Corporate social responsibility: The case for a self-regulatory model

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There has been a great deal of confusion about the ability of modern corporations to act according to public ethical and social concerns and their relationship to "the business of business". This article explores the theoretical underpinnings for the duties of directors and officers and the role of the corporation. By reference to that analysis, the authors suggest that, if the community expectation is for managers to have a wider role, then managers deserve to have some of the uncertainty removed through an internalised permissive model that recognises their ability to have regard to wider interests. Using self-regulation this article suggests a default replaceable rule that recognises the desire of managers to take the "long view" without undue fear of being sued ex post by dissident shareholders.

INTRODUCTION

Recent concerns about the proper role of large corporations in the community has led some to suggest that the legal duties of corporate managers need to be crafted so as to either permit or require corporate managers to consider interests wider than the financial benefit of shareholders. Despite these concerns, it is the authors' view that directors and officers[1] can and should consider the long- and short-term interests of the corporation without fear that they might be unduly increasing their liability by doing so.

Proposals to redefine the statutory duties of managers are, at best, an ineffective and inappropriate reaction to hyperbolic claims of corporate excess. Instead of requiring that the *Corporations Act 2001* (Cth) be revised to require directors to take into account the interests of the broader community, a better approach would be to include a default replaceable rule that gives officers some comfort if they prefer the long view over the short when determining what is in the best interests of the corporation.

A default replaceable rule giving officers and directors the freedom to consider matters such as the interests of employees, customers and suppliers and the community when determining whether a course of conduct was in the best interest of the corporation should provide managers with a safe harbour for those decisions without the possible unintended consequences of a legislated solution.

The article begins by examining the background to the current concerns of managers, including recent evidence of community expectations of a more socially responsible corporate sector. It proceeds to explore the background of the corporation and the relevance of theories of "the corporation". The review demonstrates the fundamental importance of wealth maximisation in the development of the corporation while recognising its capacity to accommodate a limitless variety of objectives. As modern commercial life evolves, and as increasing global wealth permits greater introspection, we are now seeing the results of the diverging views of the corporation as a form of social contract.

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[1] Collectively managers or management; for the purpose of this article the authors have not distinguished between officer, management and the board of directors.

Using the philosophical basis for incorporation, the discussion proceeds to examine the construction of the duties of managers not necessarily when they act altruistically but more importantly how they should consider the competing interests of long- and short-term shareholders.

Lastly, the article considers the utility of the wealth maximisation norm and the notion of shareholders' supremacy, recognising that managers may put a corporation's survival at risk if they solely pursue profits and fail to take into account the wider impact of their decisions. In particular, the article explores the utility of the business judgment rule for managers balancing the short- and long-term interests of shareholders and concludes that the answer to what is in the best interests of the corporation remains ambiguous.

The article concludes by suggesting that a default replaceable rule giving officers and directors the freedom to consider matters such as the interests of employees, customers and suppliers and the community is entirely consistent with the modern development of managers' duties. A replaceable rule would make it clear that a manager was able to take a long-term view and would protect managers that rely on their business judgment when considering actions that they believe to be in the long-term interests of the corporation. This provision would not be geared at driving behavioural change among managers; rather it would facilitate actions that many managers are already taking.

BACKGROUND

Community perceptions

The limited liability corporation is one of the greatest inventions of all time. Undoubtedly, the capacity of the limited liability corporation to facilitate large-scale enterprise has contributed greatly (some would say more than any other device) to the rapid improvement in the human condition (at least materially) in the last two centuries.

Despite the undoubted contribution of the limited liability corporation to human welfare, questions are now being raised about the extent to which the drive to expand and increase profits that characterises most corporations is appropriate. Increasingly, calls are being made to curtail the extent to which the drive to increase profits (for the benefit of shareholders) prevails in any debate about the proper basis for managerial decision-making. A common argument is that corporations ought to be prevailed upon to contribute more to the community.

A typical expression of this attitude was voiced in a recent film, *The Corporation*, which declared, following interviews

> with left-wing intellectuals, right-wing captains of industry, economists, psychologists and philosophers, … that the corporation is a psychopath. Like all psychopaths, the firm is singularly self-interested: its purpose is to create wealth for its shareholders. And, like all psychopaths, the firm is irresponsible, because it puts others at risk to satisfy its profit-maximising goal, harming employees and customers, and damaging the environment. The corporation manipulates everything. It is grandiose, always insisting that it is the best, or number one. It has no empathy, refuses to accept responsibility for its actions and feels no remorse. It relates to others only superficially, via make-believe versions of itself manufactured by public-relations consultants and marketing men. In short, if the metaphor of the firm as person is a valid one, then the corporation is clinically insane.[2]

Yet the limited liability corporation is an integral part of our society, a society that has begun to raise some challenging questions about its proper role. If the community expects more from our corporations, is there a need to find ways for corporate managers to abandon rules about the absolute supremacy of the interests of shareholders designed in the 1800s for then-emerging joint stock companies like the British East India Company?[3]

Giving the 2003 Alfred Deakin Lecture, the chair of the Australian Competition and Consumer

[2] "The Lunatic You Work For", *The Economist* (6 May 2004).

[3] The *Joint Stock Companies Act 1840* is the precursor of most modern corporate statutes, including the *Corporations Act 2001* (Cth). The statute brought together the ideas of incorporation and joint stock. See Ford HAJ, Austin RP and Ramsay IM, *Ford's Principles of Corporations Law* (2000) at [2.1.0050].

Commission, Graeme Samuel, commented:

> [T]here is a community expectation that business will act with a sensibility and responsiveness for its actions that impact on the community.
>
> Corporate social sensibility is a business imperative as well as an altruistic nicety. It is not so much about cheques as it is about attitudes, social involvement, and sensible, socially responsive business management.[4]

Is it time to re-examine the orthodox advice to boards of directors from their counsel across the country that their task is to maximise profits acting in the best interests of the corporation?[5] *The Australian Financial Review* has editorialised:

> Modern capitalism has many strengths but one big weakness. Some executives are so driven to achieve legitimate corporate goals, bigger profits, more shareholder value, a critical restructuring that they are able to justify any technically legal means of pursuing them. The risk is that management and board lose sight of a fundamental question: is this just? In the vast majority of cases their duty to the company and the law is not in conflict with any wider duty, and society as a whole benefits from the wealth created. In rare cases, what is legal and what is just are at such odds that strict legal justifications crumble before community outrage and the threat of legislative action.[6]

The sense of wider community concern about corporate behaviour has been reflected in substantial public sector activity. Indeed, the Parliamentary Secretary to the Commonwealth Treasurer, the Hon Chris Pearce MP, referred this issue to the Corporations and Markets Advisory Committee (CAMAC) for consideration and advice:

> The issue concerns the extent to which the duties of directors under the *Corporations Act 2001* (the *Corporations Act*) should include corporate social responsibilities or explicit obligations to take account of the interests of certain classes of stakeholders other than shareholders.

In particular, CAMAC was asked to consider and report on the following matters:

2. Should the *Corporations Act* be revised to require directors to take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions?
3. Should Australian companies be encouraged to adopt socially and environmentally responsible business practices and if so, how?
4. Should the *Corporations Act* require certain types of companies to report on the social and environmental impact of their activities?[7]

The reference to CAMAC produced a discussion paper in November 2005,[8] followed by a final report in December 2006.[9] The Parliamentary Joint Committee on Corporations and Financial

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[4] Graeme Samuel, Chairman, Australian Competition and Consumer Commission, 2003 Alfred Deakin Lecture, 23 October 2003, http://www.accc.gov.au/speeches/fs-speeches.htm viewed 15 November 2003.

[5] Senate Standing Committee on Legal and Constitutional Affairs, *Report on the Social and Fiduciary Duties and Obligations of Company Directors* (AGPS, 1989).

[6] "Hardie Needed to Draw the Line", *The Australian Financial Review* (22 September 2004) p 62. A fascinating side issue here is the notion of "justice" and how pervasive an issue this is. Evolutionary biologists have begun to expose the origins, purpose and biological underpinnings of morality. Elements of morality have been discovered in non-human species, particularly other primates. Some possess a sense of fairness, and many have certain codes of conduct that underlie their social interactions and almost certainly developed as adaptive strategies to help individuals cooperate and cope with conflict. See eg Jones D, "Exploring the Moral Maze", *New Scientist* (26 November 2005); and Douglas K, "Playing Fair", *New Scientist* (10 March 2001), http://www.newscientist.com/article/mg16922815.000-playing-fair.html viewed 30 November 2006: "In fact, mainstream economists are increasingly interested in adding human behaviour to their calculations. Where once the economic models assumed that we all act rationally to maximise our returns from any transaction, they are now beginning to reflect the complexity of the real world. 'The fact that a substantial fraction of people is motivated by concerns for fairness and reciprocity is very important for many areas of economics,' says Fehr. Gintis adds: 'It's not wrong to say that people are rational, but rather to think that it's rational to be a selfish, sociopathic brute!'"

[7] The letter of referral to CAMAC is available at http://www.camac.gov.au/CAMAC/camac.nsf/byHeadline/Whats+NewDirectors%27+duties+and+corporate+social+responsibility?openDocument viewed 14 April 2005.

[8] Corporations and Markets Advisory Committee, *Corporate Social Responsibility: Discussion Paper* (November 2005) (CAMAC Discussion Paper), http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/$file/CSR_DP.pdf viewed 28 November 2005.

[9] Corporations and Markets Advisory Committee, *Corporate Social Responsibility: Report* (December 2006) (CAMAC Report),

Services (PJC) released its report on corporate responsibility in June 2006.[10] The PJC had resolved:

> to inquire into Corporate Responsibility and Triple-Bottom-Line reporting for incorporated entities in Australia with particular reference to:
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> (a) The extent to which organisational decision-makers have an existing regard for the interests of stakeholders other than shareholders, and the broader community.
>
> (b) The extent to which organisational decision-makers should have regard for the interests of stakeholders other than shareholders, and the broader community.
>
> (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*, 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*.
>
> (e) Any alternative mechanisms, including voluntary measures that may enhance consideration of stakeholder interests by incorporated entities and/or their directors.
>
> (f) The appropriateness of reporting requirements associated with these issues.
>
> (g) Whether regulatory, legislative or other policy approaches in other countries could be adopted or adapted for Australia.[11]

Unlike CAMAC, the PJC chose to make express mention of both for-profit and not-for-profit incorporated entities under the *Corporations Act*.[12]

In part, the reference to CAMAC and the PJC inquiries were responses to the report of the Special Commission of Inquiry into the circumstance surrounding James Hardie's corporate reconstruction.[13] Interestingly, in March 2005, James Hardie's chair, Meredith Hellicar, called for

> a safe harbour for directors to be able to integrate corporate social responsibility into their decision making without fear that they are going to be sued both personally, and as a company, by their shareholders.[14]

In part this article is designed to analyse the extent to which the concerns of this senior manager are borne out by the law and the philosophy underpinning the corporation in its modern form. The basic goal for managers should be the success of the corporation for the benefit of its members as a whole. To reach this goal, managers believe that they should be able to "take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and suppliers, and in the community more widely"[15] and be immune from liability if they can establish they have done so rationally.

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http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2006/$file/CSR_Report.pdf viewed 15 December 2006.

[10] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Responsibility: Managing Risk and Creating Value* (June 2006) (PJC Report), http://www.aph.gov.au/senate/committee/corporations_ctte/corporate_responsibility/report/index.htm viewed 15 July 2006.

[11] PJC Report, n 10, p ii.

[12] Given that the focus of much criticism of perceived corporate excess can be characterised as, for want of a better expression, a lack of sufficient benevolence, it is curious that CAMAC did not at least acknowledge the direct role that corporations (in the form of entities incorporated on a not-for-profit basis) play in the philanthropic sector. The PJC, while at least acknowledging the existence of such entities in its terms of reference, then proceeds effectively to ignore them entirely in the critical text of its report. The authors are presently working on research related to reform of the not-for-profit sector.

[13] See DF Jackson QC, *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* (September 2004), http://www.cabinet.nsw.gov.au/hardie/PartA.pdf viewed 30 November 2005; and also Ramsay I, "Pushing the Limit for Directors", *The Australian Financial Review* (5 April 2005) p 63.

[14] Phesant B, "Directors Need a Safe Harbour: Hellicar", *The Australian Financial Review* (17 March 2005) p 3.

[15] United Kingdom White Paper, *Modernising Company Law* (2003), UK Department of Trade and Industry, http://www.dti.gov.uk/cld/WhitePaper.htm viewed 12 December 2003.

If managers think that it is in the best interests of the corporation to do so, could they "separate" a troublesome subsidiary as a way to better manage liability? That being so, "it is hard to see why it would not have been in the interests of (the parent corporation) to provide the funding which was necessary to enable that to be done effectively".[16]

Indeed, in his final report, Commissioner Jackson commented:

> The circumstances have raised … the question whether existing laws concerning the operation of limited liability or the "corporate veil" within corporate groups adequately reflect contemporary public expectations and standards.[17]

With respect, that opinion is given with the benefit of hindsight and there is real concern among managers about the extent to which they can consider the "long view" at the expense of the here and now.

It is suggested that there is some advantage in providing a moderate level of protection for those who want to take the long view, managers who divert for some time from the pure "wealth maximisation norm".[18] This position is adopted despite broad agreement with the views of those who believe the existing duties of managers, especially the overriding duty of managers to act in the best interests of the company, already accommodate consideration of wider interests if the decision is justifiable as being in the company's best interests.[19]

Like the calls for the introduction of the business judgment rule in 1998, managers are concerned and "worry … hindsight coming back to bite … if the decision turns out to be not quite as successful".[20] Indeed, some managers and their advisers are concerned that the circumstances that existed when it was in the interests of the corporation as a whole are often less than clear:

> I have noticed at a number of AGMs that some shareholders protest strongly against political or even significant charitable donations. The Directors may have not only acted in what they regarded in good faith, in the best interests of the corporation and for what they regarded as a proper purpose, but different minds have different views on these subjects.
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> I am not at all confident that the extent to which directors and officers may take into account stakeholder interests other than of shareholders is usefully clear.[21]

[16] Jackson, n 13 at [1.23].

