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# The Stakeholder Theory and its Future in Australian Corporate Governance: A Preliminary Analysis

**Abstract**
[extract] Whilst market forces lend great weight to implementation of the stakeholder theory, the theory remains an ethical model and has not attracted legal support. Whilst the legislature is not yet convinced of the benefits or necessity and particularly the workability of the stakeholder theory, I will examine the ability of companies to implement the theory as a business ethic under current Corporation Law.

**Keywords**
stakeholder theory, corporate law, corporate governance

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# THE STAKEHOLDER THEORY AND ITS FUTURE IN AUSTRALIAN CORPORATE GOVERNANCE: A PRELIMINARY ANALYSIS

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## Introduction

The history of the corporate structure over the last one hundred and fifty years reflects that its fundamental purpose has been to maximise corporate profit with a view to increasing shareholder wealth. More recently, however, with regard to social considerations, it has been realised that the 'modern corporation by its nature creates interdependencies with a variety of groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers and members of the communities in which the corporation operates'.[1] This 'stakeholder concept' has been the subject of increasing discussions with the development of industrial relations issues and economic theories. Some writers take the hard line approach that 'no corporation can sustain itself without appropriate attention to all those who hold a stake in its performance - customers certainly, but also suppliers, creditors, neighbours, society in general and, of course, those most directly affected – employees… There is a growing sense that rank and file employees, as well as middle-level management, disproportionately share the risk, but not the gains of corporate success.'[2]

As the stakeholder theory serves to broaden the previously narrow and single-minded concept of the corporation ie shareholder profit, it naturally has its sceptics. Economic support for the theory arises from the view that long term profitability of the company is dependent on more than just concentration on shareholder wealth. Many suggestions have been made by writers in recent times as to how the stakeholder concept can be introduced as an effective and progressive means of corporate governance.

The concept has found some support, throughout the modern international corporate world. It is the basis of US anti-takeover statutes, recognising non-constituency shareholders, and is the predominant corporate governance structure in Germany and Japan. The theory has also received consideration by UK politicians and is referred to by UK and US writers and economists. To date however there has been no reflection of the theory in either Australian corporate governance or the Corporations Laws. With the increasing pressure of unions and employee disputes however, it may be a natural progression to ensure

1 Donaldson T and Preston LE, 'The Stakeholder Theory of the Corporation – Concepts, Evidence, Implications' (1994) Working Paper No 37, The Centre for International Business Education and Rescources (CIBER) http:/www.mbs.umd.edu/Ciber/wp37.html , 11.

2 Mahoney RJ, 'Business Should Act for All Its Stakeholders – Before 'The Feds' Do', http://csab.wustl.edu/papers/ manage/ceo9/coe9.htm, 1.

survival of corporations. Roberta Karmel suggests 'the stakeholder model may provide a helpful framework with a renewed focus on jobs and competitiveness in a global marketplace where long term strategic planning has a higher value than stock market prices.'[3]

## Analysis

Perhaps the best definition of the stakeholder concept derives from the Pennsylvanian Stakeholder Statute which provides that 'directors, in considering the best interests of the corporation in discharging their duties, are permitted to consider the effects of any action upon all groups affected by such action, including shareholders, employees, suppliers, customers, creditors of the corporation and communities in which offices or other establishments of the corporation are located.'[4]

Taking this concept further, 'stakeholders are identified by their interest in the corporation, whether or not the corporation has any corresponding functional interest in them…each group of stakeholders merits consideration for its own sake, and not merely because of its ability to further the interests of some other group, such as the shareowners.'[5] The issue then arises as to how to identify stakeholders and evaluate their stake in the corporation.

It may be suggested that each of these alleged stakeholders hold the following 'stakes' in the company. In the case of employees it is an input of human capital particularly of long- term employees who have worked to consolidate specialist skills attributable to the company to assist with maintaining a successful business. The stake of suppliers is that they derive income from goods supplied to the company. The stake of owners is principally economic in the sense that they are relying on their shares in the company to produce a profit. The stake of the community is the need for a clean environment and boost to the economy through the provision of jobs and production of goods. Finally, the stake of creditors is that the business continues to perform well to ensure that the debts owed to the creditor are satisfied.

There has been some suggestion that the class of stakeholders could go further than those groups identified through 'the actual or potential harms and benefits that they experience or anticipate experiencing as a result of the firm's actions or inactions.'[6] Expanding the stakeholder concept to include any body that has some influence over the firm, however, is effectively expanding the concept beyond workability.

Whilst market forces lend great weight to implementation of the stakeholder theory, the theory remains an ethical model and has not attracted legal support.

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3 Karmel RS, 'Implications of the Stakeholder Model' (1993) 61 The George Washington Law Review, 1158.

4 15 PA Cons Stat Ann 1715-1716 (sup 1992).

5 Donaldson T and Preston LE, 'The Stakeholder Theory of the Corporation – Concepts, Evidence, Implications' (1994) Working Paper No 37, The Centre for International Business Education and Rescources (CIBER) http:/www.mbs.umd.edu/Ciber/wp37.html, 2.

6 Ibid at 14.

Whilst the legislature is not yet convinced of the benefits or necessity and particularly the workability of the stakeholder theory, I will examine the ability of companies to implement the theory as a business ethic under current Corporation Law.

I will seek firstly to outline the arguments for the belief that the claims of other corporate constituencies including employees, creditors, suppliers and the community are to be heard.

## Economic Support for the Stakeholder Theory

'The traditional view of Milton Friedman argues that the purpose of a company is to make profits for stockholders, which means its stockholders are the one and only stakeholder group that managers should take into account when making a decision.'[7] In recent times, however, some economists have tended to support the stakeholder theory as providing a number of potential economic benefits. Most businesses realise that the health of the economy affects all of their stakeholders including owners, suppliers, employees and customers. Regardless of the performance of individual managers, in good times profits will increase and in bad times profits will fall. It, therefore, makes good economic sense to strive for economic stability to support business for the long run. It is this long-term view that is the current focus of economists and explains the support that economic advocates have given to the stakeholder theory.

Two prominent economists, Will Hutton of the UK and Margaret Blair of the US, are staunch advocates of the stakeholder theory. Hutton considers the theory to be the answer to 'great inequality, under-investment and a hollowed-out industrial base which ultimately serves no sector of the community well.'[8] Hutton's suggested 'stakeholder capitalism' is 'a regulated system that boasts a creative, high investing and high producing business sector, that needs discriminating consumers and a highly trained and educated workforce, and a system that looks after people and distributes risk more evenly, in everything from markets to health.'[9] Margaret Blair[10] agrees that it is in a countries long-term economic interest to run corporations with the interests of all stakeholders in mind. The specialised skills that employees acquire specific to that incorporation are an asset to the corporation and should be viewed as human capital rather than their salary being viewed solely as a cost to the corporation. The age-old notion of ownership and control, that the corporation is an asset of the shareholders, should be dismissed and rather it should be viewed as 'a governance structure whose social role is to administer the resources and investments made by all the firms' stakeholders.'[11] Blair limits her notion of

7 Kujala J, 'Analysing Moral Issues in Stakeholder Relations – A Questionnaire Development Process' (1998) University of Juvaskyla, School of Business and Economics, Finland, 1.

8 Radio Australia 'Stakeholder Capitalism - Will Hutton (Part II)' (November 1997) http://www.abc.net.au/ra/elp/ sincfile/sf191197.htm, 1.

9 Ibid.

10 Blair MM, *Ownership and Control: Rethinking Corporation Governance for the Twenty-First Century*, Brookings Centre for Law, Economics and Politics (1995), http://www.brook.edu ./PA/PRESSUREL/OWNERSHP.HTM.

11 Ibid at 1.

'stakeholders', however, to 'those parties who have contributed specialised resources to the enterprise'[12] and does not extend the net of stakeholders to communities and those who do not have a direct interest in the corporation but benefit indirectly, such as the surrounding community.

