

## CHAPTER 2

### INTRODUCTION

#### **The modern corporate sector**

2.1 The corporate culture we know today is not the corporate culture of a century ago. The balance between ownership and the control of companies has shifted towards the controllers. Management has great power over vast assets which it pursues with vigour through takeovers, mergers and buy outs. Technology is a profound influence in the development of the corporate sector. It transforms old industries, engenders new ones and enables securities trading to be world wide and rapid.

2.2 The modern corporate sector has a profound effect on life in Australia. It has achieved a high public profile and, with it, a high level of public scrutiny. The corporate sector is crucial to the creation of the nation's wealth. Society looks to it to produce that wealth in accordance with community values. It wants ethical conduct, with due regard being given to the rights of shareholders, employees, creditors and consumers, and to the environment.

2.3 Directors are the mind and soul of the corporate sector. They are crucial to how it operates and to how its great power is exercised. They determine the character of corporate culture. Their actions can have a profound effect on the lives of a great number of people, be they shareholders, employees, creditors, or the public generally. They can weaken and even suppress market forces. They can disturb and destroy an environment.

2.4 Ideally, company directors' conduct should be informed by high ethical values. Ethics are morals tempered with

experience. Corporate history confirms that, without ethics, self regulation will fail. Courts and legislatures will need to step in when ethical standards are too low or when they are not met.

2.5 A legal framework has developed regulating companies' incorporation and providing a mechanism for their winding up, laying down standards of conduct for their officers, protecting their shareholders, and stating how they might merge and be taken over. This kind of legal framework will be necessary whatever the extent of self regulation. The degree to which the law will need to intervene in the corporate sector beyond the provision of this framework depends on the degree to which the corporate sector can effectively regulate itself.

2.6 Over the years the community has said much about companies, particularly in relation to directors' duties to those who have invested in the company. The laws regulating the director's role have arisen from the intrinsic nature of companies, their purpose, their structure and their history. For the most part, directors are enjoined to act in the best interests of the company. In this way, the board is required first and foremost to give regard to the shareholders' interests.

2.7 The law also deals in some respects with the duties directors have to others such as employees. This law arises largely from the relationship the company has with entities extrinsic to it. The source of these duties lies not in the nature of the corporation itself but in the nature of its traffic with those other entities.

2.8 Should the law, in either of these aspects, be extended? Some people have advocated a positive answer to this question. Some say that companies are now so dominated by directors that their owners, the shareholders, are denied any effective say in their control. They advocate a different balance. Some argue the law should move to meet the reality that the corporate sector is

now central not only to the economic well-being of society but to most dimensions of community life. They advocate the imposition of wider duties on directors.

#### Where do directors' duties lie?

2.9 In 1932, The Modern Corporation and Private Property<sup>1</sup> was first published. In this book, the authors, Berle and Means, pointed out that companies had developed so that their ownership and management were separated. They saw this separation as growing out of the ever increasing size, scope and complexity of the corporation which took from the shareholders the ability to control it.

2.10 Berle and Means saw the modern corporation as more than a mechanism allowing a number of investors to hold common property. It was a structure giving a comparatively small number of directors control over huge shareholder funds. Because of its vast economic resources and the activities these made possible, the corporate sector had great impact on the community. It had become a major social institution.

#### Wider duties

2.11 Berle and Means argued that

[n]either the claims of ownership nor those of control can stand against the paramount interests of the community ... It remains only for the claims of the community to be put forward with clarity and force.<sup>2</sup>

2.12 In this way, the 'control' of the company would become a balancing of a variety of claims by various groups in the community on the basis of public policy.

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1. See Berle, Adolf A and Means, Gardiner C, *Harvest, USA, 1968* (revised ed).

2. *Ibid*, p 312.

2.13 There is much law attending to the rights of shareholders. There is much less guiding directors in what obligations, if any, they have to the community. The legal precedents developed over the centuries give a strong basis for developing further safeguards for shareholders but a narrow one for doing the same for others. To require directors to take into account the social impact their decisions might have would be an extension of Australian company law fraught with most important consequences.

