Parliamentary Joint Committee on Corporations and Financial Services
Inquiry into corporate responsibility

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The argument of this submission in outline

1. Successful enterprise matters to all of us. Why? The corporation is a key mechanism for human inventiveness and creativity, freedom, wealth generation and its transfer to developing countries in particular. The corporation is powerful, has unique capacities, and provides a framework for collaborative action. Many people spend their working lives within the corporation. The goods and services which it generates sustain our society. Corporations have magnified capacities relative to individuals, in their financial resources, scale of operations, organisational capacity and capacity for social and individual harm. What kind of institution is the corporation? It is argued here that it is not just a legal person like you and me, and not purely a financial or economic institution either, but a social institution also. What precisely that entails is the nub of the question before the Committee.
2. This inquiry by the Parliamentary Joint Committee on Corporations and Financial Services is one of the most important undertaken in corporate law review. It goes to the *character* and *purpose* of the corporation and the role played by corporate law in shaping that character and purpose. The corporate purpose is commonly taken as a given in corporate law review, namely, the promotion of shareholder value. The terms of reference of this inquiry test that assumption. The weight of professional and business opinion favours that received wisdom. It deserves close analysis on this rare occasion where it has been directly and squarely posed for critical review. This is both a rich opportunity and an onerous responsibility for the Committee.
3. In outline, the argument of this submission may be expressed in the following propositions which are elaborated further below together with policy choices that might commend themselves to the Committee in light of the propositions advanced in this submission.
   - The commonly accepted purpose of corporate activity and measure of corporate performance is the maximization of shareholder value as expressed in the price of the corporation's shares. This principle is here called "shareholder value" as shorthand for "shareholder value maximization". Sometimes the term "shareholder primacy" is used; it may mislead, however, in suggesting that shareholder interests are ranked first among a number of legitimate claims upon directors. That is not the case: in law and in current business and investment practice, shareholder interests are the sole measure of company interests, and of corporate purpose and performance. It is argued below that shareholder value presently holds business and investment culture in thrall. It is so deeply ingrained and dominates corporate decision-making in

a manner and to an extent that is significantly different to that applying only a few decades ago.

- Shareholder value probably does not depend for its current hold upon corporate decision-makers upon its expression in legal rules although it is reinforced by their assumed requirements. This assumption is, however, less secure than commonly assumed.
- Shareholder value rests on highly contestable policy foundations. It is at best an instrument in aid of some wider value or purpose of corporate enterprise at least where that enterprise draws upon publicly solicited investment funds. A different regime might be defended for small, private business.
- Shareholder value has negative consequences as the core orienting principle of corporate law and business purpose. It pushes corporations to avoid internalising (i.e., bearing) costs of enterprise operations that they are not legally obliged to bear or which may be avoided because enforcement is deficient. This arises since corporate law contains structural incentives for the corporation to impose such costs on society or other actors and penalising in the longer term those that voluntarily internalise (the *problem of social cost*).
- In this respect, shareholder value sits uncomfortably with social expectations with respect to the character and obligations of the corporation. Those expectations, and the mismatch with the shareholder value orientation of some corporate decision-makers, was evident in the public response to the decision of the board of directors of the James Hardie Industries NV to refuse to augment the funds available to the victims of asbestos related injuries for which its former operating subsidiaries are or will become legally responsible as illness manifests itself in future.
- The corporation is more than an economic institution. It has a social dimension, at least in its larger forms that use publicly subscribed investment funds. The orienting principle of corporate law should rather be that the corporation acts with an eye to the common good and in a manner responsive to wider claims upon it especially with respect to the impacts of its operations. The opportunity should be taken to establish a positive model of corporate purpose in these terms. This model requires that directors have a licence to consider and take into account in corporate decision-making the interests of those affected by corporate conduct and operations, including employees of enterprise companies.
- The goals of corporate social responsibility, as the *voluntary* assumption of higher standards of corporate conduct, are laudable but are no substitute for legal regulation to protect vulnerable interests or achieve wider social goals or legal norms to express or shape corporate purpose.
- With respect to the specific issue of directors' duties and corporate social responsibility, there are several alternatives to shareholder value as a legal norm that might be adopted to address the problems of social cost and misdirected focus. They are not necessarily vulnerable to fears that departure from the shareholder value norm must involve indeterminacy of standards and loss of managerial accountability.

- There is much to commend the development of mandatory disclosure obligations by reference to specific and well-chosen criteria.

4. This submission covers a broad range of issues. Their treatment is necessarily more elliptic than if a narrower focus had been adopted. I am happy to develop any aspect further.

The rise of shareholder value culture, orientation and focus among corporate management and investors

The present cultural thrall of shareholder value maximisation

5. The commonly accepted purpose of corporate activity and measure of corporate performance is the maximization of shareholder value as expressed in the price of the corporation's shares (here called "shareholder value" as a shorthand for "shareholder value maximization"). Shareholder value currently exercises strong influence over corporate decision-makers and the dominant group of shareholders in large corporations, institutional investors. Thus, in 1998 the Hampel Committee on corporate governance in the United Kingdom could say that

   > *[t]he single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practical enhancement over time of their shareholders' investment. The pursuit of this objective might require the company to develop relationships with a number of non-shareholder groups but in doing so they must have regard to the overriding objective just identified.*[1]

6. This sharp shareholder focus is relatively recent. Until the 1970s or even later, a managerialist ethic held sway in the United States, United Kingdom and Australia. It has two aspects. First, managerialism assumes that corporate directors and managers enjoy a degree of independence from shareholder control; second, it stresses that corporate management owes duties to interests beyond the corporation's formal legal constituents, to "the four parties to industry"—labour, capital, management and society.[2] The managerialist model invests the corporation with an institutional personality and treats shareholders with other constituent groups as an interest external to the firm. The management function under the model is the allocation of corporate resources between the competing interest groups to achieve corporate goals. Thus, by the 1950s Adolf A Berle, who had earlier famously propounded the trusteeship of directors to shareholders[3], was arguing that American management had been "legitimated on the firing line"—that a corporate conscience had evolved among professional managers sustaining their role as disinterested arbiters of the various claims upon the corporation's purse.[4] In the United Kingdom a little over thirty years ago, the Confederation of

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[1] Committee on Corporate Governance, *Final Report* (London, 1998), para 1.16.

[2] The title of an address by the Canadian Prime Minister W L Mackenzie King in 1919. King's conciliatory ideas about labour relations were developed in his book *Industry and Humanity* (1918). Other constituents to whom modern management has expressed a responsibility include government, suppliers and consumers.

[3] Berle, A A, "Corporate powers as powers in trust" (1931) 44 Harv L Rev 1049.

4 See Berle, A A, *The 20th Century Capitalist Revolution*, Ch 5; see also Berle, A A, *Power Without Property* (1959).

British Industry was proposing "a general legislative encouragement [for companies] to recognise duties and obligations … arising from the company's relationships with creditors, suppliers, customers, employees and society at large; and in so doing to strike a balance between the interests of the aforementioned groups and between the interests of those groups and the interests of the proprietors of the company".[5] The United Kingdom Companies Act was amended in 1979 to require directors "to have regard in the performance of their functions [to] the interests of the company's employees in general as well as to the interests of its members".[6]

The concentration of share-ownership through the growth of institutional investment

7. There are undoubtedly many reasons contributing to this change in ethos and orientation. Undoubtedly, one lies in the growing concentration (or reconcentration) of voting power in an identifiable group of shareholders who have a greater capacity to exercise the control rights granted to shareholders by company law. This group comprises the institutional investors (viz, insurance companies, superannuation funds, investment fund managers etc) whose voting power usually does not rest on beneficial ownership of the securities they hold. There has been a corresponding decline in the proportion of shares held by personal shareholders who had earlier dominated corporate share registers. The dispersion of shareholdings effectively precludes the exercise of shareholders' control rights. However, these institutional investors are fewer in number and thus have lower coordination costs for collective action than dispersed personal shareholders. Relatively small coalitions of institutional shareholders can command a majority of the voting power in a shareholders meeting. Institutional investors are all but exclusively focussed upon the share price of portfolio companies; the only measure of funds management success – the key to winning and retaining investment mandate of superannuation trustees or attracting other funds for investment – is the return upon funds under investment as measured by share price movements and financial returns. The scorecard utility is thus deeply ingrained in share-ownership structure as the institutional investors' performance measure.[7]

The influence of the emergence of the hostile takeover

8. A second factor contributing to the current shareholder value culture is the emergence over the past four decades of the hostile takeover. The development of

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5 Confederation of British Industry, *The Responsibilities of the British Public Company* (1973), p 9.

