MALLESONS STEPHEN JAQUES

Submission to the Parliamentary Joint Committee Inquiry into Directors' Duties and Social Responsibility

Dated 30 September 2005

Mallesons Stephen Jaques
Level 60
Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000
Australia
Australia
T +61 2 9296 2000
F +61 2 9296 3999
DX 113 Sydney

Submission of Mallesons Stephen Jaques
Contents

1	**Scope of this submission**	**1**
2	**Summary**	**1**
3	**Current legal framework**	**2**
3.1	Fiduciary duties	2
3.2	Other common law duties	2
3.3	Statutory duties generally	3
3.4	Obligations under other Acts	4
4	**To whom is a director’s duty of loyalty owed?**	**4**
4.1	The duty of loyalty	4
4.2	Other stakeholders	5
5	**Does the current legal framework permit, encourage or require directors to consider the interests of stakeholders other than shareholders?**	**6**
5.1	Enlightened shareholder value	6
5.2	Permitted and encouraged	7
5.3	No need for reform	8
6	**Legislative reform in the United Kingdom**	**8**
6.1	UK Company Law Review	8
6.2	Recommendation against similar reform	9

1 Scope of this submission

This submission deals only with parts (c), (d) and (g) of the terms of reference of the Parliamentary Joint Committee Inquiry.

Those terms concern the legal framework governing directors duties in Australia and in other countries, viz:

"(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;

(d) whether revisions to the legal framework, particularly to the Corporations Act 2001 *("**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; and*

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

The submission is made by Mallesons Stephen Jaques, an independent legal firm, and not on behalf of any client, professional body or other party.

Mallesons Stephen Jaques has a strong commitment to its various stake-holders, to engagement in the broader community, and to ethical behaviour in business. The views expressed in this submission should be considered in the context of that commitment.

2 Summary

In our submission, the current legal framework does not discourage directors from having an appropriate regard for the interests of employees, suppliers and customers, and the consequences of corporate activities for the environment and the broader community.

Further, we do not believe that there are any circumstances in which the duties of directors prevent them from having appropriate regard for those interests.

There is a plethora of laws, in addition to the Corporations Act, that ensure that directors consider the interests of employees, suppliers, customers, and the environment when making decisions about the activities of their corporation. In fact, there are over 300 State and Federal Acts of Parliament that impose personal criminal liability on directors where the corporation fails to comply with its obligations to these interest groups and the environment.

Therefore, while the Corporations Act does not expressly encourage directors to have regard to the interests of stakeholders other than shareholders, that encouragement may readily be found in other laws.

Encouragement also arises from community pressure, social ethical standards, and occasional stakeholder activism, as several Australian public companies have found in recent years.

We do not believe that any further revision is required to the Corporations Act, or the legal framework generally, to encourage corporate entities and directors to have regard to the interests of stakeholders other than shareholders. And we are strongly of the view that directors should not be under a legal obligation to consider the interests of other stakeholders, separately from the interests of shareholders.

In particular, the terms of the "duty of loyalty" proposed under the UK Company Law Reform Bill of 2005 should not be adopted in Australia. Those terms impose a qualified obligation on directors to have regard to the interests of certain stakeholders, but fail to identify the circumstances in which directors must do so, and also fail to indicate the relative weight that must be given to the interests of various stakeholders when making a decision.

3 Current legal framework

3.1 Fiduciary duties

The relationship of director and company is fiduciary, reflecting that directors must exercise a high standard of loyalty to the company. This may be summarised as comprising positive obligations to:

- act in good faith in the interests of the company;
- act for proper purposes; and
- give due consideration to matters for decision and not to fetter discretions,

as well as negative requirements:

- to avoid conflicts of interest; and
- not to keep secret profits.

3.2 Other common law duties

In addition to the duty of loyalty, directors also are subject to a duty of care, a duty to act in accordance with the company's constitution and a duty to deal fairly as between different classes of shareholders.

The courts have developed a business judgment rule and are reluctant to review business judgments unless required to do so by statute. Business judgments must be made in good faith and not for irrelevant purposes.[1]

[1] *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.

3.3 Statutory duties generally

Part 2D.1 of the Act sets out the most significant duties of corporate directors. These sit alongside general law fiduciary duties and in many instances reflect the law as previously developed in the courts.

