# THE CONSCIENCE OF THE FICTIONAL REASONABLE PERSON AND THE CONCEPT OF "DOING THE RIGHT THING" – THEIR IMPACT ON DIRECTORS DUTIES

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# A CHANGED ENVIRONMENT

The conscience of the fictional 'reasonable person' informs the interpretation of much statutory law and concepts in equity. It is the required standard used to determine the extent of directors' duties under the *Corporations Act 2001* (Cth) (Corporations Act) which imposes on them the their legal obligation to act in accordance with the community values and expectations of our society as held by a reasonable person in their position.

This paper argues that the nature and degree of care and diligence to meet that reasonable person standard is currently at an inflection point, requiring directors to consider:

1. The impact their decisions have on a broader range of stakeholders beyond shareholders.
2. The balance between long-term accretion to value and short-term profit.
3. Whether the pursuit of profits is or should be, a purpose in itself, or a considered result of acting as a reasonable person would require in the circumstances.

This is a fundamental governance issue which is the subject of considerable public discussion. Commissioner Hayne observed in The Report of the Royal Commission into Misconduct in the Banking and Superannuation and Financial Services Industry (widely known and referred to in this paper as The Hayne Commission) that a corporation:

> "Must do more than not break the law. It must seek to 'do the right thing'."

Doing the right thing would seem to impose a higher obligation than not doing the wrong thing.

John Atkin, Chair of the Australian Institute of Company Directors, told its Annual Governance Summit[1] that the challenge facing directors is how best to reconcile competing interests of different stakeholders while maximising overall value to the corporation. He said:

> "That sounds clear enough in principle. Managing inherent contradictions in practice is not. What is obvious is the extent of change occurring in Australian boardrooms to adjust to changed expectations, realistic or otherwise…
>
> A more generalised debate is also taking place over the real responsibilities of directors. Certainly, the era of focusing so heavily on shareholder returns, especially short-term returns, has become distinctly unfashionable.…"

The community expectations now confronting boards include their action on and responses to the challenges of climate change and emissions reduction, reducing the use of plastic, promotion of diversity, prevention of money laundering, modern slavery in the supply chain, and the spread of global viruses. The Hayne Commission has played a significant role exposing misconduct in some of our most respected institutions and reshaping community expectations about the conduct of directors.

[1] As reported in the Australian Financial Review on Tuesday 3 March 2020.

Commissioner Hayne observed:

> "Much, if not all of the conduct identified in the first round of hearings can be traced to entities preferring pursuit of profit to pursuit of any other purpose… the pursuit of profit has trumped consideration of how the profit is made."

Commissioner Hayne acknowledges that officers of companies had a duty to their shareholders to pursue profit, but said doing so:

> "Has a significant temporal dimension. The duty is to pursue the long-term advantage of the enterprise and that this entails preserving and enhancing the reputation of the enterprise as engaging in the activities it pursues efficiently, honestly and fairly."

Perceived failures by directors to act adequately in the past to balance companies' pursuit of profit with community concerns has led to increasing levels of regulation and compliance being imposed on companies, requiring them to deal with these community concerns. More significantly, it has fuelled a societal response with growing expectations about how directors should act.

The current debate is whether interpretation of the existing law and the reasonable person standard have now reached the point where directors have a legal obligation to take account of the interests of stakeholders other than shareholders. This paper argues that the requirement to act in the best interests of the corporation under section 181 of the Corporations Act necessarily and derivatively requires directors to consider the effect of their actions on the company's reputation and goodwill in the community (which would be to its commercial advantage) and not just whether the exercise of the power is profit accretive to the company.

The Honourable Chief Justice of New South Wales, Tom Bathurst, addressed the opening of Law Term Dinner on 5 February 2020 at New South Wales Parliament House.

He was quoted in The Law Society Journal as saying:

> "The conscience which underlies and animates equitable principles is now interpreted as a reflection of the moral values of our society as a political whole… equitable principles are assumed to represent the dictates and demands of a fictional "conscience".
>
> The Court will hold the defendant [and section 180 of the Corporations Act will hold a director] to the standard of the "reasonable person".
>
> There is underlying similarity between the idea of "conscience" in equity and the equivalent concepts which motivate other areas of law, such as the idea of procedural fairness in administrative law and the idea of a duty of care in negligence. Each prescribes a standard of conduct drawn from the moral values of our society, and Courts are empowered to provide remedies to hold people to that standard."[2]

This paper argues that recent decisions on what is unconscionable conduct or conduct exhibiting moral turpitude are relevant when considering what a reasonable person should not do and hence may impact the standard of care and diligence the Corporations Act requires of a director in exercising their powers and discharging their duties.

This paper explores the theories and developments relating to directors' duties in this changed environment, and seeks to provide directors, and those who are supporting them, guidance about the new context in which they are operating.

[2] Issue 64 March 2020.

# THE FUTURE OF THE CORPORATION

The purpose of the corporate structure and its future was the theme of the recent Corporate and Commercial Law Conference organised by the Supreme Court of NSW and held late in 2019. The conference discussed the history of the current corporate form, the rationale for it and the changes community expectations were having on directors' duties.

The modern corporate form grants shareholders the statutory freedom to carry on through the company, any purpose (within the law) to make a profit, without risk of losses from the conduct of that purpose beyond their investment. Parliament believed the protection of limited liability would achieve a social purpose, by making it easier to commence or carry on a business and raise funds to expand economic activity, and thereby benefit society.

The statutory protection of the corporate form over the last 200+ years has enabled some corporate businesses to grow to a size larger than the economies of many countries, beyond the powers of control and regulation of governments, and substantially impacting on large sections of the population, as well as the environment, on a global scale.

The legislative framework permitting and regulating the corporate structure came into being and continues to exist as a result of a social licence from the community which requires continued legitimacy, credibility, and trust.

