SUBMISSIONS IN RESPECT OF THE GOVERNANCE INSTITUTE OF AUSTRALIA DISCUSSION PAPER, SHAREHOLDER PRIMACY AND SOCIETAL EXPECTATIONS: A NEED FOR CHANGE IN CORPORATIONS LAW?[1]

1. We welcome the Governance Institute of Australia's Discussion Paper, *Shareholder Primacy and Societal Expectations: A Need for Change in Corporations Law?* We agree that it is appropriate to take a break from time to time and consider whether corporate law is "fit for purpose".
2. We think the implicit representation that the self-interested behaviour of corporations (ie the drive for shareholder wealth maximisation)[2] is at the core of some of our society's more intractable problems is misguided. Thinking like that misconceives the role of the corporation. We do not accept that the standard corporate form is designed to be accountable to a wider group than its shareholders. Likewise, we do not accept the current state of the law constrains a broader view of what is in the best interests of the corporation. We support the outcome of two previous inquiries into this issue that there is no need for change.[3]
3. If there is a need for a permissive provision to give directors and officers more comfort that they can stray from shareholder wealth maximisation and the primacy of shareholders, then it ought to take no higher form than a replaceable rule. A rule that can, at their election, become part of the contract between the corporation and its shareholders.
4. The discussion paper poses four broad questions that we have sought to address in our submission:
   - Is there a view that there is no need for a change to the corporations law, as it currently allows directors to take account of the interests of stakeholders other than shareholders?
   - Is there a need for a change to the corporations law and should the equivalent of section 172 in the UK (permissive clause) be introduced to expand directors' duties so that they should have regard to the interests of stakeholders other than shareholders in promoting the best interests of the company?
   - Is there a need for a change to the corporations law and should an explicit clause be introduced to expand directors' duties so that they must take account of the interests of stakeholders other than shareholders?
   - Is there a role for the government to play in protecting the interests of stakeholders — not through amendment to the corporations law, but through other forms of social policy?
5. In each case we address the issue at both a philosophical and practical angle to ensure that "tinkering" does not interfere with the fabric of an institution that has been responsible for an overwhelmingly positive contribution to the lives of millions of people. An invention that has done more good for more people than effective public sanitation.[4] Since its invention in the mid-1800's the corporation has been a hugely successful means of aggregating capital. It is worth remembering that:

   Public companies built the railroads of the 19th century. They filled the world with cars and televisions and computers. They brought transparency to business life and opportunities to small investors. Because public companies sell shares to the unsophisticated, policymakers are right to regulate them

1 This submission is largely based on an article by the author and Saul Fridman published as a University of Sydney Legal Studies Research Paper. That article can be accessed here: http://ssrn.com/abstract=987960.

2 In *Dodge v Ford Motor Co.* 170 N.W. 668 (Mich 1919) the Michigan Supreme Court said: *A business corporation is organized and carried on primarily for the profit of the [shareholders]. The powers of the directors are to be employed for that end. The discretion of the directors is to be exercised in the choice of a means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits amongst [shareholders] in order to devote them to other purposes (at 684).* Cited in the Corporations and Markets Advisory Committee Discussion Paper Corporate social responsibility available at http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/$file/CSR_DP.pdf at pg 4.

3 Corporations and Markets Advisory Committee Report *Corporate social responsibility* http://www.camac.gov.au/camac/camac.nsf/byheadline/pdffinal+reports+2006/$file/csr_report.pdf and the Parliamentary Joint Committee on Corporations and Financial Services http://www.aph.gov.au/~/media/wopapub/senate/committee/corporations_ctte/completed_inquiries/2004_07/corporate_responsibility/report/report_pdf.ashx.

4 The crucial role that markets and companies can play in economic development has been ignored too often in the past, "Connecting China's poor to the businesses of the global economy reduced by at least half the number of people living in extreme poverty, less than $1.25 a day, and enabled the world to achieve the Millennium Development Goal ahead of time." "Alleviating poverty Good business How to design a company that really helps the poor" *The Economist* Oct 12th 2013.

> *more tightly than other forms of corporate organisation. But not so tightly that entrepreneurs start to dread the prospect of a public listing. The public company has long been the locomotive of capitalism. Governments should not derail it.*[5]

6. Today directors and officers face enough dilemmas attempting to reconcile long and short term interests (and the law obliges managers to consider the interests of future members as well as the future interests of current members),[6] or the interests of shareholders with creditors,[7] without internalising the interests of myriad other stakeholders. Including a permissive or mandatory consideration of non-shareholder interests is neither justifiable nor effective, even if one presumes the objective of the regulation to be defensible. The existing duties of managers, especially the overriding duty of managers to act in the best interests of the company, are sufficiently flexible to accommodate consideration of wider interests as long as the final decision is justifiable as being in the company's best interests.[8]
7. Directors can and should consider the long and short term interests of the corporation without undue fear that they might be unduly increasing their liability by doing so.
8. We suggest that if there is a need, then there is some advantage in providing a moderate level of protection for those that want to take the long view, managers who divert for some time from the pure wealth maximisation norm. This should be done through the import of a replaceable rule enabling consideration of other stakeholders which can be opted out of.
9. In Australia fundamental aspects of the management of the corporation are left to be determined by the corporate constitution. This characterises Australian corporations as being based fundamentally based on the notion of a contract between the corporators and the corporation itself.[9] At the other end of the spectrum is the view that a corporation represents a concession granted by the State (a matter that is essentially correct) and thus the corporation ought to be viewed as a "social enterprise" subject to wider public obligations is a view that we do not accept as correct.[10]

IS THERE A VIEW THAT THERE IS NO NEED FOR A CHANGE TO THE CORPORATIONS LAW, AS IT CURRENTLY ALLOWS DIRECTORS TO TAKE ACCOUNT OF THE INTERESTS OF STAKEHOLDERS OTHER THAN SHAREHOLDERS?

