

**SUBMISSION TO
PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS
AND FINANCIAL SERVICES**

FROM

DAVID WISHART

1. INTRODUCTION

1.1. Who I am:

I am a senior lecturer in the School of Law and Legal Studies at La Trobe University. I have taught and published in the field of corporations law for 25 or so years.

1.2. The Question:

The Parliamentary Joint Committee on Corporations and Financial Services Committee is inquiring into Corporate Responsibility and Triple-Bottom-Line reporting, for incorporated entities in Australia, with particular reference to:

- a. The extent to which organisational decision-makers have an existing regard for the interests of stakeholders other than shareholders, and the broader community.
- b. The extent to which organisational decision-makers should have regard for the interests of stakeholders other than shareholders, and the broader community.
- c. 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, and the broader community.
- d. Whether revisions to the legal framework, particularly to the Corporations Act, are required to enable or encourage incorporated entities or directors to have regard for the interests of stakeholders other than shareholders, and the broader community. In considering this matter, the Committee will also have regard to obligations that exist in laws other than the Corporations Act.
- e. Any alternative mechanisms, including voluntary measures that may enhance consideration of stakeholder interests by incorporated entities and/or their directors.
- f. The appropriateness of reporting requirements associated with these issues.
- g. Whether regulatory, legislative or other policy approaches in other countries could be adopted or adapted for Australia.

In inquiring into these matters, the Committee is considering both for profit and not-for-profit incorporated entities under the Corporations Act.

These questions were put to the Parliamentary Joint Committee on Corporations and Financial Services as a result of the 2004 *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation*, D. F. Jackson Q. C., Commissioner, being an enquiry into certain transactions of the James Hardie group of companies.

As I understand the position, a report by Parliamentary Secretary to the Treasurer, the Hon Chris Pearce MP, to the Ministerial Council on Corporations ('MINCO') has referred to that body the following questions:

- Whether the Corporations Act should be amended to make directors consider social responsibility as well as shareholder interests;
- Piercing the veil in the context of corporate groups, generally and specifically along the line of the employee entitlements provisions in Part 5.8A, although the toothless nature of those provisions is apparently acknowledged;
- The definition of 'creditor' and whether it comprehends personal injury claimants who develop their 'injuries' many years after the insolvency of the negligent company (the so called 'long tail' issue);
- Corporate restructures, especially the *ex parte* nature of proceedings;
- Australian procedures for allowing companies to move overseas; and
- The rules governing the cancellation of shares, especially the lack of redress in Part 2J since 1998.

I take it that the questions put to the Joint Committee exclude the specific issues and law reform proposals raised by the Jackson report, apart from the first question put to MINCO.

I note that the main issue not covered by either set of questions is the role of advisors to corporations, raised by Jackson QC at pp 547-8 of his Report. It is very clear that the legal advisor to the James Hardie group, Allens, in particular and perhaps the legal profession in general have taken the view that service to the client outweighs other ethical limits to behaviour, yet many legal processes, like the approval of schemes of arrangement, require that this service be mediated by standards of behaviour, including disclosure, that operate against the interests of clients. The legal profession has been very quick to condemn auditors for a failure to uphold standards in the face of potential loss of business as evidenced by the HIH and One.Tel fiascos in Australia and Enron in the US, and legislation has been smartly forthcoming, but when faced with similar issues in its own backyard has only given a muted response.

Nevertheless the question faced by the Joint Committee is confined to the more general and theoretical one of responsibility within the corporation to persons other than shareholders. It is this I here address.

1.3. My Approach

Acknowledging the Committee's time and energy constraints, I have kept this submission short and to the point. (The point is, of course, as I have stated it in the section immediately above.) Indeed, in positive substance it consists of the Proposal set out in Section 3 below. Direct answers are given to the particular questions put to the Joint Committee are set out in Section 4.

I have included Section 2 to clear the way for the proposal in Section 3. It is about ideas, principles and concepts which should be discarded: an application of Ockham's razor, if you like, although I prefer the ancient Greek metaphor.

If the Committee wants clarification of any of this submission, please do not hesitate to ask. My email is d.wishart@latrobe.edu.au.

2. THE AUGEAN STABLE'S CONTENTS

2.1. Stakeholder Theory

Stakeholder theory imbues the questions posed to the Joint Committee. It pervades recent discussions of corporate governance and corporate social responsibility. Yet stakeholder theory was rejected as a viable normative postulate in the 1920s. It is at core simply the position taken by the American Realists just before that time: a rather simple structuralist sociology. It fails because it presumes what it is designed to solve: the identity of the stakeholders, the homogeneity and solidarity of their interests, and the processes, beyond begging its own question by nominating them as 'balancing', by which competing interests are to be resolved.