2.14 There is support for making this extension. Mr Jim Kennan, formerly Attorney-General for Victoria and Chairman of the Ministerial Council for Companies and Securities, has said:

In my view it is essential that we ... consider ways in which the law can respond to the demands of the modern corporation and can allow the interests of those who are affected by the decisions of corporations to be taken into account in the decision making process.<sup>3</sup>

2.15 Mr Graeme Samuel, as Executive Director of the Macquarie Bank Ltd, has said:

I am beginning to question whether changing social attitudes are not now demanding that, consistent with their obligations to take account of shareholders' interests, directors should take a longer term view and act to also protect the interests of other stakeholders who are vital to the future generation of shareholders' wealth - employees, customers, suppliers and the like.<sup>4</sup>

3. *'Comments on "Directors' Wider Responsibilities - Problems Conceptual, Practical and Procedural"', speech given at AULSA conference, Monash University, 25 August 1987. See also 'The Agenda for Corporate and Securities Law Reform in Australia', paper delivered by Mr Kennan at the Eighth Annual Conference of the Australian Society of Labor Lawyers, Hobart, 19 October 1986.*

4. *Samuel, Graeme J, 'Regulation and the Vesting of Discretions in the NCSC', Macquarie Bank, Melbourne, 1986.*

2.16 These views run counter to those of Justice Plowman in Parke v Daily News Ltd.<sup>5</sup> In that case, directors of a company about to be wound up decided to pay compensation and other benefits to employees about to lose their jobs. The court held that according to law the directors were unable to do so.<sup>6</sup> Their primary duty was to the shareholders.

2.17 Mr Kennan has argued that the law should require directors to take into account interests which include 'at the very least' those of the company's employees and creditors. He has said consideration should be given to the extent to which directors should also be required to look to the interests of consumers of the company's products and services and to take into account the environmental impact of decisions, and to how those interests are to be balanced.<sup>7</sup>

2.18 Legislation already imposes on companies duties to look to the welfare of workers,<sup>8</sup> of consumers,<sup>9</sup> of competitors,<sup>10</sup> of the environment.<sup>11</sup> Should these duties be widened? Should they be imposed specifically on individual directors? In this inquiry, it has been the concern of the Committee to look more closely at these questions.

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5. [1962] 1 Ch 927.

6. *Ibid* at 962-3.

7. 'Comments on "Directors' Wider Responsibilities - Problems Conceptual, Practical and Procedural"', speech given at AULSA conference, Monash University, 25 August 1987.

8. *Eg Industrial Relations Act 1988 (Cth); Workers Compensation Act 1987 (NSW); Workplace Health and Safety Act 1989 (Qld); Occupational Health, Safety and Welfare Act 1984 (WA); Workers Rehabilitation and Compensation Act 1986 (SA); Occupational Health and Safety Act 1985 (Vic); Accident Compensation Act 1985 (Vic).*

9. *Eg Trade Practices Act 1974 (Cth), Part V, Consumer Protection; Consumer Affairs Act 1970 (Qld); Fair Trading Act 1987 (NSW); Consumer Affairs Act 1972 (Vic); Consumer Protection Act 1978 (NT).*

10. *Eg Trade Practices Act 1974 (Cth), Part IV, Restrictive Trade Practices.*

11. *Eg Noise Control Act 1975 (NSW); Control of Waters Act 1938 (NT); Environment Protection Act 1970 (Vic); Environment Protection Act 1973 (Tas); Clean Air Act 1984 (SA).*

### Multiple duties - much conflict?

2.19 To be successful, enterprises need as a rule to take into account their employees, their customers and the community, as well as their shareholders. Evidence before the Committee emphasised this: it was pointed out that, as a matter of reality, directors already take into account the various interests their decisions might affect.<sup>12</sup> It was urged upon the Committee by some that the imposition of wider duties was therefore unwarranted.<sup>13</sup>

2.20 To require directors to take into account the interests of a company's employees, its creditors, its customers, or the environment, as well as its shareholders, would be to require them to balance out what would on occasions be conflicting forces. To make it optional for directors to take into account the interests of a company's employees, its creditors, its customers, or the environment, as well as its shareholders, again would mean that directors would be in the position of weighing up the various factors. It would also limit the enforceability of shareholders' rights if directors were able to argue that, in making a certain decision, they had been exercising their option to prefer other interests.

