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Corporate cuffs? Current government inquiries

By Professor Bryan Horrigan

Newsworthy maladministration, misbehaviour and collapses by a few high-profile corporations have generated community and governmental calls for enhanced accountability of corporations across the board.

Just as corporate scandals involving Enron and WorldCom produced the *Sarbanes-Oxley Act*, and HIH's downfall and James Hardie's[1] potential asbestos liability resulted in official inquiries, public and political pressures unleashed by such events are placing corporate social responsibility (CSR) and 'triple bottom line'[2] reporting squarely on the agenda. Australia and the UK are at least considering, and perhaps on the brink of, major CSR policy and regulatory reform.

All of this dovetails with moves towards socially responsible investing and reporting, as well as increased scrutiny of corporate governance and responsibility by institutional investors, stakeholder representative groups and independent ratings agencies.

In the wake of the HIH and James Hardie commissions, three major governmental re-examinations of directors' duties and corporate responsibility were initiated or ongoing in Australia during 2005. They were:

- the review by the Ministerial Council for Corporations, of potential weaknesses in corporate law arising from the James Hardie Commission of Inquiry;

- the Australian Government's Corporations and Markets Advisory Committee (CAMAC) referral to investigate whether and how stakeholder interests and corporate social responsibility should be regulated in terms of the duties and reporting of directors; and

- the inquiry, by the federal Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS), into corporate social responsibility and 'triple bottom line' reporting.

The last includes terms of reference to assess 'whether regulatory, legislative, or other policy approaches in other countries could be adopted or adapted for Australia'. Recent UK proposals to incorporate the notion of 'enlightened

shareholder value' in the law regulating directors' duties offer an immediate model for comparison.

The CAMAC Terms of Reference are as follows:

> '1. Should the *Corporations Act* be revised to clarify the extent to which directors **may** take into account the interests of **specific classes** of stakeholders or the **broader community** when making corporate decisions?
> 2. Should the *Corporations Act* be revised to **require** directors to take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions?
> 3. Should Australian companies be encouraged to adopt socially and environmentally responsible business practices and, if so, how?
> 4. Should the *Corporations Act* **require** certain types of companies to report on the social and environmental impact of their activities?' (emphases added)

The Terms of Reference for the Parliamentary Joint Committee on Corporations and Financial Services are:

> 'The Committee will inquire 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; and
> 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 will consider both for-profit and not-for-profit incorporated entities under the *Corporations Act*.'

WIDER STAKEHOLDER INTERESTS

Some early commentators doubt the need for such corporate law reform, on the basis that existing law entitles directors to consider wider stakeholder interests in their decision-making about the best interests of their corporation. They argue that any change or clarification is best left to evolving corporate governance standards and guidelines rather than mandated legislatively (McConvill, 2005, pp101-102).

The chairman of the James Hardie Board, Meredith Hellicar, stated publicly in March 2005 that, by establishing James Hardie's compensation fund for asbestos victims in 2001, its directors:

> 'believed we had achieved the goal of fulfilling our duties as directors to current and future stakeholders, both legally and in the context of corporate social responsibility, by separating our asbestos liabilities from the balance sheet to enhance our attraction to foreign capital markets to fund future international growth, and by meeting our responsibilities by providing for future asbestos claimants' (Hellicar, 2005).

Hellicar advocated the need for clarity in this area of law to provide directors with a 'business judgment' safeguard against potential liability for making socially responsible decisions that accommodate the interests of shareholders and other stakeholders.

Leading corporate academics argue that the James Hardie saga raises more than questions about 'the role of the board of directors and the CEO in creating the right corporate culture and balancing the interest of stakeholders, growing activism by those affected by corporate action, and possible law reform'; it also shows that the fact that directors must act in the best interests of the shareholders does not mean that they are precluded from considering the interests of stakeholders too (Ramsay, 2005c: 63).

Of course, creating or clarifying a legal entitlement for directors to consider stakeholder interests in making socially responsible corporate decisions is different from legally requiring directors to take those non-shareholder interests into account in making decisions about the corporation's best interests. This is different again from mandating a legal obligation owed by directors to anyone or anything beyond the corporation as an enterprise.

This also begs the question of what we mean by such notions as the corporation as an 'enterprise', the best interests of the company as a whole, and the best interests of the shareholders, as well as the proxy measures for all of these things in practice.

We need to transcend the unproductive focus in much public debate about shareholder and stakeholder interests trumping one another in a zero-sum way. They are relational and interdependent interests. Moreover, acting primarily in the interests of shareholders without regard to, or even at the expense of, the interests of other stakeholders, including those who might have contributed something directly to the prosperity of the corporation (such as employees, financiers, creditors, and people using the corporation's products), must be justified within a coherent conceptual and regulatory framework of corporate relationships and the responsible exercise of corporate power.

Chanting simplistic mantras on all sides about 'shareholder primacy', 'enlightened shareholder value', 'stakeholder-focused obligations', and becoming a 'triple bottom line' corporation means resorting to mono-dimensional catchcries that can, at best, only ever be starting points for deeper thought and action.

