THE ROYAL COMMISSION WANTS COMPANIES TO THINK LONG TERM. WILL SHAREHOLDERS LET THEM?

THE ROYAL COMMISSION SHOWDOWN

After twelve months of spectacle and speculation, the final report of the Banking Royal Commission is done and dusted. There are countless takeaways and titbits that have been widely discussed in the media, including most prominently the willingness of the Government and Opposition to adopt all of Commissioner Hayne's recommendations. More philosophically, a real cause for reflection is what the Royal Commission actually developed into by the end of the hearings. What started as an investigation into misconduct in the financial sector, ended with the simple question "what is the role of the corporation?"

Front and centre of this debate is the shareholder primacy model – its merits and, funnily enough, whether it actually exists.

Argument about shareholder primacy hasn't been this hot since… well, ever. This debate has left its usual shadowy, subterranean domain of company law journals and obscure law firm blogs and hit the bright lights of mainstream consciousness.

QUICK RECAP

In Australia, the Corporations Act requires directors to act in good faith in the best interests of the company as a whole. This has been widely accepted to require that directors focus on protecting and generating shareholder value. Shareholder primacy was famously put by Milton Friedman as the "one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game."

The typical criticism of shareholder primacy is that directors, having to prefer the interests of shareholders above all else, can't (even with the best will in the world) take into account issues that conflict with shareholder value. The requisite link with shareholder value to permit accommodation of extraneous interests is the **"but if"** in Dyson Heydon's 1987 words:

> **"Our law [Australia's] perhaps goes less far than American in permitting consideration of such abstract matters as the national economic interest, the wishes of the government or the advancement of the environment. *But if* those matters had a link with the interests of the company they could be considered."** [1]

[1] J.D. Heydon, "Directors' Duties and the Company's Interests" in P.D. Finn (ed), Equity and Commercial Relationships (Lawbook, 1987), p. 136.

SHAREHOLDER PRIMACY IN THE BOX

In his appearance before the Royal Commission, Dr Ken Henry, the Chair of NAB, brought this issue into focus:

> The capitalist model is that businesses have no responsibility other than to maximise profits for shareholders. A lot of people who have participated in this debate over the past 12 months have said that's all that you should hold boards accountable for, is that they are focused on the maximisation of profits for shareholders. Now, of course, some people will say but that doesn't mean that you can mistreat customers, because doing so might be in the interests of short – the short-term interests of shareholders, but not in the long-term interest of shareholders. **But even that approach sees customers as instruments – in an instrumental fashion, that the customers are seen as the means by which shareholder profits are secured, rather than the customer being the focus, what the business is actually all about.** In my testimony to you yesterday and in things that the chief executive said in this room yesterday, you would have gathered that this is something that within NAB we have, over the last few years, thought very deeply about, whether we should see our customers in purely instrumental terms, as a means to an end, rather than the end in itself.
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> ...But, anyway, for what it's worth, NABs view clearly today is that incentives should be aligned with customer experience – customer outcomes, to be clear. Customer outcomes. **That instead of positioning the business in this way, that the purpose of the business should be to maximise shareholder returns subject to customer tolerance and subject to regulatory tolerance, that, rather, the purpose of the business should be about maximising the outcomes for customers subject to financial viability. And it is a rather profound distinction.**

Henry's distinction is profound. His conclusion is that, under the current corporate governance framework, a positive "instrumental" stakeholder experience is really the best we can expect. That is, the broader community, affected daily by corporate activity, needs to hope that if falls into Heydon's "**But If**".

Dr Henry's testimony was criticised in ways that would make Steve Smith and Cameron Bancroft feel good about their Cape Town press conference, but in the above quote he posited a fundamental question about whether – if Australia wants consistently positive stakeholder outcomes from corporate behaviour – can we be confident that the current system will deliver? This is a worthy question and is certainly the right one for the moment. Despite all the criticism that Henry was tone deaf, in this quote he shows he was thinking very deeply about the temperature of the times.

