CHAPTER 4

DIRECTORS' DUTIES

A director ... of a corporation must exercise their powers and discharge their duties with ... care and diligence.[1]

4.1 Term of reference (c) for this inquiry requires the committee to consider 'the extent to which the current legal framework governing directors' duties encourages or discourages them from having regard for the interests of stakeholders other than shareholders'. In this chapter the committee examines the duties currently imposed on directors by the *Corporations Act 2001* (Corporations Act), and considers whether those duties have any impact on corporate responsibility. Other social and environmental laws require corporations to attend to key social and environmental matters. Directors' duties as presently described already require directors and corporations to observe these laws, however corporations are not necessarily disclosing compliance. During the inquiry, submissions and witnesses proposed several options for changes to directors' duties. The final part of this chapter examines some of those proposals for change. The general view of the committee is that a change to directors' duties is not the best way to encourage corporate responsibility among Australian companies.

The current legislative framework

4.2 Subsection 180(1) of the *Corporations Act 2001* sets out an objective standard for the performance of directors' duties in the following terms:

> A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
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> (a) were a director or officer of a corporation in the corporation's circumstances; and
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> (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or other officer.

4.3 In *ASIC v Adler*, Santow J of the NSW Supreme Court reviewed the authorities and set out a number of principles which flow from this subsection. Prominent among these are the following:

- Directors owe a duty of care and skill, but this duty is not properly a fiduciary duty; and
- By becoming a director, a person implies that he or she has the skills of a reasonably competent person in his or her category of

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1 *Corporations Act 2001*, ss. 180(1).

appointment and that he or she will act with reasonable care, diligence and skill; and

- A director should take reasonable steps to place themselves in a position to guide and monitor the management of the company.[2]

4.4 These provisions are sensible provisions which allow investors to invest in a company on the understanding that the company directors will manage the company in the interests of its shareholders. When a shareholder invests in a company, they are in one sense investing in the capacity of the directors and managers to operate the company. Consequently they must have confidence that the directors are using their invested funds for the benefit of the company, and not for other purposes. In his submission, Mr Bill Beerworth states:

> Investors entrust their savings to corporate managers on the implicit promise that they will be increased in value through a mixture of earnings and capital gains.
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> All new capital raisings and every element of the securities industry are predicated on this core investor promise. If investors did not believe in this promise, they would invest elsewhere or they would not invest at all. [3]

4.5 Section 181 of the *Corporations Act 2001* adds to this a requirement of good faith. It states:

> (1) A director or other officer of a corporation must exercise their power and discharge their duties:
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> (a) in good faith in the best interests of the corporation; and
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> (b) for a proper purpose.

4.6 It should be noted that section 181 requires the duty of good faith in the best interests of the *corporation*, not in the best interests of the shareholders. These two will often be contiguous. However, there are cases where directors acting in the best interests of the corporation, will be acting in a manner contrary to the best interests of at least some shareholders. For instance, if directors make a decision which is in the long term interests of the company, benefiting long term and future shareholders, but which results in a short term loss (and a short term decline in share value for current shareholders), then this decision will be in the interests of the company, but will be unwelcome news for shareholders who have taken a short term, perhaps speculative position.

The business judgment rule

4.7 Subsection 180(2) of the *Corporations Act 2001* sets out what is commonly known as the 'business judgment rule'. The business judgment rule is essentially a

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2 ASIC v Adler [2002] NSWSC 171 at [372] per Santow J, paraphrased and references omitted.

3 Beerworth & Partners, *Submission 82*, p. 1.

process by which a director may argue that they have met the duty of care and skill required of them under subsection (1). A director can rely on the business judgment rule if they set out, in relation to the judgment in question, that they:

(a) make the judgment in good faith for a proper purpose; and

(b) do not have a material personal interest in the subject matter of the judgment; and

(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

(d) rationally believe that the judgment is in the best interests of the corporation.[4]

4.8 Again, it can be seen that paragraph (d) relates to the best interests of the corporation, not the best interests of the shareholders.

4.9 In their submission, Freehills Lawyers commented on the court's application of the business judgment rule as follows. Their focus was particularly on corporate *philanthropy* rather than corporate responsibility, but the analysis remains useful:

> Courts are generally reluctant to interfere in matters that involve the exercise of a commercial judgment, especially where a range of decisions could have been made by a director in a particular circumstance. This is likely to be the approach taken by a court if a reasonable corporate donation was ever challenged in Australia. Charitable donations by their nature often accrue intangible benefits to a company, making the reward for the company difficult to measure. For example, the result of philanthropy may be increased goodwill to the business, improved reputation or a long-term shift in the well-being of the community where the business operates. If a decision has been made to donate to a charity for these reasons, courts will be cautious in second guessing the business decision of the directors.[5]

4.10 On 7 April 2006, the Parliamentary Secretary to the Treasurer, the Hon Mr Chris Pearce MP, released a consultation paper entitled *Corporate and Financial Services Regulation Review*. The consultation paper canvasses a possible extension to the business judgment rule which would allow a general protection for directors, excusing them from liability under the Corporations Act provided they act:

- in a bona fide manner;
- within the scope of the corporation's business;
- reasonably and incidentally to the corporation's business; and

4 *Corporations Act 2001*, ss. 180(2).

