LECTURE 2 WEEK 2: ECONOMICS AND CORPORATE GOVERNANCE

MODERN ECONOMIC THEORIES

- ✫ Economic considerations are fundamental to companies and it is thus logical that economics, and particularly the **analytical tools of economics** should offer important **insights into the nature of the company** and the **role and function of company law**.
- ✫ 3 **economics-based theories of the corporation** have been particularly influential:
  - a) Managerialism (peaked in 1950's);
  - b) Agency theory of the firm; and
  - c) Contractarianism.

Managerialism

- ♥ Berle and Means in 1920s-1930s
- ♥ At the core of this theory was the observation that in **large public companies** there was a **separation of the ownership** (because they were the one ultimately benefitted) **of the investment by shareholders** from the **control of that investment by management (directors).**
- ♥ This separation existed because of the large size of the company's capital, and the proportionally **smaller stakes held in that capital by individual shareholders**.
  - ⇒ No individual shareholder had either the power or the incentive to exercise control of the company.
    - ▪ Shareholders also don't have the skills and expertise that experts (senior executive & directors) have
  - ⇒ **Control of the company and its wealth and power thus rested with management** (executive & directors).
- ♥ Therefore, **rational passivity of shareholders effectively freed corporate management from direct oversight and accountability to shareholders**.
  - ⇒ Corporate management was thus enabled to pursue objectives **other than the maximisation of the wealth of shareholders → self-serving objectives**

Berle and Mean's **solution** to that problem – '**Manageralism'**

- ♥ The way to control management's tendency to act in their self-interests was twofold:
  - i. Impose rules/duties on senior managers as to how they exercise their power
  - **ii. Change in perspective**
    - ▪ Management are and should be free to use their expertise not just for the shareholders' benefit but **also for the benefit of society as a whole**
    - ▪ But would they really? A utopian fantasy? But this is during the Great Depression, so it fits well with the context of the time

- ♥ Berle and Means nevertheless argued that **freedom from shareholder oversight might also allow managers to pursue the interests of society as a whole**.
- ♥ The future for corporate management for Berle and Means was thus one of evolution into a '*purely neutral technocracy, balancing a variety of claims by various groups in the community, and assigning*

1. The Function of Directors Duties

- designed to **reduce the agency costs** inherent in the separation of ownership and control
- Designed to **constrain the discretion vested in the directors** as to how the company should be operated
- **Balancing exercise**: need to allow the directors room to **take risks** to hazard the company's assets to generate a return free from the threst of liability, but also need them to **control** how the directors exercise their discretion
- In practice, in large public companies, **market forces** are the main constraint on directors, with duties operating as a 'backstop against egregious wrongdoing'.

Who is it that the modern duty of care owed by company directors, as reflected in **s 180(1)** of the ***Corporations Act* 2001 (Cth)**, **seeks to protect**? And **what is it that they are being protected from**?

1. Who is the law seeking to protect?
   → Shareholders
   → Creditors
2. Why do they need protection?
   → Because the moral hazard that comes with limited liability exposes creditors to uncompensated losses
3. From whom are they being protected?
   → Shareholders, or the directors acting on behest/request of the shareholders
   → Directors control the assets – shareholders can influence the actions of directors because they can vote them on and off the board
   → We have a company, where the company is in financial difficulty; the shareholders find out about this, they transfer assets out of the company to protect themselves
   → The Modern DOC has developed alongside the law of insolvency

<u>**Duty of Care**</u>

- Historically, the standards required of directors was **low** and the test was **largely subjective** - ***Re City Equitable Fire Insurance Company Ltd* (1925) Ch 407** per Romer J:
- Historically, according to Romer J, the skill standard at which the duty should be assessed is that possessed by a reasonable person with the knowledge and experience of the defendant. As to diligence, Romer J highlighted that the duties are of an intermittent nature and directors are 'not bound to give continuous attention to the affairs of the company'. Further, the duties may be delegated to some other official if there is absence of grounds for suspicion that the official would not perform such duties honestly.
- Why was it so low?
  (3) Court needed to balance accountability and risk – giving directors as much freedom to take risks, otherwise people will be put off from being directors
  (4) It was up to shareholders to select who would manage their business
  (5) The role actually performed by directors and companies is dependent upon the nature of the company, the size of the business, and many other factors, meaning it was impossible to develop a concept of 'the reasonable director' against which the person's conduct could be assessed

(6) Courts have always been reluctant to second guess business decisions because the courts lack such competence – would be courts involving in the merits

- **Need for raising standards**: creditors were being prejudiced by incompetent directors and also because shareholders were protected by limited liability
  - → The standards from the law of insolvent trading (has a minimum duty to understand the company's affairs, the accounts, monitor the executives) were read across to the law of directors' duty of care, skill, and diligence

- There is now a **minimum standard for all directors** stipulated in ***Daniels v Anderson* (1995) 13 ACLC 614** – is there a breach of?
  - obtain a **basic understanding** of their company's business and be **familiar** with the fundamentals of the company's business
  - **keep informed** of the activities of the company – a **continuing obligation**
  - **monitor** the company's activities (although detailed inspection of day-to-day activities not required) and **regularly attend board meetings**
  - **maintain familiarity** with the company's financial status by a **regular review** of financial statements, i.e., **monitor** the company's **financial position**

