# THE EFFECT OF INCENTIVE BASED DIRECTORS' REMUNERATION ON ETHICAL DECISION MAKING IN ORGANISATIONS.

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# DECLARATION

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

## ABSTRACT

The historical development of the role of directors in public listed companies contains inherent tensions by reference to the fiduciary responsibility of directors and the method in which directors are remunerated. The nature of incentive based remuneration is such that it will compel directors, in certain circumstances, to weigh their interests against those towards whom they owe a duty of care and a moral responsibility to act with prudence and temperance.

The modern day corporate environment is complex and calls for directors with strong ethical views. This assignment endeavours to identify some of the complexities that contribute towards directors finding it difficult to stay on the ethical "straight and narrow" and attempts to weigh the effect of those factors against the effect of incentive remuneration, both as detractors from ethical behaviour. Both the shareholder supremacy business model and the stakeholder approach are analysed to identify those factors present in each that may add to the ethical complexity that directors have to deal with. The advent of the stakeholder approach in particular, adds an enormous amount of complexity.

The case studies deal with two South African financial services companies that have both ceased trading as a consequence of unethical behaviour. The incentive remuneration models of both companies have been found to have played a major contributing role in the decision making processes in the companies, and have contributed to the demise of these organisations.

Lessons are taken from the case studies and applied against the backdrop of the various principles of ethical behaviour namely rights, utility, justice and the ethics of responsibility. The finding of this study is that there is a role for incentive remuneration of directors, provided that the ethical pitfalls that this causes are recognised and steps taken to address them. Some of these steps are identified.

## OPSOMMING

Die historiese ontwikkeling van die direkteursrol, en spesifiek van openbare genoteerde maatskappye bevat inherente teenstrydighede met verwysing na direkteursvergoeding en die vertrouensverpligtinge wat op direkteure rus. Die aard van direkteursvergoeding met 'n aansporingskomponent is so dat dit 'n direkteur van tyd tot tyd in 'n posisie plaas waar hy tussen sy eie belange en die van die ander belanghebbendes in 'n maatskappy, aan wie hy dit verskuldig is om met verdrag en versigtig op te tree, moet kies.

Die hedendaagse maatskappy omgewing is kompleks van aard, en vereis direkteure met sterk etiese oortuigings. Hierdie werkstuk poog om sommige van die komplekse faktore wat afbreuk doen aan 'n direkteur se vermoe om ten alle tye streng eties op te tree, te identifiseer en op te weeg teen die effek wat direkteursvergoeding speel – beide as items wat afbreuk doen aan etiese optrede. Hier word ondersoek ingestel na beide die sogenaamde "aandeelhouersmodel" asook die" belanghebbende" model waarvolgens besigheid bedryf word. Die ontsluimering van die belanghebbende model veroorsaak spesifiek 'n aansienlike hoeveelheid etiese kompleksiteit.

Die gevallestudies behandel twee Suid Afrikaanse finansiele instellings wat hul bedrywighede gestaak het as gevolg van onetiese optrede deur direkteure. Die aansporingskomponent van die vergoedingsmodelle in daardie maatskappye blyk 'n groot bydraende faktor te wees in die onetiese besluitneming wat plaasgevind het, en wat uiteindelik tot die ondergang van die ondernemings gelei het.

Laastens, word die lesse wat geleer is uit die gevallestudies, toegepas in gewysigde format, en getoets aan die hand van die verskillende beginsels wat etiese besluitneming onderhou, naamlik die beginsels van regte, regverdigheid, utiliteit en die beginsel van etiese verantwoordelikheid. Daar word tot die slotsom gekom dat daar wel ruimte vir aansporingskemas vir direkteure is, maar dat dit slegs eties regverdigbaar sal wees mits ag geslaan word op die lesse wat uit die gevallestudie voortspruit, tesame met die impementering van sekere korrektiewe maatstawwe.

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# PART I: THE STAKEHOLDER APPROACH CONTEXTUALISED

## Introduction

Across the globe, more companies are beginning to place increasing emphasis on adopting sustainable business practices, by reference not only to the profitability of their business, but also to the social and environmental impact that their businesses have in the areas where they operate, be that localised or trans-national. In a recent survey conducted by PricewaterhouseCoopers (The PricewaterhouseCoopers 2002 Global Sustainability Survey Report, August 2002), seventy five percent of companies polled in the United States claim to have adopted some sustainable business practises. In this context, sustainable business practises refer to not only the generation of profit, but also the impact that conducting business will have on the environment, as well as the social costs of such a business – the so-called stakeholder approach. This implies to a greater or lesser extent that the existence of stakeholders other than only the owners of a business must be acknowledged and their rights recognised. In contrast with the stakeholder approach, the other major approach to business is the shareholder wealth or supremacy view that looks almost exclusively at what is the best for the owners of a business.

The stakeholder approach is nothing new. It has been practised widely in developed economies such as Japan and Germany, whilst the shareholder wealth approach, regardless of the statistics quoted above, is more aligned with practises in the UK and the USA. (Warner M , Encyclopedia of Business and Management, Routledge 1996, Volume

1, p. 775) The reasons for the stakeholder welfare approach in Japan and Germany are largely cultural. By way of example, the German constitution states: "Property imposes duties. Its use should also serve the public weal." Warner states that such an approach focuses ultimately on the long- term health of a company, whilst considering not only the owners, but also any other stakeholders such as suppliers, employees, customers and creditors. A consequence of this is that shareholder wealth could sometimes be lower on the list of priorities of those companies, than for instance job creation or the development of quality products. (Warner: p. 775)

In countries where companies adopt the shareholder wealth approach, the structures and practises of the boards of directors of those companies are aligned with the objectives of shareholder wealth creation. Those boards are powerful and oversee the running of the companies in a manner that promotes the financial interest of the owners, almost to the exclusion of other stakeholders. In countries such as Germany and Japan, the boards are charged with overseeing the long-term health of the companies, as opposed to the exclusive pursuit of shareholder wealth. These boards play a much less active role in the day to day running of the companies and focus on three major functions namely, (1) overseeing the selection and succession of managers and directors, (2) reviewing financial performance and corporate strategy and (3) ensuring that officers and employees of the companies meet legal and ethical standards. In Germany, most companies have a two-tiered board, the *vorstand* or management board, and the *aufsichstrat* or supervisory board. The supervisory board performs the functions listed above. (Warner p.776)

Fairly recent changes in the United Kingdom have brought about a shift in emphasis on the shareholder wealth model, to one beginning to be aligned with the stakeholder approach. This change was brought about by a report issued by Lord Cadbury, on initiative from the accounting profession and the Financial Reporting Council in the United Kingdom. (The Cadbury Report). The Cadbury report was followed by the Greenbury report, the Hampel report and lastly, the Turnbull report. The thrust of all these reports was to increase the level of corporate governance in specifically listed public companies. The combined reports provide the framework for corporate governance in the United Kingdom and include reference to issues such as remuneration, expanded responsibilities of the Board of Directors and the imposition of adequate checks and balances to ensure recognition of other stakeholders' interests. (Roger Buckland: University of Aberdeen Papers in Accounting, Finance and Management: Working paper 10-10: UK Company Board Structures and Corporate Performance: A cohort study of 1990s IPOS in the UK. 2001, pp. 04-19)

In the wake of the Enron, Woldcom and other high profile corporate scandals, the United States have legislated the Sarbanes-Oxley Act of 2002 in an effort to forestall a potential crisis in public investor confidence. This Act has not brought about a dramatic shift in the style of corporate governance in the United States, but rather emphasises the principle of shareholder supremacy, whilst creating a legal framework in which officers of a company may be held liable to a greater extent than was possible prior to the implementation of the Act. (PricewaterhouseCoopers: A Comparison of the King Report 2002 and the Sarbanes-Oxley Act of 2002, p.5)

South Africa had, what would appear at first glance, a corporate governance regime modelled on the basis of shareholder supremacy, and has adopted, to a large extent, the principles of English law in its Companies Act and precedents, which precedents have evolved and are steeped in the context of the shareholder supremacy model. "*For more than a hundred years, South African company legislation has been trailing English company legislation. Though still based on the general principles of English law, the 1973 (South African Companies) Act goes in many respects its own way.*" ( J.T. Pretorius, P.A. Delport, M. Havenga, M. Vermaas: Hahlo's South African Company Law Through the Cases, Fifth Edition, Juta & Co, pp.2-3) An example of this is the rule in Foss versus Harbottle as it is commonly referred to in South African legal textbooks. (H.S.Cilliers & M.L.Benade: Company Law, Fourth Edition, Butterworth, p.563) This rule, as enunciated in the case of Foss v Harbottle (1843) 2 Hare 461;67 ER 189, determines that a single shareholder may not assume a role whereby that shareholder claims on behalf of the company, if the majority of shareholders have decided not to claim. **The majority of shareholders control the company for their benefit.** " *The rule in Foss v Harbottle as I understand it, comes to no more than this. First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is prima facie the company of the association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or* *association is in favour of what has been done, then cadit quaestio.*" (Jenkins LJ, Edwards v Halliwell [1950]2 All ER 1064 (CA) 1066.

In 1993, the Institute of Directors in Southern Africa commissioned retired judge Mervyn King to report on corporate governance practises in South Africa and to make recommendations. This resulted in the publication of the First King Report. Although not legally binding on boards of companies, the recommendations made in the First King Report were universally accepted as establishing new benchmarks by reference to the regulation of the conduct of and disclosures by boards of directors. (PricewaterhouseCoopers: A Comparison of King 2002 and Sarbanes-Oxley, p.9)

During 2002, the Second King Report (King II) was published, in an effort to expand the scope of good governance beyond those recommendations included in the first report. It did so, specifically by advocating an integrated approach to corporate governance in the interest of a wide range of stakeholders – embracing the social, environmental and economic aspects of a company's activities. King II further acknowledged that such an approach could result in severe constraints on management who previously may have operated according to the exclusive principles of shareholder supremacy, and places an obligation on the board to ensure that a balance is struck between those constraints and financial performance. This obligation placed on the board should be underpinned by a strong culture of ethics in a company, permeating from the top down. (PricewaterhouseCoopers Corporate Governance Series: Being a Director – Duties and Responsibilities – King II, p.34) The recommendations contained in both King Reports are not legislated, but carries the approval of most of the major listed firms in South Africa. The GAAP (generally accepted accounting practice) as adopted by the South African Institute of Chartered Accountants have not formally adopted any of the King recommendations other than to the extent that such recommendations made by King have also been included in listing requirements for companies on the JSE.