An example of the confusions that abound when stakeholder theory is applied to the issues of corporations law lies in the recent consultation the management of Telstra had with the Government. Was the government being consulted as a source of government funding or as a shareholder which might be asked for a capital contribution? And that is to simplify it, for it might have simply been a political move and the parties may not have been able to tease out exactly what is at stake. The definition of the Government as a stakeholder and what stake it was holding was as much up for grabs as the provision of funds.

Another example is that employees are often thought of as a clear stakeholder group and are distinguished from shareholder and creditor groups. Yet in some circumstances employees are shareholders, say if employee shares are issued, and subordinate one interest to the other. When the company undergoes voluntary administration, or indeed in any creditors' meeting, the employees are creditors through their entitlements. They then may or may not express interests as employees.

There is, however, a small utility in stakeholder theory. It is simply that it provides a possible test, one amongst many, for what is proposed to be done. 'What is the effect on people with this particular interest?' is the question that it poses. In posing it, however, one must be careful to define exactly what the stake is and that that interest may be mixed with others for unanticipated results.

Given the above, legislation should not be drafted in terms of stakeholders. The term is meaningless and contingent, and the definitions of interests it produces are correspondingly tainted.

2.2. International competitiveness

Ever since the Porter project of the early 1980s, regulatory regimes have been seen to be an essential element within a discourse of international competitiveness. This has become allied to a stream of thinking known as ‘Law Matters’, which asserts that strong regulatory regimes on a neo-liberal contractarian model are successful in economic terms. Putting the two together results in a thrust towards a legal regime on the contractual/US/UK model, rather than, in the polar taxonomy adopted, the communitarian/ Code Civil model. The latter is supposed to allow for the influence of stakeholders, although it is more accurately described as an acknowledgement that enterprise is a relationship between capital, management and labour.

Essentially international competitiveness as a restraint on any politically feasible reform proposal in Australian Corporations Law is twaddle. ‘Law Matters’ conflates cause and effect: which comes first, economic development or attractiveness to the eyes of global business? The evidence, such as it is, is equivocal even within the literature. If anything, there is a trend to a blend of the two available models, although whether this is because either has good features is not discernable. It is more likely that it is simply an artefact of cultural regulatory globalism. Moreover, there is no one model even in the US where corporations law is a matter within the powers of the States. Further, US banking law is one of the most highly and arbitrarily regulated in the world and one beset by prudential crises, yet no-one would suggest that this means the US is incapable of financing its business sector. Perhaps there is a bare minimum of liberal governance in terms of enforcement of property rights, absence of corruption and so forth, but beyond that there are many far more persuasive factors than the particularities of a corporations law regime. For example, there is little suggestion that Australia’s emphasis on fairness in its market governance structures is a severe inhibitor of investment. The Delaware preference as a matter of regulatory arbitrage producing efficient regulatory regimes and hence a model for adoption in the rest of the world again is based on the most equivocal of empirical studies. After all, News Ltd’d move now looks to have been based more on managerial self interest than shareholder welfare enhancement.

2.3. The US model

For obvious economic and cultural reasons literature out of the United States of America heavily influences Australian thinking. An example is in respect of the definition of the interests of the corporation: is it wealth or value maximisation? Another is in the necessity for and workings of a business judgment rule, now in sec 180(2) the *Corporations Act 2001*. Indeed, the frame of the debate represented by the questions posed to the Joint Committee

presupposes a polarity between the various stakeholders arising out of the particular conceptualisation of corporation that obtains generally in US law.

US law corporations law derives from the state of English law in 1760. It is a development of incorporation by charter whereby the state creates a new body with regulations for its governance. Those regulations establish positions, or statuses, with roles and functions. The board makes business decisions and the stockholders elect the board. The doctrines of corporations law as expressed in most States of the US derive from this conceptualisation. It may be but, importantly, also may not be the nature of a company in Australia. Given that the law which is now in force in Australia went down a different path, one where company law was found in contract and equity, rather than contract and equity being applied to companies, the US conceptualisation of the corporation is not the general Australian idea of a company.

In Australia we still (should) think very differently. The way we (should) think is that the company represents the result of a constitutive act by the originating members. This constitutive act creates an institution in which procedures of decision-making are as provided in its constitution. Thus Australian corporations law focuses on procedures of decision-making rather than the functions of particular statuses. Australian corporations law allows for, even presumes, the essential humanity of the participants.

