Issues

Key points

- At any point in time, corporation law, like most areas of law, has a number of current issues.
- Many of these are dealt with at various points in the book.
- Some are worthy of separate consideration and are considered in this chapter. They are:
    - whether Australia should have a national corporations law and, if so, how it can it be managed in view of the Constitution
    - corporate governance
    - institutional investors
    - corporate social responsibility
    - directors' and executives' remuneration

Introduction

At any point in time in any field of law a number of issues of greater or lesser importance and urgency arise. This is particularly true of corporations law in the last couple of decades. The field has been subject to more or less continuous change since the introduction of the Corporations Law Simplification Program (CLERP) in 1994.

Apart from apparently directed programs, the evolution of corporations law, according to many theorists, is a story of punctuated equilibrium, where crisis forces change on an otherwise complacent legal system.[1] Moreover, the course of change is path-dependent, sensitive to initial conditions.[2] While this might produce chaotic differences between legal systems, the forces of globalisation tend to coalesce.[3]

Students of law need to understand more than just the substance of the law. At the very least they must consider the policy issues of the day. These are the crises which force change, whether towards diversity or globalisation, and are worthy of consideration in themselves.

The major issues current in corporations law are the subject of this essay.[4] It is divided into sections, each describing a current issue, nominating the triggering crisis or event, and referring to the law or literature involved. The main object is to provide background for students attempting to deal with one or more of the issues. The issues are set out in no particular order. No claim is made to exhaustiveness, and many minor matters of current concern about specific aspects of the law are dealt with at the relevant point in the rest of the book. These include:

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1 M J Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 *Harvard Law Review* 641.

2 L A Bebchuk and M J Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance (1999) 52 *Stanford Law Review* 127; G Walker (ed.), *International Securiuties Regulation: Pacific Rim, Vols. I–IV,* New York, Oxford University Press; G Walker and B. Fisse (eds), *Securities Regulation in Australia and New Zealand,* Auckland, Oxford University Press, 1994.

3 The 'Law Matters' thesis of R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, 'Legal Determinants of External Finance', (1997) 52 (3) J*ournal of Finance* 1131 is an example of a centralising hegemonic view. For a critical overview, see A Pekmezovic, 'Determinants of Corporate Ownership: The Question of Legal Origin', (2007) 18 *International Company and Commercial Law Review* 97 and 147.

4 It is important, then, to note the date at which this chapter was last updated: June 2008 for this edition. Events which arose after this date are not included for obvious reasons, and as time passes those more distant become fainter and the smaller ones disappear entirely.

- Criminal and tortious liability of corporations for what is done by employees or as a result of the organisation of the firm.
- Liability of directors, executives and managers for what they do for the corporation.
- Liability of directors, executives and managers for what others do for the corporation or when the corporation is liable.
- The form of property rights and protections, market rules and market rule enforcement most appropriate for a competitive capital market and the degree to which that is essential for an efficient modern economy.
- The degree to which corporations law should accommodate different types of companies, including small, medium and large, closely held and dispersed ownership, charitable, not-for-profit or government, listed, and so forth.
- Reconsideration of the nature of membership of a corporation in view of the *Gambotto*[5] and *Sons of Gwalia*[6] cases and the impact of that on various aspects of law, including winding up.

Learning exercise

Scan the business pages of newspapers (perhaps on the Internet) to find articles raising any of the issues dealt with below. See if any other issues are being written about by journalists and commentators. You might also like to listen to business programs on the radio or watch the news on television for the same purpose.

A national scheme?

As soon as it was proposed that the Australian colonies should federate, the issue of whether the states or the Commonwealth should provide for corporations law became apparent. The Constitution arguably divided responsibility in s 51(xx) and the matter has been litigated several times.

Responsibility for corporations law was at first assumed by the states, but there have been attempts at Commonwealth assumption of power. A number of schemes have provided degrees of control from the centre while retaining ultimate power in the states.

The latest scheme as to responsibility for corporations law is the referral scheme, under which the states have referred whatever power they have over corporations to the Commonwealth. Constitutional issues remain, particularly as to separation of powers and limitations on the conferrals of power or jurisdiction between the states and the Commonwealth.

Constitutionality is frequently litigated because it challenges the power to regulate. Hence, if someone wants to avoid liability for a penalty, whether civil or criminal, have the decision of any authority nullified, break a restriction on activities or challenge a law or regulation, having the law overturned on constitutional grounds is an attractive strategy, provided only that the benefits outweigh the high monetary costs of doing so.

The issues and law involved are comprehensively considered in Chapter 2.