[6] The provision became s 309 of the Companies Act 1985. Only the company might enforce the duty, however, and only a shareholder may sue for its failure to do so. Perhaps in consequence, there was scant reported litigation invoking the section. It has recently been repealed as part of the company law review process leading to the introduction of the exposure draft reform bill discussed below.

[7] There is a structural problem not directly relevant in this inquiry with respect to management monitoring: the absence of incentive, indeed, structural impediments to, investment of time, effort and resources by institutional shareholders in management monitoring and intervention in portfolio companies and enforcement of remedies granted to shareholder under company law.

the hostile takeover and the resulting market for corporate control exercises a powerful continuing disciplinary pressure upon directors and managers and sharpens focus upon shareholder value. Thus, if the company's market capitalisation – its share price – falls below its potential value under the control of another group of managers, incumbent management are vulnerable to ouster through takeover offers made to shareholders. Takeover regulation in the United Kingdom and Australia has an exclusive shareholder focus which starts with the right that is exclusive to shareholders, namely, the right to transfer control of the company through sale of their shares. Takeover regulation has an exclusive shareholder focus and protects the shareholders' disposal right. Indeed, the outlawing of takeover defence measures by target directors under the takeover regimes in the United Kingdom and Australia strengthens the shareholder focus relative to the United States which allows greater latitude to target directors to oppose an unsolicited bid for control of the company. Company law has not otherwise significantly contributed to the development of shareholder value focus in this period since the content of directors' duties and shareholder remedies has not relevantly changed in the direction of strengthening that focus.[8]

Other developments reinforcing shareholder value culture

9. The shareholder value focus is powerfully reinforced in numerous other ways. One is through the rapid growth of the equity component of executive remuneration, particularly through share options, under the influence of the "pay for performance" movement from the early 1990s. Similarly, the pervasive use of shareholder value metrics (viz, earnings per share, return on investment etc), in the absence of clear competing metrics for other forms of corporate performance such as in social and environmental responsibility, contribute to a culture of focus upon and assessment of corporate performance by reference to share price measured over a short time frame.

The corporate social responsibility movement as a countervailing force

10. Corporate social responsibility has become a ubiquitous phenomenon in western business apologetics: who could oppose something that sounds so wholesome? The UK Government has had a Minister for Corporate Social Responsibility since 2000. In many corporations it involves integrating social and environmental concerns into business operations and in their interactions with stakeholders on a voluntary basis. The CSR movement is underpinned by many forces including

    - the idealism of some staff especially the young;
    - the desire for brand positioning: corporate social responsibility adopted as *positive* brand positioning;
    - the defence of public image and brand: corporate social responsibility adopted as a *defensive* measure;

[8] This point is developed more fully in reference to the United Kingdom by Davies, Paul, "Shareholder Value, Company Law, and Securities Markets Law: A British View" in Hopt, K J and Weymeersch, Eddy (eds), *Capital Markets and Company Law* (Oxford UP, 2003), p 261. Davies sees greater influence for financial institutions and companies in the development of financial markets law, especially through soft law such as stock exchange listing rules.

- protecting the corporate or industry licence to operate, particularly for projects with social and legal risks;
- attracting investment through the emerging market for socially responsive investment; and
- forestalling the threat of intrusive regulation: corporate social responsibility as a bulwark against legal regulation.

11. Is the modern corporate social responsibility movement in its myriad forms an injunction only to good corporate management or does it have implications for legal norms of corporate governance and corporate purposes and objectives? Is it essentially an exercise in the management of good corporate relations? At the international level and, to some degree, at the national level also, it offers assurance that corporations can be trusted to fill regulatory gaps and address the problems that their operations create. At the international level, there is a considerable body of evidence that corporate social responsibility is an inadequate substitute for legal regulation: its actions fall well short of its words.[9] The argument is made below that corporate accountability is needed, not its privatisation through voluntary company and industry codes and other manifestation of corporate social responsibility: see below, paras 39 to 52.

The resulting conception of the Anglo-Saxon or shareholder-centered corporation

12. A consequence of the shareholder value focus is that the company is seen as a set of income claims and property rights rather than as autonomous enterprise with its own claim and entity status. This is sometimes referred to as the *Anglo-Saxon corporation* to distinguish it from a European conception of the corporation in which wider social and employee claims are more clearly represented and recognized. The question whether share price is the inevitable measure of shareholder interest rather than enterprise value is considered below.

The drivers of management and investment culture with respect to corporate orientation and purpose

13. Does law matter here as the shaping influence upon corporate conduct? If company law prescribed a different norm to that of shareholder value, would different corporate practices and conduct follow? Arguably, it would not. Thus, as a response to the hostile takeover boom in the United States in the 1980s, many States enacted legislation which confer a licence upon directors of corporations domiciled in the State to consider, advance and even prefer, other stakeholder interests in their frustrating response to hostile takeover bids. These provisions, however, appear to have had little effect upon boardroom practice and the norms effectively shaping corporate action and decision. That indicates that the shareholder primacy norm as a norm shaping conduct is powerfully supported by other drivers such as

    - non-legally enforceable rules and standards such as social and industry norms with respect to the priority of profits and stock price as measures of corporate and director performance;

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[9] See, eg, Christian Aid, *Behind the Mask: The Real Face of Social Responsibility* (see http://www.christianaid.org.uk).

- financial incentives such as executive pay with its incentives through the pay for performance movement and the growth of equity based remuneration; and
- pressures from financial markets for financial performance, strengthened by the enhanced power of institutional investors.

14. Many of the elements that sustain the present cultural orientation of business and investment practice do not, therefore, appear to be shaped by legal considerations although they are undoubtedly reinforced by their perceived requirements. However, there is some evidence that legal rules constrain directors from giving effect, if they are minded to do so, to social claims and expectations upon the company that do not rest upon legal obligation: see para 15. What then is the doctrinal basis for shareholder value maximization as a legal norm?

The doctrinal basis for shareholder value maximization as a legal norm

Evidence that legal rules with respect to directors' duties may constrain the voluntary assumption of responsibility

15. The core questions posed by this review address issues arising in the inquiry into the restructuring of the James Hardie group of companies. The legal responsibility issue posed by the James Hardie restructuring should not be seen exclusively in terms of parent company liability for its subsidiary's torts. At the base of this question is a wider one: if James Hardie had a unitary and not a group structure, what would be its responsibility for the social harm occasioned directly by its operations that is not legally remediable? Are its directors' responsibilities limited to the protection of shareholder welfare so that corporate resources may not be applied to adverse claims that do not rest on legal right? There is evidence that this was the perception among James Hardie directors. Thus, the Chair of the board of directors of James Hardie Industries NV, the holding company of the group, justified to the Special Commission the refusal of the board of the former ultimate holding company (JHIL) to augment the resources of its former wholly owned subsidiaries which had unfunded asbestos liabilities (which subsidiaries had become wholly owned by the Medical Research and Compensation Foundation) on the basis that:

> *[the James Hardie] directors could not provide the [Foundation] 'with more than that for which JHIL was legally responsible, without honestly believing that … what they were doing was of benefit to JHIL's shareholders.*[10]

Similarly, JHIL's media release of October 2003, in which it announced its rejection of the Foundation's request for further funding in light of the projected incapacity to meet future asbestos liabilities, stated:

> *there can be no legal or other legitimate basis on which* [JHIL] *shareholder's [sic] funds can be used to provide additional funds to the Foundation and the duties of the company's directors preclude them from doing so.*[11]

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[10] See *Report of the Special* Commission *of Inquiry into the Medical Research and Compensation Foundation*, D F *Jackson*, QC, Commissioner, September 2004, para 14.45 (d) (here called the *Jackson Report*).

[11] Quoted in *Jackson Report*, *para* 30.22.

These are clear indications that the law on directors' duties was perceived by James Hardie Industries as constraining its capacity to assume responsibility for or to contribute to the amelioration of harm caused by its wholly owned subsidiaries which were themselves unable to provide compensation. The company had the benefit of first-tier legal advice. It is reasonable to assume that such advice is given regularly in Australia boardrooms in like contexts.

