

## ORDINARY CORPORATE VICES AND THE FAILURE OF LAW

‘[T]hey did because they could’: Kenneth Hayne<sup>1</sup>

### I INTRODUCTION

This paper had its beginning in an unpublished paper I gave more than 20 years ago. I was looking at the problem of corporate governance and expectation gaps. My particular focus was the difficulty, in the context of corporate governance principles, of legislating in such a way that ethical considerations would become part of the mainstream of corporate decision-making. The examples I used to illustrate the problem were drawn from the behaviour of Australian banks. One can ask, has the world changed at all?

Given the findings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (‘Banking Royal Commission’) exposing the recent, and ongoing, misdeeds of our large banks, it seems an opportune time to re-examine the issue and the question of why such large and prestigious institutions fall so short of community expectations. Is there any way to better align the behaviour of these institutions with community expectations? What can our corporate governance framework do to curb or contain the ease with which corporate actors adopt what is essentially anti-social behaviour? How did we end up where we are?

My principal conclusion is that much of our corporate law historically, and currently, supports ordinary corporate vices, and only discourages bad conduct when it becomes extreme. This failure of law to restrain anti-social behaviour by our major corporate players needs attention. My comments will be brief, lacking any detailed description of specific case histories. However, there is no shortage of examples to be found in the Final Report of the Banking Royal Commission. The ‘fees for no service’<sup>2</sup> scandal comes easily to mind. That scandal is already costing hundreds of millions of dollars in remediation of fees wrongly paid to the major banks.

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<sup>1</sup> Observation of Commissioner Kenneth Hayne in the Introduction to his Final Report on the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Final Report, February 2019) vol 1, 2 (‘*Banking Royal Commission Final Report*’).

<sup>2</sup> Ibid 136.

The paper is divided into three parts: (1) a description of ordinary corporate vices; (2) a few observations on corporate theory and why these vices sit easily within the framework of corporate legal principles; and (3) a few suggested legal reforms to corporate governance principles that could help reset the starting point for a change in corporate behaviour.

In this discussion I am using the term ‘corporate governance’ rather than ‘corporate law’ because it connotes the overall approach to the enterprise’s activity and decision-making framework, rather than the narrower and somewhat unfortunate ‘race to the bottom’ suggestion of minimal compliance and legal prescription that ‘corporate law’ describes. It is true that ‘corporate governance’ is a vague term. But it derives much of its charm from that vagueness. For the purposes of this paper I would describe ‘corporate governance’ as those principles which determine the structure and standards applied to corporate decision-making activity. In particular, I am concerned with how to better incorporate ethical and social considerations regarding conduct into principles of corporate governance. I hope to avoid the cynical view that ‘corporate ethics’ are to ethics what ‘corporate culture’ is to culture.<sup>3</sup>

My purpose in focusing on vices (rather than virtues) is an attempt to identify and reframe my questions in order to understand more precisely what it is that leads to negative corporate behaviour. That may put us in a better position to define what we mean when we talk about ethics in a corporate context. For example, greed may not be good but is it illegal? And, if it is illegal, when? People may expect better behaviour from their corporations, but do they have a right to it? What does it mean to say something is bad, or unfair, (as a matter of ethical judgment) as opposed to what it means to say something is unlawful (as a matter of legal judgment)? Have we drawn the lines correctly? Serious wrongdoing will always be unjust and almost always illegal. But to what extent should the law try to control behaviour just below the legal bar? Who should bear the responsibility for the ethical stance of a corporation and how should that responsibility be articulated?

### A *Corporate Ethics*

In discussing ‘corporate ethics’, I will concentrate on vices commonly identified with corporations or corporate culture rather than vices identified with particular individuals such as managers and other employees (although agency law may have something to say there). This permits me to narrow my consideration from business ethics generally to ‘corporate ethics’ in particular, if, indeed, that can be done.

