Justifying the Regulation of Corporate Behaviour: A Functional Approach

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The traditional justification of the regulation of corporate behaviour (and its extent) was conceptually dependent on the establishment of a theory of the corporation. Although the Law and Economics movement's championing of shareholder primacy represented the dominant view of corporate law, the increasing influence of the natural entity theory in promoting stakeholder interests and corporate social responsibility (CSR) initiatives makes it difficult to isolate a current prevailing theory. As a result, a better way for justifying the regulation of corporate behaviour lies in a functional examination of the corporation – if corporate behaviour affects stakeholders' rights and interests in a sufficiently intimate way, some level of regulation is warranted. Regulations exist along a continuum, with self-regulation within an industry at one end (soft law) and explicit government regulation enforceable by the courts at the other (hard law).[1] Due to the abstractness associated with the notion of corporate responsibility, especially in relation to the threshold of sufficient intimacy, soft law initiatives are therefore the most appropriate manner of regulating corporate behaviour in Australia.

I Theories of the Corporation

The traditional justifications for and against government regulation of corporate behaviour stemmed from the development of theories attempting to pinpoint the nature of corporations. The concession and aggregate theories prevalent in the 19th and early 20th centuries lost much relevance with, respectively, the advent of general incorporation legislation (as opposed to

[1] Government of Victoria, *Victorian Guide to Regulation* (Department of Treasury and Finance, 2011) 9.

specific grants of public corporate power from the state)[2] and the growth in size of corporations, meaning ownership (shareholders) no longer equated to control (management).[3] Despite this, concession theory's justification of regulation through corporations' public status,[4] and aggregate theory's goal of limited regulation through conceiving of corporations as private entities (without an existence separate to that of its members),[5] remain pertinent in informing the modern debate between shareholder primacy and stakeholder theory.

Drawing from the private and non-separate-entity characteristics of aggregate theory, the Law and Economics movement identified the primary purpose of corporations as maximising shareholders' wealth.[6] This theory viewed the corporation as a 'nexus of contracts' between shareholders, creditors, employees and customers, with directors acting as agents of the shareholders.[7] The use of both legal rules (such as directors' duties)[8] and market forces enabled investors to monitor the state of the company and ensured directors always acted in the best interests of shareholders. Due to the importance of shareholder primacy under this theory, government intervention and regulation was only justified as a means of wealth maximisation through ensuring efficient markets.[9] Under this theory, regulations should therefore be targeted at preventing, minimising or correcting the inefficiencies of market failures – situations where conditions diverge from those existing in perfectly competitive markets. For example, negative externalities such as pollution create costs for third parties not built into the equilibrium price

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[2] Stephen Bottomley et al, *Contemporary Australian Corporate Law* (Cambridge University Press, 2018) 48; David Millon, 'Theories of the Corporation' (1990) 39(2) *Duke Law Journal* 201, 206.
[3] Millon (n 2) 214.
[4] Bottomley et al (n 2) 46.
[5] Bottomley et al (n 2) 48; Millon (n 2) 213.
[6] Bottomley et al (n 2) 50.
[7] Judith Fox, 'Shareholder Primacy: Is There a Need for Change?' (Discussion Paper, Governance Institute of Australia, 2014) 10.
[8] See, eg, *Corporations Act 2001* (Cth) ss180–183.
[9] Wayne Norman, 'Business Ethics as Self-Regulation: Why Principles that Ground Regulations Should Be Used to Ground Beyond-Compliance Norms as Well' (2011) 102(Supplement 1) *Journal of Business Ethics* 43, 45

of the good or service, and companies with monopoly power may be able to earn more and produce less than they should if markets were efficient.[10]

These principles of shareholder primacy have been dominant in corporate law and policy throughout the 20th century in both the US and the UK.[11] In Australia, the law is slightly more nuanced, with s 181(1)(a) of the *Corporations Act 2001* (Cth) requiring directors to act 'in the best interests of the corporation'. While this term has ordinarily been interpreted as 'the wellbeing of … the shareholders generally',[12] it can also include stakeholders' interests 'without there being any derivative benefit for shareholders',[13] such as in the example of insolvency.[14]