The definition of company interests with those of shareholders as a group

16. So, what are the exactions of directors' duties that were perceived until quite late in the Special Commission proceedings to preclude the James Hardie board from acceding to the Foundation's claims for additional funding? The question is central to the issues presented in the Committee's terms of reference. Directors' duties are owed to their company and not, save in exceptional circumstances (usually of individual share dealings between directors and shareholders), to shareholders individually. Directors must act bona fide for the benefit of the company as a whole. One aspect of this duty, under the general law and the statutory supplement in *Corporations Act* 2001 (Cth) s 181, is to consider and act by reference to the "interests of the company". It is the duty of directors of a company "to consult [the company's] interests and its interests alone" in their decisions.[12] In *Mills v Mills* in 1938, Dixon J in the High Court said that "[a]lthough the 'best interests of the company' is an indefinite phrase, its meaning admits of little doubt".[13] A year earlier, a fellow justice of the High Court said that the phrase "'bona fide for the benefit of the company' no doubt tends to become a cant expression in these matters but is not yet a shibboleth".[14] Surprisingly, in view of the importance of the question and the confidence of these assertions, there is a rather exiguous body of case law that identifies whose interests are "the interests of the company". This case law points to the company's interests being those of current shareholders as a group. In view of the limited body of the judicial decisions that are said to underpin the edifice of shareholder value and legal conceptions of corporate purpose, and the importance of the issue, those decisions are canvassed below.

17. In Australia, the principal statement is that of the High Court of Australia in its decision in 1953 in *Ngurli v McCann*.[15] However, the joint judgment of Williams ACJ, Fullagar and Kitto JJ in this regard did no more than quote with approval from the judgment of Evershed MR in *Greenhalgh v Arderne Cinemas Ltd*, in a case relating to a special resolution altering the articles of association, who said:

> *In the first place, I think it is now plain that 'bona fide for the benefit of the company as a whole' means not two things but one thing. It means that the shareholder must proceed upon what, in his honest opinion, is for the benefit of the company as a whole. The second thing is that the phrase, 'the company as a whole,' does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body. That is to say, the case may be taken of an*

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[12] *Walker v Wimborne* (1976) 137 CLR 1 at 6 per Mason J.

[13] (1938) 60 CLR *150* at 188.

[14] *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112 at 139.

[15] (1953) 90 CLR 425 at 438-439.

individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit.[16]

The High Court noted that there are

> *two lines of cases in which it has been held that the courts will interfere to prevent the abuse of powers conferred by articles of association. One instance is where it is necessary to prevent an abuse by the majority of the powers conferred upon a company in general meeting. The other instance is where it is necessary to prevent an abuse by the directors of the powers conferred on them by the articles. The court is more ready to interfere in the second than it is in the first instance.*[17]

18. This statement excludes from consideration as legitimate interests of the company to be consulted by directors the interests of the company as a commercial entity. Directors may consider and advance other stakeholder interests only where they are not inconsistent with those of shareholders as a group. However, since the 1980s a clear body of case law has been developed that requires that creditor interests supplant those of shareholders where the company is facing the threat of insolvency.[18] They are reinforced by the statutory duty upon directors to prevent their company incurring debts while it is insolvent.[19]

19. The quoted words from *Ngurli v McCann* and *Greenhalgh v Arderne Cinemas Ltd* are a modest foundation for a legal norm that expresses company interests so narrowly. There is other supporting case decision but its modern authority is somewhat uncertain. In *Parke v Daily News Ltd* in 1962, a newspaper publisher sold its two newspapers which had been making substantial losses over a long period. The sale would dispose of substantially all of the company's assets and result in the redundancy of the overwhelming majority of its employees. The directors proposed to apply the balance of the sale money after deducting the costs of the transaction as *ex gratia* payments to workers made redundant by the closure of the plant. (Redundancy payments were not required by award, industrial agreement or legislation, it appears.) A minority shareholder's challenge to the proposed payment as ultra vires the company was upheld. Plowman J in the Chancery Division said that

> *[t]hese and other passages [from the evidence] appear to me to show that the view was taken that in respect of the proceeds of an enterprise which they had helped to build, the employees had claims to consideration to which it was proper for the defendant company to pay regard, and that the interests of the shareholders would be satisfied by ensuring that the other assets of the company remained intact for their benefit. The view that directors, in having regard to the question what is in the best interests of their company, are entitled to take into account the interests of the employees, irrespective of any consequential benefit to the company, is one which may be widely held. Traces*

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[16] [1951] Ch 286 at 291.

[17] (1953) 90 CLR 425 at 438-439.

[18] See *Kinsela v* Russell *Kinsela Pty Ltd (In Liq)* (1986) 4 NSWLR 722; *Nicholson v Permakraft (NZ) Ltd (in liq)* (1985) 3 ACLC 453.

[19] The duty is contained in the Corporations Act Pt 5.7B Divs 3 and 4.

of it appeared in Mr Redhead's evidence, and Mr Leach, an accountant of great experience, said in examination-in-chief: "I think that although obviously the prime duty of directors is to their shareholders to conserve the assets, they also have these days a very practical obligation to their employees." Mr Leach was cross-examined about that statement: "(Q) One of the matters which affected the conclusion, at least in your mind, as I understand it, was that a company's duty these days must be regarded as one not only to the shareholders, but also to the employees? (A) Yes. I think I said that the prime duty must be to the shareholders; but boards of directors must take into consideration their duties to employees in these days." But no authority to support that proposition as a proposition of law was cited to me; I know of none, and in my judgment such is not the law.

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In my judgment, therefore, the defendants were prompted by motives which, however laudable, and however enlightened from the point of view of industrial relations, were such as the law does not recognise as a sufficient justification. Stripped of all its side issues, the essence of the matter is this, that the directors of the defendant company are proposing that a very large part of its funds should be given to its former employees in order to benefit those employees rather than the company, and that is an application of the company's funds which the law, as I understand it, will not allow.[20]

The court held that the proposal to pay compensation is one which a majority of shareholders was not entitled to ratify. The proposed voluntary payments to the dismissed staff were therefore restrained by injunction.

20. In *Parke v Daily News Ltd* Plowman J relied upon the 1883 decision of the English Court of Appeal in *Hutton v West Cork Railway Co*. That latter case also concerned a situation where a company had transferred its undertaking to another company and was to be wound up. After completion of the transfer, a general meeting of the transferor company was held at which a resolution was passed to apply (among other sums) a sum of 1,000 guineas in compensating certain officials of the company for their loss of employment, although they had no legal claim for compensation. The Court of Appeal held that the resolution was invalid since the company was no longer a going concern and existed only for the purpose of winding up. Plowman J quoted from what he called the "oft-cited" judgment of Bowen LJ who said:

… [w]hat is the general law about gratuitous payments which are made by the directors or by a company so as to bind dissentients. The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company. … It is not charity sitting at the board of directors, because as it seems to me charity has no business to sit at boards of directors qua charity. There is, however, a kind of charitable dealing which is for the interest of those who practise it, and to that extent and in that garb (I admit not a very philanthropic garb) charity may sit at the board, but for no other purpose.[21]

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[20] [1962] Ch 927 at 962.

[21] (1883) 23 Ch D 654 at 671.

However, the authority of both of these decisions with respect to the narrow shareholder focus of the conception of company interests is limited by the expression of the applicable legal principle in terms of the *ultra vires* doctrine rather than that of directors' duties.[22] The *ultra vires* doctrine in its application to corporations formed under Australian companies legislation was abolished from the mid-1980s: see now *Corporations Act* s 124. Their current status is not clear.

Wider or more liberal conceptions of company interests?

21. There are also some qualifying, perhaps contrary, statements to be found in the case law. Thus, in *Gaiman v National Association for Mental Health*, in a case involving the contested exercise of the directors' power to expel members of a non-profit company, the judge applied this test of validity of the exercise of the expulsion power:

> *Such a power is, I think, plainly conferred in order that it may be exercised in the best interests of the association. The association is, of course, an artificial legal entity, and it is not very easy to determine what is in the best interests of the association without paying due regard to the members of the association. The interests of some particular section or sections of the association cannot be equated with those of the association, and I would accept the interests of both present and future members of the association, as a whole, as being a helpful expression of a human equivalent.*[23]

This test retains the membership focus but inserts a longer time frame to counterbalance the interests of future against those of current members. (The exercise of power had been made against a group of members suspected of being hostile to the association's conception of mental health and its core activities.)