It is argued that much revolves around the question of 'ownership', which has in many previous literature discussions been considered to be a right of the shareholders. Blair claims that in lieu of ownership the shareholders are actually in a 'residual claim position….that provides the economic and morale rationale for giving them certain residual control rights.'[13] It is not the fact that we casually refer to them as 'owners'. It is not possible to attribute ownership to one party or another in this form of corporate governance without asking 'which parties in the corporate enterprise are contributing what resources and which ones are bearing what risks.'[14] Blair speaks of de facto control[15], that is parties other than shareholders that have made investments in modern corporations and bear the same risk that shareholders do of their investments failing even though we are not talking of equity capital. Blair focuses her energies on the investment of human capital in the form of employees. This human capital revolves around the concept that firm specific skills are acquired by employees of a particular corporation and that these skills would not be as valuable if taken elsewhere outside of the corporation. It is estimated that approximately ten percent of the employees' salary is attributable to these firm specific skills. This percentage reflects the decrease in remuneration that an employee would take when he or she leaves a firm to which his or her skills are specifically applicable and is re-employed by a firm at which these skills cannot be equally utilised.

This percentage attributable to the employees' specific skills is considered the employees share in the 'economic surplus.'[16] The residual of this surplus is what is distributed to the shareholders. The employer, however, not only shares in the economic surplus but also shares in the risk associated with the corporation. Unless there is adequate profit generated, principally by employees, to pay the higher wages promised by management and profits to the shareholders, the employee risks being laid off. Notwithstanding the value attributed by employees, when economic benefits provided by corporate activity are counted the value of human capital is not considered. Accountants continue to register payment to employees as a cost, something which the shareholders consider should be cut. They should instead be considering that it is in the long-term best interest of the corporation to encourage investments by employees in firm specific assets, to treat this as a form of capital and to reward these employees with a share in the returns. This is allegedly in keeping with labour relation practices in the UK. Concentration should be on total wealth creation potential of the firm, increasing all firm specific investments not just maximisation of shareholder wealth, to continue to ensure an economic surplus is generated for

12 Ibid.
13 Blair M, 'Wealth Creation and Wealth Sharing' (1996) Brookings Institution – Excerpt published by US News Culture and Ideas, 1.
14 Ibid at 2.
15 Ibid at 2.
16 Ibid at 3.

the corporation.[17] Stakeholders reaching agreement with managers on such governance as internal costs and effective information transfer within the corporation, should help to decrease disputes, and resulting strikes, and consequently increase productivity.

An important rider to the economic argument is that economists do not appear to support the stakeholder theory of corporate governance for all corporations. They acknowledge that there is incredible time and energy to be put into changing the corporate governance structure of a company that has previously been ruled by a system of corporate governance that focused on maximisation of shareholder wealth. Margaret Blair does, however, make recommendations as to how to adopt the stakeholder concept in the way that corporations are run. In summary she argues that[18]

1. Boards of Directors should understand they represent all the stakeholders in a firm not just shareholders and seek to maximise the wealth creation by the enterprise as a whole.

2. Accounting rules should be reformed to ensure returns on investments in the skills of its employees and in organisational capabilities are included as assets of the company.

3. Compensation for executives and rank and file employees should be in the form of restricted stock that cannot be sold immediately.

4. Labour laws that tend to discourage employee participation in management should be revised.

5. Firms should disclose additional financial information on the market value, the risks associated with investment programs, investment in human capital and present value of compensation and benefit commitments.

6. Reforms should be monitored to ensure they are meeting the goal of total wealth creation, and reconsidered if they are not, or are having unintended consequences.

Another interesting British report investigates future companies. The 'Tomorrow's Company Report' [19] requires the most important change of abandoning the single-minded pursuit of shareholder wealth and considering the 'company's relationship with key stakeholder groups, and recognizing that the short-term needs of shareholders need not always come first.'[20] The report encouraged businesses to consider how they are going to adapt to the changing

17 Ibid at 5.
18 Blair MM, *Ownership and Control: Rethinking Corporation Governance for the Twenty-First Century*, Brookings Centre for Law, Economics and Politics (1995), 2-3.
19 PR Central (Reputation Management), 'In Britain, An Investigation into 'Tomorrow's Company'' (1995) http:/www.prcentral.com/rmso95tomor.htm.
20 Ibid at 1.

needs and expectations of society. As quoted by the Chairman of the inquiry into 'Tomorrow's Company', 'the last year or so has seen deepening concern with the way in which business conducts various aspects of its affairs. While some of these concerns may be mistaken, misplaced or simply exaggerated, they must be addressed if business is to be able to play the full part it should in the development of a prosperous society.'[21]

While there is an increasing appreciation of the need to adapt to these changes, argument against the ability to change lies in the current applicability of the laws and directors' legal responsibility. This is, however, argued as taking a narrow view of directors' liabilities in the sense that the directors' duty is applicable to the current shareholders at any one time whereas in fact it is a duty to create sustainable wealth for the benefit of a general body of shareholders over time. The commentator even goes so far as to suggest that directors may be unable to discharge their duty unless their company's relationships are considered, as there is nothing in law to prevent directors taking into account the interests of third parties if they believe to do so will contribute to the company's future success. [22]

The adoption of the stakeholder theory of corporate governance and the consideration of interests of a larger group than just the shareholders is seen to be in line with the ever- changing corporate world, including the increasing importance of environmental issues, more demanding employees, communities and customers. The difference between the approach of current companies and tomorrow's company can be neatly summarised: 'Tomorrow's company will develop and apply a unique success model… This means defining unique advantages and values that the company can create and demonstrating how these will be exploited to achieve sustainable success…. Tomorrow's companies match performance to their success model, so it can assess areas of risk and the health of relationship and anticipate opportunities. Yesterday's companies take it for granted that everybody knows what success is and are content to measure returns…. Tomorrow's company is an adaptable organism. It aims to retain and develop new business with customers as part of a relationship that creates value for both parties; it views suppliers as true extensions of the company. It shares information with long term stakeholders to increase confidence and understanding; and it recognises this inter-dependence with the community in which it operates.'[23]

## Moral and Ethical Support for the Stakeholder Theory

Outside the economic and corporate governance issues, the stakeholder theory also raises a number of moral and ethical issues in its application to employees, customers, suppliers, owners, financiers and the community. Ethical treatment does not mean equating the interests of stakeholders with those of shareholders. It means that stakeholders should be treated fairly and justly. The basis of moral reasoning is that 'each person is accountable to those whom his or her actions

21 Ibid at 3.
22 Ibid at 3.
23 Ibid at 5-6.

effects. Managers actions affect different stakeholders, and therefore it is important to develop tools for analysing managers views of accountability and responsibility in stakeholder relations.'[24] In applying this moral reasoning it may be argued that the moral responsibility of the stakeholder theory attracts a much larger range of stakeholders than, for example, the economist's view which limits the theory's application to employees and those that directly or indirectly affect, and benefit from, the company. It is considered that a company's relationships with both owners and financiers are emphasised by economic issues as opposed to moral obligations. Issues in relation to employees, customers, suppliers, the community and government and the environment can be more described as moral, as they are more expected than required from a company.

Examples of moral issues that arise include employees' rights to just wages, to participate in hiring and firing policies, removal of discrimination in working conditions, honesty, product quality and customer satisfaction. This establishes that there are more than just economic issues that should be taken into account by managers embarking on a corporate governance journey under the stakeholder theory. It should be remembered that 'companies do not exist just to satisfy the needs of their owners or stockholders, but they have a much wider range of important stakeholders who affect or are affected by the company's actions, and who set moral expectations to companies and to their managers.'[25]

Whilst there are no legal obligations enforcing corporate officials to follow legal and ethical principles, they are as bound to consider these principles as any other member of society.

This is supported by the American Law Institutes' (ALI) *Principles of Corporate Governance* which, whilst recognising that the 'objective of the business corporation is to conduct business activities with a view to corporate profit and shareholder gain'[26], permits activity which does not enhance corporate profits in certain circumstances. These circumstances allow ethical principles to be taken into consideration even if this is not in tune with maximising corporate profit.

