Corporate governance: separation of powers and checks and balances in Israeli corporate law

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Introduction – civil governance and corporate governance

The governance of a corporation is a political issue, and thus political theories of governance are well suited to illuminate the complexity of ethical relations in this area. This is not to argue that only political theories can be used to illuminate matters of corporate governance, but it is to challenge the dominance of the standard approach to corporate governance, known as 'agency theory'. In this paper we appeal to civil governance as an analogy for corporate governance. Classical theories of government, as these have been developed within the liberal political tradition since the seventeenth century, are used as a central theoretical perspective for illuminating the ethical dimensions of corporate governance. Subsequently, in order to demonstrate the value of this theoretical perspective, we apply it to the New Israeli Corporate Law.

The idea is that if we view the corporation as a political body, then in order to protect the corporation, so that its government does not become corrupt and abuse its powers, the government of the corporation must be based on a clear separation of powers between the executive branch, the legislative branch and the judicial branch. By way of analogy, we look at management as the executive branch, the board of directors as the legislature branch (in the sense of policy making) and, possibly, the auditor, internal comptroller and supervisory committee as the judicial branch. The 'judicial function' is the bailiwick of a comptroller and a supervisory committee, whose duties would expand beyond the financial to general monitoring and oversight of corporate affairs, including issuing regular reports to inform the shareholders – not just the Board – of the state of the corporate commonwealth. Sovereignty, according to this model, essentially belongs to the shareholders who come together in the General Meeting. However, in order not to ignore other stakeholders, the company is by definition a public company in which minority shareholders and potential shareholders are guaranteed certain rights within the context of the General Meeting. Once this model is applied, we can go on to investigate how exactly the separation of powers is set within a corporation, and what kinds of checks and balances are established in order to ensure that corporate governance does not become corrupt.

Different corporations will operate differently, just as different democracies operate differently. But the main thing is to ask and act on these questions: Who is sovereign? Who makes policy? Who carries out policy? Who evaluates and monitors corporate actions?

Just as civic government exists for the well-being of society, corporate governance exists for the well being of the corporation. Government and society are two different entities; similarly an organization and its governing body are two separate entities. The governance of the organization exists for the well-being of the organization, just as the governance of society exists for the well-being of society. Hence, a government that seriously jeopardizes social interests is rightly challenged or changed. One should remember in this context that even Locke, one of the forefathers of liberalism, defined the right to resist tyranny as something very basic. Similarly, if the governing body of a corporation abuses its powers or neglects the interests of the corporation, then it too should be changed. In addition, however, one should not overlook the wider implications of corporate governance for society as a whole in the sense that a well governed corporation is presumably a corporation that will not ignore and will not detach itself from the broader interests associated with corporate social responsibility (CSR) and stakeholder issues. Although the well-being of the corporation in itself is the fundamental litmus test for corporate governance, a corporation that views its interests too narrowly will consequently undermine itself.

The doctrine of 'separation of powers', which was expounded by Montesquieu in the eleventh book of the *Spirit of Laws*, has become an axiom for most modern systems of government in the West. There are commonly held to be three functions of government: the legislative, the executive and the judicial. Montesquieu's significance in this respect is in making the separation of powers into a system of legal checks and balances (Sabine 1958: 559). The separation need not, however, be absolute. Locke, for example, who perceived the idea of separation of powers to be a crucial structural principle in limiting the powers of government,[1] does not go so far as to make the separation of powers an absolute condition. According to Locke, the different branches of government are different modes of action, but are not assigned to absolutely independent organs. The British parliamentary system, upon which he partially modelled his theory, was not, nor is it today, based upon a full separation of powers but rather on a fusion of powers in which the executive is part of the legislature. Sometimes the three functions of government are described as different powers; sometimes they are described as 'organs'; and sometimes they are described as different modes of action (Barker 1967: 257). These differences, however, are more a matter of rhetoric than substance. What is significant is that the mode of action of each one of these three branches differs. The legislature mode of action is deliberative in nature with its own techniques of deliberation and debate. The judicial mode of action has to do with procedures and is essentially a mode of action that is more critical than deliberative. The judicial branch critically examines modes of conduct, procedures and the application of legislation into action. Finally, the executive mode is concerned with providing effective instructions intended to carry out the results of legislation. In addition, there are two other important principles, which have come to be regarded as axiomatic in limiting the power of government. The first of these is the democratic principle itself, according to which the people periodically elect the legislature, and the second is the idea that sovereignty ultimately belongs to the people as a corporate body.[2]