This consideration of stakeholders, as opposed to only shareholders, in directorial decision-making stems from the natural entity theory, which agrees with the natural origin of the corporation but recognises a distinction between the identity of the corporation and its shareholders.[15] This conception seems to fit legal features of the corporation such as its separate legal status[16] and perpetual succession[17] better than the economic view of a 'nexus of

[10] Wayne Norman, 'Business Ethics as Self-Regulation: Why Principles that Ground Regulations Should Be Used to Ground Beyond-Compliance Norms as Well' (2011) 102(Supplement 1) *Journal of Business Ethics* 43, 44.
[11] *Dodge v Ford Motor Co.* 170 NW 668, 684 (Mich 1919); Committee on Corporate Governance, *Final Report* (The Committee on Corporate Governance and Gee Publishing Ltd, 1998) 11.
[12] Corporations and Markets Advisory Committee, *The Social Responsibility of Corporations* (Report, December 2006) 84.
[13] Shelley D Marshall and Ian Ramsay, 'Stakeholders and Directors' Duties: Law, Theory and Evidence' (2012) 35(1) *UNSW Law Journal* 291, 298.
[14] *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1, 534 [4395] (Owen J).
[15] Millon (n 2) 203. As the natural entity theory conceived of a corporation as an entity distinct from its shareholders, advocates of corporate social responsibility relied on this theory to argue that because 1) management represented the corporation and 2) the corporation, like other natural persons, should be free to act in a socially responsible way, management should there be able to prioritise certain obligations to stakeholders and the public, even at the expense of the shareholder: Millon (n 2) 203. This theory has been described in the US as 'the dominant theory of the corporation' in the late 20th century: John C Coates, 'State Takeover Statutes and Corporate Theory: The Revival of an Old Debate' (1989) 64 *New York University Law Review* 806, 826 quoted in Stephen Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19(3) *Federal Law Review* 203, 213.
[16] *Corporations Act 2001* (Cth) s 124(1).
[17] *Communications, Electrical, Electronic, Energy, Information, Postal, Plumbing and Allied Services Union of Australia v Queensland Rail* (2015) 256 CLR 171, 188 [38].

contracts', which struggles to explain these features of a corporation that rise above the interactions of members and directors. If entity theory is accepted, the 'best interests of the corporation' can extend further than shareholders' interests, allowing directors to consider the interests of other stakeholders in the corporation such as employees, creditors, consumers or communities in which the corporation operates.[18] Furthermore, if a corporation is to have the same 'legal capacity and powers [as] an individual',[19] this theory suggests it ought also be held to similar ethical standards as natural persons. As a result, government regulation to ensure ethical corporate conduct with regard to stakeholders may be justified, with a corporation having 'a social service as well as a profit-making function'.[20]

II The Functional Approach

The weakness of this theoretical approach to justifying regulation lies in its dependence on determining a conception of the corporation that is unsettled and contested. This creates an inefficient rigidity in the development of corporate law and policy, where theoretical justifications for increasing or decreasing regulation must go beyond consideration of the circumstances at hand and attempt to resolve fundamental differences in theories of the nature of corporations. The more pertinent approach should be a functional one, which considers the impact of specific corporate conduct on stakeholders. If the rights and interests of stakeholders are affected by the behaviour of a corporation in a 'sufficiently intimate'[21] way, some regulation of that behaviour is therefore warranted.

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[18] Millon (n 2) 216.
[19] *Corporations Act 2001* (Cth) s 124(1).
[20] E Merrick Dodd Jr, 'For Whom Are Corporate Managers Trustees?' (1932) 45(7) *Harvard Law Review* 1145, 1148.
[21] Abram Chayes, 'The Modern Corporation and the Rule of Law' in Edward S Mason (ed), *The Corporation in Modern Society* (Harvard University Press, 1959) 25, 41.

This type of analysis bypasses the need to settle on a concrete conception of the corporation – regulation may be justified regardless of whether corporations possess a distinct corporate identity or if they are nothing more than individuals contracting for business. It can account for regulating both market failures (negative externalities such as dangerous products[22] ought to be regulated, as consumers who are using these products may be harmed, while shareholders who have a direct financial interest in the firm may also be foregoing potential profit due to the resulting market inefficiencies), as well as more ethical behaviour with regard to affected parties (the significant control large corporations have over employment conditions of employees may justify regulations giving employees a voice on the board or mandating adequate consideration of their interests in corporate decision-making).[23] Therefore, a functional approach to the effects of corporate behaviour can provide a more efficient framework for justifying relevant regulation.

