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Memorandum

To	DR ANTHONY MARINAC
Copy to	
From	BILL BEERWORTH
Date	30 SEPTEMBER 2005
Subject	**INQUIRY INTO CORPORATE RESPONSIBILITY**

Dear Dr Marinac –

I enclose a recent paper on the subject of Corporate Responsibility.

The paper covers the issues mentioned in the Terms of Reference of your current Inquiry.

If you wish, as a supplementary submission, I will separately organise my comments into categories corresponding with each of the particular references to the Committee.

I will be pleased to provide such assistance to the Committee as I am able.

I also attach a short resume.

Yours sincerely,

William J Beerworth
Managing Director

DIRECTORS DUTIES AND CORPORATE SOCIAL RESPONSIBILITY

BILL BEERWORTH

MANAGING DIRECTOR, BEERWORTH & PARTNERS LIMITED

27 July 2005

1. SHAREHOLDER PRIMACY

Generations of lawyers have been taught that directors must discharge their duties in the interests of the corporation. This in turn is normally interpreted as acting in the interests of the shareholders.

Corporate finance theory and Business Schools translate this duty more pointedly into the mantra that the role of Management is to *maximise shareholder wealth*.

This objective is called the **shareholder primacy** principle.

There is a fundamental basis to this principle. Investors entrust their savings to corporate managers on the implicit promise that they will be increased in value through a mixture of earnings and capital gains.

All new capital raisings and every element of the securities industry are predicated on this core investor promise. If investors did not believe in this promise, they would invest elsewhere or they would not invest at all.

The stock exchange provides a corporate cauldron in our free market system.

Companies that do not increase shareholder value as expected are devalued on the market as disappointed shareholders sell out. Their cost of capital rises and they may not be able to attract new capital at all. At a certain point, underperforming managers will be punished when a takeover bid is made by someone who can use the assets better.

This is an important cycle in our economic and financial system because it allows the best use of scarce resources.

To the extent managers use corporate assets for purposes other than to increase shareholder wealth, they lower shareholder returns and run the risk of not matching the returns of competing investment opportunities and the consequence of devaluation on the market.

2. TBL & CSR

The proposal that corporations should disclose their attitudes and actions towards society, the environment and economic sustainability has already provided the notion of *Triple Bottom Line Reporting* (**TBL**). This concept is now widely accepted and many major companies report at least annually in detail on their social and environmental policies and their approach to operational economic sustainability.

Over the last 10 or 15 years, an emerging debate has been the extent to which the controllers of corporations should have regard to the interests of ***stakeholders*** other than shareholders.

This discussion is now worldwide as a sub-set of the globalisation debate.

The argument is for what is called *Corporate Social Responsibility* (**CSR**). This idea does not have the same degree of acceptability as TBL, partly because there is considerable disagreement about what it means and what its proponents really want.

However, by definition, they appear to want managers to give effect to a principle other than shareholder primacy.

3. THE CIVILISATION OF BUSINESS

There may have been a dark Satanic Mills time in history when all forms of business were widely perceived as rapacious and perhaps anti-social because they exploited labour and public resources to achieve the highest possible profits at the lowest cost.

But that Marxist vision of business ruthlessly acting in an entirely self-interested manner has been attenuated over this century by a raft of specific statutes which establish a legislative environment of requirements and standards, including for what economists call the ***externalities*** of business operations – the costs imposed on society by the carrying on of business enterprises.

The Simpsons' Monty Burns could once have kept smoke stacks which belched toxic fumes and nuclear reactors which leaked radiation creating 3-eyed fish in Springfield's polluted rivers.

But a series of familiar statutes now impose strict requirements and standards about pollution and the environment; employment conditions; workers compensation; work place safety; trade practices and consumer protection; land use; equal opportunity and discrimination; and a multitude of other familiar matters.

A key feature of this **business legislative environment** is that it applies *equally* to *all forms of business* including individuals, partnerships, unions and government businesses.

The Corporations Act does not itself deal with these issues. It deals merely with incorporation, the organs of the entity, and how the organisation is to be governed in various circumstances.

Those who wish to impose particular social obligations on *corporations* must justify why the *same* obligations should not be imposed equally on all other business organisations, including individuals, partnerships, unions and government businesses.