[17] Sexton E, "Reviews Galore in Wake of Hardie Saga", *The Age* (6 July 2005), http://www.theage.com.au/text/articles/2005/07/05/1120329443367.html viewed 6 July 2006, citing Jackson, n 13 at [30.67]. It is interesting that the issue of corporate groups is quite difficult and creates its own complexities, complexities that have created a lot of problems. Indeed, the Hardie issue itself can be characterised as more a problem about the regulation of corporate groups than the corporate social responsibility of companies. CAMAC has considered some of the issues surrounding the imposition of responsibility for tortious liability of any group company: see CAMAC, *Corporate Groups* (May 2000), http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/$file/Corporate_Groups,_May_2000.pdf viewed 30 November 2005.

[18] Sometimes referred to as the shareholder primacy norm, this is the theory that the overriding duty of managers is to enhance the wealth of shareholders. In *Dodge v Ford Motor Co* 170 NW 668 at 684 (1919) the Michigan Supreme Court said: "A business corporation is organized and carried on primarily for the profit of the [shareholders]. The powers of the directors are to be employed for that end. The discretion of the directors is to be exercised in the choice of a means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits amongst [shareholders] in order to devote them to other purposes." Cited in CAMAC Discussion Paper, n 8, p 4.

[19] McConvill J, "Directors' Duties to Stakeholders: A Reform Proposal Based on Three False Assumptions" (2005) 18 *Australian Journal of Corporate Law* 88; see also Ramsay, n 13, p 63. This is also the view of the PJC, who refer to it as "enlightened self-interest". See PJC Report, n 10, p 63.

[20] Baxt R, "Company Law Reform by No Half Measures! The CLERP Program Really Takes Off"" (1988) 26 ABLR 217 at 218.

[21] Beerworth B, "Directors' Duties and Corporate Social Responsibility", paper presented at "Directors' Duties and Corporate Social Responsibility – The New Environment" seminar co-hosted by the Centre for Corporate Law and Securities Regulation (University of Melbourne) and the Corporations and Markets Advisory Committee, 27 July 2005, http://www.henrythornton.com/article.asp?article_id=3491 viewed 17 November 2005.

The increased calls for some form of corporate social responsibility cannot be ignored; these are the "cultural norms" that shape the way corporations are allowed to operate. Increasingly, these same norms have also affected judicial attitudes to the role of managers.[22]

However, recent research suggests that the belief that corporate social responsibility favourably drives community views of a corporation may be wrong.[23]

The surveys seem to show that "corporate citizenship", in whatever form, is less important in driving opinions than more traditional issues, such as an open and transparent operation, making profits for owners and shareholders and management/leadership strength. Shareholders do not seem to rate highly support for things like sponsoring events of community interest or being a good corporate citizen whatever benefits may devolve to the community. Yet when Australian companies donate millions of shareholder dollars to supporting tsunami appeals, the protest is at best muted. Generally there is a feeling that:

> After all can anybody put a value on the impact on a corporate's image (carefully nurtured these days) from being seen to be tight-fisted or stingy?[24]

The anecdotal evidence suggests that the community has a higher expectation of our managers than a simple responsibility for wealth accretion. As with matters of governance more generally, the community seems to expect mangers to focus on the "vibe" of the law as well as the letter.

Community attitudes demonstrate blended and at times inconsistent views: managers must remain focused on maximising the wealth of their shareholders; however, the obligation to maximise profits

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[22] Austin J in *ASIC v Rich* (2003) 44 ACSR 341 where Austin J decided to apply a standard of care that reflected contemporary community expectations of chairs of public companies and similar comments in *ASIC v Vines* (2005) 55 ACSR 617; [2005] NSWSC 738 concerning the role of the chief financial officer. For a tangible demonstration of these norms in Canadian society see Canadian Democracy and Corporate Accountability Commission, *The New Balance Sheet: Corporate Profits and Responsibilities in the 21st Century* (2002), http://www.corporate-accountability.caa viewed 17 November 2005. This study found that a significant number of Canadians, and a significant percentage of Canadian shareholders, want business executives of corporations "to take into account the impact their decisions have on employees, local communities and the country as well as making profit".

[23] Edelman Asia Pacific. The survey, conducted across eight different countries including Australia, with a variety of groups (government officials, senior business executives, NGOs/trade associations, upscale consumers and media), revealed that the top five drivers of perceptions of a corporation are management/leadership strength; brand/product quality; profitability; reputation/lack of scandal; and active promotion/advertising. Consistent with these studies, from time to time organisations such as the Australian Shareholders Association have been critical of companies that are philanthropic with shareholders' funds. For the contrary view of popular opinion, some consider that companies in Australia must be more generous and not less generous in their interaction with the wider community: see Hon Joe Hockey MP, Minister for Financial Services and Regulation, "Corporate Governance: An Extended Community Partnership", *Butterworths Corporation Law Bulletin*, No 19 (7 September 2001), adapted from a speech presented to the Australian Shareholders Association on 16 August 2001; and Lumsden A, "Soft Hearts or Soft Heads: The Case for a New View of the Altruistic Corporation", *Butterworths Corporation Law Bulletin* (December 2003).

[24] BoredWalk D and Bowyer G, "Two Takes on Australian Corporate Donations", http://www.crikey.com.au/articles/2005/01/05-0003.html viewed 17 December 2003. The more general question of the extent to which directors can and should be involved in corporate donations of this type is examined in Klein E and Du Plessis J, "Corporate Donations, the Best Interest of the Company and the Proper Purpose Doctrine" (2005) 28 UNSWLJ 69, where the authors conclude: "From a practical point of view, directors who are sympathetic to the concept of corporate philanthropy can be encouraged that there is plenty of scope for making donations to worthy causes. There are however two important provisos. First, corporate donations must be made as part of a business strategy, the primary motivation being to advance the interests of the corporation. This may be unfashionable but it is a legal requirement. Secondly, donations must be made in a transparent, accountable way. This is not required by law but it is an expectation which directors ignore at their own peril" (cited in CAMAC Discussion Paper, n 8, p 54). This question also emerged and was considered in the *Royal Commission Report on the Failure of HIH Insurance* (April 2003). There the Royal Commissioner, Justice Neville Owen, concluded that HIH's procedures with respect to donations constituted a significant departure from appropriate corporate governance practice. He observed: "The board and management of a company have a good deal of discretion as to how they use the company's funds so long as they act reasonably in the interests of the company. Beyond normal business expenditure, companies not uncommonly make donations to charitable or philanthropic causes or other discretionary contributions including to political parties. While there is nothing inherently wrong with any of this, it is an area where a board's stewardship responsibilities call for deliberation on how a payment will serve the company's interests and appropriate accountability to shareholders on whose behalf that discretion has been exercised." Owen J also said: "[H]owever laudable the object of a donation, discretionary payments of this kind from the funds of shareholders should be undertaken in a transparent and justifiable way with full regard to the interests of shareholders" (cited in CAMAC Discussion Paper, n 8, p 16).

does not replace ethics of honesty and competence or of compliance with the thrust of laws regulating our community even if this means the managers do not achieve short-term wealth accumulation objectives.

As in all aspects of life, people have an innate sense of what is fair and expect that a corporation will "play fair". In this sense, it is not surprising that the popular press rails against the psychopath corporation because it is not rational to expect them to support a selfish psychopath.[25]

That governments have the ability to impose legal obligations on managers is beyond question. The central issue here is whether it is appropriate to use the general corporate law obligations of managers as a device to achieve wider regulatory goals. The community allows the corporation to exist and government will react to community expectations, but simply to introduce provisions such as those suggested in the *Companies Bill 2006* (UK)[26] could be counterproductive.

Defining the problem

It is curious that much of the recent literature in this area, including both the PJC Report and the CAMAC Report, does little to attempt to define an actual problem. The standard approach commences with observations (often anecdotal, but sometimes supported by results of polls – like the Canadian study discussed above) evidencing a growing concern with matters beyond the bottom line. The analysis then proceeds to offer a variety of interpretations of "responsible" corporate behaviour or "corporate social responsibility".[27] What then follows is consideration of a variety of means by which corporate behaviour might be modified, including, but not necessarily restricted to, the law of directors' duties.[28]

Those who either support current "responsible" behaviour or advocate change in the law to promote it implicitly assert that the self-interested behaviour of corporations (ie the drive for greater profits) is at the core of the problem. Were corporations, or more aptly, their managers, compelled or motivated to have regard to a wider range of considerations, beyond the financial benefit of shareholders, the world would be a better place.

If we operate from the premise that profit-seeking corporate behaviour presents a problem (and we are not for any moment prepared to concede that point), then rational analysis suggests that we explore alternative solutions.

Is the behaviour we observe attributable to the nature of the corporate person?

Individuals are also engaged in the pursuit of self-interest but are not subject to any general legal obligation to "act in the interests of society". Why is the corporate person so different to the natural person that we need to develop particular means of regulating it, such as imposing an enforceable internal moral code of sorts? To some extent, our legal system already accommodates the corporate person in ways that include:

- criminalising corporate conduct itself;[29]

[25] "Playing Fair", *New Scientist* (10 March 2001), http://www.newscientist.com/article/mg16922815.000-playing-fair.html viewed 15 March 2006.

[26] The Bill discussed at http://www.dti.gov.uk/bbf/co-law-reform-bill/clr-review/page22794.html viewed 12 December 2006 was derived from the United Kingdom White Paper, n 15.

[27] The PJC Report, n 10, p 7, refers to the concepts of "sustainable responsible investment" and "socially responsible investment".

[28] See eg PJC Report, n 10, pp 3-6 and 43-63; CAMAC Discussion Paper, n 8, pp 1-27, 47-75; and the CAMAC Report, n 9, pp 81-95. Alternatively, there are accounts of the law presenting the view that the current state of the law supports profit-sacrificing social responsibility: see in this regard Parkinson JE, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford University Press, Oxford, 1993) pp 261-346. Parkinson's argument flows from his conclusion that "the shareholders' right to have the company managed in their interests [can] not be justified in terms of antecedent moral rights, but [is] justifiable only to the extent that that arrangement [is] conducive to the public good" (p 334).

[29] The most obvious examples are the *Trade Practices Act 1974* (Cth), Pt IV; and the *Protection of the Environment Operations Act 1997* (NSW), in particular Ch 5.

- creating and applying concepts of vicarious liability at both common law and under statute;[30]
- developing wider tests of culpability to suit corporate defendants;[31]
- criminalising conduct of corporate managers directly;[32] and
- rendering managers civilly liable for corporate failures.[33]

The reformist proposition is that obligations to those traditionally defined as "outsiders" in the corporate context should be internalised. In its most potent form, this suggests that the law impose a positive obligation to consider these "stakeholder" interests.[34] A weaker form is permissive, entitling, but not obliging, managers to consider various stakeholders.[35]

The authors' thesis is that neither of these methods is either justifiable or effective, even if one presumes the objective of the regulation to be defensible. Interference with the self-interest motive damages the fabric of an institution designed to effect the collective will of its owner/founders. In more practical terms, managers face enough dilemmas attempting to reconcile long- and short-term interests (and the law obliges managers to consider the interests of future members as well as the future interests of current members[36]) or the interests of shareholders with creditors,[37] without internalising the interests of myriad other stakeholders. There is a further practical question of how to enforce such a wide obligation. Which agency or agencies should be able to prosecute breaches, or should stakeholders, like shareholders, be given the ability to enforce such obligations by means of legal action?[38]

Direct legal interference with the discretions of corporate managers has historically been limited.[39] In the modern era this is typified, in Australia, by statutory codification of a "business judgment rule".[40] Interestingly enough, in one of the landmark American cases cited for the

[30] The law in this area is well summarised in Austin RP and Ramsay IM, *Ford's Principles of Corporations Law* (12th ed, 2005) pp 810-827.

[31] See eg *Criminal Code Act 1995* (Cth), s 12.3(2)(c). See also Hill J, "Corporate Criminal Liability: An Evolving Corporate Governance Technique" in Low Chee Keong, *Corporate Governance: An Asia-Pacific Critique* (Sweet & Maxwell Asia, Hong Kong, 2003) pp 519-565.

[32] See eg *Protection of the Environment Operations Act 1997* (NSW), s 119; *Environment Protection and Biodiversity Conservation Act 1999* (Cth), Div 19, ss 493, 494; *Civil Aviation Act 1988* (Cth), s 28BE.

[33] The *Corporations Act 2001* (Cth) already contains a number of powerful provisions to this effect. See particularly ss 588G and 596AC. Individual or intercorporate liability may follow from being found to have been "involved in" a contravention of the Act: s 79.

[34] On one interpretation this is what s 172 of the *Companies Bill 2006* (UK) attempts to do. It reads: "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to – …" There follows a list of various stakeholders, including employees, suppliers, customers and "others", as well as the community and the environment.

[35] See eg the American Law Institute, *Principles of Corporate Governance*, model cl 2.01(b)(3), examined in the CAMAC Discussion Paper, n 8. This provision reads: "Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes."

[36] See *Darvall v North Sydney Brick & Tile Co Ltd* (1987) 16 NSWLR 212; *Provident International Corp v International Leasing Corp Ltd* [1969] 1 NSWR 424 at 440.

[37] Directors are obliged to consider the interests of creditors as cash flows decline: see *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722.

[38] While s 1324 of the *Corporations Act* already empowers those "whose interests have been, are or would be affected" to seek relief, the courts have indicated that to have standing under s 1324, the applicant must have an interest more than merely as an ordinary member of the public: see *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 73 FCR 161; 23 ACSR 715.

[39] In *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493, the High Court put the position as follows: "Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts." Discussed in *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 260; 15 ACLR 230.

[40] *Corporations Act 2001* (Cth), s 180(2).

proposition that managers must prefer the profit-centred interests of shareholders to others, the court ultimately declined to compel directors to alter their more inclusive business plan.[41]

Is it appropriate or effective for the law to prescribe a general course of conduct by managers and, if so, in what circumstances?

