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# 2010 USAID Infrastructure Workshop

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# **Module 10: Enabling Environment, Effective Regulation, and Private Sector Participation**

## **Fixing Corporate Governance**

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## Corporatization

- Corporatization – process by which public sector utility, service provider or manufacturer is converted to financially, commercially and legally independent, distinct and viable enterprise, similar to a private sector corporation
- Accomplished by:
  - Creating separate, limited liability, legal entity (corporation, limited liability company, or similar vehicle)
  - Transfer of assets, finances, employees, and operations to the new entity (corporation)
  - Allocation of certain liabilities to new corporation



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## DEFINING KEY CONCEPTS

### Corporatization

- Development of structures to assure commercial orientation, managerial independence, customer focus, accountability and commercial sustainability
- Board of Directors, CEO and modern management organization, audit, P&L statements and balance sheets



## Corporate Governance

- “The rules and practices that govern the relationship between the managers and shareholders of corporations, as well as stakeholders like employees and creditors” – OECD *Principles of Corporate Governance*, 2004
- “The system by which a corporation is directed and controlled in the interest of shareholders and other stakeholders, to sustain and enhance value.”



## Corporate Governance

- Why do we care?
  - Good corporate governance contributes to overall economic stability and growth
  - Communicates market confidence, financial integrity and economic efficiency
  - Transparency and accountability become prominent values
  - Customer orientation, stakeholder inclusion result
- Overall economic climate becomes more favorable toward entrepreneurial activities, investment, growth, rising standards of living, and rule of law



