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Opening Our Eyes to the Blind Pursuit of Profit - Adjusting Attitudes on Corporate Governance

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OPENING OUR EYES TO THE BLIND PURSUIT OF PROFIT – ADJUSTING ATTITUDES ON CORPORATE GOVERNANCE

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It seems so obvious. Once someone has invested in a company by purchasing its shares, the company, and by extension its directors, owes it to the shareholder to operate to maximize that shareholder's interests by maximizing profits.

Really?

"The great public companies of today owe a duty, not only to their shareholders to make a profit, but to the people amongst whom they live and work, to do their best for them. Every responsible shareholder recognises this."[1]

There is a compelling logic to this. after all, if a company pursues only maximum profit at the expense of its employees, customers and others in the broader community, it will eventually find itself the engineer of its own destruction.

Yet, even though Lord Denning wrote the above in 1969, specifically addressing his points to Australian business interests, 50 years on it would seem his view has not been heeded. One result is the inquiry by a Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry from December 2017 that only recently produced a final report.

The final report underscores that the blind pursuit of profit is inappropriate. This is postulated even in its introduction: "The central task of the Commission has been to inquire into, and report on, whether any conduct of financial services entities might have amounted to misconduct and whether any conduct, practices, behaviour or business activities by those entities fell below community standards and expectations. The conduct identified and described in the Commission's Interim Report and the further conduct identified and described in this Report includes conduct by many entities that has taken place over many years causing substantial loss to many customers but yielding substantial profit to the entities concerned."[2]

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[1] Lord Denning's award concerning the Fiji sugar cane contract dispute; observations on its consequences and mistakes (1970).

[2] *Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* ("Final Report"), p. 35. <https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf>.

The commission determined that the profit-seeking behaviour of financial institutions, either on behalf of generating high dividends or for the benefit of their executives, was often, "too often", without regard for the legality or social consequences of the behaviour: "financial services entities put the pursuit of profit above all else and, in particular, above the interests of their customers, and above compliance with the law."[3]

The main protagonist of the very self-centred profit maximization view is Nobel prize-winning economist Milton Friedman, who famously [cynically] asserted the profit maximization mantra in the aftermath of the Ford Pinto scandal. [4]

In a sense, the simplicity of this mantra is seductive. "Milton Friedman in 1970 convinced many financiers that companies should focus solely on increasing shareholder value."[5] To quote Gorden Gecko in the 1987 Hollywood movie *Wall Street*, "Greed is good."

This is, however, an unbalanced view.[6] As we have already mentioned, pursuit of profit without consideration of the various "environmental" interests that can ultimately impact a company's viability, has a high potential to ultimately destroy the company and possibly even the economy in which it operates.

Indeed, Friedman's maxim has come under criticism from various quarters over the years. Even as early as 1979, "Quaker Oats president Kenneth Mason, writing in *Business Week*, declared Friedman's profits-are-everything philosophy 'a dreary and demeaning view of the role of business and business leaders in our society'… Making a profit is no more the purpose of a corporation than getting enough to eat is the purpose of life. Getting enough to eat is a requirement of life; life's purpose, one would hope, is somewhat broader and more challenging. Likewise with business and profit."[7]

Nonetheless, many continue to interpret the best interests of the company to mean profit maximization for the benefit of the shareholders. Justice Hayne has a response to this as well: "Financial returns to shareholders (or 'value' to shareholders) will always be an important consideration but it is not the only matter to be considered. The best interests of the corporation cannot be determined by reference only to the current or most recent accounting period. They cannot be determined by reference only to the economic

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3 Final Report, p. 429.

4 Cf. "Adam Smith's "invisible hand" - the notion that the individual pursuit of maximum profit guides capitalist markets to efficiency - is so invisible because, quite often, it's just not there." *Economists View: Friedman and Galbraith*, December 28, 2006. https://economistsview.typepad.com/economistsview/2006/12/friedman_and_ga.html.

5 Luigi Zingales, *Shareholder welfare should be the priority*, Financial Times, November 12, 2018. https://www.ft.com/content/52240e18-e412-11e8-a8a0-99b2e340ffeb.

6 To be fair to Friedman, his full statement is: "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud." https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html. Unfortunately, many have disregarded the qualification contained in his statement, including, arguably, Australian bankers.

