HOW CORPORATE GOVERNANCE FAILED IN THE JAMES HARDIE ASBESTOS CASE

This article reviews aspects of corporate governance, ethics and reputation in the case of the former James Hardie Industries Limited (JHIL). JHIL was prosecuted by the Australian Securities and Investment Commission (ASIC) for breaching the Corporations Act by making false statements about the Medical Research and Compensation Foundation (MRCF) the company had established in 2001 to compensate mesothelioma victims. JHIL’s inadequate corporate governance procedures led to the company’s eventual prosecution and public humiliation.

Background
ASIC’s 2007 civil action against JHIL was in fact a public testing of the standard of business ethics and corporate governance procedures in Australia. JHIL went to extraordinary lengths to avoid its responsibilities in adequately compensating former employees and customers who had fallen ill by using its products. The final indignity was when the board approved transferring all operating assets offshore into a Dutch holding company, JHNV, to avoid its Australian asbestos liabilities. Effectively having denied any culpability, the JHIL board then misled Australian courts by guaranteeing that there were sufficient funds available in the MRCF to compensate all legitimate asbestos claims. Despite JHIL’s actions being unquestionably immoral and unethical, they were, amazingly, for the most part legal.

Key Learnings
The JHIL case reinforces the fundamental importance of having effective and transparent internal and external corporate governance procedures working in harmony so boards can adequately monitor and control the actions of senior executives. To be effective a board must be both willing and able to scrutinise management actions and decision making processes. Good governance does not necessarily create a good company; that depends on the company’s leadership and strategies, but bad governance can certainly destroy one. The JHIL board was ineffective and either unable or unwilling to implement appropriate corporate governance processes.

JHIL appeared to have adequate formal external compliance mechanisms (thereby adhering to the ‘letter of the law’), they seemed to lack informal internal governance
practices (those complying with the ‘spirit of the law’). The board’s apparent lack of independence ultimately rendered it completely ineffective. JHIL’s governance process was solely compliance driven, and that there appeared to be no overarching ‘code of conduct’. A ‘lame duck’ board resulted due to a lack of independence, and a failure to challenge senior management decisions, accept accountability for key decisions, ask the ‘hard’ questions, or focus on mission critical issues. Ultimately, the board’s ineffectiveness resulted in increasingly disenfranchised shareholders as both the company’s reputation and market capitalisation took a pounding.

Why is it then that firms with effective corporate governance mechanisms inevitably also demonstrate sound business ethics? No doubt, having ethical managers can deliver tangible benefits such as a lower risk profile, better customer reputation and higher profitability. Were JHIL senior managers so bad, or did their corporate ‘systems’ allow them to make unethical decisions? I believe that the JHIL board felt that approving the ‘false’ ASX statements was the best way to protect shareholders and shield the company from mounting public disquiet. Conversely, perhaps the board believed that it was ‘above the law’ and prepared to act with its customary arrogance. There can be little doubt that the JHIL board never seriously considered that its unethical behaviour would affect the long-term reputation and market value of the firm. As the asbestos disaster unfolded, and JHIL’s market capitalisation plummeted, the board’s ineffectiveness became more apparent. This ineffectiveness was borne out in a number of ways including an increase in managerial opportunism (e.g. even though the MRCF was underfunded directors increased their fees); apparent stock market ‘myopia’ (i.e. short term view of JHIL’s earnings); flawed management practices (officers breaching the Corporations Act); and information asymmetry (false ASX reporting, media releases, road shows etc). This increasingly unethical and opportunistic behaviour by the board and management ultimately brought the company to its knees.

What has become known as the ‘James Hardie Affair’ led to a significant backlash by the wider community, with the Jackson Commission of Enquiry opining that the “moral and legal fabrications the company had elaborately constructed collapsed under public questioning.”
Outcomes
The key question remains: did JHIL deliberately and wilfully underfund the MRCF in order to reduce its liabilities? Ultimately blame was laid at the feet of the then CEO and Company Secretary, who were found to have breached their duties as officers of JHIL by providing the board with erroneous information. This finding supports the duplicity with which the board and senior executives appear to have acted. Simple reliance on the ‘word’ of senior officers and a flawed actuarial report leads me to conclude that the JHIL board had neither the mental capacity nor the moral fibre to implement an effective corporate governance procedure. Conversely, did the board fully understand what had been presented? If not, why then was it either unwilling or unable to ask the ‘hard’ questions in order to clarify the situation? With an ineffective board and inadequate corporate governance mechanisms the company was in an invidious position.

Conclusion
Since this case corporate governance procedures in Australia have improved through the introduction of initiatives such as the ‘Corporate Law Economic Reform Program’ and ASX’s ‘Principles of Good Corporate Governance and Best Practice Recommendations’ which have helped deliver more independent boards and better disclosure. However, and despite these reforms, there is still no legal imperative for Australian publicly listed companies to take into account the interests of stakeholders other than shareholders. Whilst the JHIL board believed it was acting in the best interests of shareholders it inevitably failed wider stakeholder groups by acting unconscionably, unethically and without accountability. Unfortunately, even had these reforms been introduced before 2001, JHIL may still not have acted with integrity.

One can only hope that the lasting outcome of this case is that higher standards of corporate social responsibility, governance and ethics become the norm and not the exception.