It is trite to observe that corporate managers are already exposed to a significant amount of both internal and external regulation. The issue is the internal regulation of managers, laws designed to affect the decision-making per se rather than in attributing responsibility for the results of those decisions.[42] Traditionally, the law, by imposing fiduciary and statutory duties, has responded to risks of self-interested or substandard behaviour by managers. The constituency traditionally regarded as in need of corporate law protection has historically been the company's members, or shareholders. Thus, managers must act in the best interests of the corporation, which has been interpreted to mean the shareholders as a body.[43]

Of course, in the corporate context, the notion of self-interest itself is where the debate internalises. The traditional equation of corporate self-interest concentrated on those contributing pure capital, the shareholder owners. The reason for this was simply that of agency. In recent years, recognition of a wider class of so-called "stakeholders" has led to increasing judicial and legislative imposition of internal management controls such as:

- statutory increases to the strength and scope of fiduciary law;[44]
- judicial recognition of creditors' interests;[45] and
- widening rules for standing in cases of breaches of the *Corporations Act*.[46]

The problem summarised

Ultimately, a considered response to political and community pressure to manage perceptions of corporate behaviour must acknowledge the very real and convincing arguments in favour of

[41] See *Dodge v Ford Motor Co* 170 NW 668 (1919). The case contains the classic formulation of the shareholder wealth maximisation norm historically favoured as the principal duty of directors: "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes" (at 684). Bainbridge observes that the ratio of the case is ultimately not one establishing liability for directors who depart from a profit norm in order to consider "social consequences of corporate actions". As he put it: "Invoking the business judgment rule … the Dodge court declined to interfere with Ford's plans … and dismissed the bulk of plaintiff's complaint." See Bainbridge S, "Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency", UCLA School of Law, Law & Economics Research Paper Series, Research Paper No 05-26, p 7, http://ssrn.com/abstract=832504 viewed 12 December 2006.

[42] The question of responsibility for corporate decisions is itself a complex one. The authors note that our law already exposes shareholders to liability beyond their contribution to capital in cases where a corporation is acting as agent of its shareholders. In addition, numerous statutes (see above) impose personal liability on managers for corporate fault. Beyond this, some have argued that good corporate responsibility demands removal or reduction of the benefit of limited liability in cases of corporate torts. See Parkinson, n 28, p 362. See also Hansmann H and Kraakman R, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) Yale LJ 1879.

[43] *Darvall v North Sydney Brick & Tile Co Ltd (No 3)* (1987) 12 ACLR 537 at 553; *ASIC v Adler* (2002) 168 FLR 253; 41 ACSR 72 at [738]-[740], ie a court will find against a board on the basis of a breach of the duty of care if they enter into a transaction that has no prospect of producing a benefit to the corporation. There is also a considerable body of literature dealing with the question of shareholder primacy. The economic arguments in support of this proposition are best advanced in Easterbrook F and Fischel R, *The Economic Structure of Corporate Law* (Harvard, 1991). See also Bainbridge S, "In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green" (1993) 50 Wash & Lee L Rev 1423, http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID303780_code020320630.pdf?abstractid=303780 viewed 30 November 2005. Some would argue that in providing remedies of self-help for members of companies, thereby relieving regulators to some extent of the onus of enforcing key legislative provisions, Parliament is indirectly endorsing the shareholder primacy norm.

[44] This is plainly visible in the extension of statutory duties akin to fiduciary duties to employees (ss 182 and 183) as well as the designation of key directors' duties provisions as "civil penalty provisions" (s 1317E), thereby adding the prospect of administrative enforcement to the range of possible consequences of breach.

[45] See *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722.

[46] *Corporations Act 2001* (Cth), s 1324.

shareholder primacy over all other "primacies" since it is only shareholder primacy that provides the kind of rigorous formulations that managers need when the corporate social responsibility argument moves from the obvious to the difficult.

THEORIES OF INCORPORATION AND THE PROPER ROLE OF CORPORATE LAW

The corporate concept has a long history. Initially, the concept of the incorporeal corporate person served as a means to separate an office from the person of the officeholder.[47] Thus medieval guilds and civic boroughs were recognised as corporate "persons" so as to ensure their continuance despite constant changes to their membership.

It was the concept of perpetual succession that was of more interest to those seeking incorporation in early days.[48] By the closing decade of the 19th century, the benefit of limited liability (made generally available to registered companies in the *Companies Act 1862*) was of far more importance. This is vividly demonstrated by the celebrated case of *Salomon v Salomon & Co Ltd* [1897] AC 22. Undoubtedly it is the advantage of limited liability that motivates most who choose the corporate form of organisation today; and it is the state-conferred advantage of limited liability that, in minds of many, justifies the imposition of an obligation to act in the interests of the wider community.

As appealing as this argument may appear, it is based on a flawed understanding of the nature of the corporate person, as well as a failure to appreciate the factors that led to the growth of the modern business corporation.

It is commonly observed that the emergence of the corporation as a useful form of association for trading ventures commenced with the rise of companies incorporated by Royal Charter. This important development provides a useful illustration of the relationship between private "corporate" activity and the public interest. Put simply, it was essential for the Crown to access private capital for the purpose of exploiting newly-discovered overseas territories. The subsequent development of joint stock companies provides further illustration of the practice of offsetting risk by means of inviting investor/participants.

The development of general incorporation legislation in the middle of the 19th century is consistent with the thesis that it is in the public interest to make provision for private capital raising. Prior to the *Joint Stock Companies Act 1844*, those seeking the benefits of trading as an incorporated entity required legislation or Royal Charter. The link between public or state interest and the benefit of incorporation is clear in such a case. Though the passage of general incorporation legislation can be seen as the final step in the process of legitimising the growth of private associations (by this stage in the form of deed of settlement companies), it can also be seen as recognition that, by their very existence, these private associations play an important role in the development of a modern, integrated and complex economy.

The initial general incorporation legislation required the incorporators to state, in the corporation's memorandum of association, the objects for which the corporation was formed. The legislation did not prescribe objects, leaving it to the incorporators to determine this matter for themselves. Thus, the corporation can be described as simply a means provided by the state to facilitate the formation of private associations – partnerships being creatures of equity limited in their usefulness for larger groups of individuals. The initial requirement that there be a minimum of 25 members suggests that, at least in the initial phase, the benefit of incorporation was intended only for larger associations.[49]

This requirement for objects was designed to protect the interests of investors, both shareholders and creditors, by ensuring that the corporation could not use the capital provided for purposes that

[47] See Stoljar SJ, *Groups and Entities: An Inquiry into Corporate Theory* (ANU Press, Canberra, 1973) pp 36-37.

[48] Though Stoljar, n 47, points out that perpetual succession was practically the case even in the absence of formal incorporation. Note the *Joint Stock Companies Act 1844* did not even provide for limited liability.

[49] Of course, this was drastically changed as a result of the *Salomon* decision, by which time the statutory minimum had been reduced to seven. It is frequently the case that observers fail to recognise the significance of the *Salomon* decision in terms of its legitimisation of the practice of, through nominee shareholders, incorporating what were essentially sole proprietorships.

were not authorised. Thus, even at a time when corporations were required to adopt some objective (that consequently limited the corporation's capacity to act), the state declined to impose any limitation on the range of objectives possible.

Of course, it is fair to assume that, for the most part, private associations were formed with the object of gain for contributories. The modern company limited by shares is the natural successor to the early Royal Charter companies as well as the joint stock companies that followed (both informally, in the form of deed of settlement companies and in the form of companies established under early British legislation). Later developments include the development of corporate variants more suitable for the "not for profit" society, such as the company limited by guarantee and the incorporated association.

Indeed, the provision of corporate forms entirely suited to the non-profit vehicle serves to emphasise the fact that one ought to be able to presume that, above all else, the common objective of those participating in the company limited by shares is, as with a partnership, the pursuit of a common profit.

This much is uncontroversial. Equally uncontroversial, at least until relatively recently, is the notion that it is for those managing the affairs of the company to determine what is in the best interests of the company itself (or the "body of corporators", as this was often expressed).

Today, our world is populated by companies of a size larger than many sovereign states. Some corporations have grown to a scale unimaginable to their 19th century progenitors. These transnational corporations are said to be beyond the reach of the law of any one state. Many advance this alone as justification for, in effect, imposing moral or community-based obligations on corporations. One is tempted to observe that, given the size and reach of many of the larger public companies, imposing such an obligation amounts, in effect, to "outsourcing government" to a limited extent![50]

Interestingly enough, the corporation still serves an important function in supplementing the role of the state. Large projects still continue to be funded by the state through tax revenue. However, increasingly there are restrictions on the ability of the state to accept some of the risks associated with these types of projects and the corporate form has been effectively used to finance the construction of major social infrastructure either to the private sector exclusively, or in partnership with the state to accomplish what are essentially social objectives (such as constructing schools, operating military facilities (including in-air aircraft refuelling), operating and constructing cross-city tunnels and operating and constructing railways).

Corporate law theory

There is, of course, an important distinction between the model of statutory regulation prevalent in North America and that in use in many other former English colonies (such as the various States of Australia).

In the North American model, legislation directs the manner in which corporations are managed.[51] This is not the case in Australia, where fundamental aspects of the management of the corporation are left to be determined in the corporate constitution. This distinction, among other things, characterises Australian corporations as being based fundamentally on the notion of a contract between the

[50] Macey J, "An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties" (1991) 21 *Stetson Law Review* 23; Bainbridge S, "Interpreting Nonshareholder Constituency Statutes" (1992) 19 *Pepperdine Law Review* 971, cited in CAMAC Discussion Paper, n 8, p 69.

[51] See *Canada Business Corporations Act* (Can), s 122, which contains a division of power identical to that in the *Corporations Law*, s 198A. Note, however, that the *Corporations Act* provision is a "replaceable rule".

corporators and the corporation itself.[52] This analysis is consistent with a view that corporations are no more than a "nexus of contracts" or convenient way to manage relationships between an otherwise diverse group of investors.[53]

At the other end of the spectrum is the view that a corporation represents a concession granted by the state (a matter that is essentially correct) and thus the corporation ought be viewed as a "social enterprise" subject to wider public obligations.[54] This may well explain the presence in some American States of a statutory obligation to consider the interests of stakeholders.[55]

While there is no doubt a level of abstraction involved in all theorising, this theoretical debate has profound implications for the nature of corporate regulation. In essence, the spectrum of theoretical opinion referred to above has, as its counterpart, a regulatory regime ranging from laissez-faire to central control and ownership. Those advocating a contractual view of the corporation are ordinarily associated with a political view that regulation of corporate decision-making ought be kept at a minimum.[56] Privilege theorists, on the other hand, are more apt to favour a more prescriptive corporate regulatory regime. A strong variant of privilege theory holds that corporate existence is the result of a social contract, implying conditions of corporate social responsibility.[57]

In terms of the debate about corporate social responsibility, one can effectively reduce the theoretical debate to the following propositions:

1. Either there is a current legal obligation to take "stakeholder interests" into account or there is not.
2. If there is no current legal obligation of that sort, then either:
   (a) the law permits managers to take "stakeholder interests" into account; or
   (b) the law prohibits taking into account any interests outside the interests of shareholders.

In the absence of a statutory obligation to consider the interests of non-shareholders, as a general rule, neither American nor Anglo-Australian law requires managers to account for the interests of non-shareholders.[58] Thus the first proposition can be eliminated, at least as representative of current law. There are those who argue that the *Corporations Act* ought to compel wider considerations than shareholder interests, and that such compulsion is entirely justified by a view that corporate life comes with certain conditions attached.

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[52] This is, in fact, formalised by s 140 of the *Corporations Act 2001* (Cth).

[53] There is a considerable body of literature on the subject of the contractual theory of the corporation. The following is but a small selection: Easterbrook FH and Fischel DR, "The Corporate Contract" (1989) 89 Columbia L Rev 1416; Jensen M and Meckling W, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 J of Fin Econ 305; Macey JR, "Corporate Law and Corporate Governance – A Contractual Perspective" (1993) 18 J of Corp L 185.

[54] A powerful argument in support of this proposition is found in Parkinson, n 28.

[55] These "constituency statutes" are discussed further below. For the present note that, starting in Pennsylvania in 1983, various States responded to a perceived tide of undesirable corporate takeovers by enacting legislation permitting directors to take into account interests other than those of the shareholders. Thus, any reference to this precedent as one worthy of following generally ought be subject to two important considerations: first, these statutes were a specific response to a perceived problem in the market for corporate control; and second, the imposition of such a statutory obligation would not sit well in a system that leaves essentially all aspects of internal governance (save the imposition of fiduciary duties to the corporation) to the corporators. The Anglo-Australian response to the corporate takeover problem is discussed further below. In essence, courts in Canada, Australia and, to some extent, England have developed approaches to directors' fiduciary duties that, to varying degrees, permit some latitude in responding to a hostile takeover bid. In any event, there is considerable evidence upon which to conclude that concession theory has lost significant force as a justifying rationale for corporate existence: see Bainbridge, n 43, particularly at fn 14.

[56] For a good review of principal theories of the corporation and their implications see Millon D, "Theories of the Corporation" [1990] Duke LJ 201.

[57] Lord Wedderburn, "The Social Responsibility of Companies" (1985) 15 MULR 4 at 9: "The crucial question for our company law is still what are the modern conditions on which private capital in a mixed economy can be allowed the privilege of incorporation with limited liability." See also Stokes M, "Company Law and Legal Theory" in W Twining (ed), *Legal Theory and Common Law* (Clarendon, Oxford, 1986).

[58] An exception to this general rule is the obligation to consider the interests of creditors as the corporation approaches insolvency. The authors are, incidentally, of the view that this obligation is neither justifiable nor warranted. For further discussion of the policy issues surrounding the imposition of this duty see Bainbridge, n 41.

Weakening the position of the shareholders as against others "interested" in the affairs of the corporation may well lead to providers of capital securing their interests in other forms. The rapid growth of hybrid securities in both form and popularity certainly demonstrates the flexibility of capital markets and may, to some extent, be the result of a weakening of the shareholder's traditional position of strength.

