Law Student Community Support
Law School General Office
University of Western Australia
35 Stirling Highway
Crawley, Western Australia 6009
Email: lawreform@lscs.org.au

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

Friday, September 30, 2005

Dear Sir

INQUIRY INTO CORPORATE SOCIAL RESPONSIBILITY

1. Discussed below are a number of the legal issues and problems arising from the concepts of 'corporate social responsibility' and 'stakeholder interests', as well as proposed models for ensuring corporate social responsibility. It is the respectful submission of Law Reform Branch of Law Student Community Support (LSCS) that the issues mentioned below are taken into consideration prior to any significant changes being made to the *Corporations Act 2001* (Cth).

2. The submissions have been composed by Law Student Community Support (LSCS), a University of Western Australia law student initiative. The non-profit, non-political organisation has around 120 student members across 6 branches and projects. One of the branches is the 'Law Reform Branch', which is responsible for this submission. The submission has been authorised by the executive of the association. More information can be found on the club's website at http://www.lscs.org.au.

Introduction

3. This submission has four main parts. First, there is a discussion of the multiplicity of definitions of corporate social responsibility. This is followed by a summary of the current model of corporate governance. Thirdly, the appropriateness of amending directors' duties to effect corporate social responsibility will be assessed. Lastly, an alternative model is proposed, one in which directors would be required to at least consider the interests of stakeholders other than shareholders.

Defining Corporate Social Responsibility

4. Corporate social responsibility (CSR) means many different things to different people. A detailed discussion of various definitions can be found in Lance Moir "What do we mean by Corporate Social Responsibility?" (2001) 1(2) Corporate Governance 16.

5. We provide the following ideas for creating a definition. Corporate social responsibility is a business ethics concept whereby firms consider the wider implications of their commercial activities. The concept is tied to corporate governance and has developed largely out of a 'growing demand from citizens and consumers for more transparency and more integrity on the part of enterprises'.[1] Every firm has stakeholders who are individuals or groups that are affected by the company's decisions. These 'stakeholders' can be any kind of individual or group, depending on the entity involved.

6. CSR requires that the firm considers the interests of the stakeholders, both locally and internationally, when conducting business. Stakeholders exist within the workplace, marketplace, environment and community (Moir, p 17). Firms should be aware of all the implications of corporate decisions. CSR is also considered to include ethics and human rights.

7. The concept of CSR is about responsible business practices that balance the pursuit of profit alongside the needs of the stakeholders. Responsible firms consider the social dimension along with the economic. CSR is more than mere legal compliance, and is distinct from charity. It is about accountable decision making that does not undermine the interests of stakeholders.

Current Model: Enlightened Self-Interest

8. The current model of corporate governance can be described as one of 'enlightened self interest'. It relies largely on rigid directors duties, which are enforceable by companies' members, and which are grounded in the law of negligence and fiduciary duties. They have a naturally commercial flavour, with little scope for social responsibility.

Current regime

9. Directors' duties are imposed by both the general law and the *Corporations Act* 2001 (Cth). The duties are owed to the company. Specifically, directors must:

    1) act with care skill and diligence - s180 CA;

---

[1] Yvon Pesqueux, 'Questions on the theme of "global responsibility"', *Corporate Governance*, 2004; 3, 3, p.21. See also Malla Praveen Bhasa, 'Global corporate governance: debates and challenges', Corporate Governance, 2004; 4, 2, p.5.

2) act in good faith in the best interests of the company - s181(1)(a) CA;
3) exercise powers only for proper corporate purposes - s181(1)(b) CA;
4) give adequate consideration to matters for decision and to keep discretions unfettered (imposed by equity);
5) not misuse their position - s182 CA;
6) not misuse information gained from their position - s183 CA and
7) avoid conflicts of interest.

"Best interests of the company" – To what extent? The Business Judgement Rule

10. It is worthwhile looking at the extent to which directors' duties laws currently encourage or allow corporate social responsibility. This involves an examination of the judicial interpretation of the parameters of the directors' duties.