22. Second, a decade after *Parke v Daily News*, in *Teck Corp Ltd v Millar*, Berger J in the Supreme Court of British Columbia, while retaining the identification of company interests with those of shareholders, nonetheless was prepared to grant directors a licence under their fiduciary duties to take into account wider stakeholder interests:

> *The classical theory is that the directors' duty is to the company. The company's shareholders are the company ... and therefore no interests outside those of the shareholders can legitimately be considered by the directors. But even accepting that, what comes within the definition of the interests of the shareholders? By what standards are the shareholders' interests to be measured?*
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> *In defining the fiduciary duties of directors, the law ought to take into account the fact that the corporation provides the legal framework for the development*

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[22] Thus, in *Hutton v West Cork Railway Co* the court spoke of the applicable test in terms of what is "reasonably incidental to, and within the reasonable scope of carrying on, the business of the company" (at 671); that Plowman J in *Parke v Daily News* held that the proposed payments were not ratifiable by shareholders suggests, although it does not conclusively demonstrate, that the vitiating element was their ultra vires character rather than a breach the directors' duties to consult interests properly identified as company interests.

[23] *Gaiman v National Association for Mental Health* [1971] Ch 317 at 330.

of resources and the generation of wealth in the private sector of the Canadian economy. ...

A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders.

I appreciate that it would be a breach of their duty for directors to disregard entirely the interests of a company's shareholders in order to confer a benefit on its employees: Parke v Daily News Ltd. But if they observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.[24]

This statement in *Teck* concedes to directors a greater licence than would other formulations of directors' duties. It would permit directors to "observe a decent respect" for non-shareholder interests and to be "deflected in their commitment to [company] policy" by reason of its effect on the community. However, this statement appears to be *obiter dicta* only, that is, not an essential element in the decision in the case. As a Canadian decision, it is not binding in any event upon Australian courts.

The justification for the norm of shareholder value maximization

23. The standard justification for shareholder value is that shareholders are "owners" of the corporation. However, this statement applies only at the level of metaphor. The corporation as a distinct legal person cannot be the subject of ownership by others under usual conceptions of ownership. Shareholders have no legal or equitable interest in any item of company property even where they hold all the shares in the company. Rather, shareholders are members of the corporation. Of course, shareholders "own" their shares in the company through the possession of the bundle of rights they enjoy. This ownership is itself weakened under the modern structure of share-ownership which separates the ultimate beneficial claims with respect to the shares from the legal ownership vested in financial intermediaries.

24. The assumption made under the legal doctrine of shareholder primacy is that the duty of management is to maximise the wealth of their principals, the shareholder "owners" of the firm, and that the function of corporate law is to promote that end. The claim for shareholders as owners is usually justified upon the grounds of

    - their role as ultimate risk bearers in the firm in that their financial claims as shareholders are postponed to those of creditors in the winding up of the company;

[24] *Teck Corp Ltd v Millar* (1973) 33 DLR (3d) 288 at 313-314. Berger J appears to regard the decision in *Parke* as one turning upon directors' duties.

- their entitlement to surplus income during the firm's life within limits protective of creditors which entitlement gives them a vested interest in ensuring that resources are used to the maximum effect to consequent broad social advantage; and
- their usual monopoly of voting rights within the corporation, of the right to sell control of the company through the disposal of their shares and their monopoly of rights to bring suit for wrongs suffered by the company which it has not sought to vindicate.

25. Each of these justifications has an *ex post*, after the event, character. The first justification in terms of their role as ultimate risk bearers in the firm ignores the fact that liquidation is a very rare occurrence, a remote contingency in the life of any significant company and certainly in the duration of any individual investment. It also overstates the clarity of the boundaries between shareholders and creditors: shareholders may also be creditors and enjoy equal standing with them in external administration of insolvent companies.[25] The second justification in terms of their entitlement to surplus income during the firm's life ignores the reality that directors determine dividends under standard constitutional provisions and that the settled practice is to treat dividends as functionally equivalent to creditors' claims to interest (although with the liberty denied with respect to debt not to pay a dividend in the event of inadequate distributable profits). The third justification in terms of the monopoly of rights given to shareholders under company law - voting rights, the right to sell control and rights to bring suit - is more a consequence of the shareholder primacy norm rather than a justification of it. Shareholder primacy is not based upon shareholders' assumed superior monitoring capacity or disposition, or their legal right to direct the board and corporate management.

26. The justification for shareholder value maximization as defining the corporate objective is weak from the perspective both of policy and morality. It has, however, the singular virtues of clarity and certainty. These, however, are but second order virtues. If it is misconceived or comes at considerable cost, does clarity redeem? That leads to consideration to some costs of shareholder value as the measure of corporate purpose.

Some costs of shareholder value

The structural incentive to externalise social costs

27. The legal structure of the corporation encourages the externalisation of social costs of corporate behaviour. Limited liability creates a moral hazard through the incentives it offers to externalise the risks and costs of enterprise. The combined effect of separate personality and limited liability doctrines is to encourage shifting the risk or costs of enterprise operations away from shareholders and onto stakeholders or wider society, perhaps especially those with firm-specific human capital investments such as employees, suppliers, and local communities. While some interests will be protected by specific statutory or common law provision, it is fanciful to think that all of the costs of corporate operations will be imposed by

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[25] *Sons of Gwalia Ltd (Administrator Appointed) (ACN 008 994 287) v Margaretic* [2005] FCA 1305.

legislation upon the corporation; there will inevitably be a time lag in legislation and gaps in its reach. In addition, the inevitable barriers to and costs of private and public enforcement create opportunities to disregard obligations. Legal structure thus favours the externalisation of enterprise costs, reflected in the calculus of self-interest: limited liability and the shareholder value focus encourage the corporation and its managers (a) to isolate risky activities in separate corporate structures and thereby insulate group assets from the risk of failure and (b) to slough off the costs of enterprise that it can avoid internalising. If a firm voluntarily assumes social costs that it might legally externalise, it risks its long-term survival against competitors who do otherwise.

28. This is particularly so in relation to transnational enterprise in host countries with relatively powerless governments and poor institutions for legal enforcement; these difficulties are accentuated by the mobility of and competitive auction for foreign investment capital. Globalisation and economic liberalisation offer wider opportunities for externalisation under new power differentials: globalisation simultaneously integrates on the economic dimension while fracturing on the political.[26] These important global dimensions to the Committee's terms of reference are canvassed in other submissions and I shall not develop them further here. However, I refer the Committee to, and seek to incorporate by reference, an article I have had published on the existing and potential mechanisms to set standards and secure compliance with human rights observance by transnational enterprise.[27] A hard copy will be sent to the Secretary of the Committee.

29. While neither country is in the category referred to in the preceding paragraph, James Hardie was a joint venture investor in companies which manufactured asbestos products in Malaysia from 1966 and Indonesia from 1969. James Hardie divested itself of its Malaysian investments in 1985 and in Indonesia shortly thereafter. It reports that it has not had a corporate or operational presence involving asbestos in the region since then although it accepts that the Malaysian and Indonesian governments continue to allow the manufacture and distribution of asbestos products. James Hardie's public position is that, while it would consider any compensation claim from those countries on its merits (and that none have been received to date), any liabilities remain with its joint venture partners in those countries. The compensation scheme announced in 2004 applies to Australian victims only.[28]

Infeasibility and inadequacy of protective bargaining by stakeholders

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[26] Reinicke, Wolfgang H & Witte, Jan Martin, "Interdependence, Globalization and Sovereignty: The Role of Non-Binding International Legal Accords" in *Commitment and Compliance: The Role of Non-Binding Norms in the International Legal System*, pp 77-78 (Dinah Shelton ed, 2000).

[27] See Redmond, P, "Transnational enterprise and human rights: Options for standard-setting and compliance" (2003) 37 *International Lawyer* 69.

[28] *James Hardie responds to Asia compensation queries*, Company Statement, 27 January 2005 (<http://www.ir.jameshardie.com.au/> accessed 29 September 2005); "Hardie doesn't expect flood of claim", *Sydney Morning Herald*, 14 February 2005. New Zealand victims are generally prevented by New Zealand's no-fault compensation laws from suing James Hardie.

30. A second objection to shareholder primacy is that bargaining by non-shareholder stakeholders to protect rights is infeasible as a general norm and should not be the true measure of their entitlement under corporate law.[29] This objection is developed below in the context of the communitarian, multi-fiduciary model: see paras 60-64.