7 Steve Denning, *The Origin of 'The World's Dumbest Idea': Milton Friedman*", Forbes, June 26, 2013. https://www.forbes.com/sites/stevedenning/2013/06/26/the-origin-of-the-worlds-dumbest-idea-milton-friedman/#3fad2bf1870e.

advantage of those shareholders on the register at some record date. Nor can they be judged by reference to whatever period some of those shareholders think appropriate for determining their results."[8]

This debate comes down to a disconnect between a seductive economic theory and the more practical regulation by law which, nonetheless, seems to include room for interpretation that lays it open to abuse. This, too, was noted by Justice Hayne: "Very often, the conduct has broken the law. And if it has not broken the law, the conduct has fallen short of the kind of behaviour the community not only expects of financial services entities but is also entitled to expect of them."[9]

Responsibility for placing profits above all else, both in the case of financial services entities and more generally, while undertaken in the name of the company, has to lie with those actually operating the company: its executives and directors. It is important to note that the term "directors" is defined and interpreted to include those acting *in loco princeps* even though not formally elected as a director.[10]

Among the Hayne Commission's recommendations for remedying the problems arising from the over-focus on profit maximization in the financial services sector is reiteration of the duties of a director and how these must be accomplished. The commission emphasized the need for directors to turn their minds to issues and consider the best interests of the company holistically. "Directors must exercise their powers and discharge their duties in good faith in the best interests of the corporation, and for a proper purpose (citing to Corporations Act s181). That is, it is the corporation that is the focus of their duties. And that demands consideration of more than the financial returns that will be available to shareholders in any particular period."[11]

The Hayne Commission was also troubled by the fact that the financial services institutions in Australia acted as though their activities should have been directed to profit

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[8] Final Report, p. 402.

[9] Final Report, p. 35.

[10] Corporations Act 2001, s9:

"director" of a company or other body means:

(a) a person who:
  (i) is appointed to the position of a director; or
  (ii) is appointed to the position of an alternate director and is acting in that capacity, regardless of the name that is given to their position; and

(b) unless the contrary intention appears, a person who is not validly appointed as a director if:
  (i) they act in the position of a director; or
  (ii) the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes.

Subparagraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or the company or body.

Note: Paragraph (b)--Contrary intention--Examples of provisions for which a person referred to in paragraph (b) would not be included in the term "director" are:

* section 249C (power to call meetings of a company's members)
* subsection 251A(3) (signing minutes of meetings)
* section 205B (notice to ASIC of change of address).

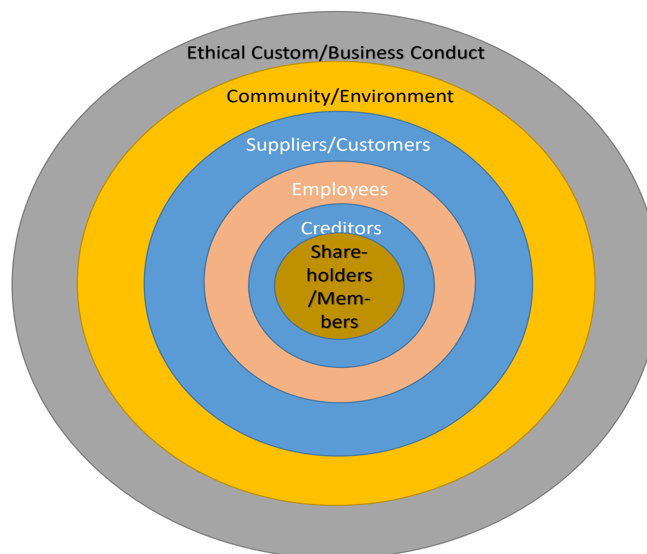
[11] Final Report, p. 402.

maximization for the shareholders without consideration of anyone or anything else. "It is not right to treat the interests of shareholders and customers as opposed. Some shareholders may have interests that are opposed to the interests of other shareholders or the interests of customers. But that opposition will almost always be founded in differences between a short term and a longer-term view of prospects and events. Some shareholders are only interested in receiving a high quarterly dividend. The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with any corporation will be seen as converging on the corporation's continued long-term financial advantage. And long-term financial advantage will more likely follow if the entity conducts its business according to proper standards, treats its employees well and seeks to provide financial results to shareholders that, in the long run, are better than other investments of broadly similar risk."[12]

Obviously, the activities of banks and other financial institutions affect many parties. The shareholders who buy shares in these financial entities are investors in the companies. In a sense, so too are creditors, who lend money or supply materials to companies for their activities and therefore have a stake in the company's success. Other groups that rely heavily on the company for their well-being include the employees and the customers. Today we see that the well-being of the environment is, or should be, very much a concern of companies as well.

All these different interest groups are known as stakeholders.

