Re-thinking Corporate Practice and Corporate Governance in light of Recent Corporate Collapses: Some evaluative questions and agenda items

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Abstract

The number and scope of corporate collapses in recent times clearly illustrates that corporate accountability practice is failing to match the rhetoric, even when regulatory enforcement is mandated by law and enforced by criminal and civil penalties. Evaluation theory and theoretical work in the field of deterrence, however, reveals that the more we can rely upon regulatory creativity, and appeal to the sense of social responsibility of those in a position to prevent wrong-doing, the more persuasion can replace criminal law enforcement in the punishment hierarchy. This paper reviews some of the current research needs. It suggests where evaluation is required in order to test further the sorts of options available to policy-makers to deter corporate wrong-doing and prevent irresponsible practices. These methods and regulatory options are becoming increasingly needed, given the inadequacies and inefficiencies of the current legal framework and the public rhetoric that suggests that the best response is (simply) more law.

Key Words

Corporate, collapse, social responsibility, deterrence, regulation, persuasion, punishment

Introduction

The Australian corporate cemetery of the 1980s contains a number of well known corpses. There has been a rather haunting reappearance of these events in the last two years (Sarre 2002). Evaluators need to be advising policy-makers towards the best and most effective regulatory processes. This paper explores some of these options and sets out some of the possible targets for the modern evaluators' gaze.

Existing legal requirements and financial compliance initiatives

It is worth reviewing, for a moment, the sorts of compliance requirements, in law and in practice, currently in place that purport to prevent corporate negligence and to thwart malfeasance. To begin with, the *Corporations Act 2001*(Cth) makes it clear that corporate directors are accountable to the law and that there are severe penalties in the event of misconduct and even inadvertence. Directors have, by virtue of the Act, and the common law, a duty to act honestly (which is more than a duty not to act dishonestly), to exercise care and diligence, not to make improper use of their position and not to make improper use of information to which they may be privy. Moreover, directors remain under the scrutiny of the Australian Securities and Investments Commission (ASIC) not to engage in any behaviour that is in contravention of the law, such as the prohibition against trading while insolvent.

The *Trade Practices Act 1975* (Cth) (TPA) Part IV provides massive fines for companies that engage in proscribed behaviour. The Australian Competition and Consumer Commission (ACCC) monitors compliance with the Act and pursues any allegations of unlawful or inappropriate activity such as price fixing, secondary boycotts and mergers that have an anti-competitive effect. There are also the not inconsiderable resources of other regulatory agencies whose task it is to ensure compliance with the law, for example, the Australian Tax Office (ATO), the Australian Transaction Reports and Analysis Centre (AUSTRAC), the National Crime Authority (NCA), and the Australian Bureau of Criminal Intelligence (ABCI)), not ignoring the resources of State and Federal Directors of Public Prosecutions whose task it is to prosecute those companies and directors who fail to abide by the law, with or without the consent of the agencies responsible for superintendence of the corporate sector.

There are, moreover, the compliance rules of the Australian Stock Exchange (ASX), such as the 'governance disclosure' requirements of ASX listing rule 4.10.3 which requires publicly listed companies to include a corporate governance statement explaining the main practices, control mechanisms and governance processes employed by the company during the reporting period.

The fact remains that all of these legal prohibitions and requirements were in place while the high-profile collapses in the first nine months of 2001 in Australia continued apace. One need only look across the Pacific to see a similar tale. Enron collapsed despite the US governance rules, and indeed, Enron had appeared in Fortune Magazine's "All Star List of Most Admired Companies" (Banerjee 2002, p 4). According to Neu *et al*, (1998), regulatory requirements and laws are not necessarily allaying stakeholders' concerns, nor are they acting to change sloppy management practices.

There is not a strong track record for official regulators either. The HIH debacle has brought buck-passing to the status of an art form, for example, between the Australian Regulatory Prudential Authority (APRA) and the Australian Securities and Investments Commission (ASIC) (Sarre, 2001). The HIH Royal Commission, too, has been a tedious, inefficient and expensive exercise so far, focusing on the personal and trivial aspects of the collapse (Scott, 2002).

