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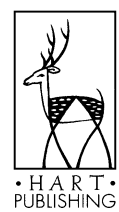

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Contributions for consideration for publication in the next volume of International Corporate Law Annual are invited.

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- international or comparative aspects of corporate law;
- theoretical or jurisprudential perspectives on corporate law;
- domestic or regional issues in corporate law which would be of interest to an international readership.

Contributions for Part II should be between 1,000 and 3,000 words including footnotes and should relate to recent developments in corporate law in one or more jurisdictions or regions.

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PART I

1

Globalisation of Corporate Regulation and Corporate Citizenship[1]

JOHN BRAITHWAITE and PETER DRAHOS

INTRODUCTION

Corporations and securities are institutions that were unknown on most of the planet until the nineteenth century. Today these institutions are ubiquitous and influential everywhere on earth. They are creations of law, abstract objects quite different from physical objects like ships and food. Ships and food became global phenomena before maritime law and food law. In contrast, it is the globalisation of companies and securities law that is constitutive of the corporatisation and securitisation of the world.

Corporations, we will see, existed for more than a millennium before securities. For our purposes, a security is a transferable instrument evidencing ownership or creditorship, such as a stock or bond.[2] The legal invention of the security in the seventeenth century was the most transformative moment in the history of corporations. It enabled the replacement of family firms with very large corporations based on pooled contributions of capital from thousands of shareholders and bondholders. These in turn enabled the great technological projects of eighteenth and nineteenth century capitalism – the railroads, the canals, the mines.

When it was first invented, however, the historical importance of the security had nothing to do with the corporatisation of the world. Rather, it transformed state finances through bonds that created long-term national debts. Today as well, some of the most important securitisation involves a transformation of banking and finance that does not involve the creation of new corporations. An example is mortgage-backed securities – securities backed by bundles of loans on real estate issued by banks. These securities may not create or be issued by corporations (as when they are issued by a government home loan insurance organisation). Other forms of securitisation, such as the privatisation of frac-

[1] This is a revised version of J Braithwaite and P Drahos, *Global Business Regulation* (Cambridge, Cambridge University Press, 2000), ch 9. It was first published in (1999) 3 *Flinders Journal of Law Reform*.

[2] There are in jurisdictions around the world more formed, legally technical definitions. For a discussion, see E Sykes, *The Law of Securities* (Sydney, LawBook Co, 4th ed, 1986), 12–13.

tions of the state by selling them to shareholders, continue to accelerate the corporatisation of the world. Securitisation has therefore been a great historical force in its own right as well as the major cause of an even greater historical force – corporatisation.

While the idea of dividing the national debt into bonds was invented in Naples in the seventeenth century, it was England that managed by the eighteenth century to use the idea in a financial revolution that helped it gain an upper hand over its principal rival, France.[3] England seized full national control of public finance: formerly private tax and customs collecting were nationalised in the seventeenth century, a Treasury Board was established in the eighteenth century, and finally the Bank of England was nationalised. The Treasury Board realised that the national debt could be made in effect self-liquidating and long term, protecting the realm from extortionate interest rates at times of war and the kind of vulnerability that had brought the Spanish empire down when short-term loans had to be fully repaid after protracted war. Instead of making England hostage to a Continental banker, the national debt was divided into thousands of bonds, with new bond issues placed on the market to pay for old bonds that were due to be paid.

> The long-term debt converted itself almost spontaneously into a perpetual debt. From now on, it did not have to be repaid by the state which, by converting its floating debt into a consolidated debt, did not have to exhaust its credit or cash reserves. As for the subscriber, he could now transfer his title to a third party – this was allowed after 1692 – and thus recover his initial payment at any time. This was a miracle: the state never repaid the loan, but the lender could recover his money whenever he wanted it.[4]

Securitisation paid for the warships that allowed Britannia to rule the waves, to trade and colonise, a good investment for British bondholders and its state and a transformative one.

GLOBALISING REGULATORY INNOVATION ENABLES GLOBALISING OF THE CORPORATE FORM

A transformation of even greater importance has been the rise of the corporation. Its sweep has been utterly global; there is no nation where corporations are not dominant in economic and social life. The largest transnational corporations have incomes higher than the Gross Domestic Products (GDPs) of the majority of the world's states. In fact, for the first time in the mid-1990s, the majority of the 100 largest "economies" in the world were corporations.[5]

[3] PGM Dickson, *The Financial Revolution in England: A Study of the Development of Public Credit, 1688–1756* (Aldershot, Gregg Revivals, 1993).

[4] F Braudel, *The Wheels of Commerce: Civilization and Capitalism in the 15th-18th Century*, Vol 2 (trans S Reynolds, London, Collins, 1982), 526–7.

[5] S Anderson and J Cavanagh, *The Top 200: The Rise of Global Corporate Power* (1996).

Yet in the United States, where incorporation rose earlier and more vigorously than elsewhere, there had been only 335 incorporations by 1800.[6] Today, in contrast, when important things are done in the world, whether for good or ill, they are more likely to be the actions of corporations than of individuals. Ronald Burt[7] has shown that during the century from the 1870s to the 1970s the percentage of front page space in *The New York Times* devoted to individual persons fell continuously and the proportion devoted to corporate actors rose continuously. By the end of World War II three times as much of the front page was devoted to corporate actors compared to persons. In the middle of the nineteenth century, fewer than 20 per cent of participants in New York State Court of Appeals cases were corporations; in 1923 for the first time the number of corporate participants exceeded the number of individuals.[8]

Two inventions of northern Italian merchants were primarily responsible for the initial rise of the business corporation. One was double-entry bookkeeping developed in Italy during the fifteenth century (which in turn had been enabled by the replacement of the Roman with the Arabic number system). Double-entry bookkeeping enabled the creation of the business as a financial entity, a fund separate from the affairs of the merchants who invested in it, yet linked to them through entries of debits and credits. The metaphysics of the firm as an independent financial entity was complemented by the Italian lawyers' metaphysical invention of the corporation as a *persona ficta*. The corporation was given a legal personality distinct from that of its members, yet linked to them through rights and duties.

These are the features that define what a corporation is. It is a group of individuals who create a financial entity separate from their personal finances that is granted a legal identity by the state as a corporate person. By definition, regulation therefore creates corporations (as well as shapes their form) because state law is necessary for the authoritative designation of a group of individuals as a corporate person. Once that recognition had been granted, the corporation could own land, enter into contracts, sue and be sued and ultimately be held criminally responsible as a corporation.

The need to accommodate such a legal personality to collective entities predates the rise of the business corporation. In the middle ages, the most important corporations were the ecclesiastical owners of land and accumulators of wealth in perpetuity, municipal corporations responsible for the governance of the emerging towns and cities, universities, schools, charitable hospitals, and most importantly guilds. The Canon Law of the Roman Catholic Church performed for Europe the service of preserving principles of Roman Law that allowed monasteries and cathedral chapters to own land and otherwise act

[6] JP Davis, *Corporations: A Study of the Origin and Development of Great Business Combinations and their Relation to the Authority of the State* (New York and London, GP Putnam's Sons, 1905), vii.

[7] Ronald Burt, cited in JS Coleman, *The Asymmetric Society* (1982), 12.

[8] N Grossman, cited in Coleman, *supra* n.7, at 11.

legally as corporate persons. Canon law made its own contributions to Anglo-American company law which were at odds with the Roman tradition, such as the Christian notion of "the legal absorption of the group in its headship".[9] It was the canonists of the thirteenth century, not the earlier Roman lawyers or the later English lawyers, who delivered us the idea of the corporation as a *persona ficta*.

THE GLOBALISATION AND DECLINE OF GUILDS

Medieval guilds had many purposes including "the preservation of the peace, the promotion of social fellowship, the performance of religious worship or some other phase of social activity of common interest to its members".[10] They were the corporate organisers of entertainment such as plays, pageants and fairs in medieval towns. They funded and ran almshouses, schools and hospitals. The most consequential guilds, however, were the merchant and craft guilds, some restricted to merchants as employers, some to craftsmen who were employees. Many guilds incorporated both merchants and journeymen. Some merchant guilds effectively governed and organised the military defence of medieval cities. Many accumulated economic power because the king granted them a monopoly in a certain sphere of commerce. The grant of such monopolies made guilds the .principal business regulators in the middle ages, (of ethics, price, interest rates, professional qualifications, weights and measures and other trade standards). Guilds were much more significant regulators than states.

In the end nation states crushed the guilds for precisely this reason. States acquired sufficient control over their territories progressively to take over regulatory responsibility from guilds. In doing so they were able to bestow political favours on those who wished to compete against the old guild monopolies, disperse threatening accumulations of economic and political power, and increase national wealth by enabling the greater efficiency of freer commerce.

We do not know whether the European guilds of the middle ages were modelled (through the Levant and Rome) on the guilds of ancient India. Indian guilds have been traced as far back as 800 BC, though they became firmly established only around the third century BC.[11] Even if they did, we cannot trace a line from ancient Indian to medieval European guilds to the nineteenth century business corporation because by the seventeenth century the guilds had been destroyed as centres of economic power almost everywhere. The modern corporation was given birth from a different corporate lineage.

[9] Davis, *supra* n.6, at 238.

[10] *Ibid*., at 148.

[11] RS Rungta, *The Rise of Business Corporations in India 1851–1900* (Cambridge, Cambridge University Press, 1970), 272.

THE *COMMENDA* AND THE GLOBALISATION OF LIMITED LIABILITY

Between the fifteenth and eighteenth century the biggest fortunes were accumulated not by merchants who made things but by those who traded them. They were especially made by Genoan, Venetian and Florentine traders and by diasporas of Jews and Armenians. Their success was based on ethnic communication networks across long distances. Trusted informants of the same ethnicity living in different trading centres across the globe wrote to one another with information on prices for different commodities. Their surviving letters record where surpluses and shortages were emerging. Superior market intelligence acquired through such networks allowed them to dispatch ships to buy in the ports where prices were low and then sail to the ports where they could be sold at the highest prices. The profits were fantastic precisely because so few were well organised into trusted communication networks.[12]

But there were also great risks of ships sinking, piracy, erroneous or dated market intelligence, or predatory pricing by a competitor acting with intent to crush your monopoly on a particular trading circuit. So Italian investors were more likely to survive if they spread their risks from ownership of one ship to being the part owner of many. The institution that spread to solve this problem was the *commenda*. Under the *commenda*, the organisers of a voyage would collect funds from a number of investors. The liability of those investors would be limited to the funds they invested, whereas the liability of the promoter would be unlimited. Hence if catastrophe ensued on the voyage, the principal of the *commenda* could be bankrupted to pay debts, while the other investors could not be called upon for more than the amount they put in.

Risk spreading through limited liability for investors was not the only appeal of the *commenda*. It was also a way around the laws of usury for investors with spare cash who did not want to run a business themselves. Instead of illegally lending money for interest, the rich man could reap a legal capital gain in a *commenda*. This was also an appeal of the *commenda* to its original inventors in the Islamic world ("the Prophet himself and his wife who was a rich widow had set up a *commenda*").[13] Whether copied from the Arabs or reinvented, the Italian traders spread the institution from city to city in Europe, variations modified by local traditions being evident across the Hanseatic ports by the fourteenth century. A Florentine statute of 1408 codified the conditions of public responsibility attached to a *commenda*: "capitalists were freed of all liability beyond their contributions, while the management contracted in their own names and were responsible for the debts of the business".[14] So-called *commandite* or limited partnerships, where directors had unlimited liability and

[12] Braudel, *supra* n.4, at 400.

[13] *Ibid*., at 556.

[14] CA Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester, Manchester University Press, 1950), 46.

investors limited liability, slowly replaced family firms throughout Europe, though not in England. *Commandite* organisations were the dominant style of firm in France in the nineteenth century until it acquired a modern law for the free incorporation of limited liability companies in 1867.[15]

JOINT -STOCK COMPANIES COLONISE THE WESTERN AND SOUTHERN HEMISPHERES

England was a laggard in all these developments. It was late to convert from Roman to Arabic numerals for recording of business transactions, late to adopt double-entry bookkeeping, and clung to the partnership form of business organisation in preference to the *commenda*.[16] However, England did charter (along with the Dutch) the most significant joint-stock companies of the early modem era. The trouble with the *commenda* and partnerships alike was that they collapsed or had to be reorganised on the death of the principals. Joint-stock companies created a permanent fund from shares in the stock of the company invested by capitalists managed by a select body drawn from the members ("a board of directors"). When members died their shares could be sold to a new member. The crucial contribution of the joint-stock company to the development of the corporate form was perpetuity: a corporation that "marches on in its elephantine way almost indifferent to its succession of riders".[17]

Some of the most important joint-stock companies started out as regulated companies – corporate charters for particular international trading activities granted to a number of specified individuals by the kings of north-west European states. These developments begin with the Muscovy Company (chartered in 1555 for trade into Russia), the Levant Company (chartered in 1581 as a regulated company and re-chartered as a joint-stock company in 1605) and the Morocco Company (1588). The most important joint-stock company – the East India Company – seems to have been an off-shoot of the Levant Company. By 1617 the Company's 954 shareholders owned thirty six vessels among other assets.[18]

Corporations like the East India Company, the Hudson's Bay Company, the Massachusetts Bay Company, the African Company and the British South Africa Company, were given charters which made them prime agents of colonial expansion for the British Empire. They were given the power to govern colonies, to make laws for them (consistent with the laws of England), tax locals and to wage war within the territories where they held sway. Significant as it was as a commercial trader, the British East India Company was more significant as the

[15] CE Freedeman, *The Triumph of Corporate Capitalism in France 1867–1914* (Rochester, University of Rochester Press, 1993), 2–5.

[16] Cooke, *supra* n.14.

[17] K Boulding, *The Organizational Revolution* (New York, Harper, 1953), 139.

[18] Davis, *supra* n.6, at 119.

private government of the Indian sub-continent in the eighteenth century. The Virginia Company was quite insignificant and short-lived commercially, but it did settle the first English colony in America, and wrote a constitution for Virginia that provided for the first representative legislature in America.[19] It was private corporate governance that first tilled the soil of democracy in Virginia that later grew a Jefferson and a Madison.

Similarly the Massachusetts Bay Company developed a democratic constitution of Massachusetts with checks and balances and a separation of legislative and judicial powers, which along with that of Virginia, became a model for other colonies aspiring to governance by elected representatives constrained by a rule of law. "The constitution of the colonial trading company was therefore perpetuated to a large extent in the State and Federal constitutions of the United States".[20] In America, governmental institutions "largely derived from corporations"[21] had a democratic vitality that was lacking elsewhere because they took root in soil clear of feudal institutions.

There is not only an historical discontinuity between the guild, monastery or municipality as corporations and the joint stock company, there is also a sharp conceptual divide between the corporation as a division of society and the corporation as an association of individuals. Corporations "were now enlarged individuals, not reduced societies".[22] But the growth into the modern liberal corporate form was far from continuous. By 1688 there were still only sixteen joint stock companies in England, but by 1695 there were 140.[23]

The English, French and Dutch stock markets crashed massively around 1720 at the end of an extraordinarily unrealistic bull market. The Board of the South Sea Company in England had been responsible for scandalous stock manipulation. It was a company established to trade African slaves to Spanish America touted as a company that would do for the (vaguely defined) South Seas what the East India Company had done in Asia. The hope was that with the peace following the War of the Spanish Succession, the company might get direct access to the Spanish colonies. So great was the outrage in Britain when the bubble burst (and the losses by members of parliament themselves, many of whom had been bribed with shares on favourable terms) that the South Sea Bubble Act 1720 put in place an out-and-out prohibition on the formation of new joint stock companies. In 1711 unfunded national debt had been compulsorily converted into shares of the South Sea Company. English thinking from 1720 was convinced that it was better to rely on business development through partnerships where the partners took a personal interest in the business. But shareholder capitalism was too resilient to be legislated out of existence. A prin-

[19] *Ibid*., at 168.
[20] *Ibid*., at 201.
[21] *Ibid*., at 205.
[22] *Ibid*., at 246–7.
[23] EV Morgan and WA Thomas, *The Stock Exchange: Its History and Functions* (London, Elek, 1962), 16–17.

cipal method of circumventing the spirit of the Bubble Act was for property to be held in a trust for an unincorporated group of investors. A body of trustees acting under a trust deed thus became a functional equivalent to the board of directors of a group of shareholders.

LIBERALISATION OF INCORPORATION AND THE GLOBALISATION OF THE INSTITUTION OF THE STOCK EXCHANGE

In the nineteenth century the policy of the Bubble Act was reversed as it became clear that progressively more liberal corporations law was needed to enable the grand capital raising required for building railways and ships, for mining and large-scale industrial enterprises. The view developed that banks should also be creatures of limited liability so as to encourage deposits. By 1870 most Western nations had adopted laws permitting free incorporation (without need for government authorisation of the purposes of the corporation) with limited liability. Even developing economies such as India had liberalised by 1870 and the Bombay share market was formally organised in 1875.[24] Liberalisation of the law had a dramatic effect on capital formation and the proliferation of the corporate form of human organisation: following liberalisation in France, incorporations increased from an average of fifteen a year (1852-1867) to 362 a year (1868-1882).[25] The limited liability corporation became a means of enticing investors to form large pools of capital in exchange for reducing their risks. This was the historical pattern in all industrialising societies.

In the second half of the nineteenth century, stock exchanges were established in most major cities in regions where capitalism flourished – approximately 250 in the United States for example.[26] Everywhere, the demand from investors was basically similar – a law that recognised simple procedures for the transfer of shares, shares of conveniently small denominations and a banking system that provided a simple means of payment. By the end of the seventeenth century, these conditions had been fulfilled only in Holland and England.[27] The first semblance of a stock exchange emerged in Amsterdam: by 1585 lists of stocks being traded existed in Amsterdam.[28] The London Stock Exchange (LSE) surpassed Amsterdam as the premier market in the world when French troops arrived in Amsterdam in 1795. It consolidated its global dominance against intermittent competition from the Paris Bourse until 1914 when the New York Stock Exchange (NYSE) assumed this mantle. The financial institutions of the Dutch republic influenced London in an era when William of Orange success-

[24] Rungta, *supra* n.11, at 257.

[25] Freedeman, *supra* n.15, at 6.

[26] RC Michie, *The London and New York Stock Exchanges, 1850–1914* (London, Allen and Unwin, 1987), 167.

[27] Morgan and Thomas, *supra* n.23, at 19.

[28] H Windcott, *The Stock Exchange* (London, Samson Low, 1946), 2.

fully invaded England and took its throne, New York took over from London on financial foundations forged when it was New Amsterdam.

Stockbroking as a profession seems to have evolved from the tally-brokers who dealt in short-term government debt.[29] The idea of partitioning a permanent national debt into divisible bonds that could be sold to many wealthy individuals both within and without the state was originally proposed by the Neapolitan Lorenzo Ponti in 1653. The brokers of Amsterdam and then of the city of London became the consummate practitioners of this idea, not only selling parcels in the British national debt, but parcelling out the national debts of many nations, making international markets in their bonds. In turn, British government loans, stock in the Bank of England and the East India Company were actively traded on the Amsterdam stock exchange both before and after the South Sea bubble burst.[30] Only in the last decade of the seventeenth century was there enough corporate stock around for brokers to begin specialising in stockbroking[31] and it was only in the second half of the nineteenth century that the LSE ceased being totally dominated by the trade in government securities.

While an Act of the British parliament of 1673 regulated all forms of broking, it made no specific mention of stockbroking. This licensing of brokers was the only form of regulation that affected stockbrokers. Their trade was a creation of spontaneous ordering forged in a number of coffee houses in the city of London and in Exchange Alley "between the salters, the Italian merchants and the Canary merchants"[32] in the Royal Exchange building. In 1697, however, an Act "To Restrain the Number and Ill Practice of Brokers and Stockjobbers" was passed. Its preamble states:

> Whereas for the Convenience of Trade Sworn Brokers have been Anciently Admitted and Allowed of within the City of LONDON, and Liberties thereof, for the making and concluding of Bargains and Contracts between Merchant and Merchant, and other Tradesmen, concerning their Goods, Wares and Merchandises, and Money taken up by Exchange, and for negotiating Bills of Exchange between Merchant and Merchant: And whereas divers Brokers and Stock-Jobbers, or pretended Brokers, have lately set up and carried on most unjust Practices and Designs, in Selling and Discounting of Talleys, Bank Stock, and Bank Bills, as may be most Convenient for their own private Interest and Advantage; which is a very great abuse of the said Ancient Trade and Employment, and is extremely prejudicial to the Public Credit of this Kingdom and to the Trade and Commerce thereof, and if not timely prevented, may Ruin the Credit of the Nation, and endanger the Government itself.

But it was only for a decade that stockbrokers were licensed as such by the City of London, the Act not being renewed in 1707.[33] Thenceforth it was the self-regulation of the brokers that set the regulatory framework for the securities

[29] Morgan and Thomas, *supra* n.23, at 19.
[30] *Ibid*., at 52.
[31] *Ibid*., at 20.
[32] *Ibid*., at 27.
[33] *Ibid*., at 23–6.

and bond markets. A building was first described as the Stock Exchange in Threadneedle Street in 1773, still without a restricted broker membership. The Stock Exchange building on its present site with a Committee restricting membership was not opened until 1802. It was not until 1812 that the first rule-book of the LSE was collated.[34] Five years later these rules were a resource when the NYSE was formally organised. Long before this codification the LSE had refined customary rules through its committee structure. As Michael Clarke[35] has shown, regulation in the City of London largely worked informally, based on trust and shame among men who shared a code of honour they had learnt at the same schools. In the 1802 structure, "[a]t the south end under the clock was a board on which the names of defaulters were exhibited".[36]

In the evolution of capitalism, there is a long period before trust becomes more generalised in a culture,[37] allowing trading in shops and in commerce with people one has never met, yet with a certain degree of trust.[38] During this painful gestation of generalised trust, trust worked in culturally homogeneous networks, including global ones of Jewish, Venetian, Genoan, Armenian and Chinese diasporas. Competitive advantage was secured when culturally homogenous, trusting communities of traders self-regulated their affairs to enable complex and sophisticated forms of quick, clean trading that other societies could not manage. This was the accomplishment of the City of London from the late eighteenth century. Earlier in the century there had been a pragmatic recognition of the kind of homogenous networks that worked in financing markets. For example, while brokers ordinarily had to be freemen of the City of London, early in the eighteenth century an exception was made for the admission of twelve Jews.[39]

Prior to the gentlemen's club era of self-regulation, female stockbrokers seemed not to be uncommon.[40] They traded in an unregulated informal market open to the general public along with others excluded as unsuitable for membership of the LSE. This happened in and around the Rotunda of the Bank of England from when it was opened in 1765 until the Bank excluded them from the precinct in 1838. By then all the reputable money was going to the LSE. Even contemporary writers have questioned the repute of the female stockbrokers in the most chauvinist way possible: "The presence of the 'female jobbers' is vouched for in contemporary illustrations though there is some doubt as to how far they were dealing in stock and how far plying an even older trade."[41]

[34] *Ibid*., at 60.

[35] M Clarke, *Regulating the City: Competition, Scandal and Reform* (Milton Keynes, Open University Press, 1986).

[36] Morgan and Thomas, *supra* n.23, at 71.

[37] F Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (London, Penguin, 1995).

[38] M Krygier, *Between Fear and Hope: Hybrid Thoughts on Public Values* (Sydney, ABC Books, 1997).

[39] Morgan and Thomas, *supra* n.23, at 65.

[40] *Ibid*., at 53.

[41] *Ibid*.

TECHNOLOGICAL CHANGE AND THE HEGEMONY OF LONDON AND NEW YORK

There is a sense in which the NYSE made New York rather than vice versa. The financing of the Erie Canal, which made New York the commanding port of the continent came from the NYSE.[42] The communications revolution of the mid-nineteenth century – first the telegraph, then the telephone, then the ticker tape machine – caused an enormous centralisation of trading in the London and New York stock exchanges which, until then, had substantial competition from provincial markets within their own states. The Dow index of NYSE stock averages, which started in 1897, was destined to become something not just New Yorkers would hear daily as they tuned into the evening news. A century later, moves from localised open-outcry trading to screen-based trading at large distances from the metropoles reinforced the grip of the major markets at the same time it localised the stockbroking industry away from the site of the exchange, globalisation to where the investors live.

By 1910, approximately two-thirds of trading in stocks in the United States occurred on the NYSE.[43] Progressively, the market-making in major stocks happened in London for the United Kingdom, New York for the United States. The biggest markets became the hubs from which the new communications wires ran. This allowed London and New York brokers to dominate international securities arbitrage – buying stock cheaply on one international market while simultaneously selling the same amount of stock at the highest price prevailing in any of the world's markets. Since arbitrage is simply market-making in one exchange writ large as market-making across all the world's exchanges, London and then New York progressively made the world's markets in securities important enough to be internationally traded. Once rapid communication allowed this to happen, the culture of trading became for provincials to watch what was happening at the metropole and adjust accordingly.

This also put limits on how far other markets could diverge from the regulatory framework for securities trading set in London and New York. Other exchanges could, did and still do compete for the listing of lesser companies by setting lower regulatory standards than New York. They can list a new Chinese stock that might have been listed on the NYSE were it not for the company's preference for the weaker disclosure requirements on a lesser exchange. This international regulatory competition had limited impact on New York until recently. Domestically, the NYSE had always been content to concentrate on blue chips that play by their rules, allowing the second board and provincial exchanges to pick up the rest.

Needless to say, however, just as a fast, efficient, high-disclosure market like New York has been important to encouraging Western investors to put their

[42] TK McCraw, *Prophets of Regulation* (Cambridge, Mass., Belknap Press, 1984), 162.

[43] Michie, *supra* n.26, at 169.

money into equities, so less open and efficient markets in Shanghai, Hong Kong and elsewhere have been important to the formation of large private corporations in China. In all this, however, stock markets are only fundamental as a secondary market that entices investors to buy new equities with the confidence that they will be able to sell some or all of them whenever they want with low transaction costs. Stockbrokers are responsible for only a small proportion of new share issues – the primary market in equities. In the nineteenth century, the merchant bankers who had dominated the international issuance of new government bonds – Barings and Rothschilds in Britain, J P Morgan in New York – also came to dominate new share issues for private corporations.[44] Needless to say, then, the emergence of a vibrant finance capitalism was essential to the emergence of strong corporate capitalism and securities markets.

THE RISE OF STATE REGULATION AROUND THE WORLD

The licensing of brokers during the early centuries of the LSE was a regulatory responsibility of the Lord Mayor of London rather than the nation state. And even this public regulation was of little consequence compared to the self-regulation of the exchange itself. This was the global pattern of securities regulation in Europe, Asia and the Pacific, Africa and the Americas. The most important state intervention during the nineteenth century was Britain's Directors Liability Act 1890. But this established modest rights in private law rather than public law regulation. It subjected directors and promoters to civil liability for false statements in prospectuses.

It was not until the Companies Act 1929 that a somewhat systematic regime of state regulation was instituted; prospectuses had to be publicly registered and certain information to be disclosed in them was prescribed. The regulation of corporations was therefore not part of Oliver McDonagh's (1961)[45] pattern of nineteenth century government growth. Nineteenth century England is best characterised by: (a) the liberalisation of state limitations on the issuance of corporate charters; and (b) the growth and refinement of self-regulatory institutions dependent on the honour of traders. The period of government regulatory growth dates from the onset of the Great Depression and was rejuvenated by the crash of 1987.

Both the 1890 and 1929 British legislative initiatives were widely modelled throughout the British Empire of course, but more widely than that. Even China acquired a Stock Exchange Law in 1929.[46] Most critically, after Wall Street crashed in 1929, the British Companies Act 1929 was the model that shaped the

[44] *Ibid*., at 116.

