NSW Bar Association: Commercial Law Section
Bathurst Lecture 2019
6 March 2019

Is the Contemporary Corporation Fit for Purpose?

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Introduction

Distinguished members of the Bench and the Bar, and distinguished guests, Ladies and Gentlemen

I am honoured to present this lecture named in recognition of Chief Justice Tom Bathurst. His Honour and I were contemporaries at the Sydney University Law School, but after a six-year sojourn in legal practice, our career paths diverged some 40 years ago. My path led to a three-part business career: first, as a management consultant for a dozen years with McKinsey & Co., second as a CEO, both of law firm Blake Dawson Waldron (as it then was), and then for eight years as CEO of the venerable, 100-year-old Perpetual Trustees, and third, for the past 15 years, as a full-time company director, specialising in chairman roles. It is nice that our paths should intersect again this evening.

My management consulting career gave me a broad exposure to the commercial challenges of managing business organisations across many sectors. My roles as a CEO deepened my appreciation of challenges of managing large business organisations, including that most idiosyncratic of business organisations—the law firm!

My role at Perpetual—a publicly listed company since the 1880s—sparked my interest in corporate governance (well before that term was widely used) when my then chairman, John Lamble, challenged me in the 1990s to think from first principles how governance of a listed company should work. I have continued this exploration over the past 15 years as a practising company director where I have had the privilege of serving on the boards of a wide range of corporations–private companies, public companies, subsidiaries of multinational corporations, government corporations and numerous not-for-profit organisations. These have included some of the largest businesses in our nation and in our region such as HSBC, SingTel and EnergyAustralia, and also government organisations including currently Infrastructure NSW. I have also pursued this interest as an active member of the Australian Institute of Company Directors' Corporate Governance Committee (AICD) for over 15 years, as a contributor to the evolution of the ASX Corporate Governance Principles & Recommendations since 2003, and as a lecturer with the AICD, including my annual Essential Director Update address and a course I present on the Role of the Chair.

Is Corporate Governance Fit for Purpose?

I have chosen as the topic for my address today the current debate on the role of the corporation in contemporary society and, along with it, the role of the company director. This debate, one that recurs periodically in our history, has been reignited in the context of the Banking Royal Commission and, in particular, by comments made during the hearings by former National Australia Bank chairman, Dr. Ken Henry, to which I shall return shortly.

The Royal Commission has, as we all know, highlighted compliance failures and poor practices amongst our five major financial institutions and some others, some of them sensationalised by the media, but nevertheless surprising, even shocking, not only to the general public but to professional company directors as well, in part because the Big Five were amongst our largest, and most profitable companies and well-resourced with capable legal and compliance professionals.

Compounding negative public perceptions about the governance of our major corporations was the report released in April 2018 commissioned by the Australian Prudential Regulatory Authority (APRA) into the governance, culture and accountability of the Commonwealth Bank following the unprecedented (for Australia) prosecution by our anti-money laundering agency, Austrac, in 2017 against CBA for failure to report some 53,000 cash transactions made at its misnamed "intelligent ATMs" over a 3-year period, together with other instances of misconduct that preceded, and also precipitated, the Royal Commission. The Austrac prosecution resulted in admissions and agreed penalties of $700 million, a new precedent in Australia but modest compared to the billions of dollars of fines extracted by the US Justice Department in cases against both international and US banks for breaches of US anti-money laundering laws and sanctions policies, notably a fine $8.9 billion levied against Banque Nationale de Paris in 2013.

Nor were egregious cases of failed governance at major corporations around the world confined to the financial sector over recent years. Amongst the unfortunately long list was the scandal that engulfed the world's largest automobile manufacturer, Volkswagen, in 2015 involving the sale of over 10 million small diesel cars fitted with computer algorithms designed to defeat emissions testing required by US, European and other national environmental regulations. It was eventually revealed that this scandal went well beyond VW's engineering department and that very senior company officers were aware of the fraud. It resulted in the resignation of the CEO, chairman and other senior executives and ongoing criminal prosecution against some of them. It is estimated that the cost of this scandal to Volkswagen shareholders was in the vicinity of $30 billion. Similarly, a major scandal in 2017 engulfed the third largest US bank, Wells Fargo, an organisation that had survived the Global Financial Crisis without major losses, which led to 5,000 employees being fired for opening financial product accounts for customers without their knowledge or consent. This

cost the bank's chairman and CEO their jobs, resulted in massive fines, and also resulted in the unprecedented demand by the US Securities Exchange Commission for the resignation of three Wells Fargo board members, without any judicial finding of fault on their part, on the basis they should be accountable for poor oversight of the culture and operations of Wells Fargo.