Equally, a 'business which ignores the demands of business ethics, or gets them wrong, is unlikely to maximise long-term owner value…..the business that characteristically lies or cheats….that treats its customers contemptuously, or its staff unjustly, or its suppliers dishonestly, will often find them hard to retain.'[27]

24 Kujala J, 'Analysing Moral Issues in Stakeholder Relations – A Questionnaire Development Process' (1998) University of Juvaskyla, School of Business and Economics, Finland, 2.

25 Kujala J, 'Analysing Moral Issues in Stakeholder Relations – A Questionnaire Development Process' (1998) University of Juvaskyla, School of Business and Economics, Finland, 14.

26 Pritchett MJ III, 'Corporate Ethics and Corporate Governance: A Critique of the ALI Statement on Corporate Governance Section 2.01(b)' (1983) 71 California Law Review, 1000.

27 Sternberg E, *Just Business: Business Ethics in Action*, Warner Books, London (1995) 19.

## Legal Perspective

The stakeholder theory currently has no basic recognition in the Australian Corporations Law. Economists such as Margaret Blair question whether the theory should be made law in the interests of public policy.[28] In addressing this question Blair raises a number of grounds that create difficulties in establishing legal certainty, sufficient to legislate. These grounds include:

- Inability of management to define the class of stakeholders whose interests must be taken into account

- Inability of management to assess respective stakeholder's 'stakes' in the corporation. Competing interests mean management must have a formula by which they can prioritise stakeholder interests and allocate risks and until this point is reached the corporation will continue to exist 'for the sole purpose of making profits for their stockholders'…until…a clear and reasonably enforceable scheme of responsibilities (is offered) to someone else.'[29]

- Stakeholders, as against shareholders, presently have no control over management decisions and have no means of enforcing what effectively amount to a corporation's social obligations.

- It is a concern that management which is answerable to many stakeholders, not just the shareholders, will harm the corporation in the sense that 'diffusing this responsibility among many groups of stakeholders means, in practice, that managers are accountable to no one.'[30]

Notwithstanding the acknowledgment of possible impediments to the stakeholder theory becoming law, Blair recognises the need for broad legislative powers, which enable a corporation to voluntarily exercise the stakeholder theory. Blair advocates that 'much of the wealth-generating capacity of most modern firms is based on the skills and knowledge of the employees and the ability of the organisation as a whole to put those skills to work for customers and clients.'[31]

It is on this basis that I will proceed to examine the current state of Australian Corporations Law and the ability of company directors and managers to exercise the stakeholder theory discretion.

The relationship between directors and the company is a fiduciary relationship that invokes a high standard of loyalty under the principles of equity. This duty of loyalty, as described by Ford and Austin[32], includes the duties:

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28 Blair MM, *Whose Interests Should Corporations Serve?* Reprinted in *The Corporation and Its Stakeholders:Classic and Contemporary Readings*, Clarkson MBE (ed), University of Toronto Press (1998) 49.
29 Ibid at 50
30 Ibid at 60
31 Ibid at 64
32 Ford HAJ, Austin RP and Ramsey IM, *Ford's Principles of Corporations Law*, (9th ed) (1999), 281

(a) to act in good faith for the benefit of the company as a whole;

(b) to give adequate consideration to matters for decision, and to keep discretions unfettered;

(c) to exercise powers only for proper corporate purpose; and

(d) to act honestly.

These equitable duties are duplicated in Section 232(2) of the Corporations Law which is relevant for civil penalties purposes. This positive duty begs the question as to what constitutes acting for the benefit of the company as a whole. It is considered that reference to 'the company' could include reference to employees, customers, contractors and community, although this raises issues as to who has the ability to complain to the courts for breach of duty. There is no current case law or provision in the Corporations Law in Australia that requires directors to take into account the interests of employees, customers and the community. Whilst there is an absence of legislative recognition, there is no prohibition on directors choosing to take into account these other interests. Indeed, management of a company would be restricted if directors were governed by the single-minded pursuit of profit for the benefit of members. Directors are not estopped from considering other interests provided that there is a prospect of commercial advantage to the company. Ford and Austin consider that 'laws on conditions of labour, consumer protection and such community matters as environmental protection apply as much to companies as other legal persons. Directors who have to make decisions for the company can be in breach of their duty to the company if their decision puts the company in breach of any such law.' [33]

Duty to act in the interests of the company as a whole also brings into consideration the duty to act in accordance with the company's constitution, as this defines the limits by which the corporation can act. Accordingly, if the company's constitution provides, or is amended to provide, for consideration of interests external to that of shareholders in making decisions concerning the corporation, these considerations may be argued to be in the interests of the body as a whole. The shareholders may, however, see this as a fetter on their rights pursuant to the constitution, and consequently choose not to pass a resolution altering the constitution to this effect. It is in this situation that shareholders would need to be convinced that the company's long-term objectives would result in increased company profitability.

Section 232(2) of the Corporations Law is a statutory reflection of the fiduciary duty of loyalty. This section provides that 'an officer of a corporation shall at all times act honestly in the exercise of his or her powers and the discharge of the duties of his or her office.' [34] Case law has dictated that directors are obliged not only to act in good faith in what they consider to be the interests of the

33 Ibid at 299.
34 Section 232(2) Corporations Law.

company, but also to exercise their powers for proper purposes.[35] The Corporations Law Economic Reform Bill 1998 (CLERP Bill), section 181, seeks to amend section 232(2) to reflect the case law position and to clarify beyond doubt that officers must act in good faith in the best interests of the company and for proper purpose. The new section 181 states specifically that 'a director or other officer of a corporation must exercise their powers and discharge their duties:

(a) in good faith in what they believe to be in the best interests of the corporation; and

(b) for a proper purpose.

This is a civil penalty provision and consequently contravention incurs a penalty.

Accordingly, while there is very little case law as to whether the interests of stakeholders may be taken into account in determining whether an action is in the interests of the company as a whole, important changes being introduced by this CLERP Bill may be interpreted to support the wider notion that more than just the interests of the shareholders should be taken into account, in management's decision-making process.

There has been much debate in recent times surrounding the balancing of directors' duties to remain accountable to the interests of the company with the director's freedom to make decisions to maximise corporate profit, which sometimes involves a degree of risk. It is on this basis that the Business Judgment Rule is being introduced into the Corporations Law. The Business Judgment Rule affords directors a 'safe harbour from personal liability for breaches of the duty of care and diligence in relation to honest, informed and rational business judgments.'[36]

The Business Judgment Rule has been the subject of debate for many years. The Rule essentially provides a defence to alleged contravention of any of the duties raised under this section of the Corporations Law, and their general law equivalent for directors who:

(b) make the judgment in good faith for a proper purpose, and

(c) do not have a material personal interest in the subject matter of the judgment, and

(d) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate, and

35 Ford HAJ, Austin RP and Ramsey IM, *Ford's Principles of Corporations Law* (9th ed) (1999) 322.
36 Department of the Treasury, *Corporate Law Economic Reform Program - Commentary on Draft Provisions* (1998) AGPS, Canberra, 38.

(e) rationally believe that the judgment is in the best interests of the corporation.[37]

The US Business Judgment Rule vested management with 'exclusive authority over the conduct of a company's affairs only on the condition that the financial welfare of stockholders is single-mindedly pursued…Recent court decisions and new legislation' however, has weakened this.[38] The US Business Judgment Rule 'shields directors from liability for disinterested business decisions made with due care, in good faith, and without an abuse of discretion.'[39] To ensure appropriate use of the Business Judgment Rule, 'the Delaware Supreme Court in *Unocal Corp v. Mesa Petroleum Co* developed two prerequisites for the application of the… rule to anti-takeover measures. Firstly, the board must demonstrate good faith and make a reasonable investigation to prove that protection of the corporate enterprise and shareholders is necessary. Second, defensive measures must be reasonable in the face of the threat posed.'[40] It has been interpreted that this investigative inquiry requires the board to consider the interest of non-shareholder constituencies. This position was supported in the 1986 Delaware decision of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[41], where the Court determined that directors may consider non-shareholder, and even non-economic, interests in deciding whether to willingly surrender to a hostile takeover bid.