[45] O McDonagh, *A Pattern of Government Growth 1800–1860* (London, MacGibbon and Kee, 1961).

[46] PSP Hsu and LS Liu, "The Transformation of the Securities Market in Taiwan, the Republic of China" (1988) 27 *Columbia Journal of Transnational Law* 169.

rise of American state regulation.[47] But British company law provided no more than a framework into which the Americans injected details of prescription and state enforcement that remained foreign to the British state until they had to deal with outsiders who strode into the city with the internationalisation of securities trading in the 1980s.[48]

The dramatic United States development was the establishment in 1934 of the Securities and Exchange Commission (SEC). While this was one of a number of New Deal independent regulatory commissions, it was one that remained consistently powerful and effective for the rest of the century. It was also the decisive move in the takeover of corporations and securities regulation from State governments by the national government, a move that ultimately occurred in other federal states such as Germany, Australia and Canada. As will be discussed in more detail below under the principle of transparency, the securities laws of 1933 and 1934 were revolutionary in the "thirty-two categories of information that must be disclosed in the registration statements of corporations issuing new securities".[49]

Japan was persuaded to adopt United States-style securities regulation before reopening its markets after World War II. Much later, other Asian states such as South Korea modelled Japanese regulation while Latin American states modeled the United States.[50] The pattern of government growth did not spread throughout Western Europe until the first European Community Company Law Directive of 1968, and in Eastern Europe until the fall of Communism in 1989. In Germany, Switzerland and the Netherlands, state regulation of securities markets remained thin to non-existent until late in the twentieth century; liberalism reigned, tempered by self-policing clubs of securities dealers, stock exchanges and banks.[51] The Francophone states experienced the pattern of government growth earlier, setting up institutions that modelled the SEC. In 1967, the French Commission des Operations de Bourse was very considerably modelled on the SEC.[52]

It is perhaps surprising that national regulation of this early modern institution – the business corporation – with its pre-modern pre-history should come so much later than the national regulation of late modern institutions such as telecommunications, intellectual property and air transport. This lateness we will now see is also a feature of the globalisation of companies and securities

[47] PR Wood, *International Loans, Bonds and Securities Regulation* (London, Sweet and Maxwell, 1995), 260; and J Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Boston, Houghton Mifflin, 1982), 57.

[48] Clarke, *supra* n.35.

[49] McCraw, *supra* n.42, at 173.

[50] Wood, *supra* n.47, at 261.

[51] *Ibid*., 262.

[52] R Bordeaux-Groult, "Problems of Enforcement and Cooperation in the Multinational Securities Market: A French Perspective" (1987) 9 *University of Pennsylvania Journal of International Business Law* 453.

regulation, notwithstanding the early emergence of international arbitrage described above. While the predecessor to the International Telecommunication Union was established in 1865, the International Organisation of Securities Commissions was fully established only in 1986.

CROSS BORDER TRADING AND UNITED STATES RESISTANCE OF THE IMPETUS TO GLOBALISATION OF REGULATION

We have seen that international regulatory competition initially had limited impact on the NYSE, which had been content to concentrate on the United States blue chips that in the decades immediately after World War II were the main game of global capitalism. Restlessness about international regulatory competition really only sharpened in New York during the bull market between 1982 and 1987. These five years saw a remarkably sudden globalisation of securities markets; in the United States, foreign securities transactions increased tenfold.[53] The big jumps in cross-border equity flows occurred in 1986 and 1987 and have not fallen back since. Even so, more than three quarters of equity transactions in 1993 remained totally domestic.

London fought back during the 1980s against the domination New York had enjoyed since World War I, more so after the deregulation of securities trading in London with the Big Bang of 1986. At the end of 1986, only fifty nine foreign companies were listed on the NYSE (a third of them Canadian) while the LSE had 512 foreign listings.[54]

But the United States of the late 1980s and early 1990s was torn between the imperatives of global regulatory competition that was seeing business go to London versus domestic imperatives to crack down on the excesses of the 1980s. The domestic imperatives were initially more profound. American voters were more moved by Hollywood's portrayal of Gordon Gecko in the movie *Wall Street* than by the need for its securities industry to be internationally competitive. Rudolf Guiliani could build a national political profile as a prosecutor of insider traders, a potential Vice-Presidential running mate and Mayor of New York. In this, the American mass public were by no means economically irrational or short-sighted: the sums they lost to shady market manipulators in the late 1980s were massive in comparison to the economic benefits from American domination of global share trading.

How did the United States state negotiate this tension? It supported the formation of the Inter-American Association of Securities Commissions in 1974 that became the International Organisation of Securities Commissions (IOSCO) in 1983, and it supported the dialogue within IOSCO toward upgrad-

[53] United States Department of Treasury, *1983 Treasury Bulletin* (March 1983) and *1988 Treasury Bulletin* (March 1988), Tables CM-V-1, CM-V-2.

[54] B Longstreth, "Global Securities Markets and the SEC" (1988) 10 *University of Pennsylvania Journal of International Business Law* 183.

ing the disclosure and other requirements of laggard securities regulators. Yet when it came to reaching agreement on global harmonisation of securities standards, for the first decade of IOSCO's existence the SEC would mostly not come to the party, steadfastly refusing any easing of its requirements to meet the regulatory laggards halfway. Instead the United States campaigned domestically within the laggard states for tougher regulation, pointing out that American capital would be shy of markets that lacked credible regulation. This strategy met with modest success. The United States was the only state that proscribed insider trading after the Great Depression (from 1934). France followed in 1970, the United Kingdom in 1980, Sweden in 1985, the Netherlands 1986, Switzerland in 1987[55] and then a host of countries after that including Japan, New Zealand, Italy, Belgium, Denmark and Ireland. In 1989 the European Community adopted a Directive on insider trading in an attempt to harmonise the enforcement approach of member states. Most of these states rarely or never imprisoned insider traders in the way the United States did, but substantial global movement toward the United States regulatory posture was certainly accomplished.

At the same time, the SEC position was supportive of "flexibility, looking behind the reasons for our rules so, for example, we can assist British Telecom to be sold in the United States … accommodation is more important than harmonization" (1992 SEC interview).[56] For the Americans international agreement on internal auditing standards, for example, should not mean that "we have to use them for domestic purposes, but that we find them acceptable for foreign offerors" (1992 SEC interview).[57] This approach of an effective double standard – fending off competition from London by lower standards for foreign firms listing in New York than for domestic firms – is hard to sustain for the long haul and frowned upon in a United States Congress afraid of foreign Gordon Geckos. This attitude reflected the longstanding American view that they still had the upper hand with which to dictate regulatory terms: "You have to come here and convince us. Issuers will come to this big market" (1992 SEC interview).[58] The SEC was critical even in the early 1990s of:

> European Community compromises that accommodate everyone. You can't have it where you're giving something to everyone where your core concern is prudential rigor. The European Community has settled for a lowest common denominator to reach agreement. The United States position is that agreement is not the be all and end all (1992 SEC interview).[59]

[55] A L Peters and A E Feldman, "The Changing Nature of Securities Markets and the Securities Industry: Implications for International Securities Regulation" (1988) 9 *Michigan Yearbook of International Legal Studies* 33–34.

[56] In this chapter, interview references are to interviews conducted by the authors for *Global Business Regulation*, *supra* n.1. ch 3 of that work and the acknowledgements explain the sources of some 500 interviews.

[57] *Ibid*.

[58] *Ibid*.

[59] *Ibid*.

FINANCIAL INNOVATION, DISASTERS AND PROGRESS WITH GLOBALISATION OF REGULATION

The expansion of cross-border trading was not the only impetus to global convergence in regulatory standards. The pace of financial innovation since the 1980s has been such that states did not have the luxury of opting to stick with regulatory standards that had stood them in good stead in the past. New standards had to be written for new technologies like screen-based trading, engineering of new products to reduce risk, indeed innovation into completely new types of markets (such as the futures exchanges now institutionalised in all major economies). Wall Street merchant banker Michael Milkin invented the junk bond and eventually went to prison for insider trading on a scale that had previously not been imagined. Wall Street lawyer Michael Lipton invented the poison pill that was used by hundreds of major companies to fend off the takeover frenzy of the 1980s, along with other innovations such as golden parachutes, pac-man defenses, scorched earth retreats, shark repellents and lockups.[60] Global regulatory convergence became somewhat easier when everyone was forced to go back to the drawing boards, especially when there was a disaster of global visibility, such as the Barings collapse, that prompted rethinking. On some key issues they decided to sit around a common drawing board.

While the G-1O managed to agree on capital adequacy standards for banks that globalised almost instantly in the 1980s, IOSCO found it impossible to settle capital adequacy standards for securities firms. The nub of the problem was the difficulty of inventing a way of assessing capital adequacy suited both to the banks that dominate securities business in some countries and the non-bank securities firms that dominate in others. Deregulation and product innovation have blurred this divide, however. European agreement on capital adequacy became somewhat easier when Britain's desire to attract business saw it allow the acquisition of member firms of its exchanges by banks. Increasingly in most of the world, banking and securities business is combined in financial conglomerates. The regulatory separation of banking and securities business has long since collapsed in Japan and is crumbling even in the United States, so the different levels of functional integration that in the past have left states with divergent interests on capital adequacy standards are beginning to dissolve.

Advances in computing power have driven innovation in engineering financial products. New financial products could be invented as a result of the new ease, speed and cheapness of collecting, processing and disseminating data. An example is securitisation itself – the conversion of cash flows from specific assets into marketable securities. Securitisation is based on the simple insight that assets are worth more if they are converted from lumpy assets to parcels of securities that can be easily traded, becoming little pieces of many investors'

[60] MJ Powell, "Professional Innovation: Corporate Lawyers and Private Lawyering" (1993) 18 *Law* and *Social Inquiry* 423.

diversified portfolios.[61] Another is innovation in derivative products – futures, options, swaps and various hedging instruments – and associated specialised markets. The collapse of Barings, England's oldest merchant bank, as a result of derivatives trading by a single employee in Singapore, added to global regulatory impetus for IOSCO's Working Party on Derivatives to settle with the Basle Commission on Banking Supervision a common framework for evaluating the risks of derivatives business among banks and securities firms. Their joint report on derivatives, written just before the Barings collapse, has been widely accepted as a framework for convergence by key players including the SEC and the United States Commodity Futures Trading Commission.[62] IOSCO reports on "Contract Design of Derivative Products on Stock Indices" and "Mechanisms to Enhance Open and Timely Communication Between Market Authorities Of Related Cash and Derivative Markets During Periods of Market Disruption" have also fostered convergence.

After years of impasse, in 1995 IOSCO and the International Accounting Standards Committee (IASC) reached agreement on international accounting standards which have the objective of allowing companies that meet IASC accounting standards to list on any of the world's capital markets by 1999.[63]

Major privatisations have been important sources of regulatory innovation on which cross-border regulatory cooperation has been required. The British Petroleum and British Gas privatisations, the latter being in 1986 the largest equity underwriting that had ever occurred, started a new era of equity offerings occurring simultaneously on the United States and European markets.[64] The difficulties Qantas encountered in keeping its foreign shareholdings within prescribed limits motivated the Macquarie Bank in Australia to tailor-make QanMac: "an innovative security which had the characteristics of a Qantas share, in terms of price and yield, but which was not subject to the same regulatory restrictions, since it was not considered to give foreign investors a direct shareholding in Qantas".[65] A more standardised product innovation is the Global Depositary Receipt (GDR). Banks that act as depositaries for foreign shares issue GDRs in units that represent the underlying value of those shares. Foreign investors can effectively trade the shares without having to deal with labyrinthine local registration and transfer procedures, confident that settlement will occur and with all transactions reaching them in United States dollars or the currency of their choice.[66] De facto stock owners who use GDRs find it

[61] JC Edmunds, "Securities: The New World Wealth Machine" (104 *Foreign Policy* 118–38, 1996).

[62] JH Cheek, "Approaches to Market Regulation" in F Oditah (ed.), *The Future of the Global Securities Market* (Oxford, Clarendon Press, 1996), 250.

[63] B Asher, "The Development of a Global Securities Market" in Oditah, *supra* n.62, at 6.

[64] B Becker, "Global Securities Markets" (1988) 6 *International Tax and Business Lawyer* 243.

[65] S Sackman and M Coltman, "Legal Aspects of a Global Securities Market" in Oditah, *supra* n.62, at 28.

[66] *Ibid*., at 22.

difficult or impossible to cast votes as shareholders, complicating the principled basis of corporate governance and its regulation.

The latter illustrates how innovation generates new kinds of regulatory challenges that confront all states with a simultaneous need for regulatory redesign. Commonality and simultaneity of both financial innovation and global financial crises conduces to convergence more than grandfathered regulation that has established entrenched habits of industry practice, training, accounting, culture and structure. While these realities are the basis for expecting more rapid progress toward global convergence of securities regulation, the fact to this point is of limited accomplishment and weak institutional infrastructure for globalisation.

ACTORS

International Organisations

Political will for globalisation of corporations and securities regulation has been limited, particularly on the part of the United States, as testified by the late arrival, limited accomplishment and minimal resourcing of the most important international organisation, IOSCO. At the time of writing IOSCO still has only four staff, most of the work being done by the chairs of working groups of representatives of member Commissions. "The philosophy is to let the agencies write the solutions. Then they won't throw them in the bin" (1994 IOSCO interview).[67]

IOSCO began life as a regional coordinator for the Americas. Following an initiative by British regulators who wished to discuss cross-border insider trading, IOSCO spread its membership to all states in 1986.[68] When it finally did get underway IOSCO struggled for some years without Germany and Japan as members. Now, however, IOSCO's 110 members account for 99 per cent of global capitalisation. The history of a Pan-American organisation evolving into the global body parallels Working Party 29 of the Economic Commission for Europe becoming the de facto global standard-setting body for motor vehicles.

During its first decade IOSCOs accomplishments were minimal assessed in terms of settled harmonisations. IOSCO compared unfavourably with the Basle Committee's accomplishments on the harmonisation of banking standards during the same period. Yet during this decade IOSCO did facilitate the evolution of a common language among the world's securities regulators. It is not impossible that the structural conditions within which IOSCO now operates – expanding cross-border trading, regulatory competition, innovation in financial products and exchanges to deliver them, continuous screen-based trading, crises

[67] *Supra* n.56.

[68] SJ Davidson, "The International Organisations of Securities Commissions" in G Walker and B Fisse (eds), *Securities Regulation in Australia and New Zealand* (Auckland and Oxford, Oxford University Press, 1994), 716.

that demand a global rather than a national response – will enable it to convert its history of impotence into rapid and substantial accomplishment of regulatory convergence. For the time being at least IOSCO will remain a supra-national coordinator of securities markets rather than regulator. An example of where IOSCO has helped to facilitate a culture of cooperation in securities markets regulation has been the formulation in 1991 of principles for Memoranda of Understanding (MOU). MOUs are legally non-binding statements of cooperation between regulatory authorities. In the longer term the IOSCO principles will help to standardise cooperation between securities regulators.

Compared to other domains of business regulation, the OECD has played an extremely modest role as an incubus of ideas for convergence in companies and securities regulation. The International Federation of Stock Exchanges and the International Council of Securities Dealers and Self-Regulatory Organisations have also hardly been major forces for regulatory globalisation.

The European Community has edged Europe toward convergence of companies and securities law through a number of key Directives including the Listing Particulars Directive, the Interim Reports Directive, the Prospectus Directive, the Major Shareholders Directive, the Insider Trading Directive, the Investment Services Directive and a variety of Directives on the formation, structure, governance, accounts, audit, disclosure requirements and merger of companies.[69] The Investment Services Directive guarantees securities firms free access to all European Community markets (the European passport) so long as the regulatory authority of their home state certifies that they have met harmonized minimum requirements.

During the 1990s, the European Community also adopted more of a leadership role at IOSCO, organising European Commissions to take more unified positions to the international forum, prompting the United States to caucus defensively among the Western hemisphere members.

States

Since the New Deal the United States through the agency of the SEC has clearly been the state that has dictated terms more than any other. IOSCO's weakness as an institution indicates that this leadership has not been directed to sustained institution building.[70] While there has been activism in the 1980s and 1990s in negotiating bilateral Memoranda of Understanding, American leadership, like British, Dutch and Italian leadership before it, was more passive than active, more a result of creating domestic institutions that others copied than of regulatory diplomacy.

The influence of the SEC, thus understood, is not just about the fact that United States market capitalisation remains considerably higher than that of all

[69] E Wymeersch (ed.), *Further Perspectives in Financial Integration in Europe* (Berlin and New York, Walter de Gruyter, 1994), 251–9.

[70] For examples of other sustained institution-building, see Braithwaite and Drahos, *supra* n.1.

of Europe combined, it is also about the depth of expertise the SEC has – legal, economic and in terms of market experience – compared with any other securities regulator. And it is also about a respect for the SEC as a regulatory success story that, for example, the United States Federal Trade Commission does not enjoy, as it was put to us immodestly, but nevertheless accurately we think, in one SEC interview:

> It's not just the capitalisation of the United States that gives it weight. Still close to 40 per cent of the world's capitalisation is in the United States. Who are the success stories? The SEC has respect. Also it's the sheer size of the SEC as a regulator. The investor confidence that has come of its competence. Japan has 20 per cent of the world's market capitalisation but no one holds it up as a model of securities regulation. That's about scandals, the insider mentality begetting no international respect.[71]

Moreover, the United States has the most innovative market: innovations hit Wall Street first, so the SEC has to deal with them first. As Powell[72] has shown, Wall Street legal entrepreneurs do not passively wait for clients to ask for their latest tactics; they get out and sell them to boards, first domestically, then internationally. So the foreign regulators know that whatever is troubling the SEC now is likely to be giving them grief soon.

Business actors

The colonies of northern Italian merchants who could be found in every major commercial centre of Europe in the fifteenth century – Geneva, Lyons, Barcelona, Seville, London, Bruges and especially Antwerp – diffused double-entry bookkeeping and other forms of business knowhow, particularly concerned with the use of credit, that laid foundations for the corporatisation of the world in later centuries.[73]

One might have expected that major individual corporations that are issuers of shares, with their interest in being able to list globally, would have been major forces for the global harmonisation of companies and securities law. We have seen no evidence of this being the case. "The accounting firms try to get them [Transnational Corporations (TNCs)] interested in harmonisation but they don't care" (1994 IOSCO interview).[74] Corporations that struggle to raise capital lack the clout to shape debates; blue chips that confront little difficulty in doing so have more important fish to fry, as do the industry associations they dominate. In the nineteenth century the house of Rothschild was more powerful than most states. By the end of the century J P Morgan had become more powerful, an influence it sustained for the first few decades of the twentieth century. But the twenty-first century will have no Rothschild or Morgan (or

[71] *Supra* n.56.

[72] Powell, *supra* n.60.

[73] R Cameron, *A Concise Economic History of the World: From Paleolithic Times to the Present* (New York and Oxford, Oxford University Press, 1989), 122.

[74] *Supra* n.56.

Fugger) who can dictate terms to heads of major states.[75] Merchant banking today is an extremely competitive industry with power diffused among many firms that are tiny compared to the industrial TNCs. In short, the height of merchant banker power preceded not only the globalisation of regulation, but the rise of state regulation from 1934.

The City of London aside, in no other economy does the securities industry account for a notable proportion of GDP. National and international associations representing stock brokers have certainly been active players in international debates, but the major changes investment we have discussed cannot be attributed to their lobbying; their lot has been a more reactive one.

The stock exchanges, particularly those of New York and London, have been pre-eminently important actors. But their influence on events has been rather in the same mould as that of the United States state – more a passive one internationally than one of active diplomacy. When the NYSE sets its domestic rules, it also sets global rules simply because other actors choose to model its policies. The three major exchanges – New York, London and Tokyo – are all active participants in IOSCO deliberation, Tokyo less so than the other two. IOSCO, in the words of one official from the NYSE, has changed from a "social organisation to actually getting things done" (1994 NYSE interview).[76] Tokyo dominates trading in Japanese securities but is not a major trader of international securities. "Not many international companies want to list in Tokyo. They do want to list in the United States" (1994 IOSCO interview).[77] This seems to be about the respect and insider mentality concerns about Tokyo discussed above. Tokyo seems too embedded in the Japanese governmental matrix. Global investors remain wary of it. There are really only three major markets and two major competitors for international listings. The next largest market, the Paris Bourse, is much smaller than the big three and much less influential in global policy discussions. "Any agreement requires the United States, the United Kingdom and Japan, though if Japan doesn't agree it doesn't matter much. Then the others will follow" (interview with keyinsider).[78] In futures trading as well, London is the second market in importance after Chicago.

Some stock exchanges along with the Investment Bankers' Association took a proactive role in the United States after the Great Crash of 1929[79] in pushing for what we will argue below has been the paradigmatic shift of the twentieth century from insider capitalism to transparency capitalism. Not so the President of the NYSE, Richard Whitney, who told Senate staff investigators in 1933: "You gentlemen are making a great mistake. The Exchange is a perfect institution."[80]

[75] R Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (London, Simon and Schuster, 1990), xvii.

[76] *Supra* n.56.

[77] *Ibid*.

[78] *Ibid*.

[79] McCraw, *supra* n.42, at 167.

[80] *Ibid*., at 194.

The most influential actors in the proactive diplomacy sense have been the major accounting firms:

> the big accounting firms have been putting tremendous pressure on all the players for globalisation of accounting standards. Peat Marwick and Price Waterhouse have been the most active. They have also been very active at the GATT on their associated agenda to free up the trade in accounting services. They also lobby the SEC who lobby our Working Groups (1994 IOSCO interview).[81]

The major accounting firms are the model mercenaries in the globalisation of American regulatory and corporate governance practice.[82]

After many years of impotence, the International Accounting Standards Committee, which represents some one hundred professional accounting bodies in fifty countries, has reached an agreement with IOSCO that seems to lay down a framework for harmonised accounting rules. One would have to say, however, that the role of professional bodies here has been much less significant than that of the leading firms. Prior to the New Deal the American Institute of Accountants advanced the cause of uniform accounting rules. While the profession were advocates of transparency, they were largely a feeble force then, dominated by their corporate clients.

NGOs and mass publics

National NGOs like the Australian Shareholders' Association do exist, but they have a limited influence on national debates and none on global debates. We have seen that mass publics, more precisely the new mass of middle class equity owners, have had enormous influence in recent decades, particularly in the United States market, which has shaped so much of the global regulatory change.[83] They bayed for blood following the excesses of the 1980s and they got a level of criminalisation of insider trading which, while it might have been feeble measured as law in action,[84] transformed the law on the books of many countries and has given us the only period in the history of securities enforcement where the criminal law has loomed as being of major importance.[85] It has been the demands of middle class investors transmitted through pension funds, mutual funds and investment advisors that has transformed capitalism more structurally from localised insider investment networks to global risk-spreading based on aggressive demands for performance and transparency by those who

[81] *Supra* n.56.

[82] Braithwaite and Drahos, *supra* n.1, ch 25.

[83] According to a survey by the NYSE in 1990, roughly 51 million Americans owned equities (about one in four adults in other words): see *NYSE Fact Book* (1991).

[84] R Tomasic and B Pentony, *Casino Capitalism: Insider Trading in Australia* (Canberra, Australian Institute of Criminology, 1991).

[85] S Shapiro, *Wayward Capitalists: Target of the Securities and Exchange Commission* (New Haven, Yale University Press, 1984).

make the investments on behalf of the new middle class equity owners. In the era of networked insider capitalism, mass publics were "a befuddled chorus of common people, alternately fascinated and horrified by the doings of the major players".[86]

Under transparency capitalism (see below under the "transparency" heading) befuddled impotence is no longer an accurate way of describing the relevance of mass publics. The workings of firms are not transparent to individual investors, but they are progressively more so to those empowered by investor demands for vigilance, such as stockbrokers, advisors, mutual funds and pension funds. None of these watchdogs have become more powerful than the pre-eminent American rating agencies – Standard and Poor's Corporation and Moody's Investors' Service, Inc. No issuer of securities in the world – corporate or state – is too mighty to be beyond the power that transparency capitalism delivers to the New York ratings agencies. They all shudder at the effect on investing publics of even a hint that one of these agencies might qualify their credit rating.

Individuals

In tune with the conclusion we will reach later that modelling is by far the most important mechanism of globalisation, it is the individuals whose innovations were modelled who have been the most decisive actors in the globalisation of companies and securities regulation. It is beyond our historical reach to know who were the individuals responsible for the idea of the corporation as a *persona ficta*, the *commenda*, double entry bookkeeping, stockbroking and market-making and the Amsterdam stock exchange. Securitization seems to have been an invention of the Neapolitan Lorenzo Ponti in 1653 when he proposed partitioning national debts into divisible bonds. In terms of building primary markets for securities through developing the institution of the merchant bank, perhaps successive generations of Rothschilds should be mentioned for their pre-eminence not only in England and France but in all the major centres of early capitalist Europe.

In the twentieth century, James Landis was a pre-eminent architect of transparency capitalism: "In the history of American liberalism, Landis embodies the generational links from Brandeis [he clerked for Brandeis], the old progressive, through Roosevelt and the New Deal, down to John F Kennedy and the New Frontier. He served all three men."[87] Early in 1933, President Roosevelt asked his friend Felix Frankfurter to help with writing new securities legislation that might prevent another Great Crash. Frankfurter turned, among others, to his brilliant young co-author at Harvard Law School, James Landis. To Landis fell the task of leadership in drafting the Securities Act 1933 and the Securities Exchange Act 1934. The latter was "among the most harshly contested pieces of

[86] McCraw, *supra* n.42, at 162.
[87] *Ibid*., at 153.

legislation in the twentieth century",[88] Landis and his colleagues being described, among other things, as "a bunch of Jews out to get J P Morgan".[89] Wall Street came to hate Roosevelt and Landis was Roosevelt's front man first as principal drafter, then as FTC and SEC Commissioner, then as SEC Chairman from 1935 to 1937.

Landis,[90] before and after, was a seminal scholar of regulatory strategy, a critic of legislative enactment uncoupled from a theory of administrative design.[91] His regulatory genius was in seeing the need for an institutional design that gave all gatekeepers – executives, accountants, brokers, bankers, lawyers – a stake in enforcing the law. Part of the disclosure regime the 1933 Act, for example, was the provision of the names and addresses of lawyers who passed on the legality of a security issue. This was a radical innovation in giving lawyers a reputational stake in enforcing the law. His ideas, subsequently modelled globally and not just in securities regulation, were for regulation that was self-enforcing, that engaged industry participants in self-regulation monitored by a federal agency. It was participatory regulation within a regulatory community, to use a term later deployed by Meidinger.[92] Landis was severely attacked both by business leaders who detested sunlight and by liberal New Dealers, including from within the SEC itself, who wanted dirigiste, punitive control rather than cooperative regulation with the business community as partners. It was the Landis vision that prevailed in the practice of the SEC and many other agencies that admired its accomplishments. Landis himself slipped into obscurity after 1937 as an undistinguished Dean of Harvard Law School who let alcohol get the better of him. He also had an undistinguished stint as Chairman of the Civil Aeronautics Board under Truman. But Landis's 1961 Report to the President-Elect, John F Kennedy, highlighted the problems of regulatory decay and the need for periodic rejuvenation of regulatory agencies, which did begin under Kennedy.

Landis had many who stood beside him, including two colleagues, Joseph Kennedy and William Douglas, who possibly administered the SEC with greater finesse than Landis.[93] He also stood on the shoulders of his mentors, Brandeis and Frankfurter. But in this respect no shoulders were sturdier than those of the man who appointed him. As Landis wrote to Roosevelt when he resigned as SEC Chairman: "Our Commission and our work sprang from your mind, your utterances, your ideals."[94]

[88] *Ibid*., at 171.