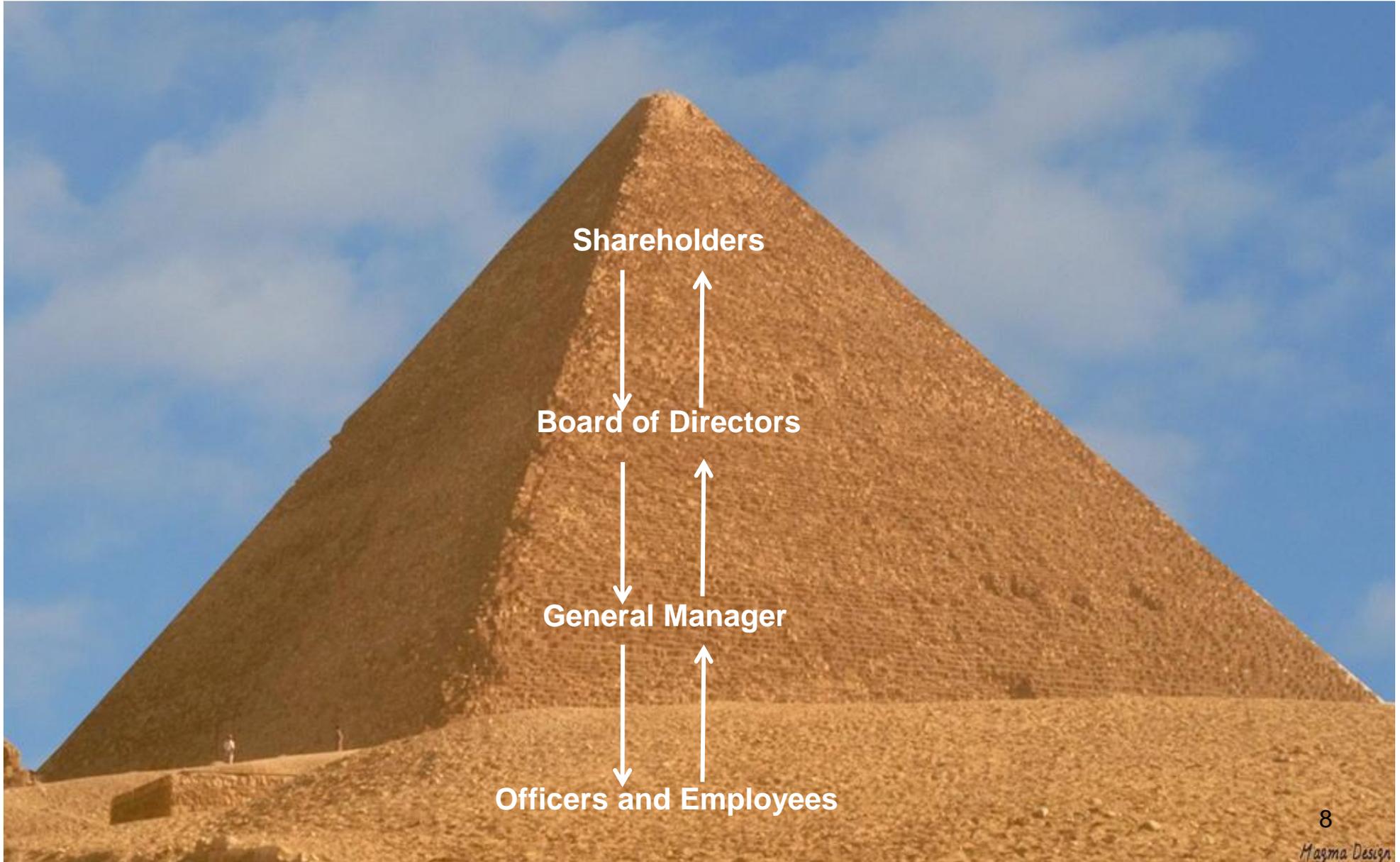
## ROOTS OF CORPORATE GOVERNANCE

- Corporate governance flows from enabling laws
- Typically, national laws allow creation of corporations or other limited liability entities for business transactions
- Four core characteristics:
  - Separate legal entity, distinct from its shareholders or employees, with ability to act as legal person
  - Liability limited to invested capital (equity) or loan capital (debt); no personal or shareholder liability beyond investment
  - Transferability of ownership interests (corporation does not cease when owner dies)
  - Governance structure under shareholder, board, management pyramid
- Corporate form has been engine of growth and driver of economic success for centuries



