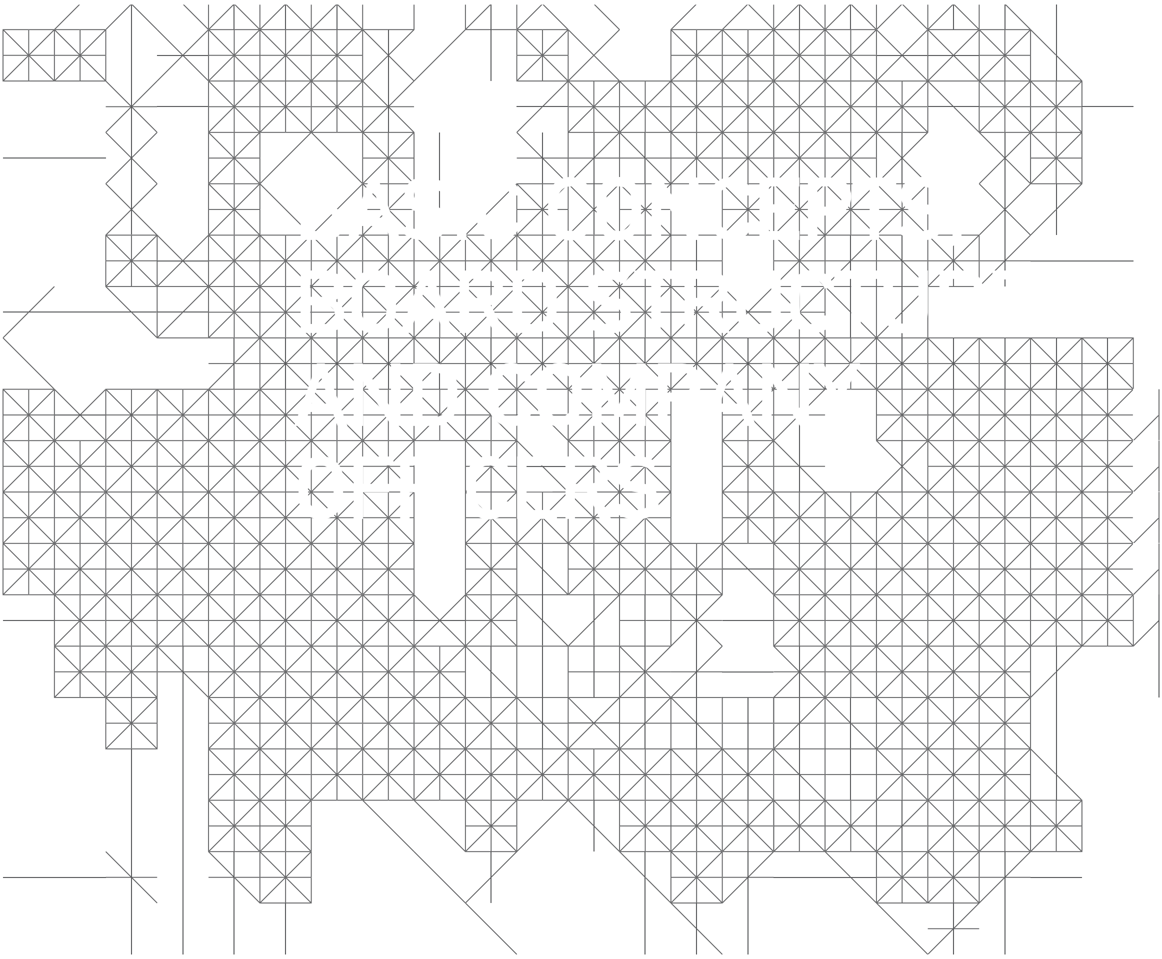
Cambridge University Press
978-1-107-43242-0 - Principles of Contemporary Corporate Governance: Third Edition
Jean Jacques Du Plessis, Anil Hargovan, Mirko Bagaric and Jason Harris
Excerpt
More information



Cambridge University Press
978-1-107-43242-0 - Principles of Contemporary Corporate Governance: Third Edition
Jean Jacques Du Plessis, Anil Hargovan, Mirko Bagaric and Jason Harris
Excerpt
More information

Cambridge University Press
978-1-107-43242-0 - Principles of Contemporary Corporate Governance: Third Edition
Jean Jacques Du Plessis, Anil Hargovan, Mirko Bagaric and Jason Harris
Excerpt
More information

1

THE CONCEPT 'CORPORATE GOVERNANCE' AND 'ESSENTIAL' PRINCIPLES OF CORPORATE GOVERNANCE

It is necessary only for the good man to do nothing for evil to triumph.

