

28 September 2005

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
Parliament House
Canberra ACT 2600

Dear Sir

Re: Inquiry into Corporate Responsibility

I am writing in response to your letter of 30 June 2005 seeking submissions to an inquiry into corporate responsibility and triple-bottom-line reporting in Australia. This written submission makes brief comments in relation to each of the terms of reference adopted for this inquiry.

Unless specifically indicated to the contrary, all comments refer primarily to 'for profit' incorporated entities.

In this submission, a 'stakeholder other than a shareholder' is stipulated to mean, "any person, group or entity on whom a corporation depends in order to pursue its objectives". This is a narrower definition than sometimes employed (one alternative is to include all persons affected by a corporation's operations). However, one benefit of this narrower definition is that it confers basic parity to the enabling roles played by shareholders and other stakeholders. Each class of stakeholder is seen to make a material contribution to the corporation (shareholders provide capital, employees provide labour, the community provides basic infrastructure and a 'license to operate', and so on).

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

While individual decision-makers will vary in their personal regard for stakeholders other than shareholders, the vast majority of people, when acting in their role as a corporate decision-maker, will consider the interests of stakeholders other than shareholders as being entirely subsidiary to those of shareholders. The reasons for this are twofold. First, the legal obligation to act in the best interests of the company as a whole is often (and somewhat problematically) reduced to being nothing more than the financial interests of shareholders. In more extreme cases, this view can lead to a total disregard for a broader range of stakeholders who simply do not 'exist' in the mind of the corporate decision-maker.

Dr Simon Longstaff Executive Director

GPO Box 3599 Sydney NSW 2001 Australia www.ethics.org.au
tel: +61 (0)2 9299 9566 fax: +61(0)2 9299 9477 Ethi-Call (ethics counselling service): 1800 672 303
abn: 83 637 740 533 arbn: 094 609 015

Second, the established history of thinking about this question, in Australia, has always considered a regard for stakeholders other than shareholders as a means to an end – namely, to fulfil a principal duty to shareholders. In its most enlightened form, the duty to shareholders has been described as a duty “to shareholders in perpetuity” – and this formulation has been argued not merely to permit but actually require a concern for a broader range of stakeholders. However, as noted above, the status of stakeholders other than shareholders is entirely derivative. If a concern for their interests were not ultimately in the interests of shareholders, then they would be of no concern to the corporate decision-maker. The classic expression of this perspective was articulated by the one-time ‘doyen’ of Australian company directors, Sir John Dunlop, who observed in 1987 that:

I put it to you that the directors are responsible to the shareholders for profit in perpetuity; and that this general expression of a principle permits, indeed **requires**, directors to pay full regard to their employees, to labour relations generally, to the community, to the country, in all their decisions for and on behalf of shareholders.

(Dunlop, 1987, p 7, my highlighting)

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

It is our view that any remarks about this issue must be considered in the context of the legal privilege of limited liability. It is remarkable that such an extraordinary privilege should have come to be so much taken for granted. Yet, the British House of Commons required more than 50 years of debate before it could be convinced that such a privilege should be enacted. It is easy to see why a democratic polity and its parliament would require such a long period of deliberation. The proposition that an initial investment should be allowed to generate an unlimited return (by way of dividends and capital gains) is, by itself, reasonably uncontroversial. However, it becomes profoundly challenging when linked to the proposition that irrespective of the damage done by a corporation – lives broken, environments ruined, and so on ... the extent of the relatively fortunate investors’ liability will be limited to the value of their initial investment. That is, all the upside of corporate activity would be ‘privatised’ while all of the downside would be ‘socialised’. The only basis on which a democratic legislature could enact such a law (and then allow it to continue) would be on the assumption that to do so would lead to an increase in the stock of what might be called the ‘common good’ (or at the very least not a decrease). That is, the legislature would need to be convinced that those enjoying the privilege (and their agents) would exercise their privilege in a manner that would make us all better off. Given this, we might expect company directors to have a proper concern for the effect of their decisions on people and entities other than shareholders alone – if for no other reason than it would be a profound breach of their duty to shareholders if their actions caused the parliament to qualify or withdraw the privilege (something that parliament could do at any time) in response to community outrage.

As will be noted, the point sketched above falls short of saying that company directors must recognise a direct duty to stakeholders other than shareholders. The argument is still couched in terms of the interests of shareholders. However, it is possible to go further in an analysis of the privilege of limited liability. The privilege is accorded to shareholders as individuals and not to the company as such. Thus, any implied obligations attached to the privilege fall on the shoulders of individual shareholders. However, the privilege enjoyed by shareholders cannot be enjoyed in isolation.