It could be said therefore that the imperative for long-term sustainable corporate development has been recognised in South Africa through the two King Reports on the one hand, and the extent in which some of those recommendations have been incorporated in the JSE listing requirements. This groundswell has not yet received any legislative backing. South Africa is currently a country shrouded in a corporate governance cocoon of legislation supporting the principles of shareholder supremacy, about to emerge through a process of corporate culture metamorphosis to at least a partial adoption of stakeholder principles.

The question is not whether the stakeholder approach is better than the shareholder wealth approach, although the shift towards the stakeholder approach seems to underscore such an inference – it is rather a question of which of the two models supports the sustainability of a company best in that company's particular context. This also serves to illustrate the difficult circumstances in which directors are expected to make decisions. In both instances, directors' remuneration may play an important role in the correct approach being chosen. If the directors are rewarded for other criteria than those demanded by an approach that would serve the company better, an ethical dilemma exists. Short-term profit seeking is not a bad thing in itself. Many companies have repetitive short-term profits as their objective and strategy, thus making their business sustainable. Short-term profit seeking is a bad thing when it is done at the expense of sustainable business practises and thus at the expense of all stakeholders. In the context of this study, and as borne out by the cases dealt with, reference to short-term profit, refers to the latter.

It is easy, in the context of a company opting to adopt a stakeholder approach, to imagine the numerous potential conflicts and ethical tensions that exist for a board that tries to weave its way through legal requirements which endorse and support the rights of shareholders to a larger extent than it does other stakeholders, and a pure stakeholder approach with emphasis on long-term sustainability. Add to this the requirement that companies must be transparent in their reporting and decision- making - and the need for a strong ethical approach in order to substantiate board decisions, becomes an imperative. Transparency will not only highlight those instances where short- term profit was sacrificed in favour of a longer- term sustainable approach, but also the instances where it was not. In those instances, and where directors are remunerated based on the short-term profits, valid questions about those directors' ability to adopt an objective stance, could be asked. Unless there are other compelling reasons why such an approach was adopted, an inference will be drawn that the directors' remuneration model has a bearing on their ethical decision- making.

The companies in the two case studies dealt with hereunder have both relentlessly pursued short-term profit - not necessarily to reward their directors, although that was a material consequence. Neither of the two companies actively trade today. Stakeholders have suffered substantial losses and commissions of enquiry have questioned the ethical ability of the directors. In each case a commission of enquiry has been established – both commissions chaired by Judge John Myburgh. (Report of the Commission of enquiry into the affairs of Regal Treasury Private Bank: Executive summary, p.27) The commission investigating the affairs of Corpcapital is still sitting, and has not released a report yet. This study shows that the manner in which directors are remunerated, has a bearing on the sustainability of a company's business. It has a bearing because the remuneration model may be at odds with the chosen strategy of either the stakeholder or shareholder approach. It also has a bearing when directors have to choose between their own well-being and that of the company. It does so by analysing the role of a director in the context of the legal and contractual requirements on the one hand and the demands made by the stakeholder approach on the other, the demands made by business analysts and the demands made by personal interests as exemplified by remuneration structures on yet other fronts. These demands are not always compatible, and are sometimes diametrically opposed.

## PART II: RELATIONSHIPS THAT CAUSE ETHICAL TENSIONS

### The history of the nature of a director's relationship with a company

A fundamental principle underpinning company law, and which gives rise to a company being seen as a separate legal entity able to initiate actions *ex meru motu,* is the distinction between ownership and control. A company functions independently from its owners, and is placed under the control of the directors. Directors are appointed by the shareholders to look after their interests, but they are not servants of the shareholders. (Hahlo's Company Law through the Cases, p. 366) Directors operate as an autonomous organ of the company. The roots of the development of the current day director's role could probably be traced back to the industrial revolution towards the end of the 18$^{th}$ century. The increasing mechanisation of the manufacturing concerns led to an increase in productivity and output. Changes in legislation regulating stock exchanges and company formation, such as the repeal of the Bubble Act, made it easier for industrialists to raise capital to invest in yet new ventures. (W.A. Thomas: The Provincial Stock Exchanges, Frank Cass: London, 1973, p.3) Gradually the owners of these businesses could no longer devote sufficient time and attention to each and every business, and the role of the professional manager or director, as we know it, evolved. We find tension between this role that the shareholders expect directors to play and the stakeholder approach.

Directors have been referred to as agents, trustees, managing partners and managers. The rights and duties of directors are similar to those of the persons described above in some respects, but not in all. The extent of directors' rights, duties and obligations can only be ascertained by a scrutiny of the Companies act, the common law and the memoranda and articles of association of the company. The memoranda and articles will regulate the nature of a director's contract with a company. (Van Dorsten JL: Rights, powers and duties of directors, Obiter publishers 1992, 2.14 p.18).

**The contractual relationship**

A director stands in a unique contractual service relationship with the company. The shareholders of a company appoint the directors according to the prescripts of the memorandum and articles of association of the company. In most instances the appointment is further regulated by a service agreement that spells out the directors' duties and responsibilities, and remuneration for the performance of those. If that contract does not mandate the director to adopt a stakeholder approach, the director may be in breach of her contractual duties if she places the interests of other stakeholders above that of the shareholders. A more utilitarian approach would be to argue that the contract does not have to make specific reference to the powers of directors to adopt a stakeholder approach, as this is already implied in the mandate to look after shareholder welfare. If the adoption of sustainable business practises benefits the shareholders in the long run, then the directors would have fulfilled their duties.

A few practical problems exist with such an approach. Firstly, not all shareholders may agree with such an interpretation, and that could harm the proper and timeous implementation of strategies. It would stand to reason that if shareholders cannot agree, then there could equally well be disagreement amongst the directors, with similar consequences. Secondly, in the event of a possible conflict between an implied and express term of an agreement, the express term would prevail, especially in instances where such an express term has been reduced to writing. (J.F. Coacker & D.T. Zeffert: Wille and Millin's Mercantile Law of South Africa, Eighteenth edition, Hortors Stationery 1984. p.54) If the director's written service agreement provides for a remuneration structure based on different criteria than those that could be crystalised from the implied terms of the memorandum and articles of the company, the implied terms will have to defer to that interpretation supported by the remuneration model. Unless the memorandum and articles of association of a company are aligned with the type of approach that the founders of the company would prefer it to take, or at least, leave it to the discretion of the directors, the tension will remain a real one.

**The legal nature**

In terms of common law, a director has a duty of care, a duty of skill and a duty of diligence towards the company, which duties stem from the fact that the director has a fiduciary responsibility to the company. A director does not have a fiduciary duty towards individual shareholders, but towards the body of shareholders represented by the company. (Percival v Wright 1902(2) Ch 421 at 425-427. Shareholders ultimately control the company, and may cause a director to be dismissed if the majority feels that way. A distinction made in law, which could be untenable in applied ethics is that a director, when that director owns shares in the company, and acts as a shareholder and not as a director, owes no fiduciary duty towards the company or towards any other shareholder. This dichotomy is part of the subject of this paper. (J.L. van Dorsten: Rights, Powers and Duties of Directors, Obiter Publishers, 1992, p.183) It is almost impossible to try and imagine when a director who owns certain share options, acts as a director, and when as a shareholder. The lack of a clear legal framework does sometimes make the assessment of ethical decision making more difficult.

Statutory law has anticipated the conflict of interests that may arise from the above as well as from the privileged position of obtaining prior information and directors' ability to benefit themselves, and has placed a number of restrictions on directors dealings in the Companies act. These include inter alia, restrictions on directors to conduct insider trading (section 233 of the Companies Act), to obtain certain loans or other financial assistance from the company (sections 226,295 and 296 of the Companies Act), as well as duties to disclose certain benefits.(section 227 of the Companies Act) The JSE listings requirements go much further in so far as it requires substantially more disclosure by reference to disclosure on directors' remuneration, than the Companies act. The Companies act further requires directors to disclose if they have an interest in any business that the company undertakes. Neither the Companies act nor the common law states specifically whether the director is obliged to disclose the extent of the profit that she stands to make out of a transaction, but it recognises the potential for abuse.

Whilst laudable, the problem with this type of legislation is that unless there is already a culture of ethics in a company, the law poses just another obstacle to overcome in pursuit of, for instance a personal short-term profit objective. Once overcome, and unless a culture of ethics exists in an organisation, such director's dealings would simply disappear from the ethical radar screen. Legislation specifies the minimum requirements that must be adhered to, but does not ensure compliance with the spirit of the act. The Companies Act only requires disclosure in the case where a potential conflict of interest may arise. If an appropriate corporate ethical culture was properly in place, directors would ensure that any similar transaction would be tested against the strategic objectives of the organisation and entered into with full disclosure, regardless of whether the act required such disclosure or not.

**The stakeholder approach**

There is a long ranging debate about whether the business of business is sustainable development. In the context of this study, by sustainable development is meant the adoption of a socially, environmentally and economic responsible position by a company, looking after the interests of all its stakeholders, and not only driven by short-term profits at the expense of other stakeholders, whilst disclosing the level of its commitment to its stakeholders through the so-called "triple bottom line reporting". *"Tripple bottom line reporting is both a conscious attempt by enlightened companies to build trust and an explicit response to society's demands for sustainable corporate behaviour."* (Tim Dickson: Lessons from the great debate. Paper read at the European Business Forum's conference on sustainable development 2002) Sustainable development and the stakeholder approach are one and the same. Sustainable development implies a stakeholder approach whilst the adoption of a stakeholder approach would result in more sustainable business practises.

Proponents of the stakeholder approach are *ad idem* that human (and business') survival is linked to a healthy environment. Natural resources cannot be depleted beyond a specific point without losing the ability to recover, with a consequential reduction in the standard of living. Opposing this view are those who take the position that we have the capacity to replace services provided by nature with services provided by man. Those that cannot be replaced are not worth replacing.

Companies have a responsibility to adopt a stakeholder approach. They have that responsibility to ensure that the company endures into the future for the benefit of all the stakeholders. Only if a company shows promise that it will endure, will it be able to attract the best management, which will in turn, enhance the company's ability to sustain itself.