[89] Seligman, *supra* n.47, at 96.

[90] See J Landis, "The Study of Legislation in Law Schools: An Imaginary Inaugural Lecture" (1931) 39 *Harvard Graduates Magazine* 433–42; and J Landis, *The Administrative Process* (New Haven, Yale University Press, 1938).

[91] D A Ritchie and JM Landis, *Dean of the Regulators* (Cambridge, Mass., Harvard University Press, 1980).

[92] E Meidinger, "Regulatory Culture: A Theoretical Outline" (1987) 9 *Law* and *Policy* 355.

[93] Seligman, *supra* n.47.

[94] *Ibid*., at 155.

Epistemic communities of actors

How does one describe Wall Street and the City of London? Not as markets. They both encompass a number of markets for money, stocks, bonds, credit, insurance, reinsurance, accounting services, legal services, indeed, regulation. And both Wall Street and the City of London are involved in all of those markets. One does not have to do much fieldwork in the City and on Wall Street, and we have not done much, to realise that these are communities in quite a serious sense.

It is disappointing that only economists seem to deploy their methods to analyse Wall Street, that we do not see more anthropologists studying the rituals and custom of the natives. Neil Gunningham[95] has completed some revealing ethnographic work on the Chicago futures exchanges and the Hong Kong Stock Exchange (that demonstrates some of the ways community is a relevant variable at these sites). Roman Tomasic and Brendan Pentony[96] have undertaken interview-based research in Australia on the culture of insider trading that reveals more the character of a casino than a community. Yet they still find some professional community among lawyers, accountants and older established brokers, and plea for renewal of ethical community. Michael Clarke[97] is doubtless right in his book-length treatment of the subject that the City of London is not the tight-knit and homogenous community of decent chaps it once was. There are women in it now. Yet the common observation in the business culture literature that the City of London is more communitarian than Wall Street is still probably true.[98]

We regard the richest ethnography of Wall Street to be the intricate account by two journalists from the *Wall Street Journal*[99] of the titanic takeover battle for RJR Nabisco. The following passage illustrates, through the agency of Henry Kravis, the investment banker who won the takeover battle, that communitarian values like healing and forgiveness are important in enabling Wall Street to work. Perhaps community is transacted in a mode that seems vulgar to non-natives, especially in the way money ceaselessly colonises the world. But we would say that those who can only read market and cannot find community in the following illustration have not learnt how to read human drama:

[95] N Gunningham, "Thinking About Regulatory Mix: Regulating Occupational Health and Safety, Futures Markets and Environmental Law" in P Grabosky and J Braithwaite (eds), *Business Regulation and Australia's Future* (1993); and "Moving the Goalposts: Financial Market Regulation and the Crash of October 1987" (1990) 15 *Law and Social Enquiry* 1.

[96] R Tomasic and B Pentony, "Insider Trading and Business Ethics" (1989) XIII *Legal Studies Forum* 151; and *supra* n.84.

[97] Clarke, *supra* n.35.

[98] See, eg, J Wechsberg, *The Merchant Bankers* (New York, Little Brown, 1966), 41; and JS Coleman, *Foundations of Social Theory* (Cambridge, Mass. and London, Belknap Press, 1990), 109.

[99] B Burrough and J Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (London, Arrow, 1991).

> Wall Street is a small place, and in the interests of harmony Kravis wasted no time healing wounds inflicted during the fight. He made peace with Peter Cohen at a summit in February and actually hired Tom Hill to investigate the possible takeover of Northwest Airlines … Kravis also moved to smooth relations with Linda Robinson. Soon after the Gerstner episode, Linda took a message that Kravis had called. She ignored it. Within days she received a small ceramic doghouse with a cute note from Kravis, suggesting he was in the Robinsons' [her husband Jim Robinson, the CEO of American Express, was also involved] doghouse. Linda Robinson waited a few days, then sent Kravis a twenty-pound bag of dog food. All was forgiven. She and Kravis still own "Trillion".
>
> Fees, of course, went infinitely further toward soothing Wall Street's wounds … Kravis even spread the largesse to those whose feelings he might have bruised. Geoff Boisi's Goldman Sachs got the job of auctioning Del Monte, while Felix Rohatyn's Lazard Freres did the same for the company's stake in ESPN.[100]

In a 1993 London interview at the Securities and Futures Authority (SFA), the following diagnosis was given of the seemingly insurmountable problems at that time of getting equity markets working in the old communist states:

> You need public spirit in practitioners. In Eastern Europe they lack this. Where do you get market-makers from? People who will buy because they reckon they can sell on. Probably the black market operator who used to operate from the corner of Stalin Avenue and Lenin Boulevard. But idealistic academics like Havel somehow think they can find Western-style ethical market-makers.[101]

In retrospect, given the virulence of the corruption of many post-communist privatisations by the Russian Mafia and others, perhaps it was Havel who was the hard-headed one. Specific lament was directed during this interview at the difficulties of making a market in shares of the Bolshevik Biscuit Factory, a challenge perhaps that would have been beyond the good Lord himself. But the basic thrust of the SFA official's account remains perceptive: You can't make markets without some sort of depth of intimate relationships that work in a locally meaningful sense in a financial community.

Wall Street and the City of London are Meccas of a global epistemic community that constitutes a culture that makes stock exchanges and futures exchanges work in other parts of the world. In many other parts of the world such exchanges cannot be made to work. One reason is that the civil societies of those nations have not partaken of the culture of the global securities epistemic community. Hence there are good reasons for a senior American diplomat to suggest in our interview with him:

> If you have on your resumé that you have worked with a reputable firm in the City [of London] or on Wall Street, that will stand you in good stead in seeking any position of power in any society. I don't care what kind of power or what kind of society.[102]

[100] *Ibid*., at 508.
[101] *Supra* n.56.
[102] *Ibid*.

THE CONTEST OF PRINCIPLES

Transparency

Transparency is emerging as the triumphant principle in the globalisation of companies and securities regulation. Transparency was decidedly not a dominant principle during the era of British hegemony of finance capitalism. The dominance of London bankers and brokers over world financial markets in the nineteenth and early twentieth century was based on networks of experts with insider knowledge in whom people with money put their personal trust. Risk was managed by relying on a combination of the knowledge an advisor had as a member of an inner financial circle and the honour he had as a member of an inner social circle – a club, a group of Eton chums.[103] In this opaque world of inner circles the principle of transparency began to emerge for banking regulation through the medium of the British state. Stability in a monetary system is not feasible without it.

American capitalism was also networked insider capitalism. Many major companies did not release annual reports until they were forced to in 1934. Corporate affairs were regarded as private and privileged, as revealed in this interrogation of Henry O Havemeyer, head of the gigantic American Sugar Refining Company, by Thomas Phillips, a member of an ad hoc Industrial Commission set up by the United States Congress in 1899:

> Phillips: You think, then, that when a corporation is chartered by the State, offers stock to the public, and is one in which the public is interested, that the public has no right to know what its earning power is or subject them to any inspection whatever, that the people may not buy stock blindly?
>
> Havemeyer: Yes; that is my theory .Let the buyer beware … They have got to wade in and get stuck and that is the way men are educated and cultivated.[104]

In contemporary capitalism investors manage risk in a very different way. They ask their friends and the unfamiliar person in their bank or the accountancy firm that does their tax or the superannuation officer at work to recommend an investment advisor. That investment advisor is a complete stranger and essentially does not rely on insider knowledge in telling us where to put our money. What she relies on is comparative analysis of the risks of many kinds of investments in many countries she might never have visited. If she advises us to invest in a mutual fund, her advice is based on peering at quantitative data disclosed through her computer about the comparative performance of dozens of mutual funds over a number of years, at the national and international diversification of the risks they offer, at the size and quality of the group of analysts they have pouring over their computers.

[103] Clarke, *supra* n 35.

[104] McCraw, *supra* n.42, at 166.

In short, today we rely for investment advice on a more impersonal kind of (sometimes accredited) trust than on personal trust; we rely on transparency more than on insiders with the good oil. We make transparency work for us by nesting our advice. We end up investing a small fraction of our savings in a Chinese manufacturer because a Hong Kong bank and a Shanghai analyst have both provided our pension fund or mutual fund managers a lot of promising data (audited by its American accounting firm) on the financial performance of this manufacturer, because our investment advisors have had publicly disclosed to them data on the comparative performance of this mutual fund compared to others and because we have had advice from acquaintances with experience of investment advisors that this is one with a good track record. Moreover, we continue to test her advice against the daily prognostications in the investment advice columns of the popular media and we would really jump if we read that Moody's were downgrading its credit rating. This is advice on the advice on the advice of advisors where the credibility of each layer of advice depends on audited public disclosure of financial information. Global transparency capitalism has succeeded local insider network capitalism.

Even if you have a network as good as George Soros's,[105] local insider network capitalism will no longer work for you as well as global nesting of critical analysis. However good the oil of the insider, if the local currency plummets, interest rates shift, confidence collapses in the local share market, derivatives trading spirals unpredictably, our money is unlikely to perform as well as it would if prudently hedged across investment in stocks of different markets in different currencies, across stocks, bonds and property.

Since the 1990s the investing public is a mass public in the developed economies. Insider traders, compromisers of transparency, epitomise evil to the new shareholding mass public. That is why democratic forces in the most advanced shareholder democracy – the United States – have caused it to resist global harmonisation of corporate disclosure rules that water down transparency. The Landis-FDR transparency-based regulatory policy that is responsive to American shareholder democracy is the great attractor of the financial universe that is sucking, has sucked, the rest of us into its vortex.

The decisive historical moment in the shift from insider network capitalism to global transparency capitalism was the New Deal. While other economies responded to the depression by tightening the in-house rules of their financial clubs, FDR's New Dealers were not all old boys; many like Landis were new boys. Their credo was Brandeisian fervour about sunlight as the best disinfectant. At first, Americans limited the globalising of their investment pretty much to putting their money in United States transnational corporations (TNCs) that established subsidiaries around the globe. In time, however, foreign firms realised that they could attract American capital if they played the game in compliance with American rules. That meant disclosure of a lot of financial

[105] G Soros, *The Alchemy of Finance* (New York and Chichester, J Wiley, 1994).

data, checking of that data by outside directors who sit on a Board Audit committee, and most importantly of all, external audit by a major American accounting firm. Foreign firms who do that to a satisfactory level may attract investment from United States mutual fund managers, takeover bids from United States TNCs, and if they do it to an exemplary level, listing on the NYSE.

These American fund managers have been the knights on white chargers of transparent capitalism, Brandeisian crusaders who have invaded the temples of infidel money changers, making public their secrets. Rather than overturning their money tables, they have hung an American Express logo on them and put PricewaterhouseCoopers on their prospectus. The potential of American capital investment caused them to securitise their money changing business, incorporating in compliance with American standards as well as local ones. If American fund managers and the NYSE started as the great attractors for the securitisation and corporatisation[106] of the world, European and Asian fund managers soon acted on the benefits of focusing their attention on transparent foreign firms audited to American standards rather than to their own national standards.

The securitisation and corporatisation of the world was not limited to foreign private firms. In the 1990s foreign states with airlines, health care systems and telecommunications systems that were strapped for capital, securitised and corporatised major slabs of the state itself. In doing so, foreign states had to submit that part of their activities to American regulatory standards, especially with respect to transparency.

The final collapse of the British gentlemen's club model of capitalism was symbolised by Nick Leeson, a boy from Watford, sufficiently trusted that he could secretly trade into liquidation the merchant bank rivalled only by Rothschilds in its importance to the building of British capitalism, a house so powerful that in the nineteenth century the Baring Brothers were often referred to as the "sixth great power" in Europe.[107] Barings had collapsed once before in 1890, but then it had been saved by the city, led by Lord Lidderdale, Governor of the Bank of England, and with the help of the Rothschilds.[108] This time round Barings went under because global transparency capitalism was resilient enough to withstand the shock of its departure, a departure the City could not

[106] By no means does all or most securitisation involve corporatisation – the formation of new corporations. Eg, the securitisation of banking creates new classes of bondholders rather than new corporations. These bondholders acquire tradable securities in illiquid assets of the bank, such as mortgages. The bank pools, unbundles, repackages and refinances the mortgages into securities that investors can buy on capital markets. What they buy is a share in the value of the income flow due to the bank from the pooled set of mortgages. In this process something that is basically untradable, an individual loan backed by a bit of dirt, is pooled with millions of others to become a mortgage bond, itself an abstract object represented by a piece of paper that can now be bought and sold by large institutional investors in the bond markets of the world.

[107] P Ziegler, *The Sixth Great Power: Barings 1762–1929* (London, Collins, 1988).

[108] G Davies, *A History of Money* (Cardiff, University of Wales Press, 1994), 348.

have withstood a century earlier. In a television interview after the Barings collapse, Nick Leeson said that the house of Morgan and its auditors would never have allowed him to get away with the kind of massive covert trading in derivatives he managed at Barings.

In fact, it was this American merchant banker who in October 1994 did something extraordinarily significant. J P Morgan released for general use its own proprietary risk management model, RiskMetrics, accompanied by the data set on the volatilities of different types of financial products used with the model.[109] As a big player, J P Morgan realised that it was in a community of shared fate with smaller players (like Barings) that used less sophisticated risk management techniques than RiskMetrics. A major financial collapse that would effect the confidence of all might occur unless the risks of derivatives trading became more transparent. Trading in derivatives does not generate new kinds of risks, but risks that can get out of hand with a rapidity obscured by the complexity of secondary markets. Primary markets in shares in contrast are transparent and move with a speed that can be observed, as it were, with the naked eye.

Transparency capitalism depends on the value and risks of tradable assets being visible to the internal management of traders, their auditors, regulators, analysts, fund managers, rating agencies and investment advisors, if not ordinary shareholders. In the case of Barings, the risks of Nick Leeson's billion dollar losses were visible to none of these players. At the very moment of the total triumph of global transparency capitalism, the complexity of the financial products its screen-based investment has spawned seem to beckon investors back to the security of local insider network investment. J P Morgan has put its systemic interest ahead of its proprietary interest. We see a direct analogue where the nuclear industry shared their proprietary risk-management systems when they realised after Three Mile Island and Chernobyl that another disaster would cause the demise of the entire industry. Nuclear technology and the risk-engineering technology of derivatives trading both create a community of shared fate among all participants in the industry when misuse of the technology risks systemic collapse.

Contemporary capitalism is an information capitalism wherein market dominance arises from the control of abstraact objects like intellectual property more than tangible property. J P Morgan is a classic instantiation of information capitalism – a major economic force that owns no factories and little land, wealth based on knowhow in trading on financial markets. This is why it is so extraordinary that J P Morgan should give away a significant part of the information on which it flourishes. It did this because we live not only in an information society but also in a risk society[110] where the wealth born of being more sophisticated analysts of information is also vulnerable to systemic risk.

[109] R Dale, *Risk and Regulation in Global Securities Markets* (Chichester and New York, J Wiley, 1996), 165.

[110] U Beck, *Risk Society: Towards a New Modernity* (London, Sage Publications, 1992).

IOSCO, the Basle Committee, and all securities and banking regulators realise that they must reach global agreement on how to mandate risk monitoring and risk reporting of derivatives trading through regulation. The industry realises that up to a point it must share risk control technology globally. Risk spreading and global growth via diversification into off-shore investment can be facilitated by mandating off-shore compliance with international accounting standards. But it will backfire if foreign firms cultivate their own Nick Leesons who lose money they do not own through derivatives trading between audits. The regulatory challenge here is enormously difficult, as Susan Phillips of the United States Federal Reserve Board has pointed out: "with derivatives and highly liquid securities, risk profiles can change drastically not only day to day, but hour to hour and minute to minute".[111]

Regulators also must acquire great wisdom in choosing when to abandon a presumption in favour of requiring transparency of risk. If a securities trader linked to a bank (a bigger one than Barings) suddenly got into trouble through risky derivatives trading, there can be a case for the regulator to keep the lid on this, to prevent a run while the bank is given a chance to trade its way out of difficulty .There is a place for both crisis prevention through a transparency that scares investment away from unacceptable risk and crisis management that brings down the shutters when transparency has failed. Crisis prevention through transparency is the more important side of this coin. Alan Greenspan, Chairman of the United States Federal Reserve Board, has outlined what confronting it might mean for regulators:

> ... regulators would specify the magnitude of the market shocks that they expect banks to be able to withstand. The banks would then use their internal models to simulate the effects of such shocks on the market value of their trading portfolio. Banks would then be expected to maintain adequate capital to withstand the declines in market value produced by the specified market stresses. Examiners would assess the adequacy of the models and related internal controls and allow this approach only if the models and internal controls met or exceeded specified standards.[112]

A working group of the Euro-currency Standing Committee of the G-10 (the Fisher Report) has recommended that financial institutions should be required to disclose publicly their internal risk management system and the information generated by it.[113] This amounts to regulatory mandating of the step J P Morgan took voluntarily. The attraction of this proposal is that it would not only improve the dynamic assessment of risk by the market and create a market incentive to have the best risk management systems, but it would also foster learning from those with the best systems. It would be a step to seize the intellectual property rights of financial risk managers that perhaps could only be taken globally: nations could not be expected to force their traders to disclose

[111] Quoted in Dale, *supra* n.109, at 171.
[112] *Ibid*., at 167.
[113] *Ibid*., at 170–1.

knowhow to foreign competitors unless the competition were required to do the same.

All IOSCO Working Groups are in some important sense concerned with an international convergence of standards that assure transparency. In addition there is a Working Group on Disclosure that is dedicated to the development of a set of General Minimum Disclosure Standards.

Mutual recognition, national sovereignty, harmonisation

Up to a point mutual recognition of corporations chartered in other countries has always been a fact of life. Whenever a ship owned by a foreign corporation sails into a port and an officer of the corporation goes ashore and buys something on behalf of the corporation, the actor has been constituted as an actor under another nation's law. Domestic law for many purposes can hold individuals liable when they act for a foreign corporation; domestic registration can be required before certain activities are undertaken. But early on nations realised that it was not necessarily practical to require a visiting Pope to reincorporate the Catholic Church domestically before he was allowed to act on its behalf. We could not begin to survey the differences among national laws in the extent and circumstances in which foreign incorporation is recognised. But to our knowledge there is no state without some degree of mutual recognition of incorporation elsewhere.

Mutual recognition has been an important principle in North American securities regulations and also between Australia and New Zealand. In 1987 the latter two countries agreed that a prospectus prepared under the law of one jurisdiction could be accepted in the other. The European Community has through its system of Directives been the main exponent of harmonisation of securities regulation. At the same time, states have been jealous of their sovereignty to incorporate on their own terms domestically and to demand that firms incorporated elsewhere at least register locally before they trade to locals. Efforts to harmonise companies and securities law have been very recent and, apart from within the European Community, have so far amounted to little. In short, harmonisation has been a late and limp ideal.

Many of the world's stock exchanges have been fairly relaxed about recognising one set of standards for domestic listings, with recognition of different standards for foreign listings. This does not mean they have been attracted to "anything goes" for foreign listings, rather to particularistic judgments of how much elasticity of mutual recognition is justified in a particular case.

Lowest cost location v competitiveness, deregulation

Lowest cost location is seen to be a major issue in the corporate law literature because of the Delaware phenomenon in the United States. Delaware attracts a lot of out-of-state incorporation because of its lower costs. There is, however,

little evidence of this happening in other federal states and the European Community.[114] Internationally, if firms incorporated and listed on exchanges where costs, particularly demands for disclosure, were lowest, they would all do so in developing countries. On the contrary, what most do is incorporate and list domestically. When they want to list internationally in order to get access to foreign investors, they pursue this objective by listing on exchanges that lend them maximum credibility in the eyes of foreign investors. Listing in New York brings most credibility. Passing the test of the most stringent listing requirements constitutes maximum competitiveness in pursuit of foreign investment. Hence, competitiveness is clearly the more dominant principle than lowest cost location. In an interview at the NYSE a senior official told us that the NYSE takes the view that "higher standard regulation draws a lot of business".[115] When one of us pressed him on this, suggesting that competition amongst stock exchanges might drive down standards, he disagreed, pointing out that the United States initiative on insider trading had not resulted in trading moving off-shore.

That said, NYSE rules, particularly on disclosure, are far too demanding for most German or Chinese companies. Many of the German companies can be comfortable with disclosure to the standards required by the LSE, however. If the costs and openness demanded in London are still too high for most large Chinese companies, the competition for their listing might occur between the Hong Kong and Singapore exchanges. That competition is not a lowest-cost race-to-the-bottom competition. It is niche competition for a middling level of market credibility – lower than New York, higher than Shanghai.

There are corporate law havens where incorporation can be bought off the shelf for a pittance with no questions asked. This is a different niche market again. Its market is to serve those who seek to avoid domestic taxes by locating off-shore, to obscure movements of assets, to create a complex round robin of holding companies to conceal a fraud on shareholders or creditors, or some other form of law evasion. In the words of one of our interviewees there are always some activities that people "will want to do in the dark" (interview at NYSE, 1994).[116] What we have in the world system then is niche competition, essentially between New York and London for high-credibility, high-cost international listing; niche competition between exchanges with middling credibility (say Singapore versus Hong Kong); and niche competition at the bottom of the market for lowest cost off-shore incorporation of non-listed companies.

The high watermark of deregulation in companies and securities law was the nineteenth century. By then most monarchs had liberalised their prerogatives to dictate the terms of corporate charters. Incorporation took off when firms were

[114] R Romano, "Explaining American Exceptionalism in Corporate Law" in J McCahery, W Bratton, S Picciotto and C Scott (eds), *International Regulatory Competition and Coordination* (Oxford, Clarendon Press, 1996).

[115] *Supra* n.56.

[116] *Ibid*.

free to incorporate for any business purpose. The Great Depression saw a triumph of state regulation over the principle of deregulation. This triumph was never really reversed in the supposed heyday of Reagan-Thatcher deregulation of the 1980s. Ronald Reagan's transition team found the SEC in 1980 to have a "deserved reputation for integrity and efficiency, [it] appears to be a model government agency". Indeed it was during the 1980s that the handcuffs were out on Wall Street more than during any other period of regulatory history.[117] Particularly after the crash of 1987, while there was some deregulation, there was more tightening of standards globally to some degree.

Strategic trade, national treatment, most favoured nation, reciprocity

Strategic trade has never been an important principle in companies and securities law. This is the prescription of designing the content and stringency of regulation so as to advantage national over foreign firms. Sometimes this principle arises in faint form as in the content of simultaneous multinational securities offerings. Here the fear in the United States is that foreign issues of multinational stock will divert business from United States issuers in United States capital markets. The prescription is sometimes argued to be that national regulation should not encourage the emergence of such offerings. To some extent, as we have seen, exchanges have given domestic investors ready access to certain foreign firms by being less demanding of the foreign offerors. The content of corporations and securities law has not been contested terrain in trade policy. For this reason, the trade policy principles of national treatment, most favoured nation and reciprocity have never played a significant part of the contest of principles fought around the companies and securities law-making of any nation we know.

Rule compliance v continuous improvement

We have not encountered a company law text that discusses the principle of continuous improvement – the prescription of doing better every year than the previous year in terms of a regulatory objective, even if the requirements of the law were exceeded in the previous year. The job of company lawyers is mostly seen as advising clients in what we have defined as the principle of rule compliance: the prescription that companies ought to see legality as exhausting their obligations; to go as far as the rules require, but no further. Whereas one can see the contest with environmental law as between rule compliance and continuous improvement, in company law the contest is really between the notion that lawyers should advise clients how to comply versus advice on how to avoid or

[117] I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (New York, Oxford University Press, 1992), ch 1. See also Organisation for Economic Co-operation and Development, *Securities Markets in OECD Countries: Organisation and Regulation* (Paris, OECD, 1995).

evade. One exception in the literature is *The Stakeholder Corporation*[118] that argues for continuous improvement in transparency and public reporting and that empirically there has been a global shift toward increased accountability.

MECHANISMS OF GLOBALISATION

Military coercion, economic coercion, systems of reward

While some American companies and securities law concepts were put in place during the occupation of Japan after World War II, these were not dictated as terms of post-war reconstruction in the way that a competition law that would break up the *zaibatsu* was dictated. British companies and securities law came to its colonies mostly as a matter of the choice of legislatures in those colonies late in the colonial experience rather than as laws that displaced indigenous law at the time of conquest. Military coercion was therefore not an important mechanism of globalisation.

Given that corporations and securities law has not been an important focus of contest in trade diplomacy, states have not sought to globalise such law through threat or use of economic sanctions or systems of reward.

Modelling

Double-entry bookkeeping and limited liability ultimately acquired legislative vindication, but their global spread was more a result of modelling custom than modelling law, at least with the former. We have seen that the LSE was the crucial model during the nineteenth century when hundreds of stock exchanges opened around the world. Again, rarely was the setting up of a stock exchange the result of a state legislative enactment. Nor is it quite right to describe it in Hayekian terms as spontaneous ordering. A stock exchange is an elaborate self-regulatory regime that came to most of the world with a rulebook copied or adapted from London. It globalised because business people in all centres where capitalism flourished – from Charters Towers to Bombay – wanted to organise themselves to raise capital and invest it.

The modelling of the SEC as a regulatory institution, shifting company law back into the public law domain from the domain of private law where it languished during the centuries of liberalisation of corporate chartering, was in contrast a modelling of law rather than a modelling of custom (that was later codified). Though more than just law in the books was modelled from the SEC; there was also modelling of the enforcement strategy and administrative practice initiated by James Landis. An explicit mechanism for this modelling has

[118] D Wheeler and M Sillanpää, *The Stakeholder Corporation: A Blueprint for Maximising Stakeholder Value* (London and Washington DC, Pitman, 1997), 340, 182.

been the bilateral MOUs the SEC has signed with many other national regulatory authorities since the 1980s. It has been the SEC that has been the initiator of these MOUs. Later IOSCO has helped to facilitate their spread. The MOUs oblige, but do not legally bind, national regulators to share intelligence, conduct surveillance in global markets at the request of their partners and conduct investigations for the foreign partner where their powers allow.

In the case of insider trading, United States diplomatic pressure was deployed, quite determinedly in cases such as Japan, for the modelling of a law that only the United States had for many years. But most of the concepts in the British and United States companies and securities laws of the 1929–1934 period were widely modelled without any diplomatic pressure to do so. While companies and securities laws differ in very important ways, the more striking fact is that comparative surveys of the law such as those of Robinson and Euromoney Publications[119] can be laid out with a comparative index covering a common set of basic concepts. Boards have different structures in different legal systems, but all legal systems have them, and there is much in common in directors' legal duties. The voting rights of shareholders vary a lot; yet there is certainly less variation in how to elect company directors than in the way citizens of the same countries elect their governments. Universally there is a concept of annual reporting based on a European calendar, something that was not even universal within the United States before 1934. There is a surprising globa1isation of usage of technical concepts like incorporation itself, the debenture, the takeover announcement, the prospectus.

The main divides found by Wood[120] in a global survey of financial law heavily weighted to the consideration of corporate bankruptcy were:

- a Common Law Group of states that accounts for a surprisingly high thirty three per cent of the world's population (subdivided into a Traditional English Group of the nineteenth century British Empire and an American Common Law Group that includes Liberia and ten small Pacific states);
- a Traditional Franco-Latin legal framework (about twenty per cent of the world's population, including France, Spain, Portugal, and their former Empires covering nearly all of Central and South America, most of Africa and some of the Middle East and the Pacific, Belgium, Bulgaria, Romania and Greece);
- a Germanis and Scandinavian Group that accounts for seven per cent of the world including Germany, Indonesia, Switzerland, Poland, Taiwan and Scandinavia;
- a Mixed Franco-Latin/Germanic Group that includes Italy, Denmark, Thailand, Louisiana, the Philippines, Turkey, Austria (Hungary) and much of its former Central European empire (six per cent);

[119] MJ Robinson, *International Securities: Law and Practice* (London, Euromoney, 1985); Euromoney Publications, *International Securities Law* (London, Euromoney, 1992).