All of these scandals have raised the challenging questions as to whether there is something inherently wrong with the role and purpose of companies in today's global economy, whether the company model is broken, and whether company directors can be expected to be effective in monitoring and managing the behaviours of large corporations to meet contemporary standards of ethical behaviour.

Making Corporations Socially Responsible

I cannot here fully explore the rising tide of political and academic voices that have begun to question the very foundation of modern corporate capitalism and to challenge the seminal thesis of the late Nobel economist, Milton Friedman, whose views are succinctly summarised in the title of his famous 1970 paper "The Social Responsibility of Business is to Increase its Profits". Friedman argued strongly that overlaying a doctrine of corporate social responsibility onto corporations was "fundamentally subversive" to our market-based economy which had delivered, on average, rising prosperity and living standards for over 200 years.

These questioning voices have, however, been growing. They have been given academic heft in recent years, even by business academics such as Prof. Colin Mayer of Oxford, supported by influential commentators such as Martin Wolf of the Financial Times, who have promoted the idea that we must "rethink the purpose of the corporation".

Wider Stakeholder Interests

We have seen over the past 30 years a movement to give greater scope for corporate boards when making decisions to take into account a wider range of stakeholder interests beyond those of their shareholders. In the United States, for example, over 40 state corporation laws have now introduced so-called "constituency statutes" which specifically permit directors to consider non-shareholder interests. These statutes were born from the hostile takeover boom of the 1980s (the era of the "Barbarians at the Gate") which questioned whether the sole duty of directors of a company under takeover is to obtain the best price for shareholders if this prejudices other stakeholder interests such as those of employees and local communities.

In a different, GFC-related context, in 2006 the UK enacted Section 172 of its Company's Act which mandates that directors must (quote) "act in a way in which they consider, 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 must have regard to a list of matters, including the long-term

consequences of their decisions, the interests of employees, the need to foster the company's business relationships with suppliers, customers and others, and the impact of the company's operations on the community and the environment.

Last year, US Presidential aspirant, Senator Elizabeth Warren, introduced into the US Congress a bill for an Accountable Capitalism Act. This Act would require companies with revenues over $1 billion to obtain a federal government charter which would require the company to have "the purpose of creating a genuine public benefit". It would require directors to direct the business in a manner that seeks to create a general public benefit and to "balance" the pecuniary interests of the shareholders with the "best interests of persons materially affected by the conduct of the corporation". In carrying out this duty, directors shall consider the interests of shareholders, employees, suppliers, customers, communities where the company is based, and the local and global environment.

Controversially, the proposed Act would require that employees elect 40 percent of the board of directors of such companies, and that 75 percent of shareholders must approve any political donation above $10,000. The Act also included a "constituency statute" that would impose on directors a duty to create "a general public benefit with regard to the corporation's stakeholders, including shareholders, employees and the environment, and the interests of the enterprise in the long term". The Act establishes the "Office of United States Corporations" with a director appointed by the President which would grant the requisite charters, and monitor compliance.

Senator Warren has espoused the notion that "corporations are not people" but as one commentator has remarked, "Warren's plan starts from the premise that corporations that claim the legal rights of personhood should be legally required to accept the moral obligations of personhood". Others see this Act as nothing less than appropriation of privately-owned corporations to public causes. Needless to say, Warren's radical proposals have given rise to heated controversary but no doubt these propositions will gain fresh currency in the run-up to the 2020 Presidential Election.

A Rekindled Debate

Three events have rekindled this debate here in Australia: The Royal Commission, the APRA/CBA Report and radical revisions recently proposed for the ASX Corporate Governance Guidelines.

As we all know, the Banking Royal Commission examined whether our largest financial institutions complied with applicable regulations and also met "community expectations", including those concerning fair and ethical treatment of customers. The implied thesis behind much of the questioning before the Commission was that the commercial objectives of banks, their governance and contemporary remuneration practices such as incentive-based compensation are all inherently antipathetical to fair treatment of

customers, thus questioning the social acceptability of the corporate model itself.