- Another response to the **NSWCA** decision in ***Daniels v Anderson:***
  "The fundamental purpose of the **BJR** is to **protect the authority of directors in the exercise of their duties**, not to insulate directors from liability. While it is accepted that **directors should be subject to a high level of accountability**, a **failure to expressly acknowledge that directors should not be liable for decisions made in good faith and with due care** may lead to failure by the company and its directors to take advantage of **opportunities that involve responsible risk-taking**." - *Explanatory Memorandum*

SECTION 180

Care and diligence – Civil obligation only

(2) [Business judgment rule] A director or other officer of a corporation who **makes a business judgment** is taken to **meet the requirements of subsection (1)**, and their equivalent duties at common law and in equity, in respect of the judgement if they:

(a) make the judgment in **good faith for a proper purpose**; and

(b) **do not have a material personal interest** in the subject matter of the judgment; and

(c) **inform themselves** about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

(d) **rationally believe** that the **judgment is in the best interests of the corporation**.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

  - → It is a procedural approach to the problem – if the directors took the right process (a)-(d) in making the decision, then the courts will not examine the substance of the decision
  - → Reluctance of courts in assessing the merits of directors' decisions
    - They would have the benefit of hindsight, which is not fair to directors

- → The only case where a defendant has **successfully relied** on the **BJR**, is ***ASIC v Mariner* [2015] FCA 589**
- → Over the years, there has been comments on whether BJR actually achieves the purposes for which it was enacted

LECTURE 7 WEEK 7: Directors' Duties (2)

Fiduciary Duties

- Functionally, fiduciary duties are part of the mechanism by which the law **balances the freedom of the directors to manage the company, and the need for accountability** for those decisions
  - Duties **must still allow the directors sufficient room to take business risks**
- **Traditional view:** The **duty of loyalty is the overarching standard** (core duty); that duty then has different aspects to it – duty to act in company's best interests, for a proper purpose, and the duty to avoid a conflict of interest
  - If a director acts without a conflict of interest and does not profit from his position – then the director is said to have acted in the best interests of the company
- **Alternative view** (emerging in Australian corporate law): **these 3 duties are separate**
  - A director who acts without a conflict of interest does not necessarily discharge his duty to act in the company's interests – director may still have to demonstrate positive action take to advance the interests of the company

1. Duty of Good faith and proper purpose (loyalty – the 'core' duty)

- ***Re Smith and Fawcett Ltd* [1942] Ch 304 (CA)**: the directors of a company must act 'bona fide **in what they consider** – not what a court may consider – **is in the best interests of the company** and not for any collateral purpose'.
  - → ***Re Smith and Fawcett*** was almost an entirely subjective test
  - → Courts: 'amiable lunatic test' – possibility of a decision that is well-intentioned, but so obviously not in the beneficiaries' interests and so it cannot be allowed to stand
    - **Within the range of what the reasonable person could have thought was in the company's interests,** the directors have a large unfettered interest

  - → Over the years, courts have slowly started to introduce an even more objective standard
    - The question is still 'what did the directors believe they were doing', but that **'belief' is then tested by objective evidence**
    - I.e. it is a subjective test, but **analysed/assessed through objective (surrounding) evidence – whether the decision was one a reasonable director in the circumstances would have reached**
    - ***Bell Group v Westpac (No 9)* [2008] WASC 239 [4619]**
    - ***ASIC v Lewski* [2018] HCA 63**
- Is the duty **proscriptive** or **prescriptive**?
  - → Understand the duty as a prohibition ('must not act in a certain way'), or imposing positive obligations to act in ways to advance the interests of the company?
  - → At the moment, it is not clear:
  - → ***Breen v Williams* (1996) 186 CLR 71**
    - **Fiduciary duties** (this is in a non-corporate context), were **prOscriptive** (**prohibited a fiduciary from acting in their own interests** or the interests of someone else) – a negative duty
  - → ***Bell Group v Westpac (No 9)* [2008] WASC 239; [2012] WASCA 157**

Enforcement of Directors' Duties

- **Policy considerations** in choices between **private and public enforcement**
  - E.g. who is motivated to bring the claim

- In a **private claw claim** to enforce common law duties owed by duties, whether there is enforcement depends on **whether there is someone willing to bring a claim (do they have standing)**
  - **Skill/expertise in the enforcement** – shareholders lack knowledge and resources (not privy to company management
    - **Directors may have more skill/expertise (hire best lawyers) to defend those claims**

- In **public enforcement**, what is **ASIC's motivation** from bringing this claim? They do not derive a benefit; they do get to keep some of the penalty. It's their job but how hard will they work?
  - ASIC does have **resources** to bring claims, but it is enforcing against all companies – may not be enough money – may have to pick and choose which claim it brings
  - Whether public enforcement creates a **meaningful incentive**, given ASIC's **limited resources**?
  - ASIC can only carry its job effectively if those that it is regulating cooperates with it – if every company and litigated everything ASIC tried to do, ASIC would inevitably fail
    - **In order to get cooperation, ASIC would have to work with companies/directors, can't be too much of a strict enforcer**, otherwise it would simply generate opposition to what it's doing
    - Hence, there are questions as to how effective ASIC's enforcement is
  - The thing that drives ASIC as an organisation is the need to keep its political paymasters happy – ultimately a public body funded by government
    - Hence, there are **evidence of ASIC targeting the easy-to-win cases**