Inadequacy to secure the buy-in for effective team production

31. A third objection is that shareholder primacy is inadequate to secure the buy-in necessary for effective team production. The team production model of the corporation seeks to address some of the social reality problems of contractual theories of the corporation, especially those of trust and commitment within the firm. The contractual concept of the publicly held corporation as simply a bundle of assets creates a "sharp dichotomy" between the claims of shareholders and those whose inputs are merely hired. The team production model offers an explanation for the observed commitment of non-shareholders to corporate activities where multiple inputs are necessary for their success. It does so through the conception of the corporation and especially its board of directors as mediating hierarchy:

> *[A] public corporation is a team of people who enter into a complex agreement to work together for their mutual gain. Participants—including shareholders, employees, and perhaps other stakeholders such as creditors or the local community—enter into a "pactum subjectionis" under which they yield control over outputs and key inputs (time, intellectual skills, or financial capital) to the hierarchy. They 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. They thus agree not to specific terms or outcomes (as in a traditional "contract"), but to participation in a process of internal goal setting and dispute resolution. Hence the mediating hierarchy of a corporation can be viewed as a substitute for explicit contracting.*[30]

The model suggests that those in the corporate hierarchy—the board of directors ultimately—work not for the shareholder owners but for the team members such as employees who actually "hire" them to control shirking and rent-seeking (looting, that is, self-dealing) among their number so as to provide the incentive to each to commit to the enterprise and the assurance that other team members will also do so:

> *[T]he primary job of the board of directors of a public corporation is not to act as agents who ruthlessly pursue shareholders' interests at the expense of employees, creditors, or other team members. Rather, the directors are*

[29] D Millon, "Communitarianism in Corporate Law: Foundations and Law Reform Strategies" in L E Mitchell (ed), *Progressive Corporate Law* (1995), p 4.

[30] Blair, M M and Stout, L, "A Team Production Theory of Corporate Law" (1999) 85 Va L Rev 247 at 278; see also M M Blair & L Stout (2001) 79 Wash U LQ 403. Blair and Stout see their model as "consistent with the 'nexus of contracts' approach to understanding corporate law" ((1999) 85 Va L Rev at 254). But see D Millon (2000) 86 Va L Rev 1001 (there is no reason to expect improvements in distributional outcomes since the model does nothing to improve the extralegal status of non-shareholders in relation to shareholders).

trustees for the corporation itself — mediating hierarchs whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.[31]

32. The team production model is valuable for identifying the problem of ensuring the employee buy-in necessary for enterprise. A culture of shareholder value maximisation as the corporate theology is a serious impediment to such buy-in. The threat of shareholder opportunism through wealth transfers from employees and others who have made firm-specific investments in the corporation (eg, by developing skills that are not readily transferable to another employer, or by investment in manufacturing processes that are specific to a particular client) is a constant impediment to full buy-in. This is especially the case in an ongoing relationship whose future contours and exigencies cannot be mapped contractually. These wealth transfers may take many forms apart from the transfer of control where the premiums received by shareholders for the sale of their shares are financed by the loss of employment and corporate relocation.

33. There is the paradox here that employees and other stakeholders have often made long-term firm-specific investments in the corporation whereas the shareholders in the company, whether institutional or personal, will have highly diversified portfolios and are in and out of the company's share register on a highly transient basis.

The narrower moral compass of corporate action and decision-making

34. The narrower moral compass of the corporation also favours externalisation of enterprise costs. For most individuals, the press of self-interest is moderated in varying degrees by the sense of personal responsibility for actions; in corporations, individual moral restraint in often blurred by the demands of corporate role and lost in the anonymity of group decision and action. This is not to suggest that corporate officers and other employees are morally deficient relative to the rest of us. It is simply to recognise the group character of corporate decision-making and the consequent inevitable diffusion of individual responsibility for decisions and action taken with many inputs. That is compounded where the ultimate purpose of group action is conceived simply in terms of shareholder value maximisation.

Does the norm of shareholder value ultimately diminish the corporation?

35. Ultimately, for many there is the further question whether the pursuit of corporate profit in the goal of shareholder wealth maximisation provides a value or norm that will sustain human commitment to the corporation as a career or life's work.[32] Shareholder value maximisation is only a scorecard measure of firm success, not a strategy for action or a value.

36. Shareholder idolatry is not grounded in a self-evident theology. Shareholder value maximisation rests on economists' assumptions that social welfare is served by market pricing as best measure of individual preference. That assumption rests, of course, on the particular limited allocation of property rights under company law.

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[31] Blair & Stout (1999) 85 Va L Rev at 280-1.

[32] Mitchell, L E, *Corporate Irresponsibility: America's Newest Export* (Yale UP, 2001), p 94.

These are confined to shareholders in respect of the key rights of control, its transfer and enforcement through litigation. As the *grundnorm* of corporate purpose, shareholder value maximisation is a norm in need of moral rehabilitation.[33]

The values that a model of corporate responsibility should incorporate

37. In the writer's view, a model of a socially responsible corporation should embrace these elements.

- The corporation should be both a community in itself and a part of the social community.
- It should be the vehicle for the realisation of the human potentiality of its workers and enable them to flourish as persons, growing in dignity through their work, its responsibilities and relationships.
- This points to the corporation constituting an economic community of shared interests and reciprocal moral duties. Such a model offers some assurance of the effective buy-in or loyalty to shared enterprise that is essential to its optimal operation.
- For the efficient conduct of business, long-term relationships also need to be established and sustained with other stakeholders apart from the suppliers of capital and employees.
- Stakeholders accordingly should not be seen, as they are under the lens of the shareholder value model, as costs to be reduced, especially as a path of easy resort through successive waves of employee downsizing. Shareholder value focus fails to nurture the firm-specific human capital development that is necessary in the enterprise's own long-term interest.
- Profits should not be seen as an end in itself but as a measure of enterprise health and a condition of survival.
- The corporation's responsibilities as a social actor extend beyond mere compliance with legal obligations. Corporate governance needs to establish structures, incentives and penalties designed to ensure corporate awareness of and accountability for its social responsibilities.
- Legal rules inevitably play a role here. The present regime of directors' duties excludes, or is widely perceived by corporate advisers to exclude, responsiveness to social claims where it is not to the simultaneous advantage of shareholders. Shareholder advantage is the eye of the needle through which corporate responsiveness must pass.
- There are significant challenges to the development of the concept of the corporation as community deriving from the transient nature of investment interests in the corporation and its hierarchical organisational structure.

An overview of some options to address perceived weaknesses in the model of corporate responsibility

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[33] Wood, D, "Whom Should Business Serve?" (2002) 14 Aust J Corp L 266.

38. The following paragraphs outline some options through which corporate responsibility might be achieved, even one that does not reflect the principles identified in the preceding paragraph. They are:
    - voluntary corporate social responsibility initiatives;
    - a clearer licence for corporate philanthropy;
    - the "enlightened shareholder value" concept proposed in the United Kingdom;
    - mandatory pluralism: directors owe a duty to have regard for other stakeholder interests as well as those of shareholders; and
    - a tempered pluralism: directors have the power or licence to pay regard for other stakeholder interests in specific circumstances but are not under a duty to do so.

    This submission argues that the optimum approach is to be found in the last, tempered pluralism model accompanied by support for disclosure of voluntary corporate social responsibility initiatives against a structured benchmark.

    These models are considered seriatim.