Further developing this analogy, we ask what is the appropriate form of governance for a corporation. Is it something more similar to parliamentary democracy, where the executive is elected or approved by the legislature, or is it something more along the lines of a presidential system, where the sovereign elects the executive directly? Should the executive branch be composed of members of the legislature branch, as is often the case in many parliamentary systems, or should the executive be more independent and accountable directly to the sovereign as is often the case in presidential systems? In civil governance it is common to distinguish between these two basic models for establishing the separation of powers. Similar questions should be asked with respect to corporate governance. As we demonstrate, corporate governance, as formulated within the context of the Israeli corporate law, is more like a parliamentary system.

This model further enables us to articulate and examine the paradigmatic ethical issues in corporate governance. The idea is to use the analogy as a critical perspective in order to flesh out the means provided within corporate law in order to: [1] safeguard against the abuse of power; [2] ensure accountability, and [3] protect minority interests. For example, in order to safeguard against abuse of power by individuals who are in positions of power, standards of decent or fair governance require transparency, accountability, and efficiency. In addition, the separation of powers between the different branches of government, along with the various checks and balances, are aimed at providing a means for further protecting against the abuse of power by individuals in positions of power. Thus, the high paid executives who control the firm have a role distinct from that of the owners. The board of directors, i.e., the legislature, makes policy decisions and supervises over the activities of the executive branch, i.e. the general manager. The executive is supposed to be accountable to the board of directors, while the board of directors must be accountable to the sovereign, which in the liberal tradition has been identified as the people, and thus within the context of corporate governance is the shareholders and stakeholders who come together in the annual general meeting.

However, just as in liberal political theory, the notion of 'the people', (identified as sovereign) denotes more than merely the present existing citizens who have voting rights, sovereignty in a corporation belongs not just to the majority shareholders. In political governance 'the people' to whom sovereignty belongs includes various individuals such as, for example, future generations, various minorities, maybe foreigners, children, mentally challenged individuals, new immigrants, citizens who are temporarily living abroad, etc. Similarly, in matters of corporate governance the sovereign of a corporation is the General Meeting and even though only shareholders have voting rights, they have an obligation to take into account the broader interests within their corporation.

The relationship between the sovereign and the legislative branch has often been described as a relationship of trust, a fiduciary relationship. In civil governance, the people as sovereign have supreme power to alter the legislature when it acts contrary to the trust imposed on it. A similar provision should be established in corporate law to allow the General Meeting to call for replacement of the board of directors if it has abused the trust invested in it.

In political philosophy theories of the origin of civil government are important for understanding its role and purpose. Thus, for example, within social contract theory the sovereign is the people. Similarly, theories about the source and nature of a company have important bearings for understanding its function and purpose. In this context it is important to try and identify what kind of minority interests must be protected. How are potential shareholders, i.e., potential investors, protected? And how is the public, who is not a shareholder, protected from the activities of the corporation? It is important in this context to note that whereas in the context of civil government it is common for each citizen to be entitled to an equal vote and an equal share, in the context of corporate governance the members' influence on the corporation is dependent on the number of shares they hold.

The new Israeli corporate law

Moving from a more abstract discussion of the issue to a more concrete demonstration, we turn to the New Israeli Corporate Law. The Israeli Companies Law of 1999 (hereinafter 'the new law') came into effect on February 1, 2000, and replaced most parts of former Companies Ordinance, which was originally enacted in 1929, and has been amended many times (hereinafter 'the old law').[3] The new law has brought into effect a new conception of corporate governance. This new conception is based on a clear separation of powers and better-defined checks and balances.