In his final report, Commissioner Hayne tackled head-on Henry's assessment of shareholder primacy (bear with us, it's a monster of a quote but important):

> "...many of the case studies considered in the Commission showed that the financial services entity involved had chosen to give priority to the pursuit of profit over the interests of customers and above compliance with the law. Some have sought to explain this emphasis on the pursuit of profit as reflecting the fact that a financial services entity is ultimately accountable to its shareholders. That proposition requires close examination. All entities that are incorporated and have a share capital have responsibilities, and are accountable, to their shareholders. It is shareholders who will elect directors and, in the case of publicly listed companies, will vote to adopt, or not adopt, remuneration reports. It is shareholders who will give effect to the 'two strikes rule' that may see the entire board spilled.
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> These forms of accountability are, of course, important. But they do not mark the boundaries of the matters that the boards of financial services entities must consider in the course of performing their duties and exercising their powers. That other considerations bear upon those decisions is most evident in the case of the largest financial services entities. Each of the largest entities is systemically important. The long-term stability and performance of each is important to the proper performance of the national economy. It follows, therefore, that the boards of those entities must have regard to those enduring requirements. And the requirements are neither wholly captured by nor completely reflected in the day to day share price of the entity or some measurement of 'total shareholder return' over some period. The horizon of these larger entities must lie well beyond the next announcement of results. This gives rise to a further point about the

nature and extent of directors' duties. Directors must exercise their powers and discharge their duties in good faith 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. And that demands consideration of more than the financial returns that will be available to shareholders in any particular period. Financial returns to shareholders (or 'value' to shareholders) will always be an important consideration but it is 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. They cannot be determined by reference only to the economic advantage of those shareholders on the register at some record date. Nor can they be judged by reference to whatever period some of those shareholders think appropriate for determining their results.

It is not right to treat the interests of shareholders and customers as opposed. Some shareholders may have interests that are opposed to the interests of other shareholders or the interests of customers. But that opposition will almost always be founded in differences between a short term and a longer-term view of prospects and events. Some shareholders may think it right to look only to the short term. The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with any corporation will be seen as converging on the corporation's continued long term financial advantage. And long-term financial advantage will more likely follow if the entity conducts its business according to proper standards, treats its employees well and seeks to provide financial results to shareholders that, in the long run, are better than other investments of broadly similar risk. Financial services entities are no different. In the longer term, the interests of all stakeholders associated with the entity converge. And the burden of the evidence from the chief executives of all four large banks was that a bank's best earnings opportunity comes from long term relationships with its customers. That is why, as Mr Hartzer said: 'banking is an annuity business'. Regardless of the period of reference, the best interests of a company cannot be reduced to a binary choice. And financial services entities are no different. Pursuit of the best interests of a financial services entity is a more complicated task than choosing between the interests of shareholders and the interests of customers."

At the heart of this passage Hayne argues that the key lens is not stakeholder vs shareholder, but long term vs short term. When viewed in this way, Hayne argues that the various interests are likely to be in sync in the long run, or as Hayne puts it:

> **"The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with any corporation will be seen as converging on the corporation's continued long term financial advantage."**

Hayne goes on to say that "Regardless of the period of reference, the best interests of a company cannot be reduced to a binary choice." Essentially he is saying that shareholder primacy requires a long-term stakeholder-centric approach which in turn solves the problem of the shareholder vs stakeholder divide.

So Hayne rejects Henry's "*instrumental fashion*" analysis (and Heydon's "*but if*").

Who is right?

HAYNE V HENRY?

Allow us to take a short excursion back through Australian case law.

The conventional view of directors' duties is often traced to a 1951 United Kingdom case, where it was held that:

> **"the phrase, "the company as a whole", does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body."** [2] (corporators meaning the shareholders)

In plain English – the "company as a whole" just means the shareholders.

This was straightforward and easy to digest. However, things have advanced a little since 1951, and more recently Australian courts have been willing to develop on this conventional view. In 2008, the Supreme Court of Western Australia noted:

> **"In my view the interests of shareholders and the interests of the company may be seen as correlative not because the shareholders are the company but, rather, because the interests of the company and the interests of the shareholders intersect. [...]**
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> **It is, in my view, incorrect to read the phrases 'acting in the best interests of the company' and 'acting in the best interests of the shareholders' as if they meant exactly the same thing. To do so is to misconceive the true nature of the fiduciary relationship between a director and the company. And it ignores the range of other interests that might (again, depending on the circumstances of the company and the nature of the power to be exercised) legitimately be considered. On the other hand, it is almost axiomatic to say that that the content of the duty may (and usually will) include a consideration of the interests of shareholders. But it 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."** [3]

This view has been cited with approval by the Supreme Court of Victoria more recently in 2015[4] and 2018[5].