We do not believe that there is a need for a change to the corporations law. The current law permits directors to consider non-shareholder interests only where they believe that, in so doing, they are acting for the benefit of the corporation's shareholders as a whole. This is a rational and justifiable approach to regulation of managerial discretion. More importantly, it is a sensible and measurable standard that prevents abuse.

10. Certainly some say that the benefits of incorporation cannot be taken for granted. That view holds that

5 *The Economist* "Rival versions of capitalism The endangered public company The rise and fall of a great invention, and why it matters" May 19th 2012.
6 See *Darvall v North Sydney Brick and TileCo Ltd* (1987) 16 NSWLR 212 and *Provident International Corporation v International Leasing Corp Ltd* [1969] 1 NSWR 424 at 440.
7 Directors are obliged to consider the interests of creditors as cash flows decline: see *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722.
8 James McConvill "Directors' duties to stakeholders: A reform proposal based on three false assumptions" (2005) 18 *Australian Journal of Corporate Law* 88, see also - Ian Ramsay, 'Pushing the Limit for Directors', *The Australian Financial Review*, 5 April 2005, 63. This is also the view of the PJC, who refer to it as "enlightened self-interest". See PJC Report at p. 63.
9 This is in fact formalised by s 140 of the *Corporations Act 2001* (Cth).
10 A powerful argument in support of this proposition is found in J. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, (Oxford: Clarendon Press, 1993).

incorporation is a set of convenient arrangements from which everyone stands to benefit[11] but corporations can only operate while the community is prepared to sacrifice entrepreneurial accountability for the community's benefit. It may be that the corporation's effective survival depends on both corporations and their managers embracing social responsibilities that go beyond maximising shareholder wealth but we seriously doubt that is the position.[12]

11. In our view, the health of society is likely to be damaged if corporations are distracted from their primary roles of supplying goods and services which people want to buy and making money for their shareholders. Managers have enough trouble meeting those challenges without diverting them to saving the world. Although in most cases considerations like worker welfare, the environment and consumer interest are in the shareholder's long term interest, the interests of shareholders and non-shareholders are not always aligned.

12. Milton Friedman argued that managers should be viewed in effect as "stewards" of the shareholders' interests.[13] Thus ownership has its privileges, principal among them being an expectation that decisions will be made in the interests of owners primarily.

13. From the perspective of risk, owners are compensated for the greater risks they take by controlling (indirectly and subject to any contractual commitments made)[14] the business of the corporation.

14. Usually shareholders have no meaningful voice in corporate decision making, being entitled to vote on very few corporate actions.[15] Formal decision making power resides mainly in the board of directors.[16] Shareholders are thus protected by the requirement that managers act in the interests of the corporation. Without this protection providers of capital may well secure their interests in other forms. One ought to be able to presume that, above all else, the common objective of those participating in a company limited by shares is the pursuit of a common profit. Equally uncontroversial, at least until relatively recently, is the notion that it is for those managing the affairs of the company to determine what is in the best interests of the company itself.

15. Although it is sometimes said that managers should be obliged to consider the interests of employees, customers, contractors and the community when making decisions for the company, there is no case law or corporations legislation in Australia that imposes that obligation. As a general rule, neither American nor Anglo-Australian law

11 David Henderson, *Misguided virtue, false notions of corporate social responsibility* (London, 2001) available at http://www.nzbr.org.nz/documents/publications/publications-2001/misguided_virtue.pdf from Sir Geoffrey Owen *Corporate Social Responsibility: rethinking the role of corporations in a globalizing world* Madingley Hall, Cambridge, 3-11 October 2002 available at Geoffrey Owen "Companies, managers and society: the state of the debate" an introductory paper for Conference on Corporate Social Responsibility organised by The 21st Century Fund, Madingley Hall, Cambridge, October 3-11 available at http://www.lse.ac.uk/collections/IIM/pdf/csr.pdf.

12 Certainly corporations, both statutory authorities as well as public companies, have featured in an increasing number of public infrastructure projects by way of "public-private partnerships" or "private financing initiatives". As we argue later in this paper, on one view this trend, especially if it were to include a statutory obligation on corporate management to obey the "spirit" of law (by accommodating stakeholders including "the community at large") amounts to outsourcing government. The CAMAC Discussion Paper refers to this argument at p 69 in its review of the American "constituency statutes": "Other critics of these statutes have argued that they would convert directors into 'unelected civil servants' with a responsibility for determining the public interest." The CAMAC Discussion Paper cites J. Macey, "An economic analysis of the various rationales for making shareholders the exclusive beneficiaries of corporate fiduciary duties" (1991) 21 *Stetson Law Review* 23 and S. Bainbridge, "Interpreting Nonshareholder Constituency Statutes" (1992) *Pepperdine Law Review* 971.

13 This expression is used by Stephen M. Bainbridge "In Defense of the Shareholder Wealth Maximization Norm" *Washington & Lee Law Review*, Vol. 50, 1993 at p 1427 available at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID303780_code020320630.pdf?abstractid=303780.

14 See *Thorby v Goldberg* (1964) 112 CLR 597. Note that this is frequently, through the use of negative pledges and other devices, how creditors are able to bargain for indirect control of the corporation.

15 Shareholders have very little direct control over the decisions of management that are made in the 'best interests of the company'. Eg *NRMA v Parker* (1986) 4 ACLC 609: *It is no part of the function of the members of a company in general meeting by resolution, ie as a formal act of the company, to express an opinion as to how a power vested by the constitution of the company in some other body or person ought to be exercised by that other body or person. ....The members ...no doubt have a legitimate interest in how these powers are exercised, but in their organic capacity in general meeting they have no part to play in the actual exercise of the powers.*

16 Stephen M. Bainbridge "In Defense of the Shareholder Wealth Maximization Norm" *Washington & Lee Law Review*, Vol. 50, 1993 at p 1442 available at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID303780_code020320630.pdf?abstractid=303780.

requires managers to account for the interests of non-shareholders.[17] However, it is our view that the present law is effectively neutral on the question of stakeholder interests, so long as they are consistent with the interests of the corporation.