The final round of Commission hearings discussed board accountability, and the legal framework for directors' duties. During his evidence, then NAB Chair Ken Henry was questioned about the concept of shareholder primacy. He stated that (quote) '*under our particular [corporate] model… it's only shareholders to whom, at law, the directors are accountable*'. Dr. Henry went on to express the view that the notion that directors are only accountable to shareholders has been an important contributor to the loss of public trust and confidence in business generally. He suggested that Commissioner Hayne should consider the case for framing directors' duties with a view to accountability to the community now and in the future.
As I will explain I believe Dr. Henry misstates the proper legal position, but it has nevertheless sparked vigorous debate about whether there is a need to change our laws and regulations to impose a social purpose and a primacy of customer and community interests above, or in some way alongside, those of shareholders in the way our corporate governance is designed and directors' duties are defined.

APRA/CBA Report

The second development to reignite the debate on the proper role of companies was the APRA/CBA Report to which I have referred.
This Report will, I believe, be the "Harvard case study" on corporate governance for many years to come. Governments, regulators, investors and boards of directors across the world, and across industry sectors have looked to it as highlighting the performance standards expected of directors and executives. A live issue at the present time for many boards is how to apply the governance lessons of the APRA/CBA Report beyond publicly listed companies to private companies, not-for-profit entities and public sector corporations as well.

The board's responsibility for company "culture" was a key theme of the APRA/CBA Report.

"Culture" is of course a slippery term of vague import but it has started to infiltrate Australian regulations and even legislation. A prime legislative example is Part 2.5 of the Commonwealth Criminal Code, which writes the concept of "corporate culture" into the criminal law. The scope of those provisions will inevitably be tested sooner rather than later. A recent regulatory example is the requirement under Australia Prudential Standard 220 that directors of deposit-taking institutions must annually certify to APRA that their organisations have in place (quote) "a sound risk management culture" along with "effective internal controls and risk management processes".

The remarkable thing about the APRA/CBA Report is that it is not a post mortem on a failed company. CBA's fall from grace and the resulting forensic analysis of its governance is set against a backdrop of continued

financial success, prudential capital strength, absence of large loss-making disasters, and, ironically, industry-leading customer satisfaction scores.

The Report's key findings on the CBA's failings are well-known. They include inadequate oversight and challenge to management by the board, unclear management accountability and ownership of risk issues, weaknesses in how risk issues were escalated within management, a lack of urgency on the part of board committees for timely resolution of risk issues, and an operational risk management framework that was said to "work better on paper than in practise". The report also criticised remuneration policies which held "little sting" for senior managers and may have provided incentives that militated against good customer outcomes. This last theme has been strongly echoed in the Royal Commission's Final Report.

The APRA/CBA Report identified four so-called "cultural factors" underlying the CBA's failings. These were:

- A widespread sense of complacency, fuelled by a belief that CBA was a well-run and inherently conservative organisation. This belief bred over-confidence.
- A reactive rather than proactive approach to dealing with compliance, resulting in slow, legalistic, and at times <u>dismissive</u>, dealings with regulators.
- A culture described as being "insular": CBA was a company that did not learn from its experiences and mistakes. In particular, a company with a "tin ear" towards community expectations about fair treatment of customers, and
- An overly collegial culture which lessened self-criticism and impeded individual accountability.

The APRA/CBA Report, while not in my view fundamentality changing the accountability of boards as most practising directors understand their responsibilities, has nevertheless lifted the bar on the expectations of regulators, and of the community in general, as to how directors will go about their roles.

An important question is how much higher the bar will be lifted in the aftermath of the Royal Commission Final Report. The basic principles of criminal responsibility written into the Commonwealth Criminal Code require that standards of culpability be established for a successful criminal prosecution. Demands have recently been made by senior politicians and the media that anything less than jail sentences for senior bank executives or directors criticised by the Royal Commission will be seen by the community as a "whitewash", and that only jail terms will prevent the banks from sliding back into back practices. The idea seems to be that directors, or at least the Chair and CEO of the company, should be held <u>absolutely</u> accountable to the criminal standard, even when they are personally unaware of the wrongdoing within the lower ranks of the organisation, have no reason to suspect any wrongdoing, and where the board has adopted and regularly

monitored compliance with appropriate behaviours which have nevertheless been breached by staff. Achieving criminal "accountability" in such circumstances would require fundamental, and I would say, outrageous changes to the criminal law which should be strongly resisted.