In the recent Brickworks decision, the Federal Court also endorsed a long-term approach adopted by the boards in question (an approach detrimental to shareholders who wanted to facilitate a takeover), giving directors substantial latitude in weighing up the best interests of the company, including by taking longer-term interests into consideration.[6] Previous CAMAC and Parliamentary Joint Committee enquiries have come to the same conclusion.[7] There is genuine flexibility for directors' to take into account broader stakeholders (at least instrumentally).

So, Hayne is right to suggest that, under the current law, pursuit of the best interests of the company is more nuanced than just a merciless pursuit of profits. And it then follows neatly that by taking a long term view of the world, directors can take into consideration the interests of a variety of stakeholders and, seemingly, act in a way that benefits everybody.

That's great then, happy days.

Can we all go home?

Well not quite.

If the current state of the law so clearly allows (or even requires) directors this latitude, why are we in this pickle? Is the proposition really that the entirety of the Australian corporate-industrial complex, with all its experience and advisers, has simply misunderstood its most basic duty?

That seems farfetched.

[2] Greenhalgh v Arderne Cinemas Ltd (No 2) [1951] Ch 286 at 291

[3] Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9) (2008) 39 WAR 1, 533-534 [4392]-[4393], [4395].

[4] Australasian Annuities Pty Ltd (in liq) v Rowley Super Fund Pty Ltd (2015) 318 ALR 302, 316-317 [57].

[5] United Petroleum Australia Pty Ltd v Herbert Smith Freehills (26 June 2018)[2018] VSC 34.

[6] RBC Investor Services Australia Nominees Pty Limited v Brickworks Limited [2017] FCA 756

[7] CAMAC, 'The Social Responsibility of Corporations' (Report, Australian Government, 2006), at 84, 91-2; PJC, 'Corporate Responsibility: Managing Risk and Creating Value' (Report, Parliament of Australia, 2006) at 52-3.

HOW DOES THIS ACTUALLY PLAY OUT IN PRACTICE?

Although the current law (reinforced by Hayne's declarations) should give directors the space required to think in the long term and consider a broad set of stakeholder interests, the real question is how this plays out in practice. In the words of Argentinian essayist, Jorge Luis Borges *"All theories are legitimate, no matter. What matters is what you do with them"* or, as more subtly put by Mike Tyson *"Everyone has a plan 'till they get punched in the mouth."*

SHAREHOLDERS OR OTHER STAKEHOLDERS?

There can't be much question that, generally speaking, directors view their core duty as being to shareholders. That will typically require doing a good job by customers and others, but all in a way that ultimately grows shareholder value. As recently put by ACCC Chair Rod Sims *"We don't want companies to get confused so I think their duty should be just to the long-term interests of shareholders."*

In all sorts of ways this makes plenty of sense. It also makes the very complex role of being a director as simple as it can be.

A lot of the hysteria around the ASX Corporate Governance Council's original "social licence" proposal can be explained by a genuine concern over how directors would actually comply with a broader, arguably nebulous, obligation (even if the widely panned "social licence" language pre-empted and absolutely nailed Hayne's message to companies). [8]

Directors also acknowledge that shareholder primacy does more than simplify things, it also means that their duties are fundamentally owed to those who've put their money in. Chair of Westpac, Lindsay Maxsted, recently said "*"They [shareholders] are the ones who appoint directors and that is who we are principally accountable to"* and shareholders *"are the ones who have their money most at risk"* Again, simple and logical.