16. The purpose of a corporation is to deliver shareholder value using a voluntary form of association; each shareholder provides management with their capital in the belief that management will apply their skills to add to the value of the investment. For most companies, the fulfilment of that purpose is a long term continuing activity. The profits they declare this quarter often come from investments made many years ago and future profits will depend upon the investments made today. This means that management has a direct interest in the health and success of the communities in which their corporations work and society as a whole. Corporations can't thrive in a society that is collapsing.[18]

17. Directors and officers must act with care and diligence[19] in good faith in the best interests of the company as a whole and for a proper purpose.[20] The members of the company are generally considered to be the company as a whole.[21] The phrase "the company as a whole" does not mean "the company as a commercial entity, distinct from the corporators,"[22] nor the individual members of the company.[23]

18. In order to discharge their duties to act in the interests of the company as a whole, managers are required to consider the interests of: existing members (who have the most immediate financial holding in a solvent company); the company as a commercial enterprise (as opposed to the interests of individual members); creditors of the company (in certain circumstances),[24] and beneficiaries (if the company is a trustee or responsible entity or similar).

19. Managers might also be entitled to consider other stakeholders' interests if this furthers the interests of the company as a whole. However, occasionally management faces situations where it is impossible to advance both shareholders and wider interests.

20. This was the view of the PJC; a view it labelled as that of "enlightened self interest". An oft-quoted example of this view in action is found in the judgement of Berger J in *Teck Corporation v Millar*:[25]

> *The classical theory is that a director's duty is to the company. The company's shareholders are the company and therefore no interests outside of those of the shareholders can be considered by the directors…[But] a classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the*

17 An exception to this general rule is the obligation to consider the interests of creditors as the corporation approaches insolvency. We are, incidentally, of the view that this obligation is neither justifiable nor warranted. For further discussion of the policy issues surrounding the imposition of this duty see: S. Bainbridge, "Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency", UCLA School of Law, Law & Economics Research Paper Series, Research Paper No. 05-26 available at http://ssrn.com/abstract=832504.

18 Sir John Browne, Group Chief Executive, BP "Governance and Responsibility - the relationship between companies and NGOs. A Progress Report." Arthur Anderson Lecture at The Judge Institute of Management Studies, Cambridge University 29th March 2001 available at http://www.bp.com/centres/press/s_detail.asp?id=107. Nor, it would seem, can a society thrive without the freedom of association crucial to the success of the corporation as witness the complete economic collapse of the iron curtain economies after 45 years of containment.

19 *Corporations Act* s 180.

20 *Corporations Act* s 181.

21 The *Corporations Act* protects the interests of members by granting members standing to apply for Court ordered remedies in situations where directors conduct the affairs of the company in a manner that is 'contrary to the interests of the members as a whole': sections 232 to 234. Additionally there are the injunctive provisions of section 1324 granting rights to a person whose interests are affected, discussed later in this paper.

22 *Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438.

23 *Percival v Wright* [1902] 2 Ch 421.

24 *Walker v Wimborne* (1976) 137 CLR 1 finding that in the case of near insolvency giving priority to the interests of creditors over shareholders is part of the fiduciary duty to the corporation as a whole.

25 (1973) 33 DLR (3d) 288 at page 299. This passage was also reproduced in the CAMAC Discussion Paper at page 52.

> *company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were reflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders.*
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> *I appreciate that it would be a breach of their duty for directors to disregard entirely the interests of the company's shareholders in order to confer a benefit on its employees: Parke v Daily News [1962] 1 Ch 927. But if they observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.*

21. The Delaware Chancery Court[26] has separately stated that:

> *Fiduciaries who act faithfully and honestly on behalf of those whose interests they represent are indeed granted wide latitude in their efforts to maximise shareholders' investment.*

22. In recent years, recognition of a wider class of "stakeholders" has led to increasing judicial and legislative imposition of internal management controls such as:
    - statutory increases to the strength and scope of the fiduciary law;[27]
    - judicial recognition of creditors' interests;[28] and
    - widening rules for standing in cases of breaches of the *Corporations Act*.[29]

23. It is conceivable that a court could find that to properly discharge their duties to act in the interests of the corporation the management may need to act in the interests of persons other than the members. The distinction in these situations is that the duty is to consider the corporations' commercial interests, rather than the members' commercial interests. However, if the constitution of a corporation defines the interests of the corporation in a way that would affect the directors' duty, then the way for managers is much clearer.[30] An example would be the constitution of a charitable company requiring profits be devoted to charitable purposes rather than be distributed among members,

24. At present, should corporators have some purpose other than shareholder wealth maximisation, there is ample opportunity to make it clear, either by utilising a form of association appropriate for non-profits or by adding appropriate provisions to the corporate constitution. Indeed, there are many companies limited by guarantee that operate as not-for-profit corporations.

25. One can take the view that, broadly speaking, government facilitates philanthropic activity through a combination of tax incentives as well as provision of suitable legal frameworks for associative activity of this nature (such as the company limited by guarantee). Indeed, there is much to commend the view that where individuals wish to associate for activity that is in the interests of others, they ought to do so by means of the various forms available to not-for-profit organisations. One ought to therefore assume that, unless there is evidence to the contrary, those forming companies limited by shares are doing so in the expectation of profit.

26. The Melbourne law school published research earlier this year following an analysis of the business objectives

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26 Jennifer Bayot "US court upholds Ovitz payout" *The Financial Review - The New York Times, Bloomberg* citing *Ovitz v Disney* 9 August 2005.

27 This is plainly visible in the extension of statutory duties akin to fiduciary to employees (s. 182 and 183) as well as the designation of key directors' duties provisions as "civil penalty provisions" (s. 1317E) thereby adding the prospect of administrative enforcement to the range of possible consequences of breach.

28 See *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722.

29 *Corporations Act* s 1324.

