AUSTRALIAN CONSERVATION FOUNDATION
INCORPORATED ABN 22 007 498 482

FLOOR ONE, 60 LEICESTER STREET CARLTON VIC 3053
phone ■ 03/ 9345 1111 // facsimile ■ 03/ 9345 1166
email ■ acf@acfonline.org.au // web ■ acfonline.org.au

14 September 2005

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
Parliament House
Canberra ACT 2600

Re: Inquiry on corporate responsibility

Dear Sir/Madam,

Please find attached the submission of the Australian Conservation Foundation (ACF) to the Inquiry into Corporate Responsibility being conducted by the Joint Committee on Corporations and Financial Services.

ACF would be pleased to appear before the Joint Committee on any of the matters addressed in the submission, and can arrange for testimony from relevant experts on any of the overseas precedents discussed in the submission.

For further information regarding this submission, please feel free to contact the undersigned on (03) 9345 1173 or c.berger@acfonline.org.au.

Yours sincerely,

Charles Berger
Legal Adviser

14 September 2005

Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Corporate Responsibility

The Australian Conservation Foundation (ACF) commends the Parliamentary Joint Committee for undertaking an inquiry into corporate responsibility, and welcomes the opportunity to make this submission to the inquiry.

The legal and practical drivers of corporate decision-making are key determinants of the sustainability of the Australian economy and thus our collective wellbeing. Until these drivers are aligned with the long-term interests of the Australian community, including the restoration to health of the Australian environment, our businesses will continue to leave a legacy of environmental and social harm.

To this end, the incentives and obligations of corporate managers, directors and shareholders must be examined as a complete system, and should be structured around the principle of ecologically sustainable development and, only subject to that overarching principle, market efficiency.

Following an introduction to the concept of corporate responsibility and the current practice in Australia, this submission outlines the following 11 reforms that would better induce Australian businesses to act responsibly and consistently with the long-term interests of the Australian community:

1. **Recovery of unjustified executive incentive compensation.** Where full financial provision for environmental and social liabilities is not made at the time the actions or omissions leading to such liabilities occur, a corporation should have the right and obligation to recover performance-based executive compensation awarded during the relevant period.

2. **Clarification of directors' duties.** A director's duty to act in the best interests of the corporation should explicitly entail an obligation to consider the interests of all relevant constituencies, including the environment and communities in which the corporation operates.

3. **Expansion of trustees' duties.** Common law and statutory trustees' duties (including section 52 of the *Superannuation Industry Supervision Act 1993*) should provide that trustees of investment funds, in discharging their duties, must take into account environmental and social considerations.

4. **Safe harbour for corporate philanthropy.** The *Corporations Act* should provide for explicit recognition of the permissibility of reasonable corporate philanthropic activities, whether related to shareholder profits or not.

5. **Extension of liability for social and environmental harm.** Individuals and communities who suffer environmental damage, personal injury or death, or human rights violations should have recourse to holding companies for the acts of their subsidiaries, to successor entities in asset transfers, and to other parties with the ability to influence operational decisions who fail to take reasonable steps to avoid or limit such liabilities.

6. **Mandatory disclosure of social and environmental data.** Large corporations should be required to disclose key environmental and social data, including key CSR risks, to the public.

7. **Elimination of perverse subsidies.** Government subsidies that reward socially and/or environmentally harmful corporate behaviour should be dismantles.

8. **Creation of sustainability investment incentives.** The government should create positive tax incentives to leverage greater private sector investment in socially and/or environmentally positive projects.

9. **Revision of insolvency and winding-up laws.** Insolvency and winding-up laws should make full provision for long-tail liabilities, whether or not the identities of potential future creditors can be ascertained.

10. **Remedies for unethical overseas conduct.** Australian law should provide a legal remedy in Australian courts for any persons injured through a breach of the United Nations Human Rights Norms for Business.

11. **Promotion of institutional reform and capacity-building.** The government should improve the capacity of ASIC on corporate responsibility issues, create a National Corporate Responsibility Commissioner, improve government reporting and procurement policies, and adopt the Genuine Progress Indicator to replace GDP as the fundamental indicator of our success as a society.

Introduction

What is corporate responsibility?

Many people and groups contribute to the success of a business; each has a legitimate claim based on that contribution to enjoy in the fruits of that success.

Some contributions are direct, as when an employee contributes their labour, while others are more diffuse, as when a community provides a healthy environment and vibrant culture which enhances the ability of the business to retain happy, qualified staff and otherwise to be successful.

Some contributions are made through formal, contractual relationships, while others are delivered through non-negotiated, implicit relationships. For example, in allowing a company to operate, a community implicitly grants to the company the utilisation of some portion of that community's limited environmental carrying capacity – that is, the ability of the environment to supply resources such as clean water and air, to absorb and recycle limited quantities of waste, and to provide a stable climate. In return for the privilege of utilising that environmental carrying capacity, the community is entitled to expect that the business will do its part not to leave a degraded environment for future generations.

Corporate responsibility is therefore best understood as the reciprocal obligations that a business incurs because of the contractual or implicit contributions of all relevant groups to that business' operations and success.

The following table shows some of these groups and the salient features of their relationships to the business:

Group	Contributions	Relationship	Corporate obligations
Shareholders	- Financial capital - Assumption of top risk band - Ultimate management	Primarily legal (*Corps Act* and organisational documents); may also be contractual	Dividends and/or increase in capital value consistent with other obligations
Financial investors	- Financial capital - Assumption of risk - Expertise, sometimes	Primarily contractual	Repayment of interest and capital
Directors	- Management oversight	Legal and contractual	Compensation
Employees	- Intellectual and physical labour - Experience, initiative, commitment, continuity	Contractual (individual or collectively)	Fair compensation and conditions; respect for human rights; safety; employment security consistent with other obligations
Customers and end consumers	- Intermediate and ultimate demand for products and services	May be direct and contractual, or mediated through retailers; also subject to legal regulation	Duty of care; fair competition and trade practices

Suppliers	- business inputs	Primarily contractual	Payment for inputs; fair competition and trade practices
Local communities in which company operates	- local security - conducive business environment - social, cultural and environmental amenities - environmental carrying capacity (biodiversity, land, renewable and non-renewable resources, ecosystem services) - subsidies and other support - physical infrastructure	Primarily informal and implicit; some local regulation	Compliance with laws, taxation, responsible use of environmental carrying capacity and support for community
State / national communities in which company operates	As above, plus: - national security - regulation - licence to operate - assumption of residual risk in insolvency	Implicit in licence to operate; legal regulation	Compliance with laws, taxation, responsible use of environmental carrying capacity and support for community
Global community	- international trade - environmental carrying capacity (biodiversity, stable climate, etc)	Almost wholly implicit; mediated through national governments	Responsible use of greenhouse and other global environmental carrying capacity; fair trading conditions

Do organisational decision-makers have regard to non-shareholder interests?

At most Australian corporations, non-shareholder interests are considered only insofar as they contribute to increased shareholder value. Such interests have no independent value or consideration; they are deemed legitimate concerns of the corporation's Board and management if and only if they add to, or least do not detract from, shareholder profits.

Some corporations state this more or less openly. An example is Woolworths, which states in its "corporate governance manual" that:

> *The overall primary objective set by the Board is the enhancement of long term shareholder value. Directors have a duty to act in the best interests of the corporation as a whole, which means that they must act in the best interests of all members …*
>
> *Although directors have a duty to act in the best interests of the corporation's members, a corporation has a separate legal existence and operates in a social and economic context. Corporations have customers, suppliers and employees and carry on their business in a physical environment. Directors have general, and in some cases specific legal responsibilities, in relation to customers, creditors, employees and the environment.*
>
> *However, a board's paramount duty is to its members. Only when a corporation is insolvent or faces a risk of insolvency does the law expect the interests of another*

stakeholder eg creditor, to take precedence over the fundamental duty to members.[1]

Notwithstanding the brief nod to other "responsibilities", a director operating under this guidance will have no doubt about to whom ultimate allegiance is owed, or about how she is expected to act if the interests of the shareholders clash with "responsibilities" to other groups.

Woolworths' position is typical; a review of the corporate governance guidance or annual reports of most of Australia's top corporations will reveal statements similarly establishing a clear precedence of shareholder interests above all else.

In practice, there are numerous cases of Australian companies that have acted with gross disregard of the environment and the communities in which they operate. The following cases are a small sample of recent irresponsible corporate behaviour:

- Esmeralda's disastrous cyanide spill in 2000 that killed off large stretches of three Eastern European rivers, including the Danube;

- ERA's criminal poisoning of its own workers with uranium at its Ranger mine in Kakadu in 2004;

- The lawsuit by Gunns Limited against community activists for, among other things, voicing their concerns about Gunns' unsustainable logging practices to Gunns' investors and customers;

- Shell's lengthy record of criminal pollution offences and breaches of its licence over many years at its Geelong refinery, including scores of oil spills into Corio Bay and 394 licence breaches during 2003-2004[2];

- The negotiation of contracts by companies that constrain the ability of governments to take responsible environmental action. One example is Transurban's negotiation of an indemnity that effectively prevents Victoria from constructing a rail line from Melbourne to the Melbourne Airport, which would compete with Transurban's more polluting road connection. Another example is UK-based International Power's deed with the Government of Victoria that gives the Hazelwood power plant – the worst polluting plant in Australia and among the worst in the industrialised world – special rights to challenge any future regulation of greenhouse pollution or claim compensation if such regulation does not treat Hazelwood "equitably".

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[1] Woolworths Limited, "Corporate Governance Manual", p. 8, available at http://www.woolworthslimited.com.au/shareholdercentre/corporategovernance/corporategovernancedocument.asp.

[2] See Ewin Hannan, "Shell faces fresh charges on oil spill risk", *The Age*, 12 September 2005.

These are among the more egregious of recent corporate excesses, but there are other examples given throughout this submission and many others besides.

In each of the cases discussed, the inadequacy of government regulation and/or the difficulty of enforcing existing regulations, or in some cases sheer governmental incompetence, played a major part. Even in the case of criminal activity, as in the cases of ERA and Shell, the maximum penalties amounted to little more than a slap on the wrist for a large and profitable company.

It also apparent that none of the supposed controls on corporate malfeasance – enlightened shareholder value, corporate reputation, voluntary commitments, personal ethics – were sufficient to prevent these events.

To be sure, there are a growing number of Australian companies that take their obligations to the community seriously. Australian insurer IAG is a good example: for the past several years IAG has developed a comprehensive strategy to address global warming and has rolled out a highly innovative environmental management program for its smash repair contractors. Recycling companies such as Visy, renewable energy businesses such as Origin and Pacific Hydro, and investment companies such as Australian Ethical Investment have also been leaders, notwithstanding often unsupportive regulatory frameworks.

Nevertheless, serious problems abound. The following case studies examine in more detail two cases where the lack of effective penalties for irresponsible action and the skewed incentives of corporate decision-makers has led to serious community and environmental costs.

Case study 1: Abandoned contaminated mining sites

In 1994, the US-headquartered company Pegasus Mining opened a gold mine at Mt Todd in the Northern Territory. The project involved acid leach mining, a method that requires the use of hazardous chemicals on a large scale that was well-known at the time to have caused extensive groundwater and site contamination at other Pegasus sites.