5 Freehills Lawyers, *Submission 38*, p. 5.

- for the corporation's benefit.[6]

Impact of the current legislative framework

4.11 One of the more significant items of contention before the committee was the impact which the current directors' duties have on corporate philanthropy and corporate responsibility. Various interpretations of what the existing legal framework allows have been put forward, and these can be classified into four groups, which the committee will describe as follows:

- the *directors' restrictive interpretation*, under which directors claim that they are unable to undertake activities based on corporate responsibility, because such activities may not be directly 'in the best interests of the corporation';
- the *shareholders' restrictive interpretation*, which objects to corporations providing philanthropic funds or acting with deliberate corporate responsibility, because those funds could be invested in wealth generation (and thus returns to the shareholders);
- the *short term interests interpretation*, which allows that investment in corporate responsibility may be appropriate, but only if it can be justified on the basis of annual return on investment (competing with other possible investments); and
- the *enlightened self-interest interpretation*, which holds that careful and appropriate corporate responsibility is almost always in the interests of the corporation, and thus falls well within the behaviours permitted to directors under current duties.

Directors' restrictive interpretation

4.12 The 'directors' restrictive interpretation' begins with a fairly narrow view of what a company is, and applies to this a very narrow view of what the directors' duties allow. For proponents of this view, a corporation is an entity which exists purely for the purpose of profit generation, by any lawful means. A corporation is not a participant in the community, and has no obligations to the community which sustains it except those prescribed by law (and in particular by contract law). Consequently, any 'corporate responsibility' undertaken by these directors will either be incidental to profit generation, or incidental to the discharge of other legal obligations.

4.13 The Chamber of Commerce and Industry of Western Australia described this perspective (without endorsing it) in the following terms:

> Under this shareholder-oriented model … no more is expected of businesses than that they obey the rules as they go about their core function

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6 Parliamentary Secretary to the Treasurer, the Hon Mr Chris Pearce MP, *Corporate and Financial Services Regulation Review*, April 2006, p. 32.

> of generating profits. […] Positive advocates of the shareholder-oriented firm assert that maximising profit within a framework of laws is both the most ethically appropriate behaviour of business managers and the most socially desirable, because it leads to the best economic and social outcomes. This view has been stated by Milton Friedman, who argued 40 years ago that "…there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits to long as it stays within the rules of the game.
>
> The negative view of shareholder orientation presumes that corporate ethics is an oxymoron. In this view nothing better than greed can be expected of business operators and pursuit of owners' interests will be at the expense of the wider community, so a system of laws and regulations is necessary to force corporations to behave according to the community interest. An oft-quoted observation from the 18th century British jurist Edward Thurlow sums up this view summarising the hopelessness of expecting unselfish behaviour from business: "Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?[7]

4.14 An example of this approach in practice, commonly referred to in evidence before the committee, was the decision of the James Hardie Group to restructure its corporate affairs so as to quarantine itself from liability for the health effects of its asbestos products. Such a decision was clearly in the interests of the shareholders at the time it was made (as it was calculated to assist them in avoiding significant financial liability) but it was clearly contrary to the interests of external stakeholders: employees and others affected by asbestos-related diseases as a result of their contact with James Hardie products. James Hardie Chairwoman, Ms Meredith Hellicar has stated publicly that the company had taken a 'hard nosed' approach to its responsibilities at least in part because of concern by the Directors that the law *required* them to circumvent liability if this was in the clear interests of the company. In the *Australian Financial Review*, Ms Hellicar stated:

> I think protection [for Directors seeking to act in the interests of stakeholders other than shareholders] would be beneficial because there is no doubt that the threat of a shareholder suit – even if we get majority shareholder support – a minority shareholder can still say, we don't agree, so some protection would help … it certainly might make us feel more comfortable.[8]

4.15 James Hardie did not make a submission to the inquiry, and hence were not called as witnesses. However during this inquiry the company's actions in restructuring to avoid liability became the key example of corporations advancing the interests of shareholders at all costs. The company's activities were discussed on a number of occasions. One significant analysis was given by Professor Nowak of the

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7 Chamber of Commerce and Industry of Western Australia, *Submission 92*, p. 5.

8 Fiona Buffini, 'Calls to Protect Corporate Conscience', Australian Financial Review, 23 November 2005, p. 4.

Governance and Corporate Social Responsibility Research Unit at the Curtin Business School who stated:

> If you take Meredith Hellicar's argument that one of the things that was in the minds of the directors was that they needed to do this restructure to protect shareholder value as they saw it at that time, then I think that gave them a rather lopsided view of the way in which they should be making their decision. I would argue that that lopsided view needs to be corrected.[9]

4.16 Another example raised during the inquiry was an issue regarding Tasmanian vegetable growers who have been dramatically affected by a series of 'ad hoc, unilateral' decisions by companies with major purchasing power, to purchase their produce from overseas.[10] The growers cast the issue in terms of corporate responsibility, as follows:

> The 'boom and bust' cycles attached to much of Australia's commodity based industries, such as vegetable processing, means that decision-making based on short term cost competitiveness is not necessarily in the long term interests of the industry sector, nor the regional communities that support them. This is because the ultimate cost competitiveness of these sectors is likely to be based on a range of pertinent long-term issues, beyond immediate cost advantages: climate, soil, diversity in product line and innovation in business models. This is an issue of sustainability, not necessarily taken into account when decisions are made on short-term, cost competitiveness.[11]

4.17 The committee agrees that the decisions of the companies involved in this example were regrettable. They appear to be driven by a restrictive interpretation of directors' duties and with a sole view to maximising short-term profits with insufficient regard for the longer-term implications for both the company or the surrounding communities. The companies have suffered reputational damage as a result of their decisions, which have clearly had a major impact on growers and their communities. The companies have also neglected the concerns of local communities, which is both its customer base, and also a potential future supplier of produce.