The opposing view holds that whilst the objectives of a stakeholder approach may be laudable, it will not work in practise. For it to work, the commitment of all players in society is required. This commitment is impossible because of the ever increasing demands made on business managers by the new global economy such as the requirement to get to market quicker, and to be closer to the customer. Demands for greater short-term profits by sometimes, ignorant shareholders and institutional investors with different agendas and a different group of beneficial owners to satisfy, also detract from the potential success of a stakeholder approach. The stakeholder approach is criticised as being the flavour of the moment, and companies adopting this approach are regarded as hypocritical and using the favoured status of the stakeholder approach to obtain a competitive advantage in the race for short-term profits. "*This is a sound development in that it reflects what business has always been about, namely facilitating the most valuable exchange between capital, competence and clients within existing frameworks. In practise, it has to be said, many companies merely put on a responsibility face, without linking their efforts to a core strategy.*" (Per Uno Alm and Mattias Iweborg: Companies can't remake the world. European Business Forum conference on sustainable development 2002)

The inherent tension that exists between these two opposing views will not be addressed further here. The purpose is to highlight the backdrop against which a company director has to make decisions with a high ethical content. The stakeholder approach requires this. Tripple bottom line reporting is designed to engender trust with the stakeholders. With such trust comes added responsibility to balance the needs of all stakeholders – which in turn requires that every business decision must be weighed to determine its economic and moral value. It is not sufficient to have the appropriate mechanisms in place such as a corporate responsibility taskforce chaired by the chief executive and codes of conduct covering human rights, security, social investment and "public engagement" issues in

Brazil and India. Such a company was Enron. What is required is a culture of high ethical decision making in an organisation. (Tim Dickson: Lessons from the Great Debate)

The PricewaterhouseCoopers survey found that although a substantial number of companies claim to have introduced some elements of a sustainable development approach – *"72% of respondents do not incorporate the opportunities associated with sustainability into their business strategies or project, investment and transaction evaluation processes. Even among those companies that identified reputation as a key factor in their decision to adopt sustainability, only a third are formally evaluating sustainability risks and opportunities."* There is a correlation between corporate strategy and directors' remuneration. If strategies in support of a stakeholder approach are lacking, then it follows that the remuneration model will not have a stakeholder-bias either.

The above attempts to deal with the concept of stakeholders as a rather amorphous and unidentified mass of interested parties whose interests should be borne in mind. I will now deal with some of the particular stakeholders other than owners, in order to demonstrate specific ethical expectations and therefore tensions by reference to the demands that they make on the new economy company director.

**Employees**

Do employees have the right to expect of directors to apply their minds to the business of their business whilst considering the impact that those business decisions will have on employees – and sometimes defer a profit driven decision in favour of one that costs the company more, but retains jobs? I think that it does not matter, when dealing with questions such as these, whether employees have rights. The distinction between say, a right and a legitimate expectation, is a legal contrivance, designed especially to allow certain culprits to escape liability and responsibility. When dealing with ethical questions, such a distinction is not necessary.

From a Kantian perspective, it could be argued that there will be instances where such behaviour could be expected of directors. A utilitarian perspective could be that profit should be deferred if the consequences otherwise would mean the loss of jobs. This loss of jobs may result in a strike, crippling the company and negating the benefit of the short-term profit. Similar arguments could be raised in respect of a multitude of employee related issues, some of which are already recognised through protective legislation, but others still requiring a strong ethical approach each and every time that a decision has to be made in a slightly different context that rules do not provide for or where rules are being challenged. In the movie "Zorba the Greek", Anthony Quinn playing Zorba asks the young man: "Why do the young die - why does anybody die?" The young man answers: "I don't know." Zorba: What is the use of your damn books? If they don't tell you that, then what the hell do they tell you?" Young man: "They tell me about the agony of men who cannot answer questions like yours." Rules do not and will never be able to cater for all instances. Directors have numerous unwritten obligations towards employees. They should not abuse their power. They should not steer the company in such a direction and in such a manner that employees' security of tenure is threatened. They have a positive obligation to continuously attempt to increase the employees' standard of living by paying market and performance related remuneration.

**Institutional investors and analysts**

Institutional investors are a type of shareholder that warrant separate discussion – not because they have any different rights from other shareholders, (in certain instances their rights may even be diminished by legislated limitations placed on their voting ability) but because they constitute such a powerful influence on market perception and a company's share price.

Markets are run by Adam Smith's "invisible hand". Nobody knows exactly how they operate. What is certain is that perception plays a major part in determining the liquidity and value of a company's shares. The number of shares available in the market also has an effect on the supply and demand, and therefore on the price that an investor is prepared to pay. Institutional investors and analysts, because of their buying power on the one hand, and their perceived insight into the operations of a company being analysed, occupy a powerful position to create and dispel perceptions about a company. If an analyst has public reservations about a company's prospects or on any other mater pertaining to the company, this is sufficient cause for other potential investors to decline to invest, or for existing shareholders to offer their shares for sale in the market, thus creating an oversupply with a resultant decrease in the price. If an institutional investor sells its shares, the same effect could result, unless the reasons for the sale have no bearing on the company's performance, and this fact is well publicised.

The result is that directors of public companies with listed shares are all too well aware of the power yielded by institutional investors and analysts, and may be tempted to ignore other stakeholders in pursuit of profit to satisfy the expectations of this class of shareholder-stakeholder. Institutional investors work according to set rules whereby they buy shares, hold them for a specified period of time or until they have achieved a specified yield or loss, and then sell. Unless a company's strategies in a stakeholder approach is communicated clearly to such investors and analysts, a decision in favour of another category of stakeholder rather than profit for shareholders, could result in a catastrophe for the company.

**Consumers**

It could be argued that consumers have a vested interest in a company for the product or service that the company provides. If a company manufactures a life saving drug, the interests of the consumer should have a very high priority in relation to those of any other stakeholders. Such was the case when pharmaceutical company Boehringer Ingelheim offered the distribution of the antiretroviral drug Nevirapene free of royalties, and thus substantially cheaper, to the South African Government to combat the effects of aids, through another company, Aspen Pharmacare. In addition, the drug was also made available free to prevent mother-to-child transmission. (South African Medical Journal,November 2002, Volume 92, no.11, p.859) The company stood to sacrifice a substantial amount in revenue had the government accepted the offer. It is common knowledge that government and other sceptics were reluctant to accept the offer partly because Boehringer Ingelheim and Aspen's motives were questioned and partly because our government's official viewpoint was that it had not conclusively been proven that HIV causes Aids, as ridiculous as that might sound. The pharmaceutical companies' motives were questioned because it was thought that their strategy was to establish a preferred long- term position for themselves at the cost of short-term profit. It is ironic that the South African government so actively endorses the stakeholder approach in conservation issues, regional peacekeeping and political issues and economic issues by reference to credible and justifiable black economic empowerment initiatives, that it failed to appreciate the effect thereof, which is an example of how the stakeholder approach could benefit those left at the short end of the stick temporarily, in the long run This example serves to illustrate a different tension – one that recognises the potential for good intentions to be misinterpreted by an uninformed or cynical audience.

Consumers who have purchased high value items such as motor vehicles likewise have an interest that a company adopts a long-term view in order to service the vehicle over its expected lifespan, and might expect the company to make certain sacrifices for the delivery of that service. Persistent unwillingness by a company to react to the expectations or demands by consumers could result in a consumer boycott of that company's goods. This could result in the company suffering severe losses, far greater than the sacrifice they could have made in adhering to consumer requests. In one of the case studies dealt with below, consumer action in the form of a mass withdrawal of deposits from a bank, a so-called "run" on the bank, caused the ultimate failure of that bank.

In summary of what was said above, and not intended to be exhaustive, directors are faced with a number of valid ethical demands made by various stakeholders as well as other demands that are the result of the contractual and legal relationship that a director has with a company and its owners.

1. Based on the contractual relationship that a director has with a company, tension exists if the terms of the contract are not compatible with a stakeholder approach, and if the remuneration model does not adequately provide for performance issues other than profits.
2. In terms of the legal nature of the relationship, tension exists because the law, both statute and common law does not seem to adequately provide for the situation where a director is also a shareholder. Directors acting as shareholders, owe the company no fiduciary responsibility, yet it is humanly impossible not to be influenced by privileged information, despite the best regulatory efforts to attempt to counter the effects of those influences.
3. The stakeholder approach holds two connected but still severable inherent tensions for directors to contend with:

- The debate about the validity of the stakeholder approach versus the shareholder supremacy approach is not settled, and does not yet enjoy legislative support in South Africa. Even if a corporate strategy in favour of a stakeholder approach has been adopted, there is still a lingering doubt about its rightful place.
- Credibility remains an issue. Statistics seem to indicate that the stakeholder approach is viewed as a handy pseudo-strategy to adopt in order to create an illusion regarding the adoption of the popular trend and to remain in the mainstream of business flow.

4. Very often there is no room for profit and employee satisfaction on the same balance sheet, due to the demands that business makes on costs. This is an age-old tension, and one that has given rise to the theories of Karl Marx. These tensions remain as valid today as ever.
5. Markets behave unpredictably. The one sure thing is profit. Analysts seem to be sceptical about the stakeholder approach and companies are not doing enough to inform them of their strategies in this regard. Analysts' opinions are held in high regard and they are therefore courted by directors – to keep the share price stable more than to explain stakeholder strategies.
6. Institutional investors hold buying power that can make or break a company. They are seldom influenced by other considerations than profit, as they serve another set of stakeholders. Directors are but too aware of this scenario.

7. Consumers are also powerful if they could harness their collective power. In companies where reputation is paramount, directors are aware of the constant threat of loss of consumer faith in their product.

The main tension between the opposing sides above is the tension between short- term profit seeking on the one hand, and satisfying other stakeholders' interests, on the other. The glue between the two is the role of the director. Directors determine which way a company's strategy will take it. The pressures brought to bear above are presented in simplistic fashion. The practical application is far more complex and interrelated and the potential conflicts somehow far less clear. Despite their best intentions, directors are only human, and will be influenced by many factors, not least of which will be their own welfare. It stands to reason that directors' remuneration in the widest meaning of the term, must have a substantial bearing on the motivation for a particular strategy – if not consciously, then unconsciously. The profit motive overshadows everything else in current corporate culture. Profits provide cash flow, profits cause increases in demand for shares, and see share prices increase. Directors are remunerated principally by way of salary, shares and bonuses, the value of all of which are determined by the profit that the organisation makes.

## PART III: DIRECTORS REMUNERATION

It is not the objective of this study to provide a compilation of all the permutations and nuances of the various elements that normally make up a director's remuneration package. To a large extent, remuneration that does not have an incentive component attached to it would be irrelevant to this study, other than where it may be argued that that part of the remuneration is so great that it completely overshadows the incentive based part. The relationship between incentive based and non-incentive based remuneration will therefore be investigated, but not non-incentive based remuneration per se.

One would expect non-incentive based or fixed remuneration to constitute that part of a director's income that would enable that director to maintain a standard of living that is commensurate with the status of, and esteem in which the position is held, having regard to the size of the company, the magnitude of the job as well as a host of other typical human resource and pay benchmarking issues. By earning that part of the remuneration, the director should be expected to perform her duties in accordance with her service agreement, and to a degree that could reasonably be expected of a person with her level of expertise and experience. This does not appear to be the case in practise however. There would seem to be a shift towards greater incentive based pay as this type of remuneration allows the director to earn more. In a country such as South Africa where there is a shortage of skilled executives, the situation is particularly precarious, as well qualified directors could demand higher packages without compromising the fixed part of their remuneration, whilst forcing an employer to accept fairly low levels of standard performance in return – but in anticipation of greater profits stimulated by incentive based remuneration packages. This phenomenon has been referred to as "*The vicious spiral of greed*" in The Business Day Management Review for August 2003, p.4.