To give further weight to this idea, a 2012 survey of directors found, when testing shareholder 'salience' (influence and ability to make demands) relative to other stakeholders, that shareholders had the highest level of salience.[9] This really comes as no surprise when you consider the actual legal framework. The mosaic of corporate governance measures have been deliberately developed to ensure that directors are accountable to shareholders. The "sticks" (think: right to remove directors, call general meetings, take directors to court, join class actions etc.) and the "carrots" (think: approving the grant of incentives or even just appointing directors) are all held by shareholders – these are the tools designed to curb the agency problem, to align directors and shareholders. Putting duties to one side, directors are primarily accountable to shareholders, and shareholders are bound to hold them to account in light of their own interests. Australia is a famously shareholder friendly jurisdiction.

Even the way ASIC prosecutes *"failure to prevent"*-type directors' duty action (also known as the "stepping stone approach") usually starts by establishing a destruction in shareholder value as the harm that was not prevented.[10] This all reinforces the core belief in the minds of directors that the shareholder is the stakeholder that matters.

When seen this way, it is understandable that in practice directors would give priority to shareholders over extraneous stakeholders when their interests conflict – especially when those other stakeholders have next to no practical influence. Employees can't roll the board, customers can't sue directors for missing earnings forecasts and subsequent share price crashes and dead fish in the Murray Darling river can't vote down a remuneration report.

So in practice shareholders hold all the cards. How does this playout when directors look to act in the long term?

[8] https://www.asx.com.au/documents/asx-compliance/consultation-draft-cgc-4th-edition.pdf, (see commentary around proposed Principle 3).

[9] Marshall, S and Ramsay, I 'Stakeholders and directors' duties: Law, theory and evidence', UNSW Law Journal, Vo 35(1), 291-316

[10] See for example, ASIC v Citrofresh International Ltd (No2) (2010) 77 ACSR 69, where it was held that a director allowing a company to make a statement that is found to be misleading conduct in contravention of section 1041H of the Corporations Act 2001 (Cth), could also be found to have failed to exercise his or her duties as a director with a reasonable degree of care and diligence. Noting that breaches of the duty to act with a reasonable degree of care and diligence do not require any actual proof of loss to the company as a requirement (see ASIC v Cassimatis and Another (No 8) 2016) 33 ALR 209 at 481).

LONG TERM V SHORT TERM

If shareholders hold all the cards, it's really only the institutional shareholders who stump up the blinds to play the hand.

To grossly oversimplify public market participants, there are broadly two divergent classes of shareholders with different objectives and approaches – mum-and-dad shareholders and institutional investors. Mum-and-dad investors are typically passive, unlikely to engage actively with boards, sell their shares en-masse, punish directors at AGMs or challenge board decision-making in the Courts. On the other hand, institutional shareholders have the time, resources, means and internal incentive structures that motivate the individuals running them to pressure directors. This means they are far more likely to utilise the tools at the disposal of shareholders generally – whether it be seeking to spill the board or bringing actions for perceived breaches of duty.

More often than not, institutional investors (or at least those that manage them) are focused on much shorter investment horizons than retail shareholders and aren't afraid to let directors know.

So "shareholder primacy" regularly turns into what we call "Goliath primacy", with the noisiest and most powerful shareholders building irresistible pressure for short-term decision making – often at the cost of the long-term aspirations of boards.

TO RECAP

+ Hayne's assessment of the current corporate governance law is both correct and a very timely reminder – it is an oversimplification to say directors must prioritise short-term profits under law, instead, it is right to say that directors can consider other interests and, in the long term, the interests of the company and all stakeholders should converge. This means that directors making decisions with the long term in mind will discharge their duties to shareholders.
+ But.... in practice, shareholders have all the tools at their disposal to influence corporate decision-making.
+ Moreover, the shareholders that have the means to utilise the tools at their disposal are more likely to be short-term focused, making long-term decision-making difficult for directors.
+ This all results in pressure to consider short-term shareholder interests in priority to other interests.

Trying on bold, long-term action in favour of broader stakeholders in the current system is just, well, hard. Ask any big company that has tried to adopt meaningful "*soft*" measures in its remuneration arrangements about how they've gone in their remuneration strike votes.

In practice, the current corporate governance framework ends up looking a lot like what Dr Henry described during the Royal Commission, with companies in good faith viewing extraneous stakeholders as instruments in the pursuit of shareholder interests, and more often than not, short-term shareholder interests.