> "The corporate social licence to operate has been described as stakeholder perception of the legitimacy of a company.
>
> The law does not contain an explicit statement of either societal purposes of companies or what the interests of the corporation are."[3]

Societal expectations of how directors should discharge their duties and exercise their powers is determined by the Court having regard to the conscience of the fictional reasonable person pursuant to Section 180(1) of the Corporations Act.

The social licence enables shareholders to profit under the protection of a statutory umbrella. We have, however, now reached a point where a significant number of companies are having a negative impact on stakeholders beyond their shareholders. This leads to questions about the legitimacy and credibility of those companies which are perceived to be making profits from producing problems for society, rather than profits acquired by producing solutions for society and thereby breaching the social licence.

The question increasingly being asked is whether the corporate structure has enabled the owners and managers of these companies to obtain private benefits which outweigh, or at least better balance with, their contribution to the public good.

The issue is whether making profits for the benefit of shareholders should be the sole purpose of

[3] Shareholder Primacy: Is There a Need for Change? A Discussion Paper Governance Institute of Australia 2014

a company and duty of its directors, or whether those profits should be the result of pursuing a purpose which benefits the company and its wider stakeholders.

Larry Fink, CEO of Blackrock, one of the largest investment management businesses in the World, was quoted in January 2019 as saying:

> "Every business needs a purpose, not a strapline or marketing campaign but a fundamental statement of its reason for being. Purpose is not the sole pursuit of profits but the animating force for achieving them."[4]

Directors are members of society and generally in tune with the conscience and expectations of a reasonable person.

In 2012, a survey of Australian directors was undertaken to see how they perceived their obligations to various stakeholders in practice. The results were compared to the findings of inquiries conducted in 2006 by the Corporations and Markets Advisory Committee (CAMAC), and the Parliamentary Joint Committee (PJC) on Corporations and Financial Services.[5] The results show that directors view shareholders as a stakeholder group and accord them the highest priority. However, none of the survey group:[6]

> "Equated the 'best interests of the corporation' with the short-term interests of shareholders alone, and only a very small proportion of directors (6.6 per cent) equated the 'best interests of the corporation' with the best interests of shareholders in the long-term. A significant proportion (38.2 per cent) equated the 'best interests of the corporation' with the interests of all stakeholders as a means to achieving the long-term interests of shareholders. Perhaps surprisingly, the majority of directors (55 per cent) understood acting in the 'best interests of the corporation' as requiring them to balance all stakeholder interests as an end in itself.
>
> Similarly, an overwhelming majority (94.3 per cent) of directors believed that the law of directors' duties was broad enough to allow them to take into account the interests of stakeholders other than shareholders… consequently, it would seem to be the case that where the shareholder primacy norm is influential, its influence does not stem from an understanding by directors that they are under a legal obligation to pursue shareholder-oriented strategies."[7]

[4] The Future of the Corporation: A Blueprint for Reform – Professor Colin Mayer. Said Business School University of Oxford. Paper Governance Institute of Australia 2014

[5] CAMAC Corporations and Markets Advisory Committee (2006).

[6] PJC Parliamentary Joint Committee on Corporations and Financial Services (2006)

[7] Shareholder Primacy: Is There a Need for Change? A Discussion Paper Governance Institute of Australia 2014

# THEORIES OF CORPORATE PURPOSE

There are two competing theories about corporate purpose.

The first, Shareholder Primacy Theory, is the traditional doctrine. It holds that the purpose of a corporation is to maximise its shareholders' wealth and profits, which is justified on the basis that by creating wealth for individuals, the corporation benefits society. This philosophy evolved from the 'invisible hands' doctrine of Adam Smith[8] writing in 1776. Silberstein said of this doctrine:

> "Profit seeking frees us from having to make controversial value judgements. The "invisible hand" doctrine assures us that profit seeking will invariably lead to the most economically efficient allocation of resources which, in turn, will produce the greatest utility for the world taken as a whole."[9]

The "invisible hand" however is blind and indifferent to consequences other than profit. Adam Smith may not have foreseen the development of corporations and banks almost too big to fail, which are so large they can dominate, control and manipulate markets and tax systems for their own benefit, thereby corrupting basic principles of free market economics that underlie the "invisible hand" doctrine.

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[8] An Inquiry into the Nature and Causes of the Wealth of Nations.

[9] David Silberstein: Managing Corporate Social Responsibility in a Changing Legal Environment. American BLJ Vol 25 525 1987.

The traditional view that directors have duties only to generate profits for the company and increase the wealth of its shareholders does not reflect the view of directors in practice (see the survey earlier referred to), as a result of changes in the expectations of the 'reasonable person' about what is the right thing to do, and the wrong thing to do.

The alternative Stakeholder Theory has developed over the last 30 years in particular, as the expectations of society and its problems have grown ever more complex. The community's view of the purpose of the corporation as reflected in recent summits, enquiries, commissions and publications, would seem to have reached a tipping point, requiring directors to take account of a broader range of stakeholder interests in exercising their powers and discharging their duties.

Silberstein takes what may be regarded as an extreme view of this evolution:

> "Business must provide a social service, even at the expense of profits, in order to serve the best interests of employees, creditors, customers and the broader community… public opinion, which ultimately makes law, views the business corporation as an economic institution which has a social service as well as a profit making function…"[10]

Shareholder Primacy Theory and Stakeholder Theory must both be evaluated by reference to the statutory duty of directors under the Corporations Act.

The duty of care and diligence of directors is imposed by section 180(1) of the Corporations Act, which provides as follows:

> A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
>
> a. were a director of officer of a corporation in the corporation's circumstances; and
>
> b. occupy the office held by, and had the same responsibilities within the corporation as, the director or officer (my underlining).

The required legal standard is what a reasonable person would have done in the circumstances faced by that director in that company. The reasonable person test represents what the fictional conscience of society would say is the right thing to do and not the wrong thing to do, for a person in the position of a director of a particular company in its situation.