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5 *Gambotto v WCP Ltd* (1995) 182 CLR 432.

6 *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1.

Corporate governance[7]

Despite its frequent mention in the media as an important issue and the many books that have been written about it, it is remarkably hard to work out exactly what ‘corporate governance’ means. The first task in any discussion is to pin down in exactly what respect the matter is being considered.

Here a narrow meaning is adopted as the other angles are dealt with as separate, but perhaps overlapping, issues. The meaning here is that corporations should be managed well. The concern is with the causes of corporate collapses, such as One.Tel and HIH, insofar as they can be laid at the feet of poor management (at best) or outright fraudulent behaviours at worst.

Other ways of thinking of corporate governance, dealt with below are:

- corporate social responsibility;
- directors and executive pay;
- the rights of employees;
- the long tail problem; and
- personal liability of managers for corporate wrongdoing.

My meaning is that ‘corporations should be managed well’. Despite excluding many matters that would otherwise fall under the rubric of ‘corporate governance, even the concept of being ‘managed well’ is problematic. Do minor frauds by low-level employees fall within the topic? Does strong concern for charitable causes fall outside the category of ‘well’? The phrase ‘should be’ indicates other difficulties: By what means and to what extent is the call for better management to be effected? And what is called for?

Who should be dealt with?

If something is to be done, should it be focused only at the directors, only at the highest executive officers, or at both, and how far down the chain of command does it extend? When the issue is as narrowly defined as it is here, discussion is generally confined to higher echelons of management. It is their responsibility to ensure that the corporation keeps on track and performing well. The issue extends to the means and techniques by which control is kept within the corporation.

The distinction between directors and managers (sometimes ‘executives’) is problematic here. The two are blurred: directors are often also managers, especially in smaller corporations. There are also substantial differences in practice between countries. The distinction is mostly maintained in functional terms in the Anglo-Australian debate, although one of the themes running through the corporate governance literature is that the functional difference is an important aspect of good corporate governance. This is allied to the case for independent directors.

By what means should better corporate management be achieved?[8]

Law-making can be a blunt tool in the pursuit of better decision making. The more obvious frauds and scams are already governed by laws and duties and yet they still take place. The problem may not be the absence of law but of compliance. Nevertheless, after each crisis, reforms are called for and frequently enacted. For example after the recent failure of insider

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7 An excellent overview is provided in Ford, 315–35. See also John Farrar, *Corporate Governance in Australia and New Zealand* OUP, Melbourne, 2001.

8 There is a good discussion of this in John Farrar, *Corporate Governance in Australia and New Zealand* OUP, Melbourne, 2001, ch 27.

trading laws in a couple of high profile cases, the contraventions were recast as attracting only civil penalty provisions, substantially lessening the requirements of establishing the contravention.

Law dealing with corporate governance in the sense outlined above includes:

- directors' duties;
- disclosure;
- audit;
- members' rights, including as to voting, meetings and as to the right to sue; and
- the constitution of the company and its enforcement.

A more subtle approach is by means of 'soft law': codes of conduct.[9] Various regulatory bodies have such codes of conduct; for example, the Australian Stock Exchange (ASX) has its *Principles of Good Corporate Governance and Best Practice Recommendations*, formulated by the ASX Corporate Governance Council—a body made up of the representatives of many interested organisations. Many other organisations and bodies have set out suggested codes of conduct, some in Australia and many overseas and internationally. A feature of many of these is that they are generated by the institutions involved—they are a matter of self-regulation. Whether self-regulation is effective is a matter of debate.

Codes have more or less binding power. A position somewhere between enforceability and recommendation is adopted by the ASX for its *Principles of Good Corporate Governance.* The ASX operating rules are enforceable as a contract between the listed company and the ASX (and all other listed companies) and there are various powers of enforcement through the *Corporations Act 2001*. Listing Rule 4.10.03 requires a listed company to include in its annual report a statement as to the extent to which they have followed the *Principles*, and explain why they have not done so when they have not: the 'if not, why not' approach. This does not require compliance with those principles—after all, they are 'recommendations'—but it does require disclosure of compliance and non-compliance.

Regulatory theory provides a useful approach to the various methods of attaining compliance with policy objectives.[10] It provides a graduated program of responses of regulatory bodies to non-compliance, culminating in the 'big stick' of prosecution for offences. It is, however, of limited utility where the policy objectives are not well formulated.

To what extent is this a matter of regulation?