This then takes us back to Henry's question about whether we are satisfied with this system.

HOW DO WE PROTECT DIRECTORS TRYING TO DO THE RIGHT THING FROM RAMPANT GOLIATHS?

Where does this leave us?

There is undoubtedly a growing expectation that corporations are run for a broader purpose other than simply profit and shareholder returns. In Australia, the findings of, and reaction to, the Royal Commission and the ASX Corporate Governance Council's new fourth edition of the Corporate Governance Principles and Recommendations all point to this expectation.

We have established that the current state of the law in Australia permits a broader stakeholder view of corporate behaviour but in practice it doesn't really play out this way – mostly for entirely logical reasons. So some change might be in order to respond to the growing zeitgeist.

The new corporate governance principles and the sledgehammer of the Commission will certainly have an effect, so those impacts remain to be seen, but the underlying power structures haven't changed.

WE ARE NOT ALONE

Almost all comparable jurisdictions are reflecting on the same issue, with prominent groups looking at actually changing the law to achieve the long term behaviours that Hayne promotes.

The British Academy's *"The Future of the Corporation"* initiative is digging into the corporation's role in UK society. In his paper *"Towards humane business"*, Professor Colin Mayer, the program lead, argues that where a corporation has *"particularly significant social consequences"*, regulation should require alignment between corporate and social purpose and that corporate law should ensure that ownership, governance and incentives are appropriate for this alignment. This has serious echoes of Hayne's statement that *"other considerations bear upon those decisions is most evident in the case of the largest financial services entities. Each of the largest entities is systemically important. The long-term stability and performance of each is important to the proper performance of the national economy."*

Mayer also says *"Corporate purpose is distinct from the consequential implications for the corporation's profitability and shareholder returns.* ***The purpose of corporations is not to produce profits. The purpose of corporations is to produce profitable solutions for the problems of people and planet. In the process, it produces profits, but profits are not per se the purpose of corporations."*** This is a lot like what Dr Henry articulated as the alternative to the *"instrumental view"* – ***"the purpose of the business should be about maximising the outcomes for customers subject to financial viability".***

Bear in mind the UK already has a Companies' Code that goes further than our Corporation Act in mandating consideration of a company's societal impacts, and the UK's Corporate Governance Code (held out as a beacon of brevity and common sense compared to ours) also says that directors and the companies they run need to maintain successful relationships with a wide range of stakeholders. Despite those stronger built-in stakeholder protections, many think change is required in the UK for significant companies.

Elizabeth Warren (6th favourite to be the next US President at the time of googling) has proposed an "Accountable Capitalism Act", under which directors of American corporations with $1 billion in revenues are required to create a "general public benefit" and to balance the shareholder interests with the interests of people materially affected by the company. This would require positive consideration of shareholders, employees, customers, subsidiaries, community, the environment, the short-term and the long-term with no greater priority given to any single factor.

A different approach, again coming out of the US, is a concept called *"The New Paradigm"*. Vigorously promoted by the renowned American corporate lawyer Marty Lipton, it is an industry led (rather than legislated) model for governance and stewardship between corporations, investors and asset managers. It explicitly rejects shareholder primacy as it has developed and is instead premised on the idea that stakeholder governance and ESG are in the best interests of shareholders. It assumes that shareholders and other stakeholders have more shared objectives than differences – namely, the same basic desire to facilitate sustainable, long-term value creation. This then should completely remove the need for activism and short-termism. This is very much like the Hayne view of the inherent benefits of long term alignment.

An altogether different approach is the US-style *benefit corporation* – a corporate structure that requires companies to articulate a "public benefit", with directors required to pursue the generation of the public benefit as part of pursuing the best interests of the benefit corporation – broadening the corporate mission and widening fiduciary wiggle-room.

It's clear then that enormous thought is being given to this problem and there are lots of ways of attacking it. What all these proposals have in common is the underlying premise that boards around the world find it difficult to resist short-term shareholder pressure. Australia's corporate governance framework may theoretically provide the required latitude for boards to think and act in the long-term, but in order to see this play out in practice, something structural might need to change.

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