There are serious theoretical problems with the path I am taking. For one thing, corporations may be legal persons but they are not generally considered to be moral agents. Popes have excommunicated corporations and kings have charged them with treason. But we are all familiar with the observation that a corporation has ‘no soul

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<sup>3</sup> See Richard M Buxbaum, ‘Responsibilities of Transnational Corporations to Host Nations’ in Lye Lin Heng et al (eds), *Current Legal Issues in the Internationalisation of Business Enterprises* (Butterworths, 1996) 48, 49.

to damn', and 'no body to kick'. How can something which isn't a moral agent have ethics of any kind? Yet, we know that despite this theoretical objection, empirical studies have suggested again and again that individuals do act differently within a corporation than they do 'on their own'. And, that difference is not always for the better.

## II ORDINARY CORPORATE VICES

What I am calling ordinary corporate vice includes conduct that is considered normal but which we all agree is bad, or at least sub-standard, even though it may or may not be so bad as to be illegal. This includes conduct which strikes one as unethical, anti-social or both. I am going to use an example from 1995, which is when I was first considering this problem. It is something of a prototype or precursor to the recent fees for no service example investigated by the Banking Royal Commission during the past year, although the dollars involved were much less. It is also an example of how long the fees problem has been around.

In January 1995, Westpac publicly apologised to 9,000 customers used in a secret trial of banking fees. Certain customers were told in October 1994 that they would be charged \$5 per month for accounts with less than \$1,500. The customers were *not* told that this was a test to see if 'low account customers' would accept higher fees (the fee was three times the normal fee). Nor were they told that the test was only being conducted on customers in the Newcastle and Hunter Valley regions of New South Wales. In other words the bank did not lie but it did not 'tell all'.

When the test came to light there was a public outcry. Westpac defended the test but also engaged in 'damage control'. It apologised to the customers; stated that it would refund the excess fees charged; and promised it would give those customers a full year free of fees on their savings accounts. The last gesture was reported to involve a projected cost to the bank of more than \$400,000 in foregone income.

What was wrong with what Westpac did? It was clearly unfair to treat different customers differently. But banks do that all the time. The Bank defended their actions by saying that it had to recover costs associated with low balance accounts. After all, corporations are supposed to make a profit. But only the fee is relevant to profit, not the non-disclosure of the marketing trial. Other reactions to what the Bank had done were not so kind. Interestingly they characterised what the Bank did in different ways, but all of them bad. National Australia Bank, for example, said it would never attempt a secret trial because that sort of thing would not suit their values or style of management. In sum, support for the Westpac fee trial was thin on the ground, although one newspaper columnist pointed out that banks do not have to be universally loved.

If one sorts out reactions to how the Bank action was described, a list of typical corporate bad behaviour results:

- (a) deception (lying, hypocrisy, dishonesty, non-disclosure, misleading statements or conduct, obfuscation, manipulation);

- (b) greed (usury, intemperance, overreaching, meanness);
- (c) abuse of power (arrogance, misuse of power, misuse of information, manipulation, intimidation, domination, oppression);
- (d) disloyalty (conflicts of interest, untrustworthiness, taking advantage, cheating, betrayal);
- (e) lack of diligence (laziness, apathy, negligence, inefficiency);
- (f) recklessness (carelessness, rashness, inattentiveness, negligence); and
- (g) poor citizenship (social irresponsibility, discrimination, disrespect, wastefulness).

*A Deception (Lying, Hypocrisy, Dishonesty, Non-Disclosure, Misleading Statements or Conduct, Obfuscation, Manipulation)*

Deception would get my vote for the vice that people associate most with corporations. Not deception on a grand scale — although that does happen — but more commonly deception on a minor but all-pervasive scale. Corporations are thought to lie about everything from how good their products are to how great their profits are, or whether indeed they are making a profit. Deception includes misleading statements and misleading conduct as well as failure to disclose relevant information.