Attributed to Edmund Burke (18th century English political philosopher)
– *The Australian*, Monday 6 December 2004, 4, reporting on the most
favoured phrase of quotation-lovers, as determined by an
Oxford University Press poll

Many companies today no longer accept the maxim that the business of business is business. Their premise is simple: Corporations, because they are the dominant institution on the planet, must squarely address social justice and environmental issues that afflict humankind.

Paul Hawken, *The Ecology of Commerce* (Harper Business, revised edn, 2010) at xi

1.1 The meaning of corporate governance

1.1.1 Generally

Corporate governance is as old as the corporate form itself,[1] although Bob Tricker correctly points out that the phrase 'corporate governance' was scarcely used until the 1980s.[2] Early attempts to define the concept of corporate governance appear in the UK Cadbury Report (1992)[3] and the South African King Report (1994),[4] both defining 'corporate governance' as 'the system by which companies are directed and controlled'. That seems not particularly helpful. Over the past decade or so there have been further attempts at a definition or description of 'corporate governance', bringing in additional aspects or elements.

1 Jean J du Plessis, 'Corporate law and corporate governance lessons from the past: Ebbs and flows, but far from "The end of History . . .: Part 1"' (2009) 30 *Company Lawyer* 43, 44.

2 Bob Tricker, *Corporate Governance: Principles, Policies and Practices* (Oxford University Press [OUP], 2nd edn, 2012) at 4. See Corina Gavrea and Roxana Stegerean, 'Comparative Study on Corporate Governance' (2011) 20 *Annals of the University of Oradea, Economic Science Series* 674 for a literature review and an analysis of the concept of 'corporate governance'.

3 *Report of the Committee on the Financial Aspects of Corporate Governance* (hereafter Cadbury Report (1992)) (Committee on the Financial Aspects of Corporate Governance, 1992).

4 *The King Report on Corporate Governance* (hereafter King (1994)) (Institute of Directors in Southern Africa, 1994).

In the Report of the HIH Royal Commission (the Owen Report) on the collapse of HIH Insurance Ltd – one of Australia's largest corporate collapses – a clearer picture of the term began to emerge:

> Corporate governance – as properly understood – describes the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. Understood in this way, the expression 'corporate governance' embraces not only the models or systems themselves but also the practices by which that exercise and control of authority is in fact effected.[5]

The trend to define 'corporate governance' more precisely continued in 2003 with the appearance of the Australian Securities Exchange's (ASX) *Principles of Good Corporate Governance and Best Practice Recommendations*.[6] The description used in 2003 was slightly different from the description of corporate governance currently contained in the ASX *Corporate Governance Principles and Recommendations* (3rd edn, 2014):

> The phrase 'corporate governance' is 'the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It encompasses the mechanisms by which companies, and those in control, are held to account.'[7]

While a closer description of 'corporate governance' is required, the concept remains one that does not lend itself to a single,[8] specific or narrow definition. As will be seen below, we attempt to define it in wide terms, but incorporate some specific aspects to give the definition some substance. In 2008, Justice Owen made the following comments in *The Bell Group Ltd v Westpac Banking Corporation* (No. 9):[9]

> [D]irectors are in control of the assets of a corporation but they do not own those assets. They control the assets on behalf of the corporation and, through the corporation, others having an interest in the wellbeing of the entity. There are no hard and fast rules that constitute 'corporate governance'. But there are some

5 Report of the HIH Royal Commission (Owen Report), *The Failure of HIH Insurance – Volume I: A Corporate Collapse and its Lessons* (Commonwealth of Australia, 2003) xxxiii.

6 ASX, *Principles of Good Corporate Governance and Best Practice Recommendations* (March 2003) 3 <http://www.asx.com.au/documents/asx-compliance/principles-and-recommendations-march-2003.pdf>.

7 ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations* (3rd edn, 2014) 3 <http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf>.