Jim Corkery arranges all of these in what he calls an onion ring diagram, with shareholders at the centre of the onion, and at the exterior-most ring, the very broad category of ethical custom/business conduct. And there is an argument to be made that in order for directors to fulfill their duties to the company, the interests of all these stakeholders must be considered.



[12] Final Report, p. 403.

Acknowledgement of these various stakeholders and their significance to the company forces recognition that directors are intended to act not on behalf of the shareholders, but on behalf of the company,[13] operating it for its own successful perpetuation.

While there are a number of judicial decisions conflating "on behalf of shareholders" and "on behalf of the company" and overriding the interests of any other stakeholder, such decisions are regularly overruled by subsequent legislation.

For example, in 1962, the UK Chancery Court found in favour of a corporate shareholder seeking to block payments to former employees left behind during a sale of the company, ruling that such payments were *ultra vires*.[14] In 1985, when the UK undertook a major revision of its Company Act, it introduced a section stipulating that directors have the power to provide for employees or former employees in the event of a cessation or transfer of the business, even where the exercise of such power may not be in the best interests of the company.[15]

The Hayne Commission also acknowledged the importance of recognizing stakeholders: "The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with any corporation will be seen as converging on the corporation's continued long-term financial advantage"[16] This implies that the central mistake of bank management that led to the Commission's inquiries was over-focus on the short-term; the blind pursuit of profit maximization.

What is to be done?

The Hayne Commission suggested that the problems in the financial services sector derive more from deficiencies in "culture and governance" than from specific deficiencies in the law. Indeed, the commissioner recommended no major changes to the law and even commented that the law as it was could sufficiently deal with the wrongdoing that the commission had unearthed.

In other words, directors and executives either had insufficient understanding of the law or simply chose to ignore it. Is it possible that directors are insufficiently aware of their role or duties as directors?

"The board is responsible for the overall governance, management and strategic direction of the organisation and for delivering accountable corporate performance in accordance with the organisation's goals and objectives."[17] Further, the Australian Securities and Investment Commission (ASIC) has usefully summarized director's duties as:

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13 Corporations Act 2001, s180: (1) A director or other officer of a corporation must exercise their powers and discharge their duties: (a) in good faith in the best interests of the corporation; and (b) for a proper purpose.

14 *Parke v. Daily News Ltd.*, [1962] Ch 927.

15 UK Companies Act 2006, s247.

16 Final Report, p. 404.

17 *Role of the Board: Governance Relations*, The Australian Institute of Company Directors, p. 1. https://aicd.companydirectors.com.au/-/media/cd2/resources/director-resources/director-tools/pdf/05446-3-11-mem-director-gr-role-of-board_a4-v3.ashx. Cf. Corporations Act 2001 s198A.

- to act in good faith in the best interests of the company and for a proper purpose
- to exercise care and diligence
- to ensure the company complies with its legal obligations
- to avoid conflicts between the interests of the company and any personal interests
- to prevent the company trading while insolvent/assist any liquidator in insolvency[18]

One major issue is the meaning of "best interest of the company." As mentioned above, in the past "the company" in this context has often been treated as synonymous with "the shareholders". It would seem an obvious and useful change to the law could be to clarify that the phrase "best interest of the company" does not mean acting solely in the "best interest of shareholders" and instead requires directors to take a holistic and long-range view of the corporation and what is best for it. This concept is often referred to as enlightened shareholder value.

Recognising this confusion, the UK enacted s172(d) of *The Companies Act* in 2006:

> A director of a company must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefits of its members as a whole, and in doing so have regard to
>
> a) the likely consequences of any decision in the long term,
> b) the interests of company's employees,
> c) the need to foster the company's business relationships with suppliers, customers, and others,
> d) the impact of the company's operations on the community and the environment,
> e) the desirability of the company maintaining a reputation for high standards of business conduct, and
> f) the needs to act fairly as between members of the company.

Australia would do well to adopt a similar provision.

It seems a distortion of capitalist theory to accept that shareholders have locked in their risk of loss (the value of their share purchase) but have unlimited profit potential, even at the expense of increasing the risk of loss of others dealing with the company, including employees, creditors, customers, community, environment, etc. Even if this is acceptable to economists, particularly those of the Friedman school, it should not be acceptable to lawyers, who can acknowledge the law's broader responsibilities and give equal concern for equity and fairness. This debate has become particularly poignant today when we are considering massive investment in infrastructure to combat global warming [which has arguably been principally created by the blind pursuit of profit].

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[18] <https://asic.gov.au/for-business/your-business/tools-and-resources-for-business-names-and-companies/asic-guide-for-small-business-directors/directors-key-responsibilities/>.