Take the Westpac example: it is clear that many who commented on the situation thought the bank was not only lying about the trial but also the need to recover costs associated with low balance accounts. This is not surprising. At the Westpac Annual General Meeting, where the Chairman of Westpac claimed the fee trial was ethical, the bank also outlined a plan to double Westpac's profit thereby joining an elite club of Australian publicly-listed companies earning a net profit of \$1 billion or more. How is the low account holder complaining about a \$5 fee expected to reconcile those two statements? A similar divergence between what was being said and what was being done appears in the Report of the Banking Royal Commission, although this time involving National Australia Bank and causing the Commissioner to question the credibility of two of NAB's top executives.<sup>4</sup> Is there any way the law can or should deal with this problem?

Of all the vices I have considered I would say the law tries the hardest when it comes to deception. There are all kinds of regulations in the *Corporations Act 2001* (Cth) and in other statutes about what a corporation can say and when it can say it. But the regulation of low-level lying, mild misrepresentation or silence, overly enthusiastic marketing and chronic optimism often proves too difficult. For example, one can be lied to because the right question is asked of the wrong person at the wrong time. Furthermore, it is difficult to trace the threads of responsibility in many corporate

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<sup>4</sup> *Banking Royal Commission Final Report* (n 1) 411.

situations. In the Westpac example, we do not know who actually authorised the trial of higher fees.

### B *Greed (Usury, Intemperance, Overreaching, Meanness)*

Greed deserves equal prominence with deception as a major corporate vice. My impression is that most people think of corporations as both greedy and mean at the same time, a view attributable to the fact that one person's gain is usually another's loss. When a corporation fails it is often said that greed has been the root problem. But such situations generally involve personal greed amounting to fraud and that kind of greed is illegal. What is more difficult is ordinary corporate greed that is often described by the corporation as pursuit of the profit objective. In the Westpac fee trial, the bank's defence is an example of that kind of unfair treatment and low-level meanness dressed up as pursuit of profit. With fees, for example, the relationship of a fee to the actual cost of providing a service is often an accounting sleight of hand, or simply what the market will bear.

In many ways corporate law supports greed. Greed is merely the extreme of a fundamental building block of capitalism: the profit incentive. What is often referred to as the economic objective of the corporation. It is difficult to encourage the production of wealth while discouraging the accumulation of it. The classic formulations of directors' duties would support the Westpac profit plan despite new fees, branch closures, and the other restructuring and rationalisations that resulted.

### C *Abuse of Power (Arrogance, Misuse of Power, Manipulation, Intimidation, Domination, Oppression)*

Abuse or misuse of power is a frequent complaint about corporations. A corporation can have an unfair advantage over an ordinary person. It is often both big and anonymous. It will usually have more money and more resources. And, the conclusion is often as the Banking Royal Commission Report opined: 'entities and individuals acted in the ways they did because they could'.<sup>5</sup> This is especially true in the area of fees. Fees, often hefty, are charged for everything in this era of 'user pays' and they may not have any relationship to the actual cost of the service. Also, while it is usually easy to see which individuals or groups are being dominated, the question of who within the corporation is responsible for the misuse of power is not so easy. Have you ever tried to complain to a large corporation about something? It is a kind of exquisite torture. And, if you think a fee is excessive, there really isn't anything you can do about it.

### D *Disloyalty (Conflicts of Interest, Self-Indulgence, Untrustworthiness, Taking Advantage, Cheating, Betrayal)*

Corporations are generally seen as being loyal only to their own enterprise. The basic rules on conflicts of interest are ignored or buried under and between layers

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<sup>5</sup> *Banking Royal Commission Final Report* (n 1) 2.

of corporate activity. Loyalty is expected of employees but loyalty to employees is not part of the dialogue. When corporations do talk of loyalty it is loyalty to the corporate objective. Such loyalty is promoted by the corporations law. But it can be overdone. The need for whistle-blower legislation is itself a result of too much blind loyalty. And, what about loyalties beyond the corporation? For example, in the Westpac situation, loyalty to the customer was an issue in the complaints by those outside the bank. However, I should point out that despite community expectations, loyalty to customers or employees is not supported by corporate law except when it is aligned with the best interests of the corporation or because the corporation is acting as a fiduciary. 'Wider community responsibilities' as such have never been part of Australian corporate law. And the concept of loyalty has been relegated to a description of programmes that award free air flights or free cups of coffee.