Where in the past directors could seek answers on what to do or not to do by calling their accountant on the profit hotline, now they must also get in touch with their inner feelings and take the pulse of the fictional reasonable person.

[10] David Silberstein: Managing Corporate Social Responsibility in a Changing Legal Environment. American BLJ Vol 25 525 1987.

# SHAREHOLDER PRIMACY THEORY

Shareholder Primacy Theory, by requiring directors to pursue profits for shareholders as their sole purpose, arguably frees them from having to make controversial value judgements (or exercise a moral conscience) about the consequences of decisions made for that purpose. This logic is similar to the principles of adversarial ethics which (on one view) guides the professional conduct of lawyers. The CEO of major Australian law firm, Clayton Utz, said of that firm's role in British American Tobacco v McCabe:[11] (*British American Tobacco v McCabe 2002*)

> "We don't take a moral stance and it's not up to us, as advocates for a client, to take a moral stance. Ultimately that comes to a decision by the client, not the lawyer. The lawyers are there to advance their client's interests subject to the constraints of their professional duties."

In a similar way, advocates for Shareholder Primacy Theory contend the director's duty is to act for the benefit of shareholders within the law and not to pursue social or moral agendas which do not advance that purpose. Eminent free market economist, Milton Friedman, suggested that external factors such as claimed social responsibilities must be considered ultra vires (which is no longer a relevant corporate constitutional concept in Australia) and illegal, if they do not result in increased shareholder wealth.

He said:

> "Managers are merely agents of the stockholders, and thus have no right to spend or give away corporate monies except in the interests of increasing shareholder wealth… there is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits."[12]

But even Friedman acknowledges that the pursuit of shareholder wealth is only ever justified to the extent a company 'stays within the rules of the game' ie doesn't do the wrong thing.

Shareholder Primacy Theory abhors moral judgements by directors exercising their conscience to determine what is the right thing to do, beyond generating profits for shareholders from lawful activity.

Mayer says a company under Shareholder Primacy Theory should not:

> "Stray into the realms of public policy, government and philanthropy. It should not confuse its objectives by introducing a plethora of others, of which there is no clear rationale or measures to quantify them with the same precision or confidence as profit.

[11] 2002 VSC 197.

[12] Milton Friedman: The Social Responsibility of Business is to Increase Profits NY Times September 1970.

It should not be accountable to anyone other than its shareholders because they have property rights that derive from the money they have invested and unique exposure to the risk of failure of a business. The rights of shareholders are more than those of providers of finance—they are rights of owners, whereas 'accountability to everyone is accountability to no one."[13]

This property rights justification for Shareholder Primacy Theory has been criticised on the basis shareholders do not have the right to deal with the company's property, only their own shares – so it is not correct to say they have rights as owners of the company's property. On liquidation they have a right to participate pro rata in any surplus profits or assets, but no right in respect of any identified company property (unless there is a distribution in specie).

Ownership of shares gives the holder limited rights, such as rights under chapter two of the Corporations Act for actions arising from an oppressive conduct of affairs and derivative actions under sections 232-241. Shareholders do not have the right to exercise control over the corporation's assets for their personal benefit (like owners of other property). They have the power to elect and remove directors, not control their decisions or interfere in the management of the business, and it is that flawed property rights concept which lies at the heart of Shareholder Primacy Theory.

The property rights justification for Shareholder Primacy Theory perhaps had some historical relevance when most of a company's property was tangible in nature such as buildings, plant, and machinery, physically located in the particular country of its incorporation and governing law amendable to regulation and control by the state. It also has more relevance and justification for small-medium enterprises (SME's) and closely held private companies where the directors either are (directly or indirectly) the shareholders or the shareholders are able to effectively ensure their directors are accountable to them. Increasingly, large and listed companies have widely-spread shareholders and transnational businesses and operations with intangible assets such as reputation, brands, and intellectual property, which do not have a physical location. Corporations now routinely operate across national borders beyond the reach of national law, regulation and taxation. Their assets and business affect people and the planet on a global scale never before imagined. This challenges the legitimacy of the legal basis on which public policy towards companies has historically been based and the ability of national laws to regulate them.

"The capacity for public policy to correct the deficiencies of corporations and markets is therefore decreasing as the scale of their defects is intensifying.

What is being sought is a shift from self-interested business moderated by the forces of competition and regulation to socially aware firms that profit from producing solutions to the problems of people and planet and do not profit from producing problems for people or planet."[14]

[13] The Future of the Corporation: A Blueprint for Reform – Professor Colin Mayer. Said Business School University of Oxford.

[14] The Future of the Corporation: A Blueprint for Reform – Professor Colin Mayer. Said Business School University of Oxford.

The alternative justification for Shareholder Primacy Theory is agency theory, which posits that:

> "Directors and the executives they oversee are agents for the shareholders, and therefore have an obligation to manage the corporation in the interests of the shareholders who are the principals."[15]

The problem with agency theory is asymmetry of information, because the agent always has more information than the principal. The principal cannot ensure the agent is always acting in the principal's best interest. The stark evidence in practice demonstrates the limited influence shareholders actually have on directors of large and listed companies.

Large-scale corporate collapses such as FAI, HIH, OneTel and Enron among others, and more significantly, the conduct by banks exposed in the Hayne Commission, have highlighted misconduct by directors and executives and the resultant considerable social costs. In addition to the financial consequences and disruption to markets, the pursuit of profit without regard to the effect on stakeholders other than shareholders can corrupt management and transfer economic burdens to the community. As Grossman observes:[16]

> "The rise of the culture of profit at any cost has been significant in shaping public opinion against big business."

Grossman quotes Coates (with whom Commissioner Hayne would no doubt agree):[17]

> "In unethical systems… the culture is so structured that management finds it easy to provide rationalisations for deviant demands. Lower functionaries feel pressured into doing things (in the name of business) that they would not otherwise do."