Mind you, Australia has received some of the alternative model in recent law reform. While it is not explicitly acknowledged, the New Zealand 1993 model is heavily influential here. It is based on the Californian and New York codes, via Canadian Business Corporations Act. Thus the New Zealand Companies Act 1993 establishes the positions of shareholder and director, even the board of directors. While we here have adopted much, we still do not establish those statuses; rather we assume them to be sets of rights and obligations pre-existing the Corporations Act's interventions. Maine's aphorism is problematic in corporations law, for the movement between contract and status is perverse.

2.4. Proper Purpose

I note that the questions posed to the Joint Committee are carefully phrased to avoid implying that profit or wealth maximisation necessarily defines the interests to be taken pursued by directors. Of course, the questions do not deny such a connection but many might assume it. The connection is to be resisted.

The critical duty as defined in law is the duty to act for a proper purpose. It is calculated to align the interests of the directors with those of the company. But exactly what 'the company' means has always been problematic. This can be seen in the two aspects to the duty: the duty to act within the purpose for which a power has been given and the duty to act *bona fide* for the benefit of the company as a whole. The first is an attempt to find the interests of the company in the constitution of the company. The second looks to a calculation made by judges as to what lies outside the possible interests of the accumulated shareholders as an institution. In this there has been considerable debate about whether interests of persons other than members are involved. In

view of the construction of company law as being about an association of members I am reluctant to move outside of member as stochastic residual cash flow claimant in the definition of the association to be taken regard of in the calculation to be made by a court. An example of the sort of matter which impels me to consider that this is the presumption on which corporations law is built is the difficulty of representing persons other than creditors in a Voluntary Administration.

Most relevantly, the ‘interests of the company as a whole’ is a test which is manifestly incapable of deciding matters between competing interests within the company. Both Latham CJ and Dixon J made that point as the core finding of *Peter’s American Delicacy Co Ltd v Heath* (1939) 61 CLR 457. To broaden out the range of matters which fall inside the category by including the calculated interests of classes of persons not part of the decision-making structure presumed by law is simply to confer an extraordinary discretion on directors. As the next section discusses, this is not a sensible move.

That is not to say that the calculation made by judges as to what lies outside the possible interests of the accumulated shareholders as an institution involves the positive formulation of the interests of the accumulated shareholders, especially in the profit or wealth maximisation. There is nothing in Australian law which makes this connection as a general proposition.

2.5. Trusting directors

Stakeholder theory requires the interests of stakeholders to be balanced by decision-makers. In terms of corporations law, it asserts that directors should balance the interests of those whose interests are at stake, whether they be tort victims, employees, unsecured creditors, consumers or environmental activists. Within any limits of fairness or oppression that might be considered necessary, the directors are given a discretion. This is often said to be the situation that obtains in codetermination on the German model but that is, I think, to misunderstand the dynamics of the two-tier board.

The question then becomes whether directors are persons to whom such a discretion should be given. This might be answered by considering the position of the board of the James Hardie group when facing the choice of whether to proceed to separate out the asbestos liabilities. Even were we to believe the board when it is asserted that it felt constrained to decide in favour of separation because of its duty to promote the interests of shareholders, to allow them to consider the interests of the asbestos victims would not compel them to behave more humanely. It would simply allow them to do so. (Mind you, I do not for one minute think that the duty is as that board asserts.) Law reform should be undertaken on the ‘bad man’ hypothesis: what could the ‘bad man’ do in these circumstances? Large corporations have such power to wreak havoc in society; their structures should not permit ‘bad men’ to make socially unacceptable decisions without appropriate consequences.

This is not even to assert the tempting argument that directors are in general simply barely competent managers of dubious morality who get to where they are by accident of birth, personality of the right mix, and a fortuitous set of circumstances in each individual case. Certainly we should not be fooled by

the ‘cult of the CEO’ as Gideon Haigh puts it (‘Bad Company: the Cult of the CEO’ (2003) 10 *Quarterly Essay*), but for present purpose it simply is not necessary to argue the matter. The possibilities of societal damage inherent is the conferral of additional discretion on directors suffices.

