Animal spirits and boards

Comment by PHILIP KOH

The first of a three-part series examines the variety of issues besetting boardroom decision-making. The second will deal with directors in a group and the concluding piece will be on business judgment and the law.

HOW does a member of a board of directors make decisions? A decision can be a positive act or it can take the form of passive consent or acquiescence.

The key to understanding and framing an explanation as to what took place in a boardroom can be found in many spheres. One may examine the agenda or review the minutes. If there is a recording, then of course a faithful transcript of the proceedings would be of great assistance. The lawyer will state that the best evidence is that recorded contemporaneous to the event or incident. Even so, interpretation and construction will have to take its place in the evaluation of the conduct, intentions and even motivations of the decision maker.

Psychologists have long pointed out groupthink and the desire for a member of a group to conform to the flow of decisions. Also the limitation of time and what economists characterise as asymmetrical information is an enduring problem.

Rational actor

The idea that a decision maker is wholly a rational actor, having an objective view of a matter, is like most ideas, simplistic.

Regulators or the courts, in assessing a conduct after the event, can err in placing a heavy burden on an officer. The adage "a fool is wise after the event" reflects a reality often experienced by the hapless officer whose negligent omission is held to scrutiny and found to be wanting. A regulator who joined the private sector once admitted that now that he has to see how the shoe fits, it can be painful and perplexing.

So discerning judges often warn that any evaluative judgment of the rectitude of a director ought to be based on the facts and circumstances that are available to the decision maker then and looking at the matter going forward is a correct perspective to take.

Retrospective criticism must be tempered with an objective evaluation as to what information was made available and whether or not in circumstances that the standard of care demanded.

Recent insistence on conformance to listing rules, practice directives and norms, coupled with core legislative provisions, have been justified by the acute failures of governance. However, what is missing is how do we reconcile this, if at all possible, with the business judgments made. If "such ventures fail, how is the undertaking of it to be judged against an allegation of negligence of an entrepreneur?" (New South Wales Supreme Court, 1995).

Animal spirits

In a recent work, Nobel laureate George Akelof, with Robert Schiller, opened up a discussion that John Maynard Keynes' idea of animal spirits ought to augment that of the classical model of Adam Smith's model of rational pursuit of interests in the free market.

Samuel Brittan (writing in the *Financial Times*) cautioned: "If there were a sudden outbreak of "animal spirits" in business without any increase in final demand or unfreezing of credit channels, those

responsible would really be jumping off those proverbial skyscrapers. Animal spirits may indeed have contributed to the asset bubble that precipitated the present crunch, although they might better have been called gullibility and greed. To be induced to expand output in current conditions, businessmen require an improved market and credit prospect and not a rush of optimism to the head."

Spontaneous urge

Keynes, puzzling over lack of full employment, observed that businessmen's calculations in an uncertain environment "can only be taken as a result of animal spirits, a spontaneous urge to action". Decisions are not, as the assumption of rational theorists would desire, be taken by "the outcome of a weighted average of quantitive benefits multiplied by quantitive probabilities". (Cited in George A. Akelof & Robert J. Shiller, 2009, Princeton).

It was perhaps an implicit recognition of the fact that corporations are wealth creation entities that courts are reticent to substitute their judgment of the matter against management.

Conceptually, a distinction ought to be drawn to the governance function of the board and that of management. The director's role is to direct a corporation and to supervise and monitor that it pursues corporate objectives as set forth in its constituent documents and by shareholders. Management, as fielded by the executive officers (who can have dual roles of being operational executives and also members of the board and thereby sharing governance functions), should execute and implement strategy.

Section 131 B(1) of the Companies Act states baldly that "the business and affairs of a company must be managed by, or under the direction of, the board of directors". Arguably, the legislature, in spelling this out, is drawing a distinction between shareholders and management, of which at the apex stands the board.

It does not mean that directors are imposed a duty to manage, at least not in a sense of day-to-day operations. However, it does go further than earlier formulations, which exempt non-executive directors from the duty of management and confining his role to the periodic monitoring duties.

Continuing obligation

What it means is that all members of the board have to take cognizance of and have continuing obligation to keep abreast of activities of a corporation and its financial health. What may be characterised as a directorial management duty will mean exercise of general monitoring of corporate affairs and policies.

They may not shut their eyes to misconduct and if there is reasonable cause for suspicion, they must not be sleeping sentinels.

Review of corporate proposals and financial statements are fraught with challenges. A member of the Enron board was a professor of accounting at an Ivy League university. He pleaded that his reliance on Andersen (the audit firm) that the special-purpose vehicle's accounting treatment is defensible, is a salutary reminder that financial statements and treatment are complex and daunting. So too, many defalcations or collapse are due to accounting fraud, affecting even the most vigilant.

Section 132 (C) provides "that a director ... may rely on information, professional or expert advice, opinions, reports or statements including financial statements" if such reliance is made in good faith and that director has made an independent assessment of such advice and information having regard to the director's knowledge of the company, its complexity, structure and operations.

Reliance

Reliance cannot be misplaced. A lawyer or corporate secretary's advice is helpful and may mitigate, but if it is not reasonable to rely on it, then it is the duty of the director to request for independent advice that he can reasonably trust and rely upon. Collegiality here does not permit an abdication of independent decision-making.

Time constraints, inadequate knowledge and information and conformity to groupthink militate against good decision-making. A blind sentinel will not be a good gatekeeper. Neither a watchdog that is asleep.

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