Overcoming the Pitfalls of Bias

Andrew Lumsden (Partner) and Felicity Daley (Senior Associate), Corrs Chambers Westgarth

Andrew Lumsden, LLB, BA, has over 26 years legal experience, specialising in mergers and acquisitions, securities transactions and corporate governance. Andrew is a Partner at Corrs Chambers Westgarth and is also the Deputy Chair of the Law Council of Australia Corporations Committee (Sydney) and an adjunct Faculty Member of the University of Sydney Faculty of Law (Equity Financing). In addition, Andrew is a fellow of the Subject Advisory Committee Applied Governance Program of the Institute of Chartered Secretaries, a member of the Corporations Committee of the Australian Institute of Company Directors, a member of the Law Society of New South Wales, a member of the Regulatory Compliance Group and a member of the Company Reporting Subcommittee of the Financial Services Institute of Australia.

Felicity Daley, LLB (Hons), BBus, GradDipACG, has over seven years legal experience, specialising in mergers and acquisitions and corporate advisory for public and private companies and trusts. Felicity is a Senior Associate at Corrs Chambers Westgarth and is also a member of the Law Society of New South Wales, the Corporate and Legal Issues Committee of the Australian Institute of Company Directors, and a member of the Institute of Chartered Secretaries and Administrators.

The views expressed in this article are those of the authors and are not necessarily those of Corrs Chambers Westgarth.

Given the high, indeed almost aspirational expectations placed on directors of large Australian companies, it is becoming increasingly important for directors to identify potential sources of errors and implement mechanisms to overcome these errors. This article identifies potential sources of risk from conscious and unconscious biases as well as potential solutions to this problem in the form of engaging external advisors, using the internal audit function and establishing an inquisitive corporate culture.

Corporate collapses and regulatory reaction

In the last few years there has been renewed focus on the role of corporate “gatekeepers”, including in particular, directors and external auditors. Gatekeepers seem to represent the vanguard of attention by regulators and the consequence of this is that they are subject to renewed scrutiny and judicial review.

Who are the gatekeepers? They are usually considered to be lawyers, investment bankers, accountants and other individuals and firms with the capacity to monitor and control poor disclosure decisions which should limit the ability of investors to be poorly informed about their investments. In the United States, a rich literature on gatekeeper liability has considered what liability regime would lead gatekeepers to minimise poor disclosure. In Australia, the phrase has usually been taken to also include key figures within the company such as directors and internal auditors.

The theory that focusing regulatory attention on these gatekeepers will cause them to exercise their ability to monitor and control, and to deter corporate wrongs, is not new. This article extends the discussion on gatekeeper liability by questioning whether it adequately addresses the growing need for behavioural economics that simple deterrence theory - the prevailing economic approach for evaluating liability regimes to deter wrongdoing - fails to consider the impact of biases towards ambiguous information, self-serving beliefs and group-think in operation and what systemic changes are needed to counter these effects.

Although a lot of attention has been focused on the development of robust corporate governance guidelines and practices, there is little empirical evidence to convincingly suggest that there is any correlation between adopting and maintaining “best practice” corporate governance procedures and structures, and successful companies.

What is behavioural economics?

Behavioural economics is a branch of economics that draws on psychology.

Behavioural economists build models to explain what is happening in different areas of economic activity. Behavioural economists however, use observations of real behaviour in their work.

These observations form the basis of their models (not the traditional assumptions of perfect rationality) and makes for more powerful results because their models provide much better approximations of the real world and because they reflect our personal experience and observable human characteristics.

Behavioural economics repeatedly shows, in both its experimental and empirical studies, that the decision-making context matters greatly. How choices are framed is crucial. If you frame a food choice as “97% fat free”, people don’t react in the same way as if you say the food “contains 3% fat” - even though the fat content is identical. Medical practitioners will choose different courses of action depending on whether an option is framed as lives saved or lives lost (when the statistical outcome is identical).

Studies have shown that successful and unsuccessful boards adopt similar corporate governance rules and procedures. For example, having a majority of independent directors was not a meaningful distinguisher between good and bad board performance, and directors of failed companies were just as likely to attend board meetings as regularly as those from successful companies.

What has “saved” the gatekeepers from challenge and arguably their companies from collapse, has been the actions of
individual employees who have recognised behaviours that might have minimised their effectiveness, and who then countered those behaviours to produce a better governance outcome.