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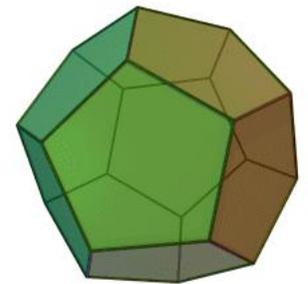
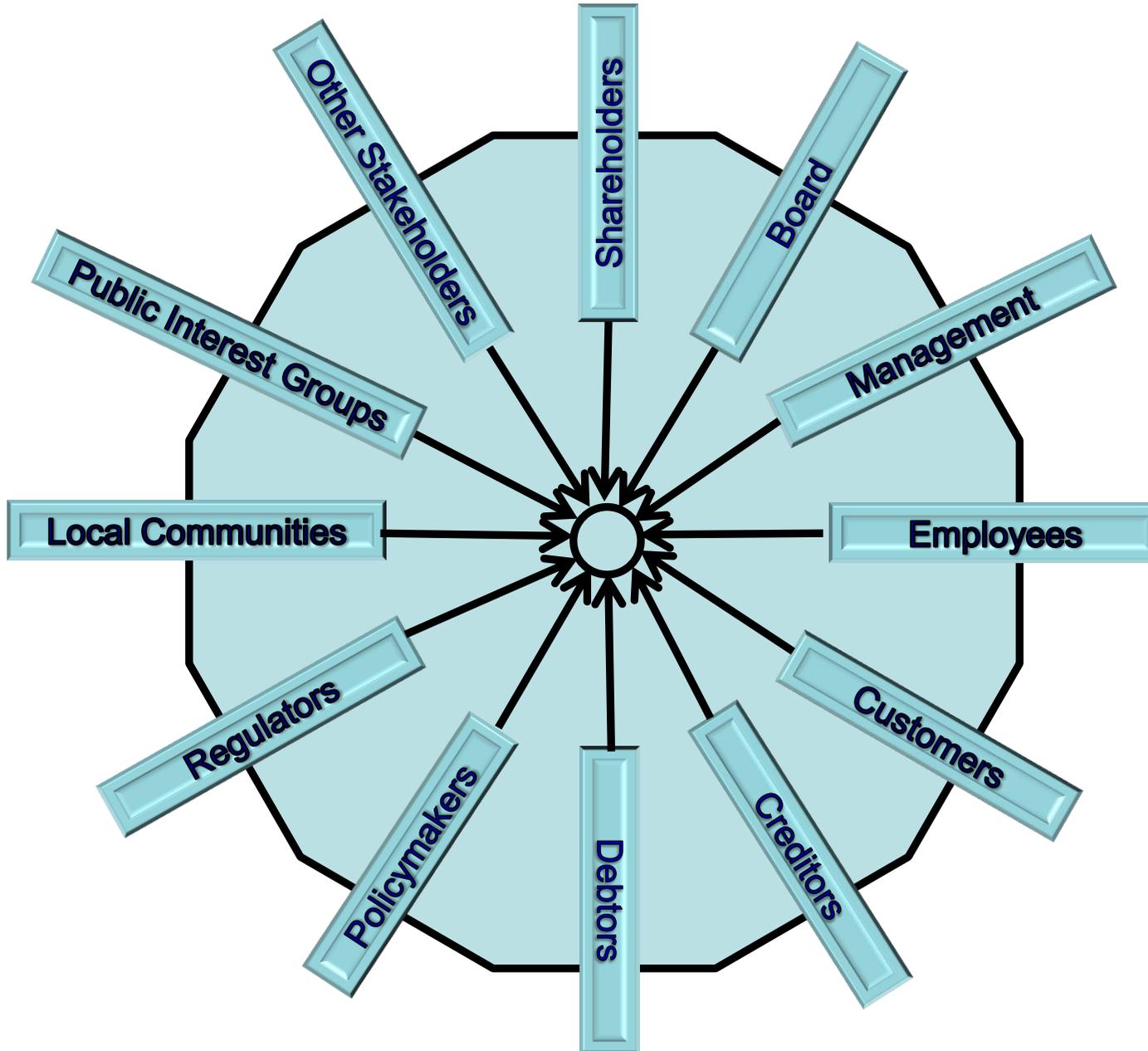
# CORPORATE GOVERNANCE PYRAMID





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# CORPORATE GOVERNANCE POLYGON





## CORPORATE GOVERNANCE ROLES

- Shareholders own corporation and elect Board of Directors
- Board serves shareholders and acts on their behalf
- Board should be ***independent*** and exercise sound judgment on matters properly before Board
  - With the exception of CEO, Board typically should not consist of company officers or employees
  - Board should be independent of regulators
  - Board members should not have material affiliation with significant customer, supplier, creditor or debtor of the company
  - Board members, their family and close personal associates should not have material contracts with the corporation



## CORPORATE GOVERNANCE ROLES

- Board establishes broad policies, goals and objectives of corporation; approves strategic business plans; hires CEO
- Board does not engage in day-to-day governance
  - Board members should negotiate contracts, even if material
  - Board should only approve major contracts
  - Board should not engage in personnel decisions, except at “C-level”
  - Board should not deal with HR complaints
  - Employees who normally report to Board limited to CEO, Head of Internal Audit, other selected parties
- Board sets policy; management manages



- Enabling law that permits establishment of limited liability enterprises
- Creation of corporate charter
  - High level document that establishes legality of enterprise
  - Typically registered with governmental office
  - Identifies broad purposes of enterprise
  - Registered agent
  - Corporate seat
  - Establishes initial capitalization



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## LEGAL STRUCTURES

- Bylaws – adopted by Board or initial incorporators pursuant to charter; establish functioning of corporation on routine basis
  - Election of officers
  - Removal of officers
  - Board Committees
  - Meetings of Board and Committees
  - Shareholder Meetings
  - Establishment of Board committees for various functions



## ROLE OF BOARD MEMBER

- Truly effective Board member will
  - Exhibit all earmarks of independence noted above
  - Attend regularly scheduled Board and Committee meetings
  - Familiarize self with workings of business (e.g., tour facilities)
  - Observe proper delineation with management and employees
  - Abide by corporate charter and bylaws
  - Provide oversight