It is notable that the US Business Judgment Rule affords such wide discretion that most decisions allegedly protected under this rule are challenged on the basis of conflict of interest or self-dealing. When the Business Judgment Rule is 'combined with a broad view of corporate long-term profit….(it creates) a very broad range of corporate ethical activities allowable under the current law's overriding standard that corporate activity be profit maximising.' [42]

Roberta Karmel agrees that future interpretations of this statute should 'motivate directors to prevent any single constituency from usurping a corporation's capitalisation for its own use in such a manner that other valid constituencies are significantly harmed…. these institutions may act to protect interests of diverse stakeholders in the corporation.'[43]

While the Business Judgement Rule is new to Australian Corporate Law it would appear, if the US application is any indication, that the rule may be broad enough to allow the interests of non-shareholder constituents to be considered in determining what is in the best interests of the company as a whole. Future case law in the application of this rule will further guide us in this area.

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37 CLERP Bill 1998, section 180(2).

38 Donaldson T and Preston LE, 'The Stakeholder Theory of the Corporation – Concepts, Evidence, Implications' (1994) Working Paper No 37, The Centre for International Business Education and Rescources (CIBER) http:/www.mbs.umd.edu/Ciber/wp37.html, 7.

39 Karmel RS, 'Implications of the Stakeholder Model' (1993) 61 *The George Washington Law Review*, 1165.

40 Ibid.

41 506 A.2d 173 (Del1986).

42 Pritchett MJ III, 'Corporate Ethics and Corporate Governance: A Critic of the ALI Statement on Corporate Governance Section 2.01(b)' (1983) 71 *California Law Review*, 994.

43 Karmel RS 'Implications of the Stakeholder Model' (1993) 61 *The George Washington Law Review*, 1175.

A second brainchild of the Corporations Law Economic Reform Program is the introduction of a statutory derivative action which enables shareholders or directors of a company to bring an action on behalf of the company, for a wrong done to the company, where the company is unwilling or able to do so.[44] The application of the statutory derivative action is restricted to members, former members or persons entitled to be registered as a member of the company or of a related body corporate or an officer or former officer of the company.[45] The right of a person at general law to intervene in proceedings on behalf of a company is abolished.[46] Only shareholders derive the benefit of the provision, even though it may be argued that 'when directors are negligent or engage in self-dealing, there is no intuitive reason why only shareholders should be entitled to hold directors to account, because these transcretions also harm other corporate shareholders.'[47] In a similar vein to the US stakeholder statutes, it does not appear that the Corporations Law intends to impose duties on directors that stakeholders, outside of shareholders, could directly enforce.

It seems, that while amendments to the Corporations Law go so far as to introduce a Business Judgment Rule, that may be widely interpreted to allow directors to consider stakeholder interests, the amendments regarding statutory derivative actions do not enable all stakeholders to enforce the newly created duty.

## Case Law

A company is empowered to alter its constitution by special resolution pursuant to s176 of the Corporations Law. Corporations, however, are limited in the application of this provision by principles of equity. Equity will not allow the adoption of provisions into the constitution, which would never have been contemplated when the company was formed. This equitable limit is imposed to prevent abuse.[48] In *Allen v. Gold Reefs of West Africa Ltd*[49] the Court developed the test of 'bona fide in the interests of the company as a whole.'[50] This test was considered in *Peters' American Delicacy Co Ltd v Heath*[51] where the Court sanctioned amendment to the company's constitution, which altered the rights of minority shareholders.

Latham CJ considered that 'It is plainly not the law that the fact that an alteration of articles alters the rights or prejudices the rights of some shareholders is sufficient to prevent the alteration from being validly made.'[52] His Honour further considered that the power must, 'like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind

44 Department of the Treasury, *Corporate Law Economic Reform Program - Commentary on Draft Provisions* (1998) AGPS, Canberra, 38.
45 CLERP Bill, section 236(1).
46 CLERP Bill, section 236(3).
47 Karmel RS 'Implications of the Stakeholder Model' (1993) 61 *The George Washington Law Review*, 1173.
48 Ford HAJ, Austin RP and Ramsey IM, *Ford's Principles of Corporations Law* (9th ed) (1999) 489.
49 [1900] 1 Ch656.
50 Ford HAJ, Austin RP and Ramsey IM, *Ford's Principles of Corporations Law* (9th ed) (1999) 490.
51 (1939) 61 CLR 457 at 511.
52 Ibid 480.

minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded. These conditions are always implied, and are seldom, if ever, expressed.'[53] Latham CJ expanded upon the concept of the benefit of the company as a whole, by suggesting that it was the shareholders who would determine whether an alteration of the articles is for the benefit of the company, noting however that 'it is not the case that it is necessary that shareholders should always have only the benefit of the company in view.'[54]

Dixon J, in the same case, took a slightly different approach to the shareholders' position.

> The power of alteration is not fiduciary. The shareholders are not trustees for one another, and, unlike directors, they occupy no fiduciary position and are under no fiduciary duties. They vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owners personal advantage.[55]

In considering the issue of 'for the benefit of the company as a whole', his Honour stated that 'the 'company as a whole' is a corporate entity consisting of all the shareholders'[56] and concluded the basis of distributing shares in this instance was 'within the scope and purpose of the power of alteration… and in voting for the resolution shareholders were not bound to disregard their own interests.'[57] The appeal was allowed and distribution of the shares proceeded.

*Peters'* was more recently considered in the High Court decision of *Gambotto v. W.C.P. Limited.*[58] This case also raised the issue of bona fide in the interests of the company as a whole and fraud or oppression of the minority. In this case two minority shareholders applied for a declaration that the amendment of the articles was invalid. The court rejected the previously applied test of 'bona fide in the interests of the company as a whole' and applied instead a two-limb test requiring that an alteration to the articles of association must be made for a proper purpose and involves no oppression.[59] The court considered that 'it is not a sufficient justification that the expropriation, being fair, will advance the interests of the company as a legal and commercial entity for those of the majority of corporators.'[60] Their Honours acknowledged that reliance on the doctrine of bona fide for the benefit of the company of the whole is difficult as the 'power of alteration is not a fiduciary power and the right to vote is an incident of property which may be exercised for the shareholders' personal advantage.'[61]

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53 Latham CJ, 481 - quoting Lindley MR in *Allen*
54 Latham CJ, 481
55 Dixon J, 504
56 Dixon J, 512
57 Dixon J, 513
58 (1995) 182 CLR 432
59 *Gambotto*, 443
60 Per Mason CJ, Brennan, Deane and Dawson JJ, 433
61 Mason CJ, Brennan, Deane and Dawson JJ, 443 citing *Peters'* at 504

The Court explicitly rejected the 'bona fide for the benefit of the company as a whole' test considering that 'in such a case not involving an actual or effective expropriation of shares or of valuable proprietary rights attaching to shares, an alteration of the articles by special resolution regularly passed would be valid unless it is ultra vires, beyond any purpose contemplated by the articles or oppressive as that expression is understood in the law relating to corporations.'[62] Their Honours did not consider that the ability for a majority shareholder to acquire compulsory the property of the minority was contemplated within the objects of the power in the instance of *Gambotto*. 'To allow expropriation where it would advance the interests of the company as a legal and commercial entity to those of the general body of corporators would, in our view, be tantamount to permitting expropriation by the majority for the purpose of some personal gain and thus be made for an improper use.'[63]

McHugh J, in a separate judgment, considered that 'a company may alter its articles of association for the purpose of enabling a shareholder to acquire the shares of existing shareholders only when the acquisition is necessary to protect or promote the interests of the company and when the alteration will not be oppressive to those shareholders.'[64] He further considered that the presence of sections 701-703 of the Corporations Law denies the application of section 176 to enable a shareholder to acquire the shares of another. 'The section should be construed, therefore, as authorising the expropriation of shares only when it is necessary to do so in the interests of the company.'[65] The resolution proposing to adopt the new article was held to be invalid and the appeal was allowed.