Both laws divide the companies into two types: public companies and private companies. The distinction between private and public companies is important for understanding what the law perceives as a public company, i.e., a company

where the public has an explicit interest. The original old law of 1929 recognized only one type of company – 'a company formed and registered under this Ordinance or an existing company'. In 1936 the old law was amended by creation of two categories of companies: private and public. The law then defined 'Private companies' while all other companies were considered public companies. 'Private Company' was defined as a company which by its articles (a) restricts the right to transfer its shares, (b) limits the number of its members to fifty (not including persons who are in employment of the company and persons who, having been formerly in the employment of the company, were while in that employment, and have continued after the determination of that employment to be, members of the company), and (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.[4] The main concern of the amendment of 1936 was the governance of private companies and the exemptions such companies may get.

The new law focuses on the governance of public companies. It defines 'public companies' while all other companies are 'private companies'. 'Public company' is defined as 'a company, the shares of which are listed for trading on a stock exchange or which were offered to the public by prospectus and are held by the public'.[5] 'Public company' as defined by the new law, means, as a matter of contents and idea, a company that the public has interests in.

Balances: separation and division of powers between the company's organs

According to the new law, the company's organs are three: the General Meeting, the Board of Directors, and the General Manager. These are the organs whose actions and intentions are considered as actions and intentions of the company. The law specifies the powers as well the limits of each organ. However, the residual powers, the powers of the company that are not assigned to another organ, may be exercised by the board of directors.[6]

Similarly to how the people periodically elect the legislature, the General Meeting appoints the board of directors[7] and the board serves as the company's legislative branch. The general manager, the CEO (Chief Executive Officer), is appointed and can be also dismissed by the board of directors. Officers of a company, other than the directors and general manager, are appointed (and may be dismissed) in a public company by the general manager, and in a private company by the board of directors.[8]

The new law stipulates that in a public company, the general manager shall not serve as chairman of the board of directors, and the powers of the general manager shall not be vested in the chairman of the board of directors.[9] In this it maintains a sharp separation of powers. Nevertheless, a company may make provisions in its by-laws, according to which its General Meeting can assume powers assigned to another organ, and also that powers assigned to the general manager can be transferred to the board of directors, all for a specific matter or for a specific period of time. The board of directors may order the general manager how to act; if the general manager did not comply with the instructions, then the board of directors may exercise the necessary power to carry out the orders in his place. In case the board of directors is unable to exercise its powers, then – as long as it is unable to exercise its function – the General Meeting may exercise it. The same rule applies when the general manager is unable to exercise his powers, then the board of directors may exercise them in his place.[10] The new law further defines the separation of powers by not permitting the board of directors to assume powers assigned to the General Meeting, nor does it allow the general manager to assume powers assigned to the board of directors.[11]

In a public company, the general manager is not allowed to serve as chairman of the board of directors and the powers of the general manager cannot be vested in the chairman of the board of directors, except when the General Meeting decides that the chairman of the board of directors may be authorized for a period of not more than three years, starting the date on which the decision was adopted, to hold the position of the general

manager or to exercise his powers, on condition that the majority at the General Meeting included at least two thirds of the votes of shareholders who are not controlling members of the company and are present at the vote. Controlling members are those who hold at least half of the voting rights at the General Meeting or have the right to appoint directors.[12]

External directors

The by-laws of the company have to prescribe the number of directors. However, a public company must have at least two external directors.[13] As external directors may be appointed, only Israeli residents who have, directly or indirectly, no interest in the company, at the time of appointment or during the two years that preceded the appointment, may be appointed. According to the new law, external directors are officers of the company and thus bear responsibility for its actions.[14] The idea is that although the external directors have no explicit interest in the company, since it is a public company, everyone has an implicit interest in it and the external directors are responsible for representing the public interest and protecting existing and potential shareholders. The company is not allowed to appoint a person, who served as an external director, to the position of an officer in it, nor to employ him as an employee or accept professional services from him for fee, either directly or indirectly.[15] In our opinion, there should be a limit on the number of companies at which one person can serve as external director. We believe that if a person serves as an external director in more than three public companies simultaneously, his participation is inefficient, meaningless, and is merely lip service. There should also be an explicit duty to attend all or most meetings of the board of directors. The qualifications needed in order to able to act as external director should be specified and prescribed in the law, and any appointment of such an external director should get the approval of an independent committee consisting of members appointed by the ministries of Justice and Finance and by the Securities Authority. External directorship should not become a profession or vocation. The external directors are nominated in order to protect the interests of the public and not only of the company, hence the responsibility laid on the external directors is greater than that laid on an internal director.