The value of, and limits to, reliance upon voluntary corporate social responsibility initiatives

39. Corporate social responsibility, as a voluntary measure under which corporations seek higher standards than those exacted by law, is entirely commendable unless it displaces legal regulation where that is more appropriate in the particular instance. Voluntary measures have great potential for effective internalisation of the norm where they are self-generated and self-imposed.
40. The structural incentive to externalise social costs (see para 27) is a significant problem that those who advocate reliance upon a voluntary system of corporate social responsibility need to address. The James Hardie Industries imbroglio is relevant here. A rare social and political coalition had formed before there was a public change of position by James Hardie Industries NV in July 2004. This coalition and the pressure it generated were wholly extraordinary. The calculus of corporate utility under the voluntary model needs to be assessed at both the aggregate and the individual company level. Voluntary corporate social responsibility makes sense at the level of general corporate advantage: who can argue against it? However, its application in a particular context is not tested against generalities but against a careful calculation of net advantage in that situation. Thus, if a majority of the board of JHI NV, a global company, had not been Australian citizens, with their consequent sensitivity to local opinion, can we be confident that the board would have taken the decision that they did in July 2004?
41. One means of testing the merits and limits to reliance upon voluntary corporate social responsibility measures is to look at their operation in one sphere. The following notes relate to the merits of and limits to voluntary codes of conduct by transnational firms to indicate their commitment to observance of human rights norms in their operations. (The notes draw upon other work of the author.[34]) It is

[34] See Redmond, *supra*.

suggested that the strengths and weaknesses identified are not peculiar to transnational firms or to global or offshore operations. Indeed, these problems are ubiquitous and not confined to large international firms; it is said with some cogency that "few companies today do not confront human rights problems".[35]

Operational weaknesses in voluntary codes

42. The significance of such private initiatives depends upon the relative importance of the firms which adopt them and the extent to which the commitments made are put into practice. There is clear evidence that codes have serious weaknesses that undermine their utility as responsibility assurance measures. One group of weaknesses arises from their practical operation, a second from characteristics inherent in the voluntary device itself. It is worthwhile looking at these two species of limitation separately. It might be useful to look at the experience of voluntary codes of conduct adopted to indicate respect for human rights observance by transnational corporations (TNCs).

43. The present wave of corporate codes emerged with the liberalization of international trade and investment. It is no surprise then that they are highly concentrated in the trade sector, particularly among northern retailers of consumer goods with high brand recognition and low production costs. The publicity attaching to code adoption by industry leaders tends to obscure the reality that the proportion of firms adopting codes is relatively low. Most TNCs have not adopted a human rights or labour code, maintaining simply that they obey the law of the countries where they do business.[36]

44. Secondly, the codes adopted are predominantly unilateral in character in that five out of every six codes in an OECD inventory were found to be either individual company or industry codes.[37] This unilateralism is reflected in the skewing of code content in the interest of the individual firm or industry. Since code adoption appears to be driven by perceived consumer sentiment, codes are often narrowly focused upon issues judged to be either key points of commercial vulnerability or advantage. Accordingly, codes focus upon issues with a high profile in developed country markets (eg, the use of child labour); different priorities might emerge from multistakeholder analysis of human rights impacts of business operations. Code content is also highly variable even within narrowly defined areas, and there are significant gaps in coverage. These omissions point to the need for an integrating mechanism to resolve what constitutes proper conduct and the appropriate social and labour standards in international production.

45. The potential significance of a code for an individual TNC is the commitment which the corporation thereby makes to ethical behaviour through the standards of conduct it expresses, and the capacity for internalisation into conduct, values and

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[35] Sir Geoffrey Chandler, Keynote Address: Crafting a Human Rights Agenda for Business, in *Human Rights Standards and the Responsibility of Transnational Corporations* (Michael K Addo ed, 1999), p 40.

[36] Compa, Lance & Hinchliffe-Darricarrere, Tashia, "Enforcing International Labor Rights through Corporate Codes of Conduct" (1995) 33 Colum J Tran'l L 686.

[37] OECD, *Codes of Conduct – An Expanded Review of Their Contents* (Working Party of the Trade Committee, TD/TC/WP(99)56/FINAL), Fig 1.

culture at all levels of the group.[38] Effective implementation of corporate codes requires dissemination within the corporation and among stakeholders. It also requires accountability mechanisms within the corporation, including systems for identifying and sanctioning violations and improving compliance across the corporation; in the case of TNCs, this means the myriad companies and divisions within an international group and their contractors and suppliers. The integrity and credibility of voluntary codes also depends upon monitoring and verification of corporate compliance systems, including through periodic independent audit.

46. There are, however, evident weaknesses in implementation and enforcement of codes, especially a lack of transparency and endemic conflicts of interest. Effective monitoring and verification of compliance with codes is uncommon.[39] Workers employed by supplier firms are often unaware of the existence of codes adopted by northern retailers to govern the conditions of their employment.[40] Even where the codes are available, workers often have no way of reading the code or reporting non-compliance without facing the threat of disciplinary action or dismissal.[41] These factors raise doubts about the practical effect of codes upon corporate behaviour.

Inherent weaknesses in private initiatives

47. Other weaknesses are inherent in codes themselves as devices to assure human rights compliance. These are arguably more egregious than operational weaknesses.

48. Firstly, codes are not, of course, legally binding. They are sanctioned by the threat of loss of brand value through the willingness of consumers to make the conditions of production a criterion in purchasing decisions.[42] Evidence suggests that consumers are interested in doing so at least within certain limits so that the threat of effective mobilization of consumer reaction by civil society organizations is a constant one. The sanction is also highly variable across sectors and countries so that there is little incentive for code adoption for firms that do not supply public markets directly. For adopting firms, the code is liable to be passed over when it is judged unnecessary for brand value assurance or for competitive market advantage over rivals. The contest between code compliance and firm

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[38] Chandler, *supra*, p 41 ("Codes have no meaning unless they are translated into action and unless that action is monitored and audited").

[39] See Redmond, *supra* text accompanying notes 121-3.

[40] Thus, a US Dept of Labor survey of major US textile firms reported that "only very few respondents indicated that they have tried to ensure that production workers overseas know about their code or policy by specifically requiring that copies of such a statement be posted. Only three [of 42 firms] stated that they unconditionally require contractors to post their code". See Dept of Labor (US), *The Apparel Industry and Codes of Conduct: A Solution to the Child Labor Problem?,* pp 99-108 (1996) available at http://ww.dol.gov/ilab/media/reports/iclp/apparel/main.htm

[41] International Labour Organisation, Working Party on the Social Dimensions of the Liberalization of International Trade, *Country studies on the social impact of globalization: Final report* GB.276/WP/SDL/1, para 60 (1999).

[42] E V K FitzGerald, *Regulating Large International Firms*, p 14 (United Nations Research Institute for Social Development, Technology, Business and Society Program Paper No 5, 2001).

profits is not an equal one. Competition in the marketplace remains the ultimate driver of firm conduct.

49. Secondly, the predominantly unilateral character of codes undermines the impulse towards the development of a consensus view as to the appropriate social, labour and environmental standards for international business. The proliferation of voluntary codes with diverse content coordinated only by individual producer or collective industry interest has the potential to confuse or misconstrue concepts of corporate responsibility and impede the development of widely accepted international standards addressing international business.[43] The current diversity of codes, not necessarily (if at all) developed by reference to international standards, points strongly to the need for coordination as to the content of human rights standards applicable to TNCs. The OECD survey indicates that the market alone, without a coherent international framework, has been ineffective in developing generally accepted standards that maximize the benefits and prevent the risks of private human rights initiatives. What is required is a framework which supports the uniform application of human rights standards that have been developed through the participation of affected parties.

50. Thirdly, the majority of firms, who do not adopt codes, share in the benefits generated by codes adoption – in enhanced industry legitimacy and diversion of pressure for regulation. Code adopters cannot capture those benefits exclusively and are liable to be undercut by competitors who do not assume the cost burdens of their adoption and implementation. This free-rider problem is a significant deterrent to code adoption and implementation.[44]

51. Fourthly, the code movement with its wellsprings in market incentives exposes the limits of the market system to advance an agenda of social amelioration. That should not surprise since it is not the purpose of corporate activity to do so. There is an endemic conflict between the goals of corporate profit maximization and those of human rights protection and social development. Corporate action to advance the latter is likely to aid profit maximization only, if at all, in the long-term and then at the broad systemic level apart from immediate marketing gains that individual corporations might capture. Human rights observance is not cost-free and is not necessarily profit maximizing: many corporations have prospered under authoritarian regimes that provide assurance against the labour and resource contingencies of enterprise. The appeal of voluntary codes at the international level reflects the complexity of international lawmaking and enforcement, especially that directed at global private actors not easily amenable to national controls. They are no substitute at the international level for attempts to propose

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[43] Office of the United Nations Commissioner for Human Rights, *Business and Human Rights: An Update* July 2001, available at http://www.unhchr.ch/businesupdate.htm. International Council on Human Rights Policy, *Beyond Voluntarism: Human rights and the Developing International Legal Obligations of Companies* (2002), p 4 (alone, they are ineffective: "their proliferation is leading to contradictory or incoherent efforts").