As for the second proposition, the better view is that current law does permit directors to consider the interests of stakeholders other than shareholders. This was the view of the PJC, a view it labelled as that of "enlightened self interest". An oft-quoted example of this view in action is found in the reasons for judgment of Berger J in *Teck Corp Ltd v Millar* (1973) 33 DLR (3d) 288 at 299:[59]

> The classical theory is that a director's duty is to the company. The company's shareholders are the company and therefore no interests outside of those of the shareholders can be considered by the directors … [But] 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 the company's shareholders in order to confer a benefit on its employees: *Parke v Daily News* [1962] 1 Ch 927. 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.

Before concluding this theoretical debate, there is one last question: whether the law *should* impose some duty on the directors of a corporation to consider matters beyond the best interests of the shareholders collectively, regardless of whether it is in the interests of the corporation. The question is phrased thus because, if current law permits wider considerations that are consistent with corporate interests, then the foregoing must represent the only remaining objection to our law in this respect from those who advocate greater corporate compassion.

Ultimately, the resolution of this question turns on shareholder primacy. Concession theorists start from the premise that state intervention in corporate affairs is justified by the privilege of corporate birth.[60] The ordinary response from those who favour shareholder primacy is that such is warranted on account of the shareholders' ownership of the corporation.[61] Perhaps the strongest advocate of shareholder primacy, Milton Friedman, argued that when managers subordinate the interests of shareholders they are literally stealing from the shareholders by "spending their money". Managers should thus be viewed in effect as "stewards" of the shareholders' interests.[62] Thus, as it were, ownership has its privileges also, principal among them being an expectation that decisions will be made in the interests of owners primarily, backed by a participatory role in corporate democracy. From the perspective of risk, owners are therefore compensated for the greater risks they take by controlling (indirectly and subject to any contractual commitments made[63]) the business of the corporation.

Despite this analysis, some theorists question the justification for shareholder primacy.

[59] This passage was also reproduced in the CAMAC Discussion Paper, n 8, p 87.

[60] Of course, the concession theory has lost substantially all of its force as a justification for corporate birth since the advent of general incorporation legislation. Even further, abolition of the doctrine of ultra vires, granting full capacity to corporate persons as well as leaving virtually all aspects of internal management to corporate constitutions, strengthens the argument against concession-based theories. Economists, by contrast, traditionally assert that the most popular of the corporate "privileges", limited liability, needs no justification beyond the fact that it is the efficient default rule for a market-driven society that permits associative activity.

[61] This ownership takes the form of a residual claim in insolvency combined with a participatory role in corporate decision-making.

[62] This expression is used by Bainbridge, n 43 at 1427.

[63] See *Thorby v Goldberg* (1964) 112 CLR 597. Note that this is frequently, through the use of negative pledges and other devices, how creditors are able to bargain for indirect control of the corporation.

An argument characteristic of the stakeholder-based approach is that shareholders do not enjoy a prior moral claim on account of ownership. According to this view, corporations are best viewed as "social enterprises". For this argument, it is necessary to rebut the proposition that corporations must be managed primarily in the interests of their owners, the shareholders. Of interest is that this argument relies (as, indeed, do most stakeholder-based claims) to some extent on concession theory:

> [T]he company cannot in any case be accounted for as a wholly contractual phenomenon. The distinctive attributes of the company, separate legal personality and limited liability, are beyond the reach of private agreement.[64]

As shareholders do not manage the corporation themselves, there is a gulf between ownership and control, thus breaking the "legitimating link" between ownership and management. As a final point, the argument seems to rely on the suggestion that ownership obligations are not absolute in any case.[65]

The benefits of limited liability and corporate personality are adopted because they are efficient. As for the "legitimating link", presumably the requirement that managers act in the interests of the corporators is precisely how that link is maintained! Thus, far from needing to intervene in management discretion in order to protect "stakeholders", government's proper role is to preserve the efficiency of the corporate form by protecting the ability of the corporators to pursue their collective self-interest.[66]

Surprisingly, economists do not rely on the concept of property to justify the position of shareholders. As Bainbridge observes:

> [Shareholder primacy] depends upon the corporation being a thing capable of being owned. In other words, it required one to reify the corporation: to treat the firm as an entity separate from its various constituents. As we have seen, however, nexus of contracts theory squarely rejects this basic proposition. By throwing the concept of ownership out the window, along with its associated economic and ethical baggage, the contractarian model also eliminates Friedman's principal argument for favouring shareholders over non-shareholders.
>
> But let's not throw out the baby with the bath water. The normative conclusion that we should displace the shareholder wealth maximization norm does not necessarily follow from the positive conclusion that we can do so. There is a considerable difference between showing that the traditional private property model is inadequate and showing that we should adopt a new decision making norm to which corporate officers and directors must conform their behaviour. Surely the latter conclusion requires some affirmative justification.[67]

Ultimately, the shareholder's position is justified, along with the privilege of limited liability, on general efficiency grounds, leaving questions of the moral prerogatives of ownership for others to ponder.[68] The question of directors' duties is discussed further below. Suffice to say that the authors' view is that present law is effectively neutral on the question of stakeholder interests, so long as they are consistent with the interests of the shareholders.

This remains the key to the magic of the corporation. The recognition of the corporation as a separate person (essential in order to produce the efficiencies of group enterprise) necessitates clear definition of the obligations of managers. As the corporation is principally a device to spread

[64] Parkinson, n 28, p 32.

[65] This is a curious point. The authors note that in the context of compulsory acquisition of shares, those normally associated with stakeholder arguments often defend the rights of dissenting shareholders: see eg Spender P, "Guns and Greenmail: Fear and Loathing After Gambotto" (1998) 22 MULR 96.

[66] Perhaps the best and most thorough presentation of this argument is found in Cheffins B, *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997) pp 126-157. Thus, Cheffins argues, corporate law should focus on protecting shareholder rights to participate in company meetings, ensure full and timely disclosure of material information (thus dealing with the problem of imperfect information). Cheffins also points out the justification for broader regulatory activity in order to deal with problems of "negative externalities", such as environmental degradation.

[67] Bainbridge, n 43 at 1428.

[68] Bainbridge, n 43 at 1428. See also Halpern P, Trebilcock M and Turnbull S, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 U Toronto LJ 117.

entrepreneurial risk through capital investment, it follows that the shareholders themselves are (within the limits of the general law) appropriately able to determine corporate priorities.

A final point concerns the question of risk itself. It is frequently observed that shareholders also benefit excessively from the limited liability that goes with corporate personality.[69]

Limited liability

In the modern era, it is limited liability, rather than the convenience and efficiency of incorporation, that is generally considered to be the most significant advantage of incorporation. Of course, limited liability, as *Salomon v Salomon & Co Ltd* [1897] AC 22[70] illustrates, is a crucial by-product of the treatment of a corporation as a person.

Limited liability is an unusual and somewhat counterintuitive benefit that our society bestows on the incorporated. It can be very difficult to explain to a tabloid journalists or an unsecured creditor how a director or officer can keep her luxurious home while others (eg, injured customers, creditors, employees, polluted neighbours etc) get nothing.

While it would be wrong to characterise the corporate form, as some have, "as a gift from the state which has to be earned via the fulfilment of social and moral duties",[71] limited liability is an unusual and powerful device granted by the community that needs to be "earned" if it is to be preserved.

The recent history of Australian corporate collapses and the Jackson Inquiry into James Hardie demonstrate the pressure from the community on governments to be involved in the regulation of corporations and, if necessary, to further erode principles of limited liability.[72] The incorporators' "licence" will be under threat when it is used in a way that offends what the people think is fair.[73]

The benefits of incorporation cannot be taken for granted. Incorporation may well be a set of convenient arrangements from which everyone stands to benefit, "the more so now that shareholding by ordinary people, whether direct or indirect through pension funds, has become so widespread".[74] However, corporations can only do so while the community is prepared to sacrifice entrepreneurial accountability for the community's benefit. Limited liability encourages public investment[75] and provides companies with a lower cost of capital.

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[69] Note eg that Parkinson, n 28, p 362, argues in favour of unlimited tort liability. See also Hansmann and Kraakman, n 42.

[70] In this case, the House of Lords held that, regardless of the extent of a particular shareholder's interest in the company, and notwithstanding that such shareholder had sole control of the company's affairs as its governing director, the company's acts were not his acts; nor were its liabilities his liabilities. Thus, the fact that one shareholder controls all, or virtually all, the shares in a company is not a sufficient reason for ignoring the legal personality of the company; on the contrary, the "veil of incorporation" will not be lifted so as to attribute the rights or liabilities of a company to its shareholders.

[71] Griffiths B, Sirico R, Barry N and Field F, *Capitalism, Morality and Markets* (London, 2001), http://www.openrepublic.org/policyanalyses/SocialismVs.Capitalism/20010813_CAPITALISM_MORALITY_AND_MARKETS.pdf viewed 12 November 2005.

[72] In the context of specific employees being left without their entitlements, in 2000 the Federal Government reacted to public outcry by enacting the *Corporations Act Amendment (Employee Entitlements) Act 2000* (Cth) which extends the personal liability of directors to those "losses" the company sustains as a result of the company entering into "uncommercial transactions".

[73] Of course, this is, to some extent, what drove the British Parliament to prevent general use of the corporate form by means of the *Bubble Act* in 1720. The result was simply to channel associative activity into use of the trust for organisational purposes. This prohibition lasted until the passage of the *Joint Stock Companies Act 1844*. For further discussion see Dubois AB, *The English Business Company after the Bubble Act, 1720-1820* (1938).

[74] Henderson D, "Misguided Virtue, False Notions of Corporate Social Responsibility" (London, 2001), http://www.nzbr.org.nz/documents/publications/publications-2001/misguided_virtue.pdf viewed 12 November 2005 from Sir Geoffrey Owen, *Corporate Social Responsibility: Rethinking the Role of Corporations in a Globalizing World* (Madingley Hall, Cambridge, 3-11 October 2002) available at Owen G, *Companies, Managers and Society: The State of the Debate*, an introductory paper for Conference on Corporate Social Responsibility organised by The 21st Century Fund, Madingley Hall, Cambridge, 3-11 October, http://www.lse.ac.uk/collections/IIM/pdf/csr.pdf viewed 16 March 2003.

[75] The traditional benefits of incorporation are generally described as:

- **Reduction of monitoring costs.** As the financial consequences of the corporation failing are limited, the time that investors spend monitoring the management is reduced.

Recent judicial comments support this view of the benefits of incorporation:[76]

> [T]he law provides limited liability to people carrying on business using a corporate vehicle because it is in the community's interest that people should venture and take commercial risks in their trade without the constant worry of being personally liable for any risk which happens to go wrong.

This is not suggesting that we support the concession model that incorporation is some sort of gift from the state which has to be earned via the fulfilment of duties.[77] Nor is the corporation as a kind of Darwinian response to the need for a legally codified business organisation.[78]

Both the contract and the concession models assume the environment is static and that the consideration once tendered is paid for ever. In essence, they both are guilty of seeing the issue in a linear way, when they are both observations of an organic system and in the end neither is particularly helpful.[79] The reality is that the answer probably lies more towards the middle than at the edge.

A more fundamental question is whether, as some commentators suggest, we are witnessing, and should welcome, a genuine change in the relationship between business and society. True, the limited liability corporation is a marvellous vehicle by which to convert the savings of a community into general wellbeing,[80] but some in the community, it would seem, now believe that the corporation has come to acquire social responsibilities that go beyond maximising shareholder wealth; those responsibilities need to be defined more precisely, possibly by governments but more properly by the corporations themselves and their shareholders. It may be that the corporation's effective survival depends on both corporations and their managers embracing those responsibilities and living up to them.[81]

The opposing view is that the health of society is likely to be damaged if corporations are distracted from their primary role of supplying goods and services which people want to buy, and making money for their shareholders. Managers have enough trouble meeting those challenges without diverting them to saving the world. Although in most cases considerations like worker welfare, the environment and consumer interest are in the shareholder's long-term interest, the interests of shareholders and non-shareholders are not always aligned.

Governments have been, and will be, asked to respond to a perceived default by business in addressing social needs, or assisting the community to adapt to inevitable economic, technological and

- **Market efficiency.** With limited liability, share prices more closely reflect the market value of the company, based on its assets, revenue, profitability etc, not the wealth of individual shareholders/members.
- **Reduced cost of capital.** Limited liability attracts a much wider range of investors. They are able to hold diversified portfolios and companies are able to raise capital at lower costs.
- **Facilitates enterprise.** Limited liability facilitates investment particularly in high risk without placing the personal wealth of shareholders unduly at risk.

[76] *Manpac Industries Pty Ltd v Ceccattini* (2002) 20 ACLC 1304.

[77] Robert Reich, former United States Secretary of Labour, has suggested that corporate "privileges" should be removed if companies do not fulfil certain obligations. "John Hood Reich and Responsibility: Business Bashing Gets Serious", *Reason* (July 1996), http://reason.com/9607/Col.HOOD.shtml viewed 16 December 2003. In addition, the *Corporations Act 2001* (Cth), s 206C, contains provisions automatically disqualifying persons convicted of certain offences from managing corporations.

[78] Bainbridge, n 43.

[79] See generally Bainbridge, n 43.

[80] Bostock T, "Is Beerworth's Proposal Really So Modest?" (Dec 2004/Jan 2005) *Company Director* 16.

[81] Certainly corporations, both statutory authorities as well as public companies, have featured in an increasing number of public infrastructure projects by way of "public-private partnerships" or "private financing initiatives". As arguedabove, on one view this trend, especially if it were to include a statutory obligation on corporate management to obey the "spirit" of law (by accommodating stakeholders including "the community at large") amounts to outsourcing government. The CAMAC Discussion Paper, n 8, p 102, refers to this argument in its review of the American "constituency statutes": "Other critics of these statutes have argued that they would convert directors into 'unelected civil servants' with a responsibility for determining the public interest." The CAMAC Report, n 9, cites Macey, n 50 and Bainbridge, n 50.

social change possibly restricting their competitive advantage.[82]

> There is a widespread demand for greater openness on the part of companies, and an entirely legitimate interest in the wider social impact of what they do. Managers of large companies increasingly have to operate on the assumption that virtually everything they do, however secret, will one day be exposed to public view; the impact of such revelations on their reputation, in the eyes of employees as well as customers, has to be taken very seriously.[83]

The purpose of a corporation is to deliver shareholder value using a voluntary form of association; each shareholder provides management with their capital in the belief that management will apply their skills to add to the value of the investment. For most companies, the fulfilment of that purpose is a long-term continuing activity. The profits they declare this quarter often come from investments made many years ago and future profits will depend upon the investments made today. This means that management has a direct interest in the health and success of the communities in which their corporations work and society as a whole. Corporations can't thrive in a society that is collapsing.[84]

CAPACITY AND DUTY

The effect of incorporation is to establish that the company or association exists as a separate legal entity distinct in law from those persons who from time to time are its members.[85] Incorporation provides the most extensive legal privilege known to our society.