8 See generally Janet Dine and Marios Koutsias, *The Nature of Corporate Governance: The Significance of National Cultural Identity* (Edward Elgar, 2013) at 67–70.

9 [2008] WASC 239 (28 October 2008) [4362].

basic underlying principles that help to explain the guidelines and legal principles that have developed over time and now dictate how a director is expected to carry out her or his responsibilities.

Before we attempt to give our own definition, it is important to consider the origins of both the corporate governance and the stakeholder debates.

1.1.2 Origins of the corporate governance debate and some corporate governance and corporate law theories

It is difficult to determine exactly when the corporate governance debate started.[10] However, there is little doubt that there were many factors that brought the debate to prominence: the separation of ownership and control (so pertinently illustrated in 1932 by Berle and Means in their book, *The Modern Corporation and Private Property*), which resulted in the so-called managerial revolution[11] or 'managerialism';[12] the pivotal role of the corporate form in generating wealth for nations; the huge powers of corporations,[13] and the effects of these on our daily lives; the enormous consequences that flow from collapses of large public corporations;[14] and the practical reality of the almost unfettered powers of boards of directors, or what Stephen Bainbridge identified as 'the director primacy model of corporate governance' (see discussion below and Chapter 3). We are, indeed, as Allan Hutchinson describes it so appropriately, living in an age of *corpocracy*.[15]

It is also beyond dispute that the corporate governance debate became particularly prominent when the basic perception of the company changed. At first the only real concern for a company was the maximisation of profits.[16] Profits for whom? – the

10 See John Farrar, *Corporate Governance: Theories, Principles and Practice* (OUP, 3rd edn, 2008) at 8–20.

11 See, for example, Klaus J Hopt, 'Preface' in Theodor Baums, Richard M Buxbaum and Klaus J Hopt (eds) *Institutional Investors and Corporate Governance* (W de Gruyter, 1994) at I; and *OECD Principles of Corporate Governance* (April 2004) 12 <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

12 Stephen M Bainbridge, *The New Corporate Governance in Theory and Practice* (OUP, 2008) at 9, 19–20, 155 *et seq*.

13 Kent Greenfield, *The Failure of Corporate Law* (University of Chicago Press, 2006) at 4–5.

14 See generally Roberta Romano, *The Genius of American Corporate Law* (AEI Press, 1993); and David S R Leighton and Donald H Thain, *Making Boards Work* (McGraw-Hill Ryerson, 1997) at 9–10.

15 Allan C Hutchinson, *The Companies We Keep* (Irwin Law, 2005) at 8.

16 Adolf A Berle, 'The Impact of the Corporation on Classical Theory' in Thomas Clarke (ed.), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (Routledge, 2004) at 45, 49 *et seq*.

shareholders.[17] This was confirmed in 1919 in the US case of *Dodge v Ford Motor*[18] and is a view many commentators adhered to for a considerable period of time, with a further confirmation of the Dodge theory in 1986 in another US case, *Katz v Oak Industries*.[19] According to this view, the shareholders are the 'owners of the company',[20] the primary stakeholders and most important providers of capital to enable the company to conduct business. This is called the shareholder primacy theory,[21] although it was hardly ever mentioned that in fact nobody can 'own' the company as it is a separate 'legal person' and it is just as unfitting to talk about 'ownership' here as it is to say (after the eradication of slavery) that one or more 'natural persons' 'own' another 'natural person'.

Gradually the 'shareholder supremacy'[22] view changed, and the company, especially the large public company, came to be seen in a different light. It was observed more pertinently that there were other stakeholders in a company, too; that if the only purpose of a company was 'the maximisation of profits for the shareholders', society could suffer tremendously – poor working conditions for workers, exploitation of the environment, pollution and so on.[23] Then came the realisation that:

> enterprise, private as well as public, because it both contributes to and benefits from society (local, national and larger), can be said to have rights and duties vis-à-vis that society in somewhat the same way as has an individual;[24]

17 Margaret M Blair, 'Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century' in Clarke (ed.), *Theories of Corporate Governance* (2004) at 175, 181. See also Bainbridge, *The New Corporate Governance in Theory and Practice* (2008) at 53.

