A SUBMISSION TO THE PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES
INQUIRY INTO CORPORATE RESPONSIBILITY

by

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Based on the interests of these contributors, the submission focuses on the following main areas:

- theories of corporate responsibility
- the need to increase the recognition of employee and environmental concerns in the corporate law framework
- enforcement mechanisms.

We address below relevant parts of the Committee's Terms of Reference for the Inquiry.

a. The extent to which organisational decision-makers have an existing regard for the interests of stakeholders other than shareholders, and the broader community.

To a limited extent, corporations in Australia do have regard to the interests of stakeholders other than shareholders, due to a range of influences including:

- Specific legal obligations imposed upon the company by various legislative schemes which protect the interests of a range of stakeholders, including employment laws, occupational health and safety laws, insolvency laws, trade practices and environmental laws.
- General fiduciary duties imposed upon company directors requiring them to act in the interest of the corporation (and its shareholders). For instance, these duties may require adoption of prudent risk management strategies to avoid or minimise the potential risk of liability to third parties arising from legal proceedings based on common law principles such as negligence, nuisance or defamation.
- Voluntary strategies which seek to protect the interests of stakeholders as a matter of good corporate citizenship. These strategies are often used to enhance the 'brand name' or reputation of the corporation in the belief this will enhance profitability.

However we would argue that there have been many well publicised instances where stakeholder (and shareholder) interests have been subverted or ignored by corporate managers, indicating that the present legal framework is inadequate to ensure the protection of non-shareholder interests (some examples are provided in other parts of this submission).

b. the extent to which organisational decision makers should have regard for the interests of stakeholders other than shareholders, and the broader community.

This issue raises a series of subsidiary questions.

(b)(1) What are the interests for which organisational decision makers should have regard, and why should they have regard for those interests?

There is a growing acknowledgment – by corporations themselves and the broader community - of the impact of corporate activity on other stakeholders, such as employees, creditors, victims of their torts, as well as the environment. This is reflected in the increased focus on corporate governance in Australian law in relation to large publicly listed companies, and the terms ‘Corporate Social Responsibility’ (CSR) and ‘Corporate Citizenship’. However, these are poorly defined concepts. They are generally understood to convey a sense that companies are powerful and have the capacity to hurt the interests of others, such as employees, creditors, and victims of their torts, as well as the environment. Our submission is that this gives rise to a responsibility to take care of those parties’ interests.

(b)1.1 Employee interests

In recent years, the high-profile collapses of companies like Ansett and One.Tel, and the James Hardie episode, have highlighted the vulnerability of employees in Australia’s current corporate law framework. In these and many other cases of corporate failures and restructures, employees’ interests have been overlooked or consciously bypassed. The political fallout from these events has led to some changes to corporations legislation, and the adoption of arrangements such as the General Employee Entitlements and Redundancy Scheme. However, these measures do not go far enough. Despite their enormous investment of “human capital” in the firms for which they work, employees are still largely regarded as “outsiders” by company law – with none of the information rights and measures to protect their interests enjoyed by “insiders”, such as shareholders and secured creditors.[1]

[1] The ‘insider/outsider’ terminology is borrowed from B Bercusson, ‘Workers, Corporate Enterprise and the Law’ in R Lewis (ed), *Labour Law in Britain* (1986) 139; see further Part (c) of this submission below.

(b)1.2 Creditors

Creditors, like employees, are also vulnerable to the risk of non-payment when a company becomes insolvent. While some creditors hold security or have had the ability to price-protect against the risk of non-payment or to diversify away their risk, other have not. These are the small trade creditors who lack information about the risks to which they are exposed or who are unable because of their lack of bargaining power to charge a premium to compensate for that risk.

(b)1.3 Tort victims

Tort creditors are particularly susceptible to the absence of any legal obligations of corporate social responsibility, because they lack the ability to self-protect ex ante or any rights of recovery ex post under the *Corporations Act*.[2] This is a particular problem when a holding company has deliberately incorporated an undercapitalised subsidiary to minimise the loss of shareholder funds. As the James Hardie case graphically illustrated, the "separate entity" principle stands in the way of tort victims seeking to recover compensation within corporate groups, in that case necessitated by the underfunding of the Medical Research and Compensation Fund that had been established for this purpose. The Report of the Special Commission of Inquiry into James Hardie identified "significant deficiencies in Australian corporate law", and raised "the question of whether existing laws concerning the operation of limited liability or the "corporate veil" within corporate groups adequately reflect contemporary public expectations and standards."[3]

Tort victims may also be disadvantaged by the adversarial nature of the judicial system in pursuing claims against powerful corporations. This was well demonstrated in the case of now deceased lung cancer victim, Mrs Rolah McCabe, whose claim against British American Tobacco was severely hindered by the destruction of relevant information by the company.[4] This case highlights the need for some form of moral or ethical charter to guide decision-making within corporations.

This vulnerability is exacerbated by the attitude of courts to claims against directors when they commit torts whilst acting on behalf of the company. First, the legal position is confusing with at least four recognised tests to ascertain the circumstances

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[2] Injury compensation enjoys a degree of priority for payment in a liquidation under s556(1)(f) of the *Corporations Act 2001* (Cth) but it ranks behind the wages and superannuation entitlements of employees. Since these and other higher ranking categories of priority must be paid in full before lower categories are considered, there is a significant risk that injury compensation claimants will not be fully compensated as a result of this priority.

[3] David Jackson, The Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation, 2004, *Annexure T The Concept of Limited Liability – Existing Law and Rationale,* < http://www.cabinet.nsw.gov.au/hardie/Volume1.pdf >.

[4] The history of this case is set out at the website of the Plaintiff's solicitors, Slater and Gordon; see http://www.slatergordon.com.au/classactions/tobacco.htm. Ultimately, an application by the plaintiff's estate for special leave to appeal to the High Court was unsuccessful. See *Cowell v British American Tobacco Australia Services Ltd* [2003] HCATrans 384 (3 October 2003).

where personal liability can be imposed on directors.[5] Secondly, some courts use the limited liability doctrine to incorrectly deny a tort victim's claim against a director in their capacity as a director, whereas its proper use is to protect shareholders.[6] Thirdly, the organic theory and the separate legal entity of the company is sometimes invoked to protect directors,[7] even though its proper role[8] is to attribute the mental state of the director to the company for the purpose of finding the company liable, and not for the purpose of removing that liability from the perpetrator of the action on which the liability is based.[9]

(b)1.4 Environmental interests

The natural environment is particularly vulnerable to corporate abuse due to a combination of rapid growth in the global economy, recent microeconomic reforms and deregulation of commercial activities. The rapid growth of human population and our western consumer based lifestyle following the industrial revolution has led to human domination of the Earth's ecosystems[10], including a crisis in resource

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[5] In *G M (North Melbourne) v Young Kelly* (1986) 7 IPR 149, directors' liability for their tortious actions on behalf of their companies was described as a 'complex and burgeoning field of the law' at 158. In *Root Quality Pty Ltd v Root Control Technologies Pty Ltd*, Finkelstein J called it a 'confusing picture on an issue that has persistently vexed the common law' (2000) 177 ALR 231, [115]. See also *Johnson Matthey (Aust) Pty Ltd v Dascorp Pty Ltd* [2003] VSC 291, [111]; John Farrar, 'The Personal Liability of Directors for Corporate Torts' (1997) 9 Bond Law Review 102; Helen Anderson, 'The Theory of the Corporation and Its Relevance to Directors' Tortious Liability to Creditors' (2004) 16 *Australian Journal of Corporate Law* 73.

[6] For example, Cooke P noted in *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517, 524 that 'I commit myself to the opinion that, when he formed his company, Mr Ivory made it plain to all the world that limited liability was intended. Possibly the plaintiffs gave little thought to that in entering into the consultancy contract but such a limitation is a common fact of business …'.

[7] For example, Hardie Boys J in *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517, 526 commented that '[t]o make a director liable for his personal negligence does not in my opinion run counter to the purposes and effect of incorporation. … What does run counter to the purposes and effect of incorporation is a failure to recognise the two capacities in which directors may act; that in appropriate circumstances they are to be identified with the company itself, so that their acts are in truth the company's acts. Indeed I consider that the nature of corporate personality requires that this identification normally be the basic premise and that clear evidence be needed to displace it with a finding that a director is acting not as the company but as the company's agent or servant in a way that renders him personally liable.'[7]

[8] *Meridian Global Funds Management Asia Ltd v the Securities Commission* [1995] 2 AC 500, 505 and *Smorgon v Australia and New Zealand Banking Group Ltd* (1976) 134 CLR 475.

[9] See further Neil Campbell and John Armour, 'Demystifying the Civil Liability of Corporate Agents' (2003) 62 *Cambridge Law Journal* 290; Jennifer Payne, 'The Attribution of Tortious Liability Between Director and Company' [1998] *Journal of Business Law* 153; David Wishart, 'Anthropomorphism Rampant: Rounding up Executive Directors' Liability' [1993] *New Zealand Law Journal* 175; John Farrar, 'Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance' (1998) 10 *Bond Law Review* 142.

[10] P M Vitousek, H A Mooney, J Lubchenco and J M Melillo, 'Human Domination of Earth's Ecosystems' (1997) *Science* 494. Estimates of the fraction of land transformed or degraded by humanity fall in the range of 39-50%. The rates of species extinction are now of the order of 100 to 1000 times those before humanity's dominance of the Earth, eg one quarter of the Earth's bird species have been driven to extinction in the last two millenia.

consumption[11], and unprecedented water shortages, deforestation and species extinction rates along with the prospect of irreversible climate change[12]. It is clear that the current framework of international agreements and national laws to protect the environment is failing.

The traditional model of environmental law has been a 'command and control' approach based on strict government regulation of industrial pollution and government ownership of natural resources. This traditional approach has become less effective following widespread micro-economic reforms that have fostered globalisation, deregulation and privatisation of state-owned enterprises. These reforms have greatly diminished government influence over the use of natural resources. The traditional model is also less effective due to a fundamental change in the nature of environmental problems, with concerns about local industrial pollution now overtaken by global concerns about excessive resource consumption, exploitation of developing countries, climate change and biodiversity loss. The role of the courts in protecting the natural environment is equally problematic, with rules of standing and inequality in financial resources between local residents and large corporations making litigation a very difficult option for stakeholders.

One important step in the transition to sustainable development is reform of decision making processes, as recognised by the United Nations Environment Program in *Agenda 21*:[13]

> 8.3. The overall objective is to improve or restructure the decision-making process so that consideration of socio-economic and environmental issues is fully integrated and a broader range of public participation assured.