The basic statutory duties are the duty of loyalty and the duty of care.

Section 181(1) states that a director must exercise their powers and discharge their duties:

(a) in good faith in the best interests of the corporation; and

(b) for a proper purpose.

A director who fails to act honestly in the discharge of this duty commits a criminal offence: section 184(1).

The standard formulation of the duty of loyalty at common law is that directors must act "bona fide in what they consider − not what the court may consider − is in the interests of the company."[2]

Section 180(1) of the Act provides that directors of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

- were a director of a corporation in the corporation's circumstances; and
- occupied the office held by, and had the same responsibilities within the corporation as, the director.

The duty of care essentially reflects the position at common law.[3]

Section 180(2) contains a business judgment rule, which provides that a director who makes a business judgment will be taken to have met the requirements of section 180(1) and equivalent common law duties if they:

- make the judgment in good faith for a proper purpose; and
- do not have a material personal interest in the subject matter of the judgment; and
- 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. (A director's belief that a judgment is in the best interests of the corporation is rational unless the belief is one that no reasonable person in their position would hold.)

---

[2] *Re Smith & Fawcett Ltd* [1942] Ch 304 at 306 per Lord Greene MR.

[3] *Re HIH Insurance Ltd (in prov liq); ASIC v Adler* (2002) 41 ACSR 72; *Daniels v Anderson* (1995) 37 NSWLR 438.

Furthermore, the Act imposes duties on directors:

- not to use their position to gain an advantage for themselves or someone else or to cause detriment to the corporation; and
- not use information obtained through their position improperly to gain an advantage for themselves or someone else or to cause detriment to the corporation

3.4 Obligations under other Acts

In May 2005, the Corporations and Markets Advisory Committee released a discussion paper entitled "Personal Liability for Corporate Fault". This discussion paper considers the imposition of derivative personal criminal liability on company directors when the company contravenes the law.

CAMAC identified over 300 State and Federal Acts concerning the protection of employees, consumers, and the environment, under which directors may face criminal charges for the company's contravention of those laws. Liability does not require the director to have engaged in any criminal conduct. This large body of law protects the interests of the stakeholders the subject of this enquiry, in a manner that pointedly encourages directors to consider their interests.

The criminal law also applies to companies and directors, prohibiting theft, fraud, and offences of dishonesty, amongst other things.

4 To whom is a director's duty of loyalty owed?

4.1 The duty of loyalty

The following Sections 4 and 5 of this submission focus on the duty of loyalty, since it is this duty that is most concerned with corporate purpose and the appropriate objective of decision making by directors.

The central question is: "to whom is a director's duty of loyalty owed?" or, perhaps more specifically, "in saying that a director must act in the interests of the company, what is meant by 'the company'?". Does it strictly refer to the shareholders as a whole or is there some degree to which a director may consider the interests of other stakeholders? If the latter, should such considerations still be made with the objective of maximising shareholder wealth?

The eminent English commentator LCB Gower noted in 1955 that the phrase "the best interests of the company" does not refer to the "sectional interest of some or even a majority of the present members or even all of the present members but of present and future members; that the directors should balance a long term view against the short term interests of present members".[4]

[4] L C B Gower, 'Corporate Control: The Battle for the Berkeley' (1955) 68 *Harvard Law Review* 1176, 1184-1185. An alternative statement of this principle is that the duty of directors is not to

A director's duty is owed to the company as reflected in the present and future interests of the shareholders as a whole. This conclusion is necessarily derived from the basic nature of a company: it is a legal entity created under statute for the purpose of conducting a business for the benefit of its investors, or for conducting a not-for-profit enterprise in pursuit of the objects mandated in its constitution.

A director of a corporation who accepts funds from an investor and donates them to the director's favourite charity for no benefit to the corporation, or a director of a charitable corporation who takes the money of a donor and invests it in an unrelated business enterprise, may be well-motivated but is not and cannot be acting in the interests of the corporation.

The director has fiduciary obligations to the corporation's investors and donors that mean that the corporation is constrained in its activities, and does not have the same discretion to allocate its assets as does an individual.

However, the concept of "enlightened shareholder value" (discussed below) which has been adopted by many of Australia's leading corporations, enables directors to take account of the interests of other stakeholders and the broader community in a manner which is consistent with their obligation to act in the present and future interests of shareholders.