Perhaps any clamour that is justified should not be for *corporate* social responsibility but for *business* social responsibility. But, when expressed in those terms, it is apparent that the advocates of change must identify clearly what elements are missing from the existing business legislative environment.

4. TERMINOLOGY

Terminology in this debate is confusing rather than clarifying.

The term **"*stakeholder*"** is itself vague and suggests that anyone identifiable as such has an interest worthy of protection.

Similarly, the phrase **"*corporate social responsibility*"** implies that corporations are *not* socially responsible and that they must be forced to become socially responsible.

5. ROLE OF THE CORPORATION IN SOCIETY

In considering how to deal with the CSR movement, the starting point must be to ponder the role of the corporation in society.

A corporation is merely a particular form of organisation of individuals.

Through legislation, society allows a group of individuals to establish an invisible construct with a separate juridical status, perpetual life, the ability to do what an individual can do, and limitation of liability for the subscribers.

Since a corporation is merely a form of organisation of individuals, there is no reason why greater or lesser social obligations should be imposed on it than on individuals, partnerships or other organisations conducting business.

After all, individuals and partnerships are as equally moved by Adam Smith's invisible hand to maximise financial gain in their business transactions.

The corporate form arose simply because it was difficult and complex to arrange and regulate the affairs of a large number of individuals prepared to risk their capital in major projects. Any lawyer can tell you of the practical limits of partnerships, trusts and the hybrid joint stock company, a cumbersome form of partnership.

Moreover, the corporation fulfils certain critical and socially desirable functions which have enabled the massive growth of free market economies.

The corporation:

- allows passive capital to be used actively
- limits the liability of the subscribers of that passive capital
- provides leverage for successful corporate managers enormously beyond their own resources
- is the most powerful engine ever devised for *capital formation* – the aggregation of vast amounts of private capital for enterprise. It was the corporation that allowed the rapid development of the New World – railways, canals, roads and mines in the United States and the evolution and propagation of new inventions and technologies like electricity generation, street lighting and the telephone

I have mentioned that, because they provide their savings as capital, it is normally considered that the enterprise should be governed for the benefit of the shareholders. This shareholder primacy model presupposes an **agency** relationship between managers and shareholders with a **board** elected to ensure that management effectively fulfils its stewardship role on behalf of the shareholders.

6. CORPORATE PHILANTHROPY

Governments sometimes advocate *corporate philanthropy*, by which they usually mean support of cultural and charitable objectives. But Governments have no obligation to maximise shareholder or even taxpayer returns and they are engaged on a different social contract than corporate managers. Moreover, money provided to Governments is given involuntarily to be used for public purposes and not for private investment.

Most shareholders to whom I speak are suspicious of corporate philanthropy. Many take the strong view that, rather than play the corporate Medici with funds that really belong to the shareholders, philanthropically minded Chairmen and CEOs should distribute them as dividends so that each shareholder can decide if she wishes to make the relevant donation.

Philanthropic Chairmen and CEOs may, of course, contribute their own didivends and remuneration to the worthy causes they espouse.

7. CURRENT CSR INQUIRIES

It is notable that 2 public Inquiries are underway on CSR at the same time – one by the Parliamentary Joint Committee on Corporations and Securities and the other by CAMAC.

Their terms of reference are slightly different, but the essence is similar:

- the current *extent* to which Directors may have regard to stakeholders other than shareholders
- whether the law should be *clarified* about the extent to which Directors may take specific account of stakeholder interests
- whether the law should *require* Directors to take such account
- whether there are other ways to *encourage* appropriate social behaviour
- whether some form of *reporting* would assist an assumed objective to make companies more socially responsible

8. CURRENT DUTIES OF CONTROLLERS

In legal terms, the CSR debate partly relates in part to the duties of directors and officers under s.181 of the Corporations Act to exercise their power and discharge their duties:

- *in good faith in the best interests of the corporation; and*
- *for a proper purpose.*

The issue is whether they properly discharge these duties if they take action for social purposes which may not maximise shareholder wealth. This could include taking stakeholder interests into account. Bear in mind that, if they breach their duties, they may be civilly liable, or even criminally liable in extreme cases.