[15] Shareholder Primacy: Is There a Need for Change? A Discussion Paper Governance Institute of Australia 2014.

[16] Breena Coates Hard Choices and Dirty Hands Dilemmas: The Jurist January 2002.

[17] Breena Coates Hard Choices and Dirty Hands Dilemmas: The Jurist January 2002.

# STAKEHOLDER THEORY

Stakeholder Theory argues that directors' fiduciary duties must include the protection of the interests of society, not just shareholders and in the long-term this is for the benefit of the company.[18]

Perhaps the most significant commercial rationale for expanded directors' duties under Stakeholder Theory is that in the long run it is good business and therefore in the best interests of the company. Goodwill and profits are better protected by acting in a socially and environmentally responsible way, and therefore are a proper purpose under section 181 of the Corporations Act.

Stakeholder Theory maintains that social and financial performance are interconnected and to maximise profits in the long-term, a company must engage with social interests and benefit, not harm the society on which it is dependent to generate its profits. Arguably, this rationale is also relevant under Shareholder Primacy Theory, (where the director's motivation is profit, albeit not the sole motivation) and engaging with social interests potentially results in less profit.

Corporate social responsibility (CSR) and philanthropy are now widely seen to benefit a company's bottom line by increasing the goodwill of the business, its perception in the community, and its corporate reputation as a model citizen. Many companies now actively promote their green credentials and public minded stance on a range of community issues under environmental, social and corporate governance principles (ESG).

"Compliance with anti-pollution and workplace safety laws to prevent harm to employees and the environment unquestionably increases the costs in business but nobody seriously frames this in terms of unjustified distraction from the bottom line or something which compromises the primary directive to satisfy shareholder interests.[19]

In practice current directors duties provide safe harbour for corporate officers who engage in activities which maximise profits. Given the relationship between financial and social performance, directors may rely on the knowledge that CSR activity should be held to be in the best interests of the company."[20]

The Australian Securities Exchange (ASX) has developed Principles of Good Governance and Best Practice Recommendations for listed companies, designed as a reference point to promote investor confidence and meet stakeholder expectations.

[18] Refining the Role of the Corporation: The Impact of Corporate Social Responsibility on Shareholder Primary Theory: Hugh Alexander Grossman Deakin Law Review Volume 10 No 2.

[19] Brian Horrigan: Fault Lines in the Intersection between Corporate Governance and Social Responsibility: 25 UNSW LR 515 2002.

[20] Refining the Role of the Corporation: The Impact of Corporate Social Responsibility on Shareholder Primary Theory: Hugh Alexander Grossman Deakin Law Review Volume 10 No 2.

When business fails to internalise its impact on the environment and society, this has caused and will cause further intervention by government through tougher regulation, competition policy, taxation and enforcement, as well as a stronger and more insistent response from the community reflected in the expectations of the fictional reasonable person.

> "We therefore face either progressively tougher more intrusive regulation and state intervention in shareholder centric corporations or the formation of purpose driven businesses with intrinsic and not externally imposed interests in others."[21]

The emphasis on profit maximisation as the sole purpose of business has coincided "precisely with the period during which the dependence and impact of firms on assets other than their financial and material, has intensified. It is this mismatch between the nature and needs of corporate governance that has been the source of growing inequality, environmental degradation and mistrust in business."[22]

# UK LEGISLATED RESPONSE

Section 172(1) of the United Kingdom's *Companies Act 2006* is often cited as an example of a legislative response which seeks to balance the interests of shareholders and stakeholders.

However section 172(1) makes it clear that directors owe a duty to promote the success of the company for the benefit of its shareholders and not a wider group of stakeholders. The section provides that:

> "A director of a company must act in a way that 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 between the members of the company."

[21] The Future of the Corporation: A Blueprint for Reform – Professor Colin Mayer. Said Business School University of Oxford.

[22] The Future of the Corporation: A Blueprint for Reform – Professor Colin Mayer. Said Business School University of Oxford.

Section 172(1) therefore means the collective shareholder interest prevails over that of other stakeholders but requires directors to consider the consequences of the decision for those other interests. The weight to be given to the relevant matters in section 172 is a matter for determination by the directors. The findings of the CAMAC inquiry in 2006 considered that since in Australia, courts "can assist in aligning corporate behaviour with changing community expectations… no worthwhile benefit it is to be gained" from a provision such as section 172(1). Recent developments considered later in this paper demonstrate the correctness of this view.

# U.S. BENEFIT CORPORATIONS

We have seen the establishment of socially responsible investment funds at a global level and the development in the United States of so called 'benefit corporations'. These funds and corporations, while intended to make a profit, must do so in a way expressly required to be socially and environmentally responsible.

> "For-profit social entrepreneurship, social investing and the sustainable business movement have reached critical mass and are now at an inflection point. Accelerating consumer and investor demand has resulted in the formation of a substantial marketplace for companies that are using the power of business to solve social problems."[23]

A number of U.S. states have legislatively prescribed Benefit Corporations which have the following features:

1. A corporate purpose to create a material positive impact on society and the environment.
2. Expanded duties of directors to require consideration of interests in addition to the financial interests of shareholders.
3. Reporting annually on social and environmental performance using an independent third party standard.

In Australia, developments in the interpretation of Corporations Act directors' duties, based on the conscience of the fictional reasonable person and what that reasonable person, require directors to have regard to the interests of a broader range of stakeholders than just shareholders. This indicates in exercising their powers there is no need for legislated benefit corporations or an equivalent to UK S172 on that account.

[23] How Benefit Corporations are Redefining the Purpose of Business Corporations: Clarke and Babson William Mitchell Law Review Volume 38 2012.

# THE DUTY OF DIRECTORS

Determining what is in the best interests of a particular corporation is a matter for the exercise of discretion by the directors, by reference to what a reasonable person would do in the particular circumstances of that company. This paper argues the interpretation and requirements of the reasonable person standard is imposing much higher obligations on directors to consider stakeholders other than shareholders.