Checks: auditor, internal comptroller and supervisory committee

In order to oversee the operation of the company and to check that it is not corrupt and that it is not abusing its powers, each company is required to have an auditor (certified accountant).[16] In addition, each public company is also obligated to have a supervisory committee[17] and an internal comptroller.[18] These function as the judicial branch in the government of the corporation.

A company is obliged to appoint an auditor, who shall audit the annual financial reports and express his opinion on them. The auditor shall be independent of the company, both directly and indirectly.[19] The auditor is appointed by the General Meeting, who also determines the terms of his employment. If the auditor resigns for reasons in which the company's shareholders may have an interest, then the board of directors shall make that known to the company, and inform the shareholders of the auditor's reasons, and it may also inform them of its stand on the matter.[20]

In addition to the auditor, the board of directors of each public company must appoint an internal comptroller. The internal comptroller has to examine whether the company's acts are correct in terms of obedience to the law and of orderly business practice.[21] Finally, the board of directors of a public company has to appoint also a supervisory committee from among its members. The number of members of the supervisory committee shall not be fewer than three, and all external directors shall be members of it. The main tasks of the supervisory committee are to find any defects in the business management of the company. This should be done in consultation with the company's internal comptroller or with the auditor, and to propose to the board of directors ways of correcting them.[22] In our

opinion, in order to remove any suspicion of prejudice, the members of the supervisory committee who are not external directors should not be from among the members of the board of directors, and should be accountable to the General Meeting.

The internal comptroller is obliged to submit an annual or periodic work program for approval by the board of directors or for approval by the supervisory committee. The chairman of the board of directors and the chairman of the supervisory committee may order the internal comptroller to conduct an internal audit – in addition to the work program – on matters where an urgent need for an examination arises. The internal comptroller shall submit a report of his findings to the chairman of the board of directors, to the general manager and to the chairman of the supervisory committee.[23]

The chairman of the board of directors or the general manager, as may be prescribed in the by-laws or as prescribed by the board of directors, in the absence of any provision in the by-laws, is the organizational superior of the internal comptroller.

An internal comptroller's term in office shall not be terminated without his concurrence, and he cannot be suspended from office, unless the board of directors so decided after it heard the position of the supervisory committee and after the internal comptroller has been given a reasonable opportunity to state his case.[24]

Powers vested in the General Meeting

As we have already suggested, the General Meeting is the 'sovereign' of the company. As a result, only the General Meeting may decide the following matters; changes in the by-laws, appointment of the company's auditor, the terms of employment and its termination, appointment of the directors, unless there is a different provision in the by-laws (but the appointment of the external directors should be done only by the General Meeting), exercise of the powers of the board of directors when the board of directors is unable to exercise its powers, approval of certain acts and transactions prescribed in the law, increase and reductions of the registered share capital, and merger.[25]

The General Meeting should get in the annual meeting a report presented by the board of directors on the state of the company's affairs and on its business results.[26] It is possible to add, in the by-laws, subjects on which the General Meeting should take decisions. However, the law forbids any derogation in the powers vested in the General Meeting or making those provisions conditional.[27]

A company should hold an Annual General Meeting every year and the board of directors may convene extraordinary meetings at its own decision. However, in order to protect minority rights, the board of directors is also obligated to convene such a meeting in a public company on the demand of either two directors or one fourth of the serving directors, or one or more shareholders who have at least 5% of the issued share capital and at least 1% of the voting rights in the company, or one or more shareholders who have at least 5% of the voting rights in the company. In case the board of directors does not convene the General Meeting in 21 days, then whoever demanded the meeting may convene the meeting by themselves, or apply to the court to order the board to convene it. All expenses incurred are to be covered by the company.[28]

Powers and responsibilities of the board of directors

The board of directors is the policy maker and the supervisor of the management. The board of directors is the organ whose task is to formulate the company's policy and to supervise the exercise of the general manager's office and acts. Its powers and responsibilities include the determination of the company's plans of activity as well as the principles for financing them and the order of priority among them. In addition, it includes the examination of the company's financial situation, the determination of the organizational structure and the wage policy, appointment and dismissing of the general manager; decision on distributing

dividends; issuing series of debentures. Finally, the board of directors must report to the Annual General Meeting about the state of the company's affairs and on its business results.[29] None of these powers and responsibilities of the board of directors can be delegated to the general manager.[30]