Incentive based remuneration is that variable part of a director's remuneration that is determined by the achievement or exceeding, by the company, of certain goals. These goals could be described in terms of a large variety of measurable components, but in the current profit driven corporate cultures, are normally expressed as the achievement of specific profit objectives. The contract that a director has with a company is *sui generis.* The nature of the relationship between a company and its directors is also unique and as such one would find a large degree of variance between the terms of various directors' remuneration agreements. These terms are normally negotiated prior to a director accepting a position, according to guidelines laid down by the company's remuneration committee. The role of the remuneration committee is twofold. Firstly, the committee assists the board in determining the most appropriate remuneration strategies and guidelines for its directors. According to the King II report, the remuneration committee should be comprised of mainly or exclusively non-executive directors to avoid a possible conflict of interest. Secondly, the role of the remuneration committee is to assess the performance of the individual directors and to make recommendations to the board regarding those directors' remuneration in accordance with the achievement of their specific goals. The remuneration committee thus plays a vital role in determining the proper level of pay, and performance expected in exchange therefore, and balances that with the type and quantum of the reward for a director having exceeded those expectations. None of the above comments about incentive or non-incentive based remuneration could be used to deduce or induce that the one is better than the other. In the context of a specific company, in a specific stage of the development of the company and other macro trends over which the company may have no control, such as the global economic climate or the scarcity of skilled resources, either may be more appropriate. Determining which, is the function of the remuneration committee. The existence of both types of remuneration in the same context causes tension, as they seem to be capable of conflicting with each other.

The King II report suggests that directors are rewarded primarily on an incentive based package in order to more closely "align their interests with those of the shareowners". It is anomalous that the report should contain such a proposal in the light of the same report containing such strong references as to the necessity of adopting a sustainable business model – yet when the need for an alignment of directors' interests with those of other stakeholders is mentioned, the only stakeholders considered sufficiently meaningful are the shareholders. The tension created by this oversight, and its adoption by most large companies and the JSE may yet cost corporate South Africa dearly. A further problem with this particular recommendation by King II is that it seems to assume that the interests of all shareholders are alike. As discussed above, this is not necessarily so. Institutional shareholders may have an entirely different objective than a joint venture partner who has invested in a company in order to obtain greater benefit from an increase in its own and its joint venture partner's share prices, or from a pensioner investing his own retirement capital. Which category of shareholders' interests should the directors be more closely aligned with?

Whilst the King II report does not stipulate exactly what the incentive based remuneration should comprise of, the most common forms of incentive based remuneration are share incentive schemes and bonus schemes. There is an undoubted correlation between share and bonus incentive schemes by reference to their rewards to the participants for good financial performance, but they are essentially two different things on many other levels. Theoretically, good financial performance by a company year on year, will cause an increase in the demand for that company's shares and a subsequent increase in the share price. So, if a company performs well in a particular financial year, the directors receive cash bonuses and they, together with the shareholders enjoy a concomitant increase in the value of their shares. Regardless of other considerations, profit is still regarded as the main contributor to share value, and the market does not seem to recognise a difference between sustainable profit or not. This sentiment is borne out by the comments made by the chairperson of the Financial Services Board, Gill Marcus, in calling on companies to rethink incentive schemes to directors in order to "reduce the need for executives to report gigantic, yet unsustainable profits annually, enabling them to secure healthy bonuses…". (FSB urges firms to rethink CE's bonus schemes." Business Day 22 September 2003. The other side of the coin is that the market demands rapid results from directors, thereby creating opportunities for directors to justify short-term profits. ("Little room for error for CEO's": Business Day, 3 November 2003, p.19)

Share incentive schemes, whether share options, share allocations in terms of a restraint of trade agreement or otherwise, are generally regarded as longer term incentives – if only from the perspective that a director has to wait longer before receiving their full benefit, and would be operational for a term of three to five years or longer. Bonus schemes are generally paid annually or half yearly, and are paid in cash. At first glance, share incentive schemes seem to be more supportive of a sustainable growth model as it pays dividends over a longer term. The executive bonus schemes seem to be more tolerant of a pursuit of short-term profits. Unfortunately this is a generalisation as matters are much more complex than that. For as long as profit remains the main driving force behind the valuation of company shares, there would seem to be a disregard for the nature of that profit. This does indeed set the scene for the pursuit of short-term profit year after year, with little consideration being given to the sustainability thereof. As there is automatically a tension between incentive and non-incentive based remuneration, there is also automatically a tension between bonus schemes based on profit, and share incentive schemes. If a company were to pursue a stakeholder approach in the interest of sustainable business practises, then it would appear that there is little room for both a share incentive and a bonus scheme.

In summary, there appears to be tension between incentive and non-incentive based remuneration because of specific market circumstances which allows directors to manipulate the minimum performance criteria in favour of a higher short-term profit oriented result. Secondly, tension exists between share incentive schemes and bonus schemes because the market does not recognise the validity of other sustainability criteria as performance indicators for directors yet. This causes directors to pursue short-term profit because they get rewarded for the achievement of the same objective twice – once by way of performance bonuses, and once more by way of an increase in the value of their share options. Lastly, the widespread if somewhat informal adoption of the recommendations of King II may also create tension as it forces directors through their remuneration structures, to side with shareholders rather than with any other category of stakeholder. (PricewaterhouseCoopers: Corporate Governance in South Africa: A Comparison of the King Report 2002 and the Sarbanes-Oxley Act of 2002) That recommendation seems to fly in the face of the seeming adoption of the stakeholder approach by the King committee. The recommendation further causes tension as it ignores the fact that there may be different classes of shareholders, distinguished not by the different rights that attach to their shares, but by the difference in investment objectives that they may wish to realise.

**CASE STUDIES**

The objective of the development of the case studies is to enable the reader to arrive at a conclusion based on the principles of inductive reasoning, as to whether the model of directors' remuneration had an effect on the decision making processes in the organisations. If, through a process of elimination, the other tensions referred to earlier as those that contribute to the difficulty in the environment in which a director must take decisions, could be eliminated or afforded lesser status, then it would mean that remuneration will have played a role. This process of elimination can only be established as a matter of fact. Even then, those facts would tend to be subjective from the perspective of the source of the information. The conclusion can therefore only be the result of inductive, and not deductive processes. As such, they will always be subject to an element of doubt. The case studies will recognise this, but will at the same time endeavour to show those instances where remuneration did affect ethical decisions – on a preponderance of probability.

The analysis of the cases will further attempt to determine whether, and regardless of the business model employed by the organisations, the effect of the decisions motivated by a particular remuneration model was contrary to the effects that should have been achieved in accordance with the chosen business model. In determining what the desired result of a particular decision ought to have been for a particular business model, cognisance will be had of the "rights" approach, the "justice" approach and from the perspective of virtue ethics and utilitarianism.

**Utilitarianism**

The utilitarian principle says that an action that produces the greater utility is the right action for a particular occasion. ((M.G. Velasquez: Business Ethics - Concepts and Cases, 3rd Edition, Prentice Hall,p.61) By this is meant that an action is the right one if the net benefit derived from that action is greater than the net benefit of any other action. Utilitarian principles are applied in ethical cases when there is a need to measure, objectively, the merits of a particular decision.

The measurability of utility sometimes poses practical problems as it is difficult to determine whether a particular thing has the same value for all people. It is also difficult to place a value on some things such as a life. In many instances, the consequences of utilitarian actions are difficult to predict, and may, in some cases, not materialise. Sometimes, the dividing line between cost and benefit is vague. What may be a benefit to a particular person may be seen as a cost to another part of society – the manufacturing and sale of weapons will be seen as a benefit to the manufacturer, but the sale will be seen as evil by the victims of warfare.

Utilitarianism sometimes clashes with the principles of rights and justice. This happens when actions taken for the greater good override individual rights and the consequences may be perceived as unjust in respect of an individual. The counter argument to these objections to utilitarianism is the so-called "rule-utilitarianism." This principle dictates that one should ask what the correct moral rule is, and only thereafter determine whether following that rule brings about the most utility. This is an almost circular argument and serves to highlight the flaws of adopting an exclusive utility- based morality. Other principles need to be applied at the same time to obtain a balanced view of an ethical question.

**Rights**

A right is a legal or moral construct allowing a person or group an entitlement to something. Through the exercising of a right one can prevent another from acting in a specific manner, or one could compel another to act in a specific manner. This is known as negative and positive rights respectively. Each right has a corresponding duty. If I have a right to use a vehicle on a public road, because I have a valid drivers license and I have paid my annual licensing fee, then I also have a concurrent obligation to only use the road in such a manner as would not cause harm to other road users. Although groups can also have rights, this is not the same as the concept of a group or majority as found in utilitarianism. Rights are applicable from the perspective of the individual. In this regard, there is tension between the two, as utilitarianism sometimes infringes on an individual's right and other times, the benefit of the greater group has to bow before an individual's right. Given what was said above, it is doubtful whether the principles of utility can provide an adequate basis for moral rights.

The ethical theory developed by Kant provides a firm foundation for the principles of moral rights – his "categorical imperative". Moral rights as opposed to legal rights tend to be more "universal" in their appeal. Based on this, Kant posits that we should only act in a specific manner if we are comfortable that the rule according to which we act, could be universally applicable. Secondly, Kant holds that people should be treated as ends in themselves, and not as means to other ends.

Critics of Kant have argued that his theory is too "empty", that it lacks precision because it is too difficult to determine whether an action would have been universally acceptable. Kant's theory assists us in determining what our moral rights and obligations are, but does not help us to determine the extent of them.

A libertarian notion of rights is that the only basic human right is the right to be free from coercion from other humans. From this basic right follows all other rights, such as the freedom to choose. This approach ignores the fact that every right has a corresponding duty, which is a limiting factor on that right. Rights are therefore not absolute.

**Justice**

A fundamental philosophical question is, "what is justice?" From an ethical perspective, if one has to make a choice regarding a course of action to take, the question could be asked if the consequences of the action will be just. John Rawls, in "Justice as Fairness" The Philosophical Review, 67 (1958) pp.164-194 advocates that justice could be defined as fairness. He uses the example of the "original position" where a group of people, not knowing anything about their circumstances, personal or otherwise, have to set rules according to which the society in which they will live, will operate. He uses this example to illustrate that in such circumstances, people would endeavour to achieve the fairest dispensation. From that perspective, justice is fairness. Other notions of justice include justice as equality – where every person should be given exactly her proportionate share of society's benefits and burdens, justice as freedom – implying that the most just situation is one where everyone has freedom to exchange their benefits as they wish. This notion is closely related to distributive justice. Other examples of justice are capitalist and social justice – justice based on contributions and justice based on needs and abilities. For the purpose of the case studies, I will model questions about justice, on Rawls' notion of justice as fairness.