30 *Whitehouse v Carlton Hotel Pty Ltd* (1987) 11 ACLR 715 holding that the constitution may be so framed that they expressly or impliedly authorise the exercise of the power of allotment of unissued shares for what would otherwise be a vitiating purpose at 719.

of the top 100 ASX-listed companies by market capitalisation. The study reports that 63 had business objectives that could be interpreted to mean they prioritised interests of shareholders and 26 of these also explicitly take into account the interests of other stakeholders. The report also indicated that 32 of the companies had objectives that indicated they prioritised the interests of a specified list of stakeholders.[31]

27. It is this permissive model that provides an answer to the question posed by managers: how am I certain I have satisfied my duties if I prefer the long term interests of the company to the short term interests of members?

28. As agents (in a non-legal sense) of the shareholders and the providers of capital, management should consider the interests of shareholders. However, managers can not know if shareholders want them to have a short term view or if they would prefer a long term approach. Australian corporate law grants directors a wide range of protection from liability for decisions that sacrifice shareholders' immediate financial interests while serving the interests of other corporate interests,[32] embodied primarily in the business judgement rule.[33]

29. Managers must deal with and make their decisions in an environment characterised by highly liquid capital markets and widely dispersed share ownership. They are vulnerable to hostile takeover bids and institutional investors demanding regular and substantial improvements in share price. In these circumstances is it surprising or wrong for managers to adopt a narrow understanding of 'shareholder value'?[34] After all this is what a powerful majority of their shareholders want.

30. Clearly, there is considerable support for the idea that managers do not need to prefer the short-term interests of present shareholders. If that were not the case then every dollar available for dividend should be paid out and there would be no justification for attempting to reinvest funds or expand the corporation's market by price cutting.[35]

31. A typical example of such balancing is the *Teck* case where the corporation was the target of a takeover bid which promised favourable terms for shareholders who wished to sell and the directors had in mind transactions which could in the long-term bring greater benefits to shareholders than they would receive by acceptance of the offers.[36]

32. In such circumstances establishing a takeover defence may be in the interests of the corporation as a whole, but not in the interests of the current shareholders who are 'denied' the opportunity to exit their investment at the best possible price. Generally speaking Australian courts have upheld 'frustrating conduct' where the intention was not designed to entrench management or to otherwise act in bad faith.[37]

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31 Reegan Grayson Morison and Ian Ramsay "An Analysis of Companies' Business Objectives" (2014) 32 *Company and Securities Law Journal* 438, 447. http://www.law.unimelb.edu.au/files/dmfile/Analysisofcompaniesbusinessobjectives-forSSRNCSLJ20142.pdf.

32 At equity courts have for many years dealt with an analogous problem of trustees needing to balance the interests of income (present) versus capital (future) beneficiaries. *Cowan v Scargill* [1984] 2 All ER 750 discussed above where the House of Lords held that the trustees had an overriding duty to invest with the primary objective of increasing the fund's value for the beneficiaries, despite their personal views or moral reservations on the choice of the most suitable investments.

33 *Corporations Act* s 180(2).

34 *Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and Labour Law* Richard Mitchell, Anthony O'Donnell, Ian Ramsay Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law The University of Melbourne 2005.

35 *Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and Labour Law* Richard Mitchell, Anthony O'Donnell, Ian Ramsay Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law The University of Melbourne 2005 citing 'Directors' Duties and the Company's Interests' in PD Finn (ed), Equity and Commercial Relationships, Law Book Co, Sydney, 1987, p 135.

36 *Darvall v North Sydney Brick and Tile Co Ltd* (1987) 12 ACLR 537 affirmed (1989) 15 ACLR 230, *Pine Vale Investments Ltd v McDonnell and East Ltd* (1983) 8 ACLR 199; *Winthrop Investments Ltd v Winns Ltd* (1979) 4 ACLR 1 and *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.

37 Similar provisions would also govern the rules in the USA *In Re Toys "R" Us, Inc.*, Cons. C.A. No. 1212—N Court Of Chancery Of Delaware, New Castle 2005 Del. Ch. LEXIS 90, June 17, 2005, Submitted June 22, 2005, Decided. In *Whitehouse v Carlton Hotel Pty Limited* (1987) 11 ACLR 715 the High Court ruled that an overall 'honest motive' would not save an act done for an 'improper purpose'. Nonetheless, the New South Wales Court of Appeal, in *Darvall v North Sydney Brick and Tile Co Ltd* (1989) 15 ACLR 230 found that the presence of an allegedly improper purpose (to defeat a hostile takeover bid) did not invalidate a decision of the directors of the target company to issue shares as part of a commercial venture. In Australia courts have found difficulties examining directors' purposes in entering into transactions which defeat takeover offers, particularly where there are multiple purposes. The current somewhat unsatisfactory state of the law is unlikely to be settled in the context of the Takeovers Panel who has its own policies on frustrating actions.

33. Attending to non-shareholder interests can increase shareholder wealth through improved corporate business performance and competitiveness and shareholders' long term interests can be served by decisions such as corporate philanthropy even though they seem harmful in the short term.

34. The success of a corporation depends upon the organisation's ability to most effectively use capital, labour and natural resources to produce goods and services. That in turn, depends upon "workers who are educated, safe, healthy, decently housed and motivated"[38] and who operate in an environment with less waste, lower pollution levels and free from the outrage of the community about corporate 'misconduct'. This much is common sense. It is generally in one's best interest to respect others, deal fairly and respect one's environment. Nonetheless, individuals act otherwise, as do corporations. In either case external enforcement addressed to specific community expectations is required.