The board of directors may delegate some of its powers to subcommittees it may appoint.[31] However, there are some matters that the board of directors is not entitled to delegate to a committee, except in order to make recommendations. These matters include determination of the company's economic policy, distribution of dividends, appointment of directors, allocation of shares or securities convertible into shares or realizable as shares or of debentures, approval of financial reports, and approval of transactions that require board of directors' approval.[32] A company may prescribe additional subjects in its by-laws on which only the board of directors shall adopt decisions.[33]

Responsibility and powers of the general manager

The general manager, who is appointed by the board of directors, is responsible for the current operation of the company's affairs within the bounds of the policy determined by the board of directors and subject to its directions. The general manager is vested with all the powers of management and implementation, which are not vested in another organ of the company, and is subject to supervision by the board of directors. The general manager may, only with the board of directors' approval, delegate powers to other persons who report to him.

The general manager must inform the chairman of the board of directors of any extraordinary matter that is substantive for the company. The general manager has to submit reports to the board of directors on subjects, at times and to an extent, as the Board may prescribe, and submit also reports to the chairman of the board of directors, at any time, when he demands reports on any subject related to the company's affairs.[34]

Offer of securities to the public and the prospectus

A company must have shares and may also have debentures or other securities. Having securities and being traded in the stock exchange is what makes a company a public company. It is in this area of the company's activities that the public has the clearest and most explicit interest. The board of directors may issue shares and other securities up to the limit of the company's registered share capital; it may also decide to issue a series of debentures within the framework of its authority and to borrow in the company's name. However, the Securities Law of 1968, as amended, prohibits any offer of shares and other securities to the public other than under a prospectus, the publication of which has been permitted by the securities authority, which consists of thirteen members appointed by the minister of finance.[35]

A prospectus should contain every detail of importance to a reasonable investor considering the acquisition of securities offered therein, and should not contain any misleading item. The Securities Law and the regulations issued by its virtue prescribe the items to be included in the prospectus. The main ones are; detailed financial reports of the issuer, its subsidiaries and associates, financial reports, the rights attached to the securities offered and to the other securities of the issuer, the right of the issuer to issue the securities in the manner offered, description of the guarantee and encumbrances granted by the issuer, a statement by an attorney that all approvals as required by law in regard to the offer of securities to the public have been obtained, particulars of interested parties in the issuer and a description of agreements between interested parties and the issuer.[36]

The Securities Authority may require inclusion in the prospectus of any other matters if it is of the opinion that they are important to a reasonable investor contemplating the purchase of the offered securities. After the Authority has granted a permit to publish the prospectus, it may be published not later than seven days afterwards. The Authority may demand, even after permit has

been granted, publication of amendments if something material has been discovered or occurred during these seven days or later.[37]

Anybody who has signed the prospectus, including those who only provided an opinion, report, review or certificate included or mentioned in the prospectus, is liable to any person who has acquired securities from the offerer and to any person who has sold or acquired securities on or outside the stock exchange, for any damage caused by the fact that the prospectus contained a misleading item.[38]

By-laws as a contract

The new law stipulates that the by-laws of the company shall be treated like a contract between the company and its shareholders and between the shareholders themselves.[39] That means that the principles of the Israeli law of contracts apply to the relations between the shareholders and the company as well as between the shareholders themselves. The core of the Israeli law of contracts is honesty, bona fide performance and the fiduciary relations between the parties.