**Virtue ethics**

The essential difference between other ethics based principles and virtue ethics is that the others all begin with the question: "What is my duty?", whilst the Aristotelean conception of virtue ethics begins with the question: "What is it to lead a good human life?" This approach allows one to investigate the moral questions not as a separate and distinct

subject, divorced from the rest of our existence, but compels us to ask the question in the context of the entirety of our lives. (B. Magee, The Great Philosophers, Aristotle: Dialogue with Martha Nussbaum, Oxford University Press, 1987, p.51)
Some latter day philosophers are of the view that the concept of a good life is realisable if one lives your life so that you cultivate the virtues in yourself and in others whilst other philosophers hold the view that a good life means that our moral thoughts should concentrate on the virtues. Moral duties and rights should play a subservient role by comparison. (Cambridge Dictionary of Philosophy, Edited by R. Audi, Cambridge University Press, Second Edition, p.960)

The cardinal virtues are those virtues, the pursuit of which will cause human life to flourish. The cardinal virtues are prudence, courage, temperance and justice. In pre-modern times, the interpretation of virtue ethics was only concerned with whether the moral agent was a good person, in the context of the demands made on that person by society. There was never a question of whether conduct was good or bad.

The latter day moral theorists draw correlations from Aristotle's concept of virtue ethics to the ethics of responsibility. In terms of the ethics of responsibility, our morality cannot be rule based or in any other manner definitively grounded. Our morality springs from the responsibility that we have by reference to others – the moral appeal of the other person on me. This is not dissimilar to the concept of "Ubuntu found in Africa, which literally means to be a person through other persons, or, "I am because we are". (L. Mbigi and J. Maree: Ubuntu: The spirit of African transformation management, Knowledge

Resources, Randburg, 1995, p.3) One of the prominent current thinkers about the concept of virtue ethics is Alasdair Macintyre. He advocates a return to this tradition because of his disillusionment with the moral muddle in which we find ourselves because of the conflicting principles of ethical behaviour. He attempts to formulate a unitary core concept of the virtues in order to obviate the tensions and conflicts between the various principles. In *After Virtue,* he formulates his concept as comprising of three stages namely the concept of a practice, the narrative order of a single human life and the existence of a moral tradition. A practice is that activity which allows us to realise the goods internal to the practise (virtues). A person should do this in order to obtain answers to the question of what is good for me – the narrative order of the single human life, and test this against the existence of a moral tradition, in order to counter the individualistic aspects of the narrative order of the single human life. This is not dissimilar to what commentators on e.g. globalisation had in mind as a guide to assist people to counter the negative effects of globalisation. Bernstein, in his commentary on Macintyre, holds that Macintyre's approach does not achieve what he has set out to do, as it attempts to merge traditional Greek philosophy, without a conception of history, with modern philosophy. He agrees that some form of return to virtue ethics has moral appeal, but that exactly how, has not yet been determined. For now, Bernstein argues, our narrative quest should be to find a solution between the conflicts in the truths embodied in the tradition of the virtues and the principles of the enlightenment. (R. Bernstein: "Nietsche or Aristotle? Reflections on Alasdair Macintyre's "*After Virtue*" in his Philosophical Profiles, pp.115-140)

For the purpose of the case studies, analyses of ethical questions will be done from the perspective of the ethics of responsibility, with regard to Macintyre's unitary core concept of the virtues.

## CASE I: REGAL TREASURY PRIVATE BANK

### Case

Regal Treasury Private Bank (Regal Bank), of which the author was an executive director and chief operating officer during the latter part of the bank's history, was founded during 1998 as the main operating subsidiary of Regal Bank Holdings, a holding company listed on the Johannesburg Stock Exchange. Although there were many more companies in the group, such as a stock broking firm, a fund management company and a number of others, it was clear from the beginning that the bank was the main subsidiary, as the bank had access to the capital required to fund the growth of the group, and had in fact provided seed capital for all the other companies in the group. The manner in which the seed capital was provided was by means of a loan, so that the bank would derive the benefit from interest on such loans as well as an increase in the value of the shares of those companies. The bank was formed under the charismatic leadership of Jeff Levenstein, and raised approximately four hundred million rand from primarily the Johannesburg Jewish community as its initial capital. At the time of the bank being placed under curatorship, the bank also had deposits in excess of one billion rand and other investments valued at approximately five hundred million rand on a "going concern" basis. A large proportion of the shareholders in the group were also clients of the bank.

The bank had adopted a so-called "new economy" approach by reference to its business model. What this implied was firstly that it had adopted some form of stakeholder approach in the sense that it had identified those groups that it regarded as stakeholders, and also what it thought the mutual obligations and expectations were in the relationship. These stakeholders included primarily the shareholders, depositors, lenders, other group client and employees. Although never formally documented, it was understood that the stakeholders as listed, were to be treated in descending order of priority. This was another component of the so-called new economy business model in that whilst the interests of every different category of stakeholder were recognised, it was also recognised that the non-adherence to some of those interests would have different effects on the immediate sustainability of the business. The main business being that of a bank, and banks operating on principles of investor trust, this generally acknowledged that the reputation of the bank should be upheld in all circumstances, and at almost any cost.

Certain specific events occurred during the last six to nine months of the bank's lifetime, which events were a culmination of consequences emanating from prior actions undertaken by the bank as well as tighter regulatory controls and new appointments to the board of directors. For purposes of this case study, these six to nine months will be referred to as the latter period, whilst the time preceding the latter period, commencing with the inception of the bank, will be referred to as the former period.

## THE FORMER PERIOD

During the former period, the board of directors of the bank where the same individuals comprising the board of directors of its holding company. The full board comprised on average, ten members, of which thirty percent were executive directors and the balance non-executive directors. The influence that Levenstein as CEO and initially also Chairman exerted over the board was such that all appointments to the board were vetted by Levenstein, and any director daring to differ from Levenstein, was summarily removed by him. This was the case with a former Chief Operating Officer, Z Lopes and other directors B Lubner and D Springett as well as Levenstein's own brother Brian. With the exception of an audit committee of sorts, there were no other functioning board committees, and specifically no remuneration committee. Staff and board remuneration was the exclusive domain of Levenstien.

The bank had what was referred to as a culture of sacrifice by reference to salaries and incentive bonuses for staff members and executive directors. Salaries were low, and substantially below market norms (Deloitte and Touché Human Capital Corporation salary benchmarking exercise conducted February 2000). Although salaries were low, every employee and executive director had a contractual entitlement to shares in the bank's holding company. This entitlement emanated from two sources namely a share allocation in restraint of trade, as well as a share option scheme. The idea behind this structure was to establish a culture of medium to long-term wealth creation, with the emphasis on shares and the share price, whilst minimising salary expenditure. Payment of performance bonuses were almost non-existent and exclusively at the discretion of Levenstein. There were no bonus guidelines or benchmarks or any other performance criteria stipulated in employee service contracts.

Non-executive directors were not paid any remuneration at all for the performance of their duties, and none were allocated shares. A number of non-executive directors were however, major shareholders in their own right, whilst yet others had been granted preferential loans at low interest rates and with no security other than the shares purchased, to purchase shares in the holding company. Any person, be it employee or director to whom an offer of a preferential loan in order to purchase shares was made, and who declined, was seen as disloyal and eventually removed by Levenstein.

From a remuneration perspective, the emphasis was clearly on wealth creation by stimulating growth in the value of the shares as well as an above average dividend policy. Executive directors were regarded as sufficiently valuable employees to justify substantial share allocations to them, but were not paid market related salaries, and received almost no performance bonuses. The role of non-executive directors was minimal in the organisation, and reflected as such in their lack of remuneration.

During the capital raising exercise initiating the establishment of the group, as well as at its subsequent shareholder and investment analyst functions, emphasis was placed on the profitability of the group and the bank specifically, and the effect that profit had on the share price. The Regal share price traded at a level of R7.00 to R8.00 per share and at a price earnings ratio in excess of 10. (Profile's Stock Exchange Handbook, Jan. – Jun. 2000, Profile Media, 2000, p.383) The price-earnings ratio is a ratio that indicates the value that a prospective buyer of a share would place on that share when it is purchased, in exchange for the dividend that that shareholder would receive on the share. The higher the price-earnings ratio, the higher the value attached to the share. In the case of Regal, the price-earnings ratio was substantially similar or slightly higher than the average for the banking industry – no mean feat considering small banks were not awarded the same status as larger banks. Due primarily to the unexpectedly high profitability of the bank as a consequence of Leventeins' revolutionary business model, the bank was favourably regarded by the investment community. The bank was a classic example of a company that paid lip service to the stakeholder approach, but focused almost exclusively on delivering profits for the sake of promoting the share price.

**THE LATTER PERIOD**

A number of things happened simultaneously during the last six to nine months of the bank's existence, which combined, caused the bank to tumble from its pedestal. Firstly, a number of directors became disenchanted and concerned with the manner in which Levenstein exerted his power over the board. These directors either resigned or were pushed out, and in most instances their leaving the bank was followed up by litigation, with the bank being the protagonist. The purpose of the litigation was to "protect the reputation of the bank", and in the process also avert the attention of the South African Reserve Bank, who, through the office of the Registrar of Banks has the function of regulating the banking industry in South Africa. Because the Registrar of Banks has to be notified of all resignations and new appointments to a board of a bank, the uncommonly high turnover in board members attracted attention, and resulted in the Registrar appointing the audit firm Deloitte and Touche, to conduct an investigation into the affairs of the bank in terms of Section 7 of the Banks Act. The scope of the investigation was to make enquiries about the high turnover in board members, corporate governance and committee structures in the bank in general as well as making an assessment of the possible abuse of his powers by Levenstein due to his strong position as Chairman and Chief Executive Officer. The findings of Deloitte and Touché in terms of their investigation highlighted several major corporate governance breaches and this was quite damaging to the relationship between the board and the office of the Registrar of Banks.

Slightly preceding this investigation in time, was another investigation commissioned by the Registrar of Banks, again in terms of Section 7 of the Bank's Act, conducted by auditing firm KPMG. This investigation was commissioned as a result of dispute between the board of the bank and its auditors Ernst & Young, regarding the recognition of income on the bank's financial statement, which income was derived from Levenstein's revolutionary business model, the so called "branding model". Ernst & Young were of the opinion that the income so derived did not constitute income according to the definition thereof in generally accepted accounting practice, and as a consequence refused to sign their auditors report on the financial statements for the year ended 28 February 2000. The Registrar of Banks commissioned KPMG to conduct an investigation into the nature of the income derived from the bank's business model in an effort to resolve the dispute between the bank and its auditors, before the bank's reputation was tarnished. The KPMG findings were that the income derived from the business model could not be recognised as such. (KPMG Report on an investigation conducted in terms of section 7 of the Banks act, on the recognition of income from Regal Bank's "branding " model, May 2000) KPMG used such dubious terminology and presented their report in such a fragmented way that this prompted Levenstein and a few other board members to publish the bank's financial statements, including the disputed income, without the auditor's consent.