35. Good corporate citizenship is good business practice. But that is not a complete answer since it will not help managers assess how they should act in all situations. Managers routinely assert that a more directive and supportive statement is required.[39]

36. As discussed above the current law permits directors to consider non-shareholder interests only where they believe that, in so doing, they are acting for the benefit of the corporation's shareholders as a whole. This is a rational and justifiable approach to regulation of managerial discretion. That is not to say that the law, generally speaking, does not allow (in some cases it even requires) managers to consider non-shareholders. The law expects that managers will deal with non-shareholders in the following ways:

    - **Creditors:** managers should consider the position of creditors as the corporation approaches insolvency. This duty is not ordinarily enforceable at the suit of creditors. However, as this duty is encapsulated by s 181(1)(a) of the *Corporations Act,* presumably a creditor (as a person "with an interest" in the corporation's affairs) would be able to enforce this duty through the procedure set out in s 1324 of the *Corporations Act*. In addition, managers may be required to compensate creditors (as well as face potential civil penalties) if they are in breach of s588G of the *Corporations Act* for "trading while insolvent";
    - **Employees:** managers may consider the interests of employees where they are consistent with the interests of the corporation. Managers are also accountable for the effects of transactions designed to reduce payment of employee entitlements;
    - **Consumers:** where it benefits the corporation, the management may consider the impact of a determination on consumers. Beyond that, Commonwealth and state law deals with consumer protection directly;
    - **The environment:** there are clearly circumstances where consideration of environmental impact is entirely in the interests of the corporation and its shareholders. Beyond this, the Commonwealth and state governments have enacted voluminous legislation of a specific nature for the purpose of environmental protection. This legislation also establishes a bureaucracy dedicated and trained to enforce these provisions; and
    - **The community at large:** it is ordinarily in the interests of a corporation to comply with the law.

38 Michael E. Porter and Mark R. Kramer "The Competitive Advantage of Corporate Philanthropy" *Harvard Business Review*, December 2002 57 at pg 59 available at http://harvardbusinessonline.hbsp.harvard.edu/b01/en/common/item_detail.jhtml;jsessionid=BZGGGU0FVUUOUCTEQENB5VQKMSARWIPS?id=R0212D&referral=7711%20&_requestid=68.

39 Indeed, the PJC Report is riddled with references to submissions of this kind received from directors and those lobbying on their behalf: see PJC Report, pp. 47-59. It is worth noting that, after referring to a number of submissions indicating that boards already do take into account non-shareholder interests, the committee chose not to endorse a prescriptive approach on the basis that it would "*introduce great uncertainty into the legal expression of directors' duties.*" (at pg 55).

SHOULD CORPORATIONS LAW BE AMENDED TO INCLUDE A PERMISSIVE OR MANDATORY CONSIDERATION OF NON-SHAREHOLDER INTERESTS?

The existing scope of directors duties is broad enough and a permissive clause may actually lead to abuse.

37. Is it appropriate to use the general corporate law obligations of managers as a device to achieve wider regulatory goals? The community allows the corporation to exist and government will react to community expectations, but simply to introduce a comparative provision to section 172 of the *Companies Act 2006* (UK) would be counterproductive.

38. Individuals are also engaged in the pursuit of self-interest but are not subject to any general legal obligation to "act in the interests of society". Why is the corporate person so different to the natural person that we need develop particular means of regulating it, such as imposing an enforceable internal moral code of sorts? Should the corporation be morally and legally obliged to consider the society in which it operates and conduct itself with a view to serving those interests (regardless of any potential benefit to itself)?

39. Presumably, in order to have any impact, such an obligation must be enforced. Who, one might ask, is best suited to enforce an obligation to act in the interests of the community at large? Which agency or agencies should be able to prosecute breaches, or should, as with shareholders, stakeholders be given the ability to enforce the obligation by means of legal action?[40]

40. One can readily see that imposition of fiduciary-style duties to consider interests of non-shareholders creates a situation where that duty becomes enforceable at large. Put another way, such a duty imposes upon directors a regime of accountability to a limitless range of potential corporate masters. This is unsustainable[41] and makes a mockery of the concept of the private association to provide means for private interference.

41. We cannot assume that the current slight use of section 1324 will continue if the ability to seek remedy is extended exponentially.[42] The alternative is, as is the case presently, to leave the enforcement of these duties to ASIC and members.[43] What use is a vague duty when no one has an incentive to enforce it?

42. Such an obligation will have a negative impact on shareholder investment, as described by Bainbridge:

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40 Whilst s. 1324 of the *Corporations Act* already empowers those "whose interests have been, are or would be affected" to seek relief, the courts have indicated that to have standing under s 1324, the applicant must have an interest more than merely as an ordinary member of the public: see *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 23 ACSR 715.

41 See further S. Bainbridge, "In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green" (1993) 50 *Washington and Lee L J* 1423. Bainbridge calls this the "two masters" problem and asserts that ultimately such rules effect a transfer of wealth from shareholders to non-shareholders. Directors required to consider all interests are almost by definition placed in a position of conflicting responsibilities...with no effective means of attempting to reconcile them in order to proceed with comfort.

42 R. Baxt, "Directors' Duty of Care and the New Business Judgment Rule in the 21st Century Environment", Seminar Paper, Seminar on Key Developments in Corporate Law & Equity, Melbourne, March 2001. *Re Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 39 NSWLR 128 may be authority for the proposition that s1324 is not available in respect of breaches of the civil penalty provisions of the *Corporations Act*. However, like R Baxt ("A Body Blow to Section 1324 of the Corporations Law Will the Derivative Action Get a New Lease of Life?" (1996) 14 CSLJ 312), we agree that "*Young J is not correct in his interpretation of the question of standing. In the first place the section uses the words "any person" [s 1324 (2)]. It would seem strange to me that the legislature would want to narrow that particular language down, at a time when standing is being given wider and wider interpretation by the courts in all sorts of areas*" (at 314) cited in S Fridman "Corporations Law in the courts and the academy: a dangerous malaise?" *Butterworths Corporation Law* Bulletin No 23 December 1996. See also *Australian Securities and Investments Commission v Mauer-Swisse Securities Ltd* (2002) 42 ACSR 605:

> ...in an application for a permanent injunction under CA s 1324(1) the court is entitled to take into account discretionary considerations which are quite foreign to the traditional principles upon which a court of equity acts in granting injunctions. On the other hand, there are authorities to the effect that in an application for an interim injunction under s 1324(4) the court should approach the matter as if it were simply exercising its ordinary equitable jurisdiction.