Given its atrocious record in the US, Pegasus never should have been allowed to operate in Australia. It was, and the Mt Todd mine turned out to be a financial and environmental disaster. Mining by Pegasus Gold Australia ceased after only 3 years, with the company being placed under external administration in 1997. A consortium of Multiplex, General Gold Resources and Pegasus sought to recommence mining in 1999, but following a default by the other partners, Pegasus resumed full ownership in 2000. Attempts to sell the mine as a going concern failed, and Pegasus Gold Australia went into receivership.

The operations at the site, brief though they were, resulted in a toxic mess of immense dimensions. Pegasus had left behind on-site storage units containing nearly 800,000 tonnes of cyanide and other toxic chemicals, and a massive pile of rock waste leaching

heavy metals and acidic water. The Northern Territory Minister for Mines and Energy has described it as a "disaster", with estimated total remediation costs of at least $20 million.[3]

The vast majority of these remediation costs are being picked up by Northern Territory taxpayers, since Pegasus posted a remediation bond of only $900,000. According to the Minister: "Mt Todd is not a pretty site. The fact is government should never have been put in the position of managing what is a private sector responsibility."

Similar environmental issues and declining gold prices drove Pegasus Gold Inc., the U.S. parent entity, bankrupt in 1998, leaving U.S. taxpayers stuck with tens of millions of dollars in environmental clean-up costs. Even as the company spiralled into bankruptcy, millions of dollars in bonuses were paid to top executives. Following restructuring, however, three of Pegasus' former mines were spun off as Apollo Gold, and continue to earn profits for shareholders to this day. None of the profits from those mines, of course, are available for remediation of contaminated sites either in the U.S. or Australia. In any event, because of the limited liability of the U.S. parent with respect to its Australian subsidiary, recovery from the U.S. parent company could not even have been contemplated unless a parent guarantee had been required as a condition for mining.

The case of Mt Todd is not unique. A 1999 report by CSIRO identified acid mine drainage undertaken at hundreds of mine sites around Australia, and highlighted that there were "many examples" of sites, active and abandoned, that "have not been managed environmentally and which have caused varying degrees of contamination."[4]

The Mt Todd case highlights that abandoned contaminated mines are not just a legacy of events long in the past. Mt Todd commenced operations a scant 12 years ago, in a period of full awareness of the risks of acid leach gold mining. Second, the case shows how corporate law encourages unacceptable risk-taking with the environment. The shareholder in the operator of the mine (ie, the U.S. parent company) was shielded from the actual clean up costs by the principle of limited liability and the structure of insolvency law, and thus had no incentive to manage the site responsibly.

Case study 2: derelict petrol station sites

In a 2001 submission to the fuel tax inquiry, the Victorian Automobile Chamber of Commerce (VACC) described the structures and processes that have led to the closure and abandonment of many petrol stations with no regard for environmental considerations or site rehabilitation. The factors contributing to the neglect of social and environmental considerations, in VACC's view, were as follows:

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[3] See Northern Territory Hansard, 30 November 2004, available at http://notes.nt.gov.au/lant/hansard/hansard9.nsf/0/cc16938c8ae0aafe69256f7100194889.

[4] CSIRO, "CSIRO Tackles Ecological Time Bomb", 6 January 1999, available at http://www.csiro.gov.au/index.asp?type=mediaRelease&id=CsiroTacklesEcologicalTimeBomb&style=mediaRelease.

As these businesses fail and the service stations close, simply "selling off" and walking away is not an option - unlike merchandise traders. Service station sites have, in many cases, become an environmental liability. The low value of land in rural areas and the projected costs involved in cleaning up potential soil and groundwater contamination have caused some sites to be simply abandoned.

Site clean-up and removal of underground fuel storage tanks is often not considered because of the following:

a) Environmental issues, such as potential contamination, are not always immediately apparent.

b) Even if the operator was aware of issues of tank leakage, fuel monitoring and environmental requirements, such things faded into the background as all their endeavour focussed on survival. The lack of income and any structural adjustment assistance, makes it impossible for them to do anything about it.

c) The desperate hope of selling the site as a going concern. Therefore, the equipment is retained so that another person may be able to "make a go of it".

d) Cost of tank removal and site clean-up is beyond the capabilities of the service station operators/owners to pay. However, many are orphaned sites. The owner who closed the site is either not available or not contactable. Some have even died.

e) Many simply walk away from the business and lose everything - including their "superannuation" which is or was, the now non-existent or even negative value of the business and property.

Consequently, fences are erected around the perimeters of orphan sites, leaving behind a legacy of negativity and destitution. Many orphaned sites are described as "eye-sores" of the townships. Beyond being a major environmental and economical issue, this has become a major Local Government issue in regional areas. The closure of many service stations has had a major negative impact on the towns' morale.[5]

Underlying these developments is the fact that many petrol stations are operated as franchises. A franchise structure enables large petroleum companies to extract profits from

[5] Victoria Automobile Chamber of Commerce, "Submission to the Fuel Tax Inquiry" 22 October 2001, available at http://fueltaxinquiry.treasury.gov.au/content/Submissions/Industry/downloads/VACC_239.pdf.

individual sites through franchise fees, while evading all of the liabilities that direct ownership would entail, such as site remediation. Franchises are an immensely successful business model precisely because of the ability of the franchisor to push liabilities onto individual operations, from which they are insulated, without sacrificing profits. The owners of individual sites have neither the ability nor the resources to remediate a failed site, while the franchisor has no incentive or legal requirement to do so.

How can reforms to the legal framework encourage organisational decision-makers to have regard to interests other than shareholders?

This question is taken up in the bulk of this submission. However, it is important to view possible reforms in the context of the organisational decision-making process as a system. This system includes at least three distinct but inter-related levels of corporate decision-making: the shareholders, the Board, and management.

Attempts to inculcate greater corporate responsibility must address this system in a holistic way, cognisant of both legal and non-legal considerations that drive corporate decisions. An isolated change to one aspect of decision-making, such as director's duties, may have very little effect if other, overriding factors (such as shareholder and Board control over incentive-based executive compensation) clash with that change.

Direct legal duties are important, but are by no means the only or even the most important drivers of corporate decision-making. The major incentives operating on each group of decision-makers are as follows:

Management: Managers have basic legal duties towards the corporation, and duties to comply with other generally applicable laws. The force of these will depend on who has the ability to enforce the obligations, what capacity and will they have to engage in enforcement action, and what personal and/or corporate penalties attach to a breach. The structure of executive compensation packages, especially the performance targets that the Board sets for senior executives, is another major influence. By setting performance incentives that reward executives for maximising shareholder value, the Board and the shareholders create a personal financial interest for management to pay greater attention to shareholder interests than to other interests. Board and shareholder control over executive appointments, and their ultimate ability to override executive decisions, also shape how an executive will manage a corporation.

The Board: Directors of a corporation are under specific duties to the corporation, as set out in the *Corporations Act*, and have other legal duties as well. Again, the effect of these depends on enforcement mechanisms and penalties. In addition to those, the directors are ultimately accountable to the shareholders. The mechanisms of shareholder control include power over appointments and compensation, and the ability to override specific decisions by shareholder resolution.

Shareholders: For individual shareholders, the desire to earn financial returns is a major driver of behaviour. A shareholder's decision-making is also coloured by the existence of limited liability for the debts of the corporation, and any possibility of piercing the corporate veil. Personal ethics of the shareholder and transactional and agency costs are further influences.

For institutional shareholders, the decision-making calculus is more complicated. Such shareholders are frequently under legal duties of their own, such as trustee's duties under common law or statute (particularly the *Superannuation Industry (Supervision) Act 1993*). Institutional shareholders will also operate under their own personal and organisational incentive structure, and may be motivated to increase the number of their customers or members. The expressed desires of an underlying constituency may be important (as in a managed fund with few investors), or may be disregarded (as in a superannuation fund with a statutory portfolio maximisation duty).

When the shareholder is a holding corporation controlling a subsidiary, any possibility of the parent company becoming liable for the debts of the subsidiary (through veil piercing, or parent-level guarantees) is among the very few constraints on profit-maximising behaviour.

The reforms outlined in section 1 of this submission are aimed at improving management decision-making. Section 2 is concerned with Board decision-making, while sections 3 and 9 are concerned primarily with shareholder decision-making. Section 5 has aspects that pertain to each group. The proposals in the remaining sections tend to act on corporate profitability overall, and so may influence the decision-making of all three groups.

These reforms should be viewed as an interrelated package. For example, adoption of reforms to directors' duties, without any change to the incentives under which shareholders operate and the structures of financial compensation that encourage managers to increase share prices, will do little to shift corporate decision-making in any meaningful way.

1. Recovery of unjustified executive incentive compensation

Executive compensation packages strongly discourage management consideration of long-term corporate, community and environmental issues.

The clearest expression of a company's priorities is how it chooses to reward its senior management. A company that adopts compensation packages for its managers that reward only short-term financial performance sends a very clear message about what it expects them to do. Managers that operate under such contracts will correctly perceive that exhortations by the Board or shareholders to "think long-term" or "have regard to a broad range of stakeholders" are peripheral and unimportant, or even just public relations drivel.

In practice, performance-based executive compensation at most top Australian companies is awarded exclusively or primarily on the basis of such short-term financial performance indicators. Executive compensation is typically a mix of fixed compensation, short-term incentives and so-called “long-term” incentives. Short-term incentives are based on annual performance measures, and may include financial and non-financial criteria. “Long-term” incentives are typically share options that vest within 3-5 years from the time of grant if performance hurdles (almost always some indicator of share performance) are satisfied.

There are scattered examples of more creative, long-term performance incentives. A few companies, generally in the resources sector, base some component of short-term incentives on the attainment of non-financial environmental and social performance goals that contribute to the long-term success of the organisation. BHP Billiton, for example, has Group KPIs in the areas of health, safety and environment that affect annual cash bonuses of senior management up to and including the CEO level. Such non-financial KPIs tend to be a very small part of total at risk remuneration, however, and are in any case the exception rather than the rule.

Thus, despite some modest improvements at a few companies, most executives have an overwhelming financial disincentive to look beyond a 3-5 year time horizon. If an executive takes steps to reduce long-term environmental and health risks, to invest in innovation with long lead times, or to position the company to succeed under likely medium-term regulatory and environmental changes, she most likely does so in spite of her own financial best interests, and not because of them.

This is not to say that executives will always act irresponsibly, with an exclusive focus on short-term profit maximisation. However, it is unreasonable to think that most executives will consistently devote meaningful attention to long-term environmental and community concerns given the incentives under which they operate.

A solution: recovery of incentive compensation to cover environmental and social liabilities.

Performance-based executive compensation should be subject to recovery by the company if the company incurs additional environmental or social liabilities (1) as a result of corporate actions or omissions taken during the period for which such compensation was awarded; and (2) for which full financial provisions were not made during that period.

This rule would create a clear financial incentive for executives to take into account long-term environmental and social risks without any legislative interference in the actual negotiation of executive compensation packages.

The possibility of compensation recovery would strongly encourage decision-makers to take a precautionary approach to possible or certain long-tail liabilities and to insist that they are fully assessed and costed in the corporate decision-making process. Faced with the potential loss of incentive compensation, executives will be inclined to err on the side of over-provisioning for such liabilities rather than under-provisioning. This may, in turn, reduce the incidence of orphaned contaminated sites, for example, or under-funded personal injury compensation funds.