A company has the "legal capacity and powers of an individual".[86] At least implicitly, the courts have in the past held that this means that a corporation could not make gifts where the making of them carries no prospect of commercial advantage to the corporation. Typical of the usual argument is that of Bowen LJ in *Hutton v West Cork Railway Co* (1883) 23 Ch D 654 at 673:

> The law does not say that there are to be no cakes and ale, but that 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.[87]

The legal capacity and powers of a corporation are determined by a combination of statutory provisions[88] and the common law. Even where corporations had limited capacity (the ultra vires rule), the purpose of that rule was for the protection of investors (and it was ultimately discarded as unworkable and unfair). The modern corporation has, however, no restriction on its ability to act as a

[82] Owen, n 74. In the recent James Hardie matter discussed above there have been suggestions for general powers to be granted that allow people like victims to be able to pierce the corporate veil and reach out to the parent company to seek "proper redress".

[83] Owen, n 74, p 8.

[84] Sir John Browne, Group Chief Executive, BP, "Governance and Responsibility – The Relationship Between Companies and NGOs. A Progress Report", Arthur Andersen Lecture at The Judge Institute of Management Studies, Cambridge University, 29 March 2001, http://www.bp.com/centres/press/s_detail.asp?id=107 viewed 18 March 2003. Nor, it would seem, can a society thrive without the freedom of association crucial to the success of the corporation, as witness the complete economic collapse of the Iron Curtain economies after 45 years of containment.

[85] See *Salomon v A Salomon & Co Ltd* [1897] AC 22.

[86] Ford, Austin and Ramsay, n 3 at [12.120]. The *Corporations Act 2001* (Cth), s 124, provides a company with all the powers and capacity of an individual although s 125 permits express restrictions on the exercise by a company of any of its powers. See also Wedderburn KW, "Ultra Vires in Modern Company Law" (1983) 46 Mod L Rev 204.

[87] See also *Barclays Bank plc v British & Commonwealth Holdings plc* [1995] BCC 19 at 29 (Harman J).

[88] Part 2B.1. The statutory provisions abolish the doctrine of "ultra vires" and expand the concepts of corporate power well beyond the common law doctrines: s 124(1). The legislation enumerates various powers, thereby effectively granting the corporation greater capacity than the natural person (eg the power to issue shares). The enumerated powers are not meant to limit a company's potential power.

natural person and in part this means that, providing they are acting in the best interests of the corporation, managers should be able to act altruistically.[89]

If the corporation has the capacity and power of an individual, is it bound to "give something back to society"? Are individuals so bound? Is the corporation morally and legally obliged to consider the society in which it operates and conduct itself with a view to serving those interests (regardless of any potential benefit to itself)? Is this another example of the public mind anthromorphising the corporation?[90] Do the essentials of corporate existence reveal anything about the nature of the corporation requiring imposition of this level of responsibility? Perhaps, some would say, the problem with the corporation is that its brain works differently to that of the natural person. The managers, therefore, must be the target of effective regulation.

The history of Anglo-Australian corporate law has imposed upon directors fiduciary duties[91] requiring that they act in ways analogous to a constructive trustee of the corporation's property.[92] However:

> The "economic function" of trustees is dissimilar to that of management: Trustees do not maximise profit in the context of the competitive market. They do not concern themselves with innovation in products … Most important, trustees need not fear that beneficiaries may sell their interest to entrepreneurs who will install new trustees.[93]

Even if we do apply the trust metaphor to corporate managers, there is ample authority in equity for the proposition that trustees, particularly where the objects of the trust are financial gain for beneficiaries, must place the financial interests of the beneficiaries ahead of any sense of general moral obligation. In the leading case of *Cowan v Scargill* [1985] Ch 270, the court considered this question in the context of a dispute amongst trustees of a mineworkers' pension fund concerning investments in (then apartheid) South Africa. Megarry V-C put it this way (at 286):

> The duty of the trustees towards their beneficiaries is paramount. They must of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests.

As far as trustees opposed to certain profitable investments on moral grounds, the Vice-Chancellor observed (at 288):

> In considering what investments to make trustees must put on one side their own personal interests and views. Trustees may have strongly held social or political views. They may be firmly opposed to any investment in South Africa or other countries, or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views that they hold.

Of course, if the trustees' power of investment were limited in such terms by the instrument of trust, the matter would be entirely different. It is open to the creator(s) of the trust to limit the powers of the trustees in such terms. It is not clear that the same applies to corporate managers.

While the fiduciary duty of managers provides the judicial device for our law to impose duties of good conduct on directors, perversely it has also been the rationale for restricting directors from acting

[89] There is some question as to whether a so-called doctrine of "ultra vires in the wider sense" still exists. Such a doctrine holds that a company lacks the capacity to act in a manner that is not in its best interest: see *ANZ Executors & Trustees v Qintex Australia Ltd (receivers & managers appointed)* (1990) 2 ACSR 307. One would think that any such doctrine has been abolished by virtue of s 124(2) of the *Corporations Act* (despite dicta to the contrary in *Qintex*).

[90] See Beerworth B, "A Modest Proposal: Recognise the Existence of Stakeholders" (December 2004/January 2005) *Company Director* 13.

[91] For example, *Industrial Developments Corp v Cooley* [1972] 1 WLR 443; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.

[92] *Selangor United Rubber Estates Ltd v Craddock (No 3)* [1968] 1 WLR 1555.

[93] Lord Wedderburn, n 57 at 23, quoting from Winter R, *Government and the Corporation* (1978) p 33.

in ways that, while for the greater benefit of the society, might not generate profits for the corporation on the basis that it could not be shown that the action was in the best interest of the corporation. The rationale for the duty, certainly according to economists, was always to minimise "agency costs", those being the costs generated as a result of one person acting for the benefit of another.[94]

Thus, the principal fiduciary duty is to act in the best interests of the principal (here, the corporation – interpreted as meaning the shareholders as a body). In cases where directors' "charitable" conduct in this regard is called into question, a court will seek to assess the state of mind of the directors in acting altruistically and their motive. The court will explore the question of what their intention was, collecting from the surrounding circumstances all the materials which genuinely throw light upon the state of mind of the directors to show they were honestly acting in discharge of their powers, powers that include the ability to behave in ways reasonably designed to ensure the present or future benefit to the corporation, rather than for any other reason.[95]

One can therefore attribute various rationalisations for the duty of directors discussed above: economic (an efficient, transactions cost reducing, market failure fixing default rule) and moral (protecting assets for the benefit of the beneficiaries). In either case, the beneficiary of the duty is ultimately the shareholders as a body. There one sees the difficulty of ascribing some unique "stakeholder interest" – it makes a mockery of the concept of the private association to provide means for private interference: what use is a vague duty with no one having an incentive to enforce it? Again, the appropriate protector of the "wider interest" is, of course, the public authority. This is ordinarily achieved through problem-specific legislation, for which the regulator is ultimately politically accountable.

Traditional position – Shareholder primacy

Using traditional analysis like that discussed above, advice to managers from their counsel across the country has generally been that their task is to maximise profits and, to the extent that it was not in the best interest of the corporation, that they were not able to consider more altruistic objectives.[96] Typical of the advice would be the following comments from *Ford's Principles of Corporations Law*:

> 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.[97]

If the altruistic purpose being considered by management cannot be couched in terms of what's good for the corporation, then management will have acted improperly. True, usually it is possible to rely on a version of "What is good for the country is good for General Motors";[98] however, even then it can mean:

[94] In simple terms, economists describe the main risks as being those of "looting" (self-interested behaviour) and "shirking" (acting in a sub-standard way). See Jensen and Meckling, n 53; Macey, n 53.

[95] See *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 and *Hindle v John Cotton Ltd* (1919) 56 Sc LR 625 at 630-631, cited in *Kirwan v Cresvale Far East Ltd (in liq)* (2002) 44 ACSR 21 at 57. The classic statement of the judicial approach to such questions is found in *Re Smith & Fawcett Ltd* [1942] Ch 304 at 306 per Lord Greene MR (emphasis added): "The principles to be applied in cases where the [constitution] confer[s] a discretion on directors … are, for the present purposes, free from doubt. They must exercise their discretion bona fide in what *they* consider – *not what a court may consider* – is in the interests of the company." Similarly, the High Court of Australia observed in *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493: "Directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts."

[96] Senate Standing Committee on Legal and Constitutional Affairs, n 5.

[97] Ford, Austin and Ramsay, n 3 at [8.130]. Note that the PJC Report expressly adopts the view that "enlightened self-interest" is the appropriate characterisation of what the law requires of directors: see PJC Report, n 10, p 53.

[98] Lord Wedderburn, n 57 at 13, quoting former General Motors President Charles Erwin Wilson in 1952 testifying before the United States Senate Armed Services Committee: "What is good for the country is good for General Motors, and what's good for General Motors is good for the country."

> "planned obsolescence," three-year styling cycles, and five years to rusted-out hulks? Superior disk brakes that were not adopted by GM until decades after they were commonplace in Europe?[99]

But could the management of GM have done otherwise if it was right but unprofitable or at least not in the interests of present and future members of the corporation? Here, then, are the outer boundaries of the shareholder primacy norm.[100]

More than 30 years ago Friedman wrote: "[T]he social responsibility of business is to increase its profits."[101] He asked:

> What does it mean to say that "business" has responsibilities? Only people can have responsibilities. A corporation is an artificial person and in this sense may have artificial responsibilities, but "business" as a whole cannot be said to have responsibilities, even in this vague sense. The first step toward clarity in examining the doctrine of the social responsibility of business is to ask precisely what it implies for whom.
>
> Presumably, the individuals who are to be responsible are businessmen, which means individual proprietors or corporate executives. Most of the discussion of social responsibility is directed at corporations, so in what follows I shall mostly neglect the individual proprietors and speak of corporate executives.
>
> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. Of course, in some cases his employers may have a different objective. A group of persons might establish a corporation for an eleemosynary purpose – for example, a hospital or a school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services …
>
> What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire "hardcore" unemployed instead of better qualified available workmen to contribute to the social objective of reducing poverty.

Friedman felt that social responsibility other than the "responsibility to make as much money for their stock holders as possible" was a furphy.[102] In Friedman's view, altruistic objectives such as expenditures to reduce pollution beyond the amount that is in the best interests of the corporation or as required by law was spending someone else's money for a general social interest:

> Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.

The management of a corporation are agents (in an economic, rather than a legal, sense) of the shareholders, owing them in aggregate, though not individually, fiduciary obligations.[103] Friedman would argue that business responsibility should remain focused exclusively on the wealth

[99] Hartman D, "Vital Signs: Economy – What's Good for General Motors", *Chronicles* (May 2002), http://www.chroniclesmagazine.org/Chronicles/May2002/0502Hartman.html viewed 3 December 2003.

[100] Lord Wedderburn, n 57 at 10, quoting Milner Holland E, *Report of Investigation into Savoy Hotel Ltd* (1954) p 16; and Gower LCB, *Modern Company Law* (4th ed) pp 577-578.

[101] Friedman M, "The Social Responsibility of Business is to Increase its Profits", *The New York Times Magazine* (13 September 1970), http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html viewed 3 December 2003.

[102] Friedman M, *Capitalism and Freedom* (Chicago, 1962).

[103] See *Automatic Self-Cleansing Filter Syndicate v Cunninghame* [1906] 2 Ch 34. See also Jensen and Meckling, n 53.

maximisation of shareholders.[104] Community responsibility is only to be fulfilled by contributing towards a vibrant business sector while public authorities look after equity and social policy.[105]

One advantage of the wealth maximisation norm is that it is much easier for shareholders (and ultimately the courts) to assess whether management have been complying with their duties; if the law were to include specific corporate social responsibility obligations, would that make management less accountable?[106]

Some argue that Friedman was wrong, not because he fails to recognise the role of the corporation in our society and the need for a "corporate social conscience", but because he fails to recognise that social values can increase shareholder wealth through improved corporate business performance and competitiveness, and that shareholders' long-term interests can be served by decisions such as corporate philanthropy, even though they seem harmful in the short term.

Alternatively, seeing the issues more holistically, it is possible to reject an analysis based upon competition between "shareholder-centred financial capital and stakeholder-centred socioeconomic capital". The economic and social interaction between the corporation and society is more than a competition between two forces; rather, it is about a range of interdependent factors and relationships (commercial, political, labour, regulatory, economic, consumer and environmental) supporting profitability, shareholder value and business sustainability.[107]

It is almost trite to say that, in a world of open, knowledge-based competition, "companies do not function in isolation from the society around them".[108] The success of a corporation depends upon the organisation's ability to most effectively use capital, labour and natural resources to produce goods and services. That, in turn, depends upon "workers who are educated, safe, healthy, decently housed and motivated"[109] and operate in an environment with less waste, lower pollution levels and free from the outrage of the community about corporate "misconduct". This much is common sense. An identical observation can be made for natural persons. That is to say, it is generally in one's best interest to respect others, deal fairly and respect one's environment. Nonetheless, individuals act otherwise, as do corporations. In either case, external enforcement addressed to specific community expectations is what is required.

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[104] Friedman, n 101.