11. It is important to note how the courts have interpreted what is expected of directors, particularly in respect to whether directors are obliged to take into account long term or short term interests, in discharging their duty to act 'in the best interest of the company' (s181(1)(a) CA).

12. Primarily many cases have enunciated the standard formulation that it is for directors to consider what is in the best interest of the company, and not for the courts to determine with the benefit of hindsight.[2] Hence courts are reluctant to review business judgments of directors where they are made in good faith and for a proper purpose.[3] However, this general law business judgment rule (BJR) is subject to the 'honest lunatic test' where a decision will be open to review if it is one that no reasonable board would have made.[4]

13. This common law rule applies generally to judgments of directors, however s180(2) sets out a statutory version of the BJR which only applies to the duty of care skill and diligence (in s180(1)). Section 180(2) states that a director or other officer of a corporation who makes a business judgment, is taken to meet the requirements of s180(1) and their equivalent duties at common law and in equity, if they:
1) make the judgment in good faith for a proper purpose;
2) do not have a material personal interest in the subject matter of the judgment;

[2] *Smith & Fawcett* [1942] Ch 304 at 306 per Lord Greene MR; *Carlen v Drury* (1812) 1 V & B 154; 35 ER 61 per Lord Eldon; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 832; [1974] 1 NSWLR 68
[3] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 832; [1974] 1 NSWLR 68; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493 per Barwick CJ, McTiernan and Kitto JJ: 'Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.'
[4] *Hutton v West Cork Railway Co* (1883) 23 ChD 654 at 671; *Shuttleworth v Cox Bros (Maidenhead) Ltd* [1927] 2 KB 9; *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62

3) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
4) rationally believe that the judgment is in the best interests of the corporation.

14. The statutory BJR is also subject to the 'honest lunatic test' and a director's belief that the judgment is in the best interest of the corporation is taken to be a rational one "unless the belief is one that no reasonable person in their position would hold."[5]

15. Notwithstanding the standards set out by the common law and statutory BJR, there appears to be no stringent legal direction as to whether boards are obliged to base their decisions on short term or long term interests of the company. So long as the decision was for a proper purpose, and one which the director honestly believed was in the best interest of the company (subject only to the 'honest lunatic test'), it appears prima facie that directors are allowed to make their own decision in favour of short term or long terms interests of the company. However there is judicial authority that casts some light on the parameters of the "best interest" duty.

Judicial Interpretation of "best Interest of the company"

16. Many judges have attempted to define what is meant by "best interests of the company" but many clarifications focus on the breadth of the duty rather than the content (for example Evershed MR in *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 at 291 defined "interests of the company" as meaning "the company as a whole" but this expression casts no more light on the content of the duty).

17. A further issue raised by s181(1) *CA* is whether it requires directors' decisions to be the 'best' possible for the company. Ford notes the interchangeable use by judges of the phrase "acting in the *interests* of the company" and "acting in the *best interests* of the company."[6] Ford submits that there is no significant difference between the two expressions, and that directors' decisions are not required to be the best possible for the company.[7] Nevertheless this clarification is again no more illuminating as to whether short term considerations or long term interests of the company are to be the foundation of directors' decisions.

18. There is however judicial authority acknowledging that both short term and long term interests are relevant considerations.[8] In situations where members of the company are divided over what is in the best interests (some preferring a short term view while others opting for a long term approach), directors can properly balance the

[5] *Hutton v West Cork Railway Co* (1883) 23 ChD 654 at 671; *Shuttleworth v Cox Bros (Maidenhead) Ltd)* [1927] 2 KB 9
[6] Ford's Principles of Corporations Law at para [8.065]
[7] Ford's Principles of Corporations Law at para [8.065]; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 at 293, 303
[8] *Darvall v North Sydney Brick and Tile Co Ltd* (1987) 16 NSWLR 212;12 ACLR 537; *Dawson International Plc v Coats Paton Plc* [1989] BCLC 233

considerations in favour of a short term perspective against a longer view.[9] The decision of *Darvall*[10] illustrates when such balancing may be appropriate.

