of the transactions without disclosing Enron’s involvement and help hide its losses. The auditors, Arthur Anderson too were influenced by huge audit fees and were accused of conflict of interest for providing consulting services simultaneously with audit thus ignoring its professional duties and ethics.

What happened to Northern Rock?

Northern Rock, formally a building society founded in 1965 was expanded through demutualisation and later converted to a bank in 2006.

The 2007 financial crisis adversely affected the solvent bank where it faced a lot of liquidity problems, due to the wholesale markets getting dry consequent to the subprime crisis and the banks low deposit business model highly dependent on the inter-bank and wholesale market for its funding with low deposits.

When discussing the Strategic Plans of Northern Rock, the bank had a very solid portfolio of mortgage loans, without expanding its deposits, highly dependent on the interbank and wholesale loans for its funds. With regard to business models used by Northern Rock, the first model used was called “originate to hold;” that is hold on to the mortgages the bank was having in its portfolio. Thereafter, with the idea of business expansion, Northern Rock directors turned to a new business model called “originate to distribute.” The idea behind this new model was; without just holding on to a large mortgage loan portfolio as illiquid assets, to “repack” and transfer to a SPV and thereby to issue securities to the end investor through the securitisation process.
As the Treasury committee at the Northern Rock investigation has pointed out, there are several issues and risks attached to this system.44 This is mainly because, in securitisation deals, the burden of assessing the credit risks in the underlying assets lies with the Investors.45 But due to the lack of information to carry out a due diligence, the investors had to heavily rely on the credit ratings given by the credit rating agencies.46

**Did failure to follow Corporate Governance Contribute to the collapses of Enron and Northern Rock?**

When a company is doing well, many believe that there is a connection to good governance, with the main players being auditors, audit committee and the corporate board. Enron with its highly regarded corporate identity was supposed to have ‘elaborate corporate governance.’47 The irony of it being, behind that corporate image, Enron was able to get through its irregular accounting practices where inflated profits and income were shown without disclosing the actual status of the company.48

Northern Rock, once a leader in the mortgage loan sector which later ventured into new modern complex structured financing sectors had to face a liquidity crisis.

**Executive Remuneration**

The directors take over the legal liabilities towards the company shareholders the moment they agree on the remuneration package; but we have witnessed that the directors take extra interest to keep the company stock at the top.49 The reason behind the directors’ focus on maintaining Enron stock value high was due to the stock option in the directors’ remuneration package.50

When discussing the remuneration for Northern Rock directors, as per the Annual Report 2006, the banks remuneration policy was: ‘designed to provide transparent, competitive packages to motivate, reward and retain Executive Director of high quality,’ stressing on ‘performance relating remuneration.’51

Under the Greenbury Committee, director’s remuneration should solely be based on the performance of the directors.52 In addition, the committee recommended a remuneration committee

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44 ibid.
45 ibid.
46 ibid.
47 n 34 above.
48 ibid.
49 n 12 above, 221.
50 n 34 above.
52 n 10 above, 327.
appointed by the board by way of imposing some kind of control over directors remuneration and stressed the ‘independence of the committee’. Revised Combined Code, renewed after the collapses of Enron and WorldCom stated that: ‘...remuneration should be sufficient to attract, retain and motivate quality directors, but the company must avoid paying more than is necessary for this purpose’. Revised Combined Code, renewed after the collapses of Enron and WorldCom stated that: ‘...remuneration should be sufficient to attract, retain and motivate quality directors, but the company must avoid paying more than is necessary for this purpose’. Revised Combined Code, renewed after the collapses of Enron and WorldCom stated that: ‘...remuneration should be sufficient to attract, retain and motivate quality directors, but the company must avoid paying more than is necessary for this purpose’. Revised Combined Code, renewed after the collapses of Enron and WorldCom stated that: ‘...remuneration should be sufficient to attract, retain and motivate quality directors, but the company must avoid paying more than is necessary for this purpose’.

Similarly in 2006, Northern Rock executive directors received a basic salary of 2.3 million pounds and a cash bonus of 2.23 million pounds together with shares in the bank.

When analysing remuneration for directors, it is therefore clear that Enron directors have failed to follow the recommendations of the Combined Code, but on the other hand, greediness, lack of moral and ethical values of the directors is also somewhat clear.

Nonetheless, even though Northern Rock director’s salaries were well balanced with the banking sector payment levels, the purpose of the bank’s remuneration policy of linking the director’s incentives with the company performance was not achieved when the directors adopted an irresponsible business model without giving any regard to the risk management. Incidentally, Northern Rock directors too did not keep up to Cadbury remuneration principles, clearly indicating some visible signs of greediness.

Financial Auditors

According to the Revised Combined Code, the Audit Committee and Auditors should present a balanced and understandable assessment of the Company’s position and prospects to the board. As per the Combined Code, the relationship of the auditors with the managers should be strictly ‘objective and professional’.