[105] Of course, there are some utility and telecommunications corporations where the boundaries between social policy and business are always blurry. Once again, the suggestion that somehow company directors are to be the guardians of the public interest looks suspiciously like outsourcing certain aspects of government. One can take the view that, broadly speaking, government facilitates philanthropic activity through a combination of tax incentives as well as provision of suitable legal frameworks for associative activity of this nature (such as the company limited by guarantee). Indeed, there is much to commend the view that where individuals wish to associate for activity that is in the interests of others, they ought do so by means of the various forms available to not-for-profit organisations. One ought therefore assume that, unless there is evidence to the contrary, those forming companies limited by shares are doing so in the expectation of profit. At present, should those corporators have some other purpose, there is ample opportunity to make it clear, either by utilising a form of association appropriate for non-profits or by adding appropriate provisions to the corporate constitution.

[106] Ramsay I, "Reform Rush Would be Unwise", *The Financial Review* (10 February 2005).

[107] Horrigan B, "Fault Lines in the Intersection Between Corporate Governance and Social Responsibility" (2002) 25 UNSWLJ 515. Here, then, is the role for "sustainability indexes" and the like; if there is a demand for this style of investment then these indices should allow for the growth of "socioeconomic capital", that is, as long as they are accurate and reliable: see Fielding Z, *Index Rates on Social Responsibility*, http://www.moneymanagement.com.au/articles/27/0c035527.asp viewed 3 December 2003.

[108] Porter ME and Kramer MR, "The Competitive Advantage of Corporate Philanthropy" (Dec 2002) *Harvard Business Review* 57, http://harvardbusinessonline.hbsp.harvard.edu/b01/en/common/item_detail.jhtml;jsessionid=BZGGGU0FVUUOUCTEQENB5VQKMSARWIPS?id=R0212D&referral=7711%20&_requestid=68 viewed 3 December 2003.

[109] Porter and Kramer, n 108 at 59.

Economic benefits that enure to a corporation from having a softer heart in terms of reputation, internal morale and improving the competitive context of a corporation[110] are laudable but such an observation amounts to no more than a different version of the view that "what is good for General Motors is good for the country".

The reasoning that managers ought to consider social values because good corporate citizenship is good business practice is mostly right (as, indeed, are most "motherhood" statements of this kind) but it will not help managers assess how they should act in all situations. Managers routinely assert that a more directive and supportive statement is required.[111]

Directors' and officers' duties

Directors and officers must act with care and diligence[112] in good faith in the best interests of the company as a whole and for a proper purpose.[113] The members of the company are generally considered to be the company as a whole.[114] The phrase "the company as a whole" does not mean "the company as a commercial entity, distinct from the corporators",[115] nor are the duties owed to individual members of the company.[116] Sometimes, a specific fiduciary duty towards the shareholders may exist such as where there is a dependence on information and advice from the management or a relationship of confidence.[117]

In order to properly discharge their duties to act in the interests of the company as a whole, management are required to consider the interests of existing members (who have the most immediate financial holding in a solvent company); the company as a commercial enterprise (as opposed to the interests of individual members); creditors of the company (in certain circumstances);[118] and beneficiaries (if the company is a trustee or responsible entity or similar).

Although it is sometimes said that managers should be obliged to consider the interests of employees, customers, contractors and the community when making decisions for the company, there is no case law or corporations legislation in Australia that imposes that obligation. That said, laws on conditions of labour, consumer protection and issues like environmental protection apply as much to companies as individuals. Managers who have to make decisions for corporations can be in breach of their duty to the corporation if their decisions put the corporation in breach of any such law as well as specific liability that might pierce the corporate veil and attach to them personally.[119]

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[110] Lambert R, "Setting the Agenda", paper for Business in the Community (London, 2002), http://www.bitc.org.uk/anniversary/lambert.pdf, cited by Samuel, n 4.

[111] Indeed, the PJC Report is riddled with references to submissions of this kind received from directors and those lobbying on their behalf: see PJC Report, n 10, pp 47-59. It is worth noting that, after referring to a number of submissions indicating that boards already do take into account non-shareholder interests, the committee chose not to endorse a prescriptive approach on the basis that it would "introduce great uncertainty into the legal expression of directors' duties" (p 55).

[112] *Corporations Act 2001* (Cth), s 180.

[113] *Corporations Act 2001* (Cth), s 181.

[114] The *Corporations Act* protects the interests of members by granting members standing to apply for court-ordered remedies in situations where directors conduct the affairs of the company in a manner that is "contrary to the interests of the members as a whole" (ss 232-234). Additionally, there are the injunctive provisions of s 1324 granting rights to a person whose interests are affected, discussed later in this article.

[115] *Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438.

[116] *Percival v Wright* [1902] 2 Ch 421.

[117] *Brunninghausen v Glavanics* (1999) 46 NSWLR 538; 32 ACSR 294.

[118] *Walker v Wimborne* (1976) 137 CLR 1, finding that, in the case of near insolvency, giving priority to the interests of creditors over shareholders is part of the fiduciary duty to the corporation as a whole.

[119] Including, in the case of the Commonwealth, the following: *Customs Act 1901* (Cth); *Environment Protection and Biodiversity Conservation Act 1999* (Cth); *Foreign Acquisitions and Takeovers Act 1975* (Cth); *Hazardous Waste (Regulation of Exports and Imports) Act 1989* (Cth); *Insurance Act 1973* (Cth); *Insurance Contracts Act 1984* (Cth); *Road Transport Reform (Dangerous Goods) Act 1995* (Cth); *Shipping Registration Act 1981* (Cth); and the *Trade Practices Act 1974* (Cth). At common law cases in which courts have been prepared to consider limited liability and to lift the corporate veil where they think circumstances require it include *Smith Stone & Knight Ltd v Birmingham Corp* [1939] 4 All ER 116 in which the judge lifted

In 2005 the Delaware Chancery Court in *Re Walt Disney Co Derivative Litig* (Del Ch, CA No 15452, 9 August 2005) warned against trying to hold a board to an "ideal":

> The law cannot blame the board for falling short of perfection, he wrote, any more than doctors sued for malpractice can be held to a standard beyond competence, lest the average medical practitioner be found inevitably derelict.
>
> Fiduciaries who act faithfully and honestly on behalf of those whose interests they represent are indeed granted wide latitude in their efforts to maximise shareholders' investment.
>
> They must act in good faith to make informed decisions on behalf of the shareholders, untainted by self-interest.
>
> When they fail to do so, this court stands ready to remedy breaches of fiduciary duty.[120]

A court should judge managers on their intentions, not on their results, Chancellor Chandler said: perhaps courts have moved from the narrower model towards a wider view of when "cakes and ale" are required for the benefit of the corporation. The *Disney case* certainly shows that, at least in Delaware, the court will allow judgment to rest with the market, in which shareholders could sell their shares and customers could go elsewhere.

This kind of judicial pronouncement supports the argument that the expression of the duties of directors and officers is sufficiently vague that managers can have regard to a pretty wide class of matters while performing their duties. However, occasionally management faces situations where it is impossible to advance both shareholders' and wider interests.

It is conceivable that a court would find that to discharge their duties to act in the interests of the corporation properly the management may need to act in the interests of persons other than the members. The distinction in these situations is that the duty is to consider the corporation's commercial interests, rather than the members' commercial interests. However, if the constitution of a corporation defines the interests of the corporation in a way that would affect the directors' duty – for example, the constitution of a charitable company could require profits to be devoted to charitable purposes rather than to be distributed among members – then the way for managers is much clearer.[121] It is this permissive model that provides an answer to the question posed by managers: How am I certain I have satisfied my duties if I prefer the long-term interests of the company to the short-term interests of members?

As agents (in a non-legal sense) of the shareholders and the providers of capital, management should consider the interests of shareholders. However, managers cannot know if shareholders want them to have a short-term view or if they would prefer a long-term approach. How do managers balance short-term profits against long-term viability benefits? Are they entitled to deprive today's shareholders in the interests of tomorrow's shareholders?

Australian corporate law grants directors a wide range of protection from liability for decisions that sacrifice shareholders' immediate financial interests in favour of other corporate interests.[122]

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the corporate veil in order to allow the holding company of a corporate group to recover compensation from the local council when it compulsorily acquired property owned by a subsidiary company for a very nominal sum. Atkinson J had held that the parent company was entitled to recover a more substantial sum because it was the true owner of the business and the property. See also *Briggs v James Hardie & Co Pty Ltd* (1989) 16 NSWLR 549, discussed in Farrer JH, "Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance" (1998) 10 Bond LR 142, http://www.bond.edu.au/law/blr/vol10-2/2-Farrar.pdf viewed 3 December 2003.

[120] Bayot J, "US Court Upholds Ovitz Payout", *The Financial Review – The New York Times*, http://www.nytimes.com/2005/08/09/business/media/09cnd-ovitz.html?ei=5088&en=2266982b7ff8af63&ex=1281240000&partner=rssnyt&emc=rss&pagewanted=print viewed August 2005.

[121] *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285; 11 ACLR 715 at 719, holding that the constitution may be so framed that they expressly or impliedly authorise the exercise of the power of allotment of unissued shares for what would otherwise be a vitiating purpose.

[122] At equity, courts have for many years dealt with an analogous problem of trustees needing to balance the interests of income (present) versus capital (future) beneficiaries. See *Cowan v Scargill* [1984] 2 All ER 750 discussed above where the House of Lords held that the trustees had an overriding duty to invest with the primary objective of increasing the fund's value for the beneficiaries, despite their personal views or moral reservations on the choice of the most suitable investments.

Short-term versus long-term interests?

The problem is not simply stated. Managers must deal with and make their decisions in an environment characterised by highly liquid capital markets and widely dispersed share ownership. They are vulnerable to hostile takeover bids and institutional investors demanding regular and substantial improvements in share price. In these circumstances, is it surprising or wrong for managers to adopt a narrow understanding of "shareholder value"?[123] After all, this is what a powerful majority of their shareholders want.

In the leading Canadian case of *Teck Corp Ltd v Millar* (1973) 33 DLR (3d) 288, the Supreme Court of British Columbia took a non-traditional approach to the question. In this case, a small mining company found itself the target of a hostile bid from one of Canada's largest mining conglomerates. In the immediately preceding period, that target had been actively seeking a partner to develop some promising claims, ultimately preferring a suitor other than Teck. The preferred arrangement involved the target issuing sufficient numbers of shares to defeat Teck's attempt to gain control. Berger J held that the issue of these shares was not a breach of duty on the part of these directors. He based his judgment on the finding that the directors had been motivated by a desire to select a preferred joint venture partner, rather than by a principal desire to defeat a hostile bid. The authors have earlier quoted some other language from this unusual judgment, equally permissive in the sense of granting wide discretions to directors. The court endorsed a course of action taken by directors that may have reduced the short-term gains of shareholders.[124]

Clearly, then, there is considerable support for the idea that managers do not need to prefer the short-term interests of present shareholders. If that were not the case, then every dollar available for dividend should be paid out and there would be no justification in attempting to reinvest funds or expand the corporation's market by price cutting.[125]

A typical example of such balancing, as in the *Teck* case, is where the corporation is the target of a takeover bid which promises favourable terms for shareholders who wish to sell and the directors have in mind transactions which could in the long term bring greater benefits to shareholders than they would receive by acceptance of the offers.[126] In such circumstances, establishing a takeover defence may be in the interests of the corporation as a whole, but not in the interests of the current shareholders who are "denied" the opportunity to exit their investment at the best possible price. Generally speaking, Australian courts have upheld "frustrating conduct" where the intention was not designed to entrench management or to otherwise act in bad faith.[127]

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[123] Mitchell R, O'Donnell A and Ramsay I, *Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and Labour Law* (Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law, The University of Melbourne, 2005).

[124] Ordinarily, the duty of directors where there is a competition for control of the corporation is to secure the best price for the shares for their shareholders: see *Revlon Inc v MacAndrews & Forbes Holdings Inc* 506 A 2d 173 (1986). On any interpretation one would have to regard this case as exceptional, though in essence the same approach to directors' duties in the context of a hostile takeover bid was taken by the New South Wales Court of Appeal in *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 260; 15 ACLR 230.

[125] Mitchell, O'Donnell and Ramsay, n 123, citing Heydon J, "Directors' Duties and the Company's Interests" in Finn PD (ed), *Equity and Commercial Relationships* (Law Book Co, Sydney, 1987) p 135.

[126] *Darvall v North Sydney Brick & Tile Co Ltd (No 3)* (1987) 12 ACLR 537, affirmed (1989) 16 NSWLR 260; 15 ACLR 230; *Pine Vale Investments Ltd v McDonnell & East Ltd* (1983) 8 ACLR 199; *Winthrop Investments Ltd v Winns Ltd* (1979) 4 ACLR 1; and *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.

[127] Similar provisions would also govern the rules in the United States: *Re Toys "R" Us, Inc Shareholder Litigation* (Cons CA 1212-N (Del Ch, 24 June 2005, Strine VC). In *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285; 11 ACLR 715 the High Court ruled that an overall "honest motive" would not save an act done for an "improper purpose". Nonetheless, in *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 260; 15 ACLR 230 the presence of an allegedly improper purpose (to defeat a hostile takeover bid) did not invalidate a decision of the directors of the target company to issue shares as part of a commercial venture. In Australia courts have found difficulties examining directors' purposes in entering into transactions which defeat takeover offers, particularly where there are multiple purposes. The current somewhat unsatisfactory state of the law is unlikely to be settled in the context of the Takeovers Panel, which has its own policies on frustrating actions.

But not every difficult question for managers can be answered by reference to the short- versus long-term interests of a corporation. Managers cannot ignore the market: they need to raise capital, attract customers and operate their business in an environment that demands that they are seen to be managing margins and achieving higher efficiencies as a means of reaching earnings targets.

What would be the situation if a newspaper owner was forced into a public auction by a hostile takeover offer? What if the board preferred to accept a small discount in price in order to sell to an organisation with a strong reputation for journalistic excellence? What, if anything, is the board's responsibility to the public? And what, if anything, would the courts have to say about it in response to potential shareholder action? How should a board respond in terms of corporate social responsibility if one offer was from a corporation with a reputation for ruthless adherence to editorial independence but who was offering to pay 10% less than its competitor who had a reputation for cutting the news gathering budget?

Impact of the business judgment rule

The business judgment rule protects managers against those that argue they have breached their duty to act with appropriate care and diligence. Generally, managers are entitled to a presumption that they exercised proper business judgment, if they can demonstrate:

- the decision was made in good faith and for a proper purpose (generally this refers to the belief that the decision was in the best interests of the corporation);[128]
- they had no material personal interest in the matter;
- they informed themselves of available material; and
- they rationally believed that the decision was in the best interests of the corporation.