E *Lack of Diligence (Laziness, Apathy, Negligence, Inefficiency)*

Corporations are often thought to be complacent, lazy and very, very slow when it suits them. The debate about bank fees can be characterised as a debate about the nature of the banking business. Are banks supposed to earn a profit by efficiently managing your money as opposed to simply charging fees? Lack of diligence is an easy vice to understand in terms of corporations because of the collective nature of the corporation. And the size and bureaucracy of large corporations are often cited in defence of slowness to act and other inefficiencies. If several individuals are responsible for a given task, they will feel personally less responsible than they would if they were the only one responsible or if they were one of two responsible. The vicious tendency of members of a large entity is to let someone else do it, or at least to hope someone else will do it. The examples of slowness in fixing mistakes and repaying improper fees and charges that came to light in the course of the Banking Royal Commission are examples of how this vice compounds others. The banks have never been quick to refund improper charges or fees. Perhaps the banks should be asked to make such reimbursements with interest at their current credit card rate.

F *Recklessness (Carelessness, Rashness, Inattentiveness, Negligence)*

Recklessness can be an aspect of laziness, but not always. Sometimes it appears as an extreme manifestation of competition and pursuit of profit. Trevor Sykes, in his book on Australian corporate collapses of the 1980s, singles out the banking community as one of the watchdogs that did not bark.<sup>6</sup> He details how enormous deals were done with amazing speed. This tendency to rush deals through without proper risk assessments has been an aspect of many deals investigated by the Banking Royal Commission. Recklessness and an illegal lack of due care are not necessarily the same, but as a matter of corporate practice one often bleeds into the other. Again, one has to recognise that competition and pursuit of profit are both supported and encouraged by our corporate law system.

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<sup>6</sup> Trevor Sykes, *The Bold Riders: Behind Australia's Corporate Collapses* (Allen & Unwin, 1<sup>st</sup> ed, 1995) 2–6.

G *Poor Citizenship (Social Irresponsibility, Discrimination, Disrespect, Wastefulness)*

Corporations are routinely charged with being poor citizens. More often than not, the complaint will have something to do with perceived social irresponsibility or discrimination. Corporations pollute; they make dangerous or shoddy products; they try to influence public debate and political action; they unfairly discriminate; they are wasteful; and they only consider short-term results.<sup>7</sup> Of course, individuals do these things as well. And, there are some laws that prohibit particular instances of poor citizenship, like polluting, whether the polluter is a person or corporation. But, there are no laws requiring anyone to exercise his or her citizenship in a particular way. There is, however, a difference between an individual and a corporation because of the corporation's greater ability to do public harm, and its ability to dominate in the political arena. It is also the case that a corporation holds a franchise from the public and should therefore have enhanced accountability to the public due to its quasi-public persona.

### III PROBLEMS WITH CORPORATE THEORY

In a famous article about law reviews written in 1936, Fred Rodell wrote that there are two problems with almost all legal writing: one is its form, the other is its content.<sup>8</sup> 'That', he continued, 'about covers the ground'. While his observation is not true of *this* law review, the same observation *can* be made about corporate theory. There are two problems. One problem is the corporate form and the other is regulatory content; and again, that about sums it up.

#### A *The Corporate Form*

While the corporation is deemed to be a legal person, it is not a natural person, it is in fact a collective. This means that you have a fictitious person that has no moral agency to whom we wish to ascribe responsibility and blame for vices that are collective vices. The collective nature of the entity and the collective nature of the vices make ordinary ethical analysis problematic. Ethical analysis usually requires the examination of motive and intention. This is difficult when many people are involved. It is also the case that in corporations there are various levels of actors — from the corporate entity itself to official organs or offices to individual moral actors (real people). And outside the corporation there can be any number of related parties and intermediaries, many of whom will be other corporations or corporate groups.