The bank was the major income contributor in the group, as most other subsidiaries in the group were in a start-up phase and were not profitable. The bank's income, in retrospect, could be broadly categorised as interest income, branding income and income derived from special structures. By interest income is meant that part of the income that the bank earns on lending out its capital and deposits. By branding income is meant the income derived from Leventein's revolutionary business model – that income that was in dispute. By income derived from special structures is meant income generated through the creation of special structures in order to create income from assets that would normally be regarded as capital, and which ultimately contributed to the demise of the bank – which will be further be dealt with hereunder.

**Interest income**

It a bank has one hundred rand of which it has lent fifty rand to various borrowers, the interest earned on the one hundred rand emanates from two sources. Firstly, the bank would earn interest from its borrowers on fifty rand, at the average interest rate charged by the bank. Secondly the bank would earn interest on the balance of its capital and deposits, in this case fifty rand, which fifty rand the bank would have on deposit with another bank. The interest earned on this fifty rand would therefore be equal to the interest paid by the other bank. Using this simplistic approach, it is easy to calculate the interest that the bank should earn. In the case of Regal, investigations showed that the bank was earning substantially less in the form of interest than it should have using the basic interest calculations. This lead to the uncovering of the special structures.

**Branding income**

In the normal course of events, a bank would lend part of its capital to a business, based on normal banking practices. In the case of Regal, the bank would not only lend a business some of its capital, bus also insist that the bank's name is attached to that of the business, as an additional token of good will, lending credibility to the business's name and the esteem in which its suppliers and customers would hold it. The term "branding income" is derived from this co-branding exercise. As consideration for the co-branding, the bank would insist on receiving a minority, but still substantial percentage of the shareholding in the company. The bank would also calculate the value of the new business prior to having attached the bank's name, and thereafter. The result of this calculation was invariably that the value of the new business would be substantially enhanced by the addition of the bank's trade name, resulting in an increase in the value of the shares of that business. Regal Bank treated the increase in the value of the shares of those businesses as income in its income statement. It was as a result of these practices that the bank was able to show substantial trading profits even in its first year of operation. All it had to do was strike similar agreements with any number of smaller companies wishing to borrow money, and it would have a virtually inexhaustible source of super, albeit paper, profit.

**Income derived from special structures**

Because of the high demand for a strong and ever increasing share price as dictated by the bank's culture and promises made to shareholders, the dispute in respect of the recognition of the branding income caused substantial reputational damage as well as an urgent need to maintain the perception of unprecedented profitability based on a revolutionary business model. This gave rise to the creation of alternative structures through which these "super profits" could be generated. In its simplest form, the bank would establish complex structures such as special purpose vehicles into which it would invest depositor's funds, which would otherwise be available to lenders. These funds would then be used to purchase shares in the bank's holding company on the open market, whilst the value of the investment would be determined by the increase or decrease in the value of the underlying Regal Holdings' shares. If the share price went up, the bank would be able to continue to show substantial profits. If the value went down, the bank would show losses, hence increased pressure upon the share price to keep rising. One of the ways to keep a share price going up regardless of poor market perceptions would be to continue buying, or "mopping up" shares. Due to the negative publicity surrounding the bank, there were may shares available in the market, most of which were bought by the bank through these structures, resulting in the bank ultimately controlling in excess of forty seven percent of the issued shares of its holding company. This was not only illegal, but had also used roughly half of the bank's capital and deposits for investments that did not yield a prudent interest return.

As part of the solution to some of the shortcoming identified by the various investigations, as proposed by the Registrar of Banks, the boards of the holding company and the bank were to be reconstituted, proper functioning committee structures were to be put in place and the concept of branding income was to be abandoned. The introduction of committees and new board members resulted in the identification of the alternative structures. Once the auditors were notified of the existence of these structures by the new board members, they withdrew their consent for the publication of the 2001 financial statements. The negative publicity surrounding the withdrawal of their consent resulted in the loss of trust in the bank by its depositors. Depositors demanded that the bank repay their deposits, a so-called "run" on the deposits of the bank. Because the majority of deposits were illiquid, primarily because of the investment in special structures, there was hardly sufficient money to repay depositors, resulting in the Minister of Finance placing the bank under curatorship.

The position is undoubtedly complex, and it would be unwise to try and reduce the reasons for the demise of the bank to one or two only. In the discussion of this case study an attempt will be made to eliminate, as far as possible, those tensions that may be said not have had a major impact, and to investigate the interplay between the remaining non-remuneration tensions and remuneration related tensions in order to achieve a greater insight into the role that directors remuneration had played. The central question to be answered is therefore not whether the particular model of directors remuneration adopted to the bank had been the sole cause of the demise of the bank, but whether the directors remuneration did play a contributing role, and whether anything might have been done as far as the directors remuneration is concerned in order to have changed the outcome of this saga.

**Discussion**

A unique tension that existed in Regal was the uncertainty that directors had regarding their tenure. This uncertainty did not stem from any flaw in their contractual relationships with the company, but rather from the enormous influence that Levenstein exerted over the Board and the company. Regardless of contractual rights and obligations, and especially during the former period, directors had to do Levenstein's bidding or face dismissal. Decision making was limited, with individual directors rather acting on instructions than exercising their own discretion.

Directors' individual service contracts with the company did not provide for a measurement of their performance against any set criteria. The determination of incentive rewards such as bonuses was left entirely to Levenstein. This changed during the latter period, but was a case of too little too late. With the exception of shares allocated to directors in terms of their original contracts, additional share options were issued from time to time. The allocation of these options was again left entirely to Levenstein's discretion and no formal guidelines were set. The directors were not alone in this position. Al staff members were treated in the same manner, contributing to the general aura of uncertainty.

In addition to contractual share entitlements, many directors were shareholders in their private capacities, having borrowed money from Regal Bank to purchase them. The loan arrangements for the purchase of the shares were so favourable, that any director offered such an opportunity and declined, was branded disloyal. Directors, it would appear, did not differentiate between their capacities as shareholders and directors. Because of the weighting attached to their shareholding relative to their other remuneration and the uncertainty linked to that other shareholding, shares and the share price became everything in the organisation. If the shares were the only thing that was relatively certain, and the only variable was the value of the share price, then, from that perspective, it stands to reason that every endeavour had to be made to ensure a constant increase in the share price. The fiduciary duties owed to the company were placed a firm second behind personal interest. None of the transactions involving loans to directors to purchase shares were ever disclosed and complicated structures with front companies and special purpose vehicles were used. This turn of events did not happen by chance. It was the design of Levenstein to ensure that he retained his position of power whilst keeping the employees "hungry". The company did not pay its employees well – the so-called culture of sacrifice, specifically so that the share price became of paramount importance.

Although the company purported to have adopted a type of stakeholder approach, the internal structures were not supportive of that approach. This caused tension from the perspective that directors had to decide beforehand, not how to decide about a particular issue, but how they were going to justify the decision in the context of a stakeholder approach. This led to many explanations in language designed to obfuscate, as most decisions were taken with the share price in mind.

Employee satisfaction did not rank high in the scheme of things at Regal. Employees were paid less than market related salaries. The justification for this was the value that they had locked in with their shares. All employees had shares, even the labourers. Levenstein and a number of other board members were committed to the Jewish faith. As such, the company spared no expense to promote religious activities on its premises. Only "kosher" foods would be allowed at functions and no person was allowed to work on Saturdays. Whilst laudable, a large percentage of employees were nor of the same religious persuasion. Their interests were not considered and were, in some instances, overridden.

Because of the importance of the share price in the context of the entire business, much time was devoted to ensuring that all the right messages were sent to analysts. Regular meetings were held with selected analysts, the services of professional public relations firms were employed and when Levenstein's reputation began to be questioned, other members of the Board were tasked with the job of communicating with the analysts. The love/hate relationship that Regal had with analysts caused an enormous amount of tension in the organisation. Whilst Levenstein realised that he needed them, he also resented them for the power that they wielded. Decisions that Levenstein felt were the exclusive domain of management had to be justified to them. Not only was this regarded as an intrusion into management's discretion, but facts often had to be coloured in order to obfuscate the real issues.

Regal did have an institutional investor in the form of Pekane Investments, a black empowerment investment company that held in excess of 15% of the issued share capital. (Regal Treasury Bank Holdings Annual Financial Statements for the year ended 28 February 2000, p.40) When Regal's share price started to decline, Pekane, who had financed their acquisition of the shares wanted to dispose of the shares because the value had gone below their internal benchmarks. This posed a major problem for Regal from a number of perspectives. Firstly, the release of such a large number of shares in the market would have increased supply with a potential negative effect on the already declining share price. Secondly, the sale of such a large percentage of shares by a single investor would have harmed the reputation of the organisation and caused the share price further damage. The concerns were all related to the share price because the entire organisations future was gambled on the share price increasing in value. No other factors were considered. This led to the bank funding the repurchase of the Pekane shares from depositors' funds and the consequent "hiding" of the highly irregular transaction from all, including the auditors. When later uncovered by the then Chief Operating Officer, this transaction directly led to the downfall of the bank.

Consumers of the bank can be divided into two broad categories – those that lent the bank money, the depositors and those that borrowed from the bank. The bank was not overly concerned about the borrowers, as the relationship with those clients was contractually regulated. The bank was concerned with its reputation for the purpose of attracting deposits, without which no bank can conduct its business. Therefore, messages that were formulated to communicate with institutional investors and analysts were also crafted with depositors in mind – the deception had to extend to them as well. When the reputation of the bank was finally damaged beyond repair, the depositors demanded their deposits back, causing the bank to be placed under curatorship.

Regal was not managed according to the stakeholder principles. It paid lip service to that principle, but had to, as part of the process, entertain some of the tensions that would normally be associated with having adopted a stakeholder approach. This does not detract from the fact that the company was exclusively focussed on the creation of shareholder wealth, but renders the context in which directors' decisions are analysed more complex. Given the central theme of share price manipulation, the tensions identified are all causally related. The obsession with the share price created the tension in the relationship with analysts, it created the scheme whereby the institutional investor's shares were bought back, it created the environment within which both directors and staff had to operate and it created the environment where actions of directors who ignored their fiduciary duties in favour of their interests as shareholders were condoned.