ASX Guidelines Proposals

The third recent development fuelling the debate about corporate responsibility was a draft set of radical revisions released for comment in mid-2018 by the ASX Corporate Governance Council, a council of 19professional bodies with oversight responsibility for the ASX Corporate Governance Guidelines which apply to all listed companies in Australia by virtue of the ASX Listing Rules. These revisions to the now 15 years old Guidelines, inter alia, would enjoin listed corporations not only to act "ethically and responsibly, but also to act in a "socially responsible" manner. They also introduced the notion that companies have a "social licence to operate" and that their boards are, therefore, bound to take into consideration a wide range of social policy considerations in the discharge of their responsibilities. These considerations would include such things as the human rights of the employees of suppliers, paying employees a "living wage", offering employment to people with disability or from disadvantaged backgrounds, and considering the company's responsibility for long-term climate change. Many of these matters are noble aspirations and several are already subject to specific legislation (for example, the recent Modern Slavery Act and our Fair Work legislation). Others are without legal definition or precedent.

The ASX Guidelines debate has been a lively one. It resulted in fairly united pushback from experienced directors against inserting vague expressions such as "social licence to operate" into a quasi-regulatory document. It was felt that these changes would serve both to complicate and confuse the duties of directors, make their decisions subject to lobbying by special interest groups, and even expose boards to class-action litigation, especially in today's highly-charged socio-political environment.

Wisely the Council deferred releasing its final proposals until after the Royal Commission's Final Report and its final revisions to the Guidelines released just last week remove references to a "social licence to operate", at least for now.

Social Purpose vs. Social Licence

Let me here draw an important distinction between the notion of a "social licence to operate" and the idea that a company has a social purpose.

Throughout history, corporations that have had any financial success and longevity have had to make and sell products or services that their customers value, and to serve customers effectively and competitively. In so doing they have by definition had an economic purpose and, by

extension, a social purpose. More recently, companies have sought to articulate more clearly for themselves a social purpose, both to burnish their brand and reputation, and also to inspire their employees to see their work as more than a job, but a job with a higher mission.

No less a capitalist than Mr Larry Fink, the celebrated chairman of Blackrock, one of the world's largest investment funds managers which boasts assets under management (mostly for pension funds) in excess of US$5.0 trillion (four times Australia's GDP) recently put this view in a letter which he sends each year to some 2,000 chairmen of leading companies around the world. His 2018 letter asserts that it is imperative for companies to succeed in the modern world to have a cogent social purpose as well as a for-profit purpose as a way of resisting community opposition to their businesses operations. This sounds similar to the "social licence" notion but comes from quite a different angle. To quote Mr Fink:

> "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society … Without a sense of purpose, no company, either public or private, can achieve its full potential and … it will remain exposed to activist campaigns that articulate a clearer goal, even if those goals serve only the shortest and narrowest objectives."

Other examples worth citing of companies choosing to promote their social purpose are set out by former British Petroleum CEO Lord John Browne in his recent book "Connect: How Companies Succeed by Engaging Radically with Society". He cites IBM and Unilever as companies that have redefined their business around a social purpose. IBM's purpose is not just to sell software services but to create a Smarter Planet. Unilever's purpose is not just to sell soap and hygiene products but to Promote Sustainable Living. But having a social purpose which is self-defined by the company itself and controlled by its board and management is very different from the notion of a "social licence to operate" which implies that the licence is given or defined in some way by the community. Such an externally-imposed licence would come with externally-defined conditions and expectations. I think this is more than a Jesuitical distinction. It has important implications for the role of corporations and for those responsible for their sound governance.

Our Corporate Law and Governance is fundamentally sound

It is my contention in this address that the laws and principles which apply to corporate governance in Australia are fundamentally sound, indeed are amongst the best in the Anglo-American world, and do not need fundamental revision. We tinker with the role of the corporation at our peril. Moreover, the role of non-executive directors has in my view by and large served the interests of both shareholders and the community well. It is a model to be nurtured and preserved and not subverted.