Committee view

4.18 The committee considers that directors who take this 'restrictive interpretation' approach to the current law are misinterpreting the law. The current directors' duties were intended to provide protection for shareholders, not to create a safe harbour for corporate irresponsibility. However, the committee also came to the view that this interpretation is relatively uncommon in corporate Australia. Most directors appear

9 Professor Margaret Nowak, Research Director, Corporate Governance and Social Responsibility Research Unit, Curtin Business School, Curtin University of Technology, *Committee Hansard*, 20 February 2006, p. 32.

10 Tasmanian Farmers and Graziers' Fair Dinkum Food Campaign, *Submission 123*, p. 2.

11 Tasmanian Farmers and Graziers' Fair Dinkum Food Campaign, *Submission 123*, p. 3.

ready to accept that the current directors' duties allow them some leeway for corporate responsibility and philanthropy. The question for them is under what circumstances they should put corporate responsibility ahead of immediate profit generation. The answer for each company will depend on which of the final three interpretations discussed in this section are adopted, and on the competitive pressures, strategic position and community expectations of each individual company.

Shareholders' restrictive interpretation

4.19 The shareholders' restrictive interpretation reaches a similar position to the directors' restrictive interpretation, but via a different route. Proponents of this position are usually shareholders or shareholder advocates. Their view is that money invested in or generated by a company is in fact the property of the shareholders. Consequently, instead of the company investing in corporate responsibility or distributing corporate philanthropy, the company should distribute its funds to shareholders, and allow *them* to choose whether to reinvest the money, use it for consumption, or apply it to philanthropic causes. For the proponents of this view, then, any director who distributes corporate philanthropy or who deliberately chooses corporate responsibility over immediate profit, is acting outside the requirements of directors' duties.

4.20 The submission from Beerworth & Partners discussed this position as follows:

> Many shareholders to whom I speak are suspicious of corporate philanthropy. Many take the strong view that, rather than play the corporate Medici with funds that really belong to the shareholders, philanthropically minded Chairmen and CEOs should distribute them as dividends so that each shareholder can decide if she wishes to make the relevant donation.[12]
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> I have noticed at a number of AGMs that some shareholders protest strongly against political or even significant charitable donations. The Directors may have not only acted in what they regarded as good faith, in the best interests of the corporation and for what they regarded as a proper purpose, but different minds have different views on these subjects. I am not at all confident that the extent under case law to which directors and officers may take into account stakeholder interests other than of shareholders is clear or easily discoverable.[13]

4.21 The committee notes that it remains open to corporations and an option for resolving any dilemma directors may feel in their particular circumstances, to put the Board policy to a shareholder vote (for example on philanthropic spending).

12 Beerworth & Partners, *Submission 82*, p. 3.

13 Beerworth & Partners, *Submission 82*, p. 5.

Committee view

4.22 In the committee's view, this interpretation is supported by a relatively small group of shareholders. Most shareholders are likely to understand that investment in corporate responsibility is likely to result in both short term and long term gains for the company, based on one of the two interpretations considered below.

4.23 In addition, the committee observed the substantial and growing group of investors who invest in 'ethical investment' structures, taking a deliberate decision to invest their money in companies with an appropriate ethical profile. These investors not only agree that directors should pursue corporate responsibility, they demand it as a precondition for their investment.

Short term interests interpretation

4.24 Directors who hold this interpretation have no particular objection to investing in corporate responsibility, but such investments must meet the same rigorous requirements as purely financial investments. Various means can be used to measure the performance of investments, but 'return-on-investment' is perhaps the most common.

4.25 Directors following this interpretation are usually prepared to consider responsible investments, but only if they can meet the required return-on-investment. So an exercise in corporate philanthropy will be considered in terms of how much goodwill (and, consequently, what increase in market share or sales) will be the result. It will *not* be measured in terms of how many underprivileged children are fed, or how many young students get scholarships, or how many youth football teams get jerseys. An investment in energy efficiency will be measured in terms of cost savings from the energy bill, not in terms of the tonnes of greenhouse gas emissions saved. An investment in workplace safety will be measured in terms of reductions in insurance premiums, not in terms of worker injuries saved.

4.26 An example of this form of interpretation can be found in the submission of the BT Governance Advisory Service (BTGAS), which stated:

> On energy efficiency, research repeatedly shows capital spending on energy efficiency, such as whole-building upgrades, are sound financial investments. A study conducted in the US assessed the financial risk and return from fourteen whole-building energy efficiency upgrade projects. The internal rate of return of the investment was calculated using a ten year project lifetime and the investment risk was measured as the variability in the expected investment return — the risk that it would produce more or less than the expected return on investment. The average return was more than 20%.[14]

14 BT Governance Advisory Service, *Submission 19*, p. 7.

Committee view

4.27 The committee is of the view that directors should not be constrained only to activities which are profitable or capable of tangible measurement. On the other hand, it is clear that there are still vast improvements to be made in corporate responsibility in areas which *do* generate profits. Australian companies, by pursuing increased water and energy efficiency, can decrease waste and decrease costs (at the same time reducing the load on essential social infrastructure). By increasing the availability of paid maternity leave, they can increase their profitability by continuing to access the talents of women who return to the workforce after having children. By contributing to scholarships, for instance, the Australian mining sector has sought to establish a steady stream of talented graduates who will ensure its continuing profitability in years to come.