Therefore engaging in the analysis of whether collapsed Enron followed the aforesaid corporate governance principles relating to Auditors, it is important to point that, Arthur Anderson, Enron’s auditors who audited the complex, misleading and fraudulent accounts of Enron has been accused for ‘conflict of interest’ issues. This is mainly because the auditors failed in their duties to maintain the said proper independence due to the fear of losing huge audit and consulting fees; Anderson collected $52 million, including $27 million for consulting services making Enron

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53 n 14 above, 392.
54 n 51 above.
55 n 51 above.
56 n 14 above, 392.
57 n 12 above, 99.
59 Ibid.
60 n 12 above 95.
Anderson’s second largest account in the year 2000. Cadbury says that it is high time to impose a prohibition on audit firms to carrying out consulting services simultaneously with auditing to the same client due to the conflict of interest issues.

Similarly, Northern Rock auditors, PriceWaterhouseCoopers too were criticised for conflict of interest, where it has been revealed that the auditors were paid enormous fees for providing non audit work. For instance, in 2006 the auditors were paid 500,000 pounds for audit and 700,000 for non audit services especially in ‘securitisation transactions and the raising of wholesale funding.’

**Audit Committee**

Cadbury in his book ‘Corporate Governance and Chairmanship’ states that: ‘the responsibility for establishing and maintaining a professional relationship between boards and their auditors rest with the audit committee.’ As per the Combined Code, the committee should consist of at least three non executive directors with at least one having ‘recent and relevant financial experience’.

When analysing Enron’s audit committee, it did consist of people with accounting backgrounds. Even though the Cadbury report points out that audit committee should review ‘the significant financial reporting issues’ and ‘company internal financial controls,’ as Cadbury explains: ‘audit members are there to ask appropriate questions, to pick up any possible weaknesses in the company’s systems and to oversee the audit process.’ In this case Enron audit committee kept silent.

Similarly, even though the purpose of Northern Rock audit committee was to: ‘...assist the Board in meeting its responsibilities for the integrity of the company’s financial statements...... for the effectiveness of the company’s internal control systems,’ the bank got caught in conflict of interest issues when for instance, one of PriceWaterhouseCoopers executives was appointed to the Northern Rock board and audit committee.

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62 ibid.
63 n 12 above 95.
64 Combined Code.
65 N 34 above.
66 n 12 above 95.
Non Executive Directors

The so called non executive directors of the Enron board were not as independent as they were supposed to be and have been criticised for having individual consultancy contracts with the company.70 Higgs Report guidelines clearly set out the fact that non executive directors should ‘constructively challenge and help develop proposals on strategy.’71 R. Tomasic in his article, ‘Corporate Rescue, Governance and Risk taking in Northern Rock: Part 2’ adds what Ruth Sunderland said about the role of non executive directors to The Observer; Sunderland totally blamed the non executive directors of Northern Rock for not questioning Adam Applegarth, the CEO about his risky business models; but Tomasic adds another point also made by Anthony Hilton which highlighted the fact that even though Northern Rock had all qualified non executive directors, it is the nature of the corporate sector that, when a company is doing well, the non executive directors most of the time find it extremely difficult to question high flown, overly powered executive directors, chairmen and the CEO, who have gained immense fame, power and respect from the corporate community.

Director’s duty of care

Directors owe a duty of care to the shareholders.72 Enron’s shareholders had to suffer a loss of more than $19 million.73 Andrew Cornford, Research Fellow of the Financial Markets Centre for United Nations in his discussion paper, ‘Enron and Internationally agreed Principles for Corporate Governance and the Financial Sectors’ states that the directors have a major role to play in order to have good corporate governance in a company; decide the remuneration of executives, not allowing conflict of interest, and have a proper, timely and accurate accounting financial reporting procedures. The article further revealed that the Enron board approved almost all the major decisions of the company without having any access to project information, without questioning or being critical about doubtful transactions and accounting practices.74 This clearly established the breach of a governing principle where the Combined Code points out that the Chairman must see to it that the directors get the required company information on time. 75 The only possibility seen in the case of Northern Rock by legal experts in suing the bank is for breach of duty of care and diligence.76

70 Higgs Report.
71 n 12 above.41.
72 n 86 above.
74 Cadbury Report.
75 n 33 above.
Risk Management

The important question is did the directors of Enron manage to ensure that its management managed risk effectively? Critics say that they have failed mainly due to the fact that management did not understand the risks involved in the company business. Therefore, it is important for directors to be satisfied that the company risk management is in place before it adopts other strategic issues. Cadbury has commented on this issue and stated that risk is not only about threats but also how to take advantage of opportunities.

The directors of Northern Rock too, tried to keep up with the new structured financing system but failed immensely as they did not take any steps to manage risks involved with that kind of structured financing.

When analysing the aforesaid Governance principles put to practice by Enron and Northern Rock, it can be established that with regard to directors’ remuneration, that both companies linked the value of the company share to the share rewards the directors were entitled as incentives. It was seen therefore that the two companies adopted very reckless business strategies; Enron even went to the extent of manipulating the accounting information. Similarly, Northern Rock too had a very reckless business strategy where it lent more than it should have and even reached out to new financial instruments available in the market. The financial auditors and audit committees failed to adapt to corporate governance principles tremendously. Both Enron and Northern Rock auditors were accused conflict of interest as they failed in the professional ethics for the fear of losing enormous fees they were to get for audit and consulting services. In the analysis of the role of non executive directors, it should be mentioned that in both companies the non executive directors breached the corporate governance principle of independence when they refused to question the top executive directors of the irresponsible reckless business models. Therefore, it can be said that the directors failed in their duty of care towards the shareholders and their investors.