43 To be sure, s 1324 of the *Corporations Act* does provide standing to a wide range of potential stakeholders. Nonetheless, there are surprisingly few examples in the case law of wide ranging use of this provision. As discussed above, the courts have indicated that to have standing under s 1324, the applicant must have an interest more than merely as an ordinary member of the public: see *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 23 ACSR 715.

> *...would most investors be willing to invest their retirement savings in corporate stock if [t]his approach became law? If not, why not? Probably because most investors do not regard their investment in corporate stock as a charitable donation made to benefit non-shareholder constituencies. Their investment in corporate stock must bring them a rate of return commensurate with the risks they are taking. If it does not, they will divest stock in favour of other investments or, at least, monitor management more closely. In either case, the cost of equity capital will rise. Ironically, [this] approach thus will ultimately redound to the detriment of non-shareholder constituencies, because the firms with the greatest need for infusions of equity capital are the very same small and medium size firms that produce most of our economic growth.*[44]

43. One advantage of the wealth maximisation norm and shareholder primacy is that it is much easier for shareholders (and ultimately the courts) to assess whether managers have been complying with their duties. If the law were to include specific corporate social responsibility obligations would that not make management less accountable?[45]

44. Proposals to redefine the statutory duties of managers are at best an ineffective and inappropriate reaction to hyperbolic claims of corporate excess.

DOES THE GOVERNMENT HAVE A ROLE IN PROTECTING THE INTERESTS OF STAKEHOLDERS THROUGH NON-CORPORATIONS LAW METHODS?

There is no material evidence to suggest a need for the government to protect the interests of stakeholders through new mechanisms that are corporate in nature.

45. Corporate managers are already exposed to a significant amount of both internal and external regulation. Internal regulation of managers is designed to affect decision-making per se rather than attributing responsibility for the results of those decisions.[46]

46. To some extent our legal system already makes accommodation for the corporate person in ways that include:

- criminalising corporate conduct itself;[47]
- creating and applying concepts of vicarious liability at both common law and under statute;[48]
- developing wider tests of culpability to suit corporate defendants;[49]
- criminalising conduct of corporate managers directly;[50] and
- rendering managers civilly liable for corporate failures.[51]

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44 S. Bainbridge, "In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green" (1993) 50 *Washington and Lee L J* 1423 at 1423.

45 Ian Ramsay "Reform rush would be unwise" *Financial Review* 10 February 2005.

46 The question of responsibility for corporate decisions is itself a complex one. We note that our law already exposes shareholders to liability beyond their contribution to capital in cases where a corporation is acting as agent of its shareholders. In addition, numerous statutes (see above) impose personal liability on managers for corporate fault. Beyond this, some have argued that good corporate responsibility demands removal or reduction of the benefit of limited liability in cases of corporate torts. See J. Parkinson, *Corporate Power and Responsibility* , p 362. See also H. Hansmann and R. Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts", (1991) 91 *Columbia LR* 1565.

47 The most obvious examples are the Trade Practices Act 1974 (Cth), Part IV and the *Protection of the Environment Operations Act* 1997 (NSW), in particular Chapter 5.

48 The law in this area is well summarised in R.P. Austin and I.M. Ramsay, *Ford's Principles of Corporations Law* (12th edition, 2005) at p 810-827.

49 See for example The Criminal Code Act 1995 (Cth) s 12.3(2)(c). See also J. Hill, "Corporate Criminal Liability: An Evolving Corporate Governance Technique" in Low Chee Keong, *Corporate Governance: An Asia-Pacific Critique*, (Hong Kong: Sweet & Maxwell Asia, 2003) at pp 519-565.

50 See for example, *Protection of the Environment Operations Act, 1997 (NSW), s. 119., Environment Protection and Biodiversity Conservation Act, 1999 (Cth), Division 19, s 493, 494, Civil Aviation Act*, 1988 (Cth), s 28BE.

51 *The Corporations Act* already contains a number of powerful provisions to this effect. See particularly, s 588G and 596AC. Individual or intercorporate liability may follow from being found to have been "involved in" a contravention of the Act: s 79.

47. Laws on conditions of labour, consumer protection and environmental protection apply as much to companies as individuals. Managers who have to make decisions for corporations can be in breach of their duty to the corporation if their decisions put the corporation in breach of any such law as well as attracting specific liability that might pierce the corporate veil and attach to them personally.[52]

48. Corporate law is not the appropriate mechanism to use for purposes of general community regulation. Imposing an expectation that corporations act for the benefit of the community amounts in many ways to outsourcing functions of government, particularly given the size and reach of many of the larger public companies. It is the role of the legislative and judicial branches of government to determine entitlements and how best to protect them. To expect this of corporate management is both unfair and unwise. Further, to expect such an obligation to be enforced by the corporate regulator is unlikely to deliver the outcome sought.

49. Interestingly enough, the corporation still serves an important function in supplementing the role of the state. Large social projects still continue to be funded by the state but carried out by corporations more capable of accepting the attendant risks.

50. Far from needing to intervene in management discretion in order to protect "stakeholders", a government's proper role is to preserve the efficiency of the corporate form by protecting the ability of the corporators to pursue their collective self interest.[53]

51. Governments have and will be asked to respond to a perceived default by business in addressing social needs, or assisting the community to adapt to inevitable economic, technological and social change which might restrict their competitive advantage.[54]

52. The appropriate protector of the "wider interest" is, of course, the government. This is ordinarily achieved through problem-specific legislation, for which the government is ultimately politically accountable. Corporations are responsible for promoting a vibrant business sector; it is for public authorities to look after equity and social policy.[55]

52 Including in the case of the Commonwealth the following, *Customs Act 1901, Environment Protection and Biodiversity Conservation Act 1999, Foreign Acquisitions and Takeovers Act 1975, Hazardous Waste (Regulation of Exports and Imports) Act 1989, Insurance Act 1973, Insurance Contracts Act 1984, Shipping Registration Act 1981 and the Trade Practices Act 1974.*

53 Perhaps the best and most thorough presentation of this argument is found in B. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: Clarendon Press, 1997) at pp. 126-157. Thus, Cheffins argues, corporate law should focus in protecting shareholder rights to participate in company meetings, ensure full and timely disclosure of material information, (thus dealing with the problem of imperfect information). Cheffins also points out the justification for broader regulatory activity in order to deal with problems of "negative externalities", such as environmental degradation.