4.28 The committee also notes a practical difficulty with this interpretation. In evidence Treasury officials noted that while the costs of undertaking corporate responsibility are reasonably quantifiable, the benefits, which are often intangibles such as improved reputation, are difficult to measure. This may reduce the likelihood of corporate responsibility activities being adopted because their benefits are underestimated. This point is discussed further in chapter 8.

4.29 Almost any Australian company could find ways to increase its profitability by looking for ways to increase its corporate responsibility. While the committee does not consider that directors' duties are *limited* to corporate responsibility which turns a short term profit, the committee is strongly of the view that Australian companies should at least seek to undertake those investments in corporate responsibility which generate profit and competitive advantage (while at the same time generating a wider community benefit).

'Shareholders first' interpretation

4.30 A further interpretation may be discerned, though it is perhaps a variation on both the shareholders' restrictive interpretation and the short term interests interpretation. Under this interpretation, there is no particular objection to directors considering the interests of stakeholders other than shareholders, but the interests of shareholders must be the clear priority. Dr Forsyth and his colleagues from the Department of Business Law and Taxation at Monash University appear to take this interpretation:

> The basic legal position is quite straightforward: the duty of directors to act in good faith and in the best interests of the company … requires directors to treat *shareholders'* interests as paramount. The interests of employees, or other stakeholders, *can* be considered in performing these duties – but only where this would be in the company's (ie the shareholders') interests.[15]

15 Department of Business Law and Taxation, Monash University, *Submission 39*, p. 17.

Committee view

4.31 The committee considers that this interpretation, like the shareholders' restrictive interpretation and the short term interests interpretation, is too constrained. In addition, as noted above, the committee does not agree that acting in the best interests of the *corporation* and acting in the best interests of the *shareholders* inevitably amounts to the same thing. Consequently, the committee is not attracted to this interpretation.

Enlightened self-interest interpretation

4.32 The enlightened self-interest interpretation of directors' duties acknowledges that investments in corporate responsibility and corporate philanthropy can contribute to the long term viability of a company even where they do not generate immediate profit. Under this interpretation directors may consider and act upon the legitimate interests of stakeholders to the extent that these interests are relevant to the corporation. Chapter 3 of this report included discussion of the factors that drive corporate responsibility, and some of these factors in particular clearly show how corporate responsibility can be in the interests of companies (and therefore well within the bounds of directors' duties). These driving factors demonstrate how forward thinking directors, motivated by an enlightened approach to the company's self-interest, can undertake activities which contribute to social wellbeing and environmental protection, and which are clearly in the best interests of the company from a commercial perspective. The key driving factors to note are:

4.33 **Community license to operate**: The concept of a 'community' or 'social' 'license to operate' by companies was raised in several submissions. By effectively engaging with the communities in which they operate, companies gain tacit permission to continue in operation.

4.34 **Reputational factors**: Enlightened self-interest takes into account reputational factors well beyond mere community license to operate. Appropriate corporate responsibility can lead to positive corporate reputations which can in themselves have value for the company (particularly in terms of intangibles such as goodwill).

4.35 **Avoidance of regulation**: Corporate responsibility serves enlightened self-interest because by taking voluntary action to improve corporate performance, corporations may forestall regulatory measures to control their conduct.

4.36 **Attraction and retention of staff:** A number of submitters and witnesses stated that an enlightened approach to corporate responsibility assisted them in their efforts to recruit and retain high quality staff, particularly in the currently-tight skilled labour market.

4.37 **Attraction of investment from ethical investment funds:** The growth of ethical investment funds has been a key feature of the corporate responsibility environment in recent years, both in Australia and overseas. While these funds

currently administer a relatively small proportion of the market, evidence before the committee was that their size is growing.[16]

Committee view

4.38 The committee has considered the various interpretations of directors' duties given above. In the committee's view, the restrictive interpretations overstate the impact of sections 180 and 181 of the *Corporations Act 2001*. While some directors have used these interpretations to defend irresponsible activities, many other directors have led their companies towards increased corporate responsibility, without facing the shareholder revolts imagined by those holding a restrictive view.

4.39 The committee considers that the most appropriate perspective for directors to take is that of enlightened self-interest. Corporations and their directors should act in a socially and environmentally responsible manner at least in part because such conduct is likely to lead to the long term growth of their enterprise.

Options for legislative change

4.40 While the committee has stated above that in its view there is nothing in the current legislation to inhibit directors from taking account of stakeholders other than shareholders, the committee is still open to consider the various proposals for reform which were given in submissions and evidence. There were four common proposals put forward. Those were as follows:

- a *directive* view that the legislation in its current form is far too weak and should be amended in order to make corporate responsibility compulsory;
- a *permissive* view that the legislation in its current form probably allows for corporate responsibility but should be clarified in order to provide directors with additional protection;
- the *status quo* view that the legislation in its current form is sufficient to allow enlightened self-interest to operate, and need not be changed; and
- the *whole-of-law* view suggesting that the Corporations Act should not be looked at in isolation, as corporations are regulated by many other pieces of state and Commonwealth legislation that cover economic, social and environmental matters.