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## ROLE OF BOARD MEMBER

- Take all decisions in best interests of corporation, and respect rights of shareholders
- Maintain appropriate financial controls and systems of risk management
- Promote transparency
- Assure annual audit of books and records performed by independent, certified auditor
- Disclose any actual or potential conflicts of interest, recuse self from votes as needed
- Will not maintain office in company offices



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## DEFINING CHARACTERISTICS

- Transparency
- Accountability
- Implementation of international accounting standards
- Customer focus
- Stakeholder orientation
- Commercial soundness and profitability



- The most elegant corporate governance structures on paper . . .
- Can fall short in implementation
- Especially in emerging economies without long history of capitalism and shareholder entities, most people are not sure what corporate governance means
- Lines of authority between government, shareholders, Board, management, employees and customers frequently collapse
- Donors have come to understand that continual education on corporate governance following corporatization and privatization is critical
- Sustained attention to corporate governance is essential



- Elections can be sensitive points in terms of proper corporate governance and Board independence
- Board meetings should be publicized
- Helpful for donors to observe Board meetings
- Enterprises in same sector need independent chairs and Boards
  - Frequent tendency to populate Boards and senior officers with same people
- Boards should adopt their own code of conduct or code of ethics



- Boards get involved in negotiating contract terms and conditions
- Boards tend to allow HR/employee concerns, firing, hiring, compensation or similar complaints to go directly to Board, instead of through proper corporate channels
- Board should only set salary of CEO and other C-level officers
- Boards tend to be sympathetic toward groups that may be protected or privileged under prevailing law, such as farmers, war veterans, war invalids, senior citizens
- Board members, even very well educated members, need tutorials in financial statements, financial reporting and accounting



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# FOUR HYPOTHETICALS





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## ADVISORY BOARD MEMBER

A former department of a ministry (gas utility) has been successfully corporatized and has adopted many hallmarks of good corporate governance, in form and in fact. Simultaneously, the country has also established an independent regulatory authority to implement tariff decisions and related important economic decisions for newly corporatized public utility monopolies. The Board has created an Advisory Board, with non-voting authority but full access to corporate books and records, and has decided that a member of the regulator should sit on the Advisory Board.

- Is this appropriate?



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## MAJOR CONTRACT NEGOTIATIONS

A fully corporatized enterprise, now only partially state-owned, is negotiating a major, long-term supply agreement. Management is over taxed and understaffed. The Board believes management is not devoting sufficient time to negotiating the details of the transaction. The other side is well represented by knowledgeable corporate officers and outside consultants. The Board decides to set up an ad hoc sub-committee to negotiate the contract.

- Right or wrong?



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## TIMING OF RATE INCREASE

The corporation is a public utility supplying electricity. It is fully corporatized, well governed, with an independent Board. The state retains a controlling share. Current tariffs are not fully reflective of costs, fail to capture depreciation, and result in a return on equity that is negligible or negative. A rate increase is warranted. National elections are nine months away. The Minister has sent word through one of his appointees on the Board that the company should hold off filing for tariff increases until after the election.

- Result?



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## CONFLICT OF INTEREST

The company is about to execute a major contract (in excess of \$1,000,000) with Supply Co. for the supply of goods and services over a five-year term. The size of the contract is such that the Board itself has to approve it. One of the Board members has a daughter, who is married to “A”. “A” has a sister, who is married to “B”. “B” has no blood relation to the Board member, nor is a child of, or a spouse of a child, of the Board member. “B”, however, owns a substantial interest in Supply Co.

- Should the Board member recuse herself from this vote?



- Corporatization and corporate governance are easy relatively to define
- They are very hard to implement, especially good corporate governance
- Even societies with advanced corporate structures and corporate practices, and long-term prevailing laws have difficulty in achieving the right balance
  - Enron



- In emerging countries, and developing markets, without a long history of corporate and capitalistic life, these pressures are even more intense
- Establishment of corporate governance structures is but the first step
- Continuous support, education, and review from international donors is essential
- Transparency and accountability must be guiding principles



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# Thank You

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