2.6. Conclusion

The above asserts that stakeholder theory does not help much, the US model should not be followed and does not constrain us, and communitarian models are similarly inappropriate, yet that the decision-making structure inherent to our corporations law allows for moral and societal responsibility for decisions to disappear. This trick is similar to, and perhaps an inextricable part of the much vaunted risk-shifting that is made possible by the corporate form. It works like this: human beings bear responsibility in law and society for their actions. Some wear this responsibility more lightly than others, but it is presumed of us as humans in the structures set up to regulate our actions. On the other hand corporations are expected to behave for the benefit of members. This is justified within notions of societal responsibility by liberal notions of accumulated self-interest representing maximum societal happiness. The decision-making structures of companies are designed to accumulate self-interests and allow for the mobilisation of capital in the directions the process indicates. In these processes questions of moral and societal responsibility have no conventional place because the processes are designed to express self-interest. Thus the conventional restraint placed on individual human beings is removed from corporations as persons. Remembering that companies are in a position of greater power due to the state’s facilitation of accumulated wealth under the strong central control of a few, those constraints are critical to the health of society.

Certainly corporations have been increasingly in recent years brought into the fold of societal responsibility (with the notable exception of corporate groups — a question left to MINCO). In some situations responsibility has devolved on corporate officers. But that is simply to band-aid the issue, because the problem lies in the design of the processes of decision-making of the corporation and not in the actions of some officers.

The question is, then, how to insert moral and societal restraints in companies’ decision-making processes without conferring discretion on directors. The key, I think, is not to assume away the possibility that members of corporations can act as a moral community; indeed, it is to assume that the members are a moral community and would wish their actions as a community to be constrained in that way. This is indeed presumed by Australian corporations law — we simply have forgotten it. The proposal that follows seeks to draw on and strengthen these principles in ways that are not susceptible to being competed away.

3. A PROPOSAL

3.1. Overview

This proposal seeks to establish moral and legal responsibility for corporate action by drawing on a number of principles:

- The accumulated members of a company can form a moral community. A board of directors does not.
- In a constituted decision-making structure the expression of constraints on decisions is best effected through its constitution. This should be recognised and facilitated by corporations law.
- Braithwaite's 'corporate culture' is a useful means of recognising and implementing implicit restraints on behaviour.
- In competitive situations survival generally overrides morals, yet competition has its own ethical justification in the efficient allocation of resources. Nevertheless, moral constraints on competition can be economically theorised and justified, provided they are equally applied. In other words, races to the bottom must be avoided.
- Responsibilities to society are best expressed by society through societal institutions. Adherence is a choice for the individual based on some individual calculus and for which consequences must be borne. In the case of corporations that may be lesser profit, but this is offset by moral satisfaction. Lack of adherence must also be penalised in ways which at best mimic moral opprobrium and at least criminal liability.

3.2. First Step: Extend the application of the Criminal Code Act

As a support measure for what follows, the Criminal Code Act (Cth) should be extended to all crimes and torts. At present it only extends to Commonwealth crimes, and even then not to breaches of Chapter 7.

The purpose of the extension is to establish the 'corporate culture' concept as essential to the decision-making processes of every company.

There is a question of the constitutionality of this extension. Crime and tort in themselves are not within the powers of the Commonwealth. Yet neither is contract law and the *Corporations Act* 2001 ss 126-130 provides for the mechanisms by which a company makes contracts. Provision for tortious and criminal liability could simply be inserted into the *Corporations Act* after s 130.

3.3. Second step: Provide that a code of conduct for officers, meetings and boards is strong evidence of a culture of compliance if provided in the corporate constitution.

The code of conduct would provide for the bases of action within a company. While I expect that they would be subject to a deal of jurisprudence and later development, the matters they would cover is the expectation of compliance with laws and that the decisions of the company would meet the standards of a reasonably moral human being. The code would express shareholders' desires that the companies of which they are members not act in socially damaging ways.

I would expect that initial formulations of the code would be by panels and public discussion. The upshot would be inserted into the Corporations Act as a replaceable rule. To avoid a race to the bottom, an appropriate version of the code should be included in the ASX listing rules.

The incentive, even compulsion, for a company to include the code of conduct in its constitution is that it would provide good defences to legal action and moral opprobrium. If there is fault and the institution has acted as a moral community, the fault is the acting individual's. Failure to include a code would be taken to imply intention to act if not purposeful then at least recklessly for ill.

To take the Anvil Mining Ltd incident in Kilwa in the Democratic Republic of Congo, were my scheme to be implemented the focus of the enquiry (beyond as to what actually happened) would be whether Anvil Mining's code of practice allowed for abuses (if they happened). If not, then the code of practice allows for the visitation of liability on the officers who carried out the abuses and, if any crimes are involved, allows for their direct liability. If there is no code or it does not constrain decision makers, liability is correctly visited on the company as well as the officers, hopefully to the substantial detriment of the members. That they may not have been members at the time of the incident is of no concern because they are seeking to benefit from holding shares in a company unrestrained by the normal constraints of a social being.