18 *Dodge v Ford Motor* 170 N.W. 668 (Mich. 1919) at 684; (1919) 204 Mich. 459 at 507: 'A business corporation is organized and carried on primarily for the profit of the stockholders The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to the change of the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.' For an overview of *Dodge's* case, see Leonard I Rothman, 'Re-evaluating the Basis of Corporate Governance in the Post-Enron Era' in PB Vasudev and Susan Watson (eds) *Corporate Governance after the Financial Crisis* (Edward Elgar, 2012) 101, 110–12.

19 *Katz v Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).

20 See generally Greenfield, *The Failure of Corporate Law* (2006) at 43, but see his arguments dispelling this 'myth' at 44–7.

21 See generally. on the theory of 'shareholder primacy', Irene-marié Esser, *Recognition of Various Stakeholder Interests in the Company Management: Corporate Social Responsibility and Directors' Duties* (VDM Verlag Dr Müller, 2009) at 19–23.

22 See generally Greenfield, *The Failure of Corporate Law* (2006) at 2 and 44–46.

23 See also Kent H Baker and John R Nofsinger, 'Socially Responsible Finance and Investing: An Overview' in Kent H Baker and John R Nofsinger (eds), *Socially Responsible Finance and Investing: Financial Institutions, Corporations, Investors, and Activists – Robert W. Kolb Series in Finance* (John Wiley & Sons, 2010–12) Vol. 612, 2.

24 Charles de Hoghton (ed.), *The Company: Law, Structure and Reform in Eleven Countries* (Allen & Unwin, 1970) at 7.

Cambridge University Press
978-1-107-43242-0 - Principles of Contemporary Corporate Governance: Third Edition
Jean Jacques Du Plessis, Anil Hargovan, Mirko Bagaric and Jason Harris
Excerpt
More information

and

> [t]he limited liability company does not simply represent one interest. It represents an arena in which there is a potential clash of many interests. We may identify the interests underlying it as: (1) investors – share capital/loan capital; (2) outside creditors – commercial finance/trade creditors; (3) employees; (4) consumers; (5) the public.[25]

The concept of 'managing the corporation' then came to be expressed in terms of these other interests:

> The balancing of the company's responsibilities – to workers as members of the company, to consumers of the goods and services it provides, and to the community of which it is a citizen – with its primary one of operating at maximum efficiency and lowest cost, so as to make profits and discharge its obligations to its shareholders, represents the full scope of management.[26]

Thus, the concept of 'corporate governance' began to adopt this new articulation of 'managing the corporation', with a central focus on the interrelationship among internal groups and individuals such as the board of directors, the shareholders in general meeting, employees, managing directors, executive directors, non-executive directors, managers, audit committees and other committees of the board. However, the profit motive was still dominant. Furthermore, it should be realised that outside interests are also at stake; for example, those of creditors, potential investors, consumers and the public or community at large (so-called stakeholders). Traditional wisdom regarding shareholder primacy[27] began to be challenged more forcefully, with statements such as 'managerial accountability to shareholders is corporate law's central problem';[28] 'corporate law is currently in the midst of crisis, because of the exhaustion of the shareholder primacy model';[29] '[s]hareholder dominance should be questioned';[30] and, as recently as 2013, '[s]hareholder primacy theory is suffering a crisis of confidence'.[31] The calls ring loud for a rethinking of a traditional Western notion of

25 John J Farrar et al., *Farrar's Company Law* (Butterworths, 1991) at 13.
26 George Goyder, *The Responsible Company* (Blackwell, 1961) at 45.
27 See again Esser, *Recognition of Various Stakeholder Interests in the Company Management* (2009) at 19–23.
28 David Millon, 'New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law' 1993 (50) *Washington & Lee Law Review* 1373, 1374.
29 Ibid. 1390.
30 Morten Huse, *Boards, Governance and Value Creation: The Human Side of Corporate Governance* (Cambridge University Press [CUP], 2007) at 29.
31 Lynn A Stout, 'The Shareholder Value Myth' (1 April 2013) *European Financial Review* – available at SSRN: <http://ssrn.com/abstract=2277141>.

the company, which still relies on 18th and 19th century principles, concepts and notions.[32]