Many learned legal commentators take the view that there is already sufficient flexibility in the case law to permit directors and officers to have regard to stakeholder interests. They argue that activity designed to build the reputation and brand of the company is protected even if it cannot be shown to provide an identifiable financial return. On this basis, reasonable charitable and political donations and sponsorships of cultural events are permissible.

The difficulty is that shareholders who do not agree with Board decisions of this type may seek to restrain them. This is particularly so in areas such as charitable or political donations or contributions to broad community projects which may not obviously advance shareholder interests.

In an age of anti-globalisation rhetoric, many in society are vaguely opposed to commercial corporate activity and wish to ensure that corporations use a proportion of their assets and profits for activities which might normally be underwritten by taxpayers generally.

I recently noticed only 2 signs at the Aboriginal Tent Embassy near the old Parliment House in Canberra. One said "*Free Redfern*" and the other said "*Corporations are Terrorists*". Neither made much sense to me, but that is because I am over-analytical, over-informed or, from their point of view, part of the problem.

I was involved in a television current affairs debate a few months ago in which a Bishop said that most corporate executives are animals who should be caged. When I protested, he hissed that I was also probably a corporate criminal.

We must therefore accept that we live in a society in which even highly educated people of good will who have not been obliged to study law or finance often have passionately negative views about the role of corporations and those who control them.

I have noticed at a number of AGMs that some shareholders protest strongly against political or even significant charitable donations. The Directors may have not only acted in what they regarded as good faith, in the best interests of the corporation and for what they regarded as a proper purpose, but different minds have different views on these subjects.

I am not at all confident that the extent under case law to which directors and officers may take into account stakeholder interests other than of shareholders is clear or readily discoverable.

Few citizens subscribe to the law reports, particularly law reports of the 19th Century.

Moreover, the outcome in litigation may depend on the predilections of the particular Judge hearing the case.

9. POSSIBLE ACTION

The 2 Inquiries into CSR will need to determine what approach, if any, should be taken.

If they agree with me that a visible *clarification* and statement of the existing law might be useful, a new provision might be included in the Corporations Act.

Some resist this on the basis that it is not necessary. But if it is already the law, why not say so plainly and clearly in the statute itself? After all, most of the duties provisions are already a codification of existing common law. Why should we resile now from adding yet a further clarification or codification if we are confident that it is the existing law?

The next issue is whether any CSR provision should merely give *permission* to Directors to take stakeholder interests into account. If so, the provision might be regarded as a **shield** to immunize directors from shareholder or regulatory action.

A quite different sort of provision would *require* Directors to take stakeholder interests into account. This approach would upend 150 years of economic and corporate theory and I do not envy the draftsman her role of defining stakeholder interests and the extent to which regard is to be given to them. This **sword** approach would presuppose a level of social experimentation which will need to be carefully articulated and tested.

Finally, as hinted by the terms of reference of both Inquiries, a possibility might be to require Boards to **report** how and the extent to which they take into account social and community issues and how they accommodate the usual expectation of shareholders that the Board will seek to maximise the value of their investment.

10. COMMUNITY SERVICE OBLIGATIONS

Some who propound CSR assume that taking account of stakeholder interests other than of shareholders is the equivalent of *ethical corporate behaviour*. Many shareholders, particularly those dependent on dividends for their retirement and livelihood, take the opposite view that *ethical corporate behaviour* lies in maximising shareholder wealth.

CSR raises the whole issue of what are called *Community Service Obligations* **(CSO)**.

I have pointed out that a corporation, however large, is merely an organisation of individuals. However, there is a vague public perception in some quarters that, the larger the corporation, the more appropriate that it should have some CSO. By this is meant that the corporation should voluntarily provide some products or services free or at a subsidised rate to some members of society.

When I was a member of the *Wallis Committee* into the Australian Financial System, a vocal group pressed hard its view that the banks should be obliged by law to make available free or subsidised banking facilities to particular groups in society.

A bank is, of course, merely a particular type of corporation. I do understand that a bank is given the privilege of a licence to create credit and to operate profitably in areas in which unlicensed corporations cannot.

If such a licence is a valuable privilege, society may require its holder to pay an appropriate annual fee. But I do not understand why it should be required to provide free or subsidised services to particular segments of society merely because it meets the licensing conditions.