Philosophical questions and challenges

Some of the apparent confusion regarding regulatory roles, laws and requirements stems from our collective inability to recognise the limited role that the law (and governments in enacting those laws) can play in regulatory governance. It appears that, as a society, we are incapable of agreeing upon philosophies attached to the role of prudential oversight. Consider the following two opinions on the way in which regulation should be approached. On the one hand, there is the view that the law (and, therefore, governments as legislators and prosecutorial authorities as their clarions) should do more to bring about regulatory enforcement. Bob Baxt, former Chairman of the Trade Practices Commission (now the ACCC), said, almost a decade ago:

> For there to be a future for regulation in this country, there is a very real need for regulators to enforce the law. Failure to do so will provide idle speculation that they have been captured by their specific industries … or certain influential sections of them. … But, regrettably, through a combination of inadequate laws, or laws which are 'poorly' drafted, unrealistic penalties to fit 'the crime', inappropriate courts to adjudicate on some of the major issues, grossly inadequate funding of agencies and courts, unimaginative and often mixed-up policies and interstate jealousies, we have a scenario in which the agencies operating [in companies and securities, tax and trade practices] have failed their charter over the last decade or so … causing irreparable damage to the confidence of the community and to our regulatory framework. … Governments must take much of the blame. (Baxt 1993, p 117)

This view is also represented in the mantra of "don't pass more laws, pay for more and better policing" (e.g. Harper 2002).

In contrast, Stan Wallis, the Chairman of the 1997 Wallis Inquiry into the financial services sector, claims that it is Australia's tough corporate governance rules that are a major reason for the under-performance of local companies. In a speech to the Centre for Corporate Public Affairs in June 2000, Mr Wallis advocated the winding back of boardroom independence rules. Governance, he said, had become an end in itself and obscured the real issues, and, as a result, directors were predisposed to be risk-averse at a time when bold moves are often needed (cited in Sarre, 2002).

It is arguable that neither of these two views was or is adequate. In contrast to the Wallis view that Australians would be better off with fewer restrictions on corporate independence, there is a wealth of historical evidence that well-financed prudential supervision is needed in order to prevent the 'bold moves' from precipitating financial doom. At the same time, however, bludgeoning firms with the heavy hand of the criminal and corporate law does not have a solid track record as the most effective way to deal with businesses intent on taking risks with other people's assets. There are a number of regulatory options, discussed below, that find an appropriate middle ground between the Baxt and Wallis views. They relate more to process and mindset than activity and legal standards.

Perhaps regulatory processes can be better conceived and executed if they embrace the paradigm shifts that are occurring worldwide in relation to the development of the notions of corporate reputation (fear of shame), the regulatory pyramid and corporate social responsibility. These are not entirely new approaches, but their modern manifestations around corporate collapses requires some theoretical development and evaluative data. The following ideas might be read as suggesting that the role of government in the regulatory sphere is less significant than it may have been in the past or should be. It is not the purpose of this paper to convey the notion that governments should back away from their responsibilities. Governments are certainly not irrelevant, even in an era of less *formal* regulation. Governments should retain a role more akin to 'steering' rather than 'rowing' (Grabosky 1995, pp 543-544). It is not more law that we need, rather clever policy ideas and theoretical positions.

> [I]t is no longer possible to assume that the state [through governments, prosecutorial authorities and regulators] is in a position to regulate corporate harm, or that it has the motivation to do so. (Haines 2000, p 176)

What are these theoretical ideas and positions worth pursuing and testing?

Ideas around 'shame', and the regulatory 'pyramid'

The emotions of shame and pride in being law-abiding featured heavily in criminologist John Braithwaite's seminal work *Crime, Shame and Reintegration*. Braithwaite's (1989) hypothesis is that fear of shame is one of the major social forces for preventing criminality and thus any criminal justice responses that create anger and foster indignity undermine respect for law and one's willingness to obey it. Reconceptualising regulation around reputation, shame and responsibility is one strong theoretical development. The other, allied, notion is the enforcement 'pyramid'. This idea has been around for a decade. According to Fisse and Braithwaite, compliance is best understood

> within a dynamic enforcement game where enforcers try to get commitment from corporations to comply with the law and can back up their negotiations with credible threats about the dangers faced by defendants if they choose to go down the path of non-compliance. (Fisse and Braithwaite, 1993 p 143, cited in Croall 2001, p 117)

At the base of the pyramid, most matters are dealt with informally, that is, dealt with by cautions, stern warnings and the like. As conduct becomes more serious, so too do civil actions and monetary penalties follow. Further up are prosecutions for more serious malfeasance, and, at the top of the pyramid, severe penalties. These ideas are all caught up in the principle of 'regulatory pluralism' (Ayres and Braithwaite 1992).