From all of this emerged a slightly different theory, one moving away from the narrow 'shareholder primacy' theory to what is called an 'enlightened shareholder value' theory. We discuss this theory in greater detail in Chapter 2, but it should be touched upon here briefly as well. The 'enlightened shareholder value' theory, very generally, holds that productive relationships (with other stakeholders) can be achieved within the framework of existing corporate law and corporate governance concepts, in fact maintaining 'shareholder supremacy', but ensuring that directors pursue shareholders' interests in an enlightened and inclusive way, meaning *having regard* to the interests of other stakeholders, *but no more than that*.[33] The principal manifestation of this theory is found in section 172 of the UK *Companies Act 2006*:

> **172 Duty to promote the success of the company**
>
> (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –
>
> (a) the likely consequences of any decision in the long term,
>
> (b) the interests of the company's employees,
>
> (c) the need to foster the company's business relationships with suppliers, customers and others,
>
> (d) the impact of the company's operations on the community and the environment,
>
> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
>
> (f) the need to act fairly as between members of the company.
>
> (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has

32 See in particular Tricker, *Corporate Governance* (2012) at 164–5 and 488.

33 See generally David Millon, 'Enlightened Shareholder Value, Social Responsibility and the Redefinition of Corporate Purpose without Law' in PB Vasudev and Susan Watson (eds), *Corporate Governance after the Financial Crisis* (Edward Elgar, 2012) at 68 and 79–80; Andrew Keay, 'Tackling the Issue of Corporate Objective: An Analysis of the United Kingdom's "Enlightened Shareholder Value Approach"' (2007) 29 *Sydney Law Review* 577, 589–90; I Esser and JJ du Plessis, 'The Stakeholder Debate and Directors' Fiduciary Duties' (2007) 19 *South African Mercantile Law Journal* 346, 351–2.

effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.[34]

There is no space in this book to discuss this in detail, but just reflecting on the approach generally will reveal how difficult it seems to break with the 'shareholder-dominance-indoctrination' that has been so strong over so many years. Clinging to the past and in fact only seeing the interests of other stakeholders in an 'enlightened' way still makes these interests peripheral – as Janet Dine and Marios Koutsias put it, this approach is simply 'a fig leaf for stakeholders other than shareholders'.[35] The 'enlightened shareholder value' theory could possibly be described as the interim stop, buying more time to reflect more on the flaws of the 'shareholder primacy' theory and the merits of a proper 'all-inclusive stakeholder' theory – one that is emerging fast, as will be seen in the discussions that follow.

That the days of the 'shareholder primacy' theory are numbered is strikingly illustrated by Lynn Stout in her 2012 essay, 'New Thinking on "Shareholder Primacy"'.[36] Note that we briefly discuss a new theory, called the 'director primacy' theory, in Chapter 3, in context of the powers of boards of directors.

Nowadays, it is fairly generally accepted that 'in future the development of loyal, inclusive stakeholder relationships will become one of the most important determinants of commercial viability and business success';[37] that 'recognition of stakeholder concern is not only good business, but politically expedient and morally and ethically just, even if in the strict legal sense [corporations] remain directly accountable only to shareholders';[38] and that '[t]he corporation as a legal entity grew out of its ability to protect not only the shareholders but also other stakeholders'.[39]

34 See Andrew Keay, 'Section 172(1) of the Companies Act 2006: An Interpretation and Assessment' (2007) 28 *The Company Lawyer* 106; Millon, 'Enlightened Shareholder Value, Social Responsibility and the Redefinition of Corporate Purpose without Law' in Vasudev and Watson (eds), *Corporate Governance after the Financial Crisis* (2012) 68 at 69 and 79–80.

35 Dine and Koutsias, *The Nature of Corporate Governance* (2013) at viii.

36 Lynn Stout, 'New Thinking on "Shareholder Primacy"' in Vasudev and Watson (eds), *Corporate Governance after the Financial Crisis* (2012) at 25.

37 David Wheeler and Maria Sillanpää, *The Stakeholder Corporation* (Pitmann, 1997) at ix. See further James E Post, Lee E Preston and Sybille Sach, *Redefining the Corporation: Stakeholder Management and Organizational Wealth* (Stanford Business Books, 2002) at 1–3; and Mark J Roe, 'Preface' in Margaret M Blair and Mark J Roe (eds), *Employees & Corporate Governance* (Brookings Institute, 1999) at v.

38 Leighton and Thain, *Making Boards Work* (1997) at 23.

39 Huse, *Boards, Governance and Value Creation* (2007) at 29.