**Background**

Over the past 10 years, Australian courts have imposed increasingly higher expectations on gatekeepers, and especially directors of Australian listed entities. In 1992, directors were entitled to rely extensively on management without verification, unless the director was aware of circumstances so manifest that no person with any degree of prudence would have relied on the particular judgement or information. There is now a strong line of case authority which indicates that while directors are still entitled to place reliance on others, they may do so only if there is no cause for suspicion or circumstances demanding critical and detailed attention. The test has been enhanced by an overarching requirement that directors must approach their tasks with an "inquiring mind". Public sentiment seems to endorse this view regardless of the size of the corporation, notwithstanding that it is generally impractical for directors of large listed entities to comprehensively delve into detailed matters of management.

On analysis of the direction of Australian case law on directors’ duties and related media reports, it becomes clear that there is a growing expectation gap between (i) the public and judicial interpretations of directors’ duties on the one hand and (ii) directors’ perception of their duties and the practical reality of directorships of large corporations on the other.

The recent Centro decision is a case in point. Middleton J held that the directors of a large listed stapled entity were personally required to apply their own minds to, and carry out a careful review of, the proposed financial statements and directors’ report before approving them. However, in many cases it is simply not practical for directors of parent entities of multiple large scale businesses to delve deeply into matters of management in a detailed and thorough manner. In reality directors and senior managers of large corporate entities must (at least to some degree) rely on the integrity of the information they receive from their subordinates and advisors. If the information is defective, directors and the company risk severe reputational damage, financial damage and legal liability. James Hardie Industries Ltd was recently the subject of this type of damage.

While public perceptions are trending towards higher standards of care from directors, section 189 of the Corporations Act 2001 (Cth) (Corporations Act) provides a limited safe harbour for reliance by a director on information, or professional or expert advice given or prepared by:

- an employee whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned
- a professional advisor or expert in relation to matters which the director believes on reasonable grounds to be within the person’s professional or expert competence
- another director or officer in relation to matters within the director’s or officer’s authority or
- a committee of directors on which the director did not serve in relation to matters within the committee’s authority, provided that reliance was made in good faith and after making an independent assessment of the information or advice, having regard to the director’s knowledge.

---

**Case example: James Hardie Industries Ltd**

James Hardie Industries Ltd implemented a corporate restructure which included transferring the asbestos liabilities of two of its subsidiaries to the Medical Research and Compensation Foundation, a vehicle it established to compensate asbestos victims and to fund medical research. Under a Deed of Covenant and Indemnity, the company agreed to make annual payments to its subsidiaries. An Australian Securities Exchange (ASX) announcement was made stating that these arrangements were sufficient to fund all present and future asbestos claims, however this announcement was found to be misleading.

The Court of Appeal found that the General Counsel and Company Secretary had breached his duty of care and diligence by failing to advise the board on the limitations of the best estimates in the experts’ reports of the company’s liabilities for asbestos claims. The Chief Financial Officer was found to have breached his duty of care and diligence by failing to advise the board of the limited nature of the reviews conducted by certain experts of the cash flow model and that the key assumptions adopted by the cash flow model had not been verified.

The facts of this matter (primarily that the General Counsel and Chief Financial Officer failed to adequately brief the board of the details of the projected liabilities) indicate that there may very well have been the presence of biases towards ambiguous information, self-serving beliefs and group-think in operation.

Although the Court found that the CEO was acting honestly, it considered that the misstatement was so serious that it refused to grant relief from liability. This indicates that where a breach of the duty of care and diligence is sufficiently serious, Courts may not relieve directors and officers from liability, even if they acted honestly, and may impose severe pecuniary penalties and disqualification orders.
of the company and the complexity of its structure and operation. The Corporations Act requires directors to recognise situations in which it would be dangerous to rely on others and requires directors to complete their own investigations or seek independent expert advice.

In light of the conscious and subconscious biases of human behaviour and the increasing perception of director responsibility, boards and corporations need to establish not only the well-touted corporate governance principles and practices but also build robust, effective social systems. These systems need to be backed up by the engagement of external advisors in appropriate circumstances and a strong internal audit function that accurately verifies important information. Establishing effective systems and processes will also assist directors to establish that their reliance on the information provided to them was reasonable in the circumstances.

There are no signs of this trend towards imposing enhanced directors’ duties slowing. The Australian and Securities Investments Commission (ASIC) chairman, Greg Medcraft, has said that ASIC’s key priorities will be imposing enhanced directors’ duties slowing.

Mr Medcraft said that part of this involved holding the “gatekeepers” of the financial service system (being directors, accountants, advisors, custodians, product manufacturers, market operators and participants) to account.