The whole point of the arrangement is that the privilege comes into effect when individuals aggregate their capital in companies. It is at least arguable that when shareholders aggregate their capital (and the privilege of limited liability), they also aggregate the implied duty not to use the privilege in a manner that is destructive of the common good. In these circumstances, company directors should be seen as effective agents for shareholders – with a responsibility for stewardship of their obligations as well as their rights.

An alternative reason for thinking that corporate decision-makers might have regard to the interests of stakeholders other than shareholders can be seen to emerge from the definition of ‘stakeholder’ stipulated above. That is, to the extent that stakeholders enable a corporation to pursue its objectives, so it is just that their interests be considered. There is no reason, in principle, why the suppliers of capital should be the only group to command the attention of corporate decision-makers. While it is true that the law confers certain rights on owners (shareholders) it is capable of recognising other rights (employees’, creditors’ etc.).

Some corporate decision-makers recognise these broader obligations but claim that they are not qualified to form a view about what might (or might not) constitute the ‘common good’. Rather, they argue that this is the role of governments – and the democratic process. Consistent with this view, they argue that they should have a clear focus on acting within the law – nothing less and nothing more. On this view, it has been argued that if a certain course of action is in the interests of the company and not illegal then it is at least permitted and probably required.

There are two problems with this position. First, it invites an increase in regulation and surveillance as the only means available for regulating corporate conduct. Second, it risks the creation of community scandal and calls for some qualification or repeal of the privilege of limited liability.

Perhaps a better point to be made in defence of the *status quo* is that it would be impractical for corporate decision-makers to be required to base their decisions on a calculation of the interests of stakeholders (as a whole) other than shareholders – not least because it is conceivable that the interests of stakeholders may prove to be fundamentally incompatible. In these circumstances, corporate decision-makers might become paralysed – having to choose between two or more incommensurate duties of equal ‘weight’. Our view is that this objection can be overstated. Corporate decision-makers need to be adept at balancing competing interests. That said, it is possible (and maybe even likely) that a stalemate could be reached. In these circumstances, we would agree that the interests of shareholders should take precedence.

In the end, what is needed is a balance of approaches. Individual companies should not be required to develop a comprehensive view of the ‘common good’. However, nor should they be indifferent to the effects of their actions. If there is *prima facie* evidence that a company’s actions are causing (or are reasonably likely to cause) harm, then corporate decision-makers should be required to take this into account in their deliberations and then be entitled to allow such considerations to inform their decisions. The distinction in the last sentence should be noted – and is indicated by highlighting (underlining) key words.

None of this should be taken to mean that incorporated entities should become financially unsustainable. It is conceivable that a company could do so much harm as to make it desirable that it cease to exist. However, this should be considered the true exception.

- 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.**

As noted above, the primary legal duty of a company director is to act in the best interests of the company as a whole, free from conflicts of interest etc. Some commentators and practitioners have argued that the duty to the company is coextensive with that owed to shareholders. However, this is probably only so if you take Dunlop's view that the duty is to shareholders in perpetuity.

There are two problems with the current position. First, the law is not clear about the extent to which the duty of directors is to shareholders 'in perpetuity' – or to those holding shares at a particular point in time. Second, although it will sometimes (or often) be the case that there is an alignment between the interests of shareholders and other stakeholders, there is absolutely no reason to think that this is necessarily or always so. As such, it is conceivable that corporate decision-makers may find themselves doing great harm to stakeholders in conditions where the objectively assessed risks of harmful consequences flowing from this action are negligible.

- 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.**

We do not support recommendations to make it compulsory for company directors to base their decisions on the interests of stakeholders other than shareholders.

However, we think that company directors should be required to consider those interests – even if in the end they opt to act exclusively in the interests of the company as a whole¹.

Finally, we would recommend an amendment to the Corporations Act, similar to the provisions relating to the 'business judgement rule', allowing company directors to make decisions based on *bona fide* ethical considerations (including but not limited to the interests of stakeholders other than shareholders) – and protecting them from liability for doing so when a reasonable person would judge those considerations to be well founded. This protection should be afforded in all cases – including when the decision may have some detrimental effect on the financial interests of the company as a whole, its shareholders or some group of them. As such, directors relying on the 'ethical judgement rule' as a defence, would be required to produce documents demonstrating the quality of the reasoning employed in reaching their decision. Courts would only be entitled to review the substance of any decision if the quality of the decision-making process was first found to be inadequate.