In this context it is important to distinguish between public or government decisions and private or corporate decisions. At the government level there have been several *mandatory* processes introduced to assist the integration of environmental outcomes in decision-making. These include the obligation to have regard to principles of sustainable development in State based pollution and planning laws, and in Federal environmental impact assessment laws.[14] Another important feature of government decision making processes is that public participation and standing to review decisions is well supported by a range of administrative law remedies.[15] By contrast, processes for review of corporate decision making are far more limited. This relative

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[11] World Wildlife Fund, *Living Planet Report 2004*. This Report indicates that our 'ecological footprint' (which measures human resource consumption) is currently 20% greater than the Earth's biological capacity to replace those resources. Any business with a similar 20% shortfall of costs over revenue would soon be wound up.

[12] Intergovernmental Panel on Climate Change, *Third Assessment Report of Working Group 1, Summary for Policy Makers* (2001).

[13] Agenda 21 is the charter for action formulated by the parties to the Rio Earth Summit. See United Nations (1992) *Agenda 21*; United Nations Conference on Environment & Development Rio de Janeiro, Brazil, 3 to 14 June 1992.

[14] Eg. ss 1A-1L *Environment Protection Act* 1970 (Vic), ss 4 *Planning and Environment Act* 1987 (Vic), and ss 3, 3A *Environment Protection and Biodiversity Conservation Act* 1999 (Cth).

[15] *Administrative Law Act* 1978 (Vic), *Administrative Decisions (Judicial Review) Act* 1977 (Cth), *Freedom of Information Act* 1989 (Cth).

lack of accountability does not sit well with the recent wave of microeconomic reforms, which have diminished government involvement and placed many corporations in a quasi-governmental role with respect to environmental protection.

This lack of environmental accountability is particularly dangerous in industries which are heavy users of natural resources, such as agriculture (water, land), paper production (water, forests), electricity generation and transport (fossil fuels, greenhouse gases). In these industries, government decision-making still has an important role, but quite often it merely sets broad guidelines for corporate activities (eg. pollution standards) whilst corporate decision-making determines the real extent of environmental damage (or protection). In effect, corporations are increasingly the *de facto* guardians of the public interest in the natural environment, and thus reform of corporations law is necessary to ensure that corporations discharge this responsibility in the best interest of the community.

However, any attempt to impose a regime of corporate social and environmental responsibility needs to be reconciled with the traditional responsibilities that companies have to their shareholders and that directors have to their companies.

(b)1.5 Theories of the Corporation and Corporate Responsibility

(b)1.5.1 Economic theories

Traditionally, directors have been confined in their actions by the shareholder wealth maximisation imperative. Companies have been seen by economic theorists as a nexus of contracts, rather than an entity in their own right.[16] The contracts in question are with suppliers of inputs, employees, and customers of outputs, and to maintain these contracts, the company needs to be concerned with the interests of these constituencies. To that extent, companies and directors choose to have regard to their interests.

(b)1.5.2 'Team production' theory

More recently developed law and economics theories look more explicitly at the contributions to the company made by non-shareholder constituencies. Team production theory[17] recognises the power of the board, but it is based on the notion that two or more individuals must combine their valuable resources to produce a single output. Directors, rather than acting solely in the shareholders' interests, act for

[16] William Bratton, 'The "Nexus of Contracts" Corporation: A Critical Appraisal' (1989) 74 *Cornell Law Review* 407, 420. The word 'contracts' is not meant literally in this context. Instead it refers to the various relationships between the parties. Companies have relationships with the eventual consumers of their products despite a lack of privity of contract between them. Companies have relationships with the community at large, for example in their environmental responsibilities. Christopher Riley, 'Contracting Out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts' (1992) 55 *Modern Law Review* 782, 785-6.

[17] Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247.

all members of the corporate team which contribute to this output.[18] The purpose of the theory is to identify a unity of interest between team members in order to overcome the agency costs which arise when their interests diverge. Agency costs are one of the transaction costs a company incurs in making a bargain.[19]

Under team production theory, while the participants know that incorporation involves giving up control over their contributions to the firm, exposing them to the risk of opportunism or shirking by others, the board of directors as a 'mediating hierarchy' resolves these clashes.[20] Directors are given the task of balancing the competing interests of the team 'in a fashion that keeps everyone happy enough that the productive coalition stays together.'[21]

(b)1.5.3 'Communitarian' theory

Another recent approach which looks at the position of non-shareholder constituencies is the communitarian, or progressive corporate law, view. This looks at the place of the company in the community and argues that various corporate stakeholders are vulnerable to abuse at the hands of those who control corporate power. It is by no means a unified school of thought: Bainbridge noted that '[t]hese scholars are far more united by what they oppose … than by what they support'.[22]

As early as 1932, commentators were looking beyond the interests of shareholders to the corporation's wider impact on society. Berle and Means argued that '[n]either the claims of ownership nor those of control can stand against the paramount interests of

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[18] 'The interests of the corporation … can be understood as a joint welfare function of all the individuals who make firm-specific investments and agree to participate in the extracontractual, internal mediation process within the firm. For most public corporations, these are primarily executives, rank-and-file employees, and equity investors, but in particular cases the corporate team may also include other stakeholders such as creditors, or even the local community if the firm has strong geographic ties.' Ibid 288.

[19] In the corporate setting, the term 'agent' is used broadly to capture the position wherever there is an arrangement where the principal's welfare depends on what the agent does. According to Jensen and Meckling, 'there is good reason to believe that the agent will not always act in the best interests of the principal.' Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 308. This behaviour, where a party's actions are for their own benefit, is known as 'shirking'. This area of study is also known as transaction cost economics. See further Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386; Armen Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organisation' (1972) 62 *American Economic Review* 777; Oliver Hart, 'An Economist's Perspective on the Theory of the Firm' (1989) 89 *Columbia Law Review* 1757, 1760-3.

[20] ' … shareholders, employees, and perhaps other stakeholders such as creditors or the local community … enter into this mutual agreement in an effort to reduce wasteful shirking and rent seeking by relegating to the internal hierarchy the right to determine the division of duties and resources in the joint enterprise'. Blair and Stout, above n 17, 278.

[21] Ibid 281.

[22] Stephen Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (1997) 82 *Cornell Law Review* 856, 857. Bainbridge also took issue with the use of the word 'progressive' which he believed is 'simply a code word used by the political left to take advantage of the positive connotations most Americans associate with the idea of progress'. Ibid.

the community … It remains only for the claims of the community to be put forward with clarity and force.' [23]

As with the team production model, the communitarian considers the wider constituency of a company. Its rhetoric is of directors' behavioural change,[24] from focusing on the traditional wealth maximisation objective to furthering the long term viability of the enterprise which relies on the co-operation of all corporate stakeholders.[25] This requires a consideration of ethics and fairness, which, progressives maintain, is in the overall best interests of the company because it fosters trust and reduces risk and the costs associated with it.[26] While directors are allowed to favour one cohort of corporate stakeholders over another, this is only permissible where this is in the long term interests of the company. Konstant remarked that this view 'provides a new and more inclusive paradigm of corporate governance in which stakeholder voice and loyalty are crucial.'[27]

The mechanisms by which progressives believe this paradigm will be achieved are less clear. Williams asserted that disclosure and transparency are key determinants of directors' actions, and that scrutiny by corporate stakeholders will foster beneficial norms of behaviour.[28] Greenfield contended that if corporate actions are perceived to be procedurally fair, the behaviour of others improves, to the benefit of all stakeholders.[29] Konstant recommended the appointment of an independent board, which 'can check opportunistic abuses by powerful inside senior managers and which can give voice and procedural fairness to all constituents.'[30] An independent board is also desirable because it lacks any personal financial incentive to benefit its members from its actions, and risks reputational damage from breaches of the law.

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[23] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (revised ed, 1968) 312.

[24] Peter Konstant, 'Team Production and the Progressive Corporate Law Agenda' (2002) 35 *UC Davis Law Review* 667, 676. 'Serious application of TPM [the team production model of Blair and Stout] offers at least the possibility that public corporations can achieve some meaningful increase in fairness for all corporate constituents. Such fairness can be accomplished without changing legal rules, but by encouraging directors and all corporate constituents to act in accordance with TPM under the existing law.'

[25] Ibid 669.

[26] Ibid 671.

[27] Ibid 674. Konstant rejected suggestions that the communitarian view is Utopian. He maintained that 'the currently dominant academic model of corporate law is such a caricature of selfishness that the ameliorative mechanisms that corporate communitarians propose can seem real, grounded, and morally refreshing' at 676.

[28] Cynthia Williams, 'Corporate Social Responsibility in an Era of Economic Globalization' (2002) 35 *UC Davis Law Review* 705, 711-17.

[29] Kent Greenfield, 'Using Behavioural Economics to Show the Power and Efficiency of Corporate Law as a Regulatory Tool' (2002) 35 *UC Davis Law Review* 581, 642.

[30] Konstant, above n 24, 683.

It may be argued that because communitarianism is ultimately in the best interests of the corporation, the implementation of these mechanisms requires no change to the existing law,[31] and thus some communitarians regard the theory as both positively descriptive and normatively useful. Nonetheless, there are serious practical obstacles in implementing communitarianism. The outlook it espouses is of more relevance to the large public company than the far more typical, closely held proprietary company. As Millon noted, any action by the board which deviates from the traditional wealth maximisation objective exposes the board to dismissal or the company to a hostile takeover, as disenchanted shareholders sell their shares and look for better investments.[32] Shareholders are legally entitled to vote in such a way that enhances their own financial position, even if that causes harm to non-shareholders. [33]

It may also be argued that the theory provides no guidance to decide between competing claims; rather it seems to hope that everyone who is fairly treated and ‘heard’ by the board will accept ‘give and take’ without making the board, as referee, decide who should win and who should lose. Moreover, it does not assist in determining the winner where two communitarian claims are competing. Communitarianism may support the imposition of liability on directors to consider the claims of creditors, employees or others, but if satisfying those claims makes a director risk averse, that could have economically detrimental effects on the directors' behaviour. In other words, is it better to ensure that a non-shareholder constituencies have an entitlement to be compensated by the director for failing to pay due regard to their interests, or that the director is more willing to take risks and expand the business, creating jobs and wealth for the community as a whole? However, it needs to be recognised that whilst taking financial risks may be a normal part of business, public policy has now reached a point where it is simply unacceptable for corporations to take risks with the environment or citizen welfare.

The focus in all of these theories of the corporation is on achieving the best for the company and its shareholders, whether that is done by concentrating on shareholders exclusively or by looking at wider stakeholder groups. Another perspective is to look at the company's place in society, regardless of its role in maximising shareholder wealth.

(b)1.5.4 ‘Concession’ theory

Indeed this is the way that some ‘progressive corporate law’ scholars understand communitarianism. It is sometimes also known as the ‘concession theory of the firm’.

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[31] Section 181(1) of the *Corporations Act* states that ‘A director or other officer of a corporation must exercise their powers and discharge their duties (a) in good faith in the best interests of the corporation; and (b) for a proper purpose.’

[32] David Millon, ‘New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law’ (2000) 86 *Virginia Law Review* 1001, 1024-30.