Corporate social responsibility

There is a view that business performance may be enhanced by the creation of initiatives (government or private) and the fostering of stakeholder pressures designed to build a 'social responsibility' ethic into a corporation's 'culture'. One happy consequence of this is that these sorts of initiatives may bring about greater overall business performance and thus a better return for shareholders. Broadly, this has been described as the movement towards *corporate social responsibility* or 'CSR'.

It is clear that more and more stakeholders, including shareholders, are demanding greater accountability from company managers on issues other than simply financial returns to investors. Broadly speaking, the concept of CSR requires corporations not only to abide by the law, to be good corporate citizens and to abide by government and professional compliance codes and requirements, but to do more – to display an elevated level of quality in all that they do. It requires cultivation of an

organisational corporate culture, a vigilant and constant awareness of the possibility of wrongdoing, a personal ethic of care, and an assumption of individual responsibility for the consequences of one's actions. This includes an organisational commitment to ensure that companies not only *conform* with the law and regulatory obligations, but *perform* to a higher standard than that which is required by the law (Sarre, Doig and Fiedler, 2001). In other words, it is a rejection of the notion that prescribing minimum standards, and enforcing them by law, is an adequate form of regulation. Minimum standards quickly become maximum standards; regulators may be captured by those they are regulating, and so forth. What are its manifestations? Arguably there are four.

Corporate 'culture'

The *Criminal Code Act 1995* (Cth) provides an example of one attempt to give a 'cultural' emphasis to the notion of corporate criminal liability. The Code explicitly states that harm caused by employees acting within the scope of their employment is considered to be harm *caused* by the body corporate, and introduces the crucial concept of 'corporate culture', defined in Section 12.3(6) of the Code as an "attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate in which the relevant activities take place". A company with a poor corporate culture may be considered as culpable under this legislation as individual directors or senior managers (para 501:2:1). The change was designed to catch situations where, despite the existence of documentation appearing to require compliance, the reality was that non-compliance was expected. This idea requires evaluative work.

Codes of conduct

A brief mention in this regard should be made of the so-called 'Caux Principles', the outcome of a group of international executives based in Caux, Switzerland, and premised upon the principles created by the Minnesota Center for Corporate Responsibility in 1992 (Minnesota 1992). As stated in the preamble to the document, "laws and market forces are necessary but insufficient guides for conduct". These principles require evaluative data.

Corporate obligation and the 'licence to operate'

The notion of 'corporate obligation' has been finding its way into the academic literature. This obligation is justified as a fair return for society granting corporations the legal protection of limited liability and according them the social permission to operate freely in the marketplace, that is, industry should earn a 'social licence to operate'. The argument is that corporations that enhance their corporate social responsibility are more likely to be sustainable and hence less likely to suffer financial catastrophe. Those that cannot show this should, it is argued, lose their right to operate with the protection of limited liability. This idea can be allied with the view of Robert Hinkley that there could be, by legislative amendment, an expansion of the duties of directors under corporations law to ensure that their primary profit-making enterprise for shareholders is not

> at the expense of the environment, human rights, the public safety, the communities in which the corporation conducts its operations or the dignity of its employees". …"This balancing factor should be implanted in corporations in a manner that tempers – but does not destroy – their drive to achieve profits. (Hinkley 2000, p 33, cited in Horrigan, 2001)

This notion too requires evaluative work before it will be taken seriously by legislators. There is little evidence of any shift in this direction.