Increasingly, modern corporate governance realises that maximising profitability, share values, and shareholder returns really requires a multidimensional focus on responding to corporate opportunities and risks from a variety of politico-regulatory, social, economic, and environmental sources.[3]

All of that is reflected in the public policy case for corporate social responsibility which, in terms of the different dimensions of a company's impact, contemplates various dimensions of that impact in environmental, economic, social, human resources and ethical terms (Zappala, 2003).
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The latest Australian initiatives touching upon directors and their corporate social responsibilities follow similar UK reform proposals, such as the draft Company Law Reform Bill 2005. This UK proposal to amend the legal duties of directors in a way that promotes 'enlightened shareholder value' is in the following terms:

> ‘Duty to promote the success of the company for the benefit of its members
>
> (1) As a director of a company you must act in the way you consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.
>
> (2) Where, or to the extent that the company is established for purposes other than the benefit of its members, your duty is to act in the way you consider, in good faith, would be most likely to achieve those purposes.
>
> (3) In fulfilling the duty imposed by this section you must take account (where relevant and so far as reasonably practicable) of:
>
> (a) the likely consequences of any decision in both the long and the short term;
>
> (b) any need of the company:
>
> (i) to have regard to the interests of its employees;

(ii) to foster its business relationships with suppliers, customers and others;
(iii) to consider the impact of its operations on the community and the environment; and
(iv) to maintain a reputation for high standards of business conduct; and
(c) the need to act fairly as between members of the company who have different interests.'

Legislative change to corporate laws to permit or require reference by directors in their decision-making to certain stakeholder interests (such as employees' interests) is already a feature of some US state-based corporate laws, prompted by, but not always limited to, circumstances of hostile takeovers (Berger, 2005).

As Australian commentators on these UK developments note, these proposed changes to directors' duties remain focused on the duty of directors to pursue the company's success for the collective benefit of its shareholders, with their obligation to consider relevant interests of employees, customers, and others in the community being structured within that overriding duty (Ramsay, 2005a; and Ramsay, 2005b). That is a significant overarching constraint.

CSR-related interests are already present in Australian corporate law. Directors are already required in their annual reports to explain corporate environmental compliance with the law (that is, *Corporations Act*, s299(1)(f)); and investment product-disclosure statements must reveal the extent to which socio-ethical factors, such as ethical, labour and human rights concerns, affect investment decisions concerning investment products (for example, *Corporations Act* s1013D(1)). Existing law on the legal duties of directors already permits reference to stakeholder interests, though not at the expense of shareholder interests, but *how* and *when* that is accommodated within decision-making and reporting frameworks and processes remains unclear.

Nor should we necessarily expect this kind of guidance from law, which is simply one form of regulation. Law is a good instrument to enforce mandatory compliance with clear and simple rules, yet a blunt instrument to enforce all aspects of CSR and 'triple bottom line' reporting. At the same time, as Meredith Hellicar's quoted comment suggests, directors need a legally-sure footing for situations of interdependent consideration of shareholder and stakeholder interests in the course of trying to make a socially responsible decision.

At a wider level, this is one reason why some commentators suggest that directors might even benefit from legislative clarification of their need to consider shareholder interests, to assist them in meeting the expectations, if not the claims, of disgruntled shareholders. This would be on the basis that legislative permission or even direction to consider relevant non-shareholder interests would 'shield' directors from both shareholder and regulatory action (Beerworth,

2005). Might such a law, for example, be of use or comfort to the James Hardie board in approving a multi-million dollar additional compensation package for asbestos victims?

DIFFERENT KINDS OF INTERESTS

One problem is that stakeholders (including shareholders) do not always, or even often, have commensurable rather than conflicting interests. So, expecting directors to serve both shareholder and non-shareholder interest is problematic, at least in terms of legally enforceable duties to both.

Stakeholders break down into different priority groups – shareholders, 'inner circle' stakeholders (such as employees, customers, creditors, financiers, and suppliers), and 'outer circle' stakeholders (for example, regulators, governments, NGOs, industry peers and competitors, and the wider community).

Moreover, both the 'shareholder primacy' norm and the mono-dimensional equation of a corporation's best interests with its shareholders' best interests both break down if pushed too far. Different kinds of shareholders have different kinds of interests. Employee shareholders who live in a local community serviced by their company employer might have different shareholding interests and concerns from institutional investors in that company. Shareholders do not equate to the company for all purposes, as a duty to the company as a sustainable enterprise is different from a duty to those current shareholders who want to maximise share prices for short-term trading.

Recent cases at the highest Australian level confirm important limitations on the capacity of shareholders to excuse anyone from abusing corporate power, including their inability to ratify what would otherwise be a breach by directors of their statutory duties.[4] Recent international research argues that there is nothing self-evident or automatic about the dominant 'shareholder primacy' norm in much corporate regulation, which developed historically in response to hostile takeovers and other accountability and governance dynamics (Deakin, 2005).

WHAT SHOULD BE DONE?