Overseas model: United States
Incentive executive compensation recovery

In 2002, the U.S. adopted a clawback of incentive executive compensation where a company has to restate financial reports. According to section 305 of the Sarbanes-Oxley Act, if an issuer of publicly-traded securities has to prepare a restatement due to "material non-compliance" with financial reporting requirements, the CEO and CFO must "reimburse the issuer for any bonus or other incentive-based or equity-based compensation received" and "any profits realized from the sale of securities of the issuer" during the period covered by the restatement.

While the U.S. scheme is based on financial reporting non-compliance rather than environmental and social liabilities, it provides a workable and tested model for encouraging decision-makers to have regard to long-term community and environmental interests.

Of course, full recovery may not be practical in all cases. By the time subsequent liabilities become evident, years or decades may have passed and the culpable executives may no longer have sufficient funds to reimburse the company, or may even be deceased. In addition, some companies may be reluctant to exercise their rights under the clawback for a variety of reasons, including personal ties and a desire that compensation recovery would discourage qualified executives from serving with the company in the future.

To address these difficulties, companies should be required to exercise their rights under the recovery provision, unless they obtain a waiver from ASIC, which can be granted only if there is no reasonable prospect of a significant recovery of funds.

2. Clarification of directors' duties

Australian directors' duties are generally interpreted to prohibit consideration of non-shareholder interests where they do not contribute to shareholder value.

The duties set out in sections 180 and 181 of the *Corporations Act* are almost universally interpreted as require directors to maximise financial returns for the shareholders of the corporation. Thus, a corporate partner of a major Australian law firm recently observed that:

> The traditional view under the *Corporations Act* and at common law is that a director's duty to act in the best interests of the corporation requires a director to govern solely in the interests of shareholders by maximising profits. Directors are

not required to consider social or environmental issues in the discharge of their duty.[6]

That this is the standard interpretation can hardly be questioned. To be sure, the directors' obligation in section 181(1)(a) is to act in the best interests of the "corporation", not in the best interests of the "shareholders". However, in the minds of many, these amount to one and the same thing – or, to be more precise, the "corporation" is little more than a piece of property owned by and operated ultimately for the sole benefit of the shareholders. Thus, Woolworths instructs its directors that the duty to act in the best interests of the corporation means a duty to act in the best interests of Woolworths' members, as a priority overriding any other corporate constituencies.[7]

This interpretation does not discourage consideration of non-shareholder interests – it positively prohibits it, except insofar as those interests might be a useful tool for increasing shareholder profits.

This view has not gone unchallenged. There are alternative views of what a "corporation" is. One such view is that the corporation is not a piece of property, but a nexus of contractual and non-contractual relationships between and among a range of groups, of which the shareholders are but one. To act in the best interests of the "corporation", so conceived, would mean to act in the collective welfare of all participants in this web of relationships.

ACF and others have urged an expansive interpretation of the duties in section 181, so that the obligation to act in the best interests of the corporation is understood as empowering directors to take into account the environment and a more balanced range of corporate constituencies.[8] Furthermore, the various cases establishing the duty to creditors, at least when a company is nearing insolvency, established beyond a doubt that the company's best interests can diverge from those of the shareholders.

However, it is not enough to point to the fact that the words of the statute are capable of bearing a broader interpretation than mere devotion to shareholder profit maximisation. The fact remains that view has not attained widespread currency, and the traditional view that shareholders are the only or at least the primary corporate constituency still prevails overwhelmingly.

The traditional interpretation, however misguided and narrow, inhibits organisational decision-makers from considering interests beyond the financial interests of the shareholders. Nowhere was this more clear than in the James Hardie controversy. One of

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[6] Mark Standen, "Corporate social responsibility: the Jackson Inquiry and tsunami donations", *Company Secretary*, July 2005, page 332, available at http://www.minterellison.com/public/resources/file/eb3e214cd56848a/CorporateSocialResponsibility.pdf.

[7] See note 1, above.

[8] See, for example, C Berger, "The Myth of Shareholder Primacy", *Online Opinion*, 13 May 2005, available at http://www.onlineopinion.com.au/view.asp?article=3436.

the very few things upon which James Hardie Chair Meredith Hellicar and ACTU Secretary Greg Combet agreed during the fight to obtain full compensation for the victims of asbestos was that the Australian directors' duties inhibited James Hardies' Board from topping up the compensation fund because of a fear of shareholder lawsuits, and that these duties need to be expanded to encompass other corporate constituencies.[9] Indeed, Ms Hellicar compares Australian law unfavourably to Dutch law, where consideration of the relationships among the company and all those involved in its organisation is permissible.

The James Hardie case highlighted the irreconcilability of the usual view of directors' duties and obligations to other corporate constituencies, but it is by no means a unique case. To a greater or lesser extent, those same duties underlie all of the instances of corporate malfeasance discussed in this submission.

The Corporations Act should clarify that the duty of a director to act in the best interests of the corporation entails an obligation to consider all corporate constituencies.

The *Corporations Act* should make explicit what is already the best reading of the text of section 181: that the obligation to act in the best interests of the corporation means a director should consider the interests of all corporate constituencies.

The best way of doing this would be to specify a non-exclusive list of relevant constituencies. Such a list should specifically include employees, financial investors, shareholders, customers and suppliers, communities in which the corporation operates, and the environment.

This development would not constitute a radical change to Australian corporate law, but would clarify that companies that wish to take into account the interests of the community and the environment may do so without fear of shareholder lawsuits. Seen in this light, the reform is much more about deregulating directors' duties and removing a barrier to responsible decision-making than about imposing a new burden.

There are a number of common objections to this and similar proposals for reform. The main objections and a response are as follows:

- *By making the directors accountable to all, they will be accountable to none.* This objection ignores the existence of direct control mechanisms by the shareholders, including the shareholders ultimate control over board appointments and compensation, the ability to pass binding shareholder resolutions, and the power to define and amend the organisational

[9] See Bill Pheasant, "Directors need a safe harbour: Hellicar", Australian Financial Review 17 March 2005, p.3; and Greg Combet, Speech to ACSI Corporate Governance Conference, 9 July 2005, available at http://www.actu.asn.au/super/news/1121040235_1934.html.

documents under which the corporation acts. A broadening of directors' duties will not dismantle these more important control mechanisms; it would simply remove a directors' fear that he or she could be personally sued for protecting the environment, giving to charity, paying a fair wage or refusing to engage in legal but harmful business activities.

- *Directors will not be able to balance competing interests.* Businesspeople and other professionals are constantly balancing competing interests. Directors already have to balance the interests of shareholders seeking short-term gains versus those with a longer investment horizon; they also must engage in a very delicate balancing of shareholder and creditor interests when a company approaches insolvency. Furthermore, they routinely must balance the competing internal demands of various business areas for scarce resources. They do not appear to be unable to accomplish any of this – indeed, it is at the core of their role as managers. Lawyers have obligations to their client and obligations to the Court; politicians must balance the competing interests of a vast range of societal constituencies. There is no reason to think businesspeople are unable to negotiate similarly complex duties.

- *Broadening directors' duties will expose companies to frivolous lawsuits from community activists.* Currently, a director's duty is to the company, and it is the company that has primary responsibility for taking action if the duty is breached. Shareholders have a limited right to take action on the company's behalf. With no modification of these standing rules, an clarification of directors' duties would tend to limit shareholder suits rather than enable suits by non-shareholders. Furthermore, the existence of the business judgment rule in section 180(2) would, as before, insulate most business decision-making from review. Finally, the Australian rule that the losing party pays the other side's costs in most litigation is a very effective deterrent against frivolous lawsuits even under broad standing regimes.

- *Expanding directors' duties will discourage investment and erode economic performance*. Again, there is no evidence of this in other jurisdictions that have adopted, or that have always had, more inclusive views of what a corporations' interests are. The real threat to a sound economy is from unsustainable economic practices, not from any imagined decrease in incentives that corporate responsibility would cause. Unsustainable businesses impose costs on the community in the form of contaminated sites, degradation of natural resources, pollution and its health effects, generation of waste and similar injuries. These costs force investment into unproductive activities (such as remediation, health care, waste disposal, etc) and impair the health of the economy overall.

Many foreign jurisdictions have broader definitions of directors' duties.

Following is a brief review of the legal position of directors in other modern economies.

- *Canada.* In Canada there is clear judicial acceptance that a directors' duty to the corporation permits consideration of non-shareholder interests, whether they promote shareholder value or not. For some time the sole authority for this was a lone 1973 case from the Supreme Court of British Columbia, but the proposition has been affirmed in other recent cases.[10]

  This was placed beyond question in 2004, when the Supreme Court of Canada in *Peoples Department Stores v. Wise* accepted "as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment."[11]

- *Civil law systems.* It is important to realise that the concept of shareholder primacy is foreign to the half of the world that operates under a civil law model. In Germany, for example, a director must promote the *Unternehmensinteresse*, or "interests of the company", which is a concept clearly distinct from the interests of the shareholders. A prominent German corporate law expert summarises the concept as follows:

  The content of the company's interests is 'the upholding and ongoing functional fulfilment of the company's duties to investors, workers, suppliers, customers, consumers, state and society'. The company's interests take into account both substantive and procedural aspects. The realisation of the company's interests involves, for example, the Board's approach to weighing up the coinciding and/or conflicting interests of stakeholders and resolving them through the principle of "practical concordance". It follows, in particular, that the Board is not obligated to pursue the exclusive goal of profit maximisation; to the contrary, the prevailing opinion admits a greater scope of discretion in incorporating the interests of other groups.[12]

  Indeed, it is uncontroversial that a German company director can, for example, make provisions for employees even if there is clearly no benefit for the

[10] *Teck Corp. v. Millar* (1972), 33 D.L.R. (3d) 288 (B.C.S.C.); *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.* (1986), 59 O.R. (2d) 254 (Div. Ct.);
[11] *Peoples Department Stores Inc. (Trustee of) v. Wise*, (2004), 244 D.L.R. (4th) 564.
[12] Chritoph Kuhner, "Unternehmensinteresse vs. Shareholder Value als Leitmaxime kapitalmarktorientierter Aktiengesellschaften" (Company Interest vs. Shareholder Value as central principle of capital market-oriented corporations), Presentation to Instituts für Arbeits- und Wirtschaftsrecht der Universität zu Köln, 21 July 2003, available at http://www.econbiz.de/archiv/k/uk/swpruefung/unternehmensinteresse_shareholder_value.pdf. (Citations omitted; translation by author of this submission.)

shareholders because, for example, the company is about to cease trading as a result of a merger.[13]

- *United Kingdom.* In the U.K., section 309 of the *Companies Act 1985* obliges directors to have regard to the interests of the company's employees as well as its members in the performance of their duties. In addition, the government has released a draft Company Law Reform Bill, which largely reflects an "enlightened shareholder value" theory of directors' duties. It would retain a primary obligation to act for the benefit of the company's members, but specify that in doing so directors should have regard to "any need of the company" to consider the interests of its employees, the environment, the community, and so forth.

  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. For this reason, it has been opposed by many workers' groups, because it downgrades the interests of employees from an independent consideration on par with members to a mere instrument for achieving shareholder profits.