Strict application of the concept of 'the benefit of the company as a whole' does not seem to find favour with the Courts at present. This is notwithstanding its application in the early case of *Allen*, its partial application in *Peters'* and acknowledgment of its relevance as a partial test in *Gambotto*. The stakeholder theory requires the courts to consider the interests of the company as a whole without delegating this decision to the determination of shareholders. Arguably, shareholders are concerned only with their share-value, notwithstanding that the stakeholder concept has been endorsed by economists as being more beneficial to the company as a whole in the long-term. *Peters'* and *Gambotto* place great emphasis on the proprietary rights of shareholders to the extent that a proposal to the benefit of the whole company, but labelled unfair, would be defeated.

If the stakeholder concept is to be endorsed by the Courts, the shareholders must be given less power to wield the reins and the company's benefit as a whole must receive greater consideration. It may be time for the Courts to revisit the principles espoused in *Allen*.

62 Mason CJ, Brennan, Deane and Dawson JJ, 444
63 Mason CJ, Brennan, Deane and Dawson JJ, 446
64 Mason CJ, Brennan, Deane and Dawson JJ, 453
65 Mason CJ, Brennan, Deane and Dawson JJ, 454

## Possible Defects in the Stakeholder Theory

Not every economic and corporate governance writer is an advocate of the stakeholder theory. In fact a number of potential defects with the theory have been highlighted in writings, a summary of which follow. Counter-argument has been included, where appropriate:

1. It may result in abuse of the directors' discretion. If there are no limits placed on the stakeholder group, self-serving managers may always claim that they are acting in the interests of one or another stakeholder when they are not, but are in fact, acting to further their own interests and increase their own powers.

*Response* - Managers under the current system of corporate governance already have great possibilities to indulge in self-serving behaviour. The basic concept of this theory, that the interests of all stakeholders and not one in particular have to be taken into account, actually restrains management from indulging in further self-serving behaviour as they are accountable to more parties.

2. Whilst putting shareholders first conceivably does do harm to other stakeholders, making managers accountable to a group of stakeholders which is undefined will in effect make them accountable to none as there is no yard stick by which to measure their performance.

3. Putting shareholders second will decrease the value of shares and may deter investors from making further investment in these shares.

*Response* - This reasoning adopts the rather simplistic and short-term view that companies that are answerable only to the shareholders will encourage investors to buy further shares. This in turn will create more jobs, better products for customers and more scope for suppliers, which results in a better economy. I refer back to the economic argument that considers that the long-term profitability of companies rests in taking into account the wealth of all who are dependent on it, not simply the shareholders.

4. Potential defects in the stakeholder theory are expressed in Pritchett's critique of the American Law Institutes' (ALI) *Principles of Corporate Governance*.[66] Section 2.01(b) of the ALI Principles attempts to balance the corporations duty to its shareholders with its corporate social responsibility. Section 2.01(b) provides that 'although the object of the Business Corporation is to maximise long term profits, the corporation may make decisions based on ethical considerations regardless of their effect on long run profits.'[67] Pritchard argues that adoption of Section 2.01(b) of the statement will bring about a change for the worse, as:

66 Pritchett MJ III, 'Corporate Ethics and Corporate Governance: A Critique of the ALI Statement on Corporate Governance Section 2.01(b)' (1983) 71 *California Law Review* 1001.

67 Section 2.01 The Objective and Conduct of the Business Corporation, Principles of Corporate Governance and Structure Restatement and Recommendations, section 2.01(b).

(b) the exercise of Section 2.01(b) may result in an abuse of discretion in the case of corporate dissolution. Liquidating corporations are rife with conflict, which opens the ground for abuse of this discretion.

(c) there is wastage of judicial resources in defending a claim of corporate abuse.

(d) it motivates incorrect ethical behaviour by overriding the duty of profit maximisation contained in the current law.

(e) it may result in a less effective allocation of ethical dollars because it may encourage a shift of spending from local matters to national or global concerns.

(f) it tempts officials to make judgements based on ethical not wealth maximisation considerations where they might, if given further consideration, have arrived at a solution that was both ethical and wealth maximising.[68]

It is also suggested that the wide discretion afforded by Section 2.01(b) should be reigned in to equate with the long-run profit maximisation standard which 'provides corporations with sufficient freedom to comport their behaviour with 'ethical principles.'[69]

5. 'The notion that a company serves stakeholders rather than shareholders is an excuse for flaccid management and poor results. The only stakeholder that paid anything for its stake is the shareholder. Therefore this is the only constituency that companies should be concerned about.'[70]

*Response* - This is contrary to evidence that companies operating on the stakeholder model have managed to balance interests of stakeholders and shareholders, and have actually created greater wealth for the shareholders over the longer-term.

Many of the defects identified above result from the reversal of meaning as to what constitutes a stakeholder from those who affect the organisation, to those who are affected by it.[71] Originally corporations employed the theory to achieve good results. It appears, however, that its support base now stems from those who are hostile to achieving the desired results. It is this misapplication that arguably creates one of the major defects of the theory. Sternberg argues that balancing stakeholder benefits is an unworkable objective, as the number of people whose benefits need to be taken into account is infinite. For a balance to

68 Pritchett MJ III, 'Corporate Ethics and Corporate Governance: A Critique of the ALI Statement on Corporate Governance Section 2.01(b)' (1983) 71 *California Law Review* 1001-1008.

69 Pritchett MJ III, 'Corporate Ethics and Corporate Governance: A Critique of the ALI Statement on Corporate Governance Section 2.01(b)' (1983) 71 *California Law Review*,1010-1011.

70 PR Central 'Dunlap's *Mean Business* Assails Stakeholder Concept', 2.

71 Sternberg E, *The Defects of Stakeholder Theory* (January 1997) 5 *Scholarly Research and Theory Papers, Corporate Governance* 3

be struck the numbers must somehow be limited and where members belong to one or more stakeholder groups, 'there is no indication in which capacity or capacities they are to be included in the calculation.'[72]

6. Whilst members may withdraw their co-operation by not supplying any further workforce, supplies or purchasing products of the company, they do not have recourse to the company to hold it accountable for its actions. They also have no recourse to legal remedies if their interests are not considered.

Response – Whilst this argument is in part countered by Blairs economic view which considers that shareholders are not essentially owners but are retained profit claimants, any argument to this effect is constrained by the application of corporate laws and director's duties.

7. Whilst other writers consider that evolution will preserve those firms in which managers, owners and workers co-operate to create consumer value, DeBow and Lee suggest[73] that this evolutionary process is already protected under the corporate law and the introduction of what they consider to be a communitarian corporate law (based on the stakeholder theory) has the potential to impede production through interruption by political, non-shareholder constituencies and will result in long term cost to all consumers. The essence of corporate law is such that hard decisions are required to be made and some of these do displease stakeholders such as employees, suppliers, customers, and local residents. The potential for these stakeholder groups to be in conflict with each other raises the question once again as to how we evaluate the stakeholders interest and how we limit the stakeholder class.[74]

8. The stakeholder theory allegedly 'undermines two of the most fundamental features of modern society…..property (rights) and the duty that agents owe to principals…by (denying) owners the right to determine how their property will be used…..The fact that shareholders are sometimes unwilling or unable actively to protect their interests does not entitle other stakeholders to commandeer corporate property.'[75]

It is unknown whether the popularity for the stakeholder theory may derive from advocates who see themselves as having something to gain from the company without having to risk loss. Opponents of the theory would suggest that these supporters must appreciate that no wealth would be available for distribution to stakeholders if the company is not meeting its long-term objective of maximising corporate profit. If the economist's argument is accepted, however, employees share in this risk.

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72 Ibid at 4.
73 DeBow ME and Lee DR, 'Shareholders, Non-Shareholders and Corporate Law: Communitarianism and Resource Allocation' (1993) 18 *Delaware Journal of Corporate Law* 393 and 418.
74 Ibid at 418-419.
75 Sternberg E, 'The Defects of Stakeholder Theory', (January 1997) 5 *Scholarly Research and Theory Papers, Corporate Governance* 8.