The central moral question is one that encapsulates all these tensions. The question is whether moral justification for directors participating in share schemes can be found in the context of the case study. If not, I will endeavour to find other contexts in which such participation may well be morally justifiable.

From a rights perspective, directors contract with a company. In terms of that contract, they acquire legal rights, which may include a right to shares. In the case of Regal it did. At first glance it may appear that the Regal directors were entitled to their shares. Legally, if not an express term, them an implied term of any service agreement is that the director is expected to discharge his duties to the best of his abilities and within the parameters of the requirements in law. Where participation in a share scheme causes the director to ignore his legal duties, in this case his fiduciary duties, then the contract becomes voidable. It would appear therefore that Regal's directors did not have an unconditional right to the shares. They failed to prove that they have discharged their duties adequately. Given the fact that a director's contract with a company is *sui generis,* and that directors are regarded as knowledgeable persons, entrusted with the stewardship of other peoples assets, it is doubtful whether a moral right to participate in the share schemes could be construed over and above the contractual right.

From a utilitarian perspective, the directors could argue, as is argued in King II, that aligning their interests with those of the shareholders will cause them to better consider the interests of shareholders and thereby create a higher net benefit for the greater number of people. As mentioned above, this argument fails to convince. Firstly, such a narrow focus on the interests of shareholders excludes the interests of other stakeholders – even in the case of Regal where the stakeholder approach was only adopted as a matter of convenience. Consistency demands that stakeholders are considered, even when they are used as a matter of convenience only. Secondly, the argument fails given the insurmountable conflict that exists between the rights and duties of directors *qua* directors and directors *qua* shareholders. Because of the legal and moral requirement that a director acts with the utmost good faith in respect of his fiduciary duties and no such requirement (except a moral one) exists in respect of shareholder - aligning directors' interests with those of shareholders for the purposes of utility remains a moral dilemma.

Negotiating from the original position, as demanded by Rawls' *Justice as Fairness,* it is highly unlikely that shareholders will entrust the job of looking after their interests to someone who may compete with them from a privileged position. It is more likely that they will negotiate that the appointed caretaker must be disinterested, other that from a professional perspective, or that if the caretaker has an interest, that that interest must be properly disclosed and carefully monitored. This second alternative has an aura of compromise about it which, I doubt will have been reached without any prior knowledge as required by Rawls' model. It would appear therefore that shareholding by directors will be difficult to justify from the perspective of justice.

The principles underlying the ethics of responsibility dictate that the moral demands made by shareholders on directors be investigated. These moral demands have mostly crystalised as legal and contractual requirements with passage of time. New demands may however appear with changes in technology, the global business environment or culture. In the context of Regal, I suggest that the demands made on directors by shareholders are adequately covered in law, by reference to the fiduciary duties of directors. In addition, and given the unique and sometimes glaring abuses of authority by Levenstein, if not legally, then shareholders could at least have demanded morally, that Levenstein's fellow directors take actions to limit his abuse of power. This would have necessitated steps by the directors that may entail investigations and actions that beyond the minimum required by law. Such actions would, ideally, be driven by an accommodating corporate culture.

The virtues at stake here appear to be that of temperance and prudence. Shareholders expect of directors to be temperate in their approach and not to place their interests ahead of those of the shareholders. They may expect of the directors to sacrifice short term gains in the value of the share price for the sake of creating a sustainable business based on the principles of honesty and integrity, as embodied by the Regal crest and slogan: "*Honor et Integritas*". Shareholders may expect directors to act prudently, and not enter into unlawful and dishonest arrangements regarding the repurchase of shares, whether through barely legal structures or not.

The practise referred to by Macintyre is the act(s) of so conducting the affairs of the company that the internal goods that are realised is the sense of achievement and the betterment of the lives of the shareholders. The narrative quest is the pursuit of the corporate ideals within a fiduciary culture. The moral tradition is best exemplified by the legal responsibility placed on directors – the duty of care. The actions of the directors show neither temperance nor prudence. Their actions indicate unbridled personal greed at the expense of those whose interests they were supposed to protect.

**Conclusion**

The actions of the directors have no moral foundation. From the case study and the unique context, it would appear as if participation in share incentive schemes as part of directors' incentive remuneration had no place in Regal. This does not mean that the same would apply universally for all companies. Various factors make Regal unique. Firstly, the fact that directors were paid very little played a major part in elevating the importance of the share price. So did the fact that directors felt that they could not control their environment, and so did the fact that the directors had no security of tenure. The only relative security to be found in especially the former period vested in the share participation, to the extent that those shares vested in the directors. Regardless of their denials, the majority of the directors were aware of what was going on. Whether they condoned it or were simply not strong enough to attempt to bring about change serves to illustrate the lesson – that the lure of incentive remuneration could have a material impact on a director's ability to make ethical decisions.

## CASE II: CORPCAPITAL

**Case**

Corpcapital, founded during 1996, is a diverse, speciality finance company listed on the JSE under the category "Speciality Finance". The initial business plan revolved around a strategy to buy companies in fragmented industries in order to consolidate those industries. One example, quoted by Mr. Nic Frangos, a founder member and former director of Corpcapital, during an interview with the author conducted on 29October 2003, of such a company formed out of a number of smaller ones, was Corpbuild – a company in the building industry. Corpcapital furthermore had banking and long term assurance licenses, and had extensive interests in Information Technology companies, one being a company styled Cytech.

During the early 2000's, South Africa went through a period that is referred to as the small banking crisis. This period saw small banks suffer severe liquidity problems due to a number of corporate governance failures, bad debt provisions and general negative publicity surrounding smaller banks. This crisis led to some banks, such as Regal and Saambou Bank, being placed under curatorship; some were consolidated and drawn into a larger corporate structure, such as Unifer and South Africa's sixth largest bank - BOE, whilst yet others, including Corpcapital handed back their banking licenses in order to free up capital for the rest of the companies in the group. In order to meet certain minimum prudent capital adequacy requirements, banks are required to keep minimum reserves in the form of cash. This cash cannot be utilised for other purposes. Handing back its banking license freed up that cash component for Corpcapital. In normal circumstances, a banking license could be lucrative. Corpcapital did not hand back the license only to free up cash. They were also the victims of the small banks liquidity crisis because of allegations made regarding corporate governance failures in the group. This led to reduced investor and depositor confidence with a subsequent high liquidity demand. "David Shapiro, Barnard Jacobs Mellet director for private clients said......"at the end of the day, there was so much suspicion and so much negative news flowing out of Corpcapital that investors took their eyes of the bottom line... some investors would have considered it best to cut their losses and avoid any nasty surprises upstream.""(Business Day, Opinion and Analysis, 15 August 2003, p.13

According to Frangos, Corpcapital's shareholders had adopted a shareholder supremacy business model. Their point of departure was that ownership is the closest to an unlimited right, and that being so, enjoyed the strongest protection in law. Incorporating the interests of other stakeholders, according to Frangos, amounted to a pure ethical decision, not defensible in law. As such, other stakeholders had no role to play in the Corpcapital business model.

Frangos made certain allegations regarding a breakdown in corporate governance in Corpcapital, resulting in the board of Corpcapital appointing an independent expert to investigate his allegations. Frangos then, disagreeing with the findings of the independent expert, commissioned his own investigation conducted on his behalf by a firm of chartered accountants. The results of this investigation conflicted with the findings of the independent investigator. "The report said: "In our opinion, there was a breakdown on good corporate governance in material respects. The valuation, accounting and disclosure of the Cytech investment were incorrect and did not reflect the true financial position of results in accordance with generally accepted accounting principles." Cytech is a key issue. The unlisted on-line gambling start-up based in the Virgin Isles was bought for

R4,5 million in 1999 but then revalued by the company at R149 million by August 2000. This valuation was carried over as profit and Cytech became the single largest contributor to profit for the year – fundamental to the R23 million in bonuses paid to top Corpcapital executives. In August 2001, Cytech was revalued again at R221 million, making a profit contribution of R72 million for that year. Since then however, the value of Cytech has been written down to its current R65 million.

Payne's investigation found "there is no evidence management tried to manipulate the value of Cytech, or were unduly "aggressive" therein". But Collett said that largely due to Cytech, net profit was technically overstated by as much as R200 million between 1999 and 2001.

Another issue of concern was the suggestion that CEO Jeff Liebesman (who has since resigned) lied to Old Mutual analyst Jeanine van Zyl about executive remuneration. In a press release in January this year, Corpcapital said the letter sent by Liebesman to Old Mutual "fully and accurately answers the queries raised".

Liebesman told Van Zyl the methods used to calculate executive bonuses were determined by the remuneration committee in consultation with P-E Corporate Services.

He said P-E used a "complicated formula" based on "information which we are not at liberty to disclose". But P-E CE Martin Wescott said his company had played an "insignificant" role in determining bonus payments." (Business Day, Company News, 15 September 2003, p. 10)

Frangos was the chairman of Corpcapital's remuneration committee. He claims that executive bonus schemes were profit motivated and did not include other criteria. Frangos further claims that there was non-disclosure on a substantial scale by executives to non-executives who served inter alia on the remuneration committee and that this non-disclosure resulted in the payment of huge bonuses to executives.

The board of Corpcapital have made an announcement (Business Day 15 August 2003) that the company will not continue to seek new business opportunities, but that it will endeavour to sell of its assets in order to repay shareholders, whereafter the directors would thereafter go their separate ways.

**Discussion**

At first glance it would appear as if very few of the non-remuneration related tensions apply to the Corpcapital case. Given the clear bias in favour of the shareholder supremacy model, and according to Frangos, there was no tension between stakeholder related issues and decisions that needed to be made. The position was clear – decisions had to favour the shareholders. Further, according to Frangos, the distinction between a director *qua* director, and the director *qua* shareholder was not made. It was generally held in the organisation that a director would be acting unethically if that director attempted to separate his shareholder related issues from his fiduciary duties. Frangos admitted that the position was far from ideal and fraught with potential ethical pitfalls. According to him, the only way to ensure that directors' personal issues do not interfere with their fiduciary duties, is to ensure that the directors are people of the highest personal integrity –"Good corporate governance starts with good personal governance".

Although not explicitly stated, it would appear as if employee satisfaction was not measured in any other terms than financial. The general impression was that Corpcapital's employees were well paid, but that similarly, the demands made on them by the company were high by reference to profitability.

A tension identified earlier, and that definitely had a bearing on the demise of the company's reputation was the relationship with analysts. The influence exerted by analysts was clearly understood by the company, as well as the relevance of perceived excessive directors remuneration. When the analyst asked questions about directors' remuneration, the answer given led to the credibility of management being doubted.