- *United States*. In the U.S., there is some diversity in approach among the 50 states. Historically, there was little consensus among courts as to whether the interests of non-shareholders could legitimately be considered by directors. To a large degree, the difference between shareholder primacy and other points of view was mostly of academic interest; as far as courts were concerned, the business judgment rule insulated most operational decisions from review. As one academic put it:

  In most jurisdictions, courts will exhort directors to use their best efforts to maximize shareholder wealth. In a few jurisdictions, courts may exhort directors to consider the corporation's social responsibility. In either case, however, the announced principle is no more than an exhortation. The court may hold forth on the primacy of shareholder interests, or may hold forth on the importance of socially responsible conduct, but ultimately it does not matter. Under either approach, directors who consider nonshareholder interests in making corporate decisions, like directors who do not, will be insulated from liability by the business judgment rule.[14]

  However, following the wave of hostile takeovers and plant closures in the 1980s,

[13] Theodor Baums, "Personal Liabilities of Company Directors in German Law", Arbeitspapier 35, available at http://www.jura.uni-frankfurt.de/ifawz1/baums/Arbeitspapiere.html.
[14] Stephen Bainbridge, *Interpreting Nonshareholder Constituency Statutes,* 19 Pepperdine Law Review 971, 979-980 (1992).

at least 31 of the 50 states enacted “corporate constituency” statutes overriding traditional notions of shareholder primacy. These statutes are diverse, with some limited to the takeover context and others extending to all corporate decision-making. Most of these statutes are permissive, in that they allow but do not require directors to consider non-shareholder interests. However, the statutes of Connecticut and Arizona are both mandatory, though limited to the takeover context. Statutes in Pennsylvania and Indiana explicitly reject the primacy of shareholder interests over those of other constituencies.

An example of a relatively broad constituency statute is that of Vermont:[15]

§ 8.30. General standards for directors
(a) A director shall discharge his or her duties as a director, including the director's duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner the director reasonably believes to be in the best interests of the corporation. In determining what the director reasonably believes to be in the best interests of the corporation, a director of a corporation … may, in addition, consider the interests of the corporation's employees, suppliers, creditors and customers, the economy of the state, region and nation, community and societal considerations, including those of any community in which any offices or facilities of the corporation are located, and any other factors the director in his or her discretion reasonably considers appropriate in determining what he or she reasonably believes to be in the best interests of the corporation, and the long-term and short-term interests of the corporation and its stockholders, and including the possibility that these interests may be best served by the continued independence of the corporation; ….

It may be that these statutes have not had a great impact on most corporate decision-making, though it is reasonable to think that they make it easier for ethically-minded directors to take community and other considerations openly into account. The limited impact is attributable to a combination of (1) the permissive rather than mandatory nature of nearly all of them; (2) the lack of standing by non-shareholders to enforce them; and (3) the lack of any broader structural and legal reforms, such as those outlined in this submission, to address the remaining bulk of corporate incentives to ignore non-shareholder interests.

[15] Vermont Statutes Annotated, Title 11A, section 8.30.

In states that have not adopted a corporate constituency statute, the legal duties of a director remain defined substantially by the courts. In Delaware, the state of incorporation of around 50% of publicly-traded U.S. corporations, judicial precedent has made clear that maximisation of shareholder profits is not required, even in the takeover context. This is demonstrated by the case of *Paramount Communications, Inc. v. Time Inc.*[16] In that matter, the Board of Time, Inc., refused to put to a shareholder vote a tender offer by Paramount Communications, notwithstanding a substantial premium for the shareholders. Instead, the Board supported a merger with Warner Brothers, which was by all accounts less advantageous to the financial interests of Time's shareholders. Part of the directors' justification for rejecting the Paramount bid was their view that it presented a threat to the "Time Culture" and the notions of "journalistic integrity" that included. The Court upheld the Board's decision, holding that the directors were entitled to make judgments based on their long-term vision of the *corporation's* interest, apparently even though that entailed a clear sacrifice of short-term shareholder value. Many have argued that *Time* at least implicitly allows broad consideration of non-shareholder interests.[17]

3. Expansion of trustees' duties

Existing trustees' duties compel irrational and unethical investment decision-making.

However narrow the duties of directors are or are perceived to be, the duties of trustees are narrower still. Under section 52(2)(c) of the *Superannuation Industry (Supervision) Act 1993*, for example, a superannuation trustee must "ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries." The "best interests of the beneficiaries" in this context is most often interpreted as requiring trustees to maximise the financial return of the funds under administration. There is no option to opt-out of this provision; it must appear in the trust deed.

There are several difficulties with this rule. To begin with, maximising the return on the investment portfolio of the trust can in some circumstances actually be against the interests of the beneficiaries, or even against their net financial interests.

Consider, for example, the case of a large group of individuals who have been seriously injured by a defective product. They have legal claims against the manufacturer. In addition, their superannuation fund may hold shares in the manufacturer. It is clearly in the financial interests that the claims be paid out, since the value of those claims would be greater than any marginal change in the stock price of the manufacturer on their highly

[16] 571 A.2d 1140 (Del.1989).
[17] See, e.g., Lyman Johnson & David Millon, "The Case Beyond Time", 45 Business Law 2105 (1990).

diversified superannuation portfolio. Yet their own superannuation fund, if limited to maximising the value of the investment in the manufacturer, may feel compelled to support the manufacturer's efforts to resist those claims. If the matter should ever come to a shareholder vote, the superannuation fund could even feel compelled to vote against payout of claims, notwithstanding the suffering this could inflict on its own members.

Indeed, this was precisely the situation faced by some victims of James Hardie's asbestos products. Imagine the mesothelioma sufferer, faced with the prospect of being denied compensation in part as the result of his own superannuation fund applying pressure as a James Hardie shareholder to refuse to top up the compensation fund.

More fundamentally, many investors do not want their savings invested to maximise profits, no matter what the cost to the environment or community. ACF regularly hears from its members who are angered and frustrated to find that their retirement funds are used to finance unethical corporations. This has to be seen in the context of a system that mandates superannuation contributions and does not afford all workers choice of superannuation fund, particularly government employees and employees covered by a certified agreement.

Overseas model: Connecticut
Social and environmental considerations in investment policy

Connecticut state law explicitly recognises that social and environmental considerations are important in securing long-term economic benefits for beneficiaries of the state pension funds. In particular, section 3-13d(a) of the Connecticut General Statutes provides that

…Among the factors to be considered by the Treasurer with respect to all securities may be the social, economic and environmental implications of investments of trust funds in particular securities or types of securities.

In implementing this provision, the Investment Policy Statement for Connecticut's Retirement Plans and Trust Funds states (p.21) that:

… Prudence and consideration of corporate citizenship are complimentary goals, as recognized by State law. Primary among considerations for the investment of the pension plans and trusts, is the prudent investment of these assets for the long-term economic benefit of the plan participants and beneficiaries. Prudence includes considerations of performance, risk and return. In addition to prudence, State law states that the Treasurer may consider the social, economic, and environmental implications of its investments ….

We can not put it more eloquently that our member who wrote the following to us, upon discovering that his superannuation fund invests in unethical logging company Gunns Limited:

> *I found to my dismay that the CSS does invest in Gunns. As this scheme is compulsory for Commonwealth employees, and provides no option for member choice of investments, there is essentially nothing that I can do about it. Even the token action of contributing at the minimum rate, 5%, would make no difference to Gunns.*

The assistant secretary of the CSS, whom I contacted, says that the CSS is bound by prudential regulation and that dispensing with their investment with Gunns would require approval from the minister, which seems unlikely.

It seems to me that a system that prevents people from exercising their social conscience, in fact forces them to invest in activities that they are ideologically opposed to, is a system that is out of control.

Even for funds whose members and trustees are all agreed that they do not wish to invest in an unethical business, no matter what the returns, a decision not to so invest apparently entails legal risk for the trustees. At least as late as July 2002, law firm Allens Arthur Robinson was advising that selecting investments on the basis of environmental or social considerations could "threaten to contravene the fiduciary duties of a trustee not to fetter his or her discretion and to maximise the financial return on investments."[18]

These duties are a concern not only in the selection of investments. Inevitably, a trustees' decision on how to engage with a company and how to vote on resolutions will be coloured by the trustees' legal duties. Trustees that feel obligated to maximise returns, no matter what the social or environmental cost, will exert heavy pressure on the companies in which they invests to do the same. By the same token, they will accord little or no recognition to companies that act responsibly, unless those actions also happen to generate large shareholder returns.

In the broadest sense, even aside from investors that have a conscience, a rule that obligates trustees to maximise financial returns is a bad idea from the perspective of society as a whole for the exact same reasons that a rule that company directors should only maximise shareholder profits is a bad idea. If we do not want companies only to maximise profits, but rather to act responsibly and with reasonable regard to all constituencies, than we must conform not only the incentives of directors and executives, but also the obligations and incentives of shareholders as the ultimate controllers of corporate activity.

Trustees, in discharging their duties to their beneficiaries, should be obligated to take into account the interests of the community and the environment.

In any conflict between the desire and ability of corporate boards to take into account non-shareholder constituencies, and the desire of shareholders to have them decline to do so, the shareholders will prevail. Whether through direct means such as shareholder resolutions or removal of overly ethical directors, or more subtle means such as the setting of performance hurdles in remuneration packages, the shareholders can impose their will on the other organisational decision-makers.

[18] Julian Donnan, "Disclosure of ethical investment considerations", *In the Money*, July 2002, p 30, available at http://www.aar.com.au/pubs/itm/jul02/index.htm.

Therefore, if Boards are to be encouraged or required to consider non-shareholder interests, the incentives and obligations of institutional investors must be fully aligned to that end.

Accordingly, Commonwealth legislation (including section 52 of the *Superannuation Industry (Supervision) Act 1993*) should require trustees to take into account in the discharge of their duties the interests of the community generally and the environment. It is within these constraints that they should maximise financial returns for their beneficiaries. The practice in the State of Connecticut, where such considerations already supplement traditional notions of prudence in the management of the state's pension funds (see inset), is a practical demonstration of the viability of this model.

A variety of other legislation, including the various state Trustee Acts, would have to accompany these changes to set uniform considerations for how funds under management for the benefit of others should be invested. Following amendment of relevant Commonwealth legislation, the issue of trustees' duties under state law should be taken up through COAG.

4. Safe harbour for corporate philanthropy

The capacity of corporations to engage in philanthropic activities should be placed beyond question.

Following the Asian tsunami, the Australian Shareholders' Association suggested that some corporate donations to assist the victims of the disaster were impermissible. According to ASA spokesperson Stephen Matthews, "Boards of directors don't have a mandate from their shareholders to spend the money in that way and they have no way of possibly knowing whether or not their shareholders want their money – the shareholders' money – spent in this way."[19] In his view, donations were acceptable only if there is a financial benefit for the shareholders.

While the ASA subsequently issued a clarification specifying that it did not oppose donations provided shareholders were "kept informed", the uncertainty engendered by its comments remains. Further, the ASA's stance appears to have been a tactical retreat in the face of public outrage rather than a principled acceptance of corporate philanthropy. The ASA's chief executive subsequently stated that the tsunami was just a poor time to "put forward a considered point of view," which implies ongoing support for Mr Matthews' comments. In any event, the damage was done, and some commentators continue to

[19] ABC local radio, "Shareholders Association opposes corporate aid donation", 7 January 2005, transcript available at http://www.abc.net.au/am/content/2005/s1278328.htm.

suggest that "genuinely selfless" corporate philanthropy could be a breach of a directors' duty.[20]

The view that corporate philanthropy is acceptable only if tied to shareholder value is inconsistent with community values, as evidenced by the backlash against the ASA's comments. No less a public figure than Prime Minister John Howard urged corporate giving following the Tsunami; his plea for generosity was not limited to situations where donations would drive increased profits. The *Corporations Act* should reflect these views by explicitly recognising the acceptability of corporate donations, whether related to shareholder value or not.