The nineteenth century founders of company law would be shocked at the idea that the performance of companies was anything to do with them. Their duty was to provide the mechanisms and to legislate to prevent their abuse. It was not the province of government to prevent bad things happening; on the contrary, the government should interfere as little as possible. These sentiments still exist, but in the form of a belief in the efficacy of markets. Markets, goes this line of thinking, are much better than any form of prescription at rewarding good performance and punishing bad performance, even when what is 'good' or 'bad' is not articulated. The markets that might deal with the way corporations are run are the product market and the market for corporate control.

The product market

The product market is the market for whatever the corporation produces, whether it be goods or services. Those things are priced, and if the corporation is badly run, costs will rise as will

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[9] 'Decentred regulation' is another way of considering the form of regulation; see, Dimity Kingsford Smith, 'Beyond the Rule of Law? Decentered Regulation in Online Investing'. (2004) 26 *Law & Policy*, 439.

[10] For a general overview of regulatory theory see C Parker (et al) *Regulating Law*, Oxford University Press, 2004.

the price and less will be sold. Profitability will drop and management's failure to perform made obvious.

The market for corporate control

The market for corporate control depends on the transferability of shares. If a company is being poorly run, its relative value will drop due to either a failure to pay dividends as high as it might or to increase in value. At some point potential owners will determine that they can do a better job with the corporation than the present owners, and in so doing will increase its value. They will then be willing to buy the shares in the corporation at a price greater than their value in the hands of the current owners. The current management will then be displaced.

Both markets can be limited in effectiveness (economists use the value-laden term 'imperfect'). The product market might be one where market power exists to displace price signals. The share market might be shallow and narrow—not enough shares in not enough companies are on sale, and not enough money is available to buy them with for price signals to work. Moreover, markets depend on information, and this might not be forthcoming.

The founders of company law demanded disclosure. It was one of the key principles of company law, although the rationale was somewhat different: that only informed people were free to make their own choices and freedom was the basis of society. Nowadays disclosure is seen more instrumentally, although it is thought no less vital. Disclosure leading to informed choice makes markets work better, and markets produce the desired effects. Disclosure, then, facilitates good corporate governance and makes prescribed standards of behaviour unnecessary.

To be done 'well': What is required by corporate governance?

Many discussions of corporate governance slide straight into the debate, 'For whom are corporate managers trustees?'—the topic of the famous argument between Berle and Dodds, and presently carried out in terms of shareholder primacy vis à vis stakeholder theory. It is quite proper to defer that debate, important as it is, to be considered along with other issues. The question here, whatever the definition of 'well', is how does society best ensure that corporations do *well* whatever they are supposed to do. This is to adopt what is called an 'enterprise' focus, although that is not, as many might assume,[11] to fix on any particular conception of the purposes or structure of corporations.

To that extent, and by the means set out, corporate governance may demand or recommend that certain standards be adhered to and certain things be done. The most important of these are as to:

- the responsibilities of the board of directors, including the decision-making role, management monitoring activities, and accountability;
- the functions and rights of shareholders as owners and equitable treatment amongst them;
- how others involved in the corporation ('stakeholders') should be regarded and treated, although this is to go further than my definition of corporate governance here; and
- disclosure and transparency.

[11] Clive Schmitthof developed an 'enterprise' theory of the corporation, founding it on German co-determination principles. It was that the corporation was a tripartite arrangement between capital, workers and management for the benefit of all. It is not implied by my usage of the word 'enterprise' here.

ASX *Corporate Governance Principles*

A company should:

- Lay solid foundations for management and oversight;
- Structure the board to add value;
- promote ethical and responsible decision making;
- Safeguard integrity in financial reporting;
- Make timely and balanced disclosure;
- Respect the rights of shareholders;
- Recognise and manage risk;
- Encourage enhance performance;
- Remunerate fairly and responsibly; and
- Recognise the legitimate interests of stakeholders.

Each of these is further explained and a guideline as to how to best achieve it is set out.

Some of the particular measures recommended are:

- Independent, non-executive directors: that the board should have a proportion of directors who are not involved in the management of the company nor connected in any way with the company. The idea is that their independence strengthens monitoring capacity, enhances accountability, confers outside perspectives and helps resolve conflicts of interest. There is only equivocal evidence as to whether independent directors do indeed serve a useful function.[12]
- Carefully structured committees of the board to deal with such matters as audit, risk, selection and remuneration. The idea is that committees with written terms of reference, adequate resourcing and agreed reporting arrangements will ensure critical matters receive proper and objective attention, despite any inherent conflicts of interest in or technical difficulty of the subject matter.