How would this work in relation to corporate groups? In any subsidiary company without a code of conduct the employees are exposed to presumed liability. If there is control of the subsidiary, section 9's extension of the meaning of 'director' to shadow directors implies that liability for improper decisions lies on the holding company. And well drafted piercing provisions for criminal liability should complete the picture. Let us not forget that s 16 of the Partnership Act 1958 (Vic) applies in a similar fashion.

3.4. Third step: Strengthen section 140 in respect of the code of conduct.

To ensure compliance the code should be enforceable by members. They are the moral community and hence should be able to ensure that the conduct of their affairs is done in accordance with their agreed standards. Section 140

provides that the constitution of a company is enforceable as if it were a contract and is the logical place for enforcement of the code within the moral community.

The problem with s 140 is that it has been taken to not require compliance with every provision of the corporate constitution. Only those matters which directly and personally affect a member and then only as member are enforceable. There is considerable jurisprudence as to what 'personally and directly' means in this context. My proposed amendment could be particular, simply stating that the code of conduct is one of those things. On the other hand the opportunity could be taken to extend s 140 to allow for all provision provisions of a corporate constitution to be enforceable, the internal management rule to operating through s 1322. The s 1324 injunction could be similarly extended, just to make the issue clear.

3.5. Fourth step: Ensure 'proper' is defined *inter alia* by the code of conduct.

'Proper', for the purposes of '*bona fide* for the benefit of the company as a whole' has, as adverted to above, always involved the interests of members, often both present and future, as defined by the corporate constitution and objects. The code of conduct should become a substantial element in that calculus. There would then be no restraint upon directors or other officers from complying with the expected standards of conduct in Australian society. There would, on the contrary, be an implication that to fail to so act is improper and in breach of the Corporations Act and the general law. Failure to so act would also disable reliance on the business judgment rule in s 180(2).

To effect this step an appropriate amendment might have to be placed in s 182.

It is worth noting that proper purpose would remain enforceable by individual shareholders through the derivative action. Were a company to be made liable through a breach of the code, a wrong would be done to the company because the officer would have acted improperly. The derivative action should stand, strengthened if necessary, to ensure that the board does not become complacent about these matters.

3.6. Fifth step: Require reporting on social and environmental impacts at least in the code of conduct.

It is obvious that any system such as I propose relies on transparency. Reporting requirements are clearly implicated. But they are not as necessary as it might seem. The dynamic of my system is a moral corporate culture defined by a code of conduct. To place reporting requirements in the code reinforces the point that the members of the company are the moral community, and the board and officers of the company put it into effect. If there is no reporting of what is done, it is unlikely that compliance with the code can be established to protect officers. The judgment that has to be made

is whether activities of corporations are sufficiently visible for societal processes to take effect or whether help has to be given by mandated reporting. My inclination is to allow a scandal to dictate the answer.

In such reporting as takes place, provable spin is, of course, a matter of the culture of compliance and the assessment of the degree of compliance with the code of conduct.

4. QUESTIONS FOR THE JOINT COMMITTEE ANSWERED

In short, my answers to the questions put to the Joint Committee are:

- a. “Stakeholder” is useless as a normative concept. The directors exercise far too wide a discretion as it is. The shareholders as an association have few means of expression of interests outside their presumed joint self-interest.
- b. The framework of this question leads to meaningless dialectic. To be sure, the actions made possible by corporations law should be constrained by community and social interests, but stakeholder theory begs the question of how to do this.
- c. The current framework of directors’ duties is fine, provided we really understand what the “interests of the company” are.
- d. & e. The revisions I would make are: extend the Criminal Code Act 1995 (Cth.) to all corporate torts and offences; providing for a voluntary code of conduct in corporate constitutions, with special provision for listed companies; strengthening s 140 to allow for the code’s enforcement, ensuring ‘proper’ conduct is defined by reference to the code, ensuring the derivative action and the business judgment rule take this sense of ‘proper’ into account, and ensuring actions of corporations are visible.
- f. This proposal is essentially self-enforcing.
- g. No.

Very little of this taken individually would raise any controversy. It would be very hard for any person subject to a code of conduct to argue that they should be permitted to act outside the moral constraints on human beings.

David A. Wishart
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