[120] PR Wood, *Maps of World Financial Law* (London, Allen and Overy, 1997).

- a Mixed Roman and Common Law Group that includes Japan, South Korea, Quebec, Scotland, Sri Lanka, South Africa and a number of other African states (five per cent); and
- an Islamic Group of seven Middle Eastern jurisdictions (one per cent).

Almost thirty per cent of the world's population lived in "Emerging" or unclassified jurisdictions, mostly former communist states, the most important being China and Russia: "It is probably too early to say which of the other groups they will join, but most appear to be leaning towards the Germanic and Scandinavian group (especially China)."[121] What is noteworthy about this interesting exercise of global mapping of financial law is that ninety nine per cent of the modelling is of a Western European model. The exception is the small Islamic Group, but even here it is noteworthy that Egypt, Iran, Iraq, Jordan, Lebanon, Syria, the United Arab Emirates, Algeria, Morocco and Libya are members of the Traditional Franco-Latin Group rather than the Islamic Group.

Western European modelling of securities law was assisted by the fact that most non-Western exchanges were run by European brokers. For example, all ninety five stockbrokers operating in China in 1914 were European, seventy two of them British.[122] Exceptions where the membership of exchanges was mainly native were the Bombay and Japanese exchanges, but even here the self-regulatory framework of the exchanges was European/North American.[123] There are significant elements of regional modelling as well. For example, the Singapore Companies Code is partly based on Australian company law and there have been some Australian influences on Malaysian, Melanesian and Indonesian corporate law, the education of key drafters in Australian law schools being a factor here.

Since the New Deal, modelling has predominantly emanated from concepts forged in Washington and New York. Consider the important instance of Board Audit Committees. The innovation begins in 1940 when the SEC recommended a Board Audit Committee of Outside Directors at an administrative hearing where it found audited financial statements prepared by Price Waterhouse for the pharmaceutical company McKesson and Robbins to be false and misleading.[124] For the next three decades the SEC only very sporadically and informally encouraged companies to have Board Audit Committees. In 1967 the American Institute of Certified Accountants responded to a wave of concern over the question of director liability by recommending Audit Committees. A special

[121] *Ibid*., at 8.

[122] R Michie, "Different in Name Only? The London Stock Exchange and Foreign Bourses, c.1850–1914" in RPT Davenport-Hines and G Jones (eds), *The End of Insularity: Essays in Comparative Business History* (London, Frank Cass, 1988), 49.

[123] JA Sarna, "Japan and Insider Trading: Some Problems when there are Different Definitions of Right and Wrong" (1990) 14 *ILSA Journal of International Law* 67.

[124] JI Samet and JA Sherman, "The Audit Committee: In Search of a Purpose" (1984) 7 *Corporation Law Review* 43.

committee went further in 1978 recommending Audit Committees as a condition of audit, a recommendation not accepted by the membership.

From 1974 the SEC began more formally to encourage the use of Audit Committees by requiring disclosure under the Securities Exchange Act 1934 of the existence or lack thereof of a standing Audit Committee. In 1978 the NYSE took the more potent step of requiring an Audit Committee as a condition of listing on the exchange. Non members of the exchange in the United States complied with the requirement as well because they assumed the courts would interpret the NYSE policy as establishing the standard of responsible behaviour now expected.[125] More significantly, major accounting and law firms recommended it to their clients; it became part of the standard of responsible professional conduct that protected them from negligence suits by recommending it, indeed urging it. The United States accounting and law firms applied this policy not only within the United States but globally to their large corporate client base. In many, if not most, countries whatever the major American accounting firms define as responsible professional behaviour in the accounting industry tends in time to become so defined by the domestic industry. Certainly this has been true in respect of the globalisation of Audit Committees of Outside Directors during the 1980s and 1990s.

In sum, the mechanism of modelling instantiates the principle of transparency; it helps to forge a United States style transparency capitalism based on the idea that "more information is better for most people" (1994 NYSE interview).[126]

Reciprocal adjustment, non-reciprocal coordination

Finally there is substantial evidence of reciprocal adjustment occurring, at least in respect of internationally agreed accounting standards, after centuries of indifference to this principle. IOSCO is historically a comparatively recent institution for fostering reciprocal adjustment. Again, because the hegemonic states have basically not cared whether other states modelled their companies and securities laws (except within the European Community), because they have never loomed as significant in GATT negotiations, there is no evidence of the mechanism of non-reciprocal coordination being in play. We know of no case where one state has changed its corporations law in response to a trade or other benefit offered by another state in some unrelated policy domain.

Capacity building

Capacity building is a mechanism of globalisation of only small significance. IOSCO has a Development Committee to assist emerging markets. It puts a

[125] *Ibid*., at 46.
[126] *Supra* n.56.

dozen or so developing country regulators through an on-the-job training program each year. The 1993 IOSCO budget for this work was a meagre $20,000. France, Britain, the United States and the European Community also contribute to training developing country regulators, but only in a modest way. The SEC effort is not trivial, however. It runs an annual two week training program at the SEC for about thirty regulators from developing securities markets. Most of the investment across all these programs in recent years has gone to post-communist societies.

CONCLUSION

The globalisations of several regulatory innovations have been responsible for the rise and rise of the corporation as a twentieth century transformation of the world to rival in importance the rise of the nation state in the Middle Ages. By the end of the twentieth century many of the things that were once monopolies of either family or state are now done by corporations: child care, cooking, policing, imprisonment, rail transport, telecommunications, entertainment, water supply, electricity, even to a considerable extent the very regulation of incorporation that has been constitutive of this takeover.

An Italian legal innovation that globalised was required to facilitate this growth – the idea of a corporation as a *persona ficta* that could own land, for example. An Italian accounting innovation – double-entry bookkeeping – was essential to the separation of ownership and control, of monies due to investors and managers, that was vital to the globalisation of the business corporation. Limited liability (probably Arab), securitisation (Neapolitan) and the stock exchange (Dutch) were institutional innovations which globalised in a way that enabled the business corporation to spread.

Technological innovation – the telegraph, telephone, ticker tape and computers – centralised efficient market-making for securities in dominant metropolitan exchanges. Communication and processing of financial information became so efficient that an unimagined variety of new assets were securitised. Where once the retail stores where we shopped were owned by families, now they are corporations that build shopping centres with money supplied in small parcels by shareholders. Owners of large assets like shopping malls learnt that they were worth more if they were securitised, because there was more demand for a piece of a high quality asset than for buying it in one big lump, because investors wanted to spread risks and have a liquid asset that could be traded on a day's notice. Just as the private individual who owned a large asset found it was worth more to ten thousand shareholders than to a single buyer of the lumpy asset, so states learned that tradable fractions of the state were worth more to shareholders than they were to the state. As a consequence large slabs of states have been securitised, expanding the dominion of corporations and markets. This lesson was the obverse of the lesson of three centuries earlier that national

debt could be sold at lower interest rates by breaking it up into bonds than by selling it in one lump to family bankers, like the Fuggers, as they previously had done.

As a result of these changes, the state itself became subject to the regulatory imperatives of a corporatised, marketised world. States were no different from other borrowers and issuers of securities in requiring a credit rating by corporate risk-assessors – rating agencies such Standard and Poor's and Moody's. It follows that we cannot understand the globalisation of the regulation of corporations and securities as public or state regulation. Our understanding must be more reflexive than that because the state itself is object as well as subject of the global regulatory transformation. Moreover, our analysis suggests that the self-regulatory activities of the NYSE may have more profound effects on the regulation of major foreign corporations than their own states. The expectations for financial disclosure it transmits through the agency of large American accounting firms with their branches everywhere are important even for stock offerors with no interest in listing on the NYSE. Wall Street not only makes the most important markets, it also makes the regulatory framework for many of the less important ones.

Through their reflexive operation, the processes of corporatisation and securitisation ratchet up levels of transparency. Privatisation around the world builds listings. The NYSE gets the cream but the total pool also increases. Other stock exchanges also pick up listings. Emerging stock exchanges around the world experience an expansion and this changes the nature of their market operation. Their growth forces them to reassess their practices. They move closer to New York's standards because they are growing and want to keep on growing. And more than ever before the NYSE cannot lower its standards.

Our story has been one of triumph of the United States model of regulated transparency, progressive securitisation of the world on terms that will attract United States purchasers of securities. A "big four" accountancy firm audits the privatised Chinese widget manufacturer not because that is what the Chinese state wants, not because that is what the United States state wants (though the SEC applauds). It happens because United States investors want the auditor to be a transmission belt for United States regulatory standards that they long since forced upon United States companies through the agency of the United States Congress, the SEC and the NYSE. United States investor demand for United States regulatory standards apply whether the United States investors are institutional or retail, whether the investment occurs inside or outside the United States. European and Japanese institutional investors, by contrast, do not care for United States disclosure requirements for their domestic investment; at home they have a comparative advantage over American capital because they have insider understanding of local risks and opportunities. When they spread their risks into offshore investment, they too quite like United States-style investor protection before they put their toe in the water.

The big picture of the history of the twentieth century in this account is that

every nation in the world corporatised and securitised, some more completely than others. But all have their credit rating set in New York. The decisive historical moment in this process is the New Deal. The decisive regulatory idea is transparency, demanded of United States security markets by the SEC, later to be transmitted by the NYSE and American accounting firms as a global regulatory ideal when investment globalises. Neither IOSCO nor any other international institution is a central actor in this process, though IOSCO became more important after the Barings fiasco dramatised the risks of insufficiently transparent derivatives trading. Modelling by actors who want to flourish in the face of global market imperatives – states, corporations, self-regulated exchanges, IOSCO itself -is the key mechanism of globalisation.

Of course, economists would say that the market is the key mechanism. And it is true that one reason the institution of the stock exchange has globalised is because it works in satisfying actors' economic interests. Yet the evidence suggests it to be a false theory that stock exchanges will spontaneously organise wherever they are functional for capital formation. Many places in the world are quite incapable of market-making; at some point in history all places were incapable of doing so. Securitized, corporatised capitalism might have taken off in Italy, Spain or Poland centuries earlier than it did.[127] The knowhow, starting capital, banking infrastructure and economic interest were no less accessible in such places than in England. Indeed, why not go back further and ask the same question about China, given its greater economic development than England until the last few centuries, or the Arab world which invented the numeration system, the *commenda*, even the steam-powered turbine[128] a millennium or more before England made so much of these innovations.

Our account is that to understand the corporatisation and securitisation of the world by the modelling of London and New York we need to understand the way specific entrepreneurial actors kept innovating, building one institution on another (for example, a futures (secondary) market on top of a primary market), taking non-tradable assets and turning them into tradeable ones (for example, the mortgage bond market) and on and on. This requires more than a

[127] F Braudel, *The Perspective of the World: Civilization and Capitalism 15th-18th Century*, Vol 3 (trans S Reynolds, London, Collins, 1984), 91:

> Paul Grousset … claimed that "contemporary capitalism has invented nothing". Armmondo Sapori is even more explicit: "Even today, it is impossible to find anything – income tax for instance – which did not have some precedent in the genius of one of the Italian republics." And it is true that everything seems to have been there in embryo: bills of exchange, credit, minted coins, banks, forward selling, public finance, loans, capitalism, colonialism – as well as social disturbances, a sophisticated labour force, class struggles, social oppression, political atrocities.
>
> One might add to this list holding companies, which were invented in Florence: Braudel, *ibid*., at 128. Flourishing capitalism is based less on original invention than on appropriating and institutionalising the inventions of others – witness Japan. Even blast furnaces and mining techniques fundamental to English industrialisation were appropriated purposively from more technically advanced Germany by importing Germans with the knowhow: *ibid*., at 552.

[128] Braudel, *ibid*., at 543.

market. The market is constituted by an epistemic community hospitable to entrepreneurship and by institutions that are constitutive of more elaborated institutions. These institutions by our account are created by purposive action, not just because they are functional. Most importantly, regulatory institutions, not just laws, but the customs of the LSE or the *lex mercatoria* are constitutive of abstract objects like corporations and securities that transform the whole world. Entrepreneurial lawyers in this story are not passive agents waiting on instructions from the powerful, nor are they superstructural dupes in the vulgar Marxian sense. They forge structures actively by selling ideas like the *persona ficta,* the securitisation of the national debt, intellectual property protections and poison pills to Popes, potentates, princes, parliamentarians and monied principals.[129]

Understanding purposive entrepreneurship at the centre as appropriating ideas like limited liability from the periphery is not enough for understanding the corporatisation and securitisation of the whole world. To understand that, we also need a theory of modelling from centre back to periphery.

[129] Powell, *supra* n.60. See also M Cain, "The Symbol Traders" in M Cain and C B Harrington (eds), *Lawyers in a Postmodern World* (New York, New York University Press, 1994); and D McBarnett, "Outlining a Theory of Legal Practice" in Cain and Harrington, *ibid*.

2

Enterprises and the Constitution of the World Economy

JEAN-PHILIPPE ROBÉ

INTRODUCTION

Notwithstanding globalisation, the traditional concept of state sovereignty is still perceived as a cornerstone of the institutional system of exercise of power in the world economy. Whatever the reduction of the states' autonomy in a globalised world, the state is still treated in legal theory as a sovereign with an independent capacity to regulate the objects falling under its jurisdiction. One is forced, however, to recognise as a matter of fact that in a globalised economy the margin of action of the state is rather limited. Let any given state adopt norms impacting on the economy (the setting, for example, of minimum salaries, safe working conditions, strict environmental regulations, and so on) against the stream of what is being done in competing states and enterprises located on its territory will be in an unfavourable competitive position in global markets and/or will "delocalise" to find in other locations more favourable "supplies" of legal norms. Fearing these negative consequences of their regulatory activity, states are hindered to adopt independent norms by the existence of an open economy which therefore constrains them. In the traditional legal analysis, this situation is a mere *fact* of no impact on the attribution of the sovereign power to regulate given by *law* to the institutions of the state. One would have to accept that there is a loss of effective power of no consequence for the traditional understanding of legal ordering, for which the state remains "sovereign" whatever its incapacity to exercise its formal competence.

This chapter will try to demonstrate that one may not understand or act upon a globalised economy without taking into account the autonomy benefiting enterprises in liberal legal systems and drawing the appropriate conclusions for the understanding of *legal ordering*. The traditional analysis neglects the fact that companies, especially large ones operating on a global scale, have such power and such a degree of autonomy, both from individual rights holders and from public institutions, that they can not be neglected in the study of the effective functioning of the *legal* system existing in the world today. My thesis is that globalisation gives us the opportunity to better understand the pluralist nature of legal ordering in a liberal society, and to draw the appropriate conclusions for

our understanding of the functioning of the institutions participating in the world economy.

I will try to demonstrate that the loss of effective power by the state is not a mere *fact* of no consequence for *legal analysis*. In our perspective, although enterprises do not officially appear in the *constitutional structure* of a globalised world society as institutions having a positive existence, they are to be analysed *in legal terms* as participants in it. By "*constitutional structure*" I mean the sum of the *legal* rules determining *who* exercises power in a given society, and according to *what legal rules* this power is exercised. We pretend that in a world where liberal principles of social organisation dominate, the constitutional structure of the world, where power is deemed to be allocated among states and the international organisations they have created, is much more complex than usually considered. Our point is that one must include within this "constitutional structure" the capacity of decision and rule making *constitutionally* guaranteed to enterprises by liberal constitutions.

INTERNATIONAL ECONOMIC LAW AND THE POLITICAL ORGANISATION OF STATES

Classical public international law is not concerned with the internal political organisation of states. The law of war, the law of the seas, the law of international treaties, and so on, takes the states as monolith sovereigns. Classical international law is theoretically free of political bias and leaves issues of political organisation to be addressed at the domestic level. In economic matters, states are therefore theoretically free to adopt the domestic mode of economic organisation of their sovereign choice.

The *liberal* juridical system of organisation of society was originally embedded in domestic constitutional documents only, with no *legal* impact on economic organisation outside of the borders of the state adopting it. This system, however, has been expanded on the international scene through a series of treaties furthering, at the international level, the freedom of movement of goods, services and investments that exist on a national scale. This liberalisation movement started in the last third of the nineteenth century, but gained momentum with the post World War II institutions, and in particular GATT which paved the way for the World Trade Organisation (WTO).

Although *classical* international law may be free of political bias, international *economic* law has therefore a very strong liberal flavour that, in turn, impacts on the whole domestic system of social organisation of the polities composing the world economy. Given the sheer amount of economic exchange covered by these treaties, and the need to abide by their rules to have effectively access to the economies covered by this network of treaties, it is very difficult to fully participate in the world economy without participating in those treaties. All polities, even when reluctant to adopt liberal principles of social organisa-

tion, are thus affected domestically in their capacity to govern themselves in an autonomous manner by the expansion of international economic exchange in an institutional environment built on liberal principles.

As a consequence of this internationalisation of liberal principles through international treaties, one must make an analysis of the functioning of the world economy from within the liberal system of social organisation. One needs to understand and draw the appropriate consequences from the fact that the *constitutional structure* of the liberal polities which make most of the core economies of the world society has an *inverted* mode of attribution of power if it is compared to that existing in a traditional, *holistic* society, which is the implied model of the traditional conception of state sovereignty in international law.[1] The point is that one can not keep on thinking about the organisation of our international society as if the component states were still the absolutist institutions they were at their origin. In all liberal societies, the constitutional revolution has taken place, which submits the state to the fundamental norms set by the Constitution. Things could have been, or may one day become, different. But this is as they are, here and now, and a thinking which disregards this is wholly irrelevant to today's reality.

THE DISTINCTION BETWEEN NON-LIBERAL AND LIBERAL LEGAL SYSTEMS

In schematic terms, one can describe the difference between a non-liberal and a liberal legal system in the following manner:

(a) Within what we call a *non-liberal* legal system, the state is an absolute sovereign from which each legal norm derives, directly or indirectly.[2] The whole of the state comes first, individuals being merely its instruments, with no rights independent from those granted by the state's legal order. Whatever the degree of autonomy granted to individuals or bodies (territorial or functional), this autonomy is always precarious since it is not based on a *right* but on the *goodwill* of the real holders of power. The limit of state action only depends, at law, on the state's decision not to act, not on legal rules to which the state is subject and which would legally impair its capacity to act. The state may be limited to act by facts; it is not limited by *law*.[3]

(b) Within what we call a *liberal* system, on the contrary, the state is forbidden, as a consequence of the recognition of certain "fundamental rights" expressed

[1] *See* L Dumont, "La conception moderne de l'individu" (1978) *ESPRIT* 12.

[2] See C Millon-Delsol, *L'Etat subsidiaire. Ingérence et non-ingérence de l'Etat : le principe de subsidiarité aux fondements de l'histoire européenne* (Paris, PUF, 1992), 8.

[3] See the presentation made by Portalis (one of the drafters of the French Civil code) in his "Preliminary Discourse" on the draft *Code civil* made to the Conseil d'Etat in F Ewald (ed.), *Naissance du Code civil* (Paris, Flammarion, 1989), 40ff.

in the constitution, and protected through effective procedures, from intervening in certain matters. Assuming an effective functioning of the liberal state according to the rule of law, the liberal state achieves the paradox of defining rights for the individual which the state places out of its own reach. This arrangement is protected through complex institutional devices (the division of state power into legislative, executive and judiciary, the right to go to court given to individuals to enforce their rights against the state, and so on).

As a consequence of the definition of fundamental rights, such as the right to property and various freedoms of movement, of initiative, of commerce, of contract, and so on, a sphere of autonomy to develop its economic activities in which the state is somehow restricted from interfering exists around the individual. The fact that the state may not *constitutionally* regulate certain aspects of social life, because it would constitute, for example, too strong an infringement to the free use of property rights, does not imply that *every* kind of regulation is prohibited concerning these aspects: it implies that this regulation is, *as a matter of principle*, in the domain of civil society and that the state may regulate, *as a matter of exception*, in the furtherance of constitutionally protected values. The regulation of matters left to individuals' autonomy is therefore left as a matter of principle to the *self*-regulation of civil society, in particular through *contractual means*.[4] The equilibrium between the rights of autonomy and the constitutionally protected values is defined through the democratic political process and procedures of constitutional review. It therefore depends on the specific content of each liberal constitution and on each domestic political process. But although the margin of autonomy left to civil society varies from country to country, the point is that this sphere exists in all liberal legal systems.

Of course, a liberal State may be taken over by political leaders who may then breach these fundamental principles of liberal social organisation. If their following is sufficient, the whole system then disappears. But, by definition, we are not in a liberal system any more. And it is not because a liberal system is exposed and can disappear in this manner that one should be prevented from considering the results of the effective functioning of liberal legal systems. There are, in today's world, liberal legal systems effectively functioning and our thesis is that this has a very serious impact on how the world economy operates. In addition, the process of globalisation, by increasing competition among states to provide favourable norms for businesses, in effect increases the margin of autonomy left to civil society and it is therefore all the more important to understand the consequences of liberal legal ordering.

In summary, the liberal constitution has a structure which is *reversed* in comparison with the non-liberal one: the *principle* is that power lies in civil

[4] For the same reason that to *deregulate* a sector of social life in effect consists in transferring its regulation from statist heteronomy to the autonomy of the actors of civil society: see A Supiot, "Déréglementation des relations du travail et autoréglementation de l'entreprise" (1989) *Droit Social* 195.

society (as a matter of principle, the individual is autonomous and has the freedom to organise its economic life with other individuals through contracts); the *exception* lies in the specific competencies devolved to the state (which may adopt norms in the common interest through its political organisation – usually democratic in a liberal system).[5]

THE ENTERPRISE IN THE LIBERAL LEGAL SYSTEM

Originally, the fundamental change introduced in legal ordering by liberal principles of social organisation occurred at the origin of the modern age and was intended to benefit to the individual only. It came as an ancillary to rising individualism in many spheres of social life (religious, political, economic). The notion of property was developed to further the individual's autonomy to act freely in those spheres, property giving the right to make one's own decisions with regard to the object of the right, and contributing therefore substantially to the effective existence of these new freedoms.

Enterprises, however, have progressively found the technical means to benefit from these rights originally defined for the individual, mostly through the use of corporate vehicles having legal personality. The capacity left to civil society to regulate itself by defining property rights and allowing freedom of contracts has been used by enterprises, which have progressively concentrated these dispersed competencies to agglomerate them into large organisations. Companies have therefore been using the autonomy granted to civil society by liberal principles of organisation to achieve a fantastic degree of concentration of power and of autonomy.[6]

This change came in an unofficial manner, progressively, with no fundamental modification brought to the understanding of the liberal organisation of society as comprised of dispersed individuals minding their own interest, on the one hand, and of the state, in charge of the furtherance of the common good, on the other. The enterprise developed its organising power without being effectively recognised as such by the legal system, which does not perceive its unity. The enterprise can exercise its organising activity as a consequence of numerous transfers of control over economic resources deriving from the conclusion of a multiplicity of contracts.[7] For example, the entrepreneur contracts with suppliers of capital to have enough financial means to lease premises, to have space to install pieces of equipment leased from manufacturers, to be able to hire individuals pursuant to employment contracts to operate them, and so on. The

[5] According to Norberto Bobbio, this radical change of perspective introduced by the American and French Bills of Rights (1787 and 1789) is tantamount to the "*discovery of the other side of the moon*": N Bobbio, *Stato, Governo, Società. Per una teoria generale della politica*, (Torino, Einaudi, 1985), 147–148.

[6] See generally J-P Robé, *L'entreprise et le droit* (Paris, PUF, 1999).

[7] See J-P Robé, "L'entreprise en droit" (1995) 29 *Droit et société* 124–130.

whole of the enterprise can be broken down in this manner into a circuit of economic exchange occurring as a consequence of the existence of a network of contracts pursuant to which the various parties are supplying specific resources through time in exchange for a consideration.

As a consequence of the network of contracts that serves as its grounding in positive law, an organisation (the enterprise) exists and is in a position to coordinate resources for an economic purpose. But despite this very real existence of the enterprise, just like the "firm" it is not an object of study for the classical economist,[8] the enterprise is not considered as a legal concept in classical legal analysis. The enterprise as a whole has no existence and breaks down into property rights and contracts. Although the word "enterprise" (or one of the words often used as a synonym, such as "firm", "company", "undertaking", and so on) is frequently used in legislative or regulatory texts, court decisions, law journal articles and books dealing with business, economic or company law, the word "enterprise" does not correspond to one unique legal concept in positive law.[9] There is a striking difference here between the common perception and that of positive law. One speaks of "IBM", "Toyota", "Microsoft", and so on. But none of these enterprises exists in itself in positive law. For positive law, the enterprise can be perceived, at best, as a series – a network – of contracts and property rights which does not, as a *whole*, have its own legal existence.[10] Positive law mostly refuses to go beyond this and therefore prevents us from understanding the enterprise as a whole.

The network of contracts is, however, only the *vehicle* used by the enterprise in *positive law*, and is not the enterprise *in itself*; this organisation effectively exists and operates as a *whole* without positive law being in a position appropriately to deal with it. Although the enterprise in itself evades legal under-

[8] See, in this regard, the seminal article by RH Coase, *The Nature of the Firm*, [1937] *Economica NS* 386.

[9] On the notion of enterprise under *French law*, see, in particular, P Durand, "Rapport sur la notion juridique d'entreprise" in (1947) 3 *Travaux de l'association Henri Capitant* 45; M Despax, *L'entreprise et le droit* (1957); A and G Lyon-Caen, "La doctrine de l'entreprise" in *Dix ans de droit de l'entreprise* (Lib Tec, 1978), 601; A Supiot, "Groupes de sociétés et paradigme de l'entreprise" (1985) 38 *Revue trimestrielle de droit commercial et de droit économique* 621; P Le Cannu, "La notion juridique d'entreprise", *Les Petites Affiches*, 14 May 1986, 19; J Paillusseau, "Le big bang du droit des affaires à la fin du XX°siècle" (1988) *Semaine Juridique*, No. 15101; N Aliprantis, "L'entreprise en tant qu'ordre juridique" in N Aliprantis and F Kessler (eds.), *Le droit collectif du travail. Etudes en hommage à H. Sinay* (Peter Lang, 1994), 185. For the notion of enterprise under *European law*, see, in particular, C Bolze, "La notion d'entreprise en droit communautaire" (1987) Special Issue: *Revue de Jurisprudence Communautaire* 65. On the vivid debate regarding *German law*, see T Raiser, "The theory of Enterprise law in the Federal Republic of Germany" (1988) 36 *American Journal of Comparative Law* 111. On the issue in the *United States*, see, in particular, AA Berle, "The Theory of Enterprise Entity" (1947) 47 *Columbia Law Review* 343. On the issue under *international law*, see specifically D A Ijalayé, *The Extension of Corporate Personality in International Law* (New York, Oceana Publications, 1978).

[10] See, eg, J Savatier, "Du domaine patriarcal à l'entreprise socialisée" in *Mélanges Savatier* (1961), 866. See generally Robé, *supra* n.7, esp 122–130 and the cited sources.

standing in classical terms, the fact remains that we have to deal with its very real existence and impact on the international economy. The amounts of property rights concentrated in these organisations are enormous.[11] Property rights being parcels of constitutionally protected rights to make decisions with regards to their objects, enterprises have concentrated a power to make rules and decisions which in effect is now challenging the classical state system of social organisation.