Organisational behaviour as a contributor

While good corporate governance serves as important building blocks, the governance guidelines and rules do not, by themselves, create a foolproof system against poor disclosure decisions for directors and other gatekeepers involved in these decisions. Boards often fail in their supervision of management by virtue of dysfunctional social systems. Human social psychology indicates that errors often occur not through incompetence or bad faith, but as a natural consequence of the human social dynamic. This dynamic sees individuals agreeing to, or failing to oppose, a group decision even though they are not satisfied with the answer to the questions or the group decision. There is a rich literature by Donald Langevoort and others discussing behavioural economics and the conscious and unconscious biases that can permeate the modern company. The key cognitive biases in corporations can be summarised as follows.

Cognitive conservatism

A normal cognitive strategy of people is to review information and circumstances in a way that confirms prior attitudes, beliefs and impressions. Busy executives and directors build plans to provide themselves with a method to process large amounts of information, make decisions and determine what is important and requires attention. This processing causes information to be simplified and provide stock understandings of people and situations. Once a methodology is established it is infrequently changed. Information that contradicts methodology can be dismissed or rationalised without conscious reasoning if it can be processed consistently with the original belief. Subconsciously, executives do not want to be bothered with contradictory information and will try to minimise the threats to their methodology.

Ambiguous information

Ambiguous information tends to be dismissed as unmanageable. Due to the demands of communication and negotiation, groups have even less capacity to deal with large volumes of information than individuals. This leads to a tendency to simplify information flow and agendas so that decision-making is tractable. This is commonly done by focusing on only immediate, first-level effects and putting more complex and unpredictable (though perhaps important) consequences out of mind.

How do decision makers deal with ambiguity?

One typical reaction that has been well documented in the decision-making literature is that people avoid situations involving ambiguity. That is, research on risky decision-making has demonstrated that people avoid taking risks with ambiguous probabilities.

For example, participants were presented a situation involving two urns, one containing 50 red balls and 50 black balls, and the second containing red and black balls in an unknown proportion.

Participants can bet on a blind draw from one of these urns, and win a certain amount of money if they correctly predict the colour of the ball. Results generally indicate that people prefer to bet on the urn containing the 50 red and 50 black balls. This phenomenon is generally referred to as “ambiguity avoidance”.

Organisational behaviour as a contributor

While good corporate governance serves as important building blocks, the governance guidelines and rules do not, by themselves, create a foolproof system against poor disclosure decisions for directors and other gatekeepers involved in these decisions. Boards often fail in their supervision of management by virtue of dysfunctional social systems. Human social psychology indicates that errors often occur not through incompetence or bad faith, but as a natural consequence of the human social dynamic. This dynamic sees individuals agreeing to, or failing to oppose, a group decision even though they are not satisfied with the answer to the questions or the group decision. There is a rich literature by Donald Langevoort and others discussing behavioural economics and the conscious and unconscious biases that can permeate the modern company. The key cognitive biases in corporations can be summarised as follows.

Cognitive conservatism

A normal cognitive strategy of people is to review information and circumstances in a way that confirms prior attitudes, beliefs and impressions. Busy executives and directors build plans to provide themselves with a method to process large amounts of information, make decisions and determine what is important and requires attention. This processing causes information to be simplified and provide stock understandings of people and situations. Once a methodology is established it is infrequently changed. Information that contradicts methodology can be dismissed or rationalised without conscious reasoning if it can be processed consistently with the original belief. Subconsciously, executives do not want to be bothered with contradictory information and will try to minimise the threats to their methodology.

Ambiguous information

Ambiguous information tends to be dismissed as unmanageable. Due to the demands of communication and negotiation, groups have even less capacity to deal with large volumes of information than individuals. This leads to a tendency to simplify information flow and agendas so that decision-making is tractable. This is commonly done by focusing on only immediate, first-level effects and putting more complex and unpredictable (though perhaps important) consequences out of mind.

Over-optimism and the illusion of control

Generally speaking, people have a systematic and unconscious tendency to overrate their own abilities, contribution and talents. This bias often takes the form of excessive optimism and over-confidence as well as an inflated sense of ability to control events and risks.