III Regulatory Frameworks

The challenge with this approach, however, is to define what constitutes a sufficiently intimate relationship that would give rise to regulations beyond the mutually agreed market failure criterion. In doing so, soft law initiatives (which are not legally binding), such as self-regulation or international organisation guidelines, should be preferred to hard law (legislation that is enforceable in the courts),[24] as the threshold of sufficient intimacy is not clearly defined. There are several reasons why legislation is inappropriate: 1) as legislation requires precision in order to be effective,[25] it is ill-suited to defining and enforcing abstract notions of CSR;[26] 2) a formal regulatory framework may impose a significant burden on corporations such that the high

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[22] Norman (n 9) 44.
[23] Millon (n 2) 226–7.
[24] Kenneth W Abbott and Duncan Snidal, 'Hard and Soft Law in International Governance' (2000) 54(3) *International Organization* 421, 421–2.
[25] Ibid 421.
[26] Norman (n 9) 46.

compliance costs across industries outweigh the legislation's social benefit[27] – for example, the introduction of the *Sarbanes-Oxley Act of 2002*[28] in the US to tackle fraudulent corporate reporting cost public corporations in 2004–05 a total of $US1.4 trillion, far more than the benefits of any perceived fraud prevention;[29] and 3) in an increasingly globalised economy where corporations have 'multi-jurisdictional footprints', unfavourable domestic corporate legislation may simply lead to companies incorporating elsewhere.[30] Therefore, in this context, self-regulation, where corporations in an industry or profession mutually agree to certain benchmarks of behaviour, or guidelines created by international organisations such as the UN Global Compact (an initiative to promote CSR through ten principles relating to human rights, labour, environment and anti-corruption[31]) are more suitable regulatory tools.

Any involvement by Parliament should either follow the example of s 172(1) of the *Companies Act* 2006 (UK) or the *Listing Rules* of the Australian Securities Exchange which requires publicly listed companies to include a 'corporate governance statement' in its annual report.[32] These provisions encourage directors to consider the interests of stakeholders in corporate decision-making while ensuring the ultimate discretion to take action and sovereignty over the company remains with directors. Although these soft law solutions are non-binding, they provide the flexibility for firms in different situations to develop their own notions of CSR. Beyond the fulfilment of firms' ordinary ethical responsibilities, such initiatives are also economically pertinent as they have been positively linked to benefits such as lowering employee turnover rates, increasing customer satisfaction and improving the firm's reputation.[33]

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[27] Government of Victoria (n 1) 12.
[28] *Sarbanes-Oxley Act of 2002* Pub L No 107–204, 116 Stat 745 (2002).
[29] James A McConvill, 'Reflections on the Regulation of Contemporary Corporate Governance' (2006) 2(1) *Corporate Governance Law Review* 1, 53–54.
[30] Iris H-Y Chiu, 'An Institutional Theory of Corporate Regulation' (2018) 71(1) *Current Legal Problems* 279, 292.
[31] United National Global Compact, 'The Ten Principles of the UN Global Compact', *United Nations Global Compact* (Web Page), https://www.unglobalcompact.org/what-is-gc/mission/principles.
[32] *ASX Listing Rules* r 4.10.3.
[33] Jeremy Galbreath, 'How Does Corporate Social Responsibility Benefit Firms? Evidence from Australia' (2010) 22(4) *European Business Review* 411, 422.

IV Conclusion

The traditional approach to justifying the regulation of corporate behaviour lay in establishing a predominant theory of the corporation. The challenge of the natural entity theory and the promotion of stakeholder interests to the 20th century dominance of the Law and Economics movement renders it difficult to identify one principal justificatory theory. As a result, an analysis of corporations' functional role can provide better guidance – if corporate conduct affects stakeholders' rights and interests in a sufficiently intimate way, regulation is therefore justified. This essay concludes that such regulation is best achieved through soft law, the most appropriate method of codifying abstract notions of corporate responsibility.

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