THE ENTERPRISE AS A SUBJECT OF LEGAL ANALYSIS

Although the enterprise in itself can not be understood in terms of positive law, for which it does not exist as such, I still think the enterprise as a whole can be analysed in legal terms. The "enterprise" is performing an organisational function – a function of regulating the activity of its members through the production of *rules and orders that are specific to each enterprise*, and are self-defined within ("by") the enterprise. This activity can be analysed in legal terms as *legal ordering*, the content of the norms thus created being the consequence of the political equilibrium between the various participants to the enterprise:

(a) The enterprise creates rules which have an impact on its constituents. As an organisation creating norms applying to people in direct relationship with it, the enterprise can be analysed as a legal order in competition with the *state legal order*, which also adopts norms in its own legal order so as to affect the internal organisation of the enterprise. In the absence of state norms, the enterprise may decide to organise its activities in a given manner (twelve hour shifts, for example), which it may be prevented from doing only where the state itself (or an administrative delegate) adopts norms (eight hour maximum shifts, for example). States' norms, in this perspective, are adopted in an attempt to modify, from the outside, the internal organisation of work within enterprises. In this perspective, the relationship between the enterprises and the state may be analysed in terms of relationships between autonomous legal orders, the enterprise having, as a matter of principle, the right to adopt norms for its internal organisation and deciding on their content as a consequence of the political equilibrium between the various participants to the enterprise; state norms being adopted (as a consequence of political choices made within the state) as a matter of exception to replace, thanks to their higher position in the hierarchy of norms, the norms spontaneously created by enterprises.

(b) The rules and decisions made within the enterprise implicitly comprehend the outcome of *political choices* made within the enterprise. The enterprise decides to allocate the economic resources it controls by taking into account the

[11] See generally D Julius, *Global companies and public policy: the growing challenge of foreign direct investment* (Royal Institute of International Affairs, Pinters, 1991).

various demands of its constituents (shareholders, workers, consumers, surrounding polities, and so on) and their relative "bargaining" strengths. Apart from being a legal order, the enterprise is therefore also a *political order*. As a political order making choices in the allocation and organisation of resources, it enters into competition with the *state political system*. And the relationship between the enterprise and the state may therefore be thought about in terms of relationship between autonomous political systems.

We will test this theory by first examining some aspects of the relationship between the firm's norms and positive law at the *micro-level* of the organisation of the enterprise. We will then look at the *macro-level* of the relationship between enterprises and positive legal orders. We will see that the understanding of the enterprise as a legal order leads to a legal conception of liberal society as being regulated both by (a) the contractual interactions of rights holders (the "market" of the economists), and (b) by the ordering activity conducted internally within organisations, including enterprises, within the general framework of positive norms authorising and orientating this self-regulation of society.

RÈGLEMENT INTÉRIEUR AND THE CONTROL OF PROPERTY RIGHTS

The enterprise is characterised first and foremost by the fact that it is an organisation ordering the activity of people entering into a relationship with it. The intensity of its *power* over people depends on the specific content of the contracts entered into by the various rights holders who have a relationship with it. The salaried employee in an enterprise is clearly subjected to the rules of the enterprise to a much greater magnitude than other parties having a contractual relationship with the enterprise (the occasional customer, for example). The employee is a subordinate and, as a consequence, the enterprise has the capacity to enact permanent and general rules applicable to employees within the enterprise. To understand how positive law has found the way to deal with this marvel of the existence of "private" unilateral power, one can look at the treatment by authors of the so-called "inner regulations" (*règlement intérieur*) of the enterprise under French law. The *règlement intérieur* is the document which contains the rules generally applicable within the enterprise; obeying it is mandatory. The question is why?

To avoid recognising the existence of an unjustifiable power of one individual against another in a liberal legal system, authors have first tried to explain the existence of this power in *contractual terms*. According to this defunct theory, the employee agrees to be bound by the *règlement intérieur* at the time of acceptance of the employment contract. The *règlement intérieur* is treated as an annex to the employment contract, tacitly accepted by the employee. Its legal validity and binding force derives then from the *common will of the parties*, and liberal theory, based on the exercise of the free will of the individual, is therefore

safely kept coherent.[12] The employee is bound by the rules because he has *accepted* them, which he could do in the exercise of his freedom to contract. But how does one explain, then, the fact that the salaried employee is subject to *amendments* brought to the *règlement intérieur* well *after* the signature of the employment contract, and that she or he does not formally accept? Also, how does one explain the fact that *any person* performing a function within the enterprise, even outside an employment contract, is subject to the clauses of the *règlement intérieur*[13]? The contractual theory does not provide answers to those questions.

As a reaction to this theory, an "institutionalist theory" developed,[14] according to which the enterprise is an *institution* that *spontaneously* creates its own law, as a consequence of the "*natural inclination*" of private groupings and institutions to provide internal legal rules for themselves.[15] This theory was happy to find sources of authority and norms outside of the state in society itself. Individuals create communities for the pursuit of their common interests, the theory goes. These communities have to create rules to regulate themselves. Such would be the case of the enterprise.

In reality, the enterprise can hardly be thought about as a community. Employees do not happily decide to create a community with their boss because they have a dire need of someone to coordinate their actions through orders. They join enterprises because they need to make a living and have to agree to abide by the orders as a consequence. The institutionalists' theory has a certain paternalistic flavour in trying to justify the authority of the management of the enterprise by appealing to the joint interest of its participants. The institutionalists' theory in effect misses the paradoxical *foundation* of the power of the enterprise in liberal *constitutional* principles when giving it an *autonomous* (sociological) foundation by presenting it as a *community*. There *is* a sociological reality to the autonomy of the enterprise, but the *legal* autonomy to make rules enjoyed by the enterprise derives from positive law.

The *règlement intérieur* in fact is nothing more than one of the consequences of the control of the property rights used within the enterprise. Although the management of the large enterprise usually does not own these property rights, it effectively controls their use and therefore may set rules in connection with this use. Anyone entering the enterprise's premises must abide by the law of the owner (or, in this case, of its legal representative). The enterprise therefore establishes in an *autonomous* manner what people have the right to do, and the

[12] A Bacquet, "Conclusions sous Conseil d'Etat, 1er février 1980, Société Peintures Corona", (1980) 310 *Droit Social* 313.

[13] A Supiot, "La réglementation patronale de l'entreprise" (1992) 215 *Droit Social* 218; B Mathieu, *Les sources du droit du travail* (Paris, PUF, 1992), 110.

[14] Which has been adopted by case law: see Mathieu, *supra* n.13, at 110.

[15] A Bacquet, *supra* n.12. See also J Savatier, "Réglement intérieur et délai de prescription des poursuites disciplinaires" (1992) 24 *Droit Social* 24; G Gurvitch, *Le temps présent et l'idée du droit social* (Paris, Vrin, 1931), 66–67.

obligation not to do, within the enterprise and has certain means available to ensure that the norms thus created have effectiveness. Although the state has a legal monopoly over legitimate physical violence on a given territory, and may use it to give effectiveness to the norms it produces, it does not monopolise the *other forms* of social violence that may be used to give effectiveness to norms. The liberal state actually uses its resources to define clearly and protect property rights that allow their owner to give legally enforceable orders to those contracting with them. The salaried employee in an enterprise, for example, is rarely threatened with the use of physical violence if he or she does not abide by the orders (only the state can do that), but the enterprise has very real and efficient sanctions available (the threat of dismissal, for example) to ensure that orders are usually obeyed, and that the inner legality of the enterprise is respected.

The autonomy of the enterprise thus derives from state law and not from a "natural inclination" of natural groupings to create rules. This "natural inclination" may very well exist. It is simply not the source of the power of the enterprise.

PROPERTY RIGHTS AND ENTERPRISE AUTONOMY

This foundation of the enterprise in constitutionally protected property rights has very serious consequences. *As a matter of principle*, the management makes the rules, and state law only provides for limits which come as exceptional derogations to this principle. This can be perceived clearly by examining how the creation and content of the *règlement intérieur* is regulated by French positive law.

Until 1982, *règlements intérieurs* appeared spontaneously in enterprises without any specific regulatory framework giving authority for their adoption and specifying their possible content. In 1982, the French legislature (after the Socialists' victory of 1981) decided that it could no longer leave the regulation of peoples' life during most of daylight abandoned to the arbitrariness of employers. Since this legislative intervention, the domain of the *règlements intérieurs* is now set by statute:[16] the *règlement intérieur* is *mandatory* in any enterprise with at least twenty employees. But it can comprise prescriptions only in strictly defined fields, and in particular those relating to discipline, hygiene and safety. For authors, the uncertainties of the past with regard to the legal basis for the existence of *règlements intérieurs* have now fortunately given way to a clear situation: the power of the employer is *based on* the statute and is limited by its provisions. For the experts in the field, the management of the enterprise now benefits from a *delegation of regulatory power* belonging to the state: the statute is making a "*delegation of normative competence to the employer*".[17]

[16] Article L.122–34 of the French *Code du travail*.

[17] Savatier, *supra* n.15. It would have now become *explicit* whereas it would have been only *implicit* in the past; hence, for Bacquet, "the employer, as a private person, disposes within his enterprise of an autonomous regulatory power by a sort of implicit delegation [of the power to do so] from the legislator": Bacquet, *supra* n.15, at 314. See also Supiot, *supra* n.13.

The theory according to which the power to adopt a *règlement intérieur* would be *based* on the statute is mistaken. The power of the enterprise to make rules does not derive from the statute but from the control over property rights. And the capacity to make rules that derives from property rights does *not* derive from statutes, but from liberal constitutional norms. Certainly, the enterprise employing at least twenty employees *must* now (since, and because of, the statute) adopt a *règlement intérieur*, which may contain provisions *only* in certain fields. To be valid *under French positive law*, the norms produced by those enterprises and comprised in the *règlement intérieur* must thus now fulfill a certain number of criteria. But this does not mean that the power to adopt a *règlement intérieur* is *based* on the statute. On the contrary, this power *preexisted* the statute since enterprises spontaneously adopted *règlements intérieurs* well before the enactment of the statute. There must, necessarily, be one *unique* foundation for this power in *all* enterprises, whatever their size. If the statute were today the foundation of the "legislative" power of the employer in enterprises of at least twenty employees, what would be the foundation of that power in enterprises with fewer employees? It clearly cannot be based on the statute.

In fact, the change brought by the statute is that whilst the exercise of the power to adopt the *règlement intérieur* within the enterprise previously was left to the discretion of the employer, it is now subject to norms applying to its drafting and its content, and to procedures for the control of those norms in certain enterprises beyond a certain size. The state could decide, as it did until 1982, to let enterprises freely choose the content of their *règlement intérieur*. In 1982, it decided to start using *certain means*, internal to its own legal order, to *reduce employers' autonomy*. But it did not *suppress* this autonomy. What was at stake, for the state, was to make sure that the employers' power was not used to subject people to a form of *social control* irrelevant to the enterprise's ends.[18] The statute did set limits to the exercise of the employers' power. But the statute did not become the *foundation* of the power. And in small enterprises, the boss still makes the rules, alone and without any control.[19]

ENTERPRISE AUTONOMY IN THE GLOBAL CONTEXT

With this example, we clearly see in a different light the relationship between the legal order of the enterprise and the legal order of the state. The ideological presentation of the state as the absolute sovereign leaves the way open to a more subtle type of relationship between authorities, each having their own sphere of autonomy as a consequence of liberal principles of the organisation of society.

The possibility of the existence of the *règlement intérieur* is a consequence of

[18] See Savatier, *supra* n.10, at 867–869.

[19] Criqui, "La citoyenneté dans l'entreprise" in D Colas (ed.), *L'Etat de droit – Travaux de la mission sur la modernisation de l'Etat* (Paris, PUF, 1987), 81–82; A Supiot, "Critique du droit du travail" in *Les voies du droit* (Paris, PUF, 1994), 55.

liberal constitutional principles; but the state may create norms pursuant to which it will use its *own* material and human *means* to verify that the *product of the internal legal order of the enterprise* (the *règlement intérieur*) is in conformity either with constitutional principles, or with principles set through state legislation or regulation, in conformity with constitutional principles.[20] There is no *integration* of the legal order of the enterprise within the state's legal order; there is the establishment, within the state's legal order, of norms and procedures to ensure that the power autonomously exercised within the enterprise is used only to pursue the *ends* for which its existence is accepted. There is clearly less *autonomy* for the enterprise after statutory intervention. But, *as a matter of principle*, the enterprise is still the decision-maker of prime resort, the role of state positive law being only to *reduce* this autonomy for the sake of the protection of individuals or the furthering of the common interest. It does not make it disappear or invert the devolution of the primary power to make rules granted to property rights holders. Positive law is, in effect, guiding *from the outside* of the enterprise, the *internal* production of law *by* the enterprise.

What this example shows is that the autonomy of the enterprise – the capacity it has to make autonomous decisions and rules – is not something new that appeared with globalisation. Since the beginning of modern times, and especially since industrialisation and the advent of the large business enterprise, this autonomy has been a fundamental element of the system of power effectively operating in a liberal society. It could be disregarded as long as this complex system of interactions among individuals one calls society took place mostly on a national scale. Rules made within enterprises could somehow be reinterpreted as *national law*, and be attributed to the *state legal system*. With enterprises operating on a global scale, this is not possible any more. If the inner law of the enterprise may be misinterpreted as national law when the enterprise remains established on the territory of one single state, doing so is a mere fiction when the enterprise becomes multinational. At the international level, one may not pretend any more that the legal order of the enterprise is "incorporated" within that of the state.[21] Each state may very well consider, *for its own purposes*, that the inner law of the enterprise is *state* law, and to *incorporate* it within its own legal order, if it meets certain conditions, or it may consider it as *illegal*. The law produced by the internal legal order of an enterprise may, in the case of a multinational enterprise, even be *illegal* in one state legal order whilst it is perfectly *legal* in another one. For the enterprise *in itself*, the norms created are the product of the enterprise itself, whatever the position of states' legal orders with respect to them.[22] These self-produced norms usually take into account the

[20] On the constitutionalisation of the sub-system of the economy in the works of Habermas, see G Teubner, *Droit et Réflexivité. L'auto référence en droit et dans l'organisation* (Paris, LGDJ, 1994), 60.

[21] F Rigaux, , "Droit international privé" in *Théorie générale*, Vol 1 (Brussels, F Lacier, 1977), 275.

[22] For Teubner, "the validity of law derives from its self-referentiality, that is to say from the

content of state laws in relation to the determination of their own content in order not to enter unnecessarily into a struggle with the various positive legal orders of the states.[23] But this does not change the fact that the norms created internally are their *own*.

This can be clearly seen by looking at the status of the manager. The enterprise creates a personal status for the manager, a sort of personal law, which follows him or her wherever he or she goes, whether on a business trip, on a long-term mission or as the head of a local subsidiary that is part of the corporate structure of a multinational enterprise. Gérard Lyon-Caen has already noted that

> human resources policies are dealt within the framework of rules internal to the multinational group of companies. The status of managers is elaborated internally. Health insurance and pension fund matters are dealt with at the group level. Naturally, relocation packages, the length of missions and detachment abroad are defined internally.[24]

Each State legal order may have its own conception of what the personal status of the manager should be. The manager may very well, in each of the territorial legal orders in which he or she operates, for one reason or another, have certain particular rights that he or she may be in a position to enforce in state courts. And in *pathological cases*, this is what happens. However, if one is not merely interested in the pathology of the legal system but in its actual functioning, the "rights" of the manager to a certain career progress, to a certain salary, fringe benefits, privileges attached to seniority, to a company pension fund, and so on, are determined by the enterprise itself, and it is *this law* that the managers operating in the normal course of business obey.

THE UNILATERAL EXERCISE OF "PRIVATE" POWER

So far, we only have looked at the normative power of the enterprise over employees. They are the easiest to deal with since they are subject to the legal order of the enterprise employing them as a consequence of a contract – the employment contract – which specifically provides for *subordination*. But the enterprise has other individuals falling within its *jurisdiction* as well.

Some enterprises have such immense power vis-à-vis the whole of their economic *environment* that the bureaucratisation of their activity[25] is such that

application of legal operations to the result of other legal operations. Validity may not be imported from the outside, it can only be an internal product of law" in G. Teubner, "Le droit, un système autopoïétique" in *Les voies du droit* (Paris, PUF, 1993), 8. See also S Romano, *L'ordre juridique* (Paris, Dalloz, 1975), xii and 32.

[23] This is so for a very simple reason: property rights are, in final analysis, allocated and protected by the state. This makes it necessary for the legal orders of enterprises to *cooperate* with the legal orders of states.

[24] G Lyon-Caen, "La concentration du capital et le droit du travail" (1983) 287 *Droit Social* 303.

[25] IR Macneil, "Bureaucracy and Contracts of Adhesion" (1984) 22 *Osgoode Hall Law Journal* 5.

it is often all their suppliers (and not only the suppliers of labour – the employees) and distributors that are being "ordered" by these enterprises.[26] In the perspective of institutional economists, the *environment* of the enterprise may be defined as *what is not ordered by it*.[27] The enterprise thus represents an island of a *certain* type of order (organisational), in an environment composed of a *different type* of order (the market); the "market" itself being the result of the combined action of individual actors and of other orders (organisations). The limits of the enterprise may be relatively loose. For example, in terms of these orders where is the contracting party having signed a long term distribution contract, leaving it relatively independent, but providing for a clause for adaptation of prices and numerous detailed and strict obligations over a very long period of time? Is this distributor within or outside the enterprise for which it is a distributor? Is the distributor really an autonomous enterprise or is it not a vassal to the producer? Where does a franchisee belong? Is he integrated within the enterprise? What about joint ventures? The difficulty that exists in finding the limits of the enterprise shows that there is often no neat border between inside and outside: there are only *margins*, zones where the authority relationships are loosely or poorly defined, changing and/or multiple. Here, we find a striking analogy with states at their formative age. These "borderline cases" are like the principalities located between the great powers of the Middle Ages, before their consolidation into clearly defined nation states led to the invention of the concept of border.

The intensity of the power of the enterprise also depends on its size, since the larger the enterprise, the more its tendency will be to have formalised rules in its dealings vis-à-vis all those entering into relationships with it.[28] The rules applicable to suppliers, manufacturers, and other weak parties will often be described in "charters", general purchase conditions, and other printed documents to take or to leave for contracting parties willing to work with the enterprise; the consumers of the products and services will also sign contracts of adhesion with non-negotiable clauses.[29]

In positive law, this unilateral exercise of the *power* of the large enterprise is formally presented under the guise of *contracts*: the supplier, the manufacturer, the consumer will *formally* accept the charters, general sales conditions, contracts of adhesion. The manifestations of the power of the enterprise are thus translated into the legal order of the state (by participants to the functioning of the state legal order – law professors, attorneys and judges) in order to give them a form compatible with the superior norms of this legal order. But in the reality of the exercise of this power in today's economy, the production of

[26] See generally J-G Bellet, *Le contrat entre droit, économie et société* (Quebec, Les éditions Yvon Blais Inc/Le droit aussi, 1998).

[27] See generally OE Williamson, *The Economic Institutions of Capitalism* (New York, Free Press, 1985).

[28] Bellet, *supra* n.26.

[29] See generally Macneil, *supra* n.25; Bellet, *supra* n.26.

these rules, is very often the expression of a *unilateral* power, of an exercise of *authority*, that of the enterprise.[30] The contracting parties in a weak position very often have little choice and sometimes do not even understand what they are signing – when they sign *anything*.

This rise of the normative and political power of the enterprise has been at the origin of an evolution of the legal system of developed economies, starting at the end of the nineteenth century. Weak participants to the enterprise, and in particular salaried employees, have been the object of the creation of a wealth of protective norms imposing material rules on the management of the enterprise. Whole branches of the law – labour law, consumer law, environmental law, and so on – have progressively been created to protect weak parties or interests external to the market system (the negative "externalities" of the economists). These evolutions, although demonstrating that the ideological dream of a liberal society self regulated by isolated individuals could not be sustained in an industrial world creating substantial "private"[31] powers, kept alive the traditional conception of legal ordering. The classical contractual theories, the strict separation between "public" (as the sole locus of power subject to democratic rule) and "private" (the locus of property rights freely enjoyed by the owner), the theory of state sovereignty, were barely affected, whatever the difficulties in maintaining the coherence of the legal system with its original constitutional foundations. When the outcome, within the political order of the enterprise, of the political choices made at the decentralised level of the enterprise were felt at the political level of the state to be inappropriate, statutory intervention, or an evolution of case law, came to change, from the outside of the enterprise, the political choices made in the first instance at the enterprise's level.[32] This did work as long as the productive aspect of economic activity took place within enterprises mostly located on the territory of one single state. With globalisation, enterprises are now organising their activities on a multiplicity of state territories. They are therefore in a position to manipulate the market between states and to limit the states' capacity of external political intervention to modify the internal political equilibrium reached within enterprises.

Only an understanding of firms as legal and political orders will allow us to understand what is happening at the macro-level of the relationships among firms and enterprises in the world economy.

[30] See, eg, E Gaillard, *Le pouvoir en droit privé* (Paris, Masson, 1985), 140–143.

[31] See PJ Dimaggio and WW Powell, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields" (1983) 48 *American Sociological Review* 147.

[32] See generally JW Ely, *The Guardian of Every Other Right – A Constitutional History of Property Rights* (Oxford, Oxford University Press, 2nd ed., 1998).

NON-RECOGNITION OF THE ENTERPRISE AS A LEGAL AND POLITICAL ORDER

If enterprises are understood as being legal orders, one may analyse their relationships with positive legal orders in a similar manner as the relationships existing between the institutions traditionally analysed as legal orders (states and public international organisations), with this caveat – of considerable importance – which is that enterprises are not *recognised* as legal orders by positive legal orders. The enterprise has the same fate as the one experienced by a state that is not recognised by other states: this state does not exist in international public law; this does not prevent it from existing *in itself*, if its power over a certain territory and a population is effective.[33]

It is necessary, however, to be very specific about what we mean when we say that there is no recognition of the enterprise as a legal order by the positive legal orders of states. Although there is no *positive* recognition of the enterprise as a *positive legal order* by the original positive legal orders (states) since, in particular, they do not grant it legal personality, the liberal legal orders operate as if there were an *implicit* acceptance of the constitution of the enterprise as a legal order. The mode of intervention of the liberal state in the economy is underpinned by the existence of the enterprise as an original locus of exercise of economic *power*. This is mere logic: two states ignoring each other (that is, which do not *recognise* each other) may perfectly coexist on the surface of the planet. They have different territories and, in a sense, their respective fields of authority, of exercise of power – their *jurisdictions* – may not meet. The situation is necessarily different in the case of the relationships between the enterprise and the state: in contrast to a state, an enterprise does not have any *territory*.[34] But it has a *jurisdiction* over which it exercises its power, *contractually* delimited by the *network* of the exchange relationships it organises as a consequence of the transfer of competencies contractually transferred to it. The enterprise, however, is *necessarily* established on the territory of one or several states. The power exercised within the enterprise therefore *necessarily* meets the power exercised within the state, or states, where it is established, since they regulate objects at least partly common to them. They therefore necessarily have *competing jurisdictions*.

The peaceful existence of the enterprise demonstrates that although the state does not *recognise* the enterprise as a legal order, the state does not *oppose* the existence of the enterprise as a legal order as it does for other non-positive legal orders, like the Mafia, for example. There is here a *fundamental* difference in

[33] Nguyen Quoc Dinh, P Dailler and A Pellet, *Droit international public* (Paris, LGDJ, 4th ed., 1992), 527.

[34] One may see it, however, as an island (or as an archipelago in the case of enterprises with several sites), with its flag at the entrance door, surrounded by high walls, with guards and dogs, ID-badges, controls at the borders, and so on.

the state/enterprise relationship that is important to understand in order to grasp the nature of the relationship between the state and the *accepted* (although not *recognised*) legal orders of enterprises. With respect to the Mafia, the state attempts to fight against its very existence as a legal order, by *incriminating,* within its own legal order, Mafia-like behaviour. Within a state that is respectful of the individual and of liberties, the existence of the legal orders of the state and of the Mafia are irreconcilable, incompatible. No official co-operation can be imagined between these two types of orders that are, in Santi Romano's terms, *irrelevant*.[35]

The situation is completely different with respect to enterprises. In contrast to the Mafia, the enterprise is not usually the object of a relentless struggle with the state, which is attempting to destroy it. *On the contrary*: if there are relationships of competition between the state and the enterprise for the ordering of the objects they have in common (labour relations, degree of care for the environment, consumer relations, safety of the production premises, nature of the investments made, and so on), there are *also*, and maybe *especially*, relationships of *co-operation*.[36] The fact that the positive orders of states let the legal orders of enterprises constitute themselves, and even facilitate their development, demonstrates the *factual* recognition of the enterprise by the state as a structuring institution of society. In this sense, these orders are – still in Romano's parlance – *relevant*.

DEVELOPING A NEW CONSTITUTIONAL STRUCTURE FOR THE GLOBAL SOCIETY

The law of liberal polities, therefore, is such that we are in a situation where a legal order (that of the state) refuses positively to recognise the existence of legal orders installed on its territory (those of enterprises), while *in fact* taking into account in its actions (legislative or administrative) that those orders effectively exist, and facilitating their development. We are thus in a much more interesting (and complex) situation than the one where there is an absence of recognition of a state by another state. The legal orders of enterprises and those of states constitute *overlapping*, tangled, *embedded* legal orders. The state may not, in its regulatory activity, neglect the existence – the *necessary existence* within a liberal legal order – of the enterprise as a legal order.

The concrete implication of this approach is that, contrary to the *modern* understanding of law that considers the actors of the legal system as being, on

[35] See generally Romano, *supra* n. 22.

[36] According to Bellet, the relationships between state and non-state regulations express themselves more in the mode of complementarity than in the mode of antagonism: J.-G. Bellet, "L'Etat et la régulation juridique des sociétés globales – Pour une problématique du pluralisme juridique" (1986) 28 *Sociologie et société* 30. See also AS Miller, "Toward the 'Techno-Corporate' State? – An Essay in American Constitutionalism" (1968) 14 *Villanova Law Review* 1, at 4.

the one side, the mass of individuals armed with their personal rights and interests and, on the other side, the sovereign state defending the general interest of internal constituents and external competitors,[37] a new polity composed of bodies with a multitude of overlapping jurisdictions and sectional interests has progressively developed, among which the most important are enterprises, which command most of the daily life of people.[38]

The attitude of positive law, consisting in ignoring the reality of the *legal* allocation of regulatory power among enterprises and positive legal orders has the advantage of leaving considerable aspects of social organisation to the autonomy of society. Once their existence is identified, the unofficial legal orders pose very serious problems of *legitimacy* regarding the private *power* they exercise and which should require, within a coherent liberal theory, the setting of rigorous procedures to designate managers, to publicise their actions and decisions, to control the use of their power, to ensure the respect for the rights of subordinates, and so on.[39] To deny – or to ignore – the existence of those orders means to leave aside the debate on the need to set those procedures, and on what they should be.

A legal analysis accounting for the mode of relationships between state legal orders and the legal orders of enterprises is fundamental today because of the globalisation of the economy.[40] Globalisation breaks the delicate dynamic equilibrium which had progressively been found between states and enterprises for the allocation of the power to regulate economic activity: enterprises had the primary right of making basic economic decisions, of arbitraging the various interests involved in each decision, within a particular setting of environmental constraints (including positive legal norms) imposed upon them; states had the duty to defend individual and collective interests insufficiently taken into account, or neglected, by autonomous enterprises, through a modification of the normative environment of enterprises.