People are often asymmetric in explaining good and bad fortune – positive events are brought about by the product of their skill and negative events are a result of external circumstances. People also filter self-referential information with the same asymmetry to improve or maintain self-esteem. Evidence suggests that groups and businesses can increase optimistic biases,
Commitment

Once a person voluntarily commits to an idea or course of action, there is strong motivation to resist information that indicates that it was not a good idea. Self-confidence and external image are threatened by introducing a troubling awareness of the possibility of mistake and raising the need to consider a reversal of a position taken, which then undermines a person’s reputation for consistency (which is highly valued in corporate cultures). Cognitive-dissonance theory predicts that once a commitment is made, attitudes and beliefs will move to preserve consistency with the commitment. Management literature suggests that once executives have committed to a course of action, their subsequent review of information is strongly biased to support their commitment. This is compounded when the executive has publically announced their commitment. Scholars have pointed to the commitment bias as a primary reason for chronic overcapacity which is often observed in industry.

Self-serving beliefs

Certain forms of managerial beliefs may be in the self-interest of senior management rather than being in the company’s best interests (despite the outward impression of it being the company’s best interests). When there is enough uncertainty, people naturally view matters in their own self-interest (ie to permit maintenance of self-image, efficacy and control), which justifies (not only to themselves but also to others) keeping their positions and status. People will therefore self-delude and persuasively articulate the corporate interest consistently with their personal goals.

Group-think

Groups are motivated to preserve cohesiveness and the effectiveness of their decision-making norms, and this can result in underestimation of risk. If one member of the group suggests the group’s decision making has failed to recognise something, stress is introduced to the group and subconsciously each member is inclined to dismiss or rationalise the information, leading to less informed decision-making. Additionally, if one member privately questions a piece of information, and other members do not appear concerned, that member may be inclined to dismiss that information (which can be dangerous in the corporate context).

This behaviour is even more likely to present itself where there is a diffusion of responsibility between group members – because no one feels compelled to lead – and can justify silence. This phenomenon could present itself when a board that unconsciously deflects threatening information to preserve cohesion, then makes an inaccurate announcement to the market.

Although the presence of these biases is highly contextual, if these forces are not understood and properly managed, they can produce problems for companies. Corporate experience has shown that management will sometimes withhold information from the board and other gatekeepers or present misleading information in order to cover up its own mistakes. The situations of HiH and One.Tel are good illustrations of this.

Recommendations and remedies

Organisations can establish initiatives which will guard against the mischief created by organisational information flows, behavioural biases and also help to establish robust defences against legal liability.

Case example: Bay of Pigs Invasion

The United States Bay of Pigs Invasion is one of the primary political case studies used in explaining the theory "group-think".

The invasion plan was initiated by the Eisenhower administration, but when the Kennedy White House took over, the plan was uncritically accepted, even after the plan began to get leaked.

Kennedy’s ingroup was overly optimistic of the Central Intelligence Agency’s (CIA) plan. When some members of the Kennedy administration, such as Arthur Schlesinger Jr and Senator J William Fulbright, attempted to present their objections to the plan, other members ignored these objections and kept believing in the morality of their plan.

The administration began to judge Schlesinger because he questioned the policy. Eventually Schlesinger began to minimise his own doubts. The CIA made many assumptions, including the weakness of Castro’s army and the lack of effectiveness of Castro’s air force. Kennedy’s ingroup believed the CIA’s assumptions, and stereotyped Castro and the Cubans. Finally, the Bay of Pigs Invasion was marked with a huge reliance on consensual validation. Kennedy came into office trusting Eisenhower’s policy and continued to trust the CIA’s intelligence without question. The fiasco that ensued could have been prevented if the Administration had followed the remedies to preventing group-think.
One of these initiatives includes creating an effective internal audit function. Internal audit can assist in the risk management process, including where organisational goals are not being met, inaccurate financial reporting or management reporting and of course fraud against the company. If a risk is considered unacceptable, internal audit can put in place internal controls like independent checks, segregation of duties and safeguards over assets. For example, internal audit can be used to verify high risk projections and estimates in public disclosures to help create a third party intervention against organisational biases in an area susceptible to misstatements in public announcements.

Internal audit is an important function to provide and independently verify information to assist the board in monitoring management's performance. This means that directors (especially the non-executive directors) have a means by which they can receive an independent opinion on the seriousness and probability of risks occurring. Therefore, there is less risk that management will mislead the board in their reports and for example, underestimate or understate the risk.

Internal audit can also help to ensure that risks are adequately managed. If directors can receive verified reports from internal audit on how high risks are dealt with, directors can assess whether management has adequately implemented risk management controls and whether those controls have been effective.

