Law Council
OF AUSTRALIA

Ms Kelly Paxman
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Ms Paxman,

Corporate Responsibility

This letter relates to the Parliamentary Joint Committee's inquiry into Corporate Responsibility and Triple Bottom Line Reporting. The submission is made by the Corporations Committee (Committee) of the Business Law Section of the Law Council of Australia. Please note that the comments in this submission have been considered by the Executive of the Business Law Section, but not by the Law Council of Australia.

The Committee first apologises for the lateness of this submission. It also assumes the wide canvassing of relevant issues in the Corporations & Markets Advisory Committee's 2005 Discussion Paper on Corporate Social Responsibility. The Committee thought it may be useful for the Parliamentary Joint Committee to receive this submission on some very short points.

Summary

In summary, the Committee's view is that the Corporations Act and the common law dealing with directors' duties allow directors appropriate flexibility to take into account a broad range of interests when they consider the interests of the company. The "principles" based approach reflected by the legislation and common law allows directors of solvent companies to take into account both necessary short term issues and the longer term, and to have regard to the circumstances of each company – its size, business and special impact on specific stakeholder groups.

These laws – which have remained the same in basic principle for over the whole of the past century and longer – have allowed corporate culture to adapt with and respond to changing societal expectations, new technologies, new business methods and changing concepts of who corporate "stakeholders" are.

The directors duties provisions of the Corporations Act and the common law do not provide disincentives to directors who want to take account of stakeholder interests. However, actions taken by companies – for instance, representations made to the market about what conduct the company will or will not engage in – can constrain action. This is a necessary consequence of the interaction of a range of provisions of the Corporations Act, and that interaction should not be overridden by amendments to the laws dealing with directors duties.[1]

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[1] Arguably what happened in the James Hardie case was this: having reconstructed the group and made representations to the market about the impact of that reconstruction on liability for asbestos related claims, the flexibility of directors may have been constrained from acting inconsistently with those representations without further shareholder approval. This is not a directors duties issue (although the public debate has framed it that way). Without the reconstruction of the James Hardie Group, the Committee considers that the directors could, consistently with their duties, have addressed asbestos liability issues.

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The Committee's philosophy most closely reflects the "commercial" view of corporate social responsibility set out in the CAMAC Discussion Paper.

The Committees views are as follows:

1. **It is both unnecessary and undesirable to amend the Corporations Act to require directors to take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions.**

   To the extent to which parliaments have considered that there are matters of public policy which override the rights of citizens – both individuals and corporations – they have enacted specific legislation to deal with the issue. Examples include environmental, occupational health and safety, industrial relations, consumer protection and trade practices laws. The Committee considers this to be the correct balance, and it is undesirable to include a generalised duty to stakeholder groups in the Corporations Act.

   An amendment to the Corporations Act which requires directors to have regard to the interests of stakeholder groups would be likely to:

   - *reduce flexibility.* By naming some stakeholders for special attention, questions are raised about the extent to which other interests must or may be taken into account.
   - *potentially increase the range of persons who can sue directors.* While it is likely that many of such cases would not be successful, the very fact that the law says an interest must be taken into account is likely to increase "opportunistic" litigation. This usually has a chilling effect on directors' willingness to take business risks (the original purpose for allowing limited liability companies) and may ultimately reduce the availability of insurance because insurers will bear the greater legal costs of more litigation, even if the litigation is ultimately not successful.
   - *reduce accountability.* This may seem counter-intuitive in light of the previous dot point, however, the current law provides a clear focus for directors' accountability. By broadening the interests which directors must take into account, it is likely also to provide a broader range of excuse for underperformance and give no guidance as to the circumstances in which one interest may or should weigh more heavily than another. ASIC, in its submission to the Parliamentary Joint Committee on Corporations and Financial Services, noted that broadening the scope of the interests that directors must take into account (or, pursuant to a "permission" provision, may take into account) may reduce effective enforcement.
   - *it is likely to increase "red tape".* This is because directors will, in recording any decisions, seek to demonstrate that they have taken into account each interest which they are specifically required to take into account. This is likely to impose costs without countervailing benefit.
   - *be of uncertain scope.* It is unclear whether a mandatory provision would apply only to listed companies or to all companies. There is no clear case why the mandatory provision should apply only to listed companies, given that there are very substantial unlisted companies and other forms of business organisation. It is equally unclear why the mandatory provision should not apply to individuals or other forms of business organisation if it did apply with justification to small companies.