[33] David Millon, ‘Communitarians, Contractarians, and the Crisis in Corporate Law’ (1993) 50 *Washington and Lee Law Review* 1373 1384 commented that ‘[t]he claim that shareholders should continue to enjoy a property right to harm non-shareholders incidentally to their pursuit of profit maximisation seems at times to rest on nothing more than a reflexive commitment to the status quo.’

It sees incorporation as a privilege bestowed by the government, thereby justifying government interference. Cohen explained:

> Under this understanding, limited liability entities have a responsibility to operate in the public interest. Under the concession/communitarian view, the 'corporateness' of the artificial entity should be disregarded when the entity is being operated in a manner which runs counter to the spirit of the grant of privilege, ie, when the public wealth is damaged, rather than enhanced, by the operation of the corporation.[34]

Unlike the other theories outlined above, this permissive philosophy allows for the consideration of the interests of non-shareholder constituencies where they actually conflict with the wealth maximisation objective. It is then a matter for legislative and political process to decide exactly how far the corporation will be responsible for matters beyond the generation of profits for its members.

It also goes some way to answering the question 'why should the company have regard for the interests of non-shareholder stakeholders and the broader community'. Two factors are important here – first, the power of the corporation, especially large corporations and secondly, the privilege that the veil of incorporation brings.

(b)1.6 Further justifications for corporate responsibility

It has frequently been observed that the economic activity of some multinational corporations is larger than the GDP of small countries. There is a perception that this size brings responsibilities, similar to those owed by governments. These companies can have significant impacts on the economy, for example if they move production offshore with resulting job losses, or on the environment. The power of the companies and the vulnerability of the community to these actions gives rise to a sense of fiduciary duty, such as is owed by trustees to beneficiaries or directors to their companies. There is also an element of market failure here, due to an absence of effective competition, which justifies government intervention.

But should McDonald's, for example, be obliged to buy Australian potatoes for their chips rather than the cheaper New Zealand ones to protect the livelihoods of Australian growers? If the cost of the product is forced to rise because Australian potatoes are used, and consumers bear this cost, which of the non-shareholder interests should be heeded? And what if the price rise is not passed on and dividends for Australian shareholders drop – who in society is deemed most worthy of the company's 'corporate social responsibility'? These questions are ultimately political in nature, and the reality for modern corporations is that they must somehow be addressed. The concession theory suggests that a corporation the size of McDonalds should consider the impact of its actions on the broader community within which it operates. After all, that community provides the corporation with a market and a licence to make profits as well as a range of essential requirements including raw materials, staff, infrastructure and environmental services. In return, it is reasonable to

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[34] David Cohen, 'Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate rules for Piercing the Veil. Fiduciary Responsibility and Securities Regulation for the Limited Liability Company' (1998) 51 *Oklahoma Law Review* 427, 444. See also Stephen Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 *Federal Law Review* 203, 206.

expect that the corporation will consider the interests of that community when it makes business decisions that may be detrimental to that community. A simplistic economic approach based purely on cost minimisation is not a sufficient process for this purpose.

Under concession theory, the idea of the vulnerability of non-shareholders and the community is compounded by the limited liability of shareholders and the separate legal entity of the company. This produces a veil of incorporation which protects the managers and owners of small and large companies alike from the consequences of their actions. This point will be explored further below under the heading of whose responsibility it is to look after non-shareholder constituents.

(b)(2) When should organisational decision makers have regard for non-shareholder interests?

Under team production theory, keeping the parties happy during the solvency of the company is relatively easy. By definition, creditors and employees are being paid; environmental agencies are enforcing the law against errant companies and directors; customers are being looked after because otherwise they may take their business elsewhere.

However, the chief problem with this theory occurs when the company nears insolvency: just when the creditors and employees need the company and its directors to take care of them, their interests deviate from those of shareholders. The natural environment is also at risk at this time as an insolvent enterprise may choose to relax its standards on pollution and waste management. Since the directors' established fiduciary duty is to the company, they may not be permitted, let alone mandated, to consider others' interests at that time. The board of directors, in whom the creditors and employees are expected to repose their trust as a mediating hierarchy, is, after all, voted for exclusively by the shareholders and not by other participants in the corporation.

Therefore, in any consideration of whether organisational decision makers should have regard to the interests of stakeholders other than shareholders and the broader community, the time when this ought to take place needs to be considered. Should it be their responsibility only when the company is a going concern, or ought it to continue when the company is in financial distress? The point here is simple – if it is difficult for managers to take into account the concerns of multiple parties when the company is viable and successful, how much harder is it to consider those parties when the company faces extinction? Yet it is often precisely at this time that non-shareholder interests are most vulnerable to the decisions of the company's board.

Scott commented:

> As long as the debtor's business prospects remain good, a strong reputational incentive deters misbehaviour. But once the business environment deteriorates, the [director] is increasingly influenced by a 'high-roller' strategy. The poorer the prospects for a profitable conclusion to

> the venture, the less the entrepreneur has to risk and the more he stands to gain from imprudent or wrongful conduct. [35]

The problem is particularly acute for directors of small companies, who do not always have reputational incentives. Keay noted that 'it has become axiomatic that this risk-taking will take place, particularly where the directors are also the owners in the context of closed corporations.'[36] However, he remarked on the importance of wanting 'to avoid, particularly where there is a conflict of interests between corporate stakeholders, ending up with a vague obligation imposed on directors that has little content and provides insubstantial guidance.'[37] This leads to the issue of whose responsibility it is to consider the interests of non-shareholder constituencies – the company's or the directors and managers?

(b)(3) Whose responsibility is it to have regard for non-shareholder interests?

(b)3.1 Should directors be made personally liable?

Imposing personal responsibility on directors for behaviour that may damage the interests of stakeholders other than shareholders, deals with the moral hazard occasioned by the separate legal entity principle. It encourages directors to either obey the law or to protect themselves against liability by some other means. This may include taking more care to maintain adequate capitalisation of the company, so that claimants sue the solvent company rather than the directors themselves. Alternatively, they may seek insurance on behalf of the company or themselves.

Imposing liability or punishment on the company alone may be insufficient especially where an undercapitalised company owned by a sole shareholder will be happily abandoned to liquidation.[38] Finch noted, with reference to ensuring compensation for tort creditors:

> Personal liability may leave risk evaluation and spreading to those individuals who are the best acquirers of information concerning corporate risks, levels of capitalisation, internal control systems and insurance. It thus offers firms a flexibility of response that may be preferable to externally-imposed rules on minimum insurance or adequate capitalisation. Making the director liable thus protects against legislative over-or-under provision for tort risks, and it permits managers to select the optimal strategy for covering risk from among insurance, self-insurance or risk-reduction though the control of the firm activities.[39]

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[35] Robert Scott, 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *Journal of Legal Studies* 597, 624.

[36] Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665, 669 (footnotes omitted).

[37] Ibid 671.

[38] Vanessa Finch, 'Personal Accountability and Corporate Control: The Role of Directors and Officers' Liability Insurance' (1994) 57 *Modern Law Review* 880, 881-2.

[39] Ibid 883 (footnotes omitted).

(b)3.2 Difficulties with imposing liability on directors

However, a number of difficulties arise from the imposition of personal liability on directors. Experienced, well qualified business people may be reluctant to take up directorships, [40] thus depriving companies of a valuable resource.[41] Moreover, imposing liability on non-executive directors may be detrimental to a large company's ability to attract such directors. Finch commented:

> The outsider faces severe obstacles in monitoring board activity and the prospect of being held liable for failing in such monitoring functions may prove an excessive deterrent to non-executive direction, notably when the economic benefits of non-executive direction are seen to be dwarfed by potential liabilities for damages.
>
> Alternatively, companies when selecting outside directors may seek to avoid such problems by choosing directors who are either non-risk averse or uncritical of risk taking. An incentive to select on such a basis would run counter to notions of the outside director as a check on corporate folly.[42]

Finch also observed that the imposition of liability may lead to inappropriate delegation to subordinates or outside consultants to avoid directors bearing personal responsibility.[43] Another difficulty is its cost, as the directors may demand compensation for being exposed to actions for breach of duties to stakeholders. Like other employees, directors generally are unable to minimise their risk by diversification. As the Easterbrook and Fischel pointed out:

> The problem with managerial liability is that risk shifting may not work perfectly. … a legal rule of managerial liability creates risks for a group with a comparative disadvantage in bearing that risk. This inefficiency leads to both an increase in the competitive wage for managers and a shift away from risky activities. And there is no guarantee that the social costs of this shift away from risky activities will not exceed the social costs of the excessively risky activities in the absence of managerial liability.[44]

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[40] The American experience following *Smith v Van Gorkom,* 488 A 2d 858 (Del, 1985) is relevant here. In *Smith*, the Delaware Supreme Court held directors liable for gross negligence and thus the directors were unable to avail themselves of the protection of the business judgment rule. 'The corporate bar responded to the decision with horror…. Stockholders' suits against directors increased at a dramatic rate. With director and officer (D&O) liability insurance premiums increasing to levels that many companies could not afford, a large number of board members in the mid –1980s resigned rather than risk exposure to liability, as their companies "went bare". Even some directors who had insurance resigned because they had too many exclusions in their policies or had inadequate protection.' Ramesh KS Rao, David Sokolow and Derek White, 'Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm' (1996) 22 *Journal of Corporation Law* 53, 58-9. (footnotes omitted)

[41] Nonetheless the fact is that most directors of closely held companies are also their major shareholders and thus will remain committed to the survival of the company even if this involves exposure to potential personal liability.

[42] Finch, above n 38, 885.

[43] Ibid 884-5.

[44] Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) 50, 62.

As Easterbrook and Fischel note here, the fear of liability may make directors overly cautious.[45] This risk averse behaviour[46] on behalf of directors could be detrimental to the achievement of the company's profit and wealth maximization objectives although Keay reasoned that the additional care taken by directors under conditions of potential liability is in fact beneficial to the shareholders.[47] He contended:

> The argument that monitoring activity is costly and reduces efficiency masks the fact that monitoring is a necessary element of responsible corporate governance and a natural part of directors' functions, whether or not a duty to creditors exists … Rather than inhibiting efficiency, it might well lead to improvements that could be made in the company's procedures and profit-making processes …[48]

(b)3.3 Why regulation of directors' decision-making is necessary

Overall, however, as noted above, certain cohorts of non-shareholder stakeholder are particularly vulnerable to the risk of improper behaviour by corporate decision makers either during the solvency of the company or in its decline.

For these reasons, in our view the public interest in regulating directors' actions by reference to increasingly accepted standards of corporate social responsibility outweighs the potential negative effects of such regulation. Our recommendations for the form of that regulation are discussed in Part (d) below.

c. The extent to which the current legal framework governing directors duties encourages or discourages them from having regard for the interests of stakeholders other than shareholders and the broader community.