But let me now return to Dr. Henry's Royal Commission comments.

Dr. Ken Henry's Comments

Was Dr. Henry correct when he said that "it's only the shareholders to whom, at law, the directors are accountable"?
Let me assay a bush lawyer's exploration of this proposition.
It is generally accepted by legal commentators that the framework of directors' duties in Australia allows directors to take into account the interests of stakeholders other than shareholders.

Prof. Jason Harris in a recent paper says that the question whether directors can take non-shareholder interests into account while still complying with their duty to act in good faith in the interests of the company as a whole is largely settled. The Privy Council in the leading case Howard Smith v. Ampol Petroleum (1974) approved the formulation by Berger J. in Teck Corp v. Millar (1972) that directors are entitled to exercise their discretion to balance a range of interests and if directors (quote) "observe a decent respect for other interests beyond those of the company's shareholders in the strict sense, that will not leave directors open to the charge that they have failed in their fiduciary duty to the company".

True it is that the best interests of the corporation require directors to attend to shareholder welfare in the longer term, but in almost all cases that welfare can only be achieved by board decision-making that factors in all relevant stakeholder concerns (including the interests of employees, customers, local communities and increasingly nowadays the environment).

One situation (perhaps one of very few) where there might be real disparity between shareholder interests and other interests is in a corporate control transaction. The board of a target company must decide whether to recommend a bid in circumstances where the company is in play and the shareholder interest has become the short-term interest of maximising the bid price. The board's recommendation is, however, directed to the shareholders, and it is the shareholders (acting in their own interests) not the directors who will make the decision to accept or reject the bidder's proposal, even if a consequence is (for example) the loss of jobs for the target's employees or a negative impact on a local community.

An inquiry into the question whether boards can consider wider stakeholder interests was conducted in 2006 by the Australian Corporations and Markets Advisory Committee (CAMAC), an advisory body now sadly demised. It concluded that no changes to the law on directors' duties were required because the existing legal framework already allows directors to take into account various stakeholder interests and, therefore, can keep pace with changing societal expectations.
In my experience, it is a rare (and imprudent) board that does not as a matter of practice consider a range of stakeholder interests in making decisions. This will certainly be the case following the APRA/CBA Report's

focus on the Voice of the Customer at the Board table and the Royal Commission findings.

It has long been clear to practising directors, I believe, that the duty to act in the interests of the company cannot in practice be regarded in isolation from the interests of other stakeholders. In the real world, acting in a responsible and ethical manner with regard to the legitimate concerns of stakeholders is often consistent with, and can often be necessary for, the promotion of the interests of the company and its sustainability over the long-term. But what constitutes responsible action will often lie in the eye of the beholder when it comes to things like bank branch closures, staff redundancies, closing down an airline to bring an industrial dispute to a head, or continuing to operate a profitable coal mine.

Overseas Experience

What can we learn from overseas experience on this topic?
Around the world, while there are differences in how directors' duties are expressed, there is a trend towards a more expansive approach to directors' duties which incorporates an element of social responsibility. As mentioned, in the United States, 'corporate constituency' provisions began to appear in a number of states from the 1980s. These provisions typically adopt a "permissive" approach by allowing, as opposed to requiring, decision-makers to consider the broader constituency interests.
I found it interesting when looking at such "constituency statutes", which permit directors to "consider the effects of the corporation's action upon a range of stakeholders, including current employees, retired employees, customers and creditors", that the legislation typically provided that nothing in the law (quote) "shall create any duties owed by any director to any person or entity to consider or give any particular weight to any of the (listed stakeholder interests) or abrogate any duty of the directors, either statutory or recognised by common law or by court decisions".

Accordingly, even these statutes that authorise broader stakeholder interests to be considered were not intended to create a cause of action by those stakeholders against directors for the manner in which they exercised that duty. Even Senator Warren's controversial Accountable Capitalism Act expressly exonerates directors from monetary damages if the corporation fails to create or pursue a general public benefit and provides that directors do not have a duty to any beneficiary of such a general public benefit.