19. Notwithstanding, discharging the duty to act " in the best interest of the company" is still largely regulated by the BJR, which does not demand any stringent checklist of whether short term or long term interests of the company are to be considered. Inadvertently under this present regime, directors can choose to base decisions on favourable short term interests of the company (i.e. immediate profits), notwithstanding long term interests of the company may suggest other considerations to be taken into account (i.e. impact on the community which may affect the company's long term reputation).

20. There are not a lot of cases to reflect the weight of judicial authority on whether short term or long term interests are expected in the consideration of "best interests."[11] Most decisions focused on defining whose "best interests" is encompassed (ie. 'company as a whole', future or existing members etc), but not many focused on the content (eg. short or long term interests).

Weakness of the current model: Carrot and Stick Publicity

21. As a consequence directors are under no direct legal obligation under the current regime, to take other interests into account other than the 'best interests of the company' (unless defined by the company's constitution[12]). The decision to do so still lies in the directors' overall control.[13]

22. Moreover judicial authority has reinforced this model, but has also placed further limits on what 'other interests' directors may consider in decision-making. Should directors choose to make decisions to ensure that the company is a good corporate citizen, those decisions must still be justified as relating ultimately to the 'best interest of the company.'[14] Ford writes that "management may implement a policy of enlightened self-interest on the part of the company but may not be generous with

[9] Ford's Principles of Corporations Law para [8.090]; *Darvall v North Sydney Brick and Tile Co Ltd* (1987) 16 NSWLR 212; 12 ACLR 537; *Dawson International Plc v Coats Paton Plc* [1989] BCLC 233

[10] *Darvall v North Sydney Brick and Tile Co Ltd (1987) 12 ACLR 537at 554*: The case involved a company the target of a takeover bid which promised favourable terms for shareholders who wished to sell, but the directors had in mind transactions which could in the long-term bring greater benefits to shareholders than they would receive by acceptance of the offers. The directors could then favour the long term view.

[11] Cf. Renard in Finn (Ed) *Equity and Commercial Relationships* (1987) at 138.

[12] *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 at 291: For example the constitution of a charitable company can effectively require profits to be devoted to charitable purposes rather than to be distributed among members.

[13] *Wedderburn* (1985) 15 MULR 4; Wilson T "The 'best interests of the company' and corporate social responsibility" (presented at the CLTA Conference, 7 February 2005), p.2-3 <http://www.law.usyd.edu.au/~parsons/CLTA/AbstractsandPapers.htm>

[14] *Woolworths v Kelly* (1990) 4 ACSR 431 at 446 per Mahoney JA; *Hutton v West Cork Railway Co* (1883) 23 Ch D 654; *Re George Newman & Company* [1895] 1 Ch 674

company resources when there is no prospect of commercial advantage to the company."[15]

23. The principal failing of this system is that the "carrot" of good publicity lies in the control of the corporations themselves, while non-governmental voluntary bodies primarily wield the "stick" of bad publicity. In terms of sheer resources, a large company is far more capable of projecting a positive image of their activities than an under-funded activist group is of exposing malfeasance. This means that the "public image" incentive to act responsibly can be subverted by slick public relations campaigns, which bear little resemblance to the reality of the corporation's actual conduct. Decided cases in this area have also not only reinforced this present model of enlightened self-interest,[16] but perpetuates the justification by directors to ignore corporate social responsibility where it cannot be related back to the pursuit of profits for the benefit of the company.[17]

24. It is argued that corporate social responsibility continues to lie in directors' discretions, given the court's reluctance to interfere with business judgments, strengthened by the enactment of the business judgement rule in s180(2) CA, and "hampered by legal duties to pursue an agenda of pure self interest."[18]

Potential Model: Expanding Directors' Duties to Stakeholders

Expanding Directors' Duties to Stakeholders

25. If the directors of a company owe their duties to the company and the company is defined to be its 'members', then why can not the company be defined to be its 'members and stakeholders'? This question is answered below.