In other words, it will generally be for the benefit of the company as a whole for directors to act ethically and consistently with the interests of the wider community. There is an ever increasing risk for Australian companies that their reputation and business will be damaged if directors fail to consider the interests of these stakeholders and the broader community, and there is no law which prevents them from acting to minimise that risk.

4.2 Other stakeholders

There is no case law or legislation in Australia that imposes a general duty on directors to consider the interests of other stakeholders (such as employees, customers, suppliers, the environment or the community in which the company operates).

However, in some States, directors have a general obligation to ensure that the activities of their company do not harm the environment, and the common law also requires that the interests of creditors must be considered by directors to a limited extent when the company is or is likely to become insolvent.

There are also hundreds of separate pieces of legislation that impose obligations on companies and their directors to protect the interests of these stakeholders. They include laws concerning minimum wages, harassment, discrimination, unfair dismissal, occupational health and safety, environmental protection, hazardous goods, consumer protection, misrepresentation, food and product labelling, consumer credit, fair trading, and restrictive trade practices.

---

take into account the interests of future members so much as the future interests of present members: I A Renard, 'Commentary' in Paul Finn (ed), *Equity and Commercial Relationships* (1987), 137, 138.

Further, in the absence of a particular legal obligation to do so, the interests of some or all of these groups will inevitably be considered by corporate directors in the course of managing the company, consistently with their obligation to maximise long term shareholder value.

5 Does the current legal framework permit, encourage or require directors to consider the interests of stakeholders other than shareholders?

5.1 Enlightened shareholder value

So long as the ultimate objective is shareholder wealth maximisation, it is open for directors to make decisions that benefit various stakeholder groups including the community in which the company operates. This is known as the "enlightened shareholder value" conception of corporate purpose.

Judicial acceptance of business judgments already gives directors broad discretion in making decisions so long as they are ultimately made with a view to maximising shareholder value. The concept of enlightened shareholder value describes the view that the goal of shareholder wealth maximisation is best achieved by taking a long-term approach and may regularly involve rewarding and compensating various stakeholders other than shareholders.

This view is taken by Austin, Ford and Ramsay, who write that:

> *An extreme view, namely that a company should make only those expenditures that are directly related to the pursuit of profit for the benefit of members, would restrict management. The decided cases in this area indicate that management may implement a policy of enlightened self-interest on the part of the company but may not be generous with company resources when there is no prospect of commercial advantage to the company.*[5]

Two kinds of conduct may be permitted within an enlightened shareholder value model that might appear at first glance not to fall within a strict shareholder wealth maximisation principle.

The first such kind of conduct is that which gives a direct benefit to a stakeholder other than a shareholder but is intended ultimately to bring maximum benefit to the company. Examples of such conduct include:

- employee benefits designed to increase productivity; and
- charitable donations designed to improve the company's public image.

[5] R P Austin, H A J Ford and I M Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005), 281-282.

Although such behaviour is unlikely to be presented as profit maximising, it is technically just a business expense, designed to increase profits like any other expense.

The second such kind of conduct is that which involves an immediate personal sacrifice with the intention of delivering broad long-term economic benefits which may benefit whole sections of an economy, including the company itself. Eisenberg calls such conduct the "prisoner's dilemma principle" after the famous game theory dilemma, and gives the example of a company that devotes resources to furthering a national war effort since it is in the interests of all domestic corporations that the war be won as soon as possible.[6] Contributions to local schools and universities might also fall within such conduct.

5.2 Permitted and encouraged

In our opinion, the current legal framework permits directors to engage in a wide variety of conduct that does not immediately appear to fall within a strict shareholder wealth maximisation objective. That conduct may include activities that benefit other stakeholders and the broader community for the long-term benefit of the company.

The broader legal framework also encourages such behaviour, for the reasons identified above, notwithstanding that the Corporations Act does not mandate it.

And there is growing acceptance that a narrow focus on short-term profits is actually undermining the shareholder wealth maximisation objective.

