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The Quinquennial System of Corporate Governance: An Update

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An editorial in the July 27 issue of The Economist ("ICI's pitch") essentially endorses the quinquennial proposal as the solution for both the institutional shareholders and the management of ICI to the problems they face as a result of the takeover threat posed by Hanson. The Economist recommends that ICI come forward with a five-year strategic plan to restructure its business and improve its performance, with ample management rewards for its achievement and with replacement of management if it fails. Noting that institutional shareholders are acutely aware of accusations that they are obsessed with short-term gains at the expense of industry, The Economist suggests that the institutions could prove their commitment to long-term performance by accepting the quinquennial test in lieu of a takeover bid.

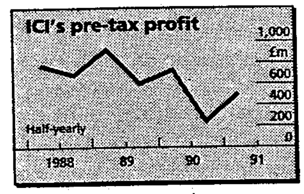
While the quinquennial proposal was not originally envisaged as a response to a specific takeover threat but rather as a complete replacement of hostile takeovers as a means of dealing with failed management or failed strategy, it works as well on an individual basis as on a universal basis. Perhaps successful experimentation on an individual basis will lead to recognition of the need to adopt it universally.

have shown their staying-power.

An independent Palestine that emerges chrysalis-like makes better negotiating sense than one that bursts into life fully fledged. Yet, even with safeguards, explosive issues are round every corner. Should Palestinians in the diaspora be allowed their own automatic law of return? Yes, if there is to be the hope of a solution to the turmoil in Jordan, Lebanon, Kuwait. No, if Israel is to be shielded from people who are still eager to claim Jaffa as their legitimate home. Should Jerusalem, revered by Jews and Arabs alike, be shared between the two states? Unthinkable that the city should be divided again, yet the Palestinians have a strong claim to more than their holy places. An exceptionally imaginative answer is required to an issue already threatening to blow things up.

Nobody should suppose that a solution to a problem 40-something years old can be easy or pain-free. A generation of Israelis has grown up almost unaware of a slimmer Israel. Yet young Israelis too want peace, and an end to the brutalisation of their country that a policy of permanent occupation seems to imply. The young, unlike their fathers, have the chance to become an integral, acknowledged part of the neighbourhood. Unusually in the Middle East, peace has a chance.

ICI's pitch



The threat from Hanson demands a bolder response than ICI is offering

IT REPRESENTS more than half a century of British industrial history. It boasts a handful of the world's most important inventions in chemicals, plastics and drugs. It is one of Britain's biggest manufacturers, one of its most international firms and, over the long run, one of the more successful. That is why the mere idea that Hanson might make a hostile bid for Imperial Chemical Industries has caused a mighty stir in boardrooms, plenums and pubs. Yet the response from ICI's board has been haughty: denigrating the bidder, while arguing that it should be left to get on with its own plans for reshaping the company. On July 25th it gave details of its modest restructuring ideas alongside its modest half-yearly results (see page 66). This will not—and should not—be enough to make shareholders immune to the temptations of a takeover.

There is more at issue in the battle for ICI than the pride of its chairman, Sir Denys Henderson, and his board. Although on May 14th Hanson merely revealed that it had bought 2.8% of ICI, the implicit threat of a takeover also offered a classic case of why such hostile bids are at once both regrettable and unavoidable. Regrettable because they are disruptive for managers, consigning long-term planning and investment to the shelf while battle is fought, often over months rather than weeks. During such a battle, only the firm's competitors can gain. But unavoidable because, in the absence of any other source of pressure, boards take their time over making necessary changes, leaning on their oars while another study is done and another year goes by.

Sir Denys's ICI is not a failure. For a start, its half-yearly results, announced at the trough of a British recession, are better than its performance in 1980-82 during Britain's previous recession. But that modest success reveals a firm that has much to be modest about. Its troubles in the early 1980s arose from being in many of the wrong businesses, in the wrong countries, and run by a cumbersome bureaucracy. It had arrived there after decades of passable drift. It responded in the right way—by shaking itself up—but for too short a time. Big, old bureaucracies hate change. They resist it, and once the shaking has stopped they "consolidate"—ie, they sit back. That is what happened at ICI during the past three or four years.

It was a missed opportunity, for when change is so hard to get going, the last thing a firm should do is to stop it prematurely. The pause left ICI still a bureaucratic place, and still with many of the classic weaknesses of the conglomerate. Each of its businesses, ranging from paints to pharmaceuticals, has its strengths, and there are undoubted synergies between them. But they also detract from one another, both because of the bureaucracy and because winners subsidise losers. The drugs business, which provides almost half ICI's profits, is typical: a good, successful firm that needs more attention than it gets inside ICI. This conglomerate, stripped down though it is compared with the 1970s, has resisted further stripping, to its own detriment.

A chance too good to miss

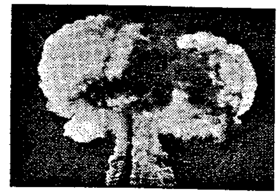
The arrival of Hanson, however, offers a fresh opportunity to get change started again. Even the staunchest of opponents of hostile bids admits that Hanson's attentions are likely to improve ICI, whatever the outcome, by concentrating directors' minds. It is also an opportunity for Sir Denys, because the cards are stacked in his favour. History and sentiment have put politicians and the press predominantly on ICI's side. Institutional investors, who own 75% of ICI's shares, are willing to sell but are acutely aware of accusations that they are obsessed with short-term gains, at Britain's industrial expense. Hanson, because of its complicated accounts and asset-dealing reputation, is viewed with admiration but some suspicion. What this means is that this battle is one for Sir Denys to lose, not for Hanson to win. So far, he looks like losing it.