[44] Utting, P, "Regulating Business via Multistakeholder Initiatives: A Preliminary Assessment" in Voluntary *Approaches to Corporate Responsibility: Readings and a Resource Guide* (prepared and published by the Non-Government Liaison Service of the United Nations), available at http://www.unsystem.org/ngls/documents/publications.en/develop.dossier/dd.07%20(csr)/1contents.htm.

solutions that address that complexity. Addressing the problems of voluntary code implementation will not "provide an adequate substitute for establishing a framework of accountability that extends across and beyond the corporate body".[45]

[45] Zadek, Simon, *The Civil Corporation: The New Economy of Corporate Citizenship* (2001), p 211.

The potential and promotion of voluntary corporate social responsibility

52. The development of voluntary corporate social responsibility initiatives is commendable. However, it is argued that they are not a sufficient response. The considerations outlined above militate against exclusive or even primary reliance upon voluntary initiatives to address problems of unwanted social impacts, of lack of clarity with respect to corporate purpose, and the narrow shareholder focus enjoined by company law, business and financial market practice, and investment structure. Many of the considerations identified in the paragraphs immediately above need to be addressed if reliance is placed on this mechanism in preference to statutory measures. In particular, there is the problem that the proliferation of voluntary codes has the potential to confuse or misconstrue concepts of corporate responsibility and impede the development of widely accepted standards of conduct either generally or within a particular sector. The development of generally accepted CSR accounting principles or other reporting and benchmarking indices is essential. There is much to commend the development of mandatory disclosure obligations by reference to specific and well-chosen criteria. The Committee will, no doubt, look at draft regulations developed in the United Kingdom requiring an annual Operating and Financial Review to replace the voluntary disclosure that has operated for some time: see para 59.

A clearer licence for corporate philanthropy, and its limits

53. Considerable emphasis has been placed in recent years upon corporate philanthropy as a solution to issues of corporate responsibility. It is not the key element by any means of a response to issues identified above. However, it might be a service to develop a more elaborated licence for corporate philanthropy since donations by some failed companies might have cast doubt as to the legitimacy of these initiatives. Developed during the 1980s and early 1990s, the American Law Institute's *Principles of Corporate Governance* (*Principles*) qualify the corporation's economic objective of profit and shareholder wealth maximization by recognizing the corporation's character as a social institution as well.[46] Thus, the *Principles* state that, notwithstanding its economic objective, the corporation must act within the boundaries set by law;[47] and further, it "[m]ay take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business."[48] The *Principles* would also permit the corporation to devote a reasonable amount of resources "to public welfare [and] humanitarian … purposes."[49] They would clarify the existence in legal doctrine of

[46] The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (Vol 1, 1994), § 2.01.

[47] The American Law Institute, at p 61 ("to the same extent as a natural person—no less but no more").

[48] The American Law Institute, § 2.01(b)(2).

[49] The American Law Institute, § 2.01(b)(3) (permitting the corporation to "take into account, within reason, public-welfare concerns relevant to groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of the communities within which the corporation operates" (at p 65). The economic objective "does not imply that the corporation must extract the last penny of profit out of every transaction in which it is involved": The American Law Institute, p 57. See also Eisenberg, Melvin Aron, "Corporate Conduct That Does Not Maximize Shareholder

a qualified licence to comply with social expectations of corporate conduct even where they do not enjoy prescriptive legal force but nonetheless attract significant normative support in the communities in which the corporation operates and from which it draws investment support.[50] These principles are permissive and modest in scope. Arguably, they are now too narrowly drawn, excessively legal, and at odds with ambient business practice which might sustain wider and less constrained forms of philanthropy. They nonetheless provide a valuable model to which reference might be made in defining for Australian conditions a clearer licence for corporate philanthropy and its proper limits.

"Enlightened shareholder value": the United Kingdom approach

54. The Committee will be aware of the model of "enlightened shareholder value" derived from the company law review conducted by the Blair Government in the UK and whose outcomes are expressed in the draft Company Law Reform Bill released in March 2005. It seeks to make directors pay attention to *all* constituencies *in the shareholders' interest*. The opening sentence of the proposed statement of duty (quoted below) follows the traditional expression of directors' duties in terms of the collective shareholder interest. That duty extends to taking into account other considerations and consequences:

> *Directors must act in the way that they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.*
>
> *In fulfilling this duty,* [the directors] *must take into account (where relevant and so far as reasonably practicable)*
>
> *(a) the likely consequences of any decision in both the long and the short term;*
>
> *(b) any need of the company —*
>
> > *(i) to have regard ... to the interests of its employees;*
> >
> > *(ii) to foster its business relationships with suppliers, customers and others; and*
> >
> > *(iii) to consider the impact of its operations on the community and the environment and*

Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure" (1998) 28 Stetson L Rev 1 (examining the several guises in which apparently philanthropic conduct may indirectly advance corporate utility).

[50] Thus, a Comment to § 2.01(b)(2) adds that a corporate official "should be permitted to take into account emerging ethical principles, reasonably regarded as appropriate to the responsible conduct of business, that have significant support although less-than-universal acceptance": The American Law Institute, at p 63. The commentary to the *Principles* states that "there is direct or indirect authoritative support [in legal doctrine] for all of the principles embodied in § 2.01": The American Law Institute, at p 55. Substantially similar principles are to be found in other corporate law systems, even those with legal traditions that attach greater weight to the social dimensions of business enterprise.

(c) *the need to act fairly as between members of the company who have different interests.*[51]

55. This model requires directors to act by reference to the promotion of "the success of the company for the benefit of its members as a whole". Is the "company" conceived as something other than "[the] members as a whole"? Would it enable, indeed, require, the directors to take account of the growth and prosperity of the business enterprise itself, acknowledging the interest in that enterprise of its shareholders? The answer is not evident.

56. The proposed provision in para (b) requires consideration of the likely consequences of any decision in both the long and the short term. This is valuable recognition of the long term interests of shareholders, and of the enterprise itself perhaps, in a manner that reflects the test of company interests adopted in *Gaiman v National Association of Mental Health*: see para 21.

57. The stakeholder interests mentioned in para (b) are not required to be considered by the directors: all that is required is that director take into account "any need of the company" with respect to the interests, relationships and impacts identified in (i)–(iii). That is, the consideration to be given to those interests, relationships and impacts is to be given by the *company* itself, not the directors specifically although it may be asked how this distinction will work in practice. The proposed provision does not itself generate the obligation to consider, but operates upon an existing need for consideration ("*any* need").

58. Does the provision give directors protection if they wish to take into account stakeholder interests? The earlier provision requiring directors to consider employee interests, recently repealed (see para 6), would have done so, at least with respect to employees.[52] But this is a different provision entirely and it seems to provide no such protection.

59. Draft regulations (2005) requiring an annual Operating and Financial Review (OFR) seek to protect stakeholders through mandated disclosure rather than through the directors' duties themselves. This will be through a new "narrative report" describing "future strategies, resources, risks and uncertainties", including policies with respect to employees and environment where they are relevant to future strategy and performance of the company. A commonly adopted reporting standard will be necessary for external monitoring and the mobilization of public opinion.

Mandatory pluralism: directors owe a duty to have regard for other stakeholder interests

60. Some critics of shareholder primacy and its reliance upon stakeholder protection through bargaining express concern at the "corrosive effect [of] interpreting social life as a continuous, self-interested negotiation".[53] A theory of the corporation as

[51] Company Law Reform Bill, Pt B, Chapter 1, s B3.

[52] In a rare instance of reported litigation under the section, directors who chose not to seek winding up of the company upon the compulsory acquisition of its premises, but rather continue a marginal business for the sake of longstanding staff, were protected by the section: *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14.