- **Possibility/probability of a private & public claim being mounted against directors for potential breach of their duties is reduced considerably (lack resources, motivation, skill)**
  - Also can't detect all breaches
    - Plus, penalties imposed are never going to be maximum
  - Hence, risks of being held personally held liable for breach of director duties is quite low

Enforcement of **Statutory** Duties - Criminal penalties

Recent developments:

- Reasons for the severe criminal penalties: **concern about level of penalties (too low)** (civil and criminal) under corporations legislation – **recent increases** - *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019*
  → Just before 2019, the average penalty imposed for breach of duties was $25,000 – 12.5% of the maximum penalty

LECTURE 9 WEEK 9: Minority Protection (2)

Minority Protection

Introduction: **the plight of minorities**

- Law uses a variety of techniques to protect minorities.
  - E.g: requirement of a **supermajority**, e.g., **special resolution** for key decisions, eg, alteration or repeal of the constitution under **s 136(2)**.
- A minority shareholder is any interest that is less than 50% (the holder of those shares is not in control because of the principle of 'majority rule')
- The law attempting to find a **balance between the right of the majority** to exercise its position as a majority and make decisions and the need to **protect the minority from** things that go beyond just the majority pursuing their own interest to things that amount to **abuse**
  - → Minority are likely to be **influenced** by decisions taken by the majority, which will be taken to **further the majority's interests and ignore the minority's interests**
  - → **Majority might extract private benefits** from the company and not share opportunities ('tunnelling'), e.g. paying directors excessive remuneration
  - → **Minority are 'locked in' in a privately held company** (not listed) – nobody can buy their shares – minority have no way of exiting the company
  - → Because they are the minority, there is always the risk that the majority may seek to force them out, to capture all the benefits of the company for themselves

***Shareholders are not in a fiduciary relationship** with anyone – they are entitled pursue their **own personal interests** – powers vested in the shareholders may be exercised in their own **self interests**

- Law uses a variety of techniques to **protect minorities**, including:
  1. **Personal Rights** - members may seek to enforce a personal right, eg, right to vote, where directors or majority members are attempting to take away this right
  2. **Fraud on the Minority** – equitable limitations on the scope of the powers of the majority.
  3. **Oppression** – statutory claim under **s 232**
  4. **Winding up** - seeking to wind up the company because it is just and equitable to do so, or because the directors are acting in their own interests: **s 461**

1. Personal actions by shareholders

1. Where **shareholders can establish a fiduciary relationship** (***Glavanics***)
   - → On the particular fact, **a fiduciary may be owed by the directors** directly to a group of shareholders, or it may be owed between groups of shareholders
   - → ***Glavanics***: a **duty will be owed to an individual shareholder** – if the member/shareholder is especially reliant upon the director for information and advice

2. Where shares have been allotted for an **improper purpose** and which **dilute the member's shareholding** in the company (***Residues Treatment***)
   - → Where this director's breach is the basis of the claim, this gives the shareholder a **personal right of action**, justified by the **particular effect** on the **member's personal rights**

LECTURE 11 WEEK 11: Public Issues, Debt, and Charges

PUBLIC ISSUES

Distinction between '**public' and 'private' share capital fundraising**

- In Australia, the right to **sell shares to the** public generally is **not available to private** (small) companies (can only sell to particular people) – only public companies have this right

Raising funds from the public

Downside

- Shares are **difficult to price**, are intangible and future-oriented
- Issuing shares to the public poses **considerable risks to investors**
- The company knows more about the shares than likely buyer, and the company is not likely to make information to shareholders that does not cast the company in a good light = **asymmetric information**

Regulatory strategy

- Therefore, a large proportion of company's legislation has been devoted to the issue of public issues and **disclosure to the public of information about the company** - **addresses the lack of appropriate information**
- It's not really about regulating the company, but **regulating the sale and purchase of a particular type of product**

LECTURE 12 WEEK 12: External Administration – Winding Up, Receivership, and Voluntary Administration

Policy for having insolvent trading:

- When the company gets to the brink of insolvency, there is an incentive for the shareholders and directors to trade the company out, because of the effects of limited liability, the shareholders' investment is already lost
- At that point, the shareholders need to trade the company's way out to get any money back
- Because of limited liability, any resources used to trade the company out will necessarily come from the creditors (i.**e. no harm to shareholders because their liability is fixed**)
  - So no downside for shareholders
- From the insolvency perspective, this is unfair
- So there is a provision to provide a **counter-incentive**
  - **Directors have a *personal* duty** to prevent the company from trading on incurring further debts while the company is insolvent – they will be held **personally liable for the further debts incurred**

Do creditors need this sort of protection?

- Arguments for: creditors can self-protect by taking security and higher interest rates