We recommend that boards consider engaging persons who are not subject to the same biases in disclosure processes (eg depending on the type of information, management consultants, accountants and law firms) who can offer useful (but by no means fail-safe) therapeutic intervention. External consultants can add another perspective to the debate by interposing different schemas and beliefs. They can also assist by alerting individuals and directors (as a group) to matters.

**Case example: HIH**

The collapse of the HIH Insurance Group in 2001 has been valued at $5.3 billion, making it one of Australia’s largest corporate failures. When HIH was placed in liquidation, there were over 250 companies in a highly complex structure. The Royal Commission findings delivered by Owen J on the HIH collapse, provide a rare and detailed investigative report into this corporate implosion.

Although Owen J acknowledged that the HIH collapse was partially due to economic factors, he did, in part, attribute the group’s demise to a number of other factors including:

- suppression of negative information from the board’s attention
- not enough sceptical questioning and analysis by the directors
- lack of accountability for performance
- lack of integrity in the company’s internal processes and systems
- blind faith in the executive management team that was ill-equipped for the task
- failure to properly identify and manage risk, and
- insufficient ability and independence among the board.

Owen J’s findings indicate that there was a dysfunctional board, possibly with many of the biases discussed above impacting on board and senior manager performance, and insufficient awareness and safeguards to protect against the risks of this type of organisational behaviour. Additionally, without adequate and reliable information, the non-executive directors had no ability to effectively monitor management.

Inadequate and misleading information flowing to the directors, with non-executive directors unable to counteract the influence of senior management.

**Case example: One.Tel**

In the case of One.Tel, when the group financial controller warned that One.Tel would miss its profit target by $52 million, the finance director ordered a number of questionable accounting adjustments and failed to pass the warning onto any of the non-executive directors. In this case, ASIC asserted that the chairman breached his duty of care by failing to:

- require frequent checks of key financial indicators
- require ongoing internal review by an internal auditor of the accounting systems and financial information flow to the board
- require an effective finance and audit committee independent from the executive directors, and
- assess whether the information supplied was accurate, complete, reliable and timely.

In this case, the signs existed of information being withheld from the board, management acting in a self-interested manner and of executives acting without restraint. Similarly to HIH, One.Tel suffered from inadequate and misleading information flowing to the directors, with non-executive directors unable to counteract the influence of senior management.

In order for directors and other gatekeepers to adequately undertake their duties and roles, sufficient safeguards and awareness of the risks associated with human nature and business function need to be recognised and managed.
they cannot easily see (eg “group-think”, collusion, factional dissent).

It is important for boards to establish a culture where the “inquiring mind” is encouraged and board members have trust and respect for each other, while also offering an open constructive dissent. In order to create this type of culture, boards need to assess their current culture, decide on what culture they want and how they will go about getting that culture. Whether this has been achieved can then be assessed during a periodic board performance review. This will assist to make the whole board and individual directors accountable for their decisions and actions as well as becoming aware of the social dynamics of the group they operate within. The assessment of the board’s culture could be undertaken via a board self-assessment with an independent validation of the review by internal audit or internal audit could undertake an independent review. Having an independent review or independent validation of the review would assist the board in overcoming the behavioural matters they cannot easily see.

This takes the discussion back to the monitoring function of this gatekeeper, and how to enhance monitoring without interfering with the other roles of the gatekeepers. It is suggested that the main problem with the failure of boards of directors in their duty to monitor managerial conduct is in large part the result of potential flaws in individual and group decision-making, which are insufficiently addressed in the standard governance discussion. These are also largely ignored by the economist’s standard model of judgement and choice.

The passivity and silence of many boards during crucial decisions and presentations of company executives underscores the fundamental difference between traditional metrics of independence and competence, and the ability to critically assess (and oppose where necessary) the activities and judgements of senior management. It is this issue which needs to be resolved in an effort to turn directors into better gatekeepers, but it is one where the internal audit function has a key role to play as advocate for a clear and dispassionate view of the affairs of the company.

References


Australian Securities and Investments Commission v Healey (2011) 278 ALR 618.


Australian Securities and Investments Commission v Healey (2011) 278 ALR 618.


3. There have been some studies which have produced results supporting a correlation between adopting “best practice” corporate governance and successful companies. One such study reported that companies which adopted best practice measures showed share price increases of an average of 0.2%: see Rosenstein, S and Wyatt, J. Outside directors, board independence, and shareholder wealth. JFE 1990, 26(2):175–191. However, Lawrence, J and Stapledon, G (in their research report: Do directors add value (or destroy value).”


5. AWA Ltd v Daniels t/as Deloitte Haskins & Sells (1992) 7 ACSR 759.