Because of the increased competition between states for the provision of norms favourable to enterprises induced by the globalisation of exchanges,

[37] See J Chevallier, "Le concept d'intérêt en science administrative" in P Gérard, F Ost and M van de Kerchove (eds.), in *Approche interdisciplinaire* in *Droit et intérêt*, Vol 1 (Publication des Facultés universitaires Saint Louis, Brussels, 1990), 141–144; F Ost,: "Entre droit et non-droit: l'intérêt" in *Droit et intérêt*, Vol 2 (Publication des Facultés universitaires Saint Louis, Brussels, 1990), 101. See also H Burstin, "La loi le Chapelier et la conjoncture révolutionnaire', in A Plessis (ed.), *Naissance des libertés économiques – Le décret d'Allarde et la loi Le Chapelier* (Paris, Histoire Industrielle, 1993), 63 and 69.

[38] See N Bobbio, *Il futuro della democrazia* (Torino, Einaudi, 1st, ed., 1991), 10.

[39] In this respect, one may note that for Bobbio, to speak about a progress of democracy today is not to speak about the substitution of direct democracy by representative democracy but to speak about a transfer of democracy from the *political* sphere to *civil society* in its various institutions, from school to manufacture. There may perfectly exist a democratic state in a society within which most of the institutions [I would say "legal orders"], from family to school, from enterprise to public service, are not democratically governed: Bobbio, *supra* n.38, at 53–55.

[40] See J-P Robé, "Multinational Enterprises: the Constitution of a Pluralistic Legal Order" in G Teubner, *Global Law Without a State*, (Aldershot, Dartmouth, 1997), 45.

divided states are not in a position to provide the appropriate normative environment for enterprises for this system to continue to function in a socially acceptable manner. It is necessary to think anew the *constitutional structure* of the world, which is now unbalanced to the detriment of the "general interest", at whatever geographical level one looks at (local, state, regional, global).

The path to follow lies, in my opinion, in the deepening of the pluralist conception of law and power.[41] The reality of state law, of positive law applied by public institutions on a given territory, is not denied. If one observes from the *internal* point of view the juridical system of a given state, the enterprise does not exist in positive law. But the situation is different if one uses a conception of law that breaks the relationship of equivalence between "state law" and "law". From such a perspective, we have seen that the enterprise may be analysed as a legal order in itself. From this point of view, the mode of the relationships between states' legal orders and the legal orders of enterprises may be thought of in the mode of the relationships entertained between *autonomous* legal and political orders.

My thesis is that by concentrating competencies located in civil society (through the concentration of property rights by contracts), enterprises concentrate a *power of original decision making* embedded in these rights that is partly out of the reach of the power of the state. From the principle that everything that is not prohibited is authorised, and that state regulations may *intervene only in the constitutionally restricted field where state action is legally valid*, one necessarily derives the principle that enterprises have the *juridical* capacity to produce their *own* norms in an autonomous manner if the state does not intervene (by political choice) and in the more restricted situation where the intervention of the state is prohibited by constitutional norms. The enterprise certainly may not ignore the law of the state on the territory in which it is located any more than the subjects of positive law can: the enterprise needs liberal law to exist through the existence of a network of contracts and of property rights in positive law. The enterprise must respect, to a certain extent, the commands of positive law if it does not want to disappear. But the margin of autonomy left is substantial, and all the more so with the globalisation of society, which allows enterprises to play state against state.

What I have attempted to illustrate are the institutional consequences of a system of regulation of world society in which the dominating constituent units are states legally constituted along liberal principles that, through history, have accepted and/or facilitated the development of the large business enterprise. The understanding of the enterprise as a *legal* order allows us to make considerable progress, not only in the analysis of the *internal* functioning of enterprises, but also, and maybe especially, with regard to their relationships with the

[41] For a description and a bibliography, see M van de Kerchove and F. Ost, "Le système juridique entre ordre et désordre" in *Les voies du droit* (Paris, PUF, 1988), 188–189. See also Teubner, *supra* n.20.

outside world – their *environment*. It allows us to examine the state/enterprise relationship as a relationship between autonomous legal and political orders, which puts us in a better position to think about the institutional needs of a globalising society.

3

The Juridical Paradox of the Corporation

RICHARD TUDWAY

INTRODUCTION

As a means of giving expression to collective and associative endeavour the corporation has undergone various transmogrifications since its earliest appearance in European history.[1] It has been radically transformed as a consequence of the legislation, first in the US and later in Europe, to introduce limited liability. This legislation, seen at the time as vital if rising levels of savings were to be harnessed to further advance industrial development, was a crucial transforming influence.

The passing of limited liability laws not only capped the upside liability of shareholders to the value of sums invested in shares in the corporation. It also separated traditional ownership from control. As a consequence, and with the passage of time, the power of management and its role in controlling the corporation has been fundamentally transformed.[2] The invisible hand of Adam Smith has given way to the visible hand of the corporation. Over the past one hundred and fifty years the corporation has grown enormously in scale and importance. At the same time legal doctrine has been stuck in a divide between those who see the corporation as a collective and concessionary legal expression of energy; and those who see it as simply a non-regulatable nexus of contracts. Part I of this chapter examines these historical developments.

If the role of management has been transformed, so too has legal doctrine and practice undergirding the corporation. It has evolved as a subtle re-interpretation of the economic theory of the market and individualism. The earliest notions in British and American law portrayed the corporation as the personification of the individual with associated rights, duties and obligations, and a guarantor of the competitive market place. In time this gave way to recognition that the underlying corporate actor is neither the corporation nor the share-

[1] See Otto von Gierke, *Political Theories of the Middle Age* (trans F W Maitland, Cambridge, Cambridge University Press, 1900 rep 1987); and AF Conard, *Corporations in Perspective* (Minolta, Foundation Press, 1976).

[2] See AP Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Massachusetts, Harvard University Press, 1977).

holders – who are the owners of the corporation – but management.[3] The doctrine of the management corporation, once dominant in its sway, has since the 1970s been further modified. The corporation has emerged once more as the true legal person consisting of a network of comprehensive commercial contracts.[4] It is portrayed as a "black box"; a private institution governable only by rules of commercial law and not an appropriate vehicle for regulation. Part II of the chapter explores the development of these doctrines within the legal systems of America and Britain with some comparative assessment of parallel developments in continental Europe.

This final transmogrification – sometimes referred to as the new economic theory of the firm – is now firmly established in American and British law. It marks the appearance of a final victory for methodological individualism. Part III explores these developments. The corporation as a individual in personification appears almost unassailable as an intellectual construct. The power now conferred upon the reified corporation ranks it, effectively, alongside the nation state without the panoply of democratic checks and balances that provide, often questionable, control and accountability of governments in constitutional democracies.[5] This leaves the corporation and its management operating from behind a convenient veil of chastity, but effectively wielding substantially unregulated and unaccountable power within the nation state and globally – a perplexing juridical paradox!

As the momentum of globalisation gathers pace multinational corporations are, as never before in history, in a position to negotiate as equals with states and successfully determine terms and conditions. If unchallenged this will empower corporations to circumvent individual democratic governments and the reflexive, autopoietic, social systems of which they are historically an expression.[6] The challenge is to ensure that a meaningful constitutionalism is properly and adequately reflected in a re-modelled corporate law.[7] Part III of this chapter identifies and explores some of the more significant aspects of these developments.

These are disturbing, daunting matters. They flow from the re-ification of the corporation and its progressive legal re-definition as a nexus of contracts.[8] These developments prevent a fundamental review of corporate governance.

[3] See AA Berle and GC Means, *The Modern Corporation and Private Property* (New York, Harcourt Brace and World, rev ed., 1968).

[4] See RH Coase, *The Firm, the Market and the Law* (Chicago, Chicago University Press, 1988); and MC Jensen and WH Meckling, "The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

[5] See F Macmillan, "Legitimating Global Corporate Power" in F Macmillan (ed.), *International Corporate Law Annual: 1* (Oxford, Hart Publishing, 2000), 155; and WB Wriston, *The Twilight of Sovereignty* (New York, Schribner, 1992).

[6] See G Teubner, *Law as an Autopoietic System* (Oxford, Blackwell, 1993).

[7] See MA Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Boston, Little Brown, 1976).

[8] See WW Bratton, "The 'Nexus of Contracts' Corporation: A Critical Appraisal" (1989) 74 *Cornell Law Review* 407.

The facade of risk-taking share ownership is presented as being coterminous with proprietorial control, and with the development of democratic principles of co-determination within the corporation and the nation state. The solution lies not in a restatement of former statist/collectivist doctrines but on developing fresh insights into the role of the modern corporation as an economic institution.[9] Part IV examines the implications of the "race to the bottom" in the context of globalisation of capital markets. It anticipates the main issues that have to be addressed if a progressive, commercially realistic and coherent policy framework is to be articulated.

PART I: THE CORPORATION AS AN PUBLIC ENABLING ACT

The history of the chartered corporation

In researching the history of the corporation at least two theoretical and practical pre-occupations over a period of some six centuries can be identified. At one level the corporation is seen as a means whereby some ultimate or higher authority could empower, through a form of corporate charter, other lower level initiatives allowing interested parties to form appropriate associations to realise agreed beneficial objectives. At another level corporate charter status was granted by monarchs and governments, which conferred privileges and rights in recognition of benefits to be derived. As we shall see these different routes have important interconnections that involve official conferment and regulation. This is sometimes referred to as the concessionist or communitarian doctrine of the corporation.

The former pre-occupation is associated historically with the Church of Rome. In the thirteenth century Pope Innocent IV encouraged the creation of fictional entities that by design had limited authority to execute specific approved initiatives.[10] Corporations so approved could be material or immaterial; the important matter is that they had individual members and that such creations were not natural but intellectual.[11] The other pre-occupation is often associated with the common practice in various European countries, including Britain, where the monarch approved charter status to towns and municipalities, and other types of institution such as gilds, and universities,[12] apart from

[9] See RM Buxbaum, "Corporate Legitimacy, Economic Theory, and Legal Doctrine" (1984) 45 *Ohio State Law Journal* 515; and J Hill, "Public Beginnings, Private Ends – Should Corporate Law Privilege the Interests of Shareholders?" in Macmillan (ed.), *supra* n.5, at 17.

[10] See Gierke, *supra* n.1; and Conard, *supra* n.1.

[11] *Innocentius Commentaria* (the official statement or encyclial), under the sub-title *Universitas*, contains the section of text that it is believed originates the fiction theory of the corporation.

[12] See RAG Monks and N Minow, *Corporate Governance* (Oxford, Blackwell, 1995). The tradition of official recognition and regulation dates back to the twelfth century. Some of the more important of the English gilds received charters from the Crown; others remained subject to control and regulation by chartered municipal institutions.

charters issued explicitly to support the furtherance of overseas trade and commerce and mercantilism.[13] Again the notions of conferment and of regulation by a higher authority were a key feature.

Emergent capitalism in Europe

Moving forward in time we need to observe what was happening in Europe at the onset of the Industrial Revolution. The description "powerhouse of the world" is taken from the comprehensive work by Norman Davies on Europe and its civilisation. It captures the dynamism and the turmoil of the nineteenth century.[14] Throughout this period secular European governments were striving to foster conditions that would take their countries from economic "ignition" to Rostovian economic "take-off". Some were more successful than others. In Britain these events were most striking. Driven by the concept of an economy as a market of competing individuals Britain's early start was followed by most of the countries of north western Europe. The promotion of down-to-earth enterprise and wealth creation in the domestic market place were of far greater importance than arcane discussions about the meaning and significance of corporate concession. Whilst limited liability law was enacted in Britain in 1856, individual proprietorship and partnerships endured for a lengthy period thereafter as the common form of commercial and legal entity.

Britain's early glory was however eclipsed by developments elsewhere. By the end of the century Britain's lead had been overhauled by the superior organisation of German industrial effort and the growth of a professional managerial class.[15] Germany's economic precocity also coincided with a policy mind set in Germany that favoured state intervention. The state was seen as a vehicle which should, for example, foster domestic economic development by selective forms of protectionism and by making heavy investment in education and infrastructure.[16] This was later to earn the title "the Prussian road to capitalism". Needless to say this point of view was not universally shared – particularly in Britain where *laissez faire* liberalism relied heavily on the efficiency of markets in determining resource allocation within the economy and on the role of individual actors.[17]

[13] An example is The Muscovy Company, which was established and chartered in 1553 in a bid to wrest the control of Baltic trade away from the Hanse League. Other well-known chartered companies include The Barbary Company, The Turkey Company, The East Indies Company, and The Royal African Company.

[14] See N Davies, *Europe: A History* (Oxford, Oxford University Press, 1996), at 759–896.

[15] See P Milward and S Saul, *The Development of the Economies of Continental Europe, 1850–1914* (London, Allen and Unwin, 1977), in which reference is made to British industry's *Makler* (or middleman) preference and the slowness of Britain to take advantage of mergers and acquisitions and the creation of a professional managerial class, preferring instead the continuation of family ownership and control.

[16] See F List, *The National System of Political Economy* (trans SS Lloyd, London, Longmans Green, 1885).

[17] See D Ricardo, *The Principles of Political Economy and Taxation* (Leipzig, Verlag von W

With the industrial revolution in full swing a series of complex consequences ensued. The emergence of the money economy turned self-sufficient peasants into wage earners, consumers and taxpayers. Paper bank notes came into common usage along with deposit banking. Developments in science and technology inevitably drew invention and innovation away from its previous informal setting to more systematic sponsorship. This led to the development of banks and insurance companies, with banks playing a new and important role in funding the working capital of businesses. The economies and the social institutions of Europe were fundamentally transformed during this period.

Changing patters of growth and prosperity in Europe

Measures of growth in gross domestic product (GDP) between 1820 and 1970 and then between 1870 and 1913 provide a vivid picture of the changing fortunes of the European region. Angus Maddison estimates that the arithmetic average for growth in the fifty years between 1820 and 1870 was 0.9% per annum for the countries of western Europe. This compares with an estimated world GDP growth of 0.33% per annum over the three centuries between 1500 and 1820. Britain, of the larger countries, enjoyed the highest annual average rate of growth at 1.2% over the period 1820 – 1870 compared with 1.1% for Germany and 0.8% and 0.6% for France and Italy, respectively.[18] In the period 1870 – 1913 the picture changed significantly. All countries recorded improved gains with the exception of Britain, whose rate of growth declined to 1% against an arithmetic average of 1.3% for all countries. Germany achieved an annual average rate of growth of 1.6% over this period.

Capital accumulation and its impact on financial markets

Capitalism brought with it new challenges and opportunities. Apart from increasing levels of prosperity, national economies began to generate much larger savings. These savings had to be deployed either domestically or overseas. Improved international communications fostered large capital outflows, particularly from Britain. Around 50% of its savings were transferred abroad. French and German overseas investments were also substantial. By 1914 British foreign owned assets were valued at one and half times money GDP. French assets, in contrast, were less at 15% greater than GDP with German assets about 40% of GDP. US assets held overseas were only 10% greater than GDP over the same period.[19]

Englemann, 1837), which is the most cogent expose of economic liberalism and the theory of comparative advantage as a support to free trade.

[18] See A Maddison, *Monitoring the World Economy, 1820–1992* (Paris, OECD, 1995).

[19] As a basis of comparison, the calculations of Maddison, *supra* n.18, show that the US economy was slightly greater than twice the size of the British economy in 1914 with the French and German economies half the size of the British economy.

Most of the world moved to fixed exchange rates by adopting the gold standard. This had been practised by the British since 1821. Germany adopted the gold mark in 1871–3. Belgium, France Italy and Switzerland created the Latin Monetary Union at the same time based on the gold franc. The Scandinavian Union of Denmark, Sweden and Norway was created in 1875–6 with the Netherlands adopting the gold system at about the same time. The US adopted a fixed parity against gold in 1879.

The debate in Britain over the corporate form

Debates about the desirability of the corporate form began in earnest during the later eighteenth century. In 1776 Adam Smith saw very definite drawbacks with the proliferation of the corporate form. With telling foresight he saw that this would lead to the separation of management from stock ownership. This would ultimately weaken the power of stockowners and foster the growth of a paid management class detached from the risks associated with investment. He saw this as a wholly undesirable development. Though it took a century and three quarters to arrive, the case for the managerial corporation was, by then, well on the way to being made. Leaving aside the conceptual fudges surrounding the issue of management accountability, the concept of the managerial corporation was the central theme exalted by Berle and Means in their 1968 seminal work.[20]

Adam Smith also expressed the view that the wider availability of the corporate form would stand in the way of both innovation and competition and would foster financial laxity. The British parliament had earlier passed the Bubble Act of 1719–20, to curtail the excesses of the period.[21] It had the effect of holding back the development of the corporate form until its repeal in 1825. Significantly, the proliferation of the corporate form in the nineteenth century and ahead of limited liability legislation reflected the view that company incorporation as a separate legal personality came as a concession from the state for certain types of commercial and industrial undertaking. The implication was that incorporation was granted in recognition that the company would be undertaking functions beneficial to the public good, as well as the investors. This is an important understanding. Incorporation thus continued to convey upon the company, as in earlier times, a "public character" that could be used to justify state intervention to monitor public benefit.

Pressure for institutional reforms

The growth of new savings, combined with the growing needs of industry for new productivity-enhancing capital, highlight another critically important

[20] Berle and Means, *supra* n.3.

[21] See M Patterson and D Reiffen, "The Effect of the Bubble Act on the Market for Joint Stock Shares" (1990) 50 *Journal of Economic History* 163.

issue. This turned around the status of shareholders and shareholding in the development of financial capitalism.[22] Pre-financial capitalism orthodoxy deemed shareholders as playing a role wider than that of putting up risk capital. Shareholders had unlimited liability for the financial affairs of the corporation. This was a fundamental drawback to channelling savings from wholesale sources into the business enterprise sector. Only when these drawbacks were remedied could the full potential of wide scale shareholding on the economic and financial system be realised. Until these reforms were introduced the role of the shareholder, as a specialised financial investor, would remain restricted along with the market for equity. These drawbacks were eventually addressed through the passing of laws on limited liability.

The legislation conferring limited liability status on shareholders had two direct effects. First, it freed up the supply of equity investment capital. Second it had the effect of creating a legal fiction – the new style incorporated company. Under unlimited liability the shareholders are, in effect, the corporation and the management. They own the corporation in association. They are jointly and severally responsible for its liabilities, rather as unlimited liability partners under existing law. Under limited liability a fundamental change occurs. The shareholders are still deemed to be the proprietors or owners of the corporation. They are no longer legally responsible, however, for its commercial activities. Their financial liabilities are limited to the paid up value of the shares.[23] Management is employed by the corporation acting as agent of the shareholders. Herein the mystery of the corporation begins to take shape. The corporation starts to take on the existence of a Cartesian "ghost in the machine". This development, designed to promote the flow of equity investment into corporations, would, by implication, involve corporations being effectively controlled by professional managers. It is also the source of much subsequent confusion about the legal status of the corporation, and the facade of ownership and control by shareholders.

In America the first limited liability acts were approved in New York State in 1811. They were designed to promote the development of activities, some of which resemble what economists refer to as "collective goods". These included railways, waterways, banks and insurance companies – all of which involved large sums of investment, where the payback period was sometimes long and uncertain. Incorporations were otherwise highly specific and restricted. There was never a clear intention that this form of incorporation would be appropri-

[22] Financial capitalism may be defined as the institutional arrangements that enabled science and technology to be harnessed to capital, with capital markets playing a key role in monitoring performance.

[23] In continental Europe the problems of unlimited liability were addressed by the creation of limited partnership (*société en commandité*) legislation. This was introduced in the early 19th century. It was never adopted as a corporate form in Britain or America even though it was enacted in 1908 in Britain: see WR Cornish and G de N Clark, *Law and Society in England, 1750–1950* (London, Sweet and Maxwell, 1989).

ate for all industrial and commercial activities. The "general form" of application only arrived at a rather later stage. It is perhaps significant that these crucial capital markets aspects were apparently largely secondary considerations. In reality, a significant influence supporting moves to limited liability was the prospect of a large-scale equity investment market. This could not occur whilst unlimited liability existed.[24]

The legal doctrinal debate over the corporation

In the specific context of American law the Angell and Ames definition[25] sets the scene for the doctrinal debate over the corporation. The key issues of the American (and English) legal debate are explored in detail by Bratton.[26] He helpfully compares and contrasts contributions from Chancellor Kent on American law, Stewart Kyd on British Law and Chief Justice Marshall's 1819 landmark judgment in the *Dartmouth College* action.[27] In summing up the argument of the three learned jurists Bratton affirms that each conceives of the corporation as a reification realised in the actions of individual persons; each recognises the aggregate characteristics of the corporation, its concessionary origins and contractual rights, and each its public and private aspects.[28]

The doctrine is modified as history progresses into the twentieth century. There is a gradual loss of confidence in the earlier definition. The emphasis on concession and the legal fiction of the corporation disappears. In its place the corporation begins to characterised by the sum of the laws that govern it. Hohfeld in the early twentieth century described the corporation as "an association of natural persons conducting business under legal forms, methods and procedures".[29]

As Mark argues convincingly the legal fiction of the corporation emerges throughout the vagaries of history as a doctrinal restatement of methodological individualism.[30] At the heart of the assertion that corporations are artificial lie the twin beliefs that private property is an individual right; and that individuals operating collectively would not manage the property of others with the same interest that each individual would manage his own. This line of argument does not go unchallenged. Perhaps the most withering critique of the legal fiction

[24] See FH Easterbrook and DR Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 89; and FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (Cambridge Mass, Harvard University Press, 1991).

[25] See J Angell and S Ames, *Treatise on the Law of Private Corporations Aggregate* (9th ed, 1871).

[26] See WW Bratton, *The New Economic Theory of the Firm: The Law of the Business Enterprise* (Oxford, Oxford University Press, 1994), 141–3.

[27] *Dartmouth College* v. *Woodward*, 17 US 518 (1819); see Bratton, *supra* n.26, at 143.

[28] *Ibid*., at 141.

[29] See WN Hohfeld, *Fundamental Legal Conceptions As Applied in Judicial Reasoning* (WW Cook (ed.), New Haven, Yale University Press, 1964), 198.

[30] See GA Mark, "The Personification of the Business Corporation in American Law" (1987) 54 *University of Chicago Law Review* 1441.

theory of the corporation is advanced by Dewey in 1924. He argued that efforts safely to establish the corporation in traditional legal terms are "logically indeterminate" and a "waste of jurisprudential effort".[31] Either way, or by whatever sleight of hand, as Mark observes, the business corporation evolved juridically to become "the quintessential economic man".[32]

Legal theory overtaken by events

Thereafter the debate about the corporation is gradually sidelined as an issue of serious legal argument. Corporate America flourished as the twentieth century advanced, driven by the exigencies of two wars in which America was involved. Berle and Means[33] offered a ready and credible justification for the legitimacy of the new style, highly specialised, capital-intensive corporation. In it they portrayed top management playing a steadying, strategic role with line management running the business on a day-to-day basis.

It is not until the end of the 1970s that arguments originally developed by Coase[34] in the 1930s begin to re-surface as a response to the niggling problem of management accountability, which was rather side-stepped by Berle and Means. These appeared in two distinctive contributions: first, by Alchian and Demsetz;[35] and, later, in the analysis by Jensen and Meckling.[36] Both approaches radically modified the managerialist approach articulated by Berle and Means. Once again the corporation is seen as a fiction. This time, however, there is a difference of treatment. The corporation is portrayed as a "black box", a nexus of comprehensive contracting relations among and between individual factors of production. The full force of methodological individualism is focused on eliminating once and for all any hint that the corporation is an entity with any features *per se* which make it an appropriate vehicle for public regulation. The corporation is contract! The thrust of development in the period since has been to tighten this conceptual framework to the point where the corporation, in all diverse roles, can be seen to be subject, exclusively, to the law of contract and tort.[37] The full significance of these developments is explored in the next part of this chapter.

[31] J Dewey, "The Historical Background of Legal Personality" (1926) 35 *Yale Law Journal* 655 at 667–678.

[32] Mark, *supra* n.30, at 1483 . See also F Hallis, *Corporate Personality: A Study in Jurisprudence* (London, Oxford University Press, 1930).

[33] *Supra* n.3.

[34] RH Coase, "The Nature of the Firm" (1937) 4 *Economica* 386 at 390–4.

[35] AA Alchian and H Demsetz, "Production, Information Costs and Economic Organization" (1972) 62 *American Economic Review* 777.

[36] Jensen and Meckling, *supra* n.4.

[37] The statutory aspects being downgraded in importance.

PART II: THE ECONOMIC AND POLITICAL SIGNIFICANCE OF THE FICTIONAL CORPORATION

Concession in furtherance of specified goals

Part I has explored the historical development of the idea of the corporation. It has portrayed the middle ages' concept of the corporation as a concession granted in recognition of certain prospective aims and objectives. In granting the concession the group of individuals become personified in a *meta* or super-individual, the corporation.

The charter was granted for purposes where individual drive and initiative would not by itself be enough or where the corporation was expected to carry forward activities over and above those of any of the individual members. Succession was therefore an important implication of the granting of corporate status. There are no better examples than municipalities or universities. Their corporate status must have reflected the notion of long-term continuity with old members leaving and new ones joining – but always subject to the sanction of review and possible suspension.

Limited liability and the corporate ghost in the machine

The event of limited liability plays a significant role in that historic process. Limited liability is the event that caused the creation of the large-scale industrial, marketing and sales corporation. Limited liability facilitated the entry of savings into the business enterprise sector in the form of equity and the creation of markets in which those securities could then be freely traded. This contrasts vividly with the atomistic model of social and economic relations as portrayed by Adam Smith. The viability of his model was ultimately overtaken by these events. Though the social and economic world he described would soon be unrecognisable, the basic simplicity of his reasoning would continue to arrest the public imagination.

As the doctrinal debate on the status of the corporation evolves in the nineteenth and early twentieth centuries we see the corporation being portrayed as a proxy-person or *meta* individual. The logic of the position reflects the concern that by some route the individuation of the corporation has to make legal sense. This is where Chief Justice Marshall's judgment in the *Dartmouth College* case[38] is so important. The judgment portrays the corporation as an "artificial being, invisible, intangible and existing only in contemplation of the law".[39] The judgment goes on to state that the corporation has only those powers conferred upon it by its charter. The judgment is seen to justify the notion of the corporation as a legal entity with powers. Its powers have purposes; they are

[38] *Supra* n.27.
[39] *Ibid.*, at 636.

means to an end.[40] Though the notion of the corporation as a state instrument is soft-pedalled, concession theory is still seen to underpin its origins.

The Jekyll and Hyde of corporate existence

As we move forward in time the power and influence of the large manufacturing corporations and utilities begins to emerge. Railways in America had boards representing not just management but also capital. Investment bankers sat on the boards of those companies. As industrial companies grew in importance and began to access capital markets, again investment bankers appeared on boards to exercise control on behalf of shareholders and protect the broader interests of capital markets. There is a re-assuring sense of adaptive, competitive balance, and control.

But there is also a well-documented darker side of corporate power in America in the late nineteenth and early twentieth century. The racketeering tactics of the railroad corporations in their negotiations with individual states are a chilling historical reminder of the impotence of government in the face of predatory corporate entities. Jurists, politicians and the public were rightfully fearful of what was seen as the unbridled power of corporations and their "control over the economic and social machinery".[41] As Timberg vividly recounts the corporations in this period enjoyed a new form of corporate feudalism, having "broken free" in the pursuit of freedom of individual association[42] with the corporation being perceived as "not a thing" but "a method".[43] This "method" was increasingly dedicated to minimising, if not eliminating or otherwise circumventing, any liabilities that might arise either for management or the corporation as a result of litigation.[44]

The impact of the Second World War on the American psyche

But fears about the exploitative powers of the corporation gradually began to recede. They did to the point where debate about the ultimate status of the corporation and its accountability all but dried up. This had a resonance with the commercial and economic success achieved by American big business. The maturing of corporate America and the public perception of its statesmanlike response to issues of corporate responsibility and patriotic support of the war effort fostered a softening of hostility. This favoured finding practical solutions

[40] See Bratton, *supra* n.26, at 143.