Obligation of loyalty

All officers of the company owe the company an obligation of loyalty, and should act in good faith and to its benefit. Loyalty in this matter includes refraining from any act that involves conflict of interests, competition with the company's business and exploiting a business opportunity of the company in order to obtain any personal benefit. Moreover, loyalty also includes the duty imposed on any officer to disclose to the company any information and to deliver to it any document that relates to its affairs, which came into his possession by virtue of his position in the company. The obligation of loyalty is owed also toward any other person, including the shareholders.[40] The enactments that apply to breach of contract apply to a breach of trust committed by an officer against the company. The company does not have the right to grant any of its officers exemption from responsibility for a breach of trust.[41]

Raising the curtain and officers' personal responsibility

The possibility of 'raising the curtain' is emphasized explicitly in the new law. It stipulates that coffering rights and obligations of the company on a shareholder in it, as well as coffering attributes, rights and obligations of a shareholder on the company constitute raising the curtain of incorporation. Furthermore, the court may raise the curtain of incorporation under any circumstances if the court finds it is just or correct to do so.[42] Furthermore, in case the court finds, during liquidation proceedings of a company, that any of the company's business was run with the intention of defrauding its creditors or for any fraudulent purposes, the court may declare that any officer who knowingly was party to the management of the business shall bear unlimited personal responsibility for all or part of the company's liabilities. Such an officer of the company is also liable to one year's imprisonment.[43]

Conclusion

As we can see, the new Israeli company law has adopted, in general terms, the democratic model and the principle of separation of powers for the governance of corporations, based on the view that a corporation is like a quasi-state, and thus should have a policy of checks and balances. The new law emphasizes the fiduciary relationship between the company and its members, as well as between the company's officers and the shareholders, and demands transparency toward the public, potential shareholders and investors. Properly structured corporate governance, with a well-defined scheme of checks and balances, cannot guarantee that corporations will act responsibly, but it is an important first step towards limiting corruption.

Notes

1. The logic behind this principle, says Locke, is that "it may be too great a temptation to human frailty

apt to grasp at Power for the same Persons who have the Powers of making the laws, to have also in their hands the Power to execute them'', in John Locke, *Two Treatise of Government,* ed. Peter Laslett (New American Library, New York, 1965) p. 410.

2. At least three different forms of spelling out the idea of sovereignty of the people are common: Among French thinkers this idea means sovereignty of the nation; sovereignty of public opinion in the Anglo-American context; and sovereignty of the electorate in a number of continental countries. See Barker, *op. cit.* p. 64.
3. The old law was revised in 1983 and is cited as Companies Ordinance [New Version], 1983. Some parts of it have not been replaced by the new law and are still in force.
4. Companies Ordinance [New Version], 1983, § 39.
5. Companies Law, 1999, § 1.
6. Ibid. §§ 46–48.
7. Ibid. § 59.
8. Ibid. §§ 92(a)(7), 250 and 251.
9. Ibid. § 95.
10. Ibid. §§ 50–52.
11. Ibid. § 92(b).
12. Ibid. § 121.
13. In some translations of the Companies Law (whose official language is Hebrew) the term ''Outside Directors'' is used. We prefer the term ''external director''.
14. Companies Law, 1999, § 1.
15. Ibid. § 240.
16. Ibid. § 154.
17. Ibid. § 114. Some translations use the traditional term ''audit committee'' having in mind the former constructions of the company's governance. The term supervisory committee is preferred because that committee's main task is to supervise the business management.
18. Ibid. § 146. Some translations use the term ''internal auditor'' for the internal comptroller. The term comptroller is preferred because the comptrollers need not be certified accountants. The comptroller's task is also to examine whether the company's acts are correct in terms of obedience to the law.
19. Ibid. §§ 154–160.
20. Ibid. §§ 57(3), 154–167.
21. Ibid. § 151.
22. Ibid. §§ 114–117.
23. Ibid. §§ 150–152.
24. Ibid. § 153.
25. Ibid. § 57.
26. Ibid. §§ 60 and 173.
27. Ibid. § 58.
28. Ibid. § 63.
29. Ibid. § 92(a).
30. Ibid. § 92(b).
31. Ibid. § 111.
32. Ibid. § 112(a).
33. Ibid. § 112(b).
34. Ibid. §§ 120–122.
35. Securities Law, 1968, § 15.
36. Ibid. § 17.
37. Ibid. § 23.
38. Ibid. §§ 31–32.
39. Companies Law, 1999, § 17.
40. Ibid. § 254.
41. Ibid. § 258.
42. Ibid. § 6. See also D.A. Frenkel *Associations Law in Israel* (Perlstein-Genosar, Tel-Aviv, 2000), pp. 67–68.
43. Companies Ordinance [New Version], 1983, §§ 373–377. See also Frenkel, *op. cit.*, at pp. 237–243.

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