As mentioned, in the UK, section 172 of the Companies Act 2006 provides that directors have a duty to promote the success of the corporation for the benefit of members as a whole while having regard to (among other things) the impact of the company's operations on the community and the environment, the interests of the company's employees, and the need to foster the company's business relationships with suppliers, customers and others. Under further recent amendments, from January this year, UK

companies subject to the Act are required to report on how their directors are complying with this requirement by way of a "section 172 statement" in their statutory reports.

Some commentators believe the UK provision, ironically perhaps, supports the shareholder primacy model because it makes clear that the primary focus of directors' duty is to promote the success of the company for the benefit of members as a whole: that is, for the benefit of the shareholders. Others argue that the UK provision requires directors to understand and consider a broad range of interests in making decisions, and the new reporting requirement in 2019 makes this clear.
By contrast, there are examples of Australian legislation which require directors to give priority to the interests of certain other stakeholders over the interests of their shareholders. For example, under our Corporations Act (ss 601FC) the directors of a responsible entity of a registered managed investment scheme are required to act in the best interests of members of the scheme and in cases of conflict between the interests of scheme members and the interests of the entity (and, by implication, its shareholders), to give priority to the members' interests. There are similar statutory requirements for a life insurance company and its directors, in the administration of a statutory fund under the Life Insurance Act 1995 (Cth), and for a registrable superannuation entity and its directors under the Superannuation Industry (Supervision) Act 1993 (Cth.

Duty to Consider Non-Shareholder Interests?

In my experience, directors are well aware that, in order to build long-term brand value and reputation, it is important to take into account the legitimate needs and expectations of a range of interest groups, rather than focusing only on short term returns to current shareholders.
This is, however, quite different from having a duty to do so. Such a duty would need to be reconciled with the well-established law regarding the duty to act in the interests of the company and for a proper purpose. I foresee a potential vein of litigation in the United Kingdom as the law tries to reconcile these two legal theories—the long-established shareholder primacy theory and the newly evolving stakeholder theory. Section 172 requires the directors to take into account listed stakeholder interests, but they are to do so in order to promote the success of the company as a whole rather than in isolation from the overall corporate interest. That provides the basis perhaps for reconciling the duties. Contrast the legislative provisions about managed investment schemes, life companies and registered superannuation entities which impose an absolute duty on directors to prioritise certain non-shareholder stakeholders over the corporate entity and its shareholders.

It is, however, debatable whether the Australian law is really very different from Section 172 of the UK Companies Act. For example, a board of directors of an Australian mining company that fails to consider how a proposal to construct a tailings dam might affect the local community could surely be brought to account for breach of at least the duty of care and diligence and possibly criminal offences. In both jurisdictions, the board's ultimate focus needs to be on promoting the success of the company as a whole in the longer term. For any high risk or controversial decision, however, boards should make sure that a paper trail of their decision-making is carefully laid down. Thus, the tailings dam proposal needs to be presented to the board together with appropriate expert advice on the risks of adverse impacts on the local community. The board minutes should show that these inputs have been provided to directors in time for the directors to consider them carefully and that they were actually discussed and considered.

Whether there is any difference, however, between Australia and the United Kingdom regarding the standard of care and diligence that is required of directors (and, for that matter, of executives who are also subject to civil and criminal liability for breaching Section 180) in taking into account the interests of other stakeholders, is less certain. Modern case law requires directors to reach an objective standard of competency concerning some matters (such as a basic comprehension of financial reports, as decided in the well-known Centro case), but a non-executive director must generally bring to board decisions <u>no more than</u> the degree of diligence that <u>a reasonable ordinary person</u> having the same skills and knowledge as the individual director would be expected to apply to those matters. It is another thing for corporate executives who would have the full resources of the corporation at their disposal to investigate and assess the interests of external stakeholders.

It is a troubling thought that, just as decisions by government officials can be overturned by courts if they fail to take account of all relevant considerations required by relevant legislation, company executives and directors may find their decisions attacked by activist litigators for failing to fully consider all allegedly relevant stakeholder interests.

Far better that courts leave room for directors to exercise conscientiously their business judgment when balancing the interests of shareholders and other stakeholders, so long as they act in good faith. As regards the directors' duty to act in good faith for proper purposes, Wilson J. said in Whitehouse v. Carlton Hotel Pty Limited (1987):

> "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 judgement, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts."

A similar respect for conscientious business judgments should, I believe, be applied by courts when assessing whether the directors have discharged their duty of care and diligence.