At the Corporate and Commercial Law Conference held in 2019, Justice James Edelman of the High Court discussed the issue of corporate purpose and directors duties.

Justice Edelman said in relation to director's duties under the Corporations Act:

"The focus of an enquiry into whether a director exercises their powers and fulfilled their duties with reasonable care and skill in all of the circumstances requires consideration of the purpose for which the power or duty was conferred… once this association between purpose and authority is understood, it can immediately be seen that one of the fundamental roles for corporate purposes is to ascertain the authority of corporate actors… the express worlds of Section 181 [of the Corporations Act] provide that the directors must discharge their duties in good faith and in the best interests of the Corporation."

His Honour went on to say:

"One battleground in the present state of the law therefore lies in the identification and application of corporate purpose in these many cases where profit is not the only purpose… most fundamentally, principles of interpretation will continue to be central to ascertaining corporate purpose and thus to shaping the conduct of the human actors."[24]

The director's statutory and general law duties are expressed as owed to the company, and not expressed as owed to the shareholders.

It would seem to be settled law in Australia that directors' duties under the Corporations Act require directors to consider and accommodate a broader range of stakeholder interests affected by the operations of the company, and not just shareholders' interests, in determining what is in the best interests of the company. In Bell Group Limited (in Liq) v Westpac Banking Corporation (number nine) Owen J said:

"The interests of shareholders and the interests of the company may be seen as cooperative not because the shareholders are the company but rather, because the interests of the company and the interests of the shareholders intersect… it

[24] Corporate and Commercial Law Conference Paper 2019.

does not follow that in determining the content of the duty to act in the interests of the company, the concerns of shareholders are the only ones to which attention need be directed or that the legitimate interests of other groups can safely be ignored."[25]

The real challenge for directors is the balancing act between shareholder and stakeholder interests when responding to social expectations which are or may prove to be profit sacrificing. The example which starkly demonstrates this issue is James Hardie Industries.

The James Hardie Group was the largest Australian manufacturer of asbestos products. It ceased asbestos operations in 1987 but was exposed to very significant legal liability for compensation in asbestos claims. The Group undertook a complex corporate restructuring to establish a foundation, transfer its subsidiaries to that foundation and provide funding to meet claims. Its external lawyers advised:

> "That directors could not provide… more than that for which [the parent company] was legally responsible, without honestly believing that… what [they] were doing was of benefit to [its] shareholders."[26]

James Hardie justified its refusal to contribute additional funding to the foundation on the basis:

> "There can be no legal or other legitimate basis on which shareholders funds could be used to provide additional funds to the Foundation and the duties of the company's directors would preclude them from doing so."[27]

One commentator observed:

> "The consensus is that directors may have regard for non-shareholder stakeholder interest within some uncertain limits, but not independently of consequential corporate benefit. This consensus is "unconfirmed" since it does not rest on explicit legislative direction or authoritative judicial decision… the scope of directors discretion to consider an act by reference to social expectations or a stakeholders interest, without personal benefit, has not been specifically addressed."[28]

A leading text concludes that directors may "implement a policy of enlightened self-interest on the part of the company but may not be generous with company resources when there is no prospect of commercial advantage to the company."[29]

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[25] 2008 39 WAR 1.

[26] NSW Special Commission of Inquiry into the Medical Research and Compensation Foundation Report 2004 (Jackson Report).

[27] NSW Special Commission of Inquiry into the Medical Research and Compensation Foundation Report 2004 (Jackson Report).

[28] Paul Redmond Directors Duties and Corporate Social Responsiveness UNSW Law Journal Volume 35(1) 2012.

[29] Austin, Ford and Ramsay Company Directors: Principles of Law and Corporate Governance Lexus Nexus Butterworths 2005.

The main difficulty for directors' in exercising their discretion is that:

> "There be the possibility of some eventual return to shareholders which justifies a departure from short-term profit maximisation... what is unclear is what commensurability, proportionality or balance, if any, is required between corporate expenditure and benefit… although it is widely assumed that Australian law and directors duties requires that stakeholder interests must pass through the eye of the needle of shareholder value, the question is not addressed specifically in judicial decision concerning companies which are not insolvent or facing the immediate threat of insolvency."[30]

The findings of the two 2006 inquiries, referred to earlier, also commented on this difficulty. The PJC said that the enlightened self-interest approach means that "directors may consider and act upon the legitimate interests of stakeholders to the extent that those interests are relevant to the corporation." CAMAC said directors could "permit stakeholder accommodation, which is likely to be in the company's own commercial interest as part of a strategy to maximise shareholder value over the long-term."[31]

The Australian Institute of Company Directors has said the "generally accepted understanding of the legislative duty among directors and senior managers was that addressing the interests of non-shareholders is inherently part of acting in the best interests of shareholders, and therefore the company as a whole."[32]

Section 181 of the Corporations Act provides:

> "a director or other officer of a corporation must exercise their powers and discharge their duties:
>
> a. in good faith and in the best interests of the corporation; and
>
> b. for a proper purpose."

The general weight of authority is that this provision has both objective and subjective elements.[33]

In *Bell Group v the Westpac Banking Corporation (No 9)* Owen J said:

> "This objective assessment gives appropriate deference to directors commercial decision making, recognising that directors are best placed to assess the interests of the company… the Court can look beyond these to objective factors to test whether the decision in question is one that no reasonable director could consider to be in the interests of the company."

[30] Paul Redmond Directors Duties and Corporate Social Responsiveness – Page 328.