Directors' Duties Ultimately Owed to the Company, Not the Stakeholders

26. Conceptually, the proposal to expand directors' duties is flawed.

27. Directors owe duties to the company, not the members directly. The members enforce breach of the duties to see the company repatriated with funds it may have lost. This is concerned with financial losses the company may be occasioned by breaches. There is also the possibility of an account of profits (lost profits).

---

[15] Ford's Principles of Corporations Law at para [8.130]

[16] *Woolworths v Kelly* (1990) 4 ACSR 431 at 446 per Mahoney JA; *Hutton v West Cork Railway Co* (1883) 23 Ch D 654; *Re George Newman & Company* [1895] 1 Ch 674

[17] *Woolworths v Kelly* (1990) 4 ACSR 431 at 446 per Mahoney JA; Wilson T "The 'best interests of the company' and corporate social responsibility" (presented at the CLTA Conference, 7 February 2005) <http://www.law.usyd.edu.au/~parsons/CLTA/AbstractsandPapers.htm>

[18] Wilson T "The 'best interests of the company' and corporate social responsibility" (presented at the CLTA Conference, 7 February 2005), p.3
http://www.law.usyd.edu.au/~parsons/CLTA/AbstractsandPapers.htm

28. Changing the directors' duties to reflect corporate social responsibility means imposing a duty on directors to avoid socially irresponsible behaviour to the company. That misses the precise point of corporate social responsibility. The duty would be owed to the company.

29. One may maintain that the company will be defined as 'members and stakeholders'. That may be so, but the ultimate remedy given for breaches of directors duties will be paid to the company, not the stakeholders. The directors will not be liable directly to the stakeholders. The stakeholders are only then put in a position to bring such a claim.

30. Most importantly, the company will not be in a position to claim a remedy for the loss which was occasioned to the stakeholders personally. The loss was occasioned to the stakeholder. The separate legal entity, which is the company, suing its director does not bear the stakeholder's loss.

31. To illustrate by example, a multinational oil company bribes a third world government for a drilling license and the forced relocation of its citizens out of a mining area. The 'stakeholders', in corporate responsibility terms, may be the United Nations or a concerned human rights group. They may sue the company's directors, enforcing the expanded directors' duties, on behalf of the company. But the company has not been inflicted any loss by this breach of duty. It has probably gained. The stakeholders do not get any money.

32. Changing the directors' duties to reflect corporate social responsibility can not work in technical legal terms.

Difficulties of Expanding Directors' Duties to 'Stakeholders'

33. Coining an all-encompassing definition for 'stakeholder' is difficult. This is due to the large number of persons and entities which may be deemed 'stakeholders' with regard to any particular entity.

34. The broadness of the definition is best illustrated by example. Take a company with its principal activity as gold mining. People that may have a 'stake' or some interest to be affected could be as wide as people who live near the mine site, native title holders in a neighboring area, an environmental group concerned with the preservation of a rare species of marsupial on that tenement and many others.

35. Across different industries and activities, all different kinds of stakeholders would exist. No exclusive definition can cover the very large class of people to be included. An analogy can be found in the public law doctrine of *locus standi* or 'standing', which permits a plaintiff to a proceeding to assert that he, she or it is an affected party

or 'party aggrieved', as the test may be. This wide definition certainly has proved trouble enough for administrative law.[19]

Other Difficulties

36. Some other difficulties are outlined in James McConvill "Directors' duties to stakeholders: A reform proposal based on three false assumptions" (2005) 18 Australian Journal of Corporate Law 88 and are of great value. We would respectfully adopt this reasoning.

Fraud and Corporate : Reasons for Changing Directors' Duties?

37. Fraudulent conduct by directors and the collapse of corporate structures are two of the clearest examples of corporate harm. Yet we would argue:
    (a) that the expansion of directors' duties would not help prevent either of these problems; and
    (b) that there are other, more effective ways of addressing the problems.

38. Fraud by directors already constitutes a direct breach of *Corporations Act* duties, such as s181(1). The individuals involved are deliberately acting against the interests of the company's members. Adding a further duty to consider the interests of stakeholders is unlikely to have any effect on the phenomenon.