This issue has already been explored in Part (b) of this submission. Australia has traditionally adhered very closely to a shareholder-centred model of corporate law.[49] Accordingly, the current legal framework provides companies and those who run them with very limited capacity to have regard for employee, environmental, and

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[45] Coase argued that it is wrong to simply impose restraints upon director behaviour without weighing up the total cost of that intervention. Ronald Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1, 2. See also Jonathan Lipson, 'Directors Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' (2003) 50 *UCLA Law Review* 1189, 1244.

[46] Eugene Fama and Michael Jensen, 'Agency Problems and Residual Claims' (1983) 26 *Journal of Law and Economics* 327, 327.

[47] For example, Modigliani and Miller contended that while the recognition of a duty to creditors causes costs to the company, directors and shareholders, the costs are offset by a correlative reduction in the cost of the credit, so that the position of the parties remains unchanged, in a state of economic equilibrium. Franco Modigliani and Merton Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48 *American Economic Review* 261, 267-70.

[48] Keay, above n 36, 686.

[49] See eg Jennifer Hill, 'Public Beginnings, Private Ends – Should Corporate Law Privilege the Interests of Shareholders?' (1998) 9 *Australian Journal of Corporate Law* 21.

other non-shareholder interests – and in several important ways, actually discourages them from doing so. This part of the submission considers, in closer detail, how the traditional shareholder-centred paradigm of Australian corporate law has impacted upon two particular categories of non-shareholder interests, being employees and the environment.

(c)(1) The Position of Employees under Australian Corporate Law

(c)1.1 The Current Legal Position

The basic legal position is quite straightforward: the duty of directors to act in good faith and in the best interests of the company (at common law and under section 181 of the *Corporations Act*) requires directors to treat *shareholders'* interests as paramount. The interests of employees, or other stakeholders, *can* be considered in performing these duties – but only where this would also be in the company's (ie the shareholders') interests. Employee concerns cannot be placed ahead of those of shareholders. For example, a company could not make redundancy payments to employees in the context of a business closure, where this would run down the funds available for distribution to shareholders. Not even the company's interest in maintaining harmonious industrial relations would warrant directors pursuing such a course of action.[50]

Case law requires directors to consider *creditors'* interests when a company is insolvent or facing insolvency.[51] However, the cases stop short of establishing a *duty* that is enforceable at the instance of creditors;[52] only the company's liquidator or the Australian Securities and Investments Commission (ASIC) can bring an action for compensation or the recovery of company funds to return to creditors. As Symes has indicated, these developments do not provide much comfort to employees in insolvency situations. He noted that '[f]rom these cases, it is not possible to state that a duty to creditors upon insolvency means that they should take "care" of employees …' albeit that employees 'are creditors (statutory priority creditors, in fact) for their unpaid salary and other entitlements.'[53]

When companies become insolvent, employees not only lose their jobs. They also have to line up with other creditors for recovery of their unpaid wages and other employment entitlements. Workers take their place in the queue behind secured creditors (such as financiers), although they have the right to priority treatment over

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[50] *Parke v Daily News Ltd* [1962] Ch 927; see also *Hutton v West Cork Railway Company* (1883) 23 Ch D 654.

[51] *Walker v Wimborne* (1976) 137 CLR 1*; Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722. The 'uncommercial transactions' provisions of the *Corporations Act* (section 588FB, 588FC, etc) operate as a form of statutory duty to protect creditors' interests.

[52] *Spies v R* (2000) 18 ACLC 727.

[53] Christopher Symes, 'A New Statutory Directors' Duty for Australia – A "Duty" to be Concerned about Employee Entitlements in the Insolvent Corporation' (2003) 12 *International Insolvency Review* 133, 137.

other unsecured creditors.[54] Frequently, however, there are no assets remaining to meet employee claims once the debts of secured creditors have been fully or partly satisfied.[55] We consider that employees are more then mere creditors, so that regulation should be put into place that reduces the "increased opportunities for business strategies that shift risk and insecurity onto workers"[56]

Employees are also comparatively disadvantaged in their capacity to *avoid* the adverse consequences of insolvency. Directors, shareholders, banks and other secured creditors are all privy (to varying degrees) to information that enables them to see the warning signs of corporate failure and act to protect their interests.[57] For example, corporate financiers have a range of devices at their disposal to secure their debts, such as mortgages, fixed and floating charges, pledges and liens.[58] Usually, these legal instruments also provide secured lenders with a vital source of information about the company's financial performance, through contractual provisions imposing reporting obligations on the borrower and allowing the lender to appoint accountants to look into the company's affairs when concerns arise.[59] The use of 'quasi-securities' of this nature not only bolsters the information rights of secured lenders, it can also obscure the company's true position for other creditors (including employees) by creating an 'illusion of financial prosperity'.[60]

Usually, employees are also the last to find out about business restructures that adversely affect their interests. Business restructuring has become an increasingly prominent feature of the Australian economic landscape over the last twenty years or so,[61] leading to the retrenchment of several million workers.[62] Recent examples have included relocations, closures and large-scale job cuts at major companies like Arnott's, South Pacific Tyres, Coles Myer, Optus, Vodafone, AMP, Telstra,

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[54] *Corporations Act*, sections 555-556.
[55] See eg Robbie Campo, 'The Protection of Employee Entitlements in the Event of Employer Insolvency: Australian Initiatives in the Light of International Models' (2000) 13 *Australian Journal of Labour Law* 236; and see further below.

[56] Richard Mitchell, Anthony O'Donnell and Ian Ramsay, *Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and Labour Law* (2005) CCLSR/CELRL Research Report (2005) p 25; Paula Darvas, "Employee's Rights and Entitlements and Insolvency: Regulatory Rationale, Legal Issues and Proposed Solutions" (1999) 17 *Company and Securities Law Journal* 106, 108.

[57] See J Adams and N Jones, 'Distressed businesses – preventing failure' in CCH, *Collapse Incorporated: Tales, Safeguards and Responsibilities of Corporate Australia*, CCH Australia Ltd, Sydney, 2001, 185.

[58] Ibid 189; see also J Riley, 'Locating Labour's Voice in Corporate Enterprise: Lessons from Ansett', Paper to the Corporate Law Teachers' Association Conference, Melbourne, February 2002, 4.

[59] Adams and Jones, above n 57, 189-190.

[60] CCH, *Australian Labour Law Reporter*, para 1-515.

[61] See eg Peter Dawkins, Craig Littler, Ma Rebecca Valenzuela and Ben Jensen, *The Contours of Restructuring and Downsizing in Australia* (1999).

[62] ABS, *Retrenchment and Redundancy, Australia* (Catalogue No 6266.0) (September 1998 and August 2002).

Commonwealth Bank, Mitsubishi and (most recently) Holden.[63] These examples have highlighted an important deficiency in Australian law – the fact that, although their interests are directly and vitally affected when companies restructure or face insolvency, employees have few rights to information or any opportunity for input into decision making in these situations. Labour law provides unions with minimal rights to seek orders compelling employers to consult over large-scale redundancies, although the effectiveness of these provisions has been questioned.[64] However, a quarter of the almost 600,000 Australian workers made redundant between 1998 and 2001 received less than one day's notice of their dismissal.[65] This leaves employees poorly positioned to deal with the implications of events that have such serious consequences for them and their families.

(c)1.2 Recent Moves to Accommodate Employee Interests

In a number of high-profile company collapses – primarily, National Textiles in early 2000, and One.Tel and Ansett in 2001 – large numbers of employees lost unpaid entitlements to annual leave, long service leave and the like, and missed out on redundancy payments prescribed in industrial awards and agreements. In response, the Federal Government has implemented the following legislative and policy initiatives:

- *Corporations Law Amendment (Employee Entitlements) Act 2000*, introducing Part 5.8A into the *Corporations Act* which builds on the existing duty of directors to prevent companies from trading whilst insolvent,[66] by imposing personal liability on directors where they enter into "uncommercial transactions" – that is agreements, transactions, or corporate restructures which are *intended* to prevent workers from accessing their accrued employment entitlements. Heavy penalties, including fines and imprisonment, are available to deal with breaches of the "uncommercial transactions" provisions, and employee creditors can themselves initiate legal proceedings with the liquidator's permission. However, the significant problems with proving that directors were acting with the requisite intention under these provisions "inevitably limit [their] scope and effectiveness as a protective mechanism for employees".[67] There have been no reported cases to date involving a successful action by employees under these provisions.

- *Corporations Amendment (Repayment of Directors' Bonuses) Act 2003,* prompted mainly by the One.Tel collapse in 2001, inserting section 588FDA in the *Corporations Act* to enable the recovery by a liquidator of excessive bonuses that

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[63] See eg CCH, *Collapse Incorporated: Tales, Safeguards and Responsibilities of Corporate Australia* (2001).

[64] *Workplace Relations Act 1996* (Cth) ss 170FA and 170GA; see Anthony Forsyth, "Giving Teeth to the Statutory Obligation to Consult over Redundancies" (2002) 15 *Australian Journal of Labour Law* 177.

[65] ABS (2002), above n 62.

[66] *Corporations Act 2001* (Cth), sections 588G and following.

[67] Jennifer Hill, "Corporate Governance and the Role of the Employee" in P Gollan and G Patmore (eds), *Partnership at Work*, 110, 119; see further Symes, above n 53, 144-145.

have been paid to directors in circumstances where a company is in no financial position to make such payments.

- The General Employee Entitlements and Redundancy Scheme ("GEERS") scheme was introduced in the wake of the Ansett collapse, replacing the former Employee Entitlements and Support Scheme. GEERS enables employees of insolvent companies to claim recovery of their unpaid entitlements from a government fund. The establishment of such a "safety net" mechanism represents a significant improvement in the level of protection offered to employees. However, it operates subject to a number of important limitations, including a limit of 8 weeks' redundancy pay (when many employees are legally entitled to far greater severance payments under industrial awards or agreements), and an overall "cap" of $94,900 on the level at which entitlements paid out under the scheme are to be calculated.[68] The future viability of GEERS may also be in some doubt, following a recent Federal Court decision indicating that the Federal Government does not have enforceable "creditor" rights to recover payments made to employees under GEERS, in respect of companies subject to a deed of company arrangement.[69] It should also be noted that the existence of a government-funded scheme arguably discourages directors from taking greater responsibility for ensuring that companies have sufficient assets to meet their employees' entitlements. While the outcome of GEERS in terms of employee protection is commendable, the public policy benefit of effectively transferring directors' potential liability to taxpayers is questionable.

- Following the Ansett collapse, the Federal Government promised to place employees ahead of secured creditors in the statutory priority list for distribution of company assets upon insolvency. However, nearly four years later, no legislation to implement this change has yet materialised.[70]

It is important to note that employees have received very little attention in the extensive debate over corporate governance reform in Australia. Rather, the debate has been overwhelmingly shareholder-centred, with legislative responses aimed at improving board relationships with shareholders, and auditor independence.[71] These reform measures make little or no mention of employees, partly because political actors representing workers' interests (such as the ACTU and the federal Labor Opposition) have not sought to take the corporate governance debate in this direction.