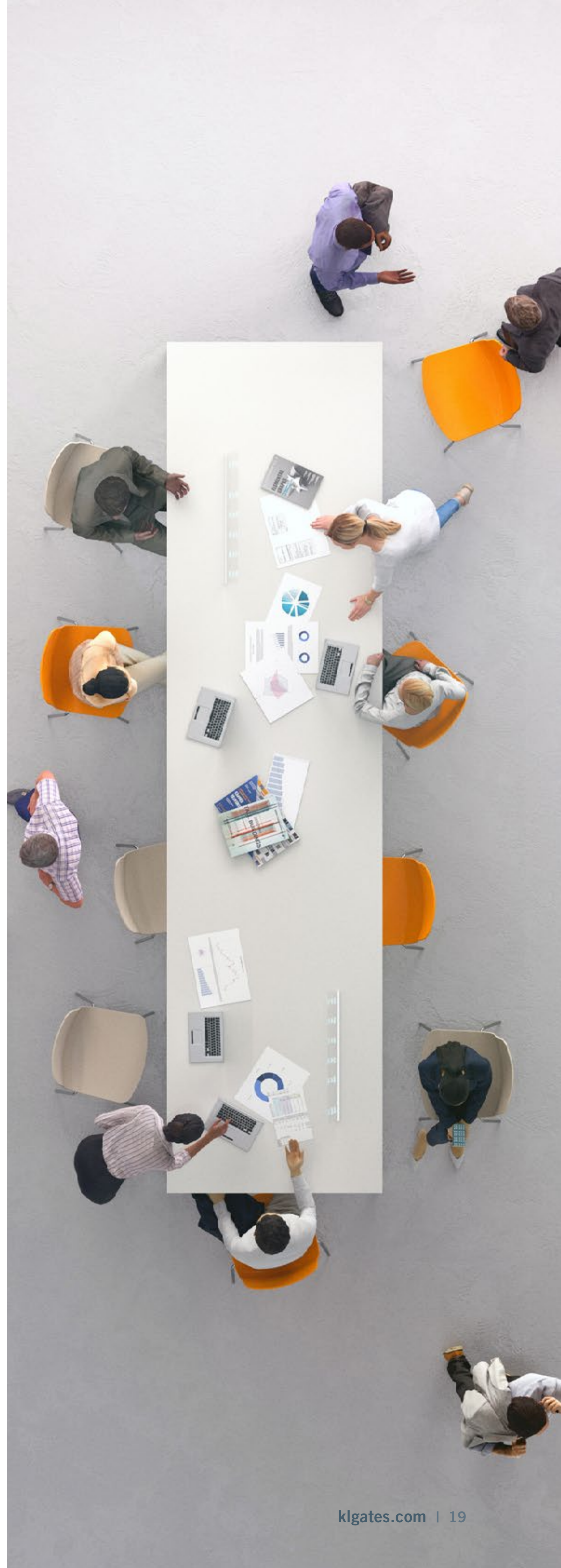
[31] Paul Redmond Directors Duties and Corporate Social Responsiveness – Page 329.

[32] AICD April 2019 Forward Governance Agenda.

[33] Directors Duty to Act in the Interests of the Company: Subjective or Objective. Langford and Ramsay Journal of Business Law 2015.

Based on current interpretations of directors' duties in Australia, there is likely to come a point where directors exercising their business judgement and the discretion the law affords them, will come to the view that any further investment in CSR measures will not increase profits by enhancing corporate reputation, and therefore on a cost benefit analysis, further steps to meet societal expectations cannot be justified. This is particularly so where the company has already implemented measures to mitigate risks which the directors consider appropriate in the circumstances of the particular company.

Once that point is reached, then the directors' obligation to consider the interests of the company's shareholders by profit making (taking a long, not short-term view) must take priority over social expenditure which is not to the commercial advantage of the company.



# A PRACTICAL EXAMPLE – CLIMATE CHANGE

Noel Hutley SC and Sebastian Davis provided detailed opinions to the Centre for Policy Development on the subject of "Climate Change and Directors' Duties".

> "In the 2016 Memorandum, we expressed opinions that, as a matter of Australian law, company directors can, and in some cases should be considering the impact on their business of climate change risks, to the extent they intersect with the interests of the firm."[34]

They took the view that climate -related risks (including physical, transition and litigation risk) are foreseeable risks of harm which require prudent directors to inform themselves, disclose the risks and take such steps as they saw fit with due regard to the circumstances of the particular company. They expressed the view that:

> "Company directors who fail to consider climate change risks now could be found liable for breaching their duty of care and diligence in the future."[35]

The circumstances they considered relevant to whether the directors of a particular corporation were required to consider matters and stakeholders other than the shareholders and the pursuit of profit in respect of climate change would also be relevant to other issues.

Factors to consider include whether:

1. The risk is a focus of Australian financial regulatory bodies such as the Reserve Bank of Australia, Australian Securities and Investments Commission and Australian Prudential Regulation Authority.
2. Reporting frameworks such as those of the Australian Accounting Standards Board and the ASX.
3. Investor and community pressures and public scrutiny of the company's activities, where they may cause or contribute to harm to society, can affect the company's goodwill and performance.
4. Developments in the state of scientific or other knowledge about the risks (like advances in awareness of risks with asbestos or smoking).

They said:

> "It would be difficult for a director to escape liability for a foreseeable risk of harm to the company on the basis that he or she did not believe in the reality of climate change, or indeed that climate change is human induced. The Court will ask whether the director should have known of the danger. This would involve an assessment of the conduct of the individual against the standard of a

[34] Original Memorandum of Opinion dated 7 October 2016 with a Supplementary Memorandum of Opinion dated 26 March 2019.

[35] Original Memorandum of Opinion dated 7 October 2016 with a Supplementary Memorandum of Opinion dated 26 March 2019.

reasonable person, by reference to the prevailing state of knowledge as publicised at the time.

At a certain point, however, ignorant defendants become liable for those risks on the basis that a reasonable person would have known of them. When it comes to climate change, the science has been ventilated with sufficient publicity to deduce that this point has already passed."[36]

As a general statement of directors' duties, this opinion in respect of obligations relating to the impact of a company's activities on climate change would equally apply to a wide range of issues now confronting society.