2.21 If contemporary public policy requires either of these approaches, then a re-think of some of the fundamentals of company law would be required.

### Is there need for more regulation?

2.22 The corporate structure is central to the nation's economic activity. Australia looks to companies for the

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12. *Eg Dr Pascoe (Evidence, p 504); Mr Bosch (Evidence, p 574).*

13. *Eg submissions from Company Directors' Association of Australia, p 8 (Evidence, p 87); Business Council of Australia, pp 22-7 (Evidence, pp 468-73).*

innovation, enterprise and productivity needed to increase its wealth. At the same time, it expects due regard to be given to the values the community places on other matters such as the rights of consumers, workers and the environment. Regulation of directors and companies (and other forms and aspects of business) must aim to secure adherence to what the community considers are reasonable standards in business practice.

2.23 The growth of public companies has placed their control in the hands of directors and managers as distinct from their shareholders. The ability, industry, honesty and sense of fairness of those directors and managers determine the welfare of shareholders and affect many aspects of community life.

2.24 Most directors, and other company officers, properly carry out their functions, not necessarily because of their legal obligations but for reasons such as their sense of responsibility, career and economic incentives, pride and professionalism. In this context, legal standards, not necessarily within the parameters of the Companies Code or the new Corporations Act, are necessary as a fall back. They provide a standard by which the public's legitimate interest in accountability may be achieved.

#### **What sort of regulation?**

2.25 Doctors, lawyers, pharmacists and others belong to honourable professions. All are expected to act according to codes of ethics. Ethics are morality tempered with experience. Peers best know what is reasonable to expect from practitioners and strong peer pressure is a powerful force for proper conduct. It is to be hoped that a code of ethics and strong peer pressure will come to guide the conduct of company directors. A corporate culture which promotes one is vital. Self regulation, if it works, in many respects is better than regulation imposed by law.

2.26 During corporate history there have been directors whose actions have drawn community response. It has been necessary to develop laws protecting shareholders, controlling fund raising, requiring the giving of information, disqualifying categories of people from being directors and prescribing the holding of meetings. A great body of corporate law has evolved to meet the failure of company directors and managers to exhibit competence, industry, wisdom and honesty.

2.27 Mr Kennan has said that, given the history of case law in the area, the regulation of companies should not be left to the courts. He has argued for more legislative activity.

2.28 Case law dealing with companies has so far been concerned predominantly with property rights. This does not preclude it from moving into other areas such as the protection of consumer or employee rights or the environment where appropriate. Some steps in this direction have already been taken in relation to creditors but, to date, regulation in those areas has largely come by way of legislation. It is probable that it will continue to do so. The extent to which this occurs will depend on the policy of the legislator.

#### **What is the standard of directors' duties?**

2.29 Because the corporate sector has a profound effect on how we live, the individuals who run the corporate sector have a responsibility to the community which sustains them. At a time of increasing deregulation, Australian business enterprises, many of them corporations, are freer than ever before. In these circumstances, the community might legitimately require even higher standards than in the past.

2.30 Doctors, lawyers, engineers, plumbers, electricians, train drivers and others are required by law to carry out their



work with reasonable care and skill. So are directors. Section 229 of the Companies Code (Corporations Act, s232), and the general law, require them to use due care, skill and diligence. What is required of a director to meet the appropriate standards, however, will depend on the circumstances of each case. Can a more objective standard be devised?

2.31 A director of a small private company might satisfy the requirements of the law by keeping accounts of a kind which, if kept by directors of a large public company, would be insufficient to meet the appropriate standard. It may well be that directors of public companies who hold themselves out as worthy of being trusted with other people's investments are obliged to possess judgment, skills and moral qualities not required in those of private companies. On the other hand, directors of all companies should ensure the workplaces in which they operate are safe and that the products they sell are not dangerous.