It could be suggested that the Corporations Act should specify that the relationship between banker and customer is a fiduciary one, although it could equally be argued that anyone entrusted with the money of another is so obviously in a position of fiduciary that there is no need to further legislate to cover this obligation. Surely the banker is in an analogous position to that of someone entrusted with medical or legal responsibilities. There is already a vast body of law on fiduciary obligations and the enforcement thereof. This should be referred to if ever the bankers' performance lapses again.

While we support legislative wording like that of UK Companies Act s172, there is no clarity on the meaning of "success" in that context. We suggest any Australian version of s172 should define "success" as successful perpetuation of the company over the long-term. Short-term measures such as mega-dividends or similar profit-taking, or excessive executive remuneration, could not satisfy this test and accordingly would constitute breaches of the law.

A challenge in the existing law noted by the Hayne Commission is that it is over-complicated by myriad exceptions, effectively loopholes that lead corporate management to be over-literal in their application of the law in an attempt to escape its constraints.[19] Perhaps a broad-based principles approach would be more appropriate.

One example of where such an approach has been successful is the anti-avoidance rules contained in Part IVA of the Income Tax Assessment Act 1936. The ALRC's principles-based approach to regulating privacy is another example. "The ALRC is of the view that principles have greater flexibility in comparison to rules… Secondly, …principles allow for a greater degree of 'future-proofing' and enable the regime to respond to new issues as they arise without having to create new rules."[20]

Another issue identified by Justice Hayne was the qualitative nature of the information provided to board directors to enable them to fulfil their monitoring and oversight responsibilities, exercising care and diligence as they are obligated to do. "Boards cannot operate properly without having the right information."[21] Justice Hayne specifically noted that the problem was not one of a need to provide directors with more background materials, but rather that directors needed to be given better, more complete information. "The evidence before the Commission showed that too often, boards did not get the right information about emerging non-financial risks; did not do enough to seek further or better information where what they had was clearly deficient; and did not do enough with the information they had to oversee and challenge management's approach."[22] This is a perennial problem, as management often tries to whitewash information and outside directors are often in a position where they don't know what they don't know.

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[19] Final Report, pp. 282-83.

[20] *For Your Information: Australian Privacy Law and Practice* (ALRC Report 108). https://www.alrc.gov.au/publications/4.%20Regulating%20Privacy/alrc%E2%80%99s-preference-principles-based-regulation.

[21] Final Report, p. 396.

[22] Final Report, p. 395.

The recent Volkswagen emissions scandal is a telling case in point. When news of the defeat device became public, one director told the BBC that the board had been kept in the dark about the deception until a short time before.[23] If Hayne's recommendation were applied to the Volkswagen case, relevant information on proposals to implement a defeat device would have been escalated from middle ranking engineering and software development staff to senior executives and on through to the board (without whitewashing), which then could have acted to quash the fraud.

In the banking sector, information about quantitative leader board practices as remuneration incentives surely should have been brought to the board's notice, giving the board the opportunity to anticipate major frauds resulting from those practices and address them accordingly. If the board had full information and then failed in its supervisory duty, such a failure should carry penalties such as imprisonment or massive fines.[24] By the same token, senior executives should bear greater responsibility for keeping the board properly information and where they fail to do so, should be the one to be punished.

Similarly, in his examination of remuneration practices and, in particular, adjustment to the variable remuneration of senior executives based on their risk management practices, Justice Hayne pointed to the Inquiry into the Commonwealth Bank of Australia (CBA) conducted by the Australian Prudential Regulation Authority (APRA) simultaneously with his own inquiry. APRA found that CBA had failed to appropriately adjust executive compensation based on the failure of its executives to effectively address "persistent significant risk issues,"[25] most particularly the non-financial--operational, compliance and conduct--risks.[26] In fact, until the specifics of executive disregard for risk became public, even CBA's Chief Risk Officer was telling the bank's remuneration committee that there was no reason for remuneration clawback. This concerningly implies that it was only the *reputational* risk and not the operational, compliance or conduct risks that were ultimately penalized by clawback. The responses of CBA and other banks with respect to exercising clawbacks of 2018 executive compensation[27] support this perception and, of course, the stance of future boards on compensation and clawback remains to be seen.

Legislating specific clawback options as a penalty for inept governance, including disregard of operational, compliance and conduct risks, could be a significant deterrent in the minds of executives otherwise intent on short-term profit maximization as a means to line their own pockets.

Equally important, however, is the fostering of a more suitable risk culture within an organization. This has to begin at the top, yet there has been resistance among those in

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23. *Volkswagen staff acted criminally, says board member*, BBC News, 29 September 2015. https://www.bbc.com/news/business-34397426.