"The duty of care and diligence obliges a director to obtain knowledge, sufficiently to place themselves in a position to guide and monitor the management of the company."[37]

This has been described as a "core, irreducible requirement".[38]

Directors must become familiar with the fundamentals of the business in which the company is engaged, and are under a continuing obligation to keep informed about its activities and "the effect that a changing economy may have on [its] business".[39]

As the NSW Court of Appeal has said, a director cannot "safely proceed on the basis that ignorance and a failure to inquire are a protection against liability for negligence".[40]

"In determining whether the duty of care and diligence has been breached, the court will engage in an exercise (which is, in effect, expected of a reasonable director) of balancing the foreseeable risk of harm to the company against the potential benefits that might accrue to the company from the activity or conduct in question."[41]

A risk for companies and directors, where there has been a contravention of the Corporations Act or indeed any other piece of relevant legislation, is that a complainant with valid standing, may be able to launch a derivative civil liability claim against the directors of the offending company for breaching their duty of care by exposing the company to a risk of prosecution.[42]

Damage can occur to the reputation of a company arising from failure of the directors

[36] Original Memorandum of Opinion dated 7 October 2016 with a Supplementary Memorandum of Opinion dated 26 March 2019.

[37] Daniels v Anderson 1995 37 NSWLR.

[38] ASIC v Healey 2011 196 FCR 291.

[39] AWA Limited v Daniels 192 7 ACSR 759.

[40] Daniels v Anderson 1995 37 NSWLR. 438.

[41] Vrisakis v ASC 1993 9 WAR 395.

[42] The Federal Court in ASIC v Cassimatis (No 8) 2016 FCA 1023.

to ‘do the right thing’ or consider the effect of the company’s business on a broader range of stakeholders, such as with climate change. Directors’ failure to consider foreseeable reputational damage to the company by engaging in activities or actions which cause such damage is likely to be considered a breach of their duty of care and diligence by a reasonable person.

*ASIC v Flugge (No 2) 2017* VSC 117 is an example of a case where the Director Chairman of AWB Ltd was found in breach of section 180, but not section 181 of the Corporations Act. AWB sold wheat to Iraq in contravention of the UN Oil for Food Program. The court found Mr Flugge failed to make inquiries about inland transportation payments to ensure AWB conducted its international trade with probity. It found a reasonable person in Mr Flugge’s position would have made those enquiries. The court said:

> “The Australian community, however, has every right to be profoundly disappointed in AWB’s conduct and the ignominy that it brought on Australia and the damage suffered by its shareholders.”

Inherent in the finding is that the directors’ conduct offended community sentiment and expectations and a reasonable director ought to have taken those matters into account in exercising their powers.

# THE FICTIONAL CONSCIENCE OF THE 'REASONABLE PERSON' TEST AND DIRECTORS' DUTIES

In applying the requirements of section 180 (1) of the Corporations Act, the court considers the conscience of the fictional reasonable person to determine what he or she would have done in the circumstances of the company.

The fictional reasonable person today expects directors with control, power and responsibility to 'do the right thing' by stakeholders beyond shareholders affected by their decision. They also expect those directors not to do the wrong thing by acting, with moral turpitude offending the standards of community expectation or engage in unconscionable conduct. What amounts to 'unconscionable conduct' was given close consideration in a recent 4:3 decision of the High Court in *ASIC v Kobelt*.[43]

Kobelt involved an arrangement conducted by a storekeeper in a remote area of Australia dealing with residents of local Aboriginal communities. Under the arrangement, the storekeeper was authorised to withdraw funds from the customer's account in reduction of the customer's debt and in return supplied goods over the interval between the customer's welfare payments. The primary judge found that the storekeeper (Mr Kobelt) had chosen to maintain a system which, while it provided some benefits to the Anangu customers, took advantage of their poverty and lack of financial literacy to tie them to dependence on his store. He imposed a pecuniary penalty of $100,000.

On appeal to the High Court, it was accepted that Mr Kobelt acted without dishonesty, with a degree of good faith and did not exert any undue influence on the customers to enter into the arrangements with him. However, acting honestly was not enough.

In *ASIC v McDonald & Others (No 12)* 2009 NSWSC 714 the court considered penalties for breaches of s 180(1). Gzell J found:

> "In my view a person acts honestly for the purposes of ss 1317S(2) and 1318(1) [which prescribe penalties for breaches of section 180 and 181], in the ordinary meaning of that term, if that person's conduct is without moral turpitude in the sense that it is without deceit or conscious impropriety, without intent to gain improper benefit or advantage and without carelessness or imprudence at a level that negates the performance of the duty in question. That conclusion may be drawn from evidence of the person's

[43] 2019 HCA 18

> subjective intent. But a lack of such subjective intent will not lead the court to conclude that a person has acted honestly if a reasonable person in that position would regard the conduct as exhibiting moral turpitude."

The court found Mr McDonald was "'overzealous' but he was overzealous in the interests of JHIL."

The director was not acting in bad faith or for an improper purpose, so did not breach s 181(1). Nonetheless, his conduct in seeking to advance what he subjectively believed was in the best interests of the corporation (and its profits and shareholders), a reasonable person would consider exhibited moral turpitude. In other words, his conduct violated the sentiment or accepted standards of the community (similar to the unconscionable conduct found in ASIC v Kobelt) and the obligation on a director not to offend those standards of community expectation, and to not do the wrong thing were more important than considerations of profit making.

The term "unconscionable" is not defined in the ASIC Act or the Corporations Act. Chief Justice Kiefel and Justice Bell (in the minority) in ASIC v Kobelt said the conclusion a supplier of financial services had engaged in unconscionable conduct was "an evaluative judgement. Nonetheless, it is a judgement that is either right or wrong." Just as a person either does or does not "do the right thing" (including performing their duty as a director) – as Yoda said in Star Wars "do or do not – there is no try".