[53] W T Allen (1993) 50 Wash & Lee L Rev 1395 at 1402.

community addresses the threat of harm to non-shareholders from exclusive management focus upon shareholder interests. It was prompted by the hostile takeover boom of the 1980s in the United States which saw massive plants closure or relocation to extract higher post-acquisition returns for shareholders. To communitarians, these gains are often achieved through wealth transfers from non-shareholders such as lenders whose security is weakened by the assumption of additional debt, employees who have made firm-specific human capital investments over many years, and the local communities whose financial and social investments were made with the expectation of continuing long-term relationships with the corporation. There are several elements to communitarian critiques:

> *The first challenges key assumptions about the feasibility of non-shareholder self-protection through bargain. The second is more fundamental. It asserts that, even if self-protection through bargain were entirely feasible in a technological sense, disparities in bargaining power would prevent at least some non-shareholder constituencies from obtaining adequate protection from the costs of shareholder wealth maximization. This argument appeals to a conception of justice that insists that people are entitled to more than merely what they can bargain and pay for. Or, stating the same idea in terms of obligation rather than entitlement, community members owe each other duties of mutual regard and support. Finally, communitarians have offered a positive vision of corporate relationships ... as a community rather than a mere aggregation of self-seeking individuals whose relationships are defined solely by contract.*[54]

61. Communitarian theory offers the concept of multi-fiduciary obligation, a duty owed by corporate managers to all stakeholders in the company and not merely to shareholders. One formulation of this duty would require shareholders to internalise (that is, bear) the cost that pursuit of profit maximisation imposes upon non-shareholders through "a duty to act reasonably to avoid injury to non-shareholder constituent groups in the process of corporate decision making."[55] Another formulation would preclude management from making

> *short-term shareholder gains (such as takeover premiums) if doing so would frustrate legitimate non-shareholder expectations. Instead, management should pursue profit-seeking strategies that harmonize shareholder and non-shareholder interests where possible. Where conflict between these interests is unavoidable (as in the case of a money-losing plant, for example), management should adopt solutions that fully compensate non-shareholders for their losses.*[56]

62. The multi-fiduciary standard is criticised on the basis of the indeterminacy of its standards and as ultimately concentrating power in management hands: "if managers are empowered to set constituency against constituency, in the end all

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[54] Millon, "Communitarianism in Corporate Law: Foundations and Law Reform Strategies" in L E Mitchell (ed), *Progressive Corporate Law* (1995), p 4.

[55] L E Mitchell (1992) 70 Tex L Rev 579 at 585.

[56] Millon, p 12.

power will fall into management's hands."[57] Is unbridled director primacy – the abdication of director accountability - the inevitable price of the multi-fiduciary model? From directors' perspective, the standard is perceived as leaving them confused as to responsibilities and vulnerable to litigation.[58] Accordingly, the communitarians' multi-fiduciary model has not commanded wide support even among many sympathetic to its underlying concerns.

63. The UK company law review adopted the enlightened shareholder value rather than the pluralist model that would have allowed directors a broader discretion to balance shareholder against other stakeholder interests. It did so on the grounds that the pluralist model would:

- confer a broad policy discretion on directors, funded by the company's resources; if directors had a *power* to decide whose interests should override those of shareholders, it would be unpoliced; if they had a *duty* to take other considerations into account, this would give a similarly wide discretion to the courts;
- create a broad and largely unpoliced managerial discretion that would not necessarily achieve its objectives;
- be largely unnecessary if the duties were expressed in inclusive terms and "maximized the opportunity for synergy between the securing of shareholders' and wider interests";
- constitute an attempt to achieve external benefits which are often better served by specific legislation which bears on business activity as a whole, such as employment, environmental, planning and fair trading and competition law; and
- enable directors to frustrate takeover bids against the wishes of shareholders where a wider public interest (which might even include the "character" of the company) requires it.[59]

64. The pluralist or multifiduciary model rests on a social, not a property, view of the corporation. It identifies the corporate purpose with maximising total constituency utility. This is an indeterminate outcome measure which poses particular difficulties is translation into a legally enforceable duty. The indeterminacy of the criteria for decision and performance measurement also points to a probable loss of accountability for directors since it offers broad scope to justify most decisions. It is difficult to resist the conclusion of the UK review that either it confers a broad unpoliceable policy discretion on managers themselves or must gives a broad jurisdiction to the courts. The model needs either practical rehabilitation or a superior performance metric. It is not clear where either might be found.

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[57] R M Green (1993) 50 Wash & Lee L Rev 1409 at 1417; Fischel, D, "The corporate governance movement" 35 Vanderbilt L Rev 1259 (1982) (vagueness of notion of corporate social responsibility and often contradictory nature of claims made under it; the task is how to secure appropriate balance); cf Sternberg, E, 'Stakeholder theory exposed' (1996) *Corporate Governance Quarterly* 36.

[58] See "Hardie changes divide lawyers", *Sydney Morning Herald*, 8 November 2004, p 3.

[59] *Modern Company Law for a Competitive Economy: Developing the Framework*, A consultation document from the Company Law Review Steering Group (2000), para 3.24 (http://www.dti.gov.uk/cld/modcolaw.htm).

Tempered pluralism: a power or licence to have regard for other stakeholder interests in particular circumstances

65. The writer suggests that the optimal response to address the perceived weaknesses in the model of corporate responsibility canvassed above is a form of tempered or constrained pluralism through a power or licence to have regard for other stakeholder interests in particular circumstances. Directors are not required to give consideration to such interests but would be protected from the threat of liability if they do so in the permitted circumstances. Those circumstances might be:

    - to consider and act by reference to the long term success or long run value of the enterprise itself[60] and
    - to internalize the costs of enterprise operations which the corporation is not legally required to assume.

66. The first circumstance identified encourages longer-term stakeholder investment and engagement through a "stewardship of enterprise" approach. There is a related issue for consideration as to whether, subject to solvency considerations, the directors of a company within a group of companies under common ownership and control should be permitted to internalize voluntarily the costs of enterprise operations of another group company which is unable to bear them. This is the situation that arose in with respect to the asbestos liabilities of the former James Hardie Industries group subsidiaries. As the Commissioner noted there, the policy issue of whether the veil of entity separateness should be lifted in the case of tort liability was considered by the statutory corporate law advisory committee without the benefit of broad input beyond that of professional groups. This issue posed here with respect to intra-group consideration is a cognate one.

67. It is proposed that, as with the revised model of directors' duties in the United Kingdom, consideration be given to structured mandatory disclosure with the characteristics briefly canvassed at para 59.

68. There may be some merit in investigating the existence of a statutory provision to protect directors through a safe haven from liability under their duty to act in the company's interests. There is an existing model here under the statutory business judgment rule protecting directors with respect to liability under their duty of care: s 180(2). The protective provision might retain the elements contained in s 180(2), namely, the directors must

    - make the judgment in good faith for a proper purpose;
    - not have a material personal interest in the subject matter of the judgment;
    - inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate and
    - rationally believe that the judgment is in the best interests of the corporation.

69. The elements of this proposal are sketchily drawn here and it is proposed to expand this proposal in a supplementary submission to the Committee. That submission will consider the concern that the licence would create an unpoliceable

[60] As proposed by Jensen, M, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (2001) 14(3) J Applied Corporate Finance.

policy discretion in directors and inevitable accountability loss or, on the contrary, that it is likely to be nugatory and of symbolic value only.

Addressing the terms of reference

The Committee will inquire into corporate responsibility and triple-bottom-line reporting, for incorporated entities in Australia, with particular reference to:

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

70. This issue is adverted to above, at paras 5-11. It is not amenable to confident assertion.

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

71. This issue is adverted to above, at para 37.

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.*

72. The state of legal doctrine with respect to the conception of company interests that directors' duties require directors to consult is discussed at paras 16 to 22. Their influence upon directors' decision-making and the culture of focus upon shareholder value is not clear. It is suggested, at paras 13 to 14, that a range of forces and norms sustain that culture, including the exactions of legal duties.

d) *Whether revisions to the legal framework, particularly to the Corporations Act, are required to enable or encourage incorporated entities or directors to have regard for the interests of stakeholders other than shareholders, and the broader community. In considering this matter, the Committee will also have regard to obligations that exist in laws other than the Corporations Act.*

73. It is suggested at paras 65-69 that an amendment to the Corporations Act is desirable to provide assurance to directors that they will not breach their duties by acceding to claims from or assuming costs of corporate activity that is not grounded in legal obligation in specific circumstances.

e) *Any alternative mechanisms, including voluntary measures that may enhance consideration of stakeholder interests by incorporated entities and/or their directors.*

74. A range of alternative mechanisms, including voluntary measures, is canvassed at paras 38 to 69.

f) *The appropriateness of reporting requirements associated with these issues.*

75. The appropriateness of imposing mandatory reporting requirements with respect to corporate social responsibility initiatives is briefly canvassed, including at para 59.

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

76. The appropriateness of adopting the measures contained in the exposure draft Bill in the United Kingdom with respect to the definition of the interests that directors must consult and reporting requirements with respect to corporate social responsibility initiatives is canvassed at paras 54 to 59.