[41] S Timberg, "Corporate Fiction: Logical, Social and International Implications" (1946) 46 *Columbia Law Review* 533.

[42] *Ibid*., at 41 .

[43] WO Douglas and CM Shanks, "Insulation from Liability through Subsidiary Corporations" (1929) 39 *Yale Law Journal* 193 at 194.

[44] See R Kraakman, "Corporate Liability Strategies and the Costs of Legal Controls" (1984) 98 *Yale Law Journal* 857 at 857–62.

to practical problems. The pursuit of "will 'o the wisp" academic legal arguments about the ultimate nature of the corporation, which seemed to fall back on state regulation or other forms of political control, fell from favour.

The impact upon the public psyche of the Second World War crusade against Nazism and other forms of totalitarianism also encouraged an accommodative pro big-business social response. There was a widespread sense of revulsion for the regimes that had encouraged collectivist and statist political philosophies to flourish in countries such as Germany and Italy, and also Japan. The populist psychological reaction was predictable. The individual and individualism is the only safeguard, ever, against tyranny! This reason, almost more than any others explains, the distinctive progress of legal doctrine in American and Britain in regard to the management corporation. It also explains why there was so little appetite for an examination of the nature and purpose of the different organs of the corporation in the context of co-determination and democratic accountability. Anything which might be remotely construed as giving licence to the "socialisation of business" was quite simply "off limits".

Individualism assumes the mantle

Wartime experience inevitably fired a new respect for liberal democracy based on a restatement of possessive individualism. Democratic societies might not have achieved the perfectibility of man's estate on earth; but they offered the next best safeguard against the tyranny of ideas whether Hegelian or Marxist in origin. The focus of academic interest in the corporation was therefore preoccupied with consolidating doctrine behind the management corporation. Berle and Means[45] addressed the reality of the management corporation by exploring how management professionalism and efficiency, tempered by the discipline of efficient capital markets, both constrained management power and fostered corporate growth and profitability. A winning combination that supported well America's "Great Society" longings.

These developments had the effect of diverting jurists' interests away from the issue of management legitimacy. For a significant period of time there was an effective truce over the residual issues of managerial accountability. The modern management corporation saw "top management" cut apart from everyday "line management" – a new division of responsibility. Top managers were portrayed as corporate statesmen, if not senior public officials, capable of identifying and internalising public interest concerns within the corporation whilst reining in the zeal of lower levels of management in the unbridled pursuit of commercial objectives. But residual uncertainties lay dormant.

Disquiet with the conceptual skewedness of Berle and Means' portrayal of the management corporation inevitably led to the opening of new avenues of debate. These centred on the primacy of contractual relationships at the core of

[45] *Supra* n.3.

the corporation, which Berle and Means had otherwise portrayed as being part and parcel of the management corporation. This resulted in a pendulum shift in favour of a reconstruction of the corporation exclusively in contractual terms. Drawing on the earlier work of Coase,[46] the corporation was systematically reduced by Jensen and Meckling[47] and others to an exhaustive nexus of contracts – a "black box". There was nothing further to explore. The bedrock had been reached.[48] The corporation is contract; the *legal person* no more!

Corporate governance – the European tradition

The demise of the corporation as a legal person is a curious event for other reasons. Teubner[49] reminds us that in the nineteenth century the legal person was portrayed as a fiery fighter for political and economic freedom against government power and regulation. Today, according to the norms of American and British jurisprudence, the legal person has been "written out of the script". How has this arisen, he asks.[50] The problem, Teubner explains, lies in the conflict between methodological individualism and the systems theory of organisations. As we have seen methodological individualism offered a means of explaining away the legal person. Self-referential systems, in contrast, allow the legal person and its social reality to be understood. Teubner tells us that this can be achieved without invoking mystical entities like the social group, and endowing them with super-organic self-sustaining powers. It can also be defined without reference to misleading collectivist or organicist metaphors that trouble the individualist soul.

Properly understood, Teubner argues, the legal person is not a legal fiction or substratum of Gierke's corporate personality; nor merely an autonomised pool of resources.[51] In this argument he also reminds us that there is no convincing social basis (the aggregate notion) for the legal person, the debate about which generated so much controversy with and between American and British jurists over such a long period. So wherein, since it does exist, lies the legal person? He suggests that it is to be found in the collectivity. This he defines as a "socially binding self description of an organised action system, a cyclical linkage of identity and action".[52]

[46] *Supra* n.4.

[47] *Supra* n.4.

[48] See Bratton, *supra* n.26, at 158.

[49] G Teubner, "Enterprise Corporatism: New Industrial Policy and the 'Essence' of the Legal Person" in S Wheeler (ed.), *A Reader on the Law of the Business Enterprise: Selected Essays* (Oxford, Oxford University Press, 1994).

[50] Teubner, *supra* n.49, describes this as a critique of the old Philadelphian social epistemology. He further addresses this issue in G Teubner, "Hypercycle in Law and Organisations", *European Yearbook in the Sociology of Law* (Milan, Dott A Giuffrè, 1988).

[51] See Gierke, *supra* n.1, at 61.

[52] Teubner, *supra* n.49, at 53.

The corporation as an autopoietic creation[53]

What this is taking us towards is a notion of the corporation that is the embodiment of collective and associative action. The actors (whoever and whatever they are) – managers, shareholders outside directors, trade union representatives and other stakeholders – express themselves through the organs of the corporation, which ultimately give it meaning. This logic stands the evolution of legal doctrine in America and Britain on its head. It starts with the corporation because it exists in reality, not as some fiction but as a real entity. It then tries to identify the organs through which the different corporate actors give expression to the corporation. In this way the conundrum of the corporate fiction disappears as a problem because the corporation is defined as a real organisation with real attributes and not as a mental construct of convenience. Teubner has exorcised the ghost in the machine.

The corporation is, in these terms, capable of "self organisation and self reproduction through a capacity for action in concert".[54] Collective actions are the product of the corporate actors to which all events are attributed. Corporate actions are therefore nothing if not the collective product of the actors.[55] The legal person is not however based merely on social relations but on "a sequence of meaningfully interrelated communicative events that constantly reproduce themselves as an autopoietic social system".[56] We begin to see emerging a very different conception of the corporation, the corporate actors and the legal processes and principles that govern its existence.

How in other more concrete terms might these same notions be expressed? The corporation is not just the "flesh and blood"[57] of individual persons – shareholders, managers and workers. The corporation is a social entity through which these various actors express themselves. The corporation, furthermore, is not simply an expression of that association of interests. It is a systems "vehicle" through which all purposes are debated, defined and implemented. We can now begin to see the corporation as an on-going democratic expression of plural interests.

[53] Autopoietic theory provides a rigorous theoretical basis for addressing the social systems in which people operate. It draws on experimental work in the fields of neurophysiology and perception first published by Maturana and Varela in 1980: see HR Maturana and F J Varela, *Autopoiesis and Cognition: The Realization of the Living* (Dordrecht, Reidel, 1980). Teubner, *supra* n.49, at 55, defines autopoiesis in the following terms: "a system of actions/communications that reproduces itself by constantly producing from the network of its elements new communications/actions as its elements."

[54] Teubner, *supra* n.49, at 55.

[55] *Ibid*., at 58.

[56] *Ibid*., at 55.

[57] See Gierke, *supra* n.1, at 20.

Comparing the Anglo Saxon and Germanic models

The difference between the Anglo Saxon and German corporate models is stark. In its baldest terms the development of corporate doctrine under American and British law leaves effectively two real parties settling matters of control – management and shareholders. The corporation is a mystical entity with a legal personality that has little meaning or relevance, but massive undefined power. Management is constrained in its actions through contractual discipline and by market forces; shareholders are protected by the existence of competitive liquid capital markets. Any negative externalities arising are dealt with on an ad-hoc basis through progressive extensions of contract and tort actions, which inevitably become more and more vigorously resisted – a state of affairs we have no difficulty in recognising. These are the parameters of the control relationship. According to the American model all liabilities arising from changes in the legal environment in which the corporation operates are thereby reduced to questions of commercial law and tort. The legislature is the font of authority for changes in the law. The parties are left to settle disputes between themselves. Law making has determined not only the parameters of debate and discussion: it has determined the legal norms, against a highly selective social and economic reality.

The German model (and models elsewhere in the continental countries of the European Union) has a different starting point. The corporation as we have seen is differently construed. Its organs play a unique role in the development and determination of values, priorities and decisions. It is a continual dialogue that ensures that all of the corporate actors have proper, effective and collective representation in that process. The law reflects, however, a much wider range of interests than simply management and shareholders. In so doing it has, as Teubner reminds us, become truly reflexive law.

Methodological individualism as the driving ideology

We may ask how this extraordinary difference in legal conception has arisen? The answer must lie in the central preoccupation of American and British law with methodological individualism. Anglo American legal traditions flow from the individual, the basic building block in commercial law. Legal persons are either real individuals or personifications of real individuals. Before limited liability real individuals, or partnerships that were jointly and severally responsible as individuals, carried out all commercial activity *per se*. The law of limited liability confronted for the first time a situation where a new party had been created. Joint and several liability in ownership disappeared with the limited liability corporation. A fictional individual entity had therefore to be "invented" to give legally consistent form to the corporation. Shareholders under limited liability are legal entities distinct from the corporation. The corporation has a singular legal identity though it cannot speak

for itself. The corporation has "no power of fiat, no authority, no disciplinary action".[58]

The corporation is nevertheless a reality even though it is veiled by legal doctrine that attributes to it an existence that is apparently no different to any other individual in the normal sense of that term. Not only is this absurd. It inevitably prompts the question – for what reason is this elaborate fiction of the corporation maintained? Why are jurists side-stepping this epistemological conundrum? The fact is that the juridical paradox is being allowed to continue unchallenged. Though unsatisfactory, the reasons for inaction are, at one level, understandable. The corporation, when defined as a nexus of contracts, offers a neat and convenient legal solution. But there is another issue. It excuses American and British jurists from examining afresh the deeper conceptual issues of power and accountability that the definition raises but seeks not to address.[59] This most unsatisfactory juridical state of affairs is explored in the next part of this chapter.

PART III: THE EVOLUTION OF THE GLOBAL CORPORATION

Some basic issues in political theory

This part will examine the dynamics of development of the corporation both as a national and multinational entity. It may be useful to begin by remembering some of the basic and unchallenged lessons of political theory in the context of the modern state. A central preoccupation of liberal democracy has been about legitimising and controlling the power of the state. The distinction between public and private power is one of the symbols of the battle to ensure that separation of the state from the individual. The reasons for this are not hard to understand. The state is still seen as the embodiment of the most important powers in any modern society. The theory, at least, is that legislatures through representative government confer accountable power upon the administrative organs of the state. It would be naive however to accept that these controls are widely accepted as being adequate in protecting the freedom of the individual. In recent years there has been a veritable onslaught against the state in a bid to make it responsive to the Rule of Law.

This has occurred against the backdrop of the collapse of communist regimes in Eastern Europe and the former Soviet Union. Whilst welcoming these developments as proof of the underlying moral and economic strength of liberal democracy,[60] it should be noted that these very events have occurred alongside increasing evidence of misdemeanours by states in so called mature democracies.

[58] Alchian and Demsetz, *supra* n.35, at 777; and see *ibid*., at 794.

[59] See RM Unger, *Law in Modern Society: Toward a Criticism of Social Theory* (New York, Free Press, 1976).

[60] See F Fukuyama, *The End of History and the Last Man* (London, Hamish Hamilton, 1992).

There is increasingly a feeling of scepticism by citizens of those states regarding the effectiveness of surveillance exercised by legislative assemblies in overseeing, guaranteeing and exacting accountability.[61]

The long arm of the corporation

The particular issue of corporate power and the management corporation has also emerged as a matter of increasing public concern. This again centres on matters of control and accountability. Citizens no longer feel confident that corporate law and corporate governance issues are being properly addressed. In both Britain and America issues of corporate governance, where they arise, appear too often to be concerned narrowly with the issue of the relationship between shareholders and management. Broader issues are excluded from the frame of reference.

In Britain the Cadbury Report[62] has recommended the separation of functions of the chairman of the board of directors and the chief executive, and an increased role for non-executive directors. These proposals were triggered principally by disputes over top management compensation and issues of audit. Understandably citizens who view corporate governance from other vantage points see this as "fiddling on the fringes". Where deeper issues of corporate governance, social responsibility and environmental liability are concerned corporate governance is judged to be inadequate.

Specifically addressing the issue of the British experience of corporate governance is instructive. In the 1970s the Bullock Committee[63] undertook an extensive review of policy alternatives as a response to the first draft of the Fifth European Community Directive. The Fifth Directive contained proposals modelled on German legislation.[64] The subsequent British government White Paper[65] favoured co-determination with a two-tier board structure – reflecting German co-determination principles. The White Paper was never implemented. Its central concerns have since disappeared from the policy agenda. Corporate reaction in Britain towards industrial democracy and social and employment protection has been generally hostile. Under the Treaty of Maastricht the

[61] The state of public confidence in government has reached all time lows in countries like Britain, which has been shocked by a stream of disclosures. These seem to support the view that the state often conceals information and misinforms the public about important events. The BSE, or mad cow crisis, over food and issues of healthcare negligence in Britain are examples. The failure of the current administration to inform the public on important matters concerning health and education, and accusations of "spin-doctoring" and "dumbing down" are all part of this disturbing picture.

[62] *The Financial Aspects of Corporate Governance* (London, The Financial Reporting Council, the London Stock Exchange and the Accounting Profession, 1992).

[63] *Report of the Committee on Industrial Democracy*, Cmnd 6076 (1977).

[64] See KJ Hopt, "New Ways in Corporate Governance: European Experiments with Labour Representation on Corporate Boards" (1984) 82 *Michigan Law Review* 1338.

[65] Cmnd 7231 (1978).

British government reserved its "opt out" rights. It has not adopted the Social Chapter of that Treaty. Much of the negative sentiment towards such developments within the European Union have been echoed by the Confederation of British Industry and other employer organisations. The debate on co-determination in Britain has been stifled during a period in which employee and trade union rights have been curtailed.

The multinationalisation of business

This chapter does not aim to address, except in passing, the phenomenon of multinationalisation. It will not examine why national businesses multinationalise their operations. What it will examine is how the issue of corporate control is affected when a business enterprise operating as a single entity within a single state becomes a multinational business. Once multinational corporate activity occurs new complex regulatory issues for states are raised. These emanate from the fact that multinational activity within a particular host state may impinge upon important economic, social and political objectives.[66] Herein lie some very great, if not insuperable, difficulties. States find that regulatory control is limited to domestic entities headquartered within their own territorial boundaries. Attempts to regulate beyond territory can result in conflicts with neighbouring states. This arises typically in double taxation agreements. Without cross-jurisdictional enforcement mechanisms any attempt is unlikely to bear fruit.

National regulation is also hampered by the absence of a business form for corporate groups which is both nationally and internationally recognised. Regulators are faced with choosing between group recognition in law or conferring separate legal status on individual members of the group.[67] The most developed international response to the issue of multinational enterprise is that offered by the EU. Though the EU is considering the possibility of pan-European legislation, the road forward will not be straightforward. In moving down this path legislators are likely to encounter some of the many problems facing the United Nations in trying to control multinational enterprises.[68] The framework is likely to remain highly fragmented. This benefits the larger and better-organised states with long reach, at the expense of smaller states.

[66] See S Wheeler, "The Business Enterprise: A Socio-Legal Introduction" in Wheeler, *supra* n.49, at 39.

[67] In the case of the UK, group liability has only been established in 3 areas: accounts; company guarantees of and loans to directors; and a company's purchase of its own shares. It is, thus, very restricted: see Wheeler, *supra* n.66, at 40.

[68] The dilemma facing the UN is well exemplified by the events that followed the UN Earth Summit in 1992. The UN's own Centre for Transnational Corporations, which tried to help weak nations to defend themselves against predatory companies, had recommended that businesses should be internationally regulated. The UN eventually refused to circulate the suggestion. In its place a business enterprise sector initiative, The Business Council for Sustainable Development, was created. It has proposed self-regulation.

PART IV: PLOTTING AN ALTERNATIVE WAY FORWARD

The conceptual limitations on corporation ownership

As we have seen, the status of the incorporated company as it exists today is a consequence of some highly specious developments in terms of legal theory. The main points I have emphasised are as follows. The corporation during the middle ages was certainly concessionary in nature. It was granted either by the church or reigning monarchs throughout the European region. Corporate status was designed to confer strength, credibility – perhaps even official approval. None of these developments had anything specifically to do with commercial activity in general; or limited or unlimited liability, though it is true that obligations arising from unlimited liability could and were in some instances waived by those offering the concession. Economic activity at the time was highly fragmented with many individual buyers and sellers. Prices were largely regulated by market forces.

The deeper implications of limited liability

Limited liability, as we have seen, arrived first in New York State. It was designed to provide limited liability on a very restricted basis. It was enacted to allow equity on a much larger scale to be put into corporations and enable them to expand. In the case of the British debate on limited liability, four decades later, the same considerations were at the forefront of the debate. Limited liability was intended to confer a special status on certain types of undertaking which were involved in launching enterprises such as canals, railways and the like where capital investment was large and pay-back long.

The passing of limited liability not only spurred the development of financial capitalism. It also determined the development of a new legal entity. This new legal entity is the corporation whose profits at least are owned by its members or shareholders. Management acts as agent for the shareholders in running and developing the business. The corporation otherwise assumes an unreal status. It cannot act for itself. It cannot speak for itself. Its voice must, for the most part, be that of management; sometimes, though rarely, the shareholders. Its day-to-day actions are taken by management in its name. Shareholders have little influence a fact well exemplified by the recent English landmark judgment in *Caparo Industries plc v. Dickman*.[69] In this case the House of Lords has ruled that there is effectively no scope for tortious actions by shareholders against auditors since the auditors owe a duty of care to the corporation *not* to shareholders.[70]

It is this awareness that suggests that there is a legal fallacy that derives from

[69] [1990] 1 All ER 568.

[70] See "Auditor's Liability: Its Role in the Corporate Governance Debate" in [1977] *Accountancy and Business Research Special Issue* 23.

the characterisation of the corporation in this way. Concessionists and conmunitarians – those who believe that the corporation is in reality a creature of the state because of the mandatory laws that fundamentally govern its existence – find themselves pitted against contractarians. Contractarians claim that the corporation is but a nexus of contracts at every level of its existence. It is a private institution and not an appropriate candidate for public regulation. These points of view reflect the debate in Britain and America since the turn of the twentieth century.

A different European tradition

The Continental European tradition reveals a very different picture. There is a tradition that sees the corporation as having customary rights, duties and obligations, which are reflected through the organs of the corporation. Capital markets in Europe have played a limited role as a provider of capital or as a market device for monitoring performance. This view is at odds with mainstream, and dominant, American and British legal doctrine. This doctrine states that the corporation is owned by the shareholders and that managers act as agents of the shareholder in the pursuit of profit within a framework of rules and always subject to the discipline of the securities markets.

An effort has been made to balance and assess these starkly different interpretations. In doing so three facts are striking. First, that the shareholders may be the technical proprietors but because of limited liability their ownership responsibilities are capped in financial terms to the value of their paid up capital. Is this to what ownership of amounts in relation to corporations that now play such a crucial role in global economic and political affairs? A second fact is the fiction that management is the agent of the shareholders, who are the proprietors of the corporation. Shareholders inevitably have little or no control over management. The third fact is that management finds ways of avoiding direct legal responsibility for the actions of the corporation. Yet we should remember this: the corporation has no voice. It can enact nothing. It is all done "for and on behalf of" the corporation by management. A juridical incongruity if ever there was one.

The unresolved status of the corporation

These observations leave little doubt that a strong case can be made for a fundamental conceptual review of the corporation and its fictional legal life. As we have seen there are compelling arguments for insisting that the various organs that are part and parcel of the corporation must serve as the most meaningful and realistic point of departure. The corporation has to be seen as a vehicle of co-determination involving the various corporate actors who give expression to commercial objectives through the organs of the corporation. If this argument is accepted as a basis on which to proceed then it appears to follow that what is

so far being discussed in the name of globalisation is mistaken. Until the corporation can properly demonstrate that it meets all the conditions governing co-determination how can it possibly speak for or otherwise act for people at large or negotiate with democratically elected assemblies as foreseen in both the draft Multilateral Agreement on Investment (MAI) and the World Trade Organisation's General Agreement on Trade in Services?[71]

The importance of an agreed framework for corporate governance

The issue of corporate governance both domestically and internationally is complex. Only when a clear and credible consensus has been reached on a legal framework that reflects the autopoietic "reality" of the corporation can the debate about globalisation be advanced responsibly. As consensus is reached at nation state level this will in turn determine the design of a new regulatory framework. If this is wisely constituted it will ensure that the global corporation can indeed act as the vehicle for global economic and technological development and the sharing of prosperity. But that process of consensus building first has to take place.

A report recently published by the World Health Organisation and the World Bank highlights the need for this process when it comes to influencing the activities of footloose corporations.[72] The report points out that of the 1,100 million cigarette smokers worldwide in 1995 some eighty per cent are now in low to middle income countries. At the same time companies like Philip Morris have systematically diversified profit generation from developed to developing countries. The report also states that by 2030 some seventy per cent of tobacco related deaths will occur in developing countries.

Mysteriously, as we shall see, the Organisation for Economic Co-operation and Development (OECD) that failed to conclude the MAI in 1998, continues to review the rules governing multinational corporations. One senior official from the OECD sums it up when he states that "the mood amongst OECD countries is that the new rules [the ones being debated] have to be applied world-wide to address public concerns about the activities of multinationals and ways will be found to make sure that it works".[73] Stout sentiments calling for stout deeds.

[71] See *OECD Policy Brief No 2* (Paris, OECD, 1997), which summarises the aims and objectives of the MAI and makes a fulsome case for protecting and enhancing flows of foreign direct investment.

[72] J Prabhat and FR Chaloupka (eds), *Tobacco Control in Developing Countries (World Health Organisation and World Bank Joint Report)* (Oxford, Oxford University Press, 2000). This reveals the scale of corporate irresponsibility where transnational sales, marketing and investment in tobacco products are concerned.

[73] Quoted in K Brown, "Guidelines on Corporate Governance", *The Financial Times*, 12 January 2000.

The race to the bottom

Some ask the question, why is all of this important – surely the most important thing is growth and prosperity? At one level this seems a not unreasonable response. But a closer look at the proposition must give cause for concern. In the name of free trade, free capital flows and effective autonomy for the largest existing global corporations – with many to follow in their wake – a particular set of arrangements is being promoted. These arrangements will leave the citizens of individual countries and the countries themselves at the disposal of those corporations on where, and the conditions under which, they will locate capital and create employment.[74] The implication is clear. Capital will be drawn to the most attractive domains. The most attractive domain[75] is likely to be one where labour costs (and other on-costs) are at their lowest. This in turn is bound to lead to competitive bidding between countries aimed at attracting footloose capital – a phenomenon sometimes referred to as the "race to the bottom".[76]

As a member of G7 Britain is perhaps an odd example to cite in this "race". It is nevertheless one that yields significant insights. As a consequence of a long standing failure by the business enterprise sector to maintain viable domestic industries capable of sustaining the levels of investment needed for them to compete effectively, a virtue has been made of necessity in a bid to promote inward investment. Because of weaker economic performance over many decades Britain, unlike any other OECD country of comparable size, has been faced with cutting back social provision on health, education, welfare and the environment, amongst other prime societal objectives of so called post-industrial societies. The necessity has created the virtue. The belief that citizens can reasonably expect to see sustained improvements in public services and private prosperity has been turned on its head. If necessity dictates dependence on inward investment, frugality as a virtue must be demonstrated and sacrifices made.

The effect has been that benefits to labour have been progressively diluted. Surveys show that working people in Britain now face a longer, less well-paid working week with fewer other non-wage benefits including holidays.[77] Provision for essential collective services such as health, education, and social provision and infrastructure, has been eroded, threatening the self-renewing capacity of the economy. Whilst the current administration can fairly claim to have tried to re-dress these imbalances, international statistical comparisons still present Britain in an unfavourable light when compared with other G7 countries. Domestically owned industries in key sectors of the economy have declined. One clear measure of this is the proportion of British manufacturing

[74] See Macmillan, *supra* n.5.
[75] See Wriston, *supra* n.5.
[76] See Macmillan, *supra* n.5, at 165.
[77] See "Business, Health and Safety", *The Financial Times Guide*, October 2000, at 14.

industry that is now controlled by foreign entities.[78] Less than a quarter of British manufacturing industry is now British owned and controlled. One inevitable consequence is that Britain is beholden, on a very significant scale, to corporate decisions being taken in other domains.[79] Though many of those investors are judged to be "benign", even friendly to British interests, the reality is that such businesses may close or relocate if the corporate parent decides that producing in Britain is no longer commercially attractive enough.

This has been shown most noticeably in early 2000 by the decision of BMW of Germany suddenly to abandon its ownership of and commitment to the Rover car company based in the Midlands of England. This leaves not only Rover, but also a large part of the regional economy, wholly dependent upon an entity judged by its erstwhile owner to be unviable. Other examples serve to illustrate the scale of vulnerability to the vagaries of effectively footloose investment. The decision of the British authorities to remain, at least during the "first phase", outside the European single currency, the euro, has resulted in several multinational businesses declaring that they will close down British operations if sterling remains outside the euro zone. Friendly or unfriendly – depending on taste – this must be proof that businesses, quite properly under existing arrangements, will act always in their own corporate interest. Sentiment plays no part in this calculation.

Courting the international investor

Yet Britain claims to have the lowest wage costs of any major industrial nation. It also tells its own electors, often not well informed on these matters, that Britain is a natural and preferred location for international capital. The inexorable decline of British owned manufacturing, and the nation's increased reliance on inward investment, has been turned to advantage by successive administrations. It is presented as proof that international capital likes the British environment and Britain's defiant stance against costly EU social support and employment protection measures. This, the public is informed, explains the strength of capital inflows.

The British economy is thus packaged as a successful, highly deregulated, low wage/low tax economy that attracts inward capital flows from wised-up global investors. This is presented as a key "selling point" to international investors. The various social and economic "indicators", which one way or another point to the British economy yielding one of the lowest standards of living to its citizens of any comparable OECD country, are presented as key features supporting the inward investment argument. It is difficult to avoid the conclusion that this is *prima facie* evidence that supports the "race to the bottom" argument.

[78] More than 25,000 companies in Britain are under foreign ownership. Yet the amount of real new inward investment that is derived from this is small where it simply involves the purchase of a British firm by a foreign entity.

[79] See B Bishof, "The Limits of Inward Investment", *The Financial Times*, March 1999.