- *have a disincentive effect.* It is possible that a mandatory provision would operate as a disincentive to companies incorporating in Australia[2]. That would simply remove out of the reach of the Australian corporate regulator a range of companies doing business in Australia. That seems to be counter to good policy.

Under current law, directors are fiduciaries of other peoples' money. That policy setting is a fundamental building block on which Australia's capital markets are built, and nothing should be done to change that, because it is essential to investor confidence in investing money in Australian companies. Other important Government policy also implicitly relies on this – such as laws requiring and encouraging superannuation savings.

2. **The Corporations Act should not be revised to clarify the extent to which directors may take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions.**

The Committee sees no legal need or benefit in providing a "permissive" provision and the Committee would not see it as an advance to the law. The Committee's concerns include:

- *interpretation.* If some stakeholder groups are named in the "permission", then the question is raised as to whether stakeholder groups who are not named may be taken into account or somehow have less priority. Further, listing stakeholder groups whose interests directors may take into account provides no guidance as to priority as between those groups or individuals in the groups (and it clearly cannot). As the law currently stands, directors are entitled to take into account a broad range of interests and to balance those interests according to circumstances.
- *reduces accountability.* This is discussed above.

The Committee notes that some other jurisdictions have included permissive provisions (eg the UK) however:

- they demonstrate the interpretation difficulty – because they do not include all classes of stakeholder.
- in the US, the provisions are usually limited to the takeover context.
- all of the overseas formulations relate to "the company" and do not address groups: ie, can a holding company act in the interests of stakeholders of subsidiary companies – the precise issue raised in the James Hardie case.

The Committee considers that the Corporations Act could usefully be amended to broaden the scope of section 1318(2) to allow courts to support decisions by directors. This provision would likely be most useful in cases of doubtful solvency. This is more fully argued in the AICD's submission to the Parliamentary Joint Committee on Corporations and Financial Services dated 30 September 2005.

3. **Should Australian companies be encouraged to adopt socially and environmentally responsible business practices and if so, how?**

The Committee considers that there are a range of factors already at work to encourage Australian companies to adopt socially and environmentally responsible practices, including:

- societal expectations. Companies are increasingly seeing the need to demonstrate good credentials in this area. This is particularly true of companies

[2] Note that as James Hardie NV is not incorporated in Australia a mandatory provision would have no impact on it.

in areas of direct environmental impact (resources, energy) but it is clear that many companies also see it as an area in which to distinguish themselves.

- growing focus on risk management, especially reputation or "brand" risk. Because of changing societal expectations, companies are increasingly demonstrating their understanding of the need to manage reputation or "brand" risk. This involves increased monitoring and management of social, economic and environmental risks. This is being expressed in the greater number of companies publishing stand alone sustainability reports. Many more companies are giving prominence either in annual reports or on their website to corporate social responsibility issues whether called by that name or not.
- increased occasions for enhanced disclosure, for instance, reporting against the Recommendations of the ASX Corporate Governance Council. Greater disclosure by some companies raises the bar for others, and this is generally increasing the quality and scope of corporate reporting in this area.

The Committee considers that Government can most effectively encourage these sorts of developments by:

- demonstrating leadership in its own practices and the reporting of Government entities.
- support of particular industry or community initiatives. Landcare is a good example. Government encouragement of the banking industry's financial literacy initiatives is another.

4. **The Committee does not consider that the Corporations Act should require certain types of companies to report on the social and environmental impact of their activities.**

The Committee does not see the need for this. To the extent that any particular industry's public disclosure should be enhanced, that should be dealt with in legislation specific to that industry.

Further, in the observation of members of the Committee, many shareholders are finding the size and complexity of annual reports inaccessible. Care should be taken in imposing further information requirements, unless:

- the requirements are specific to the particular company. Generalised reporting requirements tend to lead to formulaic disclosure which is not informative or useful; and
- there is a clear call for them from the investment community.

If you wish us to expand on any of the points made above, please contact Kathleen Farrell (02) 9225 5305 or Greg Golding, Chair of the Corporations Committee ((02) 9296 2164.

Peter Webb
Secretary General

15 May 2006