4.41 In addition, the committee noted the interesting proposals that the Corporations Act include an 'ethical judgment rule' or an additional replaceable rule. Each of these will be dealt with in turn.

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16 Ms Louise O'Halloran, Ethical Investment Association, *Committee Hansard,* 23 November 2006, p. 34.

The directive view

4.42 A number of submissions argued that the Corporations Act should direct corporations, and in particular directors of corporations, and to take account of the interest of stakeholders other than shareholders. For example, the Department of Business Law and Taxation at Monash University stated:

> The approach of mandating directors to take into account social, environmental and other stakeholder interests is not a radical step, as progressive corporations are already prepared to promote themselves as socially responsible in accordance with various voluntary CSR strategies. However, the absence of mandatory decision making criteria on these matters at the corporate level often allows social and environmental considerations to either escape notice, or be deliberately ignored. Arguments that shareholder interests are threatened by new obligations of this kind may be largely illusory. The growth of institutional shareholders and the likelihood that most shareholders will have diverse holdings across many corporations and industry sectors (either directly or through superannuation funds), means that there is now a much greater commonality of interest between shareholders and the broader community.[17]

4.43 A number of these submissions took as a model proposed British legislation entitled the Company Law Reform Bill 2005. This Bill is an extensive reform of virtually all aspects of corporate law in the United Kingdom. Part 10 Chapter 2 of the Bill sets out the proposed duties of Directors. Clause 156 sets out the duties relevant to this inquiry, and represents the UK government's attempt to balance duties to shareholders with duties to other stakeholders. The provision states:

> **156 Duty to promote the success of the company**
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> (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.
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> (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, his duty is to act in the way he considers, in good faith, would be most likely to achieve those purposes.
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> (3) In fulfilling the duty imposed by this section a director must (so far as reasonably practicable) have regard to—
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> (a) the likely consequences of any decision in the long term,
>
> (b) the interests of the company's employees,
>
> (c) the need to foster the company's business relationships with suppliers, customers and others,

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17 Department of Business Law and Taxation, Monash University, *Submission 39*, p. 28.

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.[18]

4.44 Several submissions noted that this bill represents an attempt to codify and make compulsory the 'enlightened self interest' approach discussed above. This approach was endorsed by the Australian Network of Environmental Defenders' Offices:

> It should be noted that the language of the Bill is prescriptive not merely permissive, and in effect, it would amend directors' duties to enable an enlightened shareholder value approach to decision-making. The introduction of similar legislation in Australia should be actively considered as it would address several of the concerns raised in this submission regarding the inadequate manner in which organisational decision-makers currently take into account non-shareholder interests.[19]

4.45 Some submissions however, felt that merely endorsing enlightened self interest did not go far enough. The Australian Conservation Foundation stated:

> The difficulty with this bill is that it treats the interests of corporate constituencies as means to the end of shareholder profits, rather than legitimate interests in themselves. In effect, the bill provides no greater consideration for communities or the environment, and no safe harbour for directors, beyond that contained in a simple unadorned statement of shareholder profit maximisation.[20]

Committee view

4.46 The committee does not support the British approach, which appears to introduce great uncertainty into the legal expression of directors' duties. For instance, there is no way to forecast those circumstances under which a court might decide that a company's purposes 'consisted of or included purposes other than the benefit of its members.' And what might a court determine those purposes to be? Until such a determination was made with respect to a particular company, directors may not even be sufficiently equipped with basic knowledge about those to whom they owed a duty. Subclause (3) requires directors to have regard to a menu of non-shareholder interests, but gives no guidance as to what form this 'regard' should take, and therefore gives no guidance to directors on what they must do in order to comply.

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18 Company Law Reform Bill 2005 (UK), cl.156.

19 Australian Network of Environmental Defenders' Offices, *Submission 48*, p. 11.

20 Australian Conservation Foundation, *Submission 21*, p. 17.

4.47 As a matter of general principle, the committee considers that a law which imposes duties should give those upon whom the duty is imposed clear guidance as to whom the duty is owed, and how it is to be discharged. A law which does not is bad law, and at the very least magnifies the uncertainties faced by directors.

4.48 Furthermore, it has been noted in relation to many different legislative schemes that directive legislation breeds a culture of compliance. Within corporations, once legislation is imposed, it is likely that compliance managers will take the lead and that the corporation's response will be driven by a those compliance managers' desire to meet the requirements of the legislation. Such activity is unlikely to satisfy those who advocate on behalf of social or environmental causes, leading to inevitable calls for legislation to become more stringent, prosecutors to become more aggressive, and penalties to become more severe. Chartered Secretaries Australia (CSA), for instance, stated:

> CSA also believes that performance pressures will encourage companies to have regard for the interests of stakeholders other than shareholders and that this does not need to be legislated. Indeed, if it were to be mandated, having regard for stakeholder interests other than shareholders would likely become a compliance-driven, box-ticking exercise, rather than an innovative, value-creating opportunity to improve performance.[21]