54 Geoffrey Owen "Companies, managers and society: the state of the debate" an introductory paper for Conference on Corporate Social Responsibility organised by The 21st Century Fund, Madingley Hall, Cambridge, October 3-11 available at http://www.lse.ac.uk/collections/IIM/pdf/csr.pdf. In the James Hardie matter discussed above there have been suggestions for general powers to be granted that allow people like victims to be able to pierce the corporate veil and reach out to the parent company and to seek "proper redress".

55 Of course there are some utility and telecommunications corporations where the boundary between social policy and business are always blurry.

SELF-REGULATION THROUGH A REPLACEABLE RULE

If there is a perceived need then instead of revising the Corporations Act to permit directors to take into account the interests of the broader community a better approach would be to include a default replaceable rule that gives officers some comfort when determining what is in the best interests of the corporation.

53. A default replaceable rule giving officers and directors the freedom to consider matters such as employees, customers, suppliers and the community when determining whether a course of conduct was in the best interest of the corporation should provide managers with a safe harbour for those decisions without the possible unintended consequences of a legislated solution. This is entirely consistent with the modern development of managers' duties.

54. A replaceable rule could expressly make it clear that a manager was able to take a long term view. For managers it would be an express acknowledgement that they could rely on their business judgment when considering actions that they believe to be in the long term interests of the corporation. This would be part of their contract with the members, not their contract with the state. The provision would not be geared at driving behavioural change amongst managers, rather it would facilitate conduct that many managers are already taking.

55. If corporations have come to acquire social responsibilities that go beyond shareholder wealth maximisation those responsibilities need to be explicitly accepted by both shareholders and management through the contract that binds them to each other, the constitution, even though they are yet to be precisely defined.

56. It is difficult to draw precisely the boundaries of the relationship between society and its corporations and indeed it is probable that the boundaries are constantly shifting. This is why a legislative response will founder as it is captured in the instant in which it is drawn. The law would be better drawn in a way that allows a court to apply the law flexibly to reach an appropriate conclusion in each individual circumstance but subject to a well understood norm, that is shareholder wealth maximisation and shareholder primacy.

57. Self regulation is appropriate for complex and difficult issues like corporate social responsibility that do not necessarily require an industry-wide solution. A self regulatory model allows a solution tailored to each entity's circumstances and the demands of the relevant market. If there is genuine community agreement about the value of corporate ethics then provisions affirming their place in the life of the corporation would quickly gain acceptance as best practice.

58. Imposing mandatory requirements, either through quasi-regulation or government regulation, may impose a significantly higher compliance burden than would be justified by the principle that mandatory regulation should be the minimum necessary to achieve the set objectives. Regulatory provisions might impose additional costs on top of the established regulation for little or no tangible benefit with substantial risk of uncertainty and litigation.

59. Is it necessary that corporate social responsibility be enforceable? Probably not, as calls for corporate social responsibility have largely been along the lines of the need for a permissive model. So to this extent there would seem to be no basis for criticising a self-regulation model on the basis of enforcement difficulties.

60. It is probable that the corporations that would adopt self-regulation of the type suggested are more likely to be the better performers. If the model is successful the market will reward those that participate and it may offer a strong incentive (in terms of positive impact on corporate goodwill) for other corporations to comply, but only if there is a genuine demand for this approach from investors.[56]

56 We note that both CAMAC and the PJC looked at the concept of "sustainability reporting". Undoubtedly, there are many issues connected with the drive to present useful information to the market on matters of corporate social responsibility. We simply observe that, subject to developing dependable and accurate measures of corporate good practice, the market will ultimately reward good performers if that is what investors want.

61. A self regulatory model will also ensure that only those corporations with a genuine interest or need will take the issue forward. This is less likely to result in a process focused "tick the box" approach to corporate social responsibility.

62. A replaceable rule also provides flexibility as to how corporations choose to meet socially responsible objectives, giving scope for efficiency improvements and innovation. Additionally, such a rule would recognise that many small and micro businesses use the corporate form and do not have the resources to comply with a prescriptive set of rules. Further, the risk of litigation, for example for failing to comply, is decreased under prescriptive self-regulation.[57]

63. The corporation is creature of statute designed for individuals (usually investors) to come together for a common (ordinarily business) pursuit through a legal entity that provides the benefits of limited liability, continuity of existence and simplicity in contractual dealings. Much of the argument in this paper has been presented to demonstrate that the benefits that accrue globally as a result of this scheme result from leaving the participants to determine their own objectives and methods (subject, of course, to the requirements of the general law). However, to the extent that political imperatives, as well as demands from directors for some sort of "charitable safe harbour", necessitate regulatory involvement, a default constitutional rule offers exactly the right blend of recognition and encouragement.

64. The *Corporations Act* provisions dealing with the constitution58 could have a default setting that provided that in the absence of an alternative provision in the constitution of a corporation the management would be entitled to have regard to a range of objectives beyond the short term profitability of the corporation.