Unfortunately, the business judgment rule provides very little help for managers because it has at its heart the question of what is the best interests of the corporation, ie the very question about which much of the uncertainty surrounding corporate social responsibility revolves.

If a court finds that selling a corporation to a better operator at a lower price is not in the interests of shareholders, ie that the shareholder wealth maximisation norm has been breached, then a crucial element of the business judgment might not have been made out and managers could be liable to investors. It might seem rational that managers should be free to use their business judgment to balance the kinds of competing interests discussed above but it is not necessarily the law.[129]

Indeed, in the United States there was sufficient concern that directors in the exercise of rational business judgment would always lead to a break up or sale of their companies that many States wishing to protect local companies adopted "non-shareholder constituency" statutes (or simply "constituency" statutes).

Constituency statutes permit directors to consider the interests of parties other than shareholders when evaluating takeovers. The underlying theme of these statutes is that a director may determine what is in the "best interests of the corporation", apart from what directly and immediately benefits the shareholders. Constituency statutes routinely include employees, customers, creditors, suppliers and

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[128] What is meant by "interests" of the company? As Ramsay, n 13, p 63, has noted: "Possibilities include: existing shareholders, future shareholders, creditors and employees, customers, suppliers, the environment and the community." As discussed, courts have generally interpreted the interests of the company to mean the interests of existing shareholders.

[129] The *Revlon case*, decided in 1986, that a board of directors' primary consideration in an auction for control must be to obtain the highest price for shareholders. Shareholders' immediate returns take precedence over the interests of perpetuating the business as a going concern, employees' job security, and other such concerns: *Revlon Inc v MacAndrews & Forbes Holdings Inc* 506 A 2d 173 (1986). See also *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 (1985) where the court recognised that these situations confront courts with "the omnipresent spectre that a board may be acting primarily in its own interests" (at 954); and *Unitrin, Inc v American General Corp* 651 A 2d 1361 (1995). In Australia the position is less clear but not sufficiently different to change the proposition: see *Winthrop Investments Ltd v Winns Ltd* (1979) 4 ACLR 1; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.

communities. In some cases, managers may consider other pertinent factors, such as national and State economies, long-term and short-term effects of a transaction as well as the benefits of remaining independent.[130]

The target directors of the newspaper owner know how hard it will be to find a middle path between the interests of shareholders and non-shareholders. How should their decisions be judged, how will the conflict be resolved? Can the managers of the newspaper owner operate under some type of multi-fiduciary duty? Can they be sure they have acted in the best interests of the corporation and will not be subject to "the imposition of an aspirational morality"[131] by the courts? Could an obligation to consider these wider social issues result in judges replacing the business judgment of directors with their own judgment?[132] How can shareholders be sure that their interest has not been subjugated to a social interest as a way of management pursuing its own self-interest?

The existing business judgment rule would not protect the newspaper owner directors' decision unless they could show that it also was in the interests of the shareholders. Indeed, the existence of a "change of control situation" would most likely preclude the board from considering the impact of their decision on the firm's non-shareholder constituencies or the corporation itself. Is this different from what the community would expect?

Here, then, is a reason for not moving too far from the wealth maximisation norm. This is why the corporate constitution retains the basic corporate law doctrine that managers need to be accountable to shareholders. In most cases the business judgment rule will preserve managers' decisions from judicial review provided they can establish the criteria (ie a properly informed decision without self-interest) and there is no transfer of control situation.

Corporations are different from other forms of business organisation because ownership is diverse and, unlike individuals, there is always the argument that the managers are "spending someone else's money for a general social interest".[133] As a practical matter, our model of corporate ownership means that usually shareholders have no meaningful voice in corporate decision-making. Shareholders are only entitled to vote on very few corporate actions.[134] Rather, formal decision-making power resides mainly in the board of directors.[135]

If there is a change in the relationship between corporations and society, it is a change that comes from community expectations and a recognition of those changes by corporations, society and, axiomatically, shareholders. If corporations have come to acquire social responsibilities that go beyond shareholder wealth maximisation; those responsibilities need to be explicitly accepted by both shareholders and management through the contract that binds them to each other, the constitution, even though they are yet to be precisely defined.

It is difficult to draw precisely the boundaries of the relationship between society and its corporations and, indeed, it is probable that the boundaries are constantly shifting. This is why a legislative response will founder as it is captured in the instant in which it is drawn. The law would be better drawn in a way that allows a court to apply the law flexibly to reach an appropriate conclusion in each individual circumstance but subject to a well-understood norm.

[130] Turner C, "Shareholders vs the World: "Revlon Duties" and State Constituency Statutes" (January/February 1999) ABA Section of Business Law, *Business Law Today*, http://www.abanet.org/buslaw/blt/8-3shareholders.html viewed 12 March 2003.

[131] Finn P, "Simplification and Ethics: A Commentary" (1995) 5(2) *Australian Journal of Corporate Law* 158 at 161, cited in Horrigan B, "Teaching and Integrating Recent Developments in Corporate Law, Theory, and Practice" (2001) 13 *Australian Journal of Corporate Law* 182.

[132] Lord Wedderburn, n 57 at 18.

[133] Friedman, n 101.

[134] Shareholders have very little direct control over the decisions of management that are made in the "best interests of the company": see eg *NRMA v Parker* (1986) 6 NSWLR 517; 4 ACLC 609: "It is no part of the function of the members of a company in general meeting by resolution, ie as a formal act of the company, to express an opinion as to how a power vested by the constitution of the company in some other body or person ought to be exercised by that other body or person … The members … no doubt have a legitimate interest in how these powers are exercised, but in their organic capacity in general meeting they have no part to play in the actual exercise of the powers."

[135] Bainbridge, n 43 at 1442.

On the question of the proper constitution of a manager's duties, the current law permits directors to consider non-shareholder interests only where they believe that, in so doing, they are acting for the benefit of the corporation's shareholders as a whole. This is not only an accurate representation of the law, but also a rational and justifiable approach to regulation of managerial discretion. That is not to say that the law, generally speaking, does not allow (in some cases it even requires) managers to consider non-shareholders. The law expects that managers will deal with non-shareholders in the following ways:

1. **Creditors**: a manager should consider the position of creditors as the corporation approaches insolvency. This duty is not ordinarily enforceable at the suit of creditors. However, as this duty is encapsulated by s 181(1)(a), presumably a creditor (as a person "with an interest" in the corporation's affairs) would be able to enforce this duty through the procedure set out in s 1324. In addition, managers may be required to compensate creditors (as well as face potential civil penalties) if they are in breach of the "trading while insolvent" provisions of the *Corporations Act*.
2. **Employees**: the managers may consider the interests of employees where that is consistent with the interests of the corporation. Further than this, the provisions in Pt 5.8A render managers accountable for the effects of transactions designed to reduce payment of employee entitlements.
3. **Consumers**: again, where it benefits the corporation, the management may consider the impact of their decisions on consumers. Beyond that, Commonwealth and State law (through the *Trade Practices Act 1974* (Cth) and the various State Fair Trading Acts, among other statutes) deals with consumer protection directly. Furthermore, the *Trade Practices Act* establishes a jurisdiction-specific regulator, the Australian Competition and Consumer Commission, with power to prosecute corporations for breach of the legislation.
4. **The environment**: again, there are clearly circumstances where consideration of environmental impact is entirely in the interests of the corporation and its shareholders. Beyond this, Commonwealth and State governments have enacted voluminous legislation of a specific nature for the purpose of environmental protection. This legislation also establishes a bureaucracy dedicated and trained to enforce these provisions.
5. **The community at large**: as discussed above, it is ordinarily in the interests of a corporation to comply with the law. Corporate law is not the appropriate mechanism to use for purposes of general community regulation. Imposing an expectation that corporations act for the benefit of the community amounts in many ways to outsourcing functions of government. It is the role of the legislative and judicial branches of government to determine entitlements and how best to protect them. To expect this of corporate management is both unfair and unwise. Further, to expect such an obligation to be enforced by the corporate regulator is unlikely to deliver the outcome sought.

A final point concerns the impact of including in statutory (or general law) directors' duties a reference to the interests of non-shareholders. Presumably, in order to have any impact, such an obligation must be enforced. Who, one might ask, is best suited to enforce an obligation to act in the interests of the community at large? The answer must be a member of that community. One can readily see that the imposition of fiduciary-style duties to consider interests of non-shareholders creates a situation where that duty becomes enforceable at large. Put another way, such a duty imposes upon directors a regime of accountability to a limitless range of potential corporate masters. This is unsustainable.[136] The alternative is, as is the case presently, to leave the enforcement of these duties to the Australian Securities and Investments Commission and members.[137]

[136] See further Bainbridge, n 43 at 1423. Bainbridge calls this the "two masters" problem and asserts that ultimately such rules effect a transfer of wealth from shareholders to non-shareholders. Directors required to consider all interests are almost by definition placed in a position of conflicting responsibilities with no effective means of attempting to reconcile them in order to proceed with comfort.

[137] To be sure, s 1324 does provide standing to a wide range of potential stakeholders. Nonetheless, there are surprisingly few examples in the case law of wide-ranging use of this provision. As discussed, the courts have indicated that, to have standing under s 1324, the applicant must have an interest more than merely as an ordinary member of the public: see *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 73 FCR 161; 23 ACSR 715.

The law does not prevent managers from acting with non-shareholder interests in mind, so long as whatever results is also in the interests of shareholders. Professor Bainbridge uses the example of the "Bhopal tragedy" (where a plant operated by Union Carbide released toxins responsible for approximately 2,500 deaths) to illustrate how a "stakeholder" approach to the duties of managers would effectively solve nothing.

The evidence suggests that management were aware of the risks confronted at the Bhopal facility but considered the risk small in relation to the cost of remedying it; hence, management's decision not to effect repairs makes sense from the perspective of shareholder wealth maximisation. Advocates of corporate social responsibility ordinarily assert that, if the law were to protect managers who chose to act for the benefit of employees or local residents, then the outcome in this case might have been different. According to Bainbridge, those commentators "ignore the very real possibility that the decision also was a sensible one from the perspective of the plant's workers and the local community."[138] As Bainbridge states:[139]

> Unless managers are to be held strictly liable for decisions that harm some non-shareholder constituency, hindsight cannot be used when measuring their compliance with their multi-fiduciary responsibility. Rather, their compliance must be measured by what they knew or should have known at the time the decision was made. Union Carbide management knew that the plant was losing money and that there was little chance the plant could be turned around. Under those circumstances, their only realistic choices were to close the plant or to forego maintenance. Given those options, and knowing that the risks were slight, both management and, more important, the plant's workers and the surrounding community probably would have thought foregoing repairs to be a gamble worth taking if it meant preserving jobs and the local economy.
>
> [CSR advocates] likely would insist that there is a third choice: keep the plant open and undertake the necessary maintenance. This is consistent with [their] apparent view of shareholders as geese that lay golden eggs for the benefit of non-shareholder constituencies …

Bainbridge then refers to the argument to the effect that shareholders are able to diversify their investments, so that the likely impact on a shareholder-investor can be offset or the shareholder who objects to such a course of action can divest. Bainbridge refutes this argument thus:

> [T]aking this argument to its logical extreme, it is acceptable to wipe out the entire shareholder value of a particular firm because only part of the shareholders' portfolio will be lost.
>
> … [W]ould most investors be willing to invest their retirement savings in corporate stock if [t]his approach became law? If not, why not? Probably because most investors do not regard their investment in corporate stock as a charitable donation made to benefit non-shareholder constituencies. Their investment in corporate stock must bring them a rate of return commensurate with the risks they are taking. If it does not, they will divest stock in favour of other investments or, at least, monitor management more closely. In either case, the cost of equity capital will rise. Ironically, [this] approach thus will ultimately redound to the detriment of non-shareholder constituencies, because the firms with the greatest need for infusions of equity capital are the very same small and medium size firms that produce most of our economic growth.

Finally, we might consider that the law should simply leave matters such as this to the ethical and moral considerations of managers. As Bainbridge observes:

> One who relies on management's moral sense to prevent corporations from externalizing certain costs relies upon a very thin reed indeed. Again, consider the Bhopal disaster. Under current law, the business judgment rule almost certainly would have insulated Union Carbide's directors from liability if they had chosen to undertake the necessary repairs. Yet, they did not do so. Given that Union Carbide's board had almost unrestricted freedom to pursue their own ethical precepts under existing law, why would [the pro CSR model] have led to a different outcome?[140]

[138] Bainbridge, n 43 at 1423.

[139] Bainbridge, n 43 at 1423.

[140] Bainbridge, n 43 at 1423.

TIME FOR THE CORPORATIONS ACT TO INCLUDE A NEW REPLACEABLE RULE?

Self-regulation is appropriate for complex and difficult issues like corporate social responsibility that do not necessarily require an industry-wide solution. A replaceable rule[141] is a self-regulatory model that allows a solution tailored to each entity's circumstances and the demands of the relevant market. If there is genuine community agreement about the value of corporate ethics and embedding those values in the modern corporation, then a replaceable rule that affirmed their place in the life of the corporation would quickly gain acceptance as best practice.

The alternative, ie mandatory requirements either through quasi-regulation or government regulation, may impose a significantly higher compliance burden than would be justified by the principle that mandatory regulation should be the minimum necessary to achieve the set objectives. Regulatory provisions might impose additional costs on top of the established regulation, for little or no tangible benefit with substantial risk of uncertainty and litigation.

Is it necessary for corporate social responsibility to be enforceable? Probably not, as calls for corporate social responsibility have largely been along the lines of the need for a permissive model. So, to this extent then, there would seem to be no basis for criticising a self-regulation model on the basis of enforcement difficulties.

It is probable that the corporations that would adopt self-regulation of the type suggested are more likely to be the better performers. If the model is successful, the market will reward those that participate and it may offer a strong incentive (in terms of positive impact on corporate goodwill) to other corporations to comply, but only if there is a genuine demand for this approach from investors.[142]

A self-regulatory model will also ensure that only those corporations with a genuine interest/need will take the issue forward. This is also less likely to result in an approach to corporate social responsibility that is a process-focused "tick the box" approach.

