HOW THE COLLAPSE OF ONETEL AND HIH INSURANCE CHANGED CORPORATE GOVERNANCE IN AUSTRALIA

Background
The first years of the 21st century were remarkable for a number of high profile corporate collapses, most notably in the US, Enron and WorldCom and, in Australia, OneTel, HIH Insurance, Harris Scarfe and Ansett Airlines. This case study investigates two prominent Australian corporate failures, namely OneTel and HIH Insurance (HIH), and reviews what part inadequate corporate governance practices played in their demise. Whilst both collapses are examined, the conclusions focus on the recommendations made by the HIH Royal Commission, which had far reaching ramifications for the practice of corporate law in Australia.¹

In August 2001, HIH was liquidated with losses in the range of AU$3.6 billion to AU$5.3 billion. Similarly, just before its collapse, OneTel, at one time the fourth largest telecommunications company in Australia and one of the ASX’s fastest growing companies, posted an operating loss in 2000 of AU$291 million. When HIH and OneTel failed both companies ‘...shared myriad problems including weak corporate governance, unsustainable business strategies, aggressive financial reporting, poor auditing, ineffective working capital management, potentially excessive management compensations and questionable related party transactions.’² The failure of OneTel and HIH highlight the importance of not only having good corporate governance practice, but also ensuring that it is rigorously implemented and not merely paid “lip service”.

The fundamental problem at both OneTel and HIH was their zeal in chasing low yield business and not setting aside sufficient capital to cover future liabilities. Inevitably, this problem was exacerbated by the failure of management and the BOD to effectively enforce and monitor due diligence practices.
The Collapse of HIH Insurance

The collapse of the HIH Insurance group of companies was Australia's biggest corporate failure and resulted in the incumbent Liberal Federal Government establishing a Royal Commission (RC) to investigate ‘the reasons for and the circumstances surrounding the failure of HIH’. Importantly, the RC made a number of far reaching recommendations which resulted in changes to the Australian Corporate Law regulatory landscape. The RC provided insights into how a company with ostensibly award winning corporate governance systems and policies could fail in such a spectacular fashion. Commissioner Mr. Justice Owen concluded that ‘HIH’s collapse related more to vanity and inflated egos, poor systems and lack of monitoring rather than systemic fraud.’ A number of Directors were found to have breached their duties as directors under the Corporations Act and were banned from any involvement in company management for significant terms and hit with substantial financial penalties.

HIH had been described as having ‘a conservative corporate culture’ and the glaring governance deficiencies which resulted in HIH’s downfall came as a surprise to many observers. It had a charismatic and dominating CEO and engaged in high-risk practices in extremely competitive markets. The HIH BOD lacked independent directors to the extent that ‘three of the [eleven] BOD members, including the chairman were former partners at the company’s auditors, Arthur Andersen.’ The few independent directors alleged that they were misled as to the true financial positions of the respective companies.

Many of HIH’s difficulties can be attributed to its aggressive acquisition strategy, a growth- at- all- costs mentality and a culture of never giving “bad news”, which resulted in conflict between profit maximisation and the implementation of, and adherence to, sound corporate governance procedures.
**The Demise of OneTel**

OneTel’s demise also highlights a number of key deficiencies in its corporate governance practices. When it collapsed it had annual sales of AU$653 million and operations in seven countries. However, despite an apparently secure financial position, OneTel had a dangerously inadequate corporate governance structure. Its two chief executive officers had excessive influence on the BOD to the extent that the company never had a regular, designated chairman in place. Rather, the CEOs and other executive directors acted as the BOD chair on an ad hoc basis. Non-executive directors had inadequate monitoring and oversight of management, which was reflected in the composition of the audit, corporate governance and remuneration committees, all of which were dominated by the CEOs and the executive directors.

Ultimately OneTel collapsed due to a number of relatively straightforward corporate governance failures. Firstly, the two CEO’s had excessive influence over a rather inept BOD, rendering the latter ineffective and reducing its capacity to provide effective oversight and control. Secondly, large investors, despite maintaining that they were profoundly misled about OneTel’s true financial situation, failed to take little more than a passing interest in the management of the firm and relied too heavily on the direction of the CEO’s and other executive directors. Thirdly, non-executive (and ostensibly independent) directors were ineffective due to their close association with the CEOs. Fourthly, the auditor had a conflict of interest and was compromised due to its provision of non audit services to the firm. Lastly, the BOD chair was not independent and was unable effectively monitor management behaviour and control the BOD agenda.