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

We believe that the use of legislation, regulation and surveillance as the principal means for protecting the interests of stakeholders other than shareholders is misguided. Our concerns are twofold. First, an over-reliance on such an approach is largely ineffective because it invites a negative culture of compliance characterised by indifference to the principles that inform the legislation or regulations. In these circumstances, corporations become adept at playing a game of 'regulatory arbitrage' – across jurisdictions and through the exploitation of loopholes.

Second, we believe that an over-reliance on regulation and surveillance can inadvertently weaken the ethical sinews of society. When people comply by merely 'ticking the box', then they are absolved (or absolve themselves) of any responsibility for choosing to act in a manner that is right and good. One of the unintended consequences of a system designed to ensure that people cannot choose to do what is 'wrong' is that they can no longer choose to do what is 'right'. They no longer choose at all – they merely comply. This weakening of the ethical sinews of society generates considerable, latent risk. If for any reason the regulations fail, the lack of underlying resilience can lead to a broad failure of responsible conduct.

It is for these reasons that we recommend the encouragement of corporations to participate in voluntary exercises such as the Corporate Responsibility Index (CRI). St James Ethics Centre is the 'trustee' for this instrument in Australia and New Zealand. Developed in the United Kingdom, the CRI provides a highly effective tool for measuring corporate performance across dimensions that necessarily require a consideration of interests other than those of shareholders. The most important features of the CRI are that it offers detailed information that helps corporations to improve their actual performance. Secondly, the reporting process leads to the publication of an Index available for examination by the broader community. Along with the Dow Jones Sustainability Index (DJSI) we believe the CRI provides a powerful tool for encouraging an underlying culture of corporate responsibility.

As noted below, we think that government has an important role to play in encouraging and supporting businesses that voluntarily undertake valid and credible steps to measure, report on and improve their performance in the overlapping areas of corporate governance and responsibility. Businesses undertaking these commitments should be eligible for 'regulatory relief' – moving from highly prescriptive regimes to a 'principles based' system of co-regulation. The community may require the maintenance of a more prescriptive regulatory regime where companies opt not to adopt voluntary programs of the kind outlined above.

Further details about the operation of the CRI can be found at www.corporate-responsibility.com.au

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

For reasons outlined above, we support the development of a voluntary initiative by which business reports on its performance in the field of corporate responsibility. However, it should be noted that a voluntary scheme may not succeed. Given this, government should consider asking the ASX and ASIC to deliver minimal and mandatory reporting standards – which would ensure that, without specifying the form of reporting, all annual reports, at a minimum, included basic information about corporate responsibility – if not at the level required by instruments such as the CRI.

Most importantly, Government should consider providing positive incentives to corporations that voluntarily participate in programs like the CRI and DJSI – for example government might offer some regulatory relief to companies able to demonstrate a credible commitment to the principles of corporate responsibility and their application.

Finally, government might consider making available some modest financial assistance to corporations needing to employ additional resources so that they can improve their performance across the field of corporate responsibility. Funding would be available for a limited period of time to allow for the purpose of capacity building.

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

No specific comment to make other than to draw the committee's attention to the UK's Operating and Financial Reporting (OFR) review.

Please feel free to contact me if I can be of any assistance in your deliberations.

Yours sincerely,



Dr Simon Longstaff
Executive Director
St James Ethics Centre

Reference:

1. Dunlop, Sir John, (1987) "The Responsibility of Company Directors: Formulation of the Major Policies of The Company" in, *Dunlop on Directors*, Sydney, The Institute of Directors in Australia.

ⁱ It should be noted that recent decisions by Finkelstein, J. and Emmett, J. in the Federal Court have introduced a further 'wrinkle' in contemporary understanding of what is meant by "the company as a whole". In ordinary commercial language this is taken to include the company as a legal person and all of its shareholders. The recent decision implies that the duty to act in the interests of the company as a whole, arising under the Corporations Law, may only apply to those shareholders who purchase shares through an initial subscription of capital – and not those who have purchased shares 'on market'. One practical effect of this decision has been to allow some shareholders to rank with creditors when suing companies in liquidation. There are, of course, further implications in terms of the broad duties of directors discussed in this submission.