The notion that corporate philanthropy must be linked to shareholder value is not only out of touch with community norms, but also completely unnecessary to protect shareholder interests. Shareholders already possess the ability to appoint (and dismiss) directors, set executive remuneration, and override any policies with which they disagree by shareholder resolution. If shareholders desire restrictions, disclosure, or a corporate donations policy of any sort, there is nothing preventing them from passing a resolution to that effect.

Given these mechanisms of control outside of fiduciary duties, it seems unlikely that directors or executives would irresponsibly fritter away corporate assets if corporate philanthropy was explicitly shielded from review. This is backed up by evidence from the United States, where all 50 states explicitly permit corporate donations (see box). Despite such facilitative laws, the average corporate giving rate in the U.S. remains at a modest 1.0-1.3% of income, well below the average individual giving rate of about 1.9-2.2% despite the tax advantages of corporate over individual giving.[21]

Overseas model: United States
Corporate philanthropy statutes

In the U.S., all 50 states have for many years had statutes explicitly permitting corporate philanthropic donations. 24 states authorise donations "donations for the public welfare or for charitable, scientific, or educational purposes", a further 19 have similar provisions and authorise in addition donations "furthering the business and affairs of the corporation."

Seven states, including New York and California, explicitly allow donations regardless of corporate benefit. New York's Business Corporation Law, section 202(a)(12), sets out a replaceable rule that a corporation has the power:

> to make donations, irrespective of corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civic or similar purposes, and in time of war or other national emergency in aid thereof.

Many of these laws were enacted to override the 19th-century view that corporate donations were *ultra vires*, or beyond the powers of a corporation.

[20] See Malcolm Maiden, "Tsunami: the backlash", *The Age*, 12 February 2005, available at http://www.theage.com.au/articles/2005/02/11/1108061871800.html.

[21] See Einer Elhauge, *Sacrificing Corporate Profits In The Public Interest*, presentation at Environmental Protection and the Social Responsibility of Firms seminar, Harvard University, at p. 66, available at http://www.ksg.harvard.edu/cbg/Events/Papers/RPP_2-12-04_Elhauge.pdf.

For comparison, Australia's rate of corporate giving is running at an average of only 0.15% of corporate income.[22] Removal of any doubts about the legality of such initiatives is a precondition to encouraging Australia's corporate sector to improve upon this rate.

5. Extension of liability for social and environmental harm

The justifications for limited liability, while appropriate for negotiated commercial relationships, do not extend to shifting of environmental and social risks and liabilities to the community.

The point of forming a corporation is for individual shareholders to avoid personal liability for the corporation's debts. The cap on liability at the extent of a shareholder's investment in a corporation is commonly justified as necessary to facilitate risk-taking ventures, which are said to be the engine of economic growth.

It would be a curious feature of corporate law if it sought to encourage risk-taking, the very thing that so much of the rest of our legal landscape is concerned with discouraging. Indeed, the primary purpose of the law of unintentional torts, and much of the statutory law of products liability, trade practices, environmental law, and OH&S law is fundamentally designed to shift conduct so that it is less risky towards others and the community more generally.

Why, then, would we want to encourage the taking of risks by corporations that we affirmatively try to discourage individuals and non-corporate businesses from taking? It is not enough merely to say that risk-taking is necessary to stimulate economic growth: if so, why don't we exempt corporations from negligence laws altogether? Or, why not extend limited liability for business operations undertaken by sole proprietors? Surely either of these would stimulate even more risky behaviour, if that is the goal.

In fact, the principle of limited liability has nothing to do with encouraging or discouraging risk-taking. Rather, the point of limited liability is to provide a convenient and efficient baseline for the negotiation of shared entrepreneurial risks.

Financial investors are free to contract around limited liability, or course. A bank may, for example, require a businessperson to post his home as security for a business operation that, standing alone, would be too risky for the bank. Equally, a large supplier may require a parent-level guarantee as a condition of doing business with a subsidiary of a major corporation, if the subsidiary has few assets of its own.

[22] Prime Minister's Community Business Partnership, "Giving Australia: Summary of Key Data" (September 2004) at p. 31, available at http://www.partnerships.gov.au/philanthropy/philanthropy_research_ProjectUpdate.shtml.

Conversely, businesses that are not corporations may establish at least partial limited liability by contract. For example, a bank may provide a limited recourse loan to a partnership or sole proprietorship, under which the partners or sole proprietor is not personally liable except to the extent of specifically identified assets.

The rule of limited liability for corporations merely establishes a default position that facilitates an optimal degree of entrepreneurial risk-sharing in many cases among businesses and investors. Entrepreneurial risk in this sense encompasses the risk of business failure because of market factors such as competition, insufficient demand, or inability to keep pace with innovation.

This justification for limited liability makes sense if and only if entrepreneurial risks are transferred from businesspersons to other parties who have the capacity to negotiate with the corporation and who are themselves taking a calculated risk in doing business with the corporation. For example, a bank extending credit to a corporation knows that there is a risk of default, and is able to inform itself about that risk and reflect it in negotiating the terms of the loan. No injustice can be said to be done if the corporation, despite its good faith efforts, defaults.

Unfortunately, limited liability as it currently operates also distorts behaviour regarding environmental and social risks and embeds incentives for corporations to take less care in those areas than individuals would. The principle is not justified when applied to these situations, because the involuntary creditors that assume environmental and social risks have no capacity to negotiate for some of the benefits of such risk-sharing – or to decline the relationship if they find it not to their liking.

Consider, for example, a mining company that is deciding on the best level of environmental safeguards at its mine. If it skimps on environmental management, it saves some money (a benefit), but increases the risk of a major pollution disaster (a harm). The harm is a limited one, as far as the investors are concerned: at most, they will lose the amount of their investment. Any remediation costs or other liabilities above that amount will be for the public or other parties to bear. The risk is thus shared between the investors and the public. However, the benefit of money saved on environmental safeguards is for the investors alone to enjoy.

There is thus a serious imbalance between investor risk and reward: an investor enjoys all of the potential reward of skimping on environmental protection, but only some of the potential risk. Limited liability systematically distorts the effective price that market participants would otherwise assign to environmental and social risks. The ability to externalise risks onto the community functions as a structural incentive for corporations to pay less regard to environmental and social issues that individuals would in the same position.

Corporate group structures amplify this corporate incentive to engage in risky behaviour. If a company undertakes risky operations through a specially-incorporated subsidiaries, its other assets are protected if things go wrong and the ultimate investors in the parent company get something much better than limited liability. They are no longer exposed even to the full extent of their investment in the parent, since the parent has created "limited liability within limited liability".

Additional protection from environmental risks is not a by-product of parent-subsidiary structures, but often a core purpose.[23] This is especially evident when the major business partners of the subsidiary demand a parent-level guarantee as a condition of doing business with a subsidiary. In such situations, the is no real reduction of entrepreneurial risk from the perspective of the parent, only a transferral of environmental and social risk to the public.

Again, there is a perfectly legitimate justification for limited liability within corporate groups where the risks are of a commercial nature and are transferred to parties entering into a relationship with the subsidiary with full knowledge and opportunity to bargain for their assumption of risk, or to decline the relationship entirely. However, where subsidiaries impose risks on the public generally, or on involuntary creditors, the limited liability of the subsidiary heightens the incentive for the parent to act irresponsibly.

As layer upon layer of parent-subsidiary relationships are built up, the ultimate investors in the parent company get something more akin to immunity from environmental and social risk than limited liability. Complicated corporate structures, with many individual operating companies, are common in the extractive and shipping sectors. In many shipping groups, each individual ship is frequently its own corporation, even though a parent company extracts the full profits (through dividends, return of capital, or other mechanisms) from the operation of the ship. The purpose of such structures is to limit the exposure to an environmental or other disaster to the ship itself, with the parent corporation's other assets fully protected.

Extension of liability part 1: parent-subsidiary structures

While limited liability should be retained within group structures with respect to those voluntarily entering into commercial transactions with subsidiaries, it should not used as a

[23] This point was noted matter-of-factly by the Companies and Securities Advisory Committee (CASAC) in its 2000 report on corporate groups, which stated that a so-called "benefit" of corporate group structures was "lowering the risk of legal liability by confining high liability risks, including environmental and consumer liability, to particular group companies, with a view to isolating the remaining group assets from this potential liability." See CASAC, "Corporate Groups: Final Report", May 2000, at page 3, available at www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/$file/Corporate_Groups,_May_2000.pdf

vehicle for externalising environmental and social risk onto the community. The solution is to impose direct joint and several liability for specified environmental and social liabilities on the parent of any "subsidiary", as defined in sections 46-49 of the *Corporations Act*.

The relevant liabilities should include those related to the environment, human rights, and personal injury or death.

Extension of liability part 2: successor entities

Australia does not recognise the concept of successor liability. That is to say, a transfer of assets from one company to another, even if it involves the de facto transfer of an entire business as a going concern, does not trigger the assumption of non-transferred liabilities to the purchaser.

One consequence of this is that companies are able to evade contingent or future environmental or social liabilities by transferring business operations though an asset sale to another entity, which may be under common ownership, possibly at a below-market price. An asset sale may be a transaction of convenience, used to accomplish what is in effect a merger but possibly leaving the selling entity undercapitalised and unable to meet future liabilities.

An example of this apparently being attempted occurred in New South Wales in 2002. A waste disposal company called "Energy Services International", which was wholly-owned by a Malaysian entity, had illegally stored PCB-contaminated transformer oil waste, and incurred substantial fines and clean-up costs as a result. The directors placed the company into voluntary liquidation, and sold the entire business to the orthographically challenged "Energy Services Invironmental". (Presumably, they could continue to use "ESI" letterhead.) It also attempted, unsuccessfully, to foist the waste onto the public by disclaiming ownership of it in the liquidation process.[24]

The NSW Supreme Court noted that the evidence suggested that the arrangement was "a device by those controlling the Company to avoid liability for the contaminated waste". Because the environmental liabilities were current, the device does not appear to have succeeded in that goal. (Energy Services Invironmental, incidentally, continues to operate in the hazardous waste disposal business in Australia.) However, the outcome could well have been different if the liabilities had been contingent or future liabilities, instead of current at the time of liquidation.

Indeed, this was precisely the situation that led ultimately to the James Hardie dispute. The stripping of assets out of James Hardie's asbestos subsidiaries, which did not trigger a corresponding transfer of liabilities, set the stage for the undercapitalisation of the

[24] See *Environment Protection Authority v Energy Services International Pty Limited* [2001] NSWLEC 59 (15 June 2001) and *Sullivan v Energy Services International Pty Ltd (In liq)* [2002] NSWSC 937 (11 October 2002).

compensation fund. If those transfers had entailed assumption of corresponding liabilities, the dispute could have been averted from the outset.

To avoid evasion of environmental and community responsibilities through corporate shell games, and to encourage bona fide purchasers of assets to inquire carefully into any potential risks, liability for environmental and social harm should pass with the transfer of assets where that transfer involves continuity of the business enterprise.[25]

Extension of liability part 3: other responsible parties

The limited liability afforded by a corporate structure is not the only way businesses are able to evade their environmental responsibilities. Contractual arrangements such as franchising structures serve this purpose just as well.