Joseph Fuller and Michael Jensen, both leading advocates of the shareholder wealth maximisation principle, write that:

> *Managers must confront the capital markets with courage and conviction. They must not collude with analysts' expectations that don't fit with their strategies and the underlying characteristics of their markets. They must not bow to analysts' demands for highly predictable earnings. The art of analysis includes the capacity to understand phenomena like seasonality, cyclicality, and random events. Companies do not grow in a constant fashion with each quarter's results better than the last. In the long run, conforming to pressures to satisfy the market's desire for impossible predictability and unwise growth leads to shortened careers, humiliation, and damaged companies.* [7]

Lawrence Mitchell has suggested that the combination of a focus on short-term share price maximisation and a view of laws as obstacles to profits has been particularly disastrous in the United States.[8]

[6] Melving Aron Eisenberg, 'Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, The Penumbra Effect, Reciprocity, The Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure' (1998) XXVIII(1) *Stetson Law Review* 1.

[7] Joseph Fuller and Michael C Jensen, 'Just Say No to Wall Street' (2002) 14(4) *Journal of Applied Corporate Finance* 41, 45.

[8] Lawrence E Mitchell, *Corporate Irresponsibility: America's Newest Export* (2001), 4-6, 52.

These observations do not support a conclusion that short-term, opportunistic behaviour is consistent with the existing obligations of directors.

5.3 No need for reform

Accordingly, as consideration by directors of the interests of other stakeholders and the broader community is permitted by the current legal framework, and encouraged in many ways, including personal criminal sanctions for directors, we do not believe that there is any need to amend the legal framework to permit or encourage such behaviour.

Calls for corporate law reform are often made in response to egregious corporate behaviour. However, in most of those cases, the companies involved and their directors have breached existing laws. The directors of Enron and WorldCom engaged in massive frauds; directors and officers of HIH committed criminal offences under the Corporations Act. The chairman of One.Tel was found to have breached his duties as a director.

In the rare instances that corporate behaviour offends social mores but not the law, community pressure has proved to be an effective sanction. We do not believe that the law should attempt to prescribe ethical behaviour for corporations to any greater extent that it does so at present.

6 Legislative reform in the United Kingdom

6.1 UK Company Law Review

The UK Department of Trade and Industry began an extensive review of company law in 1998. The steering committee of that review presented its report in 2001 and the Government published a White Paper in March 2005, containing reforms which will be introduced to the Parliament through the Company Law Reform Bill, referred to in the Queen's speech of 17 May 2005.

One of the outcomes of the review was the codifying of company directors' duties and an aim to cultivate a culture of long-term value in British corporate governance.

The proposed duty to promote the success of the company for the benefit of its members is worded as follows:

> ***B3 Duty to promote the success of the company for the benefit of its members***
>
> *(1) As a director of a company you must act in the way you consider, in good faith, would be most likely to promote the success of the company for the benefits of its members as a whole.*
>
> *(2) Where or to the extent that the company is established for purposes other than the benefit of its members, your duty is to*

act in the way you consider, in good faith, would be most likely to achieve those purposes.

(3) In fulfilling the duty imposed by this section you must take account (where relevant and so far as reasonably practicable) of −

(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,

(iii) to consider the impact of its operations on the community and the environment, and

(iv) to maintain a reputation for high standards of business conduct, and

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

(4) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.[9]

6.2 Recommendation against similar reform

The difficulty of legislating to mandate the consideration of stakeholder interests other than shareholders is readily apparent from the UK draft.

First, the duty remains primarily a duty to act for the benefit of members as a whole. Nothing in the draft permits directors to disregard that obligation in favour of the interests of other stakeholders.

Second, while the draft imposes a further obligation on directors to take account of the interests of other stakeholders, it fails (notably) to specify when directors must actually do so. The obligation only applies "where relevant", and directors must only consider "any need of the company" to consider other stakeholders, which begs the question as to whether and when such a need exists.

Third, the draft provides no guidance as to the relative weight to be accorded by directors to these various interests when making decisions that affect all interest groups in different ways. If the interests of one group are adversely affected, but the interests of another are advantaged, how must directors decide?

[9] Ibid, 89-90.

Accordingly, we would not recommend reforms similar to the UK proposal. In our view, while the UK draft would no doubt encourage directors to consider the interests of other stakeholders, it actually adds nothing to the current legal position in Australia, and would only bring uncertainty and confusion to the obligations of directors, without any clear benefit to other stakeholders or the broader community.

Mallesons Stephen Jaques

30 September 2005