4.49 For the reasons expressed above, the committee is opposed to directive provisions in the Corporations Act.

A permissive provision

4.50 One approach in use overseas, particularly in the United States, is a permissive provision to make it clear that directors are entitled to make decisions which reflect the interests of stakeholders other than shareholders. The argument in this case, essentially, is that directors (following the directors restrictive interpretation) have been unnecessarily timid in approaching corporate responsibility, concerned that where efforts to improve corporate responsibility result in diminished short-term performance, there will be a backlash from shareholders or from the stock market. Mr Kerr set out one view of the United States experience:

> Some commentators feel that U.S. constituency statutes are “red herrings” and have done little to advance the interests of non-shareholders under U.S. corporate law. While these statutes represent a statutory variation of the directors' duty to act in the best interests of the company, the laws do not oblige directors to act in a socially responsible fashion. Of the 32 constituency statutes in place, all but one are permissive in nature. In other words, the directors may take the interests of non-shareholders into account, but are not obliged to do so. As a consequence, constituency groups do not have enforceable rights should their interests be ignored.[22]

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21 Chartered Secretaries Australia, *Submission 28*, p. 10.

22 Mr Michael Kerr, *Submission 7*, pp 114–115.

4.51 This approach had limited support from witnesses and submitters before this inquiry. Some, such as the Department of Business Law and Taxation from Monash University, were prepared to support a permissive provision as a less preferred option, but most stakeholders, from both sides of the debate, saw it as a poor alternative.

4.52 Some submitters saw a permissive provision as an easy way out, unlikely to result in increased corporate responsibility. The Public Interest Law Clearing House stated:

> Such an approach [a permissive provision] is, however, likely to be deficient for two key reasons.
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> First, experience suggests that compliance with voluntary or permissive legislation or codes of conduct is likely to be limited, particularly where compliance may occasion some form of financial detriment (regardless of social or environmental outcomes) and among reticent corporations. Permissive legislation tends to work best for already well-intentioned actors.
>
> Second, where a director may be permitted, but is not required, to consider the interests of a stakeholder other than a shareholder, it is unclear whether, how and by whom such consideration could be assured or enforced.[23]

4.53 Other submitters were concerned that a permissive provision may end up as a *de facto* mandatory provision. Mr Münchenberg from the Business Council of Australia noted in evidence that:

> A large part of our concern is that … [courts] assume, perhaps from naivety, that the parliament does not do things without good reason. They infer what those reasons might be. […]They then construct interpretation around what that may mean. The thing that worries us is that we do not know what bizarre circumstances may one day arise about which a court has to take regard to this provision. Were we solving a particular key problem we may be prepared to take the risk, but, if there is no major problem, why take the risk?[24]

4.54 Mr Münchenberg then agreed with Senator Brandis' proposition that 'there are some Federal Court judges who … say may means ought'.[25]

Committee view

4.55 The committee is concerned that such a permissive provision may in effect amount to shifting the goalposts rather than dealing with the problem. Directors who currently feel constrained by the Corporations Act may, after the enactment of such a

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23 Public Interest Law Clearing House (Homeless Person's Legal Clinic), *Submission 4*, p. 23, references omitted.

24 Mr Steven Münchenberg, Deputy Chief Executive, Business Council of Australia, *Committee Hansard*, 23 February 2006, pp 100–101.

25 Senator George Brandis, *Committee Hansard*, 23 February 2006, p. 101.

provision, find themselves constrained instead by whatever definition of corporate responsibility is built into the Act. If a history had emerged of court judgments taking a narrow view of directors' duties, interpreting the law in such a way as to suggest that corporate responsibility did involve risk to directors, then the committee would consider a permissive provision. In the current inquiry, no submitter has been able to point to court judgments which suggested a judicial misinterpretation of current provisions. Under such circumstances, and given the clear lack of support from all parties, a permissive provision appears to be unjustified.

Arguments favouring the status quo

4.56 A substantial number of submissions argued that the current legislative scheme is not the problem: that it is sufficiently open to allow companies to pursue a strategy of corporate responsibility, and that many corporations are actively doing so. The Group of 100, for instance, argued that:

> ...mandating change is unnecessary in view of the current Corporations Law and other requirements. In many of these areas, as evidenced in the Business Council of Australia findings, the imperative is to remove regulatory duplication and contradictions rather than to impose another layer of requirements which may inhibit progressive behaviour on the part of companies and directors. The best encouragement for entities is to create an environment in which experimentation with reporting in this evolving area is able to flourish. In a competitive environment the priorities and reporting of leading companies will induce improved reporting by other companies in response to changes in community expectations. This is unlikely to occur under a mandatory regime.[26]

4.57 ASIC expressed the view that to change the law in relation to directors' duties would create problems for ASIC in effectively performing its role as the enforcement regulator:

> ...as an enforcement regulator on the one hand and a disclosure regulator on the hand we can see great problems in opening up very well settled law as to what the duties of directors are. If it were felt absolutely necessary by the government—and this is a government decision—to have some change to the system, we would prefer a tightly focused disclosure solution rather than opening up the whole question of directors' duties. The upset to the business of actually changing the law would be too great: 'What are we supposed to do? Who are these stakeholders? How to we rank the priority of one stakeholder against the other?' There would be all those questions. We see problems there. With our enforcement hats on, we see that if we are not careful that might build areas into which directors who had done something wrong could go and sit and say, 'Actually, the reason we did this was because of these new stakeholder rules.'[27]

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26 Group of 100, *Submission 27*, p. 2.