Learning exercise

How many sets of corporate governance principles can you find? What are their differences and similarities? What do they recommend is done to enhance corporate governance? Especially note their definition of corporate governance and the techniques of enforceability deployed.

Institutional investors

Reading

The presence of institutional investors is often mentioned as defeating the scheme of corporations law. It is not easy to precisely define ‘institutional investor’ although the sense of the term is readily understood. It encompasses superannuation funds, investment companies and funds, insurance companies, and charitable foundations. In other words, it is an institution or organisation which invests in other companies. The problem is either that the scheme of corporations law envisages that members of companies are owners and have the interests of owners—the Berle and Means conception—whereas institution do not or cannot express those interests, or that the agency problems are multiplied by indirect holdings. Essentially the issue is whether systems of control and accountability remain as they should be when institutional investors are involved.

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12 Farrar, 346–7.

No single event can be nominated as triggering recent concern with the phenomenon of institutional investments. This has been a concern since the work of Berle and Means in the 1930s. While the evidence is not convincing, the prevailing notion is that the proportion of shares held by institutional investors is growing due to compulsory superannuation and expanded use of managed investments.

Discussion of the issue generally focuses on shareholder activism. The idea is that because institutional investors are simply interested in the wealth effects of their shareholdings they are ‘passive’: they choose ‘exit’ over ‘voice’. This passivity disrupts the systems of control of management. A number of points can be made about this argument:

- It assumes the individual owner is less passive, when most evidence suggests they are equally so.
- There have been recent instances of institutional activism.[13]
- Some of the original passivity is due to legal restraints: the risk of infringing takeover laws, problems with exercising voting power with self-interest, and insider trading laws. Recent attention to legal restraints on institutional activism has lead to their amelioration.
- It is debatable whether the interference in management by institutional investors is beneficial.

Corporate social responsibility

Reading

The single-minded pursuit of any person’s interest can hurt other people’s interests, even when conducted within the law. To a degree, this is implied by a competitive market economy. In business, managers are required to subordinate their own interests and pursue the interests of the corporation. This may hurt the interests of others involved in the corporation, including shareholders, creditors, employees, victims of corporate action, consumers and even society or the environment generally. Two questions follow:

- Are there limits to what managers can do in pursuit of the company’s interests?
- What does ‘the interests of the company’ mean?

These are rolled together into the issue of ‘corporate social responsibility’.

Three recent situations exemplify the issues.[14] The first is the waterfront dispute of 1998 in which employees’ entitlements were threatened.[15] The second is the James Hardie controversy, where compensation for the victims of negligence was prejudiced. In both these a series of transactions was conducted to deprive a company of the assets to pay the liability. In the third, the Australian Wheat Board scandal, corporate management flouted the UN-mandated Oil-for-Food Program. Other situations include the pollution of the Fly River in Papua New Guinea by a company owned by BHP Billiton, the Bhopal disaster in which over 20,000 people died and many times that permanently incapacitated by the release of toxic chemicals. We can also think of the encouragement of people to smoke by tobacco companies and the activities of pharmaceutical corporations in Africa. Examples are legion.

There have been two recent reports into the social responsibility of corporations in Australia, by CAMAC and by the Joint Parliamentary Committee on Corporations and Financial Services.

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[13] Boros and Duns 82–3; Satpledon 1996.

[14] They are set out in a little more detail in the History essay, under their respective dates.

[15] The subject of the recent ABC TV mini-series *Bastard Boys*.

In so far as the two issues involved are separated, discussion of the first is muted. Reliance is placed on law and general codes of morality. The second is subject to some cynical amusement, as it is asserted that morality does not survive well when faced with competition. Morality is costly and competition forces production to the least cost provider.

To think about

Do you agree that morality cannot survive in the face of competition?

Note: This is an exceptionally important question yet equally difficult. Recourse might be had to economic notions of the rational actor and ideas of game theory. From a sociological point of view, we might think in Foucauldian terms of normalisation and the government of the self. Empirically, one could turn to examination of the success of ethical investment institutions or the story of the Body Shop.

‘The interests of the company’ has been the subject of considerable theoretical and doctrinal examination. The first is the subject of the long debate between shareholder primacy models of the corporation and stakeholder or communitarian theories. Both come under many names and in considerable variety and are considered in Chapter 4. Theoretical examination leads to the interests of all but shareholders being left to the uncertain protection of legally defined interests. Doctrinal approaches lead to conferral of a mediating discretion to managers, in the interstices of which is considerable uncontrolled power.