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[68] For further detail, see the GEERS Operational Arrangements available at: http://www.workplace.gov.au/workplace/Category/SchemesInitiatives/EmployeeEntitlements/GEERS/GeneralEmployeeEntitlementsandRedundancyScheme.htm.

[69] See *Commonwealth of Australia v Rocklea Spinning Mills Pty Ltd (Receivers and Managers Appointed)* [2005] FCA 902 (1 July 2005).

[70] As at March 2004, the federal Treasury Department was reportedly still consulting on these proposals: M Priest, "States want 'workers first' legislation", *Australian Financial Review,* 19 March 2004.

[71] Andrew Clarke, "The Relative Position of Employees in the Corporate Governance Context: An International Comparison" (2004) 32 *Australian Business Law Review* 111; Paul von Nessen, 'Corporate Governance in Australia: Converging with International Developments' (2003) 15 *Australian Journal of Corporate Law* 1.

Rather, they have supported moves to strengthen the requirements for independent company auditors, and increased shareholder scrutiny of executive remuneration.[72]

Several academics have lamented the narrow focus of the corporate governance debate in Australia, arguing that it should be broadened to consider options such as employee representation on company boards.[73] The ACTU has embarked on a strategy of 'shareholder activism', seeking to utilise the combined voting power of employee and superannuation fund shareholdings to influence decision-making and question management about retrenchments, wage disparities and other issues at company annual general meetings.[74] Similarly, it has endorsed the idea of 'boardroom activism', encouraging union representatives on superannuation fund boards to use their positions to ensure 'socially responsible' investment decisions.[75] Several unions have also tried (unsuccessfully) to obtain seats on the boards of major companies. At this stage, the ACTU has not embraced the idea of legally-mandated employee representation at board level.

In contrast, employees have figured far more prominently in the debate over corporate governance reform in the UK. This has included consideration of a 'major redesign of [company] decision-making structures to permit participation by the relevant stakeholder groups', such as employees[76] (see further Part (g) below). Although inter-connected with labour regulation, Australian corporations law must follow the UK path and be substantially re-shaped to enhance the voice of workers in corporate enterprises.[77]

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[72] See eg Senator Stephen Conroy, *Directions Statement: Improving Corporate Governance* (2002); ACTU, *Corporate Governance Policy* (ACTU Congress 2003).

[73] See eg R Markey, "A Stakeholder Approach to Corporate Governance: Employee Representatives on Boards of Management" in Gollan and Patmore, 122, 132-3; Clarke (2004), above n 71, 114, 119, 130-1.

[74] See eg ACTU, *Corporate Governance Background Paper* (ACTU Congress 2003); Greg Combet, *Superannuation, Unions and Good Labour Relations* (Address to the Conference of Major Superannuation Funds, Ashmore, 14 March 2002).

[75] See Sharan Burrow, 'Whispers Outside the Boardroom Door: Making Working Australia's Money Talk' (Address to the Sydney Institute, Sydney, 29 August 2000); Greg Combet, *Speech to ACSI Corporate Governance Conference*, 9 July 2005.

[76] John Parkinson, 'Models of the Company and the Employment Relationship' (2003) 41 *British Journal of Industrial Relations* 481, 499-504; see also Paul Davies, 'Employee Representation and Corporate Law Reform: A Comment from the United Kingdom' (2000) 22 *Comparative Labor Law and Policy Journal* 135; Janet Williamson, 'A Trade Union Congress Perspective on The Company Law Review and Corporate Governance Reform since 1997' (2003) 41 *British Journal of Industrial Relations* 511.

[77] Several options are discussed in Part (d) below; other options traditionally falling more within the realm of labour law than corporate law, including 'partnership' strategies and information and consultation rights modelled on European Union directives, should also be explored; for detailed discussion, see Anthony Forsyth, *Transplanting Social Partnership: Can Australia Borrow from European Law to Improve Employee Participation Rights in Business Restructuring?* (Unpublished PhD Thesis, University of Melbourne, 2005); and Anthony Forsyth, 'Corporate Collapses and Employees' Right to Know: An Issue for Corporate Law or Labour Law?' (2003) 31 *Australian Business Law Review* 81.

(c)(2) The Position of the Environment under Australian Corporate Law

(c)2.1 The General Position

The general position with respect to the environment is similar to that described for employees. Company law provides only that directors have a broad duty to act in the best interests of the company. Thus directors may only sacrifice profits for protection of the environment if this coincides with the profit-making objectives of the company.

(c)2.2 Recent moves to Encourage Corporate Environmental Responsibility

Of course the Federal government has made some response to the growing calls for measures to encourage corporate environmental responsibility, including the following amendments to the *Corporations Act*:

(c)2.2.1 Mandatory environmental reporting - s 299(1)(f)

Paragraph 299(1)(f) was introduced into the *Corporations Act* in 1998. It provides a rather vague obligation for a director's report to include 'details of the entity's performance' in relation to any 'particular and significant' environmental regulation under a law of the Commonwealth or of a State or Territory. This provision in particular and the concept of mandatory environmental reporting in general have been strongly criticised by business groups and a 1999 Parliamentary Committee concluded that the provision should be repealed on the following grounds:[78]

- that environmental reporting is not a matter for the Corporations Act
- the provision is vague and uncertain
- the provision is of limited practical effect as it duplicates other reporting obligations, with additional cost
- the desirability for environmental reporting to develop in a non-prescriptive manner rather than as a response to government mandate.

In our view the Committee's conclusions were poorly reasoned and are certainly not justified. To suggest that environmental matters have no place in corporations law is simply an outmoded and unrealistic view contrary to Australia's obligations under various international agreements like the *Rio Declaration* as well as the Federal Government's own policy under the *National Strategy for Ecologically Sustainable Development*. It is easily demonstrated that environmental risks cannot be separated from the various financial considerations dealt with at length in the *Corporations Act*. The vagueness and uncertainty of s 299(1)(f) do not justify removal of the provision, as it is clearly a useful measure which is consistent in principle with international best practice; eg. see the Global Reporting Initiative.[79] However, the provision needs to be

[78] Parliamentary Joint Standing Committee on Corporations and Securities, *Matters Arising from Company Law Review Act 1988* (AGPS, Canberra, October 1999.

[79] The Global Reporting Initiative (GRI) is a multi-stakeholder process and independent institution whose mission is to develop and disseminate globally applicable Sustainability Reporting Guidelines. GRI is an official collaborating centre of the United Nations Environment Programme (UNEP) and

reformed to provide for more comprehensive and uniform disclosure to meet world best practice. The other two objections lack substance as many researchers have found that s 299(1)(f) has markedly improved the standard of environmental reporting by corporations.[80]

It can be argued that stronger environmental reporting is already required under the existing obligations of company directors. Sean Lucy and Megan Utter have argued that directors' reporting obligations under s 295 of the *Corporations Act*, requiring that company financial statements must give a 'true and fair view' of 'the financial position and performance of the company', necessitates careful consideration of the environmental sustainability of the company's operations.[81] They point out that there is a growing trend for the intangible aspects of a company's business to make up the bulk of the value of the company, and that this value is highly vulnerable to environmental risks. This is highly pertinent in industries associated with climate change, where sectors like motor vehicle manufacturing and coal fired power generation are vulnerable to declining profitability. It is argued that directors who do not report on such matters may subsequently be sued by disgruntled investors. However, it s 295 does not provide a sufficient basis for full environmental disclosure.

(c)2.2.2 Minority shareholder resolutions – s 249D

Another relevant measure introduced into the *Corporations Act* in 1998 was s 249D, which enabled either a minimum of 100 shareholders, or 5% of all shareholders, to put a resolution to an extraordinary general meeting. This has led to several instances of environmental activism by minority shareholders of companies such as North Ltd and Gunns Ltd.[82]

(c)2.2.3 Product Disclosure Statements – s 1013DA

Under the recent Financial Services Reforms, a new financial product disclosure requirement was introduced into the *Corporations Act* under s 1013DA. This provision requires 'product disclosure statements' to indicate whether labour standards, environmental considerations, social considerations or ethical considerations have been taken into account by the product issuer in selecting retaining or realizing an investment.

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works in cooperation with UN Secretary-General Kofi Annan's Global Compact. See the GRI website at: http://www.globalreporting.org/index.asp

[80] See eg G R Frost (2001) 'An Investigation of Mandatory Environmental Reporting in Australia' Paper presented to the *Third Asia Pacific Interdisciplinary Research in Accounting Conference*, 15-17 July 2001 Adelaide.

[81] Sean Lucy and Megan Utter, 'Directors' duties and sustainability: Are you being true and fair?' *Keeping Good Companies* , February 2004 at 40.

[82] See Paula Darvas 'Section 249D and the 'Activist' Shareholder: Court Jester or the Conscience of the Corporation?" (2002) 20 *Company and Securities Law Journal* 390, and Shelley Bielefeld, Sue Higginson, Jim Jackson and Aidan Rickets, 'Director's duties to the company and minority shareholder activism' (2004) 23 *Company and Securities Law Journal* 28.

These three 'environmental' measures have made a useful contribution but overall their effect on corporate behaviour is quite limited. However, a more significant factor is the range of specific environmental obligations that corporations face under State and Federal laws. It is necessary to review the effectiveness of these specific obligations in order to understand the appropriate role of corporations law.

(c)2.3 The effectiveness of specific environmental regulation

Company directors must always ensure that the company meets a wide range of specific environmental obligations under State and federal laws on a wide range of environmental matters, like the use of toxic chemicals, industrial pollution, waste disposal and the protection of nature resources. These specific environmental obligations are generally regulated by State Environment Protection Authorities and Natural Resources departments. Unfortunately, these agencies seem to be failing in their task. Peter Christoff has recently stated:

> Australian EPAs lack the capacity – and often the will – to fulfil their mandate … Yet it is also obvious that there are fundamental limits to what such localised agencies can achieve. The widely held expectation that EPAs can, given their present resources and regulatory scope and culture, guide complex economies towards ecological sustainability is manifestly unrealistic.[83]

With regard to forestry in Victoria, Andrew Walker has recently described a series of serious deficiencies in the forestry controls including a lack of ecologically sustainable management principles, effective exemption from the biodiversity protection legislation, absence of environmental impact assessment procedures, lack of accountability and transparency and a lack of community participation.[84]

At the federal level, the most relevant environmental legislation is the *Environment Protection and Biodiversity Conservation Act 1999* (Cth). This Act establishes a comprehensive scheme for environmental impact assessment of new proposals which may have a significant impact on certain specified 'matters of national environmental significance' as well as a range of biodiversity protection measures. The impact assessment function is restricted to certain specified matters based upon international obligations under various treaties like the World Heritage Convention, the Ramsar Wetlands Convention and the Biodiversity Convention.