Notwithstanding the faults highlighted, Sternberg does concede that the stakeholder theory can be valuable as '…businesses can't afford to ignore any stakeholder concern that might effect its ability to generate long-term owner value.'[76] The stakeholder concept serves to highlight the meaning of social responsibility for, while the stakeholders have no power to alter business objectives, they can decide whether or not to support the business with their labour, supplies and utilisation of the goods provided by the company.

## Current Uses

### US Anti-takeover Statutes

Over the last 12 years more than half the states which comprise the United States of America have passed stakeholder or non-shareholder constituency statutes. These statutes propose a differing model of corporate governance to that traditionally utilised by American corporations, pursuant to which directors act for the interests of the shareholder in maximising shareholder profits. These stakeholder statutes, or non-shareholder constituency statutes, have met with some disapproval by the legal establishment and in many cases have been relegated to use as a mere anti-takeover device. The statutes have primarily been used in the US to defend hostile takeovers, which were seen as contrary to public welfare.

One potential arguments in favour of the statutes suggests 'The threat of takeover can act as an important deterrent on the formation of long-term stakeholder relationships, or on (research) and (development) spending, which many argue are vital to firm competitiveness. Hence takeovers which are privately beneficial to the shareholders involved may actually impose a cost on the rest of society. Conversely, if the boundaries of the firm could be redefined to incorporate key stakeholder interests, then those takeovers which did occur would tend to be value creating: there would be greater congruence between the interests of the firm and society.'[77]

The statutes support a general theme allowing directors to consider the interests of other corporate constituencies, outside of the shareholder, in ascertaining what is best for the company. Interestingly, the stakeholder statutes are alike in other ways – they are principally anti-takeover mechanisms, they are non-mandatory in nature and there is no provision for remedial action to be taken by non-shareholders against a corporation for breach of this duty.[78] Although stakeholders are to be given consideration, the lack of enforcement provisions undermines the statute. It appears that public support for the stakeholder statute is based on public assumptions as to the outcomes from a hostile takeover bid. Namely, that a successful bid would result in downsizing of the companies

76 Ibid at 9.

77 Gamble A and Kelly G, 'Stakeholder Capitalism: Limits and Opportunities' http:\\www.dar.cam.ac.uk\nexus\gamkel.html, 3.

78 DeBow ME and Lee DR, 'Shareholders, Non-Shareholders and Corporate Law: Communitarianism and Resource Allocation' (1993) 18 *Delaware Journal of Corporate Law* 402.

affected by the restructure and that non-shareholders need protection from the disruptive impact from the restructuring that is likely to take effect.[79]

Whether or not these assumptions are correct, there is currently only one state in which the application of the stakeholder statute is mandatory and where stakeholder interests must be considered. The non-mandatory nature of the anti-takeover statutes may stem from the fact that the most ardent supporters of the legislation are top managers, the ones most likely to lose their job in a corporate restructure, not business and community leaders that fear that change will result in loss to the economy. [80]

This non-mandatory nature is clearly evidenced In the case of *Paramount Communications, Inc. v. Time Inc*.[81] in which Time restructured a merger with Warner Bros solely to avoid a Time shareholder vote which would defeat the proposed merger in favour of a bid by Paramount for Time for a higher premium. The Delaware Court upheld Time management's restructure.[82]

The effectiveness of the stakeholder statutes has been questioned as a result of economic studies and 'signals that the statutes do not affect the law of takeovers. Namely, the market does not expect managements' reaction to bids, or courts evaluation of management's defensive behaviour, to change under such statutes. If Boards already factor in stakeholders' interests when engaging defensive tactics with judicial approval, then enactment of other-constituency statutes will have no impact on investor wealth. This explanation is plausible, because most statutes have been added to Codes already replete with anti-takeover provisions, and the statutes do not provide stakeholders with the right to take legal action against the Board to ensure that their interests are properly considered.'[83]

In Australia, a 1986 discussion paper, issued by the then NCSC (National Companies and Securities Commission), developed a defensive scheme comprising defensive strategies and tactics which could be invoked in response to a takeover bid, whether actual or apprehended. One of the defensive tactics available to a Board of directors in the face of a takeover, is an appeal to suppliers or employees. Notwithstanding the absence of anti-takeover statutes and minimal support for the stakeholder concept, this tactical ground for defending a takeover bid is available in Australia. However, this defence has not proved as popular as the institution of legal action to challenge Part A statement and offers, generally on disclosure grounds.[84]

Whilst the effective application of the stakeholder concept as a takeover defence is not infallible, it may be time for the states to consider broader application of the stakeholder concept as a corporate governance model.

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79 DeBow ME and Lee DR, 'Shareholders, Non-Shareholders and Corporate Law: Communitarianism and Resource Allocation' (1993) 18 *Delaware Journal of Corporate Law*, 399.
80 Romano R, *The Genius of American Corporate Law*, The AEI Press (1993) 57.
81 571A.2d 1140 (Del. 1990).
82 Romano R, *The Genius of American Corporate Law*, The AEI Press (1993) 73.
83 Ibid at 74.
84 Ford HAJ, Austin RP and Ramsey IM, *Ford's Principles of Corporations Law* (9th ed) (1999) 994.

**Two-Tier Board Structure – Corporate Governance in Germany and Japan**

The stakeholder model of corporate governance has provided in Germany, Japan and many European countries. Stakeholder capitalism is evidenced by the state of play in Germany and Japan where 'banks own large chunks of shares in firms, as well as lending money to them and industrial firms own shares in each other. In theory these powerful, informed, long-term shareholders could hold bosses accountable, although they forgo liquidity to do so. In practice, they have certainly fostered stability.'[85]

The so-called 'co-determination' laws of Germany require employee representation on second tier Boards of directors. The Companies Act of Great Britain 'mandates that company directors shall include the interests of employees in their decision making and, the new harmonisation laws of the European Community (EC) will, when approved, include provisions permitting corporations to take into account the interests of creditors, customers, potential investors and employees.'[86] Consequently, the trend towards adaptation of the stakeholder theory is not solely confined to the US in its anti-takeover legislation. I shall concentrate in this regard on the current corporate governance systems of Germany and Japan.

***Germany***

It is assumed that the co-operation approach adopted by German companies will benefit the community as a whole and, in some cases, this requires placing economic benefits second behind social duties. German management, boards, supervisors and banks alike tend to think in the long-term, which is consistent with a consideration of social duty and the co-operation theory. In summary, 'the objectives of Germany companies however do not stop at maximisation of the return on investment. Their philosophy is based on 'the concept of the interest of the company as a whole', a key concept of German corporation culture.'[87]

German management gives priority to management and employees' concerns and acknowledges that the shareholder forms only one interest amongst the stakeholder group. This is reflected in the two-tier structure of the German Board. All large companies in Germany have the Vorstand (Management Board) and the Aufsichtsrat (Supervisory Tier). The Vorstand performs all the functions of direction and management whilst the supervision function is performed by the Aufsichtsrat. The composition of the Aufsichtsrat involves shareholders and employee representatives who 'share management's concern about the prosperity of the enterprise and would much rather proceed by co-operation than confrontation.'[88] The Aufsichtsrat has power of appointment to the Vorstand and successful appointment requires a two-thirds vote.

85 Matthew Bishop 'Corporate Governance - Watching the Boss' (29 January 1994) The Economist, 3.
86 Donaldson T and Preston LE 'The Stakeholder Theory of the Corporation – Concepts, Evidence, Implications' (1994) *Working Paper No 37, The Centre for International Business Education and Rescources* (CIBER) http:/www.mbs.umd.edu/Ciber/wp37.html , 7.
87 Charkham J, *Keeping Good Company*, Clarendon Press, Oxford (1994)10.
88 Ibid at 14.

Appointment to the Vorstand is fairly secure as members are appointed for five years, subject to acts of gross misconduct or negligence. The Aufsichtsrat has legal duties and must comply with the law and historically has taken a keen interest in the happenings of the company with a view to ensuring their legal obligations are met and their employee's position is preserved through prosperity and longevity of the company.