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<sup>7</sup> See, eg, Suzanne Corcoran, 'The Corporation as Citizen and as Government: Social Responsibility and Corporate Morality' (1997) 2 *Flinders Journal of Law Reform* 53; Helen Anderson and Wayne Gumley, 'Corporate Social Responsibility: Legislative Options for Protecting Employees and the Environment' (2008) 29(1) *Adelaide Law Review* 29 for an analysis of corporate irresponsibility in respect of employees and the environment.

<sup>8</sup> Fred Rodell, 'Goodbye to Law Reviews' (1936) 23(1) *Virginia Law Review* 38, 38.

Whose intention in such cases is the operative intention and operative responsibility? One is left looking for a directing mind or principal decision-maker or some other construct to which one can attribute intention. This is not as easy as it may seem. Yet, without intention it is hard to ascribe moral culpability (or criminal *mens rea* for that matter). Think of how many times during the Banking Royal Commission you heard the phrases, ‘I don’t know’, ‘I don’t remember’, ‘I don’t know the details’, that ‘wasn’t my area of responsibility’ or ‘someone else was in charge of that service’. We have to find better ways of dealing with the problem of corporate intent.

A further problem with the corporation as a legal person is that the corporate entity has never been viewed as having any citizenship or social responsibility beyond obeying the law. This is despite the fact that all corporations have a franchise and privilege from the state to act as legal persons and to enjoy the benefits of legal personhood. Also, to the extent that corporations themselves wish to contribute to the community, there is an inbuilt tension with their legal objective to maximise profit for their shareholders.

Lastly, in corporate theory it is the shareholders who are the gatekeepers. They are ultimately responsible for the good governance of the corporation. And, indeed, as the owners, they have the most to lose when things go very wrong. But, as we all know, in the modern large corporation they are often the *last* to know about corporate misbehaviour. This is particularly true with the widespread use of intermediaries (agents, brokers, contractors etc) to perform every day corporate activities.

### B *Corporate Law Content*

We need to refocus the content of the corporations law. It is surprising that ordinary corporate vice and anti-social behaviour are often supported to some extent by the law. Of the seven vices I mentioned, deception, greed, disloyalty and poor citizenship are all at least indirectly supported by traditional concepts of corporate law theory such as the profit objective. Even if you disagree that the law tacitly supports ordinary vices, you would have to admit that in many areas, such as good citizenship, the law gives no support for what is generally perceived as positive social behaviour. We need to take steps to rebalance the moral imperatives of our corporate law.

We also need to simplify and clarify our law. It is much too long. This has been tried before but must be revisited. A law that is less complex is also easier to enforce. One of the recommendations of the Banking Royal Commission is to simplify the law governing financial services so that its intent is met.<sup>9</sup> It is the case that the entire corporations law also needs simplification so that the law’s unifying and informing principles are more readily recognisable. As it is, one cannot see the forest for the trees.

Flexibility has also been damaged by the exhaustingly proscriptive content of the corporations law. Much of the corporations law can be described as reactive legislation.

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<sup>9</sup> *Banking Royal Commission Final Report* (n 1) pt 1.4.1.



That is, regulation created to deal with a particular problem. Reactive legislation is the reason Australia has a corporations law running to more than 1,500 sections, many with multiple sub-sections. This kind of regulation is typically not flexible enough to deal with changing corporate practice. This magic pudding of legal provisions makes the law both impenetrable and rigid. That is not an optimal combination. We can do better.

#### IV REVISING CORPORATE JURISPRUDENCE

With the above observations in mind, what can we say about the reframing of corporate governance principles? What can we do in terms of improving corporate behaviour and closing expectation gaps? How can we draft standards that are clear, flexible and promote positive behaviour?