The ICI board has made three serious mistakes. It let it be known that the firm has a break-up value of at least £16 billion ($26 billion), well above its current market value. Intended to show Hanson how costly a bid would be, this was a tacit admission that the board was failing to do its job. Second, it attacked Hanson with a series of small smears, winning publicity but losing ammunition and perhaps even some respect. The third mistake is the worst, however: it is missing the chance to strike a new deal with its shareholders.

The problem faced by any incumbent board during a takeover bid is that to propose big changes is to admit past failures. Given that the cards are stacked in ICI's favour, however, its board could afford to be both humble and brave—especially before a bid has actually been made. It could go to its shareholders and say, in effect, that Hanson has a point: ICI is not doing as well, and is not worth as much, as it could be.

It should offer a plan to change this, with both carrots and sticks attached. Carrots, to reward the management over the next five years if it meets its own, newly stiff, targets. Sticks, to accept that it should be replaced if it fails. With such a plan would come the impetus to force change lower down: to remove more bureaucracy, to cut out more jobs, to sell off old empires. If the plan were genuinely radical—which the board keeps promising, but has yet to deliver—shareholders would be hard-pressed to say no, unless Hanson offered an unusually high premium. But if it merely offered modest proposals to nudge ICI gently in a new direction, shareholders would have only one good option: sell.

It's broke, so fix it



The Nuclear Non-Proliferation Treaty is in urgent need of repair

THE failure to nail Iraq before the Gulf war, despite suspicions that it was building the bomb, was bad enough. The news that it had been trying, not one way, but three ways, two of which not even eagle-eyed America knew about, has knocked the stuffing out of the world's best-loved arms-control agreement, the Nuclear Non-Proliferation Treaty.

Unlike India, Pakistan and Israel, co-suspects among the gang of secret bomb-builders, Iraq had signed the NPT, promising not to acquire the wherewithal to build nuclear weapons. It had a safeguards agreement with the International Atomic Energy Agency, allowing regular checks that nuclear fuel for civilian reactors was not being put to military use. Were it not for Iraq's defeat and the revelations of an Iraqi defector, the IAEA would still be reporting nothing amiss. Now Iraq's bomb-making plants are to be destroyed. Where does that leave the NPT?

Don't tear it up, tighten it up

At present, inspectors can drop in only when and where governments say they can. The "special" inspections allowed for in the IAEA charter have never been used. The idea was to get as many countries as possible to sign up, in the hope of casting a cloud of disapproval over the would-be proliferators. Instead the treaty has cast a cloak of respectability over cheaters like Iraq (and probably North Korea). It's better than nothing, the argument used to run. But unless it is fixed, the NPT may be worse than nothing: if it is misleading about some countries, others will be tempted to cheat, or pull out.

Last year Mexico blocked agreement on new safeguards, because America and Britain would not agree to ban nuclear testing. Yet a test ban would not stop countries from building the bomb. The techniques are well known. Of the eight states thought secretly to have nuclear weapons or to be well on the way to having them, only three are suspected of having conducted a test. Iraq was not one of them. Time to set aside the testing row and try harder to stop the bomb-builders.

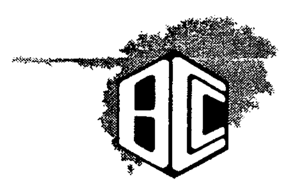
The first job is to tighten the IAEA safeguards. The inspectors found nothing amiss in Iraq, because their mandate was to look only at the civilian plants on Iraq's declared list. The bomb-making was going on elsewhere. Similarly, countries which have not signed the NPT, such as India, Pakistan, Argentina and Brazil, but which get help with bits of their civilian nuclear industry from NPT signatories, have never had to open their other reactors to inspection. Technologies have been bootlegged to places where the inspectors never set foot.

Since the Gulf war the IAEA inspectors in Iraq have been operating under special go-anywhere-see-anything instructions from the UN Security Council. In future all countries which have signed the NPT, or which want to do nuclear business with NPT states, should be obliged to open all their nuclear sites to inspection, including inspection at short notice of suspicious sites. Such checks are now a familiar feature of other arms-control agreements. Cheats and refuseniks should be named and sanctions applied.

Better policing is also needed for the trade in high-tech bits for nuclear weapons. Some of these have legitimate civilian uses. That makes the job more difficult. But because there are still only a few supplier countries, it ought to be possible to keep track of who sells what to whom, and why. Iraq's clandestine nuclear programme is a good enough reason to try.

Iraq's swipe at the NPT comes at a time when the superpowers are cutting their nuclear arsenals and when some notable refuseniks are thinking again. France has decided to sign up. China—the last objector among the big five nuclear powers—may do so. Even South Africa, a past nuclear miscreant, has joined. All very encouraging. And all the more reason to make the treaty they sign worth the paper it is written on.

The BCCI trail



As the affair spreads, so does the risk of muddle

JUST as the fraud at the Bank of Credit and Commerce and International was much larger than anyone realised until shortly before regulators closed the bank on July 5th, so the post mortem is ranging much wider than anyone would have imagined. Even to those in the know, BCCI looked like a fairly obscure third-world bank, dealing with shady types and in shady ways, perhaps, but hardly likely to shake the earth. Yet that is just what its collapse is doing. It has captured headlines in the politics of both Britain (was John Major, the prime minister, negligent when he first heard of BCCI's troubles?) and