2.32 A large public company is likely to have a greater impact on society than a small private one. A corporation employing thousands of people and carrying out massive mining operations is a much more powerful force in the community than one with two or three employees engaged in gardening. Directors of the former can be expected to have processes of supervision and control set up within their company of a kind not required of directors of the latter.

2.33 This kind of distinction is not new. In 1925 Judge Romer said:

The position of a director of a company carrying on a small retail business is very different from that of a director of a railway company. The duties of a bank director may differ widely from those of an insurance director, and the duties of a director of one insurance company may differ from those of a director of another. In one company, for

instance, matters may normally be attended to by the manager or other members of the staff that in another company are attended to by the directors themselves. The larger the business carried on by the company the more numerous, and the more important, the matters that must of necessity be left to the managers, the accountants and the rest of the staff.<sup>14</sup>

### Close corporations

2.34 The Close Corporations Act 1989 will reduce the need to draw such a distinction in relation to many aspects of company directors' duties and responsibilities in the future. Many of what are now small proprietary companies will in future incorporate under that legislation.

2.35 A close corporation has no directors - all members may participate in the management of its affairs<sup>15</sup> and will, in reality, be like partners in the corporate enterprise. Nevertheless, many of the provisions of the (new) Corporations Act will apply, including the prohibitions which apply to directors.<sup>16</sup> Members of a close corporation will be relieved of various obligations that apply under companies legislation at the expense of limited liability in the event of non-compliance.

### Sanctions

2.36 Any regulatory system involves sanctions. Self regulation means wrong doing will be met with peer pressure, for example, through public censure. Regulation by law can be enforced by civil or criminal penalties or both.

2.37 Where people suffer loss through a director's breach of duty they should be able to recover compensation from him or her.

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14. Re City Equitable Fire Insurance Co Ltd [1925] 1 Ch 407 at 426-7.

15. Close Corporations Act 1989, s72.

16. Ibid, s63(3).

The cost of litigation should not be a barrier. Enforcement action initiated by regulatory agencies should target individual directors or corporate bodies on a principled basis rather than on the ad hoc basis that currently appears to prevail. If the breach is criminal in nature, criminal penalties should follow. But it is draconian to apply such penalties in the absence of criminality. This appears to be the case with section 229 of the Companies Code (Corporations Act, s232).

### **Summary**

2.38 Corporate culture is changing. This is in response to a number of forces.

2.39 The more productive the corporate sector, the more secure the economic well-being of Australia. Directors are crucial to its success. To restrict unnecessarily the operation of their skills, their industry, their enterprise, is to threaten unnecessarily a factor vital to economic growth. Any regulation of directors' activities must be warranted and a sensible balance must be found between measures necessary to promote corporate activity in a way which will be of benefit to all, and measures necessary to protect the bona fide shareholder, worker, consumer, financier, and the public at large. Profitability is but one basis for good corporate citizenship.

2.40 The corporate sector possesses most of Australia's assets, employs most of its workers, and is the sector most capable of injuring the environment. Given this, it is of vital concern to the community and the community is entitled to impose appropriate restrictions on it.

2.41 Companies should be run so that the interests of their members are properly attended to. This is particularly so with public companies, the control and management of which are substantially separated from the ownership.

2.42 Company law, as distinct from the law applicable to companies, deals mainly with the intrinsic nature of companies. The Committee considers it should continue to do so. Where there is a need to govern the relationship between companies and things external to them, this is more appropriately done in separate legislation. Usually such legislation will be applicable not only to companies but to all bodies dealing with, or in a way that will affect, those other things. To illustrate, the environment will require protection not only from the corporate sector but from sole traders, partnerships and all individuals whose actions potentially affect it. The environment should be dealt with in legislation that protects it from whoever or whatever may be in a position to harm it.

2.43 An ethical code is the ideal guide for the activity of directors. Peers know best what can reasonably be expected of their fellows. The development of a corporate culture within which adherence to ethical conduct would grow is essential, but corporate history shows that ethics are not sufficient to ensure proper corporate conduct. The way in which company law has developed testifies to that.

2.44 Where directors fail to regulate themselves effectively, the courts and the legislature will be obliged to do so. It will then be up to the courts to interpret the legislation in accordance with the intent of the legislature.