In the analysis of this study, the evidence suggests that the two chosen collapsed companies, Enron and Northern Rock had strategies, plans, policies and practices that were contradictory to the corporate governance principles and practices and have clearly contributed to their said collapses. It was also apparent that there were several internal and external governance mechanisms that may have contributed to the said collapses despite the failure to follow corporate governance principles and practices.

77 ibid.
78 n 12 above 220.
Accordingly, it is now important to examine some factors that may have contributed to the corporate collapses.

### Market behaviour

Many critics have argued that market behaviour has also contributed to the current financial crisis. After witnessing Enron’s fall, the crucial question may therefore be how the stock markets were ‘fooled’ in spite of all the warnings to be aware of market ill practices.\(^{80}\) It is argued that stock markets were easily carried away by overwhelming stock prices and conveniently overlooked doubtful signals.\(^{81}\)

### Corporate Ethics

Enron’s Code of Ethics created confidence in investors’ minds that Enron is a company that could be relied for good values; but with its fall, it was evident that simply having a Code of Ethics in writing is not sufficient to judge a company for its good values, thereby establishing the viewpoint that ethics is something that should be fastened to the company culture.\(^{82}\)

On the other hand Enron, apart from not following corporate governance principle of disclosure, its management and auditors failed in their ethical duties too, when they deliberately did not disclose vital accounting information in the audited financial statements.\(^{83}\) Therefore, it is time to ask the question as to how ethical it is for the top management of a company to sell their shares with inside knowledge they get when the ignorant shareholders have been misled by false exaggerated profits and high stock prices.\(^{84}\)

Corporate governance principles clearly emphasise the directors duty of care; even though there is no fiduciary duty owed by directors to its employees, in Enron’s case most of its employees were shareholders who have invested their pension in the company under an incentive scheme.\(^{85}\)

Northern Rock Corporate Code of Business Ethics and Human Rights clearly emphasises as follows: ‘Our relationship with shareholders, customers and other stakeholders is of paramount importance to us and to retain their trust and faith in us our staff must act in an appropriate manner at all times’.\(^{86}\)

\(^{80}\) ibid.


\(^{82}\) ibid.

\(^{83}\) n 211 above.

\(^{84}\) Ibid.


The crucial question therefore is whether Northern Rock did keep up to its code of ethics in practice. It has been revealed that Northern Rock had a very arrogant approach towards its customers in default with no regard given to the Banking code or the Office of Fair Trading guidelines clearly indicating breach of ethics.  

**Regulatory Failures**

Regulation of financial markets have been criticised for contributing to the current financial crisis. In the UK the tripartite agreement entered between Bank of England, Treasury and the Financial Services Authority (FSA) has not helped to combat the crisis mainly due to competition among the institutions and the uncertainty as to the role each has to play.

**Credit Rating Agencies**

Credit Rating Agencies have been criticised for contributing to the said corporate collapses mainly by giving very high rates for the asset backed notes issued by the SPV’s and for failing to properly monitor the said securitised products. It is interesting to note that the rating agencies that always gave very high ratings to Enron and its SPVs, at the edge of the company’s collapses downgraded Enron drastically.

**Conclusion**

Overall, owing to the reasons set out above, it is evident that the lack of corporate governance is not the only reason for corporate collapses; there are many more other factors that have contributed to this calamity. Market behaviour has contributed to corporate collapses tremendously. Unpredictable human motivations and objectives with not much legal interference have misled the markets. In addition, the financial conditions that prevailed in the markets have encouraged withdrawal of large amounts of money from the markets which resulted in drying up of liquidity in the interbank market system.

It was further evident that merely having a Code of Ethics does not help a company to have a good corporate culture with good morals and values; it is something that should be inherent within the corporate culture and definitely has a big impact on corporate collapses. It was further pointed out how top management especially the directors, auditors and accountants failed in their professional duties and were caught up in conflict of interest issues and breached duty of care. Regulators had a main role to play in corporate collapses. As discussed above, FSA, BOE, and the Treasury failed to carry out their duties and overlooked some significant warning signals. Lack of

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87 n 33 above.
88 n 34 above.
89 n 34 above
professional staff with adequate monitoring and reviewing was seen as the main reason for the failure. It was clear that credit rating agencies too contributed to the collapses where they overrated and downgraded the companies and the financial instruments that were issued. Finally, it was discovered how new financial instruments and the accounting techniques were used to manipulate information that contributed to the collapses. Therefore, it is evident that internal and external mechanisms have indirectly contributed to the said collapses. It must be noted that human behaviour is somewhat tested in all instances; where greediness to maximise profit at any cost was a significant occurrence.