**Outcomes of the HIH Royal Commission**

The HIH RC made a series of governance-related recommendations to the legislature, regulators, and the ASX, which ultimately resulted in the development of the CLERP 9 and the release of the ASX’s Principles in 2003. Both CLERP 9 and the ASX Corporate Governance Principles provided substantial guidance to companies on either a
mandatory or, in the case of the ASX principles, a ‘comply or explain’ basis that was more stringent than previous Australian disclosure requirements.\(^7\)

**CLERP 9**

CLERP 9 was the ‘pivotal Australian legislative reform’ in response to the failure of HIH and has had a major impact on corporate governance in Australia which continues up to the present day.\(^8\) The CLERP 9 proposals which directly impacted corporate governance practices mandated increased auditor independence, required that the top 500 listed Australian companies have audit committees, that ‘...external auditors of listed companies attend annual general meetings (AGMs) to answer reasonable questions from shareholders, auditors report any attempt to influence, coerce, manipulate or mislead them, ‘whistleblowers’ reporting suspected breaches in corporate law be protected from any retaliation in employment, and that there be improved shareholder participation at company meetings’.\(^9\)

**ASX Listing Rules and Corporate Governance Principles**

As a result of the collapse of OneTel and HIH, the ASX Corporate Governance Council developed a set of corporate governance recommendations for listed entities, which reflected international best practice. In 2003 the ASX published its corporate governance principles and best practice recommendations and amended its listing rules to require full inclusion of the principles in members’ annual reports. The ASX advised companies that the best practice recommendations were not prescriptions, but guidelines designed to produce outcomes leading to increased efficiency, quality and integrity. In summary, the ASX’s Principles of Good Corporate Governance (refer Appendix3) advise listed companies about how to implement good corporate governance practice, structure the BOD to add value to a company’s activities, promote ethical and responsible decision making, ensure integrity in financial reporting, better respect shareholder rights, make timely, accurate and balanced company disclosures and ensure that there is a fair remuneration policy for the BOD and senior managers.\(^10\)
**Findings of the HIH Royal Commission**

The RC concluded that good governance is achieved through the judicious combination of regulatory action, codes of best practice and the implementation of company charters on ethics or governance; it also found that there were significant disparities in the quality of managerial oversight and control mechanisms applied in boardrooms across Australia. The objectives of the legislative reforms and codes of practice were to promote, implement and oversee more effective corporate governance practices.

**Ramifications for Corporate Governance Practices in Australia**

Notably, the RC recognised that good corporate governance processes are likely to create an environment conducive to success and cited the main reasons for the failure of HIH as ‘...poor management and greed characterised by a lack of attention to detail and skills, a lack of accountability for performance, and a lack of integrity in the company's internal processes and systems.’ The RC summarised the necessity for good corporate governance practice as follows:

- Senior managers should know the core difference between managing and directing; even if a manager is on a BOD, the director/manager must always act in the best interests of the company; there are clear lines of authority and delegations from the BOD and that everyone understands and agrees with them;
- Codes of Conduct be developed and implemented to cover not only legal and management guidelines but also the written expression of the culture of the organisation; risk management programs be established; and monitoring and review mechanisms at the strategic, operational and project levels be incorporated.

Directors are now also required to acquire at least a rudimentary understanding of the company’s business, be well informed about its activities, adopt an oversight and monitoring role which also requires regular attendance at BOD meetings and to remain familiar with the financial status of the company.
Conclusion

Best practice in corporate governance is necessary to facilitate good financial performance and maximise shareholder returns. The cases of HIH and OneTel demonstrate that corporate governance is much more than compliance with a set of ‘tick-the-box’ guidelines. HIH had an award winning oversight and monitoring model but it was ineffective, whilst OneTel clearly disregarded the principles of good corporate governance. The OneTel and HIH BODs failed in their duty to periodically assess the effectiveness of their corporate governance practices. As a result of the OneTel and HIH collapses, legislation and voluntary codes have been introduced which forced BODs to review the manner in which they operate. Mechanisms including CLERP 9 legislation and voluntary self-regulatory codes of practice provide detailed guidelines for BODs to follow in order to ensure that their corporate governance is effective.

References

3 HIH Royal Commission, above n 1.
4 Ibid.
8 Barney, above n 5, 26.
11 Cagan, above n 6.
12 Owen J, quoted in Cagan, ibid
13 Ibid.