Directors' duties owed to the company

The new stakeholder theory approach sits awkwardly with the Corporations Act provision that the directors owe their duties "to the company as a whole". The Corporations Act does not define the interests of the company. Generally, Australian case law indicates that the "interests of the company as a whole" equate with the medium to long-term interests of the body of shareholders.

While some legal commentators say that the law requires directors to consider primarily the interests of existing shareholders, the better view seems to be that directors must also balance the interests of future shareholders and the importance of balancing short-term and long-term interests.

The doctrine that a corporation is a separate legal entity (distinct from its shareholders) existed at common law before registered corporations existed. In the mid-1800s, the proposal to facilitate incorporation of a separate legal entity (distinct from its shareholders) by the enactment of a general Companies Act was much debated in the United Kingdom, but ultimately the idea that limited liability should be offered to shareholders was adopted on the basis that they do not exercise direct control over the company. Similarly, the proposition that directors owe their duties to the company was developed over time on the basis that "*shareholders are the proprietors of the company who have risked their capital in the hope of gain*".

In this context, the recent case of ASIC v. Cassimatis–the Storm Financial case (2016)–drew a stark distinction between the company and its shareholders. The two sole directors of Storm Financial were prosecuted by ASIC for breach of their duty of care and diligence under Section 180 for having allowed the company to provide high-risk financial advice to unsophisticated investors in breach of the requirements of the Corporations Act and thereby caused damage to the company, financially and reputationally. Their defence was that they were the two sole shareholders of the company, and they could not therefore breach their duty to themselves. Justice Edelman gave this proposition short shrift and drew a very clear distinction between the interests of shareholders and the interests of the company they owned.

In short, in my view, proposals to broaden the purpose of corporations and to impose new requirements on directors will sit awkwardly with the core directors' duties as these have evolved over the past century, specifically the duties codified in Section 180(1)-the duty to exercise care and diligence;

and Section 181(1)–the duty to act in good faith in the best interests of the company and for a proper purpose;

Corporate Governance Remains Fit for Purpose

I have argued in this address that, far from being broken or in need of radical surgery, the role of corporations as they have evolved in Australia over the past century remains fit for purpose in the 21st Century. The limited liability company is thought by many economic historians such as Niall Ferguson to have been a crucial legal and social innovation that facilitated wealth creation in open-market western economies by channelling surplus economic resources to productive investments which have, in turn, generated higher productivity, increased innovation and higher aggregate community wealth and wellbeing.

Moreover, I believe that the legal structures supporting contemporary corporate law and governance remain sound. The case for imposing new and wider social obligations and purposes on companies has not been made. Indeed, this should be resisted. There is an important distinction between, on the one hand, the imposition of social purposes upon companies, either directly or indirectly through imposing new obligations on company directors, and, on the other hand, companies embracing for themselves a social purpose or mission and being answerable to their shareholders for the consequences. Requiring all directors by law to prioritise other stakeholder interests would, in my view, be misconceived and unnecessary, except in special cases such as the managed investment and superannuation statutes. It would serve to complicate the role of directors, and expose them to a wider ambit of liability and potential litigation. It will also be an almighty distraction from the all-too challenging task of competing successfully in today's era of pervasive technological disruption and global competition.

Equally misconceived is Dr. Henry's statement, if he meant that the law requires directors to consider only the interests of shareholders. Our law and practice have evolved to acknowledge that shareholder primacy is not an absolute, that directors may take wider community interests into account but they do so in the long-term interests of their shareholders. Moreover, a plethora of statutory requirements make it essential for company directors to be ever mindful that if the law unambiguously says that the company must do something, with no exception, then the board's task is to make sure that the law is complied with, regardless of whether compliance will reduce profitability or damage shareholder interests. To that extent, the company's and the directors' own priority obligation is to have regard to the social and community interests that are reflected in the specific law. On the other hand, where there is no mandatory law applying to the matter before the board, contemporary governance practice leaves no room for doubt that prudent and wise company directors must promote the success of their company in a way that always has an eye to the impact of corporate

operations on all relevant stakeholder groups, including the general community. The value of corporate reputation and brand depends upon boards doing so in a way that balances short and long-term interests of the company having regard to the interests of all relevant stakeholders.