27 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 29 March 2006, pp 12–13.

Committee view

4.58 The committee is of the view that no compelling case for change has been presented during this inquiry. Directors' duties as they currently stand have a focus on increasing shareholder value. This is important, because the provision is first and foremost intended to protect those investors who trust company directors with their savings and other investment funds. Directors' duties enable such investors to have some confidence that their funds will be used to in order to increase the income and value of the company they part-own.

4.59 In many cases, it will be clear that corporate responsibility enhances shareholder value. At the very least, it is clear that rampant corporate irresponsibility certainly decreases shareholder value. Public allegations that the James Hardie Group had demonstrated corporate irresponsibility had dramatic and public consequences for the company over the past year. The more recent alleged irresponsibility of AWB Ltd has led to the resignation of its managing director and the commencement of a commission of inquiry under the Royal Commissions Act. Progressive, innovative directors, in seeking to add value for their shareholders, will engage with and take account of the interests of stakeholders other than shareholders.

Other legislation

4.60 Term of reference (d) for this inquiry specifically asks the committee to have regard to obligations that exist in laws other than Corporations Act. A number of submissions to the inquiry made the point that modern corporations are in fact bound by any number of statutes and regulations, arising from Commonwealth, state and territory laws. Environmental law, in particular, has been the scene of much activity in recent years. Simply in order to stay in business, corporations are required by various laws to take account of their environmental and social impacts. For instance, they are required to seek environmental approval before proceeding with certain projects, they are held to account for their pollution, and they are required to meet guidelines of safety for communities and for the workforce. In evidence, officers from Chartered Secretaries Australia stated:

> It is our view that a legislative and regulatory framework relating to the individual components of corporate responsibility is already in place. This body of existing federal and state law covers the environment, financial services, human rights, equal opportunity, industrial relations and occupational health and safety et cetera. Much of this legislation requires directors and other officers to take account of interests other than shareholders'.[28]

4.61 Several submitters recognised the legitimate role for governments to regulate in certain areas of corporate performance. For instance GlaxoSmithKline stated:

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28 Mr Tim Sheehy, Chief Executive, Chartered Secretaries Australia, *Committee Hansard*, 23 November 2005, p. 41.

> Few would seriously question the role of government in regulating some aspects of business behaviour. Competition and consumer laws are essential to combat unscrupulous conduct and protect more vulnerable members of the community. Securities and investment laws are necessary to maintain confidence in a functioning business sector. Workplace relations and occupational health and safety laws are vital to address imbalances of power between employees and their employers. And environmental regulations have proven an effective mechanism for combating market externalities.[29]

Committee view

4.62 In the committee's view, this network of legislation shows that the social and environmental performance of corporations is already regulated in a number of areas. The existence of such substantial and specific legislation provides further argument against the need for any amendment of Corporations Act.

An ethical judgment rule

4.63 The St James Ethics Centre proposed an 'ethical judgment rule' which could be included in the Corporations Act and which would have similar status to the business judgment rule currently used to assess the performance of directors. The proposal was put in this form:

> we would recommend an amendment to the Corporations Act, similar to the provisions relating to the 'business judgement rule', allowing company directors to make decisions based on *bona fide* ethical considerations (including but not limited to the interests of stakeholders other than shareholders) – and protecting them from liability for doing so when a reasonable person would judge those considerations to be well founded. This protection should be afforded in all cases – including when the decision may have some detrimental effect on the financial interests of the company as a whole, its shareholders or some group of them. As such, directors relying on the 'ethical judgement rule' as a defence, would be required to produce documents demonstrating the quality of the reasoning employed in reaching their decision. Courts would only be entitled to review the substance of any decision if the quality of the decision-making process was first found to be inadequate.[30]

4.64 The committee does not support this proposal. However it was one of the most innovative and interesting proposals for legislative change put forward during this inquiry. Consequently, the committee wishes to be clear about its reasons for not supporting such a role.

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29 GlaxoSmithKline, *Submission 49*, p. 4.

30 St James Ethics Centre, *Submission 50*, p. 4.

4.65 First and foremost, as noted above, the need for an amendment to the Corporations Act has yet to be shown. Before considering the value of amendment such as an ethical judgment rule, the committee would need to be convinced that *any* amendment to the Act was required. In the committee's view, the Act in its current form is sufficient.

4.66 Second, the committee is concerned that an ethical judgment rule, rather than enabling decision-making based on court responsibility, would become a defence against allegations that the business judgment rule had been broached. Directors accused of failing to exercise proper business judgment might instead point to the ethical judgment rule as a justification for their actions. The committee notes the view put in evidence by Dr Longstaff that this objection is not insurmountable:

> It is possible to develop principles. I would be happy to rely on the fact that, if somebody was just trying it on and saying, 'We made a hopeless decision but we are going to pretend it was an ethical decision,' they would be exposed. One of the things you would want to do is ensure that they were not retrospectively trying to justify it. If such a provision was introduced into law to afford this kind of protection, it would have to be for decisions made at the time, where you could see the process of decision making going on as the decision was being made, and not something which is introduced after the event.[31]

4.67 The committee notes that there is an argument that with the various corporate governance rules that already apply to corporations, the business judgement rule already requires (implicitly at least) an ethical judgement.