39. Similarly, corporate collapse is against the interest of a company's members. Directors acting in the interests of the members will invariably attempt to prevent corporate collapse. The imposition of a further duty will not add anything to their willingness or ability to save the company.

40. Quite often, in the worst cases of corporate irresponsibility and collapse, the directors have made conscious decisions to ignore the corporate governance laws. Studies have shown that many of these corporate collapses are more attributable to bad corporate culture and psychology.[20] The best examples can be found in the string of major recent Australian corporate collapses.

41. It is our submission that the idea of 'strengthening' directors' duties to include social duties would not help to prevent fraud and corporate collapse. Fraud and corporate collapse should not motivate the imposition of a system of directors' duties aimed at encouraging corporate social responsibility.

---

[19] See the extensive discussion in M Aronson, B Dyer & M Groves, *Judicial Review of Administrative Action* (The Lawbook Company, 2004, 3rd Edition) and coverage of inquiries and reform projects.
[20] Richard J Pech & Geoffrey Durden "Where the decision-makers went wrong: from capitalism to cannibalism" (2004) 4(1) Corporate Governance 65 and S Velayutham & M H B Perera "The influence of emotions and culture on accountability and governance" (2004) 4(1) Corporate Governance 52

42. The new reforms under CLERP 9 introduce external auditing measures which will serve to diminish the risk of both fraud and corporate failure.[21] That is the purpose of that wave of reforms. Constant checks and balances, responsibility through peer review and continual review are at the core of preventing these corporate collapses.

43. Audit and financial reporting compliance regimes prevent corporate collapse. Not duties owed to removed third parties on 'social responsibility' notions.

Proposed Model: "Prescribed Considerations"

44. The problem of accommodating stakeholder interests involves two competing imperatives: firstly, the need to change patterns of corporate decision-making; and secondly, the need to preserve the ability of companies to act profitably and competitively.

45. The compromise we propose does not affect the board's *substantive* freedom to make decisions in the company's interests, but instead introduces a *procedural* duty to at least *consider* the interests of other stakeholders.

46. A similar system is already employed by State and Commonwealth legislation that regulates the exercise of discretion by administrative decision-makers (for example, s39 *Native Title Act 1993*). The objective in each case is the same – to retain the decision-maker's basic autonomy, while ensuring that the process of deciding involves the consideration of certain matters.

47. The specific regulatory process we propose would be built onto the existing requirements for minutes at directors meetings, under Part 2G.3 *Corporations Act*. It would involve the imposition of a further requirement, namely that the minutes reflect that the directors have directed their minds to certain "prescribed considerations".
    - This requirement might be as simple as a pro forma enquiry as to the impact of a decision on, for example, "Employees", "Environment", "Customers", and "Potential Victims".
    - If the decision is a routine one, with no significant effect on any of these, then each heading could be marked "Nil".

48. In order to avoid a lax attitude toward compliance, the requirement could be drafted as follows:

[21] See generally James McConvill, *An Introduction to CLERP 9* (LexisNexis Butterworths, 2004). See also Australian Government: The Department of Treasury, *CLERP (Audit Reform & Corporate Disclosure) Bill Commentary on the Draft Provisions* (Corporate Law Economic Reform Program No 9, October 2003); Australian Parliamentary Joint Committee on Corporations and Financial Services, *CLERP (Audit Reform and Corporate Disclosure) Bill 2003*, Part 2, Financial Reporting and Audit Reform, June 2004, Report.

The company must ensure that the minutes of a resolution indicate that the directors considered the likely impact of the resolution on each of the Prescribed Interests.

***"likely impact"** means any impact which the directors could foresee or ought reasonably to have foreseen.*

49. If the proposed requirement is considered to be too onerous for all companies, it could be restricted to public companies and large proprietary companies.

50. The penalty for non-compliance could be set at the same level as the penalty for failing to properly prepare minutes under the current requirements (s251A *Corporations Act 2001*), namely 10 penalty units and/or 3 months imprisonment.

Advantages

51. The "prescribed considerations" model is not about enforcing strict compliance – this avoids the trouble of defining exactly what balance of competing interests is required. A director's duties should not be vague or ill-defined and should also permit significant discretion to run a commercial entity.