This reflects a political compromise reached between the Federal Government and the States in 1992 after many bitter disputes over environmental matters in the 1970s (eg. the Tasmanian dams case). Andrew McIntosh has recently concluded that this Act is not meeting its environmental protection objectives due to a combination of administrative failings and structural flaws (including exemptions for existing uses and forestry operations, and a failure to specifically deal with land degradation and

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[83] P Christoff, 'EPAs -the orphan agencies of environmental protection' in S Dovers & S Wild River *Managing Australia's Environment,* The Federation Press, Sydney, 2003 at 316.

[84] Andrew Walker, 'Forest Reform In Victoria: Towards ecologically sustainable forest management or mere greenwash?' (2004) 29:2 *Alternative Law Journal* 58 (Apr 2004).

climate change).[85] This is not surprising due to the flawed structure of this Act which attempts to divide up discrete areas of environmental management between federal and state governments, and in particular, to leave most resource use issues to the States.

These weaknesses in the framework of specific environmental obligations have increasingly placed corporations in the role of primary protector of the environment, and thus under the present law, its protection now largely depends upon voluntary actions by corporations. The limited effectiveness of reliance upon voluntary corporate action can be illustrated by a range of recent examples:

- BHP Ltd mining operations at Ok Tedi in Papua-New Guinea, between 1994 and 1996 which destroyed the traditional lifestyle of some 30,000 landowners in the Fly River catchment.[86]

- forestry in Tasmania, where Gunns Ltd has a very poor record with respect to clear felling of native forests[87], misuse of pesticides[88] undue influence over government agencies,[89] and using legal proceedings against the Wilderness Society and other community activists.[90]

- the Shell Oil Refinery at Corio Bay, which has breached environmental standards several hundred times in recent years. The company has been content to regularly pay modest fines imposed by the Magistrates Court rather

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[85] Andrew Macintosh, 'Why the EPBC Act's referral assessment and approval process is failing to achieve its environmental objectives' (2004) 21 *Environmental and Planning Law Journal* 288.

[86] In 1995, the PNG landowners filed a $4 billion damage claim against BHP in the Victorian Supreme Court for economic loss and environmental damage, and argued that BHP be forced to build a tailings dam instead of letting mine waste flow down the river systems. BHP responded by secretly drafting legislation for the PNG government that would make it a criminal offence to take legal action against BHP in courts outside Papua New Guinea. BHP was found guilty of contempt of court, causing its share prices to plummet. The contempt finding was later overturned on appeal on a technicality.

[87] See the many submissions about unsustainable forestry practices made to the Senate Rural and Regional Affairs and Transport References Committee Inquiry: *Australian Forest Plantations A Review of Plantations for Australia: The 2020 Vision. Submissions to this inquiry are available at: http://www.aph.gov.au/Senate/committee/rrat_ctte/completed_inquiries/2002-04/plantation_forests/index.htm.*

[88] See NineMSN Sunday Program, September 26 2004, 'Name Your Poison' which investigated the misuse of chemicals and water contamination linked with public health problems in St Helens and death of oysters in Georges Bay, north-east Tasmania. Transcript available at: http://sunday.ninemsn.com.au/sunday/cover_stories/article_1649.asp.

[89] Forestry Tasmania, the government agency which administers forestry operations in Tasmania, has been exempted from Freedom of Information laws in that State.

[90] See Friends of the Earth (2004) 'Gunns Action Threatens Free Speech' Press Release 20 December 2004 available at: http://www.foe.org.au/mr/mr_20_12_04.htm, and Andrew Darby, (2005) 'Lawyers, Gunns and forests' *Sydney Morning Herald*, January 27, 2005.

than make the necessary capital investment needed to prevent these problems. Meanwhile the EPA has failed to take stronger action.[91]

- the expansion of unsustainable agricultural ventures, such as irrigated cotton which been responsible for excessive water diversion in the Murray Darling system[92] and increasing chemical discharges to the Great Barrier Reef in Queensland[93].

These examples indicate some serious general problems in the regulation of environmental issues in Australia:

- Firstly, they reinforce the view that the mandatory government controls over corporate environmental impacts are often inadequate (particularly in 'rogue' states).

- Secondly, even where government regulation is adequate, it may not be enforced due to 'capture' of the regulators, particularly where large corporations attract valuable economic development to a region.

- Thirdly, that corporate decision making is more often the critical process that determines the real extent of environmental damage (or protection).

- Fourthly, that within that corporate decision making process, conflicts between profit maximisation and environmental responsibility are generally exercised in favour of the short term interests of shareholders rather than the long term interests of the broader community.

- Fifthly, they demonstrate that 'top-down' models of environmental regulation are not sufficient. These failures illustrate the importance of engagement of community stakeholders and industry managers in the relevant decision-making processes.

The examples also reveal some common weaknesses in corporate decision-making processes:

- Inadequate disclosure of environmental impacts;

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[91] An investigation in 2003 revealed Shell had committed more than 300 environmental breaches in the prior two years, including 145 between June and September 2003. It had been fined just 31 times for those breaches. See *The Age* 11 November 2003, 'The Shell refinery: an issue on the nose'
For a more recent incident, see press report by Ewin Hannan 'Shell under fire over secrecy on discharges', *The Age*, Melbourne, 18 August 2005.

[92] Within the last ten years, irrigation properties on the lower Ballone river system north of the NSW border have built dams and water storage systems capable of retaining 1.2 million megalitres, or twice the water capacity of Sydney Harbour. See Peter Mac 'Agribusinesses in huge water scam', *The Guardian*, No. 1171, 18 February, 2004

[93] For example, the current dispute over the Natham Dam proposal for expansion of irrigated cotton farming in the Fitzroy River catchment in central Queensland which was the subject of a recent *ADJR Act* challenge: *Minister for the Environment and Heritage v Queensland Conservation Council Inc* [2004] FCAFC 190 (Full Court, 30 July 2004).

- Lack of stakeholder engagement in decision making; and

- Lack of commitment to the principles of sustainable development.

Fortunately, these decision-making weaknesses have been the focus a range of voluntary measures developed under State laws such as the Victorian *Environment Protection Act* 1970. These include:

- recognition of environmental management systems and environmental audits as a prerequisite for determining environmental performance to qualify as an ‘accredited licencee’ under s 26B of the *Environment Protection Act* 1970 (Vic); environmental management systems have also been endorsed as part of a ‘minimum profile’ expected where company directors seek to raise a defence of due diligence against statutory liability for environmental offences;[94]

- processes for participation of the community in corporate environmental management, as an essential prerequisite for approval of an ‘environmental improvement plan’ under s 31C(6) of the *Environment Protection Act* 1970 (Vic);

- the recognition of ‘resource efficiency’ and ‘reduction of ecological impact’ as key criteria for establishment of a sustainability covenant under s 49AA of the *Environment Protection Act* 1970 (Vic). These strategies focus on ‘extended product responsibility’, using a ‘cradle to grave’ approach to managing environmental impacts throughout the raw materials supply chain as well as production and downstream product distribution and waste recovery.

Together with comprehensive ‘sustainability reporting’, these voluntary measures are close to international ‘best practice’ in environmental management, and they have been willingly adopted by a growing number of environmentally responsible corporations in Victoria. Thus it is submitted here that the next phase of environmental law should make these strategies mandatory. However, in recognition of the limited jurisdictional reach and lack of resources of State environmental agencies, it is recommended that these measures will be of greatest impact if they are introduced as part of an expansion of corporate law obligations. This will be described further in Part (d) below.

d. Whether revisions to the legal framework, particularly to the Corporations Act, are required to enable or encourage incorporated entities or directors to have regard for the interests of stakeholders, other than shareholders, and the broader community.

(d)(1) Introduction

[94] See s 66B(1A)(c) of the *Environment Protection Act* 1970 (Vic) and the comments on due diligence by Ormston J in *R v Bata Industries Ltd et al* (1992) 70 CCC (3d) 394 (Canada).

The economic theories outlined in Part (b) above recognise that there are non-shareholder stakeholders that are vulnerable to abuse of power by corporations because of their inability to protect their own interests. This is specifically acknowledged by the growth in theories such as team production, communitarianism. and concession theory. The examination of the current legal framework under Part (c) revealed that there is currently no effective framework for corporations to take these non-shareholder interests into account.

What is needed, therefore, is guidance as to how these interests are to be considered and protected. According to Millon, communitarians are characterised by their 'willingness to use legal intervention to overcome the transaction costs and market failures that impede self-protection through contract.'[95] He contended:

> If one discards the view that bargaining is sufficient to mediate among those interests, reform of the rules structuring corporate governance presents an opportunity to develop rational, well-considered regulation of relations among shareholders and non-shareholders. Perhaps supplemented by public law interventions, this approach seems preferable to a number of uncoordinated, ad hoc reform efforts, in various discrete areas of the law, that ignore the need for systematic balancing of shareholder and non shareholder interests.[96]

In order to genuinely protect non-shareholder constituencies, legislation would need to be passed to mandate directors to consider their interests in situations where there is a conflict with the interests of shareholders and the shareholder profit maximisation objective. The issue of when such interests are to be given priority is problematic. However, as has been demonstrated in earlier parts of this submission, non-shareholder cohorts are most vulnerable when the company is in financial distress and the directors are desperately seeking to keep it afloat. For these reasons, sanctions need to be targeted against directors' personal assets, to deter them from any improper behaviour in such situations. This would justify the imposition of financial penalties and other sanctions against directors for breach of any new duty to consider stakeholder interests (see further below).

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

[95] Millon, 'Communitarians' above n 33, 1379.

[96] Millon, 'Communitarians' above n 33, 1386-7.

(d)(2) Recommendations for new directors' duties to recognise stakeholder interests in company decision making

Accordingly, we recommend that the duty of directors under the *Corporations Act* to act in good faith in the best interests of the company should be amended to enable and, in certain circumstances, require directors to consider the interests of non-shareholder stakeholders.

The essence of these additional duties upon directors is to reform corporate disclosure and decision making processes by mandating for all corporations the best practice on social and environmental responsibility already implemented voluntarily by many progressive corporations in Australia.

By way of enforcement, the civil penalty regime discussed below will be extended to provide standing for appropriate non-shareholder stakeholders to seek remedies including civil penalties, injunctions and declarations.