The importance of employee representatives and the power they hold on the Aufsichtsrat should not be understated. Through the 'Works Council' the Aufsichtsrat is fed a wealth of information, as a result of which they are able to become informed participants in company discussions. The Works Council comprises members elected from the workforce and its size is reflective of the size of the company to which it is attached. The Works Council is constituted under the Works Constitution Act 1972 which 'lays down the rights of the body representing workers' interests at plant level in private companies…. The act covers virtually all German businesses except the miniscule.'[89]

Any matters relating to the conditions of employment of employees of the company including hours, overtime, remuneration is the business of the Works Council. 'The idea behind the Works Council is co-determination, that is the right to participate in decisions… they are an embodiment of the attitude of co-operation rather than confrontation. Employers believe that informed and trusted employees are more likely to have the welfare of the business at heart, to be sympathetic to its aims and understanding of its problems – and it would seem they are.'[90] Even though this co-determination or co-operation in making decisions comes at a price to the company, usually as some sort of compromise, the German corporations have found it to be an effective tool in addressing corporate governance matters. Employee issues that are within the union's domain are left to the unions. The roles of the Works Council and employee unions are distinctly separate. The ideology of the Works Council is the belief that employees are interested in the long-term view of business and are, to a large extent, unconcerned by dividends to shareholders.

It is interesting to note that the Germans approach accounting prudently, again with the concept of sustainability overriding shareholder profits. Rather than declare huge profits to shareholders, the Germans prefer to hold reserves to ensure that any future risks or problems with the companies can be addressed by calling on these reserves. This approach is at the cost of lower profits in the short term but naturally meets with employee approval both from the Aufsichtsrat and Works Council level. The employees realise that the sustainability of the company implies long-term continuity of employment for them.

One further positive feature of the German company is that management boards do not have to concern themselves with hostile takeovers, as there are virtually no hostile bids within the open market. This combined with minimal

89 Ibid at 2.
90 Ibid at 13.

government interference means German management can continue to govern their company as they best see fit.

Another integral part of corporate governance in Germany is the involvement of banks in the running of corporations. A good flow of information from the company to the bank ensures that the bank and company will operate together in a long-term relationship. In addition the bank offers a counseling and management consultancy and, in some cases, is a substantial shareholder of the company with which they are involved.

As with any method of management there are critics of the German system of corporate governance who consider that the German system results in:

1. 'trade-offs and compromises between management and employees which may disadvantage shareholders; and

2. the whole process of decision making slow(ing) down.'[91]

3. the need for two tiers to continue operating effectively. If the Vorstand or Aufsichtsrat is weak, this can effect the second tier and may call for remedial action, which is not welcomed, in this non-confrontational system.

Despite the potential negatives, there is no change proposed to the two-tier structure and the concept of co-determination. The stock market is neither a key indicator of, nor key influence in, the success of German companies.

The German system of corporate governance can be neatly summarised: 'the German view of the purpose of companies gives shareholders an interest and a role, but not such a pronounced one as in the UK and USA. They are important, but further down the pecking order.'[92]

Institutional investors in particular play a lesser role in the German system to that of other countries. 'The expectations of institutional investors in Britain, regarding short term earnings, forced dividend policies on companies which are incompatible with the latter's long term health, a point clearly demonstrated by companies paying dividends even out of reserves in the present and previous recession. By comparison, institutional investors are, in Germany, insignificant, equity investment plays not nearly as great a role generally, and therefore in the presence of equivalent shareholder pressure I could not conceive of a German company committing the folly of involuntarily depleting its reserves to pay dividends.'[93]

91 Ibid at 46.
92 Ibid at 51.
93 Charkham J, *Keeping Good Company*, Clarendon Press, Oxford (1994) 56, quoting Herr Gottfried Bruder, previously London General Manager of the Commerzbank.

***Japan***

'The well known corporate governance model in Japan – through both law and custom – presumes a Japanese corporation exists within a tightly connected, inter-related set of stakeholders, including suppliers, customers, lending institutions and friendly corporations.'[94]

Japan also practices the co-determination, non-confrontationalist form of corporate governance seen in Germany. Although this co-determination process often involves lengthy and at times cumbersome decision-making, the Japanese ensure that proposals are moved both horizontally and vertically through the company before a decision is reached, to ensure that all are satisfied with the result.

Like the German system, there is a major stakeholder interest other than shareholders considered in Japanese decision making. In Japan, however, it is more the input of the bank that is held in high regard. Majority stakes in many Japanese companies are held by 'the company's own banker and by other companies which there is close business ties and relationships.'[95] These cross-shareholdings are known as 'keiretsu' and inside each keiretsu each firm is his 'brothers keeper'. As a result the Japanese company forms a 'family' which concentrates its focus on continuing business and co-operation rather than dividends and gains. 'The Japanese believe that all tasks must be carried out by groups, and that success lies in the success of the group in achieving the task set for it … It has given the Japanese company great flexibility and mobility, which have in turn helped it to meet crises, external business challenge. Coupled with the 'ringi' system, in which all who are able to contribute to a business decision are closely involved at all levels and stages, this has given the Japanese company commitment to decision finally made, and thus a concerted drive, which other competing countries have not been able to match.'[96]

It is this collective sense of responsibility that many believe has supported the development and success of Japanese companies through the years and it is the collective interests, including trade groups, industry federations and professional associations, that will perceivably always remain stronger than the self-interest of management.[97]

I briefly addressed earlier the concept of the 'keiretsu' under which there are both horizontal and vertical keiretsu groups. Vertical keiretsu produce a particular range of products in contrast to horizontal keiretsu which do not necessarily work in concert to provide a common product but prefer products produced elsewhere in the keiretsu. The keiretsu group also offers an insurance aspect whereby the companies do not interfere with each others corporate

94 Donaldson T and Preston LE, 'The Stakeholder Theory of the Corporation – Concepts, Evidence, Implications' (1994) *Working Paper No 37, The Centre for International Business Education and Rescources (CIBER)* http:/www.mbs.umd.edu/Ciber/wp37.html, 7.
95 Mills G, *Controlling Companies*, Unwin Hyman, London (1988) 86.
96 Ibid at 89.
97 Ibid.

governance while things are going good, but are there to limit damage and remedy defects in companies that are in trouble. Trading on the share market of shares is relatively infrequent which asserts that 'long-term shareholders have a real proprietal interest in the businesses in which they hold investments… If, however, there is clear evidence of a problem which management appears unable or unwilling to address, the 'stable' shareholders may be so positioned as to pay their part in remedial action.'[98] The keiretsu Council has a number of members each of who has accountability to its individual constituency and they are strongly bonded to this constituency. This creates a division of powers and checks and balances, which makes for better-informed and independent management.[99]

The Japanese appreciate that whilst profit constitutes neither the sole nor main objective of the corporation, without it there is a possibility that a company may be dissolved. Notwithstanding, the stock market does not play a major part in allocation of the profits but rather it is the banks who are often major shareholders in the companies and who have financed the rebuilding of Japanese corporations. These banks prefer to maximise safety and growth over maximisation of profits. The relationship with banks is such that the bank has a deep interest in the continuing prosperity of the company as a result of not only its enduring relationship with the company but the ability for it to lose money and face if the company goes bad. 'Hostile' takeovers are impermissible on social grounds.[100]

The Japanese business culture considers that 'any company anywhere touches society at many points because it has customers, employees, suppliers, creditors, and shareholders…..All have some interest in the company, though not to the same degree.'[101] The Japanese consider the interests of employees are as important to them as the interests of shareholders. The importance of employees to Japanese corporations cannot be understated as one of the most significant features of a big company is the 'capacity and resources to offer recruits a life time career with all the diversity and security that implies.'[102] It is argued that 'an employee who devotes his life to a business has morally a bigger stake in it than a shareholder… Even so they cannot totally neglect their owners.'[103]

In essence, while shareholders' interests can be relegated, they cannot be ignored. It is conceded that outside the company, Japanese shareholders as well as other external parties such as banks and interested stakeholders share the view that the shareholders' interest is not such that is necessitates receipt of a continuous stream of dividends. Culturally, the Japanese loyalty and duty to their nation will always champion over duty to their shareholders.