52. Further, by taking the focus off strict compliance, the model works towards cultivating a culture of informed and considered decision-making, rather than single-minded compliance with legal duties. This may, in the right environment, lead to a *higher* standard of conduct.

53. Companies are still able to act in the best interests of their members, such that no radical departure from fundamental concepts of commerce is required.

54. Although "bad" decisions could not be reviewed or prevented, this "lack of teeth" provides the flexibility that is required to preserve the ability of companies to act profitably and competitively.

55. Substantive harm can be adequately addressed by other legal mechanisms (environmental law, mining law, industrial relations law, native title law), but the *process* of decision making and the balance (simply consideration/recognition) of interests can be effected by this model.

56. The entries in the minutes could be used to evidence a company's state of mind for prosecutions against the company. Other areas of law which would form the basis for 'social responsibility' in corporate sense could be relied upon. For example, social irresponsibility through making a commercial decision to place employees in dangerous working conditions and factoring in the cost of fines and penalties under occupational health and safety laws would be evidenced in the board's minutes.

57. The official record provided by the minutes would constitute a useful tool in the "shaming" process whereby "bad" decisions are subjected to public condemnation. It is harder to put a positive "spin" on a decision in the face of evidence that the directors either were aware of the adverse impact on other stakeholders, *or* (if the relevant interest is marked "Nil") that the directors were either willfully or negligently shortsighted in failing to recognize the adverse impact.

58. If it could be shown that the company ought reasonably to have recognized and considered a particular effect on a stakeholder's interests, then this could amount to a failure to comply, raising the same sanction as blatant non-compliance.

59. Few would dispute that a responsible corporate citizen should consider the effects of every decision it makes. Companies should not act recklessly. The extra time and effort taken to *record* this consideration would not be unduly burdensome. In any case, minutes are already required under the current law.

60. Directors are, especially in large companies, adequately remunerated for the extra responsibilities that accompany their position. Professional indemnity insurance also has a bearing.

61. While the board is perfectly free to act against the interests of stakeholders, and indeed may be "obliged" to do so by their duty to act in the best interests of the members, the idea of the minutes-process is that this is made *explicit*. So where the decision is defensible, it may be defended. And where it is indefensible, this will appear on the record.

62. The minutes-based model incorporates corporate social responsibility into the day-to-day running of a company, rather than leaving it to a single annual report. It also permits flexibility in decision making without unduly affecting commerce and the economy.

Disadvantages

63. Directors might not take the requirement seriously – they might do as little as possible to comply.

64. The sheer number of decisions that would be subject to the "prescribed considerations" requirements might make compliance quite onerous (though see "*Advantages*" above).

65. The model would "lack teeth" (though see "*Advantages*" above with regards to possible sanctions for non-compliance being imposed).

66. Some might criticize any increase in the level of regulation, and some may consider the job of a director to be difficult enough.

67. The stigma of failing to recognize stakeholders' interests would not be as negative as the stigma of knowingly acting against stakeholders' interests. This might result in directors marking the considerations as "Nil" in virtually every case. This might be seen as a way of protecting the company (and its directors) against future liability. In the worst case scenario, the company might use such minutes in their defence, as evidence of the company's state of mind (though if directors are willing to distort the truth, then there is always the risk that they will get away with it. Any scheme of regulation that requires self-reporting runs this risk).

68. Some might consider triple-bottom-line reporting to be a better means of achieving the same objective; it allows for a large-scale of a company's activities, rather than an atomistic scrutiny of each isolated decision.

Conclusion

63. We respectfully provide these submissions on issues surrounding corporate social responsibility for the Honourable Committee's consideration.

Sincerely,

Anthony Papamatheos
LSCS President

Nicholas Duff
LSCS Law Reform Coordinator

Simon Rootsey
LSCS Secretary

Gemma Taylor
LSCS General Executive

Lavina Cheong
LSCS Member

Christopher Bates
LSCS Member

Christopher Harrison
LSCS Member