The new duties would have the following elements:

(d)2.1 A *permissive* aspect having general application:

- That is, it would be made clear that directors *may* consider the interests of employees, the environment, creditors, consumers, and other stakeholders in the normal course of company decision-making, even where this would conflict with the interests of shareholders and the shareholder profit maximisation objective.
- The legislation would need to provide some guidance for directors as to when stakeholder interests may be prioritised ahead of those of shareholders. Usually, this would be the case where it is necessary to ensure that the company meets its obligations under other relevant laws, such as employment and occupational health and safety standards, environmental regulations, and the like.
- The legislation could take this a step further by enshrining higher standards of corporate behaviour, the observance of which would enable a director to put stakeholder interests ahead of those of shareholders. That is, rather than simply promoting *observance* of existing laws, the new duty could allow directors to take active steps to *exceed* those standards – for example, by tying increases in executive remuneration to the level of salary increases for the regular workforce, even though no labour law or corporate law rules require directors to do so.
- Directors could also be permitted to place stakeholders' interests ahead of shareholders', where the company's reputation or long-term viability would be at risk if the directors failed to do so. This would involve legislative recognition of directors' capacity to act *other* than with a view to ensuring short-term returns to shareholders, and enabling them to act in accordance with the principle of "enlightened shareholder value" (in line with current law reform proposals in the United Kingdom)[97].

[97] See further Part (e) below.

(d)2.2 A *mandatory* aspect having specific application:

- That is, *requiring* directors to prioritise stakeholder interests over those of shareholders, where the risk of stakeholder interests suffering adverse treatment is particularly heightened – primarily, when the company is encountering financial difficulty and may, or has, become insolvent.
- The relevant stakeholder individual(s) or group(s) could be required to show that its/their interests were "substantially prejudiced" by the directors' actions or proposed actions, in order to show a breach of this aspect of the new directors' duties.

(d)2.3 Two further *mandatory* aspects to specifically address employee interests:

(i) In the insolvency or near-insolvency situation, the interests of employees warrant particular protection from steps being taken by directors to deplete company assets, or to preserve such assets for the benefit of directors and shareholders at the expense of employees.

- Further specific obligations should be imposed on directors to prevent such behaviour. A duty on directors aimed at achieving this objective should not be based on the necessity of proving that directors intended to cause detriment to employees, as is currently the case under Part 5.8A of the *Corporations Act*.
- Rather, it should be sufficient to show that a director acting reasonably in such circumstances would have taken steps to safeguard the accrued entitlements and other amounts owed to employees.

(ii) Consideration should also be given to ensuring the recognition of employee interests whenever the company is considering a reorganisation or restructure that could have a detrimental impact on employees, such as large-scale redundancies.

- Companies frequently implement such decisions with the stated aim of enhancing "shareholder value". However, it may be necessary to require directors to demonstrate that they have considered the impact of these restructuring decisions on employees, and explored all available alternatives, before implementing them.
- This could be done through the imposition of a specific duty in the *Corporations Act* to this effect, which directors could "opt out" of by showing that the company has established permanent structures for ongoing consultation with employees about major business and investment decisions.
- For example, the creation of specially-constituted board committees with employee representatives,[98] or worker-elected

[98] See R Markey, 'A Stakeholder Approach to Corporate Governance: Employee Representatives on Boards of Management' in P Gollan and G Patmore (eds), *Partnership at Work*, 122.

councils,[99] with access to company financial information and consultation rights in relation to strategic business decisions, would enable a company to exercise the "opt out" from the obligation to consider employee interests in restructuring situations.

- It is acknowledged that works councils, mandatory employee representation at board level, and other features of "stakeholder"-oriented corporate governance systems may not be readily adaptable to the Australia's shareholder-focused business culture.[100]
- However, the encouragement of these types of innovative institutional arrangements as a backdrop to a new obligation to consider employee interests in specific cases of restructuring would give businesses the capacity to fashion such arrangements to their own circumstances.

(d)2.4 Four further *mandatory* duties to specifically address the interests of the broader community in achieving ecologically sustainable development and protection of the natural environment:

(i) Directors must prepare and publish an annual environmental impact and ecological sustainability report in accordance with international best practice; eg. the Global Reporting Initiative or similar guidelines. This report shall be integrated with the financial reporting obligations of the company and thus subject to audit along with the financial report.

(ii) Directors must ensure that each distinct business division of the company establishes and maintains an appropriate environmental management system to be verified by ISO 14001 accreditation. A mandatory independent environmental auditing process should be introduced to monitor this requirement.

(iii) Directors must prepare and implement an appropriate 'environmental improvement plan' as a mandatory component of the environmental management system. This plan will establish procedures to improve the ecological sustainability of all company activities, with special attention to 'resource efficiency' and 'reduction of ecological impact' following appropriate principles of extended product responsibility.

(iv) Directors must regularly consult with the local community in relation to all activities that have a significant impact upon the natural environment. For this purpose the company shall establish a 'community consultative

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[99] See Anthony Forsyth, 'Giving Employees a Voice over Business Restructuring: A Role for Works Councils in Australia' in P Gollan and G Patmore (eds), *Partnership at Work*, 140.

[100] On the distinction between shareholder-centred (Anglo-American) and stakeholder (continental European) corporate governance models, see eg Parkinson, above n 76; Jeswald Salacuse, 'Corporate Governance, Culture and Convergence: Corporations American Style or with a European Touch?' (2003) 14 *European Business Law Review* 471.

committee' which includes at least one board member and the senior environmental manager together with an appropriate range of community representatives.

(d)(3) Enforcement mechanisms

Consideration also needs to be given to the question of how best to enforce the new directors' duties outlined above. In our view, the proposed duties should be enforced by the civil penalty regime contained in Part 9.4B of the *Corporations Act*. This would be desirable for two reasons. First, it would provide consistency as the current directors' duties are enforced by this regime and secondly, the regime has been proven to be effective in the enforcement of those duties. Only those duties cast in mandatory terms (that is, those described in paras (d)(2.2)-(2.4) above) would lend themselves to enforcement through these mechanisms.

(d)3.1 Civil penalty provisions

Civil penalty provisions are "punitive sanctions that are imposed otherwise than through the normal criminal process." [101] These provisions were introduced to assist ASIC in its role as the regulator of corporate law.[102] Civil penalty provisions provide an alternative to traditional criminal enforcement regimes. These penalties fall between civil actions for damages and criminal prosecutions. Just as it does in a criminal matter, a court may impose a civil penalty when an adverse finding has been made against a defendant. However, the rules of evidence and procedure applicable to a hearing for a civil penalty are civil, not criminal.[103] Civil penalties are attractive enforcement mechanisms because they allow ASIC to obtain an enforcement order on the civil standard of proof. The increased likelihood of a civil penalty order being made against a director provides an increased deterrent to encourage him or her to comply with the directors' duties.

The imposition of a civil penalty does not amount to a criminal conviction. Usually the behavior that attracts a civil penalty does not involve any connotation of the commission of a crime.[104] It is argued that the stigma that would follow a criminal conviction does not attach to a civil penalty.[105] Incarceration is reserved for criminal offences and is never available as a civil penalty. As the type of conduct that attracts these civil penalties is not regarded as criminal, incarceration is deemed to be inappropriate.[106]

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[101] Michael Gillooly and Nii Lante Wallace-Bruce, 'Civil Penalties in Australian Legislation' (1994) 13 (2) *University of Tasmania Law Review* 269, 269.

[102] Vicki Comino, 'National Regulation of Corporate Crime' (1997) 5 *Current Commercial Law* 84, 91 and 92; and Explanatory Memorandum, Corporate Law Reform Bill 1992, paras 61 and 113.

[103] *Corporations Act 2001* (Cth) s 1317L.

[104] Harold Ford and Robert Austin, *Principles of Corporations Law* (9th ed, 1999) 83.

[105] Gillooly and Wallace-Bruce, above n 101, 289.

[106] Ibid.

Certain provisions of the *Corporations Act* are deemed to be "civil penalty provisions" and are subject to the civil penalty regime.[107] The civil penalty provisions are categorised as corporation/scheme civil penalty provisions or financial services civil penalty provisions.[108] The corporation/scheme civil penalty provisions include the directors' duty provisions. If the court is satisfied that one of the civil penalty provisions have been contravened the court is required to issue a declaration to that effect.[109] If a declaration of a contravention is made the court can ban the contravening person from managing a corporation for a period specified in the order and order the contravening person to pay a pecuniary penalty.[110] In addition, the court has the power to order the person who contravenes a corporation/scheme civil penalty provision to pay compensation to the corporation that suffers loss or damage as a result of the contravention.[111]

Whilst the number of civil penalty applications issued by ASIC is not large, ASIC is making increasing use of the civil penalty regime in high profile cases. For example, many of the cases issued since 2000 were issued against directors involved in high profile corporate collapses including the directors of the HIH group of companies, the Water Wheel groups of companies and One.Tel Ltd.

ASIC has enjoyed a high rate of success with the civil penalty applications it has issued. Research published in 2004 indicated that from March 1993 to May 2004 nineteen applications for civil penalty orders issued by ASIC were finalised.[112] ASIC was successful in all but one of these nineteen cases. Success is defined as the obtaining of a declaration that a contravention of a civil penalty provision had occurred and the subsequent making of civil penalty orders.

The successful use by ASIC of the civil penalty regime in high profile cases sends an important message to directors and the community. ASIC has at its disposal enforcement mechanisms which allow it to successfully pursue actions against directors who contravene the provisions of the *Corporations Act*. The proposed duty mandating directors to consider other stakeholders' interests in situations where there is a conflict with the interests of shareholders and the shareholder profit maximisation objective should be made subject to the civil penalty regime so that ASIC can successfully pursue actions against directors who contravene this duty.

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[107] *Corporations Act* 2001 (Cth) ss 1317E(1).

[108] *Corporations Act* 2001 (Cth) s 1317DA.

[109] *Corporations Act* 2001 (Cth) s 1317E.

[110] *Corporations Act* 2001 (Cth) s 206C and 1317G.

[111] *Corporations Act* 2001 (Cth) s 1317H.

[112] Michelle Welsh, 'Eleven Years On – An Examination of ASIC's Use of an Expanding Civil Penalty Regime' (1994) 17 *Australian Journal of Corporate Law* 175.

(d)3.2 What changes would need to be made to the regime?

Amendments would need to be made to the civil penalty regime to allow the proposed duty to be enforced effectively and to allow the benefits of that enforcement action to flow to the victims of the contravention. In relation to a contravention of the directors' duty provisions the current civil penalty regime does not contemplate enforcement action being taken by stakeholders other than ASIC or the company to whom the directors' duties are owed. Only ASIC and the company affected by the contravention can seek orders under the civil penalty regime.[113] No other person may apply for a declaration of a contravention, a pecuniary penalty order or a compensation order.[114] Stakeholders other than the company have no standing to apply for a compensation order.

In addition, the current provisions do not allow ASIC to seek compensation on behalf of stakeholders other than the company. Where the directors' duties have been contravened and damage results from the contravention the court may order a person to compensate the corporation who suffered damage as a result of the contravention.[115] The provisions do not allow the court to make a compensation order in favor of any other stakeholders.