24 In the Volkswagen case, Volkswagen ultimately paid USD2.3 billion in criminal penalties and another USD1.5 billion in civil penalties. Similar fines were also imposed in Europe.

25 Final Report, pp. 359-360.

26 *APRA releases CBA Prudential Inquiry Final Report and accepts Enforceable Undertaking from CBA*. https://www.apra.gov.au/media-centre/media-releases/apra-releases-cba-prudential-inquiry-final-report-accepts-eu.

27 Final Report, pp. 360-362.

director positions. For example, when APRA tried to introduce a requirement that boards 'ensure that a sound risk management culture is established and maintained throughout the institution', the proposal was opposed by company directors, who felt that non-executive directors, in particular, would be powerless to foster such a culture without overly interfering in management.[28] Justice Hayne's response to that attitude is: "It is plainly not the role of the board to review every piece of correspondence that goes out the door. But it is the role of the board to be aware of significant matters arising within the business, and to set the strategic direction of the business in relation to those matters. When management is…delaying [to act], it is appropriate for the board to intervene and say, 'Enough is enough. Fix this, and fix it now'."[29]

In light of this, any board would be well advised these days to have a risk management sub-committee to which middle management should disclose risky circumstances or developments that the sub-committee then monitors and regularly reports back to the board or even to the annual general shareholders meeting. Such a sub-committee provides a mechanism to ensure that quality information flows upward to the board in keeping with the recommendation of the Hayne Commission. This is not just an exercise in creating a trail of evidence, but rather promotes appropriately informed monitoring and decision making by the board.

Steven Bainbridge in his book, *Corporate Governance After the Financial Crisis*, discusses this very point, namely the relative strengths and weaknesses of non-executive (independent) directors in their role of monitoring management/executives.[30] Bainbridge is not the first to acknowledge that independent directors can be compromised by their personal relationships with executives, which are often the reason for their presence on the board in the first place.[31] Nonetheless, Bainbridge concludes that independent directors can be important to effective governance where they are pro-active to ensure they are sufficiently well informed so as to properly fulfil their monitoring role.[32] This comports with the Hayne Commission's position.

Conclusion

One thing is very clear at this point. The profits and the profit pursuit activities of companies are under scrutiny as never before. Whether we're looking at the financial services sector or other spheres of business, the blind pursuit of profit maximization is no longer an unacceptable way to run a company. As Henry Ford said, "A business that makes nothing but money is a poor kind of business." Responsibility to set appropriately balanced goals for a company and ensure a suitable corporate culture ultimately lies with the company's directors, working closely with its executives.

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28 Final Report, p. 380.
29 Final Report, pp. 399-400.
30 Stephen M. Bainbridge, *Corporate Governance After the Financial Crisis* (Oxford, 2012), pp. 87-90.
31 See, eg, Philip Augar, *The Greed Merchants: How the investment banks played the free market game* (Penguin, 2006), p. 178.
32 Bainbridge, pp. 98-99.

This responsibility necessarily involves creating a sense of purpose for a company, something essential to 21st century corporate governance. BlackRock CEO Larry Fink's 2019 letter to CEOs emphasized the importance of purposeful goals for the modern corporation.[33] His views are consistent with those of Lord Denning in 1969 and Kenneth Mason in 1979 (see above). Fink's comments have been widely well-received, coming as they did from the CEO of one of the largest investment management firms in the world, and are rapidly becoming an influential part of the debate.[34] We can but hope they will not be forgotten over time, as appears to have happened in the cases of Lord Denning and Mason.

We could say that the Hayne Commission's inquiry exposed the fact that management in Australia's financial services sector had lost sight of the purpose on behalf of society that banks perform, namely to create a sense of order in the management of money and the means of orderly distribution of money/funds for the common good. Social good was definitely a goal of Governor Lachlan Macquarie in establishing Australia's first bank, the Bank of New South Wales (now Westpac).[35] As he knew, civilized society cannot exist without a functioning banking system. Bank Australia's current "people before profit" campaign embraces this purpose, showing leadership that other banks, and even other businesses, would do well to adopt. It falls to directors and the corporate governance system to ensure this happens.

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33 *Larry Fink's 2019 Letter To CEOs: Purpose & Profit.* https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

34 "Beyond the bottom line" by Andrew Edgecliffe-Johnson, FT Weekend, 5-6 January 2019, p. 12.

35 "Lachlan Macquarie" <https://www.encyclopedia.com/people/history/australian-new-zealand-and-pacific-islands-history-biographies/lachlan-macquarie>.