First, we have to look closely at those legal principles that have been most successful in dealing with a wide range of behaviour — the heavy lifters of corporate law. I have in mind provisions like the duty to act honestly, diligently and carefully,<sup>10</sup> and the prohibition against oppression and unfair conduct.<sup>11</sup> These provisions contain statements of principle, not detail. These concepts and others such as materiality, relevance and reasonableness have traditional legal meanings but they also have flexibility both in terms of adaptation to particular circumstances and in terms of development over time. The Banking Royal Commission has focused on acting ‘efficiently, honestly and fairly’<sup>12</sup> in the provision of financial services as the most relevant to the bad practices it uncovered in the financial services industry. This provision applies to those with a license to provide financial services and was amended in March 2019 to add substantial civil penalties for its breach.<sup>13</sup>

We should move beyond only financial services and articulate a general duty of good faith and fair dealing that requires *all corporations* to act fairly in their decision-making and in dealings with others. This principle would include dealing in good faith, full disclosure and consideration of the position of the other party. And, it would apply in *all* circumstances to *all* corporations. Substantial civil penalties would be triggered by non-compliance. We are already part way there with some of the provisions in our consumer law.

Secondly, we should make more use of presumptions and shifting burdens of proof where elements of intention are concerned and where conduct is open to a variety of interpretations. Presumptions promote flexibility while permitting the introduction of evidence to defeat the presumption. Presumptions can be used to establish

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<sup>10</sup> *Corporations Act 2001* (Cth) ss 180, 184.

<sup>11</sup> *Ibid* s 232.

<sup>12</sup> *Ibid* s 912A(1)(a). See also *ASIC v Avestra Asset Management Ltd* (2017) 348 ALR 525, 561 [191] (Beach J) for an exposition of the meaning of this phrase.

<sup>13</sup> *Ibid* s 912(5A), as inserted by *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (Cth) s 76.

a framework for the attribution of responsibility and intention within a corporation. Agency law can also be relevant given the multiple levels of corporate responsibility and where corporations make use of intermediaries from outside the corporation.

Finally, our statutes should articulate some form of social objective as a limitation on the economic objective of the business corporation. The best model that currently exists of which I am aware is that in the American Law Institute's *Principles of Corporate Governance*<sup>14</sup> and a consideration of that provision would be a good place to start.

Section 2.01(a) of the ALI *Principles of Corporate Governance* sets forth the economic objective of the corporation, which is the conduct of business activities with a view to enhancing corporate profit and shareholder gain. That economic objective is then qualified by s 2.01(b). It provides that even if corporate profit and shareholder gain are not thereby enhanced, a corporation in the conduct of its business

- (1) is obliged, to the same extent as a natural person, to act within the boundaries set by law;
- (2) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
- (3) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

The official comments to the section state that it is meant to reflect a recognition that the corporation is a social as well as an economic institution, and accordingly that its pursuit of the economic objective must be constrained by social imperatives and may be qualified by social needs.

The Interim Report and Final Report of the Banking Royal Commission have focused only on misconduct in the provision of financial services. But, they have given us a clear idea of the scope and depth of the misconduct by large corporations. The analysis of corporate wrongdoing in those reports is an excellent place to start the reform discussion. The *Final Report* has also given us principles (pt 1.1.5.1) and norms of conduct (pt 1.1.5.2) that the financial services industry should follow, as well as an extended discussion of the 'pursuit of profit' (pt 6.3.2.1). We need to extend our reconsideration of those principles and norms to corporate theory generally. Like it or not, our social and financial interactions will continue to be mediated through corporations. What is at issue here are fundamental jurisprudential ideas about the role of the corporation in modern society. That is, whether corporations can be said to have any positive obligations of citizenship and who should answer for corporate misbehaviour.

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<sup>14</sup> American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (American Law Institute Publishers, rev ed, 2008).