The civil penalty regime would need to be amended to give stakeholders other than the company standing under the regime. In addition the orders available to the court would need to be expanded so that compensation could be awarded to stakeholders other than the company. This would allow ASIC to apply for compensation orders in favour of these stakeholders. In addition, stakeholders themselves would be able to apply for a compensation order.

There is some precedent for this type of order. As stated previously the provisions of the *Corporations Act* that are enforced by the current civil penalty regime are categorised as either corporation/scheme civil penalty provisions or financial services civil penalty provisions. The directors' duty provisions are categorised as corporation/scheme civil penalty provisions. Provisions such as the continuous disclosure and market manipulation provisions are categorised as financial services civil penalty provisions.116

The orders available for a contravention of a financial services civil penalty provision are wider than the orders available for a contravention of the corporation/scheme civil penalty provisions. If a financial services civil penalty provision has been contravened the court may make a compensation order in favour of any person (including a corporation), or a registered scheme, for damage suffered by that person or scheme.[117]

[113] *Corporations Act* 2001 (Cth) s 1317J.

[114] *Corporations Act* 2001 (Cth) ss 1317J(4).

[115] *Corporations Act* 2001 (Cth) ss 1317H(1).

[116] *Corporations Act* 2001 (Cth) s 1317DA.

[117] *Corporations Act* 2001 (Cth) s 1317HA.

The difference between the compensation orders available for corporation/scheme and financial services civil penalty provisions is that under the former, compensation can be awarded in favour of the corporation or registered scheme whereas under the latter an order for compensation can be made in favour of a corporation, a registered scheme or a person for damage suffered by the corporation, scheme or person. In addition, persons who suffer damage in relation to a contravention, or alleged contravention, of a financial services civil penalty provision have standing to apply for a compensation order.[118]

In order to encourage directors to have regard for the interests of stakeholders, other than shareholders, and the broader community, the orders available for contravention of the proposed duties and the persons who have standing to apply for those orders should be the same as those currently provided for a contravention of the financial services civil penalty provisions.

(d)3.3 Standing for environmental breaches

With regard to a breach of the new 'environmental' duties proposed above, the standing rules will need to be extended beyond the existing classes of 'a person whose interests have been, are or would be affected' (under the injunction provision, s 1324) and 'any other person who suffers damage' (under the financial services penalty provision, s 1317J). It is submitted that the appropriate standing rule for a breach of environmental obligations should be based upon the concept of an 'interested person' in s 475(6) of the *Environment Protection and Biodiversity Conservation Act 1999* (Cth), which extends standing to any individual or organisation engaged in activities or research for protection or conservation of the environment.[119]

(d)3.4 Strategic regulation theory

To be effective an enforcement regime should comply with strategic regulation theory. Strategic regulation theory is an economic theory of regulation under which a regulator's goal is defined as being the need to secure compliance with the law. This theory offers guidelines as to how that compliance may be best secured. It requires the regulator to be equipped with a range of sanctions that are ordered from the least to the most severe.

Strategic regulation theory advocates that regulators are best served to attempt to secure regulatory compliance by persuasion rather than through punishment. Persuasive measures will be less costly than legal enforcement through punishment. However for persuasion to be effective it must be backed up by a real threat of punishment. The punishment that can be threatened should consist of a set of

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[118] *Corporations Act* 2001 (Cth) ss 1317J(3A).

[119] This rule has been successfully used by environmental groups in several *EPBC Act* applications; for example see *Booth v Bosworth* [2001] FCA 1453 (17 October 2001) and *Queensland Conservation Council Inc v Minister for the Environment and Heritage* [2003] FCA 1463.

integrated sanctions escalating in severity in proportion to the contravention that has been committed.[120]

Usually strategic regulation theory is represented graphically by the pyramid model. The pyramid model was developed and expanded by John Braithwaite, Brent Fisse and Ian Ayres.[121] The pyramid model requires the regulator to be armed with a range of sanctions that escalate in severity from education and persuasion at the base, through various other stages in the middle to incarceration of individuals or winding up of companies at the apex. The regulatory agency should move from one level to another, commencing at the lowest level in the majority of cases.

As stated previously the directors' duties are currently enforced by the civil penalty regime. In addition to civil liability criminal penalties are available for the most severe cases. For example criminal sanctions can be imposed when a director is reckless or intentionally dishonest and breaches his or her duty to act in good faith in the best interests of the corporation.[122] Consideration would need to be given as to whether or not a director breaching the duty proposed in this submission should be subject to criminal sanctions.

In 1989 the Senate Standing Committee on Legal and Constitutional Affairs conducted an enquiry into the duties and obligations of company directors. The committee issued a report entitled 'Report on the Social and Fiduciary Duties and Obligations of Company Directors' (the Cooney Committee Report).[123] One of the matters considered by that report was whether or not criminal penalties should be imposed for breach of the directors' duty provisions.

The committee recognized that the directors' duties could be contravened at different fault levels. While criminal penalties would not be appropriate in every circumstance, these penalties should be available where the conduct in question is genuinely criminal in nature. If criminal penalties were introduced in relation to the proposed duty the enforcement regime would comply with strategic regulation theory and it would provide consistency with the enforcement regime available for the other directors' duties. However, this submission does not support the introduction of criminal liability for the new duty for the following reasons.

As noted previously expanding the directors duties may increase the reluctance of experienced, well qualified business people to take up directorships, thus depriving companies of a valuable resource. The imposition of liability may also lead to inappropriate delegation to subordinates or outside consultants to avoid directors bearing personal responsibility. Another difficulty is the cost of increased liability, as the directors may demand compensation for being exposed to it. Moreover, the fear of

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[120] George Gilligan, Helen Bird and Ian Ramsay, 'Civil Penalties and the Enforcement of Directors'Duties' (1999) 22 (2) *University of NSW Law Journal* 417, 425.

[121] Brent Fisse and John Braithwaite, *Corporations Crime and Accountability* (1993).

[122] *Corporations Act 2001* (Cth) s 184.

[123] Senate Standing Committee on Legal and Constitutional Affairs, Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors, Nov 1989, AGPS (Cooney report), paras 13.3 and 13.4.

liability may make directors overly cautious. These factors will be increased to an unacceptable level if criminal liability is imposed.

In addition, there are practical reasons for not extending corporate criminal liability. Many commentators have identified the difficulties associated with the imposition of criminal liability on directors.[124] Corporate criminal offences are difficult to enforce because of the evidentiary requirements and criminal standard of proof. In many cases offenders are powerful and well resourced and are able to take advantage of the vagaries of the criminal law. A further problem is the apparent reluctance of the courts to convict white collar or corporate offenders. It has been argued that in many cases juries do not perceive business people as 'candidates for gaol'.[125] For these reasons this submission does not support the imposition of criminal liability in relation to the proposed duty.

This submission supports the expansion of the civil penalty regime to enforce the new duties. The civil penalties should be supplemented with education and persuasion strategies. If education and persuasion strategies do not work it is proposed that ASIC should be able to escalate its enforcement activities to civil penalties. Criminal penalties should not be imposed.

The proposed enforcement regime is as follows:

First Tier - Lesser penalties, education and persuasion

It is proposed that the first tier of liability should be introduced to enforce relatively minor contraventions. It could involve the director being warned, minor pecuniary penalties being imposed or orders being made that the director undertake a relevant education program or implement a relevant compliance program.

Second Tier - Civil Liability imposed pursuant to the civil penalty regime

A second tier of civil liability should be introduced. The proposed second tier would allow the current civil penalty regime to be expanded to cover the new duties. The advantages of the civil penalty regime are outlined above.

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[124] See Henry Bosch, 'Bosch on Business' (1992) *Information Australia* 1, 1; Seumas Miller, 'Corporate Crime, the Excesses of the 80's and Collective Responsibility: an Ethical Perspective' (1995) 5 *Australian Journal of Corporate Law* 139, 162; Roman Tomasic, 'Corporate Crime' in Duncan Chappell and Paul Wilson, P (Eds), *The Australian Criminal Justice System The Mid l990,* (1994) 263 and Roman Tomasic, 'Corporate Crime in a Civil Law Culture' (1994) 5 *Current Issues in Criminal Justice* (3) 244, 251.

[125] Roman Tomasic, 'Corporate Crime in a Civil Law Culture' (1994) 5 *Current Issues in Criminal Justice,* 244, 251.

g) Whether regulatory, legislative or other policy approaches in other countries could be adopted or adapted for Australia.

(g)(1) Recent legal changes in the United States

Designing an effective mandatory framework for integration of non-shareholder interests in into corporate decision making will be a difficult task. One model that has recently emerged in response to corporate failures in the USA is the new disclosure requirements under section 404 of the *Sarbanes-Oxley Act* of 2002. Under these new rules, a company is required to disclose annually whether the company has adopted a code of ethics for the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If it has not, the company will be required to explain why it has not.[126]

These new provisions appear to give statutory form to the "if not, why not?" approach to improving corporate governance practices embodied in the Australian Stock Exchange's *Principles of Good Corporate Governance and Best Practice Recommendation*.[127] The operation of the *Sarbanes-Oxley* provisions, and the extent to which they are enforced by regulatory bodies in the USA, should be closely monitored by Australian observers to determine their effectiveness as a mechanism for safeguarding stakeholder interests. A more appropriate measure could be to mandate not only the adoption and disclosure of a code of ethics, but also an obligation that the code would be taken into account in corporate decision making.

(g)(2) Current and proposed legislation in the United Kingdom

In the UK, corporations legislation currently requires directors, in carrying out their functions, to have regard to the interests of employees as well as those of the company's shareholders.[128] The real value of this provision for employees has been questioned, on the grounds that it only requires employee interests to be *considered* (not that they be given priority); and because the duty is owed to the company, and therefore is enforceable only at the instance of shareholders.[129]

Legislative proposals currently under consideration in the UK would see this provision replaced with a more general duty on directors – in acting in good faith to

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[126] See further J O'Brien, 'Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets' in J O'Brien (ed), 'Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets' (2005) 1, 17.

[127] For detailed discussion see R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (12th ed, 2005), para [7.660].

[128] *Companies Act 1985* (UK), section 309(1); see C Villiers, 'Section 309 of the Companies Act 1985: Is it Time for a Reappraisal?', in H Collins, P Davies and R Rideout (eds), *Legal Regulation of the Employment Relation* (2000) 593.

[129] See eg Villiers, above n 128, 595-597; Lord Wedderburn, 'Employees, Partnership and Company Law' (2002) 31 *Industrial Law Journal* 99, 106-108.

promote the success of the company and for the benefit of its members as a whole – to consider a wide range of interests; specifically, those of the company's employees, suppliers and customers; the impact of the company's operations on the community and the environment; and the company's need to maintain high standards of business conduct.[130] Clearly, the final formulation of this duty and its operation under UK law will hold important implications for the adoption of similarly-styled legal duties on company directors in Australia.

[130] Department of Trade and Industry, *Company Law Reform White Paper* (March 2005), 20-21.

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