The difference between the Judges in Kobelt lay in their assessment of what conduct was acceptable to the community and what was so unfair (or unreasonable by the standards of a fictional 'conscience') it should be subject to sanction. It appears this determination is very similar to the determination of what the fictional reasonable person would do in the position of a director in a corporations' circumstances.

Gageler J (in the minority) said:

> "For a Court to pronounce conduct unconscionable is for the Court to denounce that conduct as offensive to a conscience informed by a sense of what is right and proper according to values which can be recognised by the Court to prevail within contemporary Australian society."

The minority found Mr Kobelt did no more than exercise his legal rights to contract with his customers in the way he did, so his conduct did not exhibit moral turpitude.

Nettle and Gordon JJ in the majority said:

> "Unconscionable conduct in equity can include the passive acceptance of the benefit in unconscionable circumstances. Mr Kobelt's conduct went beyond that – he engaged in an active system of conduct that, even if approached without dishonest motives or with a 'degree of good faith', had the effect of being exploitive and unfair. The requirement is still 'victimisation or exploitation' by a stronger party of a more vulnerable party."

They said:

> "The Anangu were at a material, relevant disadvantage to Mr Kobelt, and that Mr Kobelt took unconscionable advantage of them by stipulating for the conditions he did, notwithstanding that other,

> less onerous requirements would have been adequate to protect his legitimate interests."

Substantially the same language could be used by the court in other (hypothetical) circumstances, where directors acted with moral turpitude, offending standards of community expectations. It is possible to imagine in a fictional case that the court might say in considering the duty under section 180(1) (to adopt a paraphrasing of the Kobelt decision):

> "The community was at a material, relevant disadvantage to the company and the company took unconscionable advantage of them in the pursuit of profit, notwithstanding that other less socially damaging behaviour would have been adequate to generate a fair and reasonable profit and to protect its legitimate interests."

When we are applying the fictional reasonable person standard to the decisions of directors in the discharge of their duties and exercise of their powers, in effect what we are assessing is what is acceptable to the community and the 'right thing to do'. There seems to be differences of view about whether that standard is similar to the considerations in determining what constitutes moral turpitude or is unconscionable which are, if not the wrong thing to do, then certainly not the right thing to do.

NSW Chief Justice Tom Bathurst was quoted in the Australian Financial Review on Thursday, 6 February 2020 in relation to the Kobelt decision.

He referenced section 21 of the *Competition and Consumer Act 2010* (Cth) (which was considered in Kobelt) which provided "no guidance about what values, 'norms of society', or 'accepted community standards' might be relevant to a particular type of conduct."

He said:

> "It would be better for the legislator to take a more active role in prescribing more carefully the standards of conduct which it expects individuals to meet. This could well avoid many of the problems I see with the general prohibition on unconscionable conduct.
>
> Penalties rely on certainty if they are to be an effective deterrent.
>
> If this is lacking, then I find it difficult to see how these statutory prohibitions are to achieve their goal of defending and reinforcing the "moral conscience" of society… I think that this points to the need for a degree of specificity in how to frame legislation if it is to be effective."

This comment seems to go to the heart of the issue of when not doing the right thing based on community expectations becomes doing the wrong thing subject to legal sanction.

Would the decision of the judges in Kobelt have been any easier or different if the test was what the fictional reasonable person in the circumstances would do, rather than what was unconscionable? The arcane term 'unconscionable' possibly created an interpretative distraction (similar to 'moral turpitude'), but is the real enquiry 'the right thing to do' substantially the same?

Speaking at the Corporate and Commercial Law Conference in 2019, Daniel Crennan QC, Commissioner of ASIC, referred extensively to the judgment in Kobelt. He believed directors have responsibility to consider "the importance of a purpose consistent with the proper and fair

treatment of customers… that does not prefer shareholder primacy or profit to the detriment of the interests of the customer."

Mr Crennan referred to a number of public inquiries in respect of the Corporations Act (including PJC and CAMAC) and said:

> "In summary, those inquiries found there was no need for change in the Corporations Law in Australia in circumstances where the current law… was sufficiently flexible to ensure that corporations and their stewards, the directors and officers, are able to be held to account for its and their actions that affect stakeholders beyond shareholders."

He expressed the view that concerns in relation:

> "To the environment, social expectations and employees are probably, to an extent at least, addressed in existing current Australian legislation. The existing legal framework might relate to a corporation's purpose that transcends, deliberately so, the pursuit of profit.
>
> When taking a long-term view, factoring in the interests of the multitude of stakeholders beyond shareholders alone as well as the company's reputation is arguably consistent in considering the best interests of the company."

In summing up the Conference, Chairman Justice Barrett commented:

> "Corporations legislation is not to be viewed as the only body of law that corporations need to look at to decide how they should conduct themselves: that they, like all of us, are citizens with responsibilities to society regardless of corporate law concepts."

# EYE ON THE FUTURE

Having regard to the extensive current movement in community expectations of directors in the performance of their duties, and having regard to decisions such as Kobelt, we can expect more emphasis on the consideration of directors' duties to stakeholders other than shareholders based on the conscience of the fictional reasonable person.

The reasonable person now expects directors to act in the interest of the community which that has bestowed the gift of the corporate form to enable shareholders to make profits, including from the use of public assets. The community now expects that if a company business may cause harm to the community, then the company must be responsible to take reasonable steps to avoid that harm or be liable for the damage caused, even at the expense of profits.

If directors fail to exercise their powers and discharge their duties under the Corporations Act in a way so as to avoid harm to society, then a reasonable person is likely to consider they have acted unconscionably, with moral turpitude, not as a reasonable person would have acted and hence should be subject to sanctions.

Community expectations and judicial interpretation seem to be moving in the direction that not doing the right thing is doing the wrong thing.

It would seem there is no need to amend legislation to achieve this end, because current judicial interpretation of the standard of a reasonable person under the Corporations Act already require it.

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