98 Charkham J, *Keeping Good Company*, Clarendon Press, Oxford (1994) 107.
99 Shann Turnbull 'Stakeholder Governance: A Cybernetic and Property Rights Analysis' (January 1997) 5 *Scholarly Research and Theory Papers - Corporate Governance*, 17.
100 Charkham J, *Keeping Good Company*, Clarendon Press, Oxford (1994) 116.
101 Ibid at 115.
102 Ibid at 75.
103 Ibid at 116.

## Introduction of the Stakeholder Theory into Australian Corporate Governance – Suggestions

How we can successfully introduce the stakeholder theory into Australia is a topical question for certain Australian writers who consider that once the economic benefits of stakeholder capitalism are realised 'the new reason for being in business will tend towards serving the customer and unfolding a larger, long-term corporate strategic vision which embraces all stakeholders.'[104]

Following is a number of suggested vehicles by which the stakeholder concept could be introduced into the sphere of Australian corporate governance:

**Institutional investors**

Institutional ownership is growing rapidly to the point where institutional investors, such as insurance companies, own a large percentage of shares in listed companies. The weight attaching to the size of this shareholding can be used by institutional investors to force changes in corporate governance on the management of the company. Until recently, many corporations consisted of small individual shareholders that really carried no weight to effectively alter the course of management. 'Institutions with only a small percentage of corporations' capitalisation can exert the same leverage as a controlling shareholder, especially if several like-minded institutions act in concert or even in tandem.'[105] Notwithstanding this leveraging power institutional investors have historically been known to be passive participants restricted by regulation.

Institutional activism is on the increase with the proliferation of issues of economic impact that institutional investors are able to vote on. Historically institutional investors have been quick to buy and sell when disgruntled by management's performance, 'rather than undertake the time consuming, expensive, collective action to replace or influence management through the proxy process.'[106] This has resulted in increased market volatility. Institutional investors now prefer to consider a long-term view of their shareholder responsibilities, and appear to have no qualms in confronting corporate management. Institutional activism is resurrecting the voice of the shareholder in serving to make corporate management more accountable.

It is therefore arguable that institutional investors could take an active turn and effectively control corporate governance of the companies in which they are shareholders. In the same vein, they are also in a position to further the part played by stakeholders in the company's decisions.

While there is some suspicion on the part of corporations and the public with regard to institutional investors and the part they play in takeovers, market

104 Kaleski M, 'The New Capitalism Cometh' (June 1996) *Company Director – Directors' Forum* 22-23.
105 Karmel RS 'Implications of the Stakeholder Model' (1993) 61 *The George Washington Law Review* (1993) 1159.
106 Heard JE 'Institutional Investors and Corporate Governance: The US Perspective', printed in *International Corporate Governance* (Lufkin JCF and Gallagher D eds) Euromoney Books (1990) 251.

volatility and potential political power of institutional investors, others see them as championing the course of labour and the public interest. One such supporter advocates that 'if institutional investors took a closer interest in the firms in which they invest, they would represent the stakeholder interest of their policy holders, and result would be better management, and firms which are more strongly committed to long term investment.'[107]

**Increase of Directors' Discretion**

The CLERP Bill 1998 proposes amendments to the Corporations Law to introduce a Business Judgment Rule and statutory derivative actions. The Business Judgment Rule gives greater discretion to directors in making decisions in the best interests of the company, by providing them with a defence against any argument that an act was ultra vies.

Further, the expansion of the duty to act honestly enables directors to do acts in the interest of the company as a whole, which as discussed previously is yet to be proven in the courts.

**Revisiting Case Law**

The legislative lean towards increased director discretion may encourage the Courts to revisit the principle of acting 'for the benefit of the Company as a whole', originally espoused in *Allen*[108], but since altered in application by *Peters'* [109]and *Gambotto*.[110]

**Further Developing Corporate Governance Codes and Practices**

There have been a number of suggestions made by advocate writers in the stakeholder field as to how the stakeholder concept of corporate governance could be introduced. Mahoney suggests:[111]

- 'Install demanding performance based stock options.
- Options would vest only when the corporation meets tough targets relevant to its own circumstances.
- Broaden stock option participation to increase employee 'ownership' of corporate objectives and the opportunity for sharing corporate gains. Several companies have extended modest numbers of option to all employees, with positive effects. It should be noted that shareholders are willing to share more than a limited portion of the returns that they are receiving, with the employees who help create them, …. risk the creation of

107 Gamble A, Kelly G, 'Stakeholder Capitalism: Limits and Opportunities', http://www.dar.cam.ac.uk/nexus/gamkel.html, 6.
108 *Allen v. Gold Reefs of West Africa Ltd.* [1900] 1 Ch. 656 .
109 *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457.
110 *Gambotto v WCP Ltd* (1995) 182 CLR 432.
111 Mahoney RJ, 'Business Should Act for All Its Stakeholders – Before 'The Feds' Do', http://csab.wustl.edu/papers/ manage/ceo9/coe9.htm, 4.

conflict between employees and investors that will hurt investors' return in the long run.

- Increase opportunities for decentralised entrepreneurialism by carving out real financial rewards for outstanding group performances by lower level employees.

- Develop much greater attention to lower and middle level management issues eg 'life time training' programs to make the employees more valuable within the company.

- Develop diversity programs that work moving people into top management.

- Increased corporate involvement in 'public education'.

- At the Board of Directors level, 'bringing increased attention to societal needs'… ie regularly assessing the impact of the corporation on all its stakeholders and …. urge balance.

- Consider board establishment of a 'non-executive Chairman'…. silencing critics of alleged passive Boards.

- Move to truly independent Directors on compensation and related committees.'

It is also considered that in the public policy and communication areas advantages may be obtained by

- 'increasing political activity at all employee levels…. in the early formative stages of issues.

- Publicising the long-term actions that the firm is taking.

- Developing and publicising data on the hundreds and thousands of jobs created by outsourcing staff services and other functions. Outsourcing does not necessarily mean job killing.

- Remind the public and government that corporations are not impersonal and monolithic entities.'[112]

UK authors consider that the concept of stakeholder capitalism can be adopted if we enable 'a strong stakeholder ethos to be incorporated into the formation and delivery of policy at different levels – global, national, regional and local; and….a willingness to learn from past experience within the UK and to use this experience as a basis for new forms of governance and institutions.'[113]

112 Ibid at 4-6.
113 Gamble A, Kelly G, 'Stakeholder Capitalism: Limits and Opportunities', http://www.dar.cam.ac.uk/nexus/gamkel.html, 5.

Corporations should be considering introducing a number of these suggestions into their own constitutions to increase the directors' discretion when determining what constitutes 'in the interests of the company as a whole.'

## Conclusion

The reasoning behind Australia's cautious approach to the Stakeholder Theory of corporate governance may be as simple as 'If it ain't broke, don't fix it?' Gamble and Kelly surmise that in order for any change to succeed new forms of corporate governance need to show that they are superior to the old. 'At the moment we do not have the knowledge to say that they are, although there are some convincing pointers. Reconciling high economic performance with stakeholder participation in decision making in firms can help…A clear grasp of the limits but also the opportunities of the concept of stakeholder capitalism and the stakeholder firm provides an important set of guidelines for the program and suggestions for policy.'[114] The key is to 'ensure that there is proper balance between the key stakeholders such as shareholders, consumers and suppliers, and to ensure that the regulatory procedure is transparent.'[115]

The results of my discussion suggest consideration of a combined application of the stakeholder and shareholder concepts. In essence, although the corporation can be seen to owe a duty to non-shareholding constituencies, this duty is non-enforceable and constrained in its application, whereas the duty to shareholders is open-ended. Notwithstanding, the duty to maximise shareholder profit will always be exercised within the constraints of the non-shareholder constituency interests and neglect of those interests is likely to affect the long term viability of the corporation. Consideration of the stakeholder interests should, therefore, be part of any comprehensive reform of Australian corporate governance.[116]

114 Ibid at 7.
115 Ibid at 6.
116 Turnbull S, 'Stakeholder Governance: A Cybernetic and Property Rights Analysis' (1997) 5 *Corporate Governance – Scholarly Research and Theory Papers* 18.