In doctrinal terms, Australian corporation law is somewhat surprising. Often considered to adhere strongly to shareholder primacy, a number of inroads have been made into that principle:

- The doctrine of ‘proper purpose’, deployed both in directors duties and in restraints on shareholder action, does not provide an objective test for benefit for shareholders. It does not refer to their wealth or the company’s wealth. It envisages a purpose for the company determined from the purposes of the members but also taking account of the company’s nature and history: see *Peters American Delicacy Co Ltd v Heath* (1939) 61 CLR 457*; Gambotto v WCP Ltd* (1995) 182 CLR 432. Moreover, impending insolvency forces consideration of creditors’ interests rather than members’.
- Frequently when the interests of employees have been threatened by corporate action beyond what are considered to be normal commercial dealings, legislators have stepped in to provide further protection. An obvious example is Part 5.8A, enacted (somewhat reluctantly) in response to the Waterfront dispute, whereby employees’ entitlements are protected from transactions designed to defeat them. A similar set of provisions is envisaged for tort victims in response to the James Hardie affair.
- The priorities in winding up provide for deferment of some unsecured creditors to others thought more worthy. Indeed, the partial subordination of floating charges reflects an 1890s concern for workers.
- Private enforcement of the Act is provided for in s 1324. This enables those ‘whose interests are or have been affected’ by the breach to seek an injunction or damages. Generally this is widely interpreted, although there are unresolved questions about the degree of intervention this permits in matters thought to be within the province of the members.
- Consideration of the examples of socially irresponsible conduct reveals that most occur within the context of corporate groups. BHP Billiton owned the company that operated the Ok Tedi mine, Union Carbide’s subsidiary released the gas. The manoeuvres involved in both the Waterfront dispute and the James Hardie affair allowed liabilities to remain, but shifted assets out to other members of the group. The issue then is of extent to which the idea of corporate entity is going to stand in the way of

compensation. Profits have flowed to owning companies, but liability does not, even when the profits have been derived from wrongful conduct.[16] Hence the very idea of isolation of risk in business activity comes under challenges. Australia until recently strongly repudiated inroads into separate legal entitihood to make owners liable but there are some hints of both legislative and judicial inroads: sec 588V–X and *Briggs v James Hardie.*

Directors' and executives' remuneration

The amount senior executives are paid is attracting much criticism. Total remuneration packages in the millions are not unusual—this when average weekly earnings are less than $50,000. There are two issues: what justifies the quantum and how the packages work to provide incentives for executives.

Learning exercise

Find published empirical evidence of the levels of executive and director's pay.

The quantum

Remuneration levels have accelerated in the last ten years. Every few months another extraordinary package worth tens of millions of dollars comes to light. The response of law-makers has been simply to legislate for disclosure: sec 202B and ASX Listing Rule 10.17. The question is said to one for shareholders, although this seems illusory in view of shareholder passivity.

There are four justifications for the levels of remuneration:

- The reward is deserved. (But then the question is, how should deserts be measured?)
- Shareholders have consented to it. (Yet they are passive; even if not passive, how can they be certain that the recommended package is too high and what are the risks if in error?)
- It is compensation for risk-taking. (Yet most risks, other than malfeasance, are insured against.)
- The market sets the price. (But how are demand and supply for executives determined, and how is quality measured?)

As incentive

The Enron collapse revealed a flaw in the reasoning behind common practice in remuneration. Stock options had been rising in popularity as pricing them at a low level gave a large incentive to increase the value of the company.

How do these options work? The executive is given, on day one, say, 1,000,000 options, each to purchase a single share at the price of $5 in, say, three years. The price at day one is $1. If the executive does the job really well, the share price in three years might be $8. The executive can then buy shares worth $8 for $5 by exercising the option. If the executive sells them straight away, they will make a profit of $3 on each share.

Of course that is a simple version. There are many permutations: the price can be set by reference to a stock index or even prevailing interest rates. There might be a graduated scale of options with various maturity dates. One of the tasks of a remuneration committee is to work out an appropriate incentive plan. Outside advice is often sought for this task.

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[16] A point made very strongly in the James Hardie commission: Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation (2nd printing, D F, Jackson Q C, Commissioner), Cabinet Office, NSW, 21 September 2004, 555; available at http://www.cabinet.nsw.gov.au/publications.html.

The flaw was that the incentive can prove to be too great and lead to a focus on stock price as at certain dates. In the Enron case, there was such a focus on share prices that accounting and reporting practices were perverted to keep them high. More generally, options tend to turn policy to the short term, rather than building wealth over a long period.