4.68 However, ultimately, the committee remains concerned that in an appropriate court case, even as a defence of last resort, the ethical judgment would be called upon by directors who had failed in their duties.

A replaceable rule

4.69 The *Corporations Act 2001* contains a series of provisions (listed in tabular form in section 141) which are known as *replaceable rules*. Under subsection 135(2) of the Act, a replaceable rule has effect on a company as though it were part of the company's constitution. However the rule 'can be displaced or modified by a company's constitution.'[32] In other words, the replaceable rule provides a default provision, but any company may, by resolution, opt out of the rule. CSA initially proposed a replaceable rule to cover corporate responsibility:

> A clause can be included in a company's constitution permitting directors to take account of the interests of stakeholders other than shareholders, for example, 'for any purpose that the board sees fit'. CSA believes there is

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31 Dr Simon Longstaff, Executive Director, St James Ethics Centre, *Committee Hansard*, 23 November 2005, pp 19–20.

32 *Corporations Act 2001*, ss. 135(2).

> merit in the *Corporations Act* including such a provision as a replaceable rule. Shareholders would decide whether they wanted it, or a revised version of it, as an object in the constitution.[33]

4.70 This idea has some initial appeal, because it would make a subtle but profound change to the dynamics of decision making on corporate responsibility. Corporate responsibility proponents would no longer be required to try to convince companies to take greater account of stakeholders other than shareholders; rather, any corporation which so wished could make a deliberate decision to exclude such considerations. The reputational implications of doing so may, of course, be significant.

4.71 Perhaps for this reason CSA moved, in oral evidence, towards recanting its support for a replaceable rule:

> I think it is important for the record that technically we are not calling for this. I think that is an important point to make. We definitely have included it in our submission—and we chose our words carefully—as a notion that has some merit. But we are firmly of the view that the Corporations Act is adequate. We are not calling for an enabling section or anything like that. In honesty, I guess that if we were pressed then this would be something that we think has merit […]For the record, we are not calling for it.[34]

4.72 Other witnesses expressed reservations about a replaceable rule. A witness from the Australian Institute of Company Directors stated:

> I would say to somebody who came to me, 'Are you in fact, by another route, trying to limit your directors rather than making them more free?' At the end of the day, I think that is what that does.[35]

4.73 Mr Honan from the Group of 100 brought consideration of a replaceable rule back to the concept of enlightened self-interest:

> I do not believe that is necessary, because the directors need to act in the best interests of the company and, if they ignore the interests of the community or other stakeholders, they are not acting in the best interests of the company.[36]

4.74 Professor Redmond raised perhaps the most cogent argument against a replaceable rule when he noted that such a rule would effectively give shareholders the right to withdraw from directors the capacity to consider stakeholders other than

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33 Chartered Secretaries Australia, *Submission 28*, p. 11.

34 Mr Tim Sheehy, Chief Executive, Chartered Secretaries Australia, *Committee Hansard*, 23 November 2005, p. 44.

35 Ms Kathleen Farrell, Member, Law Committee, Australian Institute of Company Directors, *Committee Hansard*, 23 November 2005, p.86.

36 Mr Thomas Honan, National President, Group of 100, *Committee Hansard* , 24 February 2006, p. 4.

shareholders. Where a company's shareholders have removed the replaceable rule, it seems to follow that directors would consider themselves under instructions to refrain from considering the interests of other stakeholders. Professor Redmond stated:

> This is not a matter of shareholder autonomy; this is a matter in which I think you are legitimately protecting directors against shareholders to a certain extent. You are enabling them to give effect to either ethical considerations or their own sense of where the company's long-term benefit lies, against all the market pressures of short-term impacts. I think there is a public interest in granting that licence and doing it in a way that does not allow shareholders the autonomy of withdrawing it.[37]

Committee view

4.75 The committee remains of the view that a replaceable rule is an interesting approach to the issue of corporate responsibility. In view of the Chartered Secretaries' clarification of their position, and the rebuttals expressed by other witnesses, the committee does not recommend that a replaceable rule be implemented.

Conclusions

4.76 The committee considers that an interpretation of the current legislation based on enlightened self-interest is the best way forward for Australian corporations. There is nothing in the current legislation which genuinely constrains directors who wish to contribute to the long term development of their corporations by taking account of the interests of stakeholders other than shareholders. An effective director will realise that the wellbeing of the corporation comes from strategic interaction with outside stakeholders in order to attract the advantages described earlier in this chapter.

4.77 The committee considers that more corporations, and more directors, should focus their attention on stakeholder engagement and corporate responsibility. However it is clear from this chapter that any hesitation on the part of corporate Australia does not arise from legal constraints found in the Corporations Act. As the problem is not legislative in nature, the solution is unlikely to be legislative in nature. Elsewhere in this report, the committee gives long consideration to other, non-legislative ways in which Government might encourage greater corporate responsibility. However, the conclusion of this chapter is that amendment to the Corporations Act, and in particular to the provisions setting out directors' duties, is not required.

Recommendation 1

4.78 The committee finds that the *Corporations Act 2001* permits directors to have regard for the interests of stakeholders other than shareholders, and recommends that amendment to the directors' duties provisions within the Corporations Act is not required.

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37 Professor Paul Redmond, *Committee Hansard*, 9 March 2006, p. 47.