The same issues apply to Telstra and to what is said to be its *Universal Service Obligation.*

There was a time when Telstra was a public utility. However, even as a partly privatised corporation, I have difficulty understanding, except perhaps on a transitional basis, why it should be required to provide free or subsidised services to any customers or segment of society including farmers and those who live in remote areas. If society wishes to subsidise national communications for some reason, it should do so explicitly by a subsidy from taxpayers generally. Any such subsidy should be a visible and quantified transfer payment from tax payers rather than a disguised and unquantified subsidy provided by a private corporation at the expense of its shareholders.

Requiring a listed company to provide a subsidised product or service smacks of what was once properly called *Socialism*, a political philosophy properly considered thoroughly discredited, particularly by most of those who advocate a USO for Telstra.

Requiring any corporation to provide free or subsidised products or services is no different from requiring a butcher or greengrocer to provide free or subsidised meat or vegetables to some customers.

The mere size of the corporation or the complexity of its activities cannot hide the essential element that a demand for free or subsidised products or services is really a demand for the shareholders to provide those products or services at their personal expense.

If follows that I would resist CSR to the extent that it means that corporations should effectively subsidise communities or segments of society just because they are corporations.

11. SOURCE OF ANY CHANGE

If it is decided that change is necessary, the identity of the relevant statute will need to be determined.

A new provision could be added to the Corporations Act.

But if it is considered desirable that businesses should make some free or subsidised contribution to the community, I would argue that the source should be a specific and separate statute called the "*Social Contributions Act*" which would have equal application to individuals, unions,

partnerships, corporations and perhaps government business enterprises. Of course, we already have a statute designed to provide funding for social and community objectives. It is called the *Income Tax Assessment Act*.

If none of clarification, shield or sword is chosen as the way forward, it would certainly be possible to require Directors in the Corporations Act to *report* how and in what fashion they take account of stakeholder interests. I imagine that would really be a mandatory TBL requirement.

In this context, it is of interest that ASX Corporate Governance Principle 10 recommends that companies should establish and disclose a code of conduct to guide compliance with legal and other obligations to *legitimate stakeholders*.

ASX is delightfully vague on who might be a legitimate (or an illegitimate) stakeholder.

12. A MODEST PROPOSAL: EXTEND THE BUSINESS JUDGMENT RULE

My own view is that the extent to which Directors may take into account stakeholder interests other than shareholder interests is not usefully clear, and it is particularly unclear to non-lawyers.

I would strongly resist a provision which *required* a corporation to have regard to interests other than of the shareholders.

But if Directors wanted to have regard to a relevant range of stakeholders, I would be happy to provide a shield for them.

In this context, it is noteworthy that the 1999 CLERP Bill which provided the present section 181(1) of the Corporations Act originally stated that a Director must exercise her powers "*in good faith* ***in what she believes to be in the best interests of the corporation and for a proper purpose***".

The Labor Opposition wanted an objective test, so the words "*in what she believes to be*" were omitted.

Having regard to the evolution of two lines of case law at the time, there were rational reasons for the Opposition's position.

My colleagues who believe that the Corporations Act is already clear will disagree, but I am a believer in providing a form of *Business Judgment Rule* **(BJR)**, not only for all duties and obligations in the Corporations Act, but in all other statutes.

When introducing the original BJR to qualify the care and diligence provision of the Corporations Act (s.180), the Treasurer, the Hon. Peter Costello, said that, if the BJR for s.180 was a success, the Government would consider introducing it generally.

I applaud that thinking and my *Modest Proposal* is that a new provision be added to the Corporations Act in s.181 to provide a BJR for a director or officer who undertakes an activity:

- bona fide
- within the scope of the corporation's business
- reasonably and incidentally to the corporation's business
- for the corporation's benefit

This is, after all, the common law test and has been since the 19th Century.

It would permit Directors and Officers to have appropriate regard to stakeholder interests without fear of being held in breach of their duties.

Since this test is from the 19th Century, perhaps there is, after all, nothing new under the corporate sun or, as the French have it, *plus ça change; plus c'est la même chose.*

Bill Beerworth is Managing Director of Beerworth & Partners, a corporate advisory firm specialising in Mergers and Acquisitions. He has spent much of his career in securities regulation as a lawyer and investment banker. He was a member of the Wallis Committee on the Australian Financial System and is a member of the Australian Competition Tribunal.