65. The model provision might read:

> **198B(1) [Default provision]** Except as specifically modified by a company's constitution subsection 198B (2) applies to every company notwithstanding subsection 135(1).
>
> **198B(2) [Promotion of the success of the company]** In exercising their power to manage and direct the affairs of the Company directors may have regard to those matters they consider would be most likely to promote the interests of the Company [and/or the Group].[59] In particular, the Board may take into account:
>
> a) the likely consequences of any decision in both the long and the short term for the Company [and/or the Group],
>
> b) any need of the Company [and/or Group] to or likely advantage the Company [and/or Group] may gain from:
>
> (i) having regard to the interests of its employees;
>
> (ii) fostering business relationships with suppliers and customers;
>
> (iii) considering the impact of its operations on the community and the environment;

57 *Grey-Letter Law: Report of the Commonwealth Interdepartmental Committee on Quasi-regulation*, released on 9 September 1999. It was established to inquire into the extent of quasi-regulation, the circumstances in which quasi-regulation is a viable alternative to government regulation, essential features of successful quasi-regulation, and processes for monitoring and reviewing quasi-regulation to ensure that it is current, effective and efficient. Available at http://www.pc.gov.au/orr/reports/external/greyletterlaw/index.html at pg xiv and 40.

58 A company's internal management may be governed by provisions of the *Corporations Act* 2001 that apply to the company as "replaceable rules", by a constitution, or a combination of both: s 134.

59 Whilst s 187 allows a replaceable rule for directors of wholly-owned subsidiaries, it might make sense to consider the issue more widely in the context of this type of provision. Generally see CAMAC Corporate Groups (May 2000) available at http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/$file/Corporate_Groups,_May_2000.pdf.

(iv) maintaining a reputation for high standards of business conduct;

(v) making donations for the public welfare or for charitable purposes; and

c) the need to act fairly as between Members who have different interests.[60]

66. The provision would thus form part of the contract between the members and the corporation as well as that between officers and the corporation. Any further consideration of such a provision, including modification or possible rejection, would be the exclusive province of members.[61] It would also not be open to regulators, "stakeholders" or anyone who was not a member or officer to enforce against managers.

67. The formulation should provide a safe harbour to allow management to take the interests of various constituencies into account without being vacuous ie allowing "management to justify almost any action on the grounds that it benefits some group."[62]

68. If the directors had taken a decision favouring the long term sustainability of the corporation which resulted in financial detriment to the current shareholders the directors could argue the existence of the replaceable rule was a relevant factor in determining the 'corporation's circumstance' or the office held and their 'responsibilities within the corporation'.[63]

69. There might be legitimate concerns that managers will face an irreconcilable dilemma between the profit maximisation norm and changing social norms.[64] In practice, a constitution provision such as this allows a board to have regard to matters outside the narrow range of profit maximisation but does not oblige them to do so; it is a discrete safe harbour not an expansive coastline.

70. A contrary constitutional provision would not fundamentally alter the requirement to act in the best interests of the corporation, which might allow consideration of other stakeholders' interests in particular circumstances. A director who chose to do so would not be breaching his duty to the corporation.

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60 This drafting is loosely based upon B10 (3) of the UK Company Law Reform Bill introduced in May 2005 (and which was superseded by s 173 of the Companies Bill (UK) July 2006 which followed from the UK White Paper on Modernising Company Law available on the UK Department of Trade and Industry's website at http://www.dti.gov.uk/cld/WhitePaper.htm. The paper suggests that:

> *The statement of duties will be drafted in a way which reflects modern business needs and wider expectations of responsible business behaviour. The CLR proposed that the basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and suppliers, and in the community more widely. The Government strongly agrees that this approach, which the CLR called "enlightened shareholder value", is most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all. It will therefore be reflected in the statement of directors' duties, and in new reporting arrangements for quoted companies under the Operating and Financial Review Regulations.*

The drafting avoids suggested phrases like "success" and "others" on the basis they are too imprecise a concept to be helpful. Unlike the phrase "in the interests of the company", it is not supported by an existing body of case law. Similarly, we have removed any reference to directors being required to promote the company's success "for the benefit of its members". On the basis that the company is an entity separate from its members. See *The response of the Law Society's Company Law Committee, the Company Law Sub-Committee of the City of London Law Society and the Law Reform Committee of the General Council of the Bar* June 2005 available at http://www.lawsociety.org.uk/secure/file/141081/d:/teamsite-deployed/documents//templatedata/Internet%20Documents/Non-government%20proposals/Documents/complawreformwhitepaperlawsocresponse.pdf.

61 *Corporations Act* s 136(2).

62 Oliver Hart "An Economist's View of fiduciary duty" (1993) 43 *University of Toronto Law Journal* 299 at p 303.

63 Section180(1)(a) and (b).

64 For example see Tom Bostock "Is Beerworth's proposal really so modest?" *Company Director* December/January 2004-2005 16.

CONCLUSION

71. The wealth maximisation and the shareholder primacy norms are well founded and a logical foundation for much of what we understand by modern corporation law. It provides managers with a touchstone when they have to deal with difficult issues involving weighing up competing economic and social interests.

72. Ultimately, a considered response to political and community pressure to respond to perceptions of corporate behaviour must acknowledge the very real and convincing arguments in favour of shareholder primacy over all other "primacies" since it is only the shareholder primacy model that provides the kind of rigorous formulations that managers need when the corporate social responsibility argument moves from the obvious to the difficult. Legislators should be very careful before they introduce uncertainty at such a fundamental level of managerial duties, especially when there is a better alterative. A mandatory rule modifying the shareholder primacy norm would be a serious mistake.

73. If the social norm has shifted - and we don't believe that it has - then that can be accommodated in a new default replaceable rule. The self regulatory model suggested will allow corporations to create wealth on a sustainable basis, subject to the requirements of responsible business conduct.

74. As with other corporate governance reforms, a self regulatory approach to corporate social responsibility is the surest way to ensure meaningful action on this issue. If there is a case for reforming directors and officers' duties, the changes needed should not be revolutionary. A self regulatory model is a better way of influencing behaviour by institutionalising a change that is permissive and reflective of each corporation's own circumstances. Essentially this approach recognises the benefit of the shareholder primacy model where management's only duty is to the members of the corporation as a whole as a general rule but accepts that corporations that want to adopt a different rule can opt out.

Corrs Chambers Westgarth

December 2014

Andrew Lumsden, Jessica Crawford and Erin Kiley