Franchising is common in the petrol distribution sector, among others. A franchise agreement between a multinational petroleum company and a local petrol station operator has several features. First, it allows the petroleum company to specify many aspects of the retail outlet (such as its branding, pricing, and operational standards) without having any direct day-to-day responsibilities. Second, it allows the petroleum company to extract profits from the operation in return for lending the station its brand name. Finally, it insulates the petroleum company entirely from environmental and other liabilities arising from the operation of the station.

In effect, franchising in the petrol distribution sector is a way for petroleum companies to extract profits from the retail distribution business while avoiding responsibility for site remediation when nominally independent franchisees go out of business. The result is a legacy of orphaned contaminated sites, with the public footing the bill for clean-up.

There are other circumstances in which contractual counterparties should bear some of the residual risk of environmental and social liabilities. These include situations where a person is aware of significant environmental issues and has the capacity to influence decision-making, but does not take reasonable measures to minimise or avoid those liabilities. A joint venture partner with a 40% equity share might not be a controlling shareholder in a legal or accounting sense, but it is reasonable to expect that shareholder to utilise their position to seek to ensure adequate environmental management measures. The same can be said of a financer who, through due diligence, becomes aware of environmental risks but facilitates a project by extending financing without sufficient environmental conditions attached.

[25] Successor liability is an accepted concept under U.S. corporate law, where it applies at least to situations where the asset sale is a *de facto* merger. Some U.S. courts have applied the concept more broadly to situations where the purchaser "substantially continues the business of the seller", notably under the Comprehensive Environmental Response, Compensation and Liability Act. For a review of relevant cases, see Alicia Rood, "CERCLA Successor Liability: Theories of Liability", available at http://library.findlaw.com/1997/Jun/1/127681.html.

For such parties, a defence to liability for situations would be appropriate where the person made all appropriate inquiries in the circumstances and took all reasonable steps to avoid and limit the likelihood and extent of the events leading to liability.

A parallel to the imposition of liability on third parties exists in the United States, where securities underwriters are liable for material errors in public securities offer documents, subject to a "due diligence" defence.[26] This liability exists even though the issuer, not the underwriter, is the author of the offer document. In effect, the U.S. Congress decided to make underwriters the guarantors of issuers and thereby to strengthen the reliability and investor confidence in capital markets. The same mechanism could be used to create incentives for others who have access to information and influence over corporate operational matters to take reasonable steps to avoid harm to the environment and the community.

6. Mandatory disclosure of social and environmental data

Corporate disclosure of social and environmental data is important to level the playing field among businesses, provide accountability to the community, and drive improved performance.

Currently, there are at least three unfair distinctions arising out of the lack of consistent, mandatory corporate environmental and social reporting requirements in Australia:

- Differences among companies headquartered in Australia and those active in Australia but listed or headquartered overseas, where mandatory reporting requirements may be in force;

- Differences among companies voluntarily reporting environmental and social data, and thus exposing themselves to public scrutiny and possibly criticism, and those that do not; and

- Differences among industry sectors (an example of this is the proposal to require reporting of greenhouse emissions by certain recipients of diesel fuel tax rebates, but not requiring similar reporting by companies not eligible for such rebates, even if they pollute more);

The effect of these distinctions is that companies that do achieve improvements in environmental and social performance are not able to reap the full benefits of those improvements, since poor performers are insulated from criticism. The lack of comparability and availability of data also hinders the ability of innovators to demonstrate their leadership position by benchmarking against their competitors.

[26] See *Securities Act 1933*, sections 11-12 (15 U.S.C. ss 77k & 771(a)(2)).

An exhaustive review of reporting across the EU in 2001 concluded that "Companies will only compete on environmental performance (as well as on price and quality) if high-quality information is freely and easily available to the market. Transparency and information are prerequisites for environmental competition."[27] Currently in Australia, such competition on environmental performance occurs infrequently at best, and is fundamentally hindered by a basic lack of information on which companies and markets can reliably judge which companies are performing well.

Aside from being a powerful way of ensuring that good performers are able to capitalise on their positive initiatives, the public also has a right to know who is polluting the atmosphere, who has a poor OH&S record, who is squandering scarce water resources. Public exposure of poor performers is a legitimate and effective way of driving performance improvements.

This data is also necessary for the efficiency of capital markets. Without data on CSR performance levels, investors do not have the information they need to assess fully the effect of those issues on the financial prospects and performance of individual companies. The lack of such information means that there is little incentive for mainstream financial analysts to take into account information on emissions or water use, for example, even where a single company makes such information available, since the analyst is not in a position to compare that company's position with its competitors.

The need for baseline environmental and social data is even more crucial in the fast-growing ethical or sustainable investment sector. For sustainable investors, information on environmental performance is a core aspect of investment selection methodology. Such methodologies have been proven to perform above the market if done well, and are increasingly accepted as successful financial strategies. One example is the recent award of the Standard & Poor's 2005 Australian Fund Award in the "Balanced Funds – Neutral" category to the Australian Ethical Balanced Trust, a fund with a "deep green" investment philosophy and investment selection methodology.

For such funds, meaningful environmental and social data are as essential as good financial accounts, and it is time that our regulatory structure supported their data requirements as well as those of investors and fund managers who limit themselves to purely financial metrics.

Existing mandatory and voluntary disclosure of social and environmental data is inadequate and far below international standards.

Currently in Australia, mandatory environmental disclosure requirements are weak and often unenforced, while voluntary environmental disclosure by companies is sparse at best

[27] EC Environment and Climate Research Program, "Measuring the Environmental Performance of Industry: Final Report", February 2001, page 206, available at http://cleantech.jrc.es/docs/MEPI%20FinalReport.pdf.

and often lacks rigour. Consistently trustworthy reporting is undertaken by only a handful of Australian companies.

There are three specific Australian legal requirements for disclosure relating to environmental issues. The National Pollutant Inventory is the most effective, although it is limited by the current exclusion of greenhouse pollutants (under review).

Section 299(1)(f) of the *Corporations Act* nominally requires reporting on compliance with environmental laws, but it is so ridden with qualifications that most companies provide no meaningful information, even when they have breached environmental laws during the relevant period. Companies also commonly read a "materiality" qualification into the clause, which eviscerates it. A few examples of shoddy practice are as follows:

- Coles-Myer, with 1900 stores around Australia, including environmentally sensitive operations such as petrol stations and auto repair shops, took the view in its 2003-04 report that it was not subject to *any* particular and significant environmental regulations whatsoever, and made no disclosure.

- Toll Holdings' 2004 Annual Report made the extraordinary claim that licences, consents and approvals to use and develop land, transport goods, and dispose of wastes are not "particular and significant" regulations, since they apply to everybody who does those things. Thus Toll Holdings exempts itself from reporting on all environmental regulations that actually apply to it. This generous interpretation conveniently allowed them to leave out of their report a $30,000 penalty imposed in 2004 for a diesel spill.

- Patrick Corporation stated in its 2004 report that there were no "material breaches of environmental regulations" during 2004, even though its subsidiary Patrick Autocare was fined $22,500 plus costs for various environmental violations.

The third disclosure requirement is Section 1013DA of the *Corporations Act*, which requires disclosure by issuers of investment products of the extent to which they take into account specified ethical issues into account in their investment decision-making. Compliance is poor.[28]

[28] See Australian Conservation Foundation, "Disclosure of Ethical Considerations in Investment Product Disclosure Statements: A Review of Current Practice in Australia", August 2004, available at www.acfonline.org.au/uploads/res_investment_product_disclosure.pdf.

These disclosure requirements do not require a company to address key environmental issues, such as waste generation, resource consumption, energy and water use, and environmental risk in its business.[29]

Two recent studies have highlighted just how sporadic Australian corporate reporting on these issues actually is. KPMG's latest international survey of sustainability reporting shows that only 23% of Australia's top 100 businesses issue a stand-alone annual sustainability report, compared to 80% in Japan and 71% in the U.K. Australia lags behind many other countries in this respect.[30] Furthermore, 13 of these Australian reports were not externally verified in any way; only 10 had the assurance of some external audit.

A study commissioned by CPA Australia indicates that rates of reporting below the very largest companies drop off even more sharply. That report was able to locate only 25 separate sustainability reports in 2003 among the ASX 500, of which 10 were not in the ASX 100. This implies a reporting rate of only 2.5% among medium-sized public Australian companies.[31]

The chart on the following page compares Australia's reporting requirements and current practice with other industrialised countries. As the table shows, Australia is lagging well behind international developments.

[29] The CLERP 9 reforms, which introduced a general requirement to report on the operations, financial position, and prospects of the reporting entity, in theory broadens the scope of environmental risk reporting. However, with no specific mention of social and environmental issues in the new section 299A of the *Corporations Act*, it is highly unlikely that this provision will result in greater disclosure of specific environmental data for most companies, and it does not appear to have had this effect to date.

[30] KPMG, "KPMG International Survey of Corporate Responsibility Reporting 2005", June 2005, figure 3, available at http://www.kpmg.com/news/index.asp?cid=1040.

[31] CPA Australia, "Sustainability Reporting: Practices, Performance and Potential", July 2005, Appendix 1, available at xxx

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Comparison of Corporate Environmental Disclosure Requirements and Practice

	Australia	Canada	France	Germany	Japan	Netherlands	Norway	South Africa	UK	USA
Compliance with Environmental Laws	Corp. Law 299(1)(f) (but vague and marginal compliance)	Current and future financial and operational effects of env't protection and risk must be addressed in Annual Information Statement (AIS)	Damages paid for non-compliance; remediation efforts	BilReG of 2004 – disclosure of environmental issues material to operations or position of company	No specific requirement	Disclosure of incidents, complaints and their resolution	Major compliance orders, but only at listing of new securities	Required by JRE Listing Rules, by reference to GRI	OFR requires disclosure of environmental issues, as they relate to principal risks & uncertainties	Disclosure if liability incurred material or greater than $100K
Environmental Risks	No specific requirement		No specific requirement		No specific requirement	No specific requirement	Disclosure of risk of accidents and expected "limitations"	No specific requirement		Regulation S-K: material environmental issues (but marginal compliance)
Greenhouse gas emissions	No requirement	Required for large facilities (above 100,000 tonnes CO2-e)	Required by Article 148-3 of Decree 2002-221	EPER Register (EU requirement) for certain large industrial sites	No requirement	Required by Environmental Reporting Decree	Required by Law of Accounts	Required by JSE Listing Rules, by reference to Global Reporting Initiative	Pollution Inventory (EU requirement) for certain large industrial sites	No general requirement, but some states require limited disclosure
Other pollutant emissions	National Pollutant Inventory	National Pollutant Release Inventory			PRTR Law					Toxic Release Inventory
Waste generation and management	No requirement	No requirement		No requirement	No requirement				No requirement	No requirement
Energy Use	No requirement	No requirement		No requirement	No requirement				No requirement	No requirement
Water Use	No requirement	No requirement		No requirement	No requirement				No requirement	No requirement
Other Resource Use	No requirement	No requirement		No requirement	No requirement	No requirement			No requirement	Some states require disclosure of raw material inputs
Product life cycle data	No requirement	No requirement	No requirement	No requirement	No requirement	No requirement			No requirement	No requirement
Environmental management policies and practices	No requirement	Must be disclosed if "fundamental to operations" as part of AIS		No requirement	No requirement				No requirement	No requirement
Environmental initiatives and targets	No requirement	No requirement		No requirement	No requirement				No requirement	No requirement
Applicability of specific requirements to international operations	No requirement	No requirement	Decree 2002-221 may apply, but legislation lacks clarity on scope	No requirement	No requirement	Implied by Environmental Reporting Decree	Implied by Law of Accounts		No requirement	No requirement
Environmental considerations in investment decisions	Required for most investment products	No requirement	Required for Pension Reserve Fund	Required for pension funds	No requirement	No requirement	No requirement	Fund managers must disclose their voting of equity securities	Required for pension funds	No requirement
% of top 100 companies releasing annual separate sustainability report	23	41	48	36	80	29	15	18	71	32
GRI reporting organisations (#; # per million inhabitants)	38 1.99	23 .73	32 .54	30 .36	124 .98	38 2.39	6 1.33	26 .60	80 1.34	75 .27

Notes:

1) The table compares reporting requirements for publicly listed companies. In some countries, certain requirements apply more broadly. For the Netherlands, statutory reporting requirements apply to approximately 300 companies with serious impacts on the environment.