A multi-pronged approach is needed. This includes:

- possible legislative clarification of the connection between stakeholder interests, on one hand, and both directors’ duties and correlative ‘business’ judgment defences, on the other;
- enhanced CSR-based corporate governance standards developed and monitored through the ASX Corporate Governance Council (CGC);
- enhanced CSR-based corporate reporting;
- development of CSR-friendly corporate decision-making frameworks and guidelines (which are then tied to corporate reporting obligations);

- incorporation of CSR elements within ordinary corporate planning and risk-management processes; and
- promotion of CSR-based criteria in government concessions, incentives and procurement.

On the first prong, simply legislating corporate social responsibility via an immediate and dramatic change to the law on directors' duties is only one possibility. A key factor favouring incremental change is that clarifying the law will benefit directors and corporations engaged in socially responsible actions. A key factor favouring more dramatic change is that current laws and standards treat CSR as one step removed from a corporation's central mission, so that simply clarifying the existing law will be insufficient to achieve meaningful change in this area. One factor against any change except a declaratory one is that judicial exposition of the meaning and application of the formulation of directors' duties and 'business judgment' defences would start afresh in terms of precedent. Another is that CSR remains a controversial and multi-faceted idea, which should not be legislatively mandated in a particular form without first trying other regulatory options. Yet another is that, in the absence of evidence that any board has been constrained under current law from factoring relevant stakeholder interests into their decision-making, no change is necessary.[5]

You can be an advocate of corporate social responsibility and still want legislators to choose carefully from the menu of CSR-options confronting them in inquiry submissions and the academic literature. It is not anti-business to advocate a rethinking of corporate obligations and directors duties' so that both are more sensitive to the interplay between shareholder and stakeholder interests. Some of the early public submissions to the current Australian CSR inquiries adopt the same line. Sustainability and inter-generational equity might point to the need to change regulatory, judicial, and business mindsets about the nature of a corporation as an enterprise. Influencing directors to change their mindsets and actions might be one of the highest points of leverage for creating such a change (Hinkley, 2005).

Still, we should not change directors' duties too much without first challenging regulators and business to develop better operational and decision-making guidelines that reflect a change in thinking and behaviour, starting with amplification of the ASX CGC principles to enhance corporate decision-making and reporting in terms of the interdependence of shareholder and stakeholder interests. Importantly, the main ASX CGC principle concerning stakeholders – namely, Principle 10's injunction to 'recognise the legitimate interest of stakeholders', originally framed in terms of a stakeholder-focused code of conduct – is broad and open-ended, and still has much work to do in developing stakeholder-focused guidelines for corporations.

Any proposal to change Australian corporate law must also be undertaken with full regard to the flow-on implications of such changes elsewhere in corporate law

and practice. For example, enhanced obligations upon directors to consider stakeholder interest and to report in 'triple bottom line' terms have a correlative impact upon ASIC's enforcement domain. Changes to the content of directors' duties also have a correlative impact upon 'business judgment' defences, outsider assumptions about compliance with directors' duties in corporate dealings, judicial relief of directors from liability, and other aspects of corporate law.

'Shareholder primacy' can be code for shareholder interests at the expense of community interests and at the cost of harm to society. 'Stakeholder engagement' can be code for corporate philanthropy at the expense of shareholder interests. A different model and mindset is needed – one that recognises and operationalises the interdependence of those interests.

In my view, that requires a multi-pronged approach across various forms of regulation. A focus just on possible legislative amendments to directors' duties and reporting requirements is too blunt, too law-focused, and too incomplete to achieve the desired outcome of socially responsive and responsible corporate activity.

There is emerging acceptance across the public, private, and civic sectors, nationally and internationally, that the ways in which corporations choose to act in the interests of their shareholders should not be at the expense of causing undue adverse consequences for non-shareholders and society at large. The trouble is that there is much disagreement about the following: how corporate activities are conditioned or constrained in this way; what makes an adverse consequence for non-shareholders 'undue', or unjustified, and hence impermissible in terms of business ethics and law; and how any of this is best regulated. Whatever the latest Australian inquiries recommend, they must not throw the good corporate baby out with the bad corporate bathwater.

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Shareholder and stakeholder interests are relational and interdependent

Law is a good instrument to enforce mandatory compliance with clear and simple rules, yet a blunt instrument to enforce all aspects of CSR and 'triple bottom line' reporting.

Notes: [1] Professor Horrigan consults to Allens Arthur Robinson and had peripheral involvement there in some James Hardie work.
[2] The ‘triple bottom line’ commonly refers to the social, economic and environmental dimensions of corporate activity, in contrast with a ‘single bottom line’ focus upon financial aspects such as profits, share values, and dividends. For further discussion, see Horrigan, 2005.
[3] For further discussion, see the references and arguments cited in Horrigan, 2002 and Horrigan, 2005.
[4] *Angas Law Services PtyLtd (in liquidation) v Carabelas* [2005] HCA 23.
[5] This argument is not the author’s idea but was raised and discussed at the 2005 Corporations Workshop of the Business Law Section of the Law Council of Australia.