> Large transnational corporations responsible for major environmental disasters and negative social impacts in the Third World (Union Carbide, Nike Exxon, Shell to name a few) rather than lose their licence to operate have actually become stronger and more powerful whether through mergers, restructures or relentless public relations campaigns. (Banerjee 2002, p 3)

'Triple Bottom Line' reporting

The triple bottom line (TBL) concept is an idea that is designed to highlight the view that a company's consideration of only one measurement of success – the financial 'bottom line' – is inadequate in a

number of respects (Elkington 1997, p 109). Triple bottom line thinking insists that there are at least two other aspects of doing business today that require equal consideration and active managerial attention – the social impacts (for example, health, welfare and safety), and the environmental impacts that a company's activities may be having. Advocates of triple bottom line reporting declare that the idea of three reporting considerations instead of one is also necessary for, indeed irretrievably linked to, the financial bottom line and hence prevents financial irresponsibility. In other words, financial success itself is reliant upon not only economic sustainability but also social and environmental sustainability. A company that can meet the needs of the present in terms of social and environmental impact, without compromising the needs of the future, is, so the thinking goes, more likely to appeal to investors and customers alike, and thus be financially successful. This is done by using TBL reporting as a selling point in the marketplace, through appealing to customers concerned about the environment and the reduction of risk to workers, consumers and the public in general. Companies that incorporate this approach in their strategies can, it is claimed, generate substantial competitive advantages. According to some respondents, these claims have not yet been adequately borne out by the data.

> The literature on corporate social responsibility easily identifies "bad" corporate citizens: tobacco companies, weapons manufacturers, environmental polluters. However, the fact that these companies regularly publish corporate citizenship and social performance reports tends to muddy the waters more than a little. (Banerjee 2002, p 3)

Discussion

Where do these theoretical positions take us? To summarise the argument: the notion of corporate social responsibility is foundational to the idea that corporations are less likely to engage in activities that are unsustainable (a precursor to collapsing) where their reputation is strong and where the shame factor provides deterrence against irresponsibility, and where they have embraced the principles of corporate social responsibility either by their own doing or under duress/coercion from government or regulatory forum. In that light, regulatory 'carrots' that are designed to enhance the development of a sound corporate culture and business reputation should be put in place both by governments and industry associations alike. According to the theoretical material, these types of 'carrots' are more likely to be effective in preventing corporate collapses than legal and regulatory 'sticks'. What is needed is evaluative data that test the arguments and theoretical developments.

Moreover, there is another crucial question worth pursuing from a theoretical perspective: whether applying corporate social responsibility pressure, be it 'stakeholders', shareholders, consumers, industry associations or governments doing the pressuring, is done for profit reasons alone. True, it is possible to be able to equate good business with good business ethics, according to observers such as Primeaux (1998). But if that evidence were *not* there, would altruism necessarily outweigh the demands for shareholder profits? Corporate discussions, according to some sceptics, tend to be based upon mere tinkering, with the "business as usual" sign displayed, and would quickly be abandoned if there were scope for the financial bottom line to suffer. "Far from being a soft issue grounded in emotion or ethics, sustainable development involves cold, rational business logic" (Magretta 1997, p 81 cited in Banerjee 2002, p 7). This attitude requires some better evaluative data too.

Conclusion

Recent history has reinforced the notion that, in order to prevent corporate disaster and corporate irresponsibility, the state cannot simply rely upon legal and administrative regulation, nor simply leave matters to the market. In addition to the development of shame and reputation, and the regulatory pyramid, the notion of corporate social responsibility has been touted as a potentially powerful alternative paradigm that ought to be pursued by governments and regulators alike in order to stop the 'rot'.

True, through incentives, governments can encourage risk-prevention propriety in business affairs. True, by virtue of demanding 'triple bottom line' reporting mechanisms, shareholders can convince those still wedded to the financial bottom line that the pursuit of sustainability does not necessarily carry financial risk. The proof of the pudding, however, is in the eating. Some of the best 'reporters' have been some of the worst performers. If the *status quo* is not an option, then these new paradigms will need not only further theoretical development, but some evaluative data as well. The challenge is for governments, industry associations and companies themselves to investigate the possibilities tossed

up by these ideas and to test them for their potential to effect the desired outcome, that is, a corporate landscape filled with business and enterprise, safe practices and unpolluted environments, rather than one littered with business remnants, polluted landscapes and unsustainable practices.

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