A replaceable rule provides flexibility as to how corporations choose to meet socially responsible objectives giving scope for efficiency improvements and innovation. Additionally, such a rule would recognise that many small and micro businesses use the corporate form and do not have the resources to comply with a prescriptive set of rules. Doing so also is preferred because the risk of litigation, for example for failing to comply, is perceived as less under prescriptive self-regulation.[143]

The corporation is creature of statute designed for individuals (usually investors) to collect together for a common (ordinarily, business) pursuit through a legal entity that provides the benefits of limited liability, continuity of existence and simplicity in contractual dealings. Much of the argument in this article has been presented to demonstrate that the benefits that accrue globally as a result of this scheme result from leaving the participants to determine their own objectives and methods (subject, of course, to the requirements of general, ie non-corporate, law). However, to the extent that political imperatives, as well as demands from directors for some sort of "charitable safe harbour", necessitate regulatory involvement, a default constitutional rule offers exactly the right blend of recognition and encouragement.

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[141] The CAMAC Report acknowledged the idea that a replaceable rule might be introduced to allow directors to take account of the interests of stakeholders other than shareholders, but in the end did not propose such a model: CAMAC Report, n 9, p 110.

[142] Both CAMAC and the PJC looked at the concept of "sustainability reporting". Undoubtedly, there are many issues connected with the drive to present useful information to the market on matters of corporate social responsibility. The authors simply observe that, subject to developing dependable and accurate measures of corporate good practice, the market will ultimately reward good performers if that is what investors want.

[143] *Grey-Letter Law: Report of the Commonwealth Interdepartmental Committee on Quasi-regulation* (9 September 1999), http://www.pc.gov.au/orr/reports/external/greyletterlaw/index.html viewed 13 March 2003, pp xiv and 40. It was established to inquire into the extent of quasi-regulation, the circumstances in which quasi-regulation is a viable alternative to government regulation, essential features of successful quasi-regulation, and processes for monitoring and reviewing quasi-regulation to ensure that it is current, effective and efficient.

The *Corporations Act*[144] provisions dealing with the constitution could have a default setting that provided that in the absence of an alternative provision in the constitution of a corporation the management would be entitled to have regard to a range of objectives beyond the short-term profitability of the corporation.

A model rule

The model provision might read:

> **198B(1)[Default provision]** Except as specifically modified by a company's constitution, subsection 198B(2) applies to every company notwithstanding subsection 135(1).
>
> **198B(2) [Promotion of the success of the company]** In exercising their power to manage and direct the affairs of the Company directors may have regard to those matters they consider would be most likely to promote the interests of the Company [and/or the Group].[[145]] In particular, the Board may take into account:
>
> (a) the likely consequences of any decision in both the long and the short term for the Company [and/or the Group],
>
> (b) any need of the Company [and/or Group] to or likely advantage the Company [and/or Group] may gain from:
>
> (i) having regard to the interests of its employees,
>
> (ii) fostering business relationships with suppliers and customers,
>
> (iii) considering the impact of its operations on the community and the environment,
>
> (iv) maintaining a reputation for high standards of business conduct,
>
> (v) making donations for the public welfare or for charitable purposes; and
>
> (c) the need to act fairly as between Members who have different interests.[146]

The provision would thus form part of the contract between the members and the corporation as well as that between officers and the corporation. Any further consideration of such a provision, including modification or possible rejection, would be the exclusive province of members.[147] It would also not be open to regulators, "stakeholders" or anyone who was not a member or officer to enforce against managers.

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[144] A company's internal management may be governed by provisions of the *Corporations Act 2001* (Cth) that apply to the company as "replaceable rules", by a constitution, or a combination of both (s 134). This means that companies incorporated since July 1998 or any company that subsequently repeals its constitution (s 135(1)(a)) can modify that rule by changing its constitution (s 135(2)).

[145] While s 187 allows a replaceable rule for directors of wholly-owned subsidiaries, it might make sense to consider the issue more widely in the context of this type of provision. Generally see CAMAC, n 17.

[146] This drafting is loosely based upon the original language of cl 10(3) of the *Company Law Reform Bill* (UK) introduced in May 2005 (and which was superseded by s 172 of the *Companies Act 2006* (UK) – July 2006 which followed from the United Kingdom White Paper, n 15. The White Paper suggests that: "The statement of duties will be drafted in a way which reflects modern business needs and wider expectations of responsible business behaviour. The CLR proposed that the basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and suppliers, and in the community more widely. The Government strongly agrees that this approach, which the CLR called 'enlightened shareholder value', is most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all. It will therefore be reflected in the statement of directors' duties, and in new reporting arrangements for quoted companies under the Operating and Financial Review Regulations." The drafting avoids suggested phrases like "success" and "others" on the basis they are too imprecise a concept to be helpful. Unlike the phrase "in the interests of the company", it is not supported by an existing body of case law. Similarly, the authors have removed any reference to directors being required to promote the company's success "for the benefit of its members" on the basis that the company is an entity separate from its members. See "The Response of the Law Society's Company Law Committee, the Company Law Sub-Committee of the City of London Law Society and the Law Reform Committee of the General Council of the Bar" (June 2005), http://www.lawsociety.org.uk/secure/file/141081/d:/teamsite-deployed/documents//templatedata/Internet%20Documents/Non-government%20proposals/Documents/complawreformwhitepaperlawsocresponse.pdf viewed 12 December 2005.

[147] *Corporations Act 2001* (Cth), s 136(2).

The formulation should provide a safe harbour to allow management to take the interests of various constituencies into account without being vacuous, ie allowing "management to justify almost any action on the grounds that it benefits some group".[148]

If, however, a statutory provision to similar effect were included, then provisions like s 1324[149] have the potential to enable the "stakeholders" to seek remedies against those managers for not having, for example, proper regard to "the community and the environment". While little use has been made of this provision to date, we should not assume that, were corporate officers to owe duties to others in addition to their corporation, this would continue to be the case.[150] The future battleground for lawyers looking for ways of representing people like the landholders surrounding Papua New Guinea's Ok Tedi mine might be based around provisions like s 1324 and corporate social responsibility provisions, however cast.

There might be legitimate concerns that managers will face an irreconcilable dilemma between the profit maximisation norm and changing social norms.[151] In practice, a constitutional provision such as this allows a board of managers to have regard to other matters outside the narrow range of profit maximisation but does not oblige them to do so: it is a discrete safe harbour, not an expansive coastline.

A constitutional provision would not fundamentally alter the circumstances where management had somehow failed to properly consider corporate social responsibility-type matters in circumstances where it would have been in the best interests of the corporation to do so. Those managers would still be liable for failing to satisfy their duty of care and diligence. However, if the directors had taken a decision favouring the long-term sustainability of the corporation which resulted in financial detriment to the current shareholders, the directors could argue the existence of the replaceable rule was a relevant factor in determining the "corporation's circumstance" or the office held and their "responsibilities within the corporation".[152]

While the PJC considered the possibility of amending the *Corporations Act* to include a replaceable rule of the sort proposed above, it did not recommend that one be implemented.[153] The PJC referred to numerous submissions to the effect that a replaceable rule was unnecessary. Strangely,

[148] Hart O, "An Economist's View of Fiduciary Duty" (1993) 43 U Toronto LJ 299 at 303.

[149] Section 1324(1) provides: "Where a person has engaged, is engaging or is proposing to engage in conduct that constituted, constitutes or would constitute: (a) a contravention of this Act; (b) attempting to contravene this Act; … the Court may, on the application of [ASIC], or a person whose interests have been, are or would be affected by the conduct, grant an injunction on such terms as the Court thinks appropriate, restraining the first-mentioned person from engaging in the conduct and, if in the opinion of the Court it is desirable to do so, requiring a person to do any act or thing." Under s 1324(10), where the court has power to make an order under s 1324(1) against a person, it may, in addition to or in substitution for, the grant of an injunction, order that person to pay damages to any other person. As discussed, courts have indicated that to have standing under s 1324, the applicant must have an interest more than merely as an ordinary member of the public: see *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 73 FCR 161; 23 ACSR 715

[150] Baxt R, "Directors' Duty of Care and the New Business Judgment Rule in the 21st Century Environment", seminar paper, Seminar on Key Developments in Corporate Law & Equity, Melbourne, March 2001. *Re Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 39 NSWLR 128 may be authority for the proposition that s 1324 is not available in respect of breaches of the civil penalty provisions of the *Corporations Act*. However, like Baxt R, "A Body Blow to Section 1324 of the Corporations Law: Will the Derivative Action Get a New Lease of Life?" (1996) 14 C&SLJ 312, the authors agree that "Young J is not correct in his interpretation of the question of standing. In the first place the section uses the words 'any person' [s 1324(2)]. It would seem strange to me that the legislature would want to narrow that particular language down, at a time when standing is being given wider and wider interpretation by the courts in all sorts of areas" (at 314), cited in Fridman S, "Corporations Law in the Courts and the Academy: A Dangerous Malaise?", *Butterworths Corporation Law Bulletin*, No 23 (December 1996). See also *Australian Securities and Investments Commission v Mauer-Swisse Securities Ltd* (2002) 42 ACSR 605: in an application for a permanent injunction under the *Corporations Act 2001* (Cth), s 1324(1) the court is entitled to take into account discretionary considerations which are quite foreign to the traditional principles upon which a court of equity acts in granting injunctions. On the other hand, there are authorities to the effect that in an application for an interim injunction under s 1324(4) the court should approach the matter as if it were simply exercising its ordinary equitable jurisdiction.

[151] For example, see Bostock, n 80.

[152] *Corporations Act 2001* (Cth), s 180(1)(a), (b).

[153] PJC Report, n 10, p 63.

the PJC observed that the most "cogent" argument against a replaceable rule was that it would provide shareholders with too much power. The PJC seemed persuaded by the view of Professor Redmond that "such a rule would effectively give shareholders the right to withdraw from directors the capacity to consider stakeholders other than shareholders".[154] Having previously concluded that present law permits directors to act in "enlightened self-interest", it seems surprising that the PJC appears to be of the view that the general law can somehow be modified by shareholders.

Put more precisely, should shareholders opt to alter the replaceable rule and directors nonetheless consider stakeholder interests, would not the directors be able to do so as long as they are acting in the best interests of the corporation? In any event, if the directors, acting with proper information and in the absence of material personal interest, honestly conclude that their actions are in the best interests of the corporation, would they not also be protected by the statutory business judgment rule?

Protecting directors against shareholders is incongruous. Why is it appropriate for managers to be able to impose their own sense of ethics on anyone? What real difference did the PJC envisage? When appointing directors, are shareholders unleashing a species of powerful but unaccountable public servants, justified by a vague concept of the "public interest"? Those who formulate and implement public policy should be accountable to the public. Why shouldn't the incorporators and managers be free to manage their relationship in a way that suits them?

The PJC was, with respect, missing the point. A replaceable rule is not the means of providing the licence, nor is it a case of the shareholders back-seat driving. What it is intended is a "bargain" between the shareholders and management: a contract that says "we accept that from time to time you may choose to prefer other relevant considerations to our immediate interests". It protects managers from a claim by dissident shareholders that the money they spent on an altruistic objective within the scope of the rule, really belongs to shareholders. It is hard to see why the shareholders themselves should not be given the ability to permit certain conduct by managers that allows those managers to consider some broader "social objectives" while considering matters to "promote the interests of the company". That being the case, it is hard to see the harm in establishing a safe harbour at least as a default arrangement.

Further, a replaceable rule would also be consistent with the ASX Principle 10.[155] Compliance with this requirement was contemplated by a corporation adopting a code of conduct but the suggested replaceable rule would be entirely consistent with the recommendation.[156] The replaceable rule would give managers more certainty than a code of conduct, in terms of their duties to the corporation and the availability of business judgment defences.

CONCLUSION

The wealth maximisation norm is a well-founded and logical foundation for much of what we understand by modern corporation law. It provides managers with a touchstone when they have to deal with difficult issues involving weighing up competing economic and social interests. Legislators should be very careful before they introduce uncertainty at such a fundamental level of managerial duties, especially when there is a better alterative.

[154] PJC Report, n 10, p 63.

[155] Companies have a number of legal and other obligations to non-shareholder stakeholders such as employees, clients/customers and the community as a whole. There is growing acceptance of the view that organisations can create value by better managing natural, human, social and other forms of capital. Increasingly, the performance of companies is being scrutinised from a perspective that recognises these other forms of capital. That being the case, it is important for companies to demonstrate their commitment to appropriate corporate practices. See ASX, *Principles of Good Corporate Governance and Best Practice Recommendations*, http://www.shareholder.com/visitors/dynamicdoc/document.cfm?documentid=364&companyid=ASX viewed 16 December 2005. It might also be relevant to Principle 7 which refers to listed companies establishing "a sound system of risk oversight and management and internal control" designed to identify, assess, monitor and manage risk; and inform investors of material changes to the company's risk profile. According to the guidance on Principle 7, a company's risk profile should describe the material risks facing it – material risks include financial and non-financial risks.

[156] The Recommendations are that they are not prescriptions, but guidelines allowing for the choice of non-compliance, again consistent with a replaceable rule. Naturally, non-compliance operates within a "comply or explain" regime set out in ASX Listing Rule 4.10.3.

As with other corporate governance reforms, a self-regulatory approach to corporate social responsibility is the surest way to produce a meaningful approach to this issue. If there is a case for reforming directors and officers' duties; the changes needed should not be revolutionary. A self-regulatory model is a better way of influencing behaviour by institutionalising a change that is permissive and reflective of each corporation's own circumstances. Essentially this approach recognises the benefit of the shareholder primacy model where management's only duty is to the members of the corporation as a whole as a general rule but that corporations that want to adopt a different rule can opt out.

If the social norm has shifted, then that pressure can be accommodated in a new default replaceable rule. The self-regulatory model suggested will allow corporations to create wealth on a sustainable basis, but subject to the requirements of responsible business conduct. A mandatory rule modifying the shareholder primacy norm would be a serious mistake.