2) Under "Compliance with Environmental Laws" and "Environmental Risks", the table addresses the existence of specific environmental requirements in these categories; it does not reflect (1) general securities law requirements to disclose material risks and/or liabilities, or (2) accounting rules that may result in the disclosure of environmental liabilities in financial statements.

3) Source for number of top 100 companies reporting: KPMG, "KPMG International Survey of Corporate Responsibility Reporting 2005", June 2005, figure 3, available at http://www.kpmg.com/news/index.asp?cid=1040. Source for number of GRI reporting organisations: GRI website, www.globalreporting.org.

Quality of regulation / practice		
Good	Mediocre	Poor

Reporting on environmental and social data by reference to the GRI framework should be mandatory for large companies.

Despite the cajoling of governments, public interest organisations, industry groups and some investors and consumers over many years, voluntary reporting is not being taken up in large numbers in Australia. Unfortunately most Australian companies have simply rejected their responsibility to report to the community, unlike in Japan where a voluntary approach appears to have achieved much greater success.

Overseas model: South Africa
Integrated Sustainability Reporting

In 2002, the King Committee in South Africa released its second Report on Corporate Governance. The "King II" Report includes a "Code of Corporate Practices and Conduct" that was subsequent adopted as mandatory by the Johannesburg Stock Exchange.

Section 5 of the Code sets out principles for integrated sustainability reporting, which requires every company to report annually on "the nature and extent of its social, transformation, ethical, safety, health and environmental management policies and practices."

Section 5.1.3 further provides, in part, that:

Disclosure of non-financial information should be governed by the principles of reliability, relevance, clarity, comparability, timeliness and verifiability with reference to the Global Reporting Initiative Sustainability Reporting Guidelines on economic, environmental and social performance.

Thus, the Code requires companies to refer to the Global Reporting Initiative, but not necessarily to report on each GRI indicator if it is not material to the sustainability report.

A summary of the King II Report, including the text of the code, can be viewed at http://www.ifc.org/ifcext/corporategovernance.nsf/Content/SouthAfrica

Mandatory public reporting on environmental and social issues, using the widely-accepted framework of the Global Reporting Initiative, is the best solution to this problem.

The reporting requirements should extend beyond publicly listed companies. Entities with similar environmental and social impacts should not have different disclosure requirements merely on the basis of their ownership structure or place of public listing. Such a rule would also further perpetuate the invisibility and lack of accountability of some foreign-headquartered companies that have very large effects on the Australian environment.

For these reasons, the reporting requirement should apply initially to the largest 500 businesses in Australia, irrespective of share ownership or corporate structure, as well as to all listed companies. The existing section 299(1)(f) of the *Corporations Act* should be replaced by a general obligation to address each of the GRI indicators, either in full in the directors' report or by reference to a stand-alone report. In addition, to ensure that the information about non-listed entities is available to the public, section 299(1)(f) should provide that companies or disclosing entities that are not listed public companies must also disclose the information required by 299(1)(f) to a database of public reports to be maintained by an appropriate authority. The Department of Environment and Heritage's existing library of corporate sustainability reports is an existing resource that could easily be adapted for this purpose.[32]

[32] See http://www.deh.gov.au/settlements/industry/corporate/reporting/reports/index.html.

7. Elimination of perverse subsidies

Government subsidies that discourage environmentally and socially responsible corporate behaviour should be dismantled.

Corporations will not behave responsibly if the government pays them not to.

Currently, there remain a range of subsidies, tax incentives, and other government policies that reward companies for operating unsustainably. Many of these encourage profligate use of scarce resources by lowering the effective price of those resources, or encourage companies to engage in polluting or other harmful behaviour.

One egregious example of an environmentally perverse subsidy is the $1,100 million per annum fringe benefits tax concessions for use of company cars. Under the statutory formula used to calculate these concessions, the more one drives using a company car, the lower the tax rate applied to the fringe benefit. This results in the infamous "March rally", during which business executives take unnecessary road trips in order to lower their tax bill by bumping their car usage into the next higher tax bracket. Through this formula, the government hands out at least $1,100 million per year to reward the profligate use of internal combustion engines.[33]

Furthermore, company cars need not be used at all for business purposes, and it is common practice for executives to receive additional cars for use by family members. Compounding the perversity of the rules, similar concessions are not available to users of more sustainable transport options, such as bicycles or public transit. Finally, the subsidy is regressive, since the concessional rates are attractive only to relatively high income earners.

Overseas model: Germany
Ecological tax reform

In 1999, Germany introduced a long-awaited "ecological tax reform". The core features of this were:

- Increased taxation of oil and gas products, with exemptions for socially and environmentally beneficial uses;
- Introduction of taxation of electricity use, with exemptions for environmentally beneficial generation and to avoid social hardship; and
- 90% of revenue generated used to reduce social security contributions;
- Remaining revenue directed to support for renewable energy and sustainable buildings projects;
- Overall fiscal neutrality.

Phased in over a six-year period, the reforms substantially lower the cost of labour inputs, while raising the cost of energy and resource use and thus stimulating efficiency measures. The German Federal Environment Ministry has estimated an overall reduction of greenhouse pollution of 2-3%, and the creation of up to 250,000 new jobs, as a result of the reform package. (see http://www.foes-ev.de/downloads/oekosteuerreform.pdf)

The net effect of the policy is to encourage companies to structure compensation packages for their high-earning employees that reward wasteful and environmentally harmful car use.

[33] Commonwealth of Australia, Tax Expenditure Statement 2004, page 9, available at http://www.treasury.gov.au/contentitem.asp?NavId=022&ContentID=950

Unfortunately, while the FBT concessions stand out as particularly objectionable, they are far from unique. Numerous concessions rewarding fossil fuel use, including concessional rates on aviation fuel and rebates for off-road diesel fuel use, result in greater greenhouse pollution. Failure to properly price natural resources is another area of serious concern. The exemption of water from the GST, for example, does nothing to encourage water conservation measures, and gives companies a reason to use purchased water over possible substitutes, all other things being equal.

A full review of these issues is beyond the scope of this submission. A 2003 academic review identified more than $5 billion per year in perverse subsidies encouraging fossil fuel use alone.[34] Subsidies that encourage habitat destruction, water and other resource use, and other harmful activities have not yet been systematically quantified.

To address these issues, the Government should immediately repeal the most obviously perverse subsidies, such as the FBT concessions for company cars. In addition, the Government should initiate an enquiry into environmental and social taxation, with a view to (1) identifying and quantifying perverse subsidies at both the federal and state levels; (2) shifting taxation from desirable activities, such as work, to undesirable activities, such as pollution and resource consumption; and (3) evaluating structural options for embedding environmental and social considerations better into taxation and spending policy development.

8. Creation of sustainability investment incentives

The Government should create positive tax and other incentives to leverage greater private sector investment in socially and/or environmentally positive projects.

There is great scope for Australian governments to encourage more sustainable corporate behaviour by providing targeted tax incentives and other benefits for projects that have substantial environmental and social benefits. This approach seeks to shift incentives to make sustainable projects marginally more attractive than they would otherwise be. Such programs are very efficient from a budgetary perspective, since the government incentives have a substantial multiplier effect. They also have the advantage of working within existing capital markets, and thus avoid imposing any new regulatory burden on operating businesses.

This concept has been implemented on a large scale successfully in the Netherlands through a mechanism called the “fiscal green funds”. First developed in 1992, the fiscal green funds are tax-advantaged investment vehicles for certified “green” projects. The funds are set up by Dutch banks and attract primarily retail investors. Interest paid to investors from the fund is tax-free. This tax advantage is then split three ways:

[34] Chris Riedy, “Subsidies that Encourage Fossil Fuel Use in Australia”, University of Technology Sydney, Institute for Sustainable Futures, January 2003, available at http://www.isf.uts.edu.au/publications/CR_2003_paper.pdf.

- Investors receive an interest rate somewhat lower than market rates, but still earn a better-than-market return because of the tax-free status of interest payments;

- Green businesses have access to lower interest rates than they could otherwise receive, since the investors are willing to accept lower rates of return; and

- Banks are able to charge somewhat higher fees, to cover higher transaction costs and risk.

A schematic example of how it works in practice is given by Marcel Juecken in *Sustainability in Finance: Banking on the Planet*:

Table 7.1 Principles of the Dutch fiscal green regulation[35]

	Standard commercial loan	Fiscal green funds loan	Difference in favour of green funds
Net return for saver/investor	2.6%	2.8%	**+0.2%**
Tax	2.6%	0%	-2.6%
Gross return for saver/investor (= 1+2)	5.2%	2.8%	-2.4%
Funding by bank (=3)	5.2%	2.8%	-2.4%
Interest margin for bank	1%	1.4%	**+0.4%**
Interest on credit for business (= 4+5)	6.2%	4.2%	**-2%**

In this model, the cost of capital for the green project has been reduced by two percentage points, or about 35%, while both the bank and the investor have increased their returns on the investment. Jeucken reports that the tax loss for government of 10 million euro in this scheme results in an actual investment of 450 million euro in green projects. Thus, each investment of 1 euro by the Dutch government mobilizes 45 euro of private capital that would not otherwise have been directed to green projects.

Projects become eligible for funding from a fiscal green fund by applying to the Dutch government for certification, which is awarded to environmental projects in specified categories.

Leveraged private investment has been successfully implemented in the context of health care and education in Australia, and has been applied to environmental issues on a relatively small scale through the Victoria Water Trust, for example.[36] There is great opportunity to draw upon these successes to establish a national leveraged private investment scheme for environmental and social projects generally, including clean energy, sustainable land management, residential and commercial building efficiency, and many other areas.

[35] Marcel Juecken, *Sustainability in Finance: Banking on the Planet*, Eberon Delft, 2004, p. 198.

[36] For a much fuller discussion of the concept of leveraged private investment, including responses to common objections, see Allen Consulting Group, *Repairing the Country: Leveraging Private Investment*, August 2001, available at http://www.acfonline.org.au/uploads/res_private_investment.pdf.

9. Revision of insolvency and winding-up laws

Insolvency and winding up laws should ensure proper provisioning for long-tail liabilities.

The James Hardie fiasco highlighted a crucial inadequacy in the structure of Australian external administration procedures. In that case, a central problem was that the interests of "unascertained future creditors" of certain of James Hardie's subsidiaries – an inchoate but large group of people who will in the future have claims against the manufacturers of asbestos products to which they were or will be exposed – were not and could not legally be taken into account in external administration.