There is no clear indication that institutional investor considerations played a role in the decision-making processes followed in Corpcapital. If however, an inference can be drawn from the issue raised above, where it is alleged that Liebesman lied to an analyst regarding remuneration issues, it is a short step to take from there to arriving at a conclusion that profit would have been sought at the expense of other considerations, should institutional investors have demanded it.

The case is reasonably clear. Corpcapital was not hindered by many of the other considerations such as other stakeholders, employees or consumers. Its primary stated purpose was to look after the interests of the shareholders by generating profit. It clearly had medium to long-term strategies in place by reference to the objectives as stated by Frangos – to consolidate industries. This is not something that can be achieved overnight. Sustainability of the business model had to be paramount in the minds of the directors, and lacking any other interests to consider, sustainability through the creation of sustainable profits. An elaborate structure was established in order to create the sustainability, including obtaining a banking license to facilitate the group's acquisitions and consolidations. No expense was spared to assist the group with the attainment of its business objectives. What went wrong?

Decisions with far reaching effects were taken by the directors. The decisions in question are the decision to attribute such a large amount of profit to Cytech, and the decision to make misleading statements to the Old Mutual analyst regarding directors' remuneration. These decisions are causally connected. Questions regarding the profitability of Cytech directly led to questions regarding directors' remuneration. The inference was there for all to see. The inference was that the Cytech profits were boosted or overstated because the directors were rewarded handsomely on that basis. Reference therefore, to Cytech, is meant to include not only the decision to "overstate" the company's valuation, but also to the subsequent misdirection by reference to the questions asked about directors' remuneration.

It is not common cause that the Cytech profits were overstated. A committee under John Myburgh had been appointed to establish inter alia the answer to that question. The writing down of Cytech to a value of R65 million would seem to support some contention that its value had been overstated initially. It has already been established that there would appear not to be any other compelling reason for the directors to have taken the course that they did regarding Cytech. With the exception of shareholder considerations, (and to a lesser but interconnected extent, institutions) directors' remuneration would appear to be the only other factor influencing that decision.

If we proceed on the basis, that indications point, on a preponderance of probability, to a manipulation of the Cytech valuation, then we have to analyse the shareholders' position against that of the directors'. Looking at the shareholders' position in the context of the Cytech valuation, and measuring shareholders' interests against the ethical principles should give us a good idea how defensible the decision by the directors is, from a moral perspective.

From a rights perspective, it could be argued that the valuation was not only done to enhance the shareholders' position, but that they would have demanded that type of decision from the directors. Such an argument would be short sighted as the valuation of Cytech clearly led to market scepticism and a consequent loss of confidence in the organisation. The valuation appears to be a short-term measure to boost profits, but not in the interests of the shareholders – certainly not against the backdrop of a sustainable profit and business model. It would appear that shareholders would not have a right, either from a legal or moral perspective to expect such behaviour from the directors. The directors' contracts do not appear to require that type of behaviour from them, and neither does the common or any other law.

The perspective of justice as fairness demands that one should consider the Cytech valuation in the context of an original position. It is extremely doubtful whether any moral agent, negotiating from that position would have arrived at the conclusion that a re-valuation of Cytech was necessary. Ignoring all other implications, and considering only the interests of shareholders versus those of the directors, no moral agent would when wearing a shareholders hat, condone such behaviour and no moral agent wearing a directors hat would condone such behaviour as it ultimately led to the effective loss of the company and consequent loss of positions for directors.

From a utilitarian perspective, the question is whether the actions of the directors, by the valuation of Cytech, led to a result that brought about the greatest net benefit to the greatest number of people. The answer to this question is no. The shareholders (even taking them as the only other parties) far outnumbered the number of directors. Any benefit therefore passing to directors could only pass the utility test with the greatest difficulty. Ignoring that approach, an argument could be raised that the shareholders did derive a benefit from the valuation, as the profit attributed to the group as a result thereof caused a temporary increase in the value of the share price. Given the uncertainty in the market, only those shareholders who sold their shares would have had a benefit. The remaining shareholders would have, and did lose out.

From a virtue ethics perspective, it would seem as if the virtues under consideration here are temperance and prudence. This is so as the directors have a responsibility to ensure that they act as the caretakers that they are, so that the shareholders' assets are not recklessly diminished. Shareholders demand from directors that they act responsibly, without placing their interests before those of the shareholders. As has been the case in the discussion of the Regal case study, the practise is the act(s) of so conducting the affairs of the company that the internal goods that are realised is the sense of achievement and the betterment of the lives of the shareholders. The narrative quest is the pursuit of the corporate ideals within a fiduciary culture. The moral tradition is best exemplified by the legal responsibility placed on directors – the duty of care. The actions of the directors show neither temperance nor prudence. Their actions indicate unbridled personal greed at the expense of those whose interests they were supposed to protect.

**Conclusions**

The actions of the directors cannot be justified morally, from any of the principles of ethical decision-making. There is an absence of any other contexts against which the directors' actions could be measured. Very few of the tensions (barring remuneration) that could otherwise have affected decision-making were present in the case of Corpcapital, yet decisions to inflate the valuation of Cytech appear to have been made –

and the questions pertaining to directors' remuneration as a consequence of that valuation, in total, incentive bonuses in the amount of R23 million, appear to have been evaded and answered less than truthfully.

The only inference that can be drawn, and that makes sense in the context of the facts, is that the directors were motivated by greed. The opportunity to earn huge incentive bonuses through the generation of short-term unsustainable profits overshadowed the high ethical demands made on directors. This inference is further supported by the trail of deception regarding the questions about remuneration. Frangos, as chairman of the remuneration committee admitted that the directors' contracts did not motivate any other behaviour. He further alluded to the fact that many salient details of the deals on which the directors were remunerated were never divulged to the remuneration committee. It appears that as if some checks and balances were in place to ensure adherence to the "rules", but that those with the knowledge and the means, bent the rules to suit their own ends. In the case of Corpcapital, the lure of incentive based remuneration without adequate balances, proved too great a temptation, and had a disastrous effect on the company.

## CONCLUDING COMMENTS

Both companies used as case studies had various checks and balances in place to ensure not only compliance with the minimum legal requirements, but also with the spirit of corporate governance as espoused by the King reports and a large variety of other regulatory and other bodies. Abuses still occurred. Incentive remuneration played a central part in the occurrence of the abuses. In the case of Regal, the offending part of the incentive remuneration structure was the share schemes. In the case of Corpcapital, it was the huge bonus potential.

It cannot be categorically stated that all incentive remuneration schemes for directors are immoral. It can be stated that they are open for abuse. The case studies have served to illustrate some of the circumstances that would indicate that the potential for abuse is higher than elsewhere. These circumstances could be summarised as follows:

- Neither company had adopted a substantial stakeholder approach, but both were subject to some of the other tensions that make ethical decision taking difficult by adding to the complexity of the context. This complexity was used to obfuscate and detract unwanted attention, if even for a short while;
- In both companies, stakeholder communication was less than absolutely honest and transparent;
- In both companies, information was not freely shared by the CEO or other directors – minimum information was provided, which severely curtailed the efficacy of for instance, the remuneration committee. In Regal, there was no such committee, except in name;
- Both organisations had a corporate culture that encouraged and condoned short-term profit making at the expense of sustainable profits. Both companies had compelling reasons why that should be so;

- Neither company had aligned its remuneration policy with any other measurable performance indicators to determine the extent of incentive remuneration, and especially not in respect of the sustainability of profits or any other strategy;
- Both companies had CEO's with strong personalities, coupled with a willingness to manipulate other people. This was especially so in the case of Regal. In the case of Corpcapital, this contention is based on hearsay.
- Both companies had directors who were not dishonest or in any way different (except for the instances referred to above) from any other director. The combination of circumstances allowed them to abuse their position, partly because of the tensions present in the companies which added to the complexity of the decision making process, and partly because they were incentivised to do so.

Not present at either company, because they did not embrace the stakeholder approach, but still something that could serve as an indicator for the potential for abuse, would be instances where the memoranda and articles of a company do not expressly provide for such a strategy or culture.

Does this mean that directors ought not be incentivised? I do not believe that such a situation will be tolerable, and certainly any proponent thereof could be accused of lacking practical wisdom – one of the virtues. What would then, be the circumstances in which, incentive remuneration for directors will be morally justifiable – at least so that it can be said that it has a lesser role to play in clouding the directors' minds when it gets to ethical decision making?

From a rights perspective, and drawing on the libertarian notion of freedom from coercion, the principle of contractual freedom is well established in law. Directors should be able to negotiate any incentive remuneration, provided that it is aligned firstly with them performing their duties according to the minimum legal requirements. This is already the case. In addition, given the lessons learnt from the case studies, the minimum requirements may be expanded to accommodate other moral or corporate cultural issues not yet embodied in law. If a director does not like this, he should not accept the position. The director's performance by reference to the legal and moral duties ought to be monitored regularly, by a properly empowered remuneration committee. I believe that this simple addition of regular monitoring and the expansion of a director's duties to encompass other moral duties serve to counter-balance the imbalances highlighted by the case studies. From a rights perspective, incentive remuneration for directors could be made morally acceptable.

From a utilitarian perspective, the moral objections raised against share participation as incentive (or other) remuneration remain insurmountable as it excludes other stakeholders from the equation. Even if it is argued that all other stakeholders will also benefit because the company is successful, there may still be instances where success could be better measured than by shareholder wealth.

A utilitarian approach with regards to bonus schemes could be justified in the case of companies adopting a stakeholder approach. The directors are not exclusively aligned with shareholders, and provided that the bonus calculations take into consideration all other aspects that are of importance to all stakeholders, would work well. For companies adopting a shareholder supremacy strategy, the same insurmountable issues as discussed above remain. It is doubtful whether justification of incentive remuneration using arguments of utility will have any meaningful practical application given the narrow band of its operation.

From a justice perspective, I believe that incentive remuneration could be justified, subject to the necessary checks and balances being put in place, such as the proper measurement of directors' performance in the context of both a stakeholder and shareholder approach as discussed above. Using Rawls' model of fairness, I believe that the "compromise" that is currently applicable by reference to the original position not involving prior experience by the participants would work equally well if it is agreed that the participants all have the same level of prior knowledge and experience. This strikes me as the more pragmatic approach.

The requirements of ethics of responsibility, by reference to the virtues of temperance and prudence can be satisfied by the introduction of the necessary checks and balances in measuring directors' performance as alluded to earlier as they apply to incentive bonuses. The instances where, in the case studies, the directors have failed were because of a lack of such proper measures.

The possibility of personal interests overriding the demands of ethical decision- making is real and happens every day in companies. A holistic approach to the problem, including not only regulatory measures, but also strong emphasis on the ethical justification for incentive schemes, which can only be done in the context of a total alignment of the corporate culture with proper performance measures taking into account all the relevant stakeholders will go some way towards alleviating the problem.

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