Furthermore, developments such as Section 172 in the United Kingdom should, in my view, be resisted because they are unnecessary. Directors' responsibilities are adequately addressed by the statutory duties of care and diligence, and the obligation to act for a proper purpose–duties owed to the company, not to any third party. They would also open directors to a wide range of special interest group pressure, regulatory intervention and potentially class action lawsuits, consequently adding bureaucracy and creating work for corporate communications profession to craft anodyne statements that will avoid exposing the company and its directors to challenge in the media and in the courts.

Similarly, backdoor efforts to impose social obligations on corporations exemplified by the proposed incorporation of notions such as "a social licence to operate" into the ASX Guidelines should be strongly resisted.

Royal Commission Findings

None of this is to say that our corporations are all saintly, that human errors will not occur and that human frailties will not manifest themselves from time-to-time in fraud and personal greed when governance fails.

It was pleasing to me, as the chairman of an Australian bank, that the Royal Commission's Final Report did not recommend legislative changes to the objectives of financial corporations, or corporations generally. Commissioner Hayne, I believe wisely, did not take up Dr. Henry's suggestion in this regard. Nor did he recommend new duties or obligations on directors, though he did recommend extending the Bank Executive Accountability Regime (BEAR) beyond banks to all APRA-regulated financial institutions, including superannuation funds and financial planning organisations, and, somewhat delightfully, to the financial regulators themselves! The BEAR regime itself does not formulate new or different duties for directors but rather asks that companies articulate the accountabilities of their directors and senior executives in formal Accountability Statements so that is clearer, it is hoped, precisely who should be responsible for decisions and actions that lead to compliance breaches or bad conduct. In the complex and often matrixed organisation structures of today's large corporations, however, this hope may prove to be elusive.

Nor did Commissioner Hayne in the Final Report advocate <u>increased</u> regulation, at least for banks, but rather concluded that increased regulatory complexity may serve only to obscure what he enunciated as the six basic principles that should govern corporate behaviour, namely, to:

1. Obey the law
2. Not mislead or deceive

3. Be fair, especially with customers
4. Provide services that are fit for purpose
5. Deliver services with reasonable care and skill, and
6. When acting for another, always act in their best interest

These principles resonate with me as a company director because they are, in substance, identical to the fiduciary and statutory duties imposed on directors under the general law and under the Corporations Act.

I, for one, am pleased that the Commission's Final Report did not seek to overturn the highly-evolved and, to my mind, fully effective accountabilities of directors as they are set down in the Corporations Act.

On the contrary, Commissioner Hayne seems to me to have squarely endorsed the law as most directors understand it. To quote [page 402]:

> "Directors must exercise their powers and discharge their duties in good faith and in the best interests of the corporation, and for a proper purpose. That is, it is the corporation that is the focus of their duties. … [but] that demands consideration of more than the financial returns that will be available to shareholders in any particular period. Financial returns … [are] not the only matter to be considered. The best interests of the corporation … cannot be determined by reference only to the current or most recent accounting period … [or] … to the economic advantage of those shareholders on the register at some record date … The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with the corporation will be seen as converging for the corporation's long-term financial advantage."
>
> Hayne goes on to say: "Financial services entities are no different … In the long run, the interests of all stakeholders associated with the entity converge … The best interests of a company cannot be reduced to a binary choice … Pursuit of the best interests of [the company] is a more complicated task than choosing between the interests of shareholders and the interests of customers."

Conclusion

Let me conclude with a further quote from Kenneth Hayne's Interim Report which I believe is both a wise and a timely caution against legislative overreaction to the Royal Commission's findings:

> "Good culture and proper governance cannot be implemented by passing a law. Culture and governance are ***affected*** by rules, systems and practices, but in the end, they ***depend*** upon people applying the right standards and doing their jobs properly."

To this I say Amen.

Ladies and gentlemen, that concludes my address.

Thank you.

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I gratefully acknowledge the assistance of Dr Robert Austin, Ms Vanessa Wallace, Ms Louise Petschler and Mr Tim Bednall in preparing this address. The views expressed and all errors remain mine alone. I also wish to thank Professor Jason Harris for his excellent paper (Shareholder Primacy in Changing Times) presented at the Supreme Court's Corporate and Commercial Law Conference 2018.