As the Jackson Inquiry noted:

> *All parties to the Commission were agreed that the current arrangements available to the [Medical Research and Compensation] Foundation under the Corporations Act to manage its liabilities are inadequate. The essential difficulty is that none of the external administration mechanisms under the Act recognises the position of persons in the category of unascertained, future creditors, such as future claimants in respect of asbestos disease for which [James Hardie subsidiaries] Amaca and Amaba will be liable.*[37]

While the inquiry stopped short of endorsing specific legislative changes, Mr Jackson did note that "unless some general reform is enacted that permits external administration to deal with long tail liabilities, future cases will arise that will have to be the subject of ad hoc legislative solution, if serious injustice is to be avoided."

One of the flaws highlighted in this case is that the *Corporations Act* does not recognise unascertained future creditors as "creditors" within the context of external administration. Thus, a corporation can be wound up and its assets fully distributed to creditors and investors, while individuals and communities whose claims against the corporation will become evident only in the fullness of time fall through the cracks of the insolvency system.

The problem is not only in the context of product liability matters. Other long-tail liabilities may include environmental remediation and/or toxic tort claims. For example, unremediated site contamination may lead to health problems and personal injury claims long after the corporation that polluted the site is wound up. The public may also be an unascertained future creditor in such cases, if the burden of cleaning up a site falls on public authorities.

To ensure that long-term social and environmental issues are fully taken into account in the external administration of a company, the following reforms should be pursued:

[37] Report of the Special Commission of Inquiry Into the Medical Research and Compensation Foundation, page 551, available at http://www.cabinet.nsw.gov.au/publications.html.

- External administrators should be required to undertake a reasonable investigation in the circumstances into the existence and magnitude of any unascertained future claims, and to ascertain if possible the identities of potentially affected claimants;

- Where possible unascertained future claims have been identified, a representative of possible future claimants (including the public generally) should be appointed to represent their interests; the representative should have appropriate investigative powers and standing analogous to that of a creditor in all proceedings; and

- The interests of claimants whose claims are wholly prospective but reasonably likely to arise (whether they can be specifically identified or not) should be considered as equal in all respects to current, contingent, and future creditors' interests. Where claims are identified as reasonably foreseeable but the identities of claimants is not clear, a compensation fund should be set aside to provide for future payment of such liabilities, with an adequate margin for error.

A positive side-effect of these changes may be an increase in the vigilance and due diligence of financial investors on potential long-tail liabilities, since the class of creditors in an insolvency proceeding would be expanded if such liabilities exist. It is reasonable to expect a corresponding modest reduction in the risk of such liabilities in the first place.

Finally, costs of environmental remediation should be given priority over residual claims in insolvency proceedings. In particular, a section 556(1)(i) should be added to the *Corporations Act*, establishing "any actual or future environmental remediation costs or other environmental liabilities" in the priority of debts just below injury compensation and employee entitlements but above general unsecured debts. This will ensure full payment of environmental liabilities rather than proportional treatment alongside general creditors and, again, may increase somewhat the attention of creditors to environmental management of the company.

10. Remedies for unethical overseas conduct

Australia should implement the U.N. Human Rights Norms for Business, and provide a remedy for breach of those norms.

While many Australian companies operate in overseas jurisdictions responsibly, unfortunately hard experience has demonstrated that some companies are willing to take advantage of conditions in developing countries to engage in exploitative activities that would be totally unacceptable in Australia.

Examples of Australian companies acting irresponsibly outside of Australia include the following:

- The disastrous pollution of the Fly River in Papua New Guinea by riverine disposal of mining waste from BHP's mine at Ok Tedi, which resulted in widespread environmental devastation and destruction of resources essential to local communities;

- The lethal cyanide spill caused by Australian gold miner Esmeralda (now Eurogold) in 2000 from its mine at Baia Mare in Romania, which turned large stretches of the Somes, Tisza and Danube Rivers into a dead zone. Esmeralda denied that it was responsible, downplayed the scope of the calamity, and then when evidence of its magnitude was incontrovertible, placed itself into voluntary administration in an obvious attempt to protect its assets before the extent of liability could be fully assessed;

- The apparent complicity of Perth-based Anvil Mining in human rights atrocities in the Congo in October 2004. Anvil has stated that it acceded to a request from the Congolese military to use Anvil's vehicles in a military operation; that operation resulted in the execution of unarmed civilians. Anvil apparently had taken no steps to ensure that did not support the activities of a military well known for human rights abuses. When questioned about the use of Anvil's vehicles in this way, CEO Bill Turner replied, "So what?"

These examples and others demonstrate that the laws of the countries in which these companies operated, their voluntary commitments, and the risk of damage to their business or reputation were all insufficient to deter the companies from engaging in irresponsible or even brutal conduct. The Anvil Mining case in particular highlights the fact that even today Australian companies will not always observe even the most basic standards of environmental care and human rights when operating outside of a reliable regulatory structure.

In countries without developed systems of substantive legal protection or the enforcement capability to ensure they are complied with, or where governments are corrupt or have collapsed completely, domestic regulation cannot be relied upon to ensure that Australian companies behave decently.

The United Nations Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights seek to ensure that businesses act responsibly in the areas of human rights and consumer and environmental protection.[38] Adopted by the United Nations Sub-Commission on the Protection of Human Rights, the norms are the best statement of principles regarding businesses' obligation to respect basic human rights.

Australia should translate these norms into domestic law, by creating a right of action in Australian courts for persons injured by any breach of the norms.

[38] Available at http://www.unhchr.ch/huridocda/huridoca.nsf/(Symbol)/E.CN.4.Sub.2.2003.12.Rev.2.En?Opendocument.

Australia has already implemented legislation that extends the reach of Australian law overseas in a variety of cases, including terrorism, war crimes, crimes against humanity, trafficking in persons and even contamination of goods.[39] The same should be done for fundamental breaches of basic human rights standards by Australian companies, wherever they may operate.

In each of these cases, Parliament determined that the severity of the conduct and the fundamental importance of the interests those laws protect justified extraterritorial legislation. These laws were passed over the traditional objections to extraterritorial legislation, such as deference to governments of foreign jurisdictions, the desire to avoid potentially conflicting legal regimes, and enforcement difficulties. Ensuring that business operations are conducted in accordance with basic environmental, social and human rights standards is of similarly crucial importance.

11. Promotion of institutional reform and capacity-building

Institutional reform 1: Australian Securities and Investment Commission.

The Australian Securities and Investment Commission (ASIC) has demonstrated little interest in development or enforcement of corporate law as it pertains to environmental and social issues, even where legal obligations currently exist.

ASIC has refused to take action on even the most blatant breaches of disclosure laws regarding environmental issues, on its own or even when those breaches are brought to its attention. For example, in March 2004, a uranium leak at the Ranger mine in Kakadu National Park resulted in the poisoning of at least 24 workers, the temporary shutdown of the mine, a range of audits and required investment in improved environmental management, and ultimately a successful criminal prosecution of the company. The incident was plainly price-sensitive and was material in both a financial and non-financial sense, yet the owner, Energy Resources of Australia, neglected to disclose it to the market until a full six days after the incident. ASIC declined to take any enforcement action.

More generally, we are not aware of a single instance of ASIC taking action to ensure compliance with the environmental reporting requirements in section 299(1)(f) and 1013D(1)(l) of the *Corporations Act*, either with respect to an individual company or particular sensitive industry sectors. This is despite evidence of regular non-compliance with both of those reporting requirements.

It would appear that ASIC is not attuned to the needs of the sustainability investment sector, which relies on accurate information about the environmental and social impacts of companies.

[39] See, for example, *Criminal Code Act 1995*, sections 101.1-103.1 (terrorism and related offences), 268.117 (genocide, war crimes and crimes against humanity); 270.5 (sexual servitude), 271.10 (trafficking in persons); 380.5 (contamination of goods).

The Government should create a unit at ASIC, with dedicated expertise and capacity in the area of corporate responsibility, responsible specifically for monitoring corporate compliance with disclosure and other obligations as they relate to environmental and social issues.

Institutional reform 2: National Corporate Responsibility Commissioner.

The issues addressed in this inquiry are complex and wide-ranging. Furthermore, implementing voluntary or mandatory initiatives to improve corporate responsibility, continuing development of sound policy on corporate responsibility, and coordinating the efforts of the diverse range of government authorities in this area will all require ongoing, dedicated expertise. There is currently no obvious governmental responsibility in this area. Some discrete corporate initiatives are undertaken by the Department of Environment and Heritage, but of course questions of corporate responsibility extend well beyond the environment portfolio.

The Government should create the office of a National Corporate Responsibility Commissioner, with responsibilities for those tasks and sufficient resources to continue sensible policy developments and to carry out the needed reforms.

Institutional reform 3: Government reporting, procurement, and internal performance.

While the Australian Government has made some advances in its own procurement, reporting and environmental and social performance commitments, overall there is still much progress to be made. Two departments (DEH and FACS) have issued triple-bottom line reports, but the bulk of the federal government appears to have made little headway on reporting and reducing their own social and environmental impacts. The federal government as a whole should issue a triple bottom line budget alongside the annual financial budgetary processes.

Furthermore, a serious, whole-of-government approach to responsible, environmentally sound procurement and operations must be undertaken if the government expects businesses to do the same. For example, the government should commit to becoming carbon neutral over the next five years, as a number of private companies have already done. Such practices are valuable as examples and demonstrations of commitment, as well as enabling improved social and environmental performance by the government itself.

Finally, the government can support corporate responsibility by monitoring the effects of economic behaviour on the environment and our society in a more balanced, systematic way, and incorporating those measurements better into policy-making. Currently, macroeconomic health is generally measured by indicators such as GDP, which is wholly inadequate for gauging the long-term health of a society. This is because the GDP measures only the benefits of a given activity, and none of the costs. For example, the clean-up of a contaminated site generates employment for environmental remediation experts, which shows up as a positive contribution to the

GDP. However, none of the ills attributable to the contaminated site – such as the waste of resources that could be put to more productive uses, and the damage to the health of individuals and ecosystems – are taken into consideration.

The result of the widespread focus on the GDP is that environmental, social and other policies as they relate to corporate behaviour are structured to maximise an incomplete view of economic progress. Those policies will then tend to compromise our collective wellbeing and the long-term sustainability of our economy in the pursuit of short-term benefits.

The development and adoption of more sensible and balanced metrics for what we as a nation should strive for will help us to achieve a more sustainable future economy. The work by the Australian Bureau of Statistics on measuring Australia's progress, including a range of indicators separate from GDP, is a step in the right direction. However, even at the ABS GDP is still the headline indicator, and they have not yet accepted any environmental indicators as "key national indicators". The government still relies heavily on the GDP and similarly narrow indicators as the basis for actual policy formulation. Replacing the GDP by a more balanced set of measures, such as the Genuine Progress Indicator (GPI), can be expected to encourage policies across the board that better encourage responsible business activity.[40]

END

For more information, please contact
Charles Berger
Legal Adviser
Ph: (03) 9345 1173
email: c.berger@acfonline.org.au

FLOOR ONE, 60 LEICESTER STREET **CARLTON VIC 3053**
phone ■ **03/ 9345 1111** // facsimile ■ **03/ 9345 1166**
email ■ **acf@acfonline.org.au** // web ■ **acfonline.org.au**

The Australian Conservation Foundation is committed to achieve a healthy environment for all Australians. We work with the community, business and government to protect, restore and sustain our environment.

[40] For information on the Genuine Progress Indicator, as developed by The Australia Institute, see www.gpionline.net.