Identifying a progressive path forward

As stated earlier, the solution to the challenges of both effective corporate governance and globalisation lie not in out-moded statist solutions. Nor should solutions, from the point of view of governance, seek to equate corporate or managerial power and responsibility with that of government. Eisenberg defines the corporation as a "profit-seeking enterprise of persons and assets organised by rules".[80] Some of these rules are determined by contract, others by law and mandatory rules. He admits that it cannot be assumed that because markets are *not* perfect that mandatory rules would necessarily be better but sensibly urges the pursuit of more creative solutions to the interest conflicts that arise from and between market and regulatory reliance.[81]

In acknowledging the illusion of the "Nirvana Fallacy", that the best of all possible worlds can be attained by design, this should not discourage efforts to create a framework within which legitimate concerns about industry and commerce can be democratically debated and resolved with the other corporate actors. In discussing the balance between the corporation and society, Buxbaum underscores the continuing nature of the challenge, which is to find "a better match between modern market modelling and modern institutional economics".[82] More explicitly, Hill argues that developments in modern capital markets – especially the blurring of definitions as between equity and debt – and the increasing indivisibility of labour and capital, represent a fundamental challenge to orthodox corporate legal theory.[83]

The journey ahead will be difficult to chart. The solutions in terms of institutional design are not immediately obvious. Statist designs do not offer a way forward. Mainstream regulatory approaches cannot straightforwardly address the challenge of overseeing multiple jurisdictions. There is also enormous entrenched corporate inertia to overcome. First instincts will be to resist moves aimed at redressing the existing balance of freedoms by measures designed to enforce greater corporate disclosure and accountability. The debate, nonetheless, must be opened up. Inaction will heighten further hostility to globalisation and alienate, still further, multinational enterprise.

Failure to address these challenges carries another danger. It will have the effect of propagating still further the dangerous myth that globalisation is a win/win game which holds only hidden promise for all our futures. Micklethwait and Wooldridge's *A Future Perfect*[84] is a compelling and plausible apology for unleashing the huge potential benefits to be derived from globalisation. Apart from the conceptual difficulties that are embedded in the

[80] MA Eisenberg, "The Structure of Corporation Law" in Wheeler, *supra* n.49, at 243.

[81] See Eisenberg, *supra* n.7; and Eisenberg, *supra* n.80.

[82] RM Buxbaum, "Corporate Legitimacy, Economic Theory and Legal Doctrine" (1984) 45 *Ohio State Law Journal* 515.

[83] See Hill, *supra* n.9.

[84] J Micklethwait and A Wooldridge, *A Future Perfect: The Challenge and Hidden Promise of Globalisation* (London, Heinemann, 2000).

argument,[85] there is no escaping the highly selective social and economic reality that has been chosen to demonstrate the argument. All of which confirms the eternal truth that "everything said is said by an observer": what you end up approving for others depends very much on the vantage point from which you do your viewing.[86]

[85] These are not specifically examined in this chapter, but centre upon a collapsing of the theory of comparative advantage and the rationale of welfare being relaxed through trade, which results from the globalisation of footloose capital. This breaks the win/win equation embedded in the comparative advantage argument. It will lead to capital being allocated globally on the basis of absolute advantage – a game in which it can be demonstrated the winner takes all.

[86] See Maturana and Varela, *supra* n.53, at xix.

4

Towards Ethics for the Corporation

SALLY WHEELER

INTRODUCTION

In this paper I outline what I call a "founding ethic" for the corporation. By this I mean not simply an ethics that informs relationships internal to the corporation such as that between employer and employee but an ethics that goes to the heart of corporate existence, an ethics that informs the entire relationship between corporations and their surrounding social context. Social I use here as a term that embraces the political, the economic and the emotional. In part one I draw upon empirical data about current corporate activities and investor decisions to posit the argument that adoption of ethical behaviour would not necessarily run counter to corporate action. Many corporations currently engage in what is termed within corporate strategy as philanthropic activities, acts of citizenship and corporate social responsibility, although the level of these activities has been the subject of criticism.[1] Nevertheless this criticism cannot detract from the fact that the acts necessary for an ethical persona are already in part in place. My desire is to set out a methodology whereby ethical behaviour becomes an integral part of business practice. In addition to encouraging ethical practice as an end in itself my methodology would also add the ideas of structure and consistency to existing corporate practices and thus ensure a more effective intervention in the life of the polity. My approach to providing a theoretical grounding for corporate behaviour is to use Aristotelian virtue ethics and the expansion of the same that is provided by the work of Alasdair MacIntyre. I set this out in the third part. Part four builds upon this by explaining the relationship that the corporation should enjoy with the wider community. In part five I examine how, through the use of MacIntyre's particular concept of community construction and reconstruction, the gap between the life of universal community that Aristotle advocates and the postmodern position that collective identity is not a possibility in the age in which we live can be bridged. In part two the chapter looks at another ethically based device that has been employed to reconfigure corporate activity, namely stakeholding. The agenda for part two is

[1] See the speech by Gordon Brown, Chancellor of the Exchequer, to the NCVO Annual Conference in February 2000 criticising the average business donation of 0.2% of pre-tax profits to charitable purposes as disappointing. This criticism was repeated by Stuart Etherington, chief executive of the NCVO, in February 2001.

to explain the ways in which stakeholding is an inappropriate mechanism with which to create an ethical dimension to corporate culture.

Ethical life

There is a certain topicality in the offering of an "ethical discourse" of corporate existence. Ethics has become a dominant theme of post millennium life. It seems that the collapse of the possibility of a socialist transformation and the failure of the right to win all remaining ground has resulted in a politics that is rooted in the middle ground. Debate is no longer polarised between right and left positions, ideas that were once considered partners only in opposition are now paired together.[2] Interest in the position of the "state" as one of the binding forces of political discourse has largely given way to a focus on globalisation and its winners and losers. Political economy is now about more than national issues. As Bourdieu points out the site of the economy is moving to supra-national bodies such as the European Union (EU). Nation states cannot control corporate behaviour but that does not mean that localism has no appeal. Initiatives such as regional development ensure that it has. In a world where exchange rates and interest rates are decided at a level above the nation state, an appeal to ethics becomes more important.[3] Politics now asks different questions. Central to discussions are debates about values within the polity, questions about identity and issues around inclusion.[4] These are all dilemmas that contain an ethical component. I offer these comments more as a statement, or observation, of the moment. This chapter will not examine the events that have resulted in the rise of this "new politics",[5] there are numerous accounts available elsewhere. The "turn to ethics", as it has been labeled, is not without its detractors. Those on the left see it as promoting "a sort of moralizing liberalism … filling the void left by the collapse of any project of real political transformation"[6] or signaling the beginning of a post-political age in which the existence of a tolerant democracy structured around global capitalism allows "elementary social decisions [to be] no longer discussed as political decisions [but as] simple decisions of gesture and of administration".[7] However in respect

[2] A Giddens, *The Third Way* (Cambridge, Polity Press, 1998), 26; A Giddens and C Pierson, *Conversations with Anthony Giddens* (Cambridge, Polity Press, 1998), Interview 6.

[3] P Bourdieu, *Acts of Resistance* (Cambridge, Polity Press, 1998), 61–4.

[4] See the themes explored in A Gamble, *Politics and Fate* (Cambridge, Polity Press, 2000).

[5] A persuasive account is provided by E Hobsbawm, *Age of Extremes* (London, Penguin, 1994). For an account that examines the impact of these events upon developing economies, see W Dierckxsens *The Limits of Capitalism* (London, Zed Books, 2000).

[6] C Mouffe, "Which Ethics for Democracy" in M Garber et al, *The Turn to Ethics* (London, Routledge, 2000) 85 at 86. This critique is directed in part against those who offer a consensus based politics derived from deliberative democracy (*ibid*., at 88–9). To assess the extent to which Habermas in particular might answer the criticisms leveled at him through his most recent work, see D Cook, "The Talking Cure in Habermas's Republic" (2001) 12 *New Left Review* 135.

[7] S Žižek Internet interview with *Spiked Magazine*. See also S Žižek (with J Butler and E Laclau),

of the corporation, the elision of ethics and politics does allow a discussion around an ethical existence for the corporation to take place without such discussion being immediately confounded by the argument that any notion of a redistributive function within the corporation can be framed only as a fundamental question of politics or economics.

It is clear from Jo Hunt's chapter in this volume[8] that corporate social responsibility has a place within the political agenda of the EU. As Hunt explains, what that agenda advocates is the adoption of practices of corporate social responsibility on a voluntary basis. Corporate social responsibility is rather different from the ethical position that I put forward for the reasons that I give below but both involve a departure from the idea that only those who hold shareholder rights in relation to the corporation can benefit from its profit accumulation activities. Pursuit of corporate social responsibility or the adoption of an ethical existence will result in a redistribution that is far less extensive than could be achieved through taxation of corporate profits to this end. The particular practices that are adopted as a result of the EU political agenda are themselves considered irrelevant unless a particular corporation becomes involved in tendering for or seeking contracts with the governance structure. This idea of pursuit of social responsibility on a voluntary basis is present in the UK government's forays into this area.[9] It seems that as far as redistribution efforts are concerned, the relevant political actors are expressly not framing the question as one of politics backed by regulation. Ironically, the absence of practical political interest in imposing an ethical existence on corporations might mean that there is actually a greater possibility of the same being achieved. From an empirical standpoint it is possible to point to the manipulation of corporate regulation by corporations as an aspect of prevailing corporate culture.[10] It is also the case that the history of regulatory content to date demonstrates that the concern of regulatory intervention has been to monitor the performance of corporate executives to the extent that the market for corporate control can function as an "efficient" mechanism. Other

Contingency, Hegemony, Universality (London, Verso, 2000), 93–101; G Rose, *Mourning Becomes the Law* (Cambridge, Cambridge University Press, 1996), 15–39; and C Boggs, *The End of Politics* (New York, The Guildford Press, 2000), 243f.

[8] See ch 5 *infra*.

[9] See S Driver and L Martell, "New Labour's Communitarianisms" (1997) 17 *Critical Social Policy* 27 at 43, who cite both Blair and Darling, in opposition, when the latter was Shadow Chief Secretary to the Treasury, as asserting that regulation would not change corporate culture, only persuasion and voluntary agreement. This position is reinforced by Stephen Byers in his speech to the UK-US Enterprise Conference on 5 July 2000, where he states that Government had a responsibility not to intervene and dictate how "businesses must conduct themselves".

[10] A Prakash, "Why do Firms Adopt 'Beyond Compliance' Environmental Policies?" (2001) 10 *Business Strategy and Environment* 286; K Hawkins, *Environment and Enforcement* (Oxford, Oxford University Press, 1984); and D McBarnet and C Whelan, "The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control" (1991) 54 *Modern Law Review* 848.

constructions of what might be deemed "efficient" in the context of corporate structure or performance are eschewed as is the issue of ethics.[11]

PART 1: CHANGING PATTERNS OF CORPORATE BEHAVIOUR

There is a history of what is popularly called corporate social responsibility or corporate community involvement in both the US and the UK corporate sector.[12] This type of behaviour it seems is more established in the US where corporate giving runs in excess of 1% of pre-tax profits.[13] However corporate largesse is becoming the norm in the UK as well. The figures made available by the Directory of Social Change show that UK companies provide not just cash donations but are also involved in a large range of community projects. In the area of employee training it is estimated that the corporate sector spends ten billion pounds per annum.[14] British Telecom pumped 15 million pounds into core community programmes in 1996/7. Grand Metropolitan spent 13 million pounds on community investment in roughly the same period. That, as Grand Metropolitan proudly announces, is 1.5 per cent of its world-wide trading profit less interest.[15] British Petroleum's (BP) expenditure in the same period on community projects was 19.5 million pounds, a figure that according to BP's Social Report for 1997 represents 0.5 per cent of its total pre-tax profit for 1997 and as the Report points out a figure that does not include their environmental operating costs. It is difficult to establish a precise figure for declared corporate

[11] D Campbell, "The Role of Monitoring and Morality in Company Law: A Criticism of the Direction of Present Regulation" (1997) 7 *Australian Journal of Corporate Law* 343. As an active example, see the speech by Stephen Byers, Secretary of State for Trade and Industry, to a TUC/IPPR Seminar on Corporate Governance 7 June 2000, in which he asserted that the key issue for reform within company law was disclosure &, allied to that, consequent changes in the formulation of directors' duties. Disclosure relates to directors disclosing to shareholders "what the company is doing in a whole host of areas that relate to their stakeholders" and within this is included "relations with suppliers, customer complaints … environmental and social and ethical policies … material to the business". The idea of this disclosure is apparently so that "shareholders, customers and other stakeholders can make informed decisions". As far as shareholders are concerned this information will presumably be used to reflect upon the quoted value of their shares. What informed decisions the second layer of interest groups will make on the basis of this information made available to shareholders is anyone's guess.

[12] B Pettet "The Stirring of Corporate Social Conscience: From 'Cakes and Ale' to Community Programmes" in M Freeman (ed.), (1997) 50 *Current Legal Problems* 279 at 280–6 and 301. A brief synopsis of the US legal position is provided by M Blair "A Contractarian Defense of Corporate Philanthropy" (1998) 28 *Stetson Law Review* 27 at 41–8. The position in both jurisdictions is examined in C Munoz Slaughter, "Corporate Social Responsibility: a new perspective" (1997) 18 *The Company Lawyer* 313.

[13] D Morgan, "Trends in Corporate Charitable Contributions" (1997) 41 *New York Law School Law Review* 771.

[14] Source: "The Evaluation of Funding for the Development of Continuing Vocational Education" University of Birmingham, HEFCE 98/44.

[15] Grand Metropolitan Report on Corporate Citizenship 1997.

contributions because there is no single method of calculation but a figure of around 315 million pounds is broadly correct for 1999. When set against the income allocated to the Single Regeneration Budget of 1.4 billion pounds, the 40 billion pounds required to run the NHS in the same period, a figure of 315 million pounds does not sound very substantial. It is also the case that this figure accounts for only 5 per cent of the voluntary sector's donated income. However when looked at in the context of charity income it appears more substantial; 315 million pounds is more than the fundraising of Cancer Research Campaign, British Red Cross NSPCC and RNIB put together in the same period.[16]

Acts of altruism by the corporate sector are occurring in a world that is globalised in the sense of markets, consumers and information. Thus they are public practices and there exists the potential to make them ever more public. Below I argue that the corporate response to global exposure in this way is to indulge in the creation of a competitive social agenda. By the same token the availability of information through media such as the internet[17] and television makes unpalatable corporate practices such as environmental damage and social dumping harder to hide. This access to information makes it easier for representative consumer groups or less formal "activist" groupings to organise product and producer boycotts. Pressure groups, both single and multi-issue NGO's, act as informers and co-ordinators of consumer feeling using these methods for knowledge acquisition, information transmission and co-ordination of action.[18] The position of Nestlé is illustrative of this. From 1974 to 1984 consumers were urged by activists to boycott Nestlé products as a demonstration of their feeling against Nestlé's practice of distributing Infant Milk Formula in the developing world. This boycott was re-introduced in 1988 due to Nestlé's alleged non-compliance with the World Health Organisation Code on the Advertising of Milk Substitute. Individuals can participate in the debate around the boycott or consult lists of Nestlé products using information posted on the Internet. Contributions to the formal policy process around consumer issues are also co-ordinated through bodies such as the Transatlantic Consumer Dialogue. This was launched in 1998 as a mechanism for US and EU consumer groups to make representations to the US Government and the EU Commission. The availability of global information, the ease of global communications and the decline in the importance of physical place and presence have made all of this very much easier.

[16] The sources for these figures are various but in the main they can be extrapolated from the Social Change publications; *The Major Companies Guide 1999–2000 and The Guide to Company Giving* (4th ed, Jan 2002).

[17] D Crowther, "Corporate Reporting, Stakeholders and the Internet: Mapping the New Corporate Landscape" (2000) 37 *Urban Studies* 1837.

[18] J Rosthorn, "Business Ethics Auditing – More than a Stakeholders' Toy" (2000) 27 *Journal of Business Ethics* 9; and J Grolin, "Corporate Legitimacy in Risk Society: The Case of Brent Spar" (1998) 7 *Business Strategy and Environment* 213.

Investor behaviour

Changes in corporate values can also be monitored through looking at the growing popularity of ethical investment. In the US the total value of all assets consciously invested as "responsible investments" is 1.185 trillion dollars.[19] In the UK the figure is put at in excess of 2.8 billion pounds and can be compared with a figure of 500 million pounds in 1995.[20] Obviously there are debates about what constitutes ethical investment; not every investor has the same view on issues such as tobacco production, road building and intensive farming. What is starting to emerge within this market is a reproduction of Drucker's pyramid[21] that already subsumes a large part of the conventional investment market: individuals delegate ethical choices and assessments to fund managers who are promote a range of ethical funds within a portfolio of "socially responsible investment". The oldest of these funds are the Stewardship funds launched by Friends Provident in 1984. These particular funds account for about 50 per cent of the market share. About twenty other financial institutions have joined Friends Provident in the market for the money of the ethical investor.[22] It seems that an ethical profile for these purposes is constructed from assessing positive corporate activity such as conservation and resource management against negative corporate activity such as the production of greenhouse gasses.

There are clear difficulties with this approach such as the lack of mechanisms to test the veracity of corporate statements and the inherent bias towards clean hands corporations such as those engaged in the telecoms industry. It is not clear how far ideas of ethical behaviour should drill down into a corporation's operations, for example corporations within the so-called clean hands industries might pursue employment practices that fall far short of those that would be acceptable in the US or the UK. Ethical investing, while it is a potential curb on corporate power and activity, does not have the same popular appeal as consumer boycotts and lobbying which are open to all regardless of their ability or desire to become shareholders. Ethical investing does not necessarily involve moving corporate strategy away from Milton Friedman's assertion that all responsible corporations should do is care for shareholders.[23] Shareholders in this instance have demanded "ethical" policies be pursued to obtain return upon their investment. These demands can be satisfied without the corporations involved being forced to consider the position of those outside the corporate property matrix.

[19] This is the 1997 figure, *Report on Responsible Investing Trends* (Washington, Social Investment Forum, 1997).

[20] EIRis, February 2000.

[21] P Drucker, *Post Capitalist Society* (Oxford, Butterworth-Heinemann, 1993).

[22] A Lewis and C Mackenzie, "Morals, Money, Ethical Investing and Economic Psychology" (2000) 53 *Human Relations* 179.

[23] M Friedman, *Capitalism and Freedom* (Chicago, University of Chicago Press, 1962).

The emergence of competitive social conscience

The question of whether ethical profile, assertions of corporate social responsibility and the present popularity of ethical investing have a positive impact on corporate financial performance is a hotly debated issue. There are numerous studies, mainly based on US data, which give conflicting answers.[24] There are methodological difficulties in both conducting this type of research and comparing the results. The type of conduct studied varies, as does the approach to measuring financial performance. All the studies are firmly locked into the stakeholder paradigm which creates further difficulties as there is no standard to determine which groups are included and excluded.[25] The general view is that the worst that can be said about these activities is that they do not appear to depress financial performance.[26]

However whether financial performance is, in reality, improved or not in these circumstances is not really the issue. What is much more relevant is the fact that corporations clearly think that it is or at least that it has the potential to be. This explains the emergence of a competitive structure that encompasses social responsibility agendas.[27] In addition to competing in areas such as product development, production costs and ultimately price, corporations compete over their social awareness and responsiveness. Advertising of products is now not confined to the sponsorship of glamorous sporting events and advertising hoardings but takes place through links with charities. The idea is that consumers will have faith in the values of the charity and then, through the link with the charity, transfer that faith to the merits of the product or the producer depending on how narrowly the link is focused.[28] The concept of cause related marketing has resulted in leading supermarket chains, for example, competing over the donations such as books and computers that they will make to schools as an incentive to would be customers to patronise their establishments rather than those of their competitors.[29] A more recent addition in this area has been corporate recognition of work-life balance issues. A grouping of large corporations calling themselves Employers for Work-Life Balance have begun to issue a number of position papers and best practice guidelines around not only the

[24] For a review of the literature and an indication of the answers provided by numerous different studies, see C Verschoor, "A Study of the Link Between a Corporation's Financial Performance and Its Commitment to Ethics" (1998) 17 *Journal of Business Ethics* 1509.

[25] For a detailed review of methodological problems, see S Waddock and S Graves "Quality of Management and Quality of Stakeholder Relations: Are They Synonymous" (1997) 36 *Business and Society* 250.

[26] R Roman et al, "The Relationship Between Social and Financial Performance: Repainting a Portrait" (1999) 38 *Business and Society* 109 at 121.

[27] C Smith, "The New Corporate Philanthropy" (1994) *Harvard Business Review* 105.

[28] M Stork, "Brand Aid: Cause Effective" (1999) 40 *Brandweek* 20.

[29] S Wheeler, "Inclusive Communities and Dialogical Stakeholders: a Methodology for an Authentic Corporate Citizenship" (1998) 9 *Australian Journal of Corporate Law* 1 at 13f; and T Mescon and D Tilson, "Corporate Philanthropy: A Strategic Approach to the Bottom-Line" (1987) 29 *California Management Review* 49.

offering of different types of work form, such as working from home and short-fat working weeks, but also dealing with employees' health and well-being. Their suggestions embrace those employees with and without caring responsibilities. The rational for this is apparently that as employers they feel it is their responsibility to their employees to offer them the means to have fulfilled lives outside work. Mitigating against this positive attitude are a number of questions that, if answered by future research, will provide a much clearer picture of the value and extent of corporate policies on this issue. For example it is not clear if all employees working at every level are included in these policies nor is it clear that employees working in the few remaining heavy industries as opposed to "clean hands" industries will have these policies offered to them.[30]

Corporations have become increasingly interested in applying the label "citizen" to themselves. They see this as a way of developing market reputation, as identifying with the current debates in society and, most importantly, as labeling themselves as wishing to make a positive contribution to society.[31] If social responsibility practices are justified in this way as being potentially value enhancing this avoids confrontation with the traditional position taken by law and economics scholars. From their standpoint, corporate managers are to manage the firm in the interests of enhancing long term shareholder value. If it were the case that shareholders seemed to be asserting through market behaviour that higher returns were to be traded against the ethical profile of investments, products and community activism then the law and economics explanation of the corporation as the site of shareholders, as residual claimants, requiring of their managers wealth maximizing behaviour would be seriously compromised.[32]

Previously calls for the corporation to act in a socially responsible manner have been met by arguments that not only will corporate executives not know how to exercise their largesse (in terms of whose interests to exercise it in)[33] but also that such an exercise would be essentially undemocratic.[34] This point relates directly to the idea of the corporation as a vehicle for enhancing the wealth of a small number of individuals occupying the position of investors. To

[30] It is perfectly possible that a competitive agenda will emerge around performance on this issue with regard to the recruitment and retention of employees, see D Greening and D Turban, "Corporate Social Performance as a Competitive Advantage in Attracting a Quality Workforce" (2000) 39 *Business and Society* 254.

[31] R Gray, "Developing a tight fit is crucial to CRM", *Marketing* (4 May 2000), 37. Gray's article cites Dean Sanders (founder of Good Brand Works, a social marketing consultancy as saying "I wonder how history will judge cause related marketing … My instinct is that it will be seen as a catalyst in the wider move to the socialisation of business".

[32] J Boatright, "Business Ethics and the Theory of the Firm" (1996) 34 *American Business Law Journal* 217.

[33] Friedman, *supra* n.23, at 133–4.

[34] H Glasbeck, "The Corporate Social Responsibility Movement – The Latest in Maginot Lines to Save Capitalism" (1988) 11 *Dalhousie Law Journal* 363; and R Reich, "The New Meaning of Corporate Social Responsibility" (1998) 40 *California Management Review* 8.

allow decisions regarding welfare provisions and other social policy questions to be made by those within the matrix of the corporation would indeed be undemocratic. This approach has a flavour of grand corporate benevolence about it rather than, as I have argued elsewhere,[35] corporate social contributions as a way of securing corporate legitimacy in the face of popular opposition to corporate acquisitiveness without more. This I think reflects more the modern setting of corporate behaviour. The democracy argument and the emergence of a competition in relation to socially responsible behaviour are both useful in highlighting the difference between corporate social responsibility and its family of related concepts such as corporate social performance and an ethical persona. There is a developed literature in the US that devotes itself to defining corporate social responsibility and related terms. No single definition dominates. Numerous models have been set up and then refined and reworked.[36] All commentators would probably agree that corporate social responsibility involves corporations doing more than simply complying with their legal obligations. Many would include within their definition a reference for the need for corporations to be "ethical". The difference between this position and the adoption of an ethical persona goes to the question of motive. Corporate social responsibility is often constructed as a descriptive theory. A genuine ethical position is one that is aspirational in its focus. Motive has to be to do the act in question for itself and not in pursuit of competitive advantage. Pursuit of an ethical agenda involves more than corporate largesse on a whim – it requires genuine engagement with social issues and targeted intervention following consultation with interested parties. It requires determinations of support to be capable of being expressed as products of ethical consideration and not simply the directing of an amount of money or managerial or financial support into the polity outside the corporation on an *ad hoc* basis.

PART 2: STAKEHOLDING AS AN ETHICAL INTERVENTION

Ethical interventions in corporate behavior have followed the majority of ethical discussions within modernity by centering upon notions of Kantian imperatives. Stakeholding is the summation of these efforts.[37] The appropriateness of stakeholding to found a new ethical life was given encouragement in recent years by the adoption of some of its tenets as part of a larger political philoso-

[35] S Wheeler, *Corporations and the Third Way* (Oxford, Hart Publishing, 2002).

[36] For a comprehensive overview of three models dating from the 1950s onwards, see A Carroll, "Corporate Social Responsibility" (1999) 38 *Business and Society* 268. For a review of Carroll's own model, see D Swanson, "Towards an Integrative Theory of Business and Society: A Research Strategy for Corporate Social Performance" (1999) 24 *Academy of Management Review* 506.

[37] R Edward Freeman, *Strategic Management: a Stakeholder Approach* (Boston, Pitman, 1984); and T Donaldson and L Preston, "The Stakeholder Theory of the Corporation: Concepts, evidence and implications" (1995) 20 *Academy of Management Review* 65.

phy. This adoption was however short lived and stakeholding in both contexts has suffered something of a reverse in popularity. Stakeholding in its corporate sense has centered its theoretical propositions around a particular base line – "no stakeholder should be used as a means to an ends".[38] In the discussion that follows I disavow the utility of Kantian ethics in the corporate sphere. Scholarship around the corporation has yet to build a model based upon the favourites of post-Kantian deontology – Derrida and Levinas. The apparent need for a model built upon responsibility has had added to it the dimension of recognition. Recognition goes beyond responsibility and emerges as obligation – obligation to the "other". The unfortunate part of this is that it has found voice mostly through the current discourses around human rights. In the main these discourses reflect the smug and self-satisfied affluent West seeking to gloat with the after glow of righteousness as they re-legitimise their imperialistic ambitions in the name of "human rights".[39]

The promise of stakeholding

Stakeholding should rightly be credited with bringing discussions about the shape of corporate life to the fore in both an academic and political sense. In terms of political discourse the UK had not looked at an agenda wider than the equation between management accountability and the return of profit to shareholders since the days of the Bullock Committee[40] and the subsequent White Paper[41] that followed its deliberations. In an academic sense the corporation has begun to be viewed in the cultural, economic and political maelstrom in which it exists. As Millon has explained, the Law and Economics scholarship of the corporation (in his terms, the contractarians) have concentrated on property relations within the corporation while stakeholder scholars (in his terms, the communitarians) have looked more broadly at the social context and impact of corporate existence and activity.[42] However this would seem to be where the utility of stakeholding as an ethical proposition ends. It is essentially a rights based philosophy. Taken to its logical conclusion the goal of a rights based philosophy in the corporate context would be the dismantling of the privileges accorded to property owning shareholders and a creation of structures to allow other groups (stakeholders) to share in the establishment and realisation of

[38] For a discussion of Kant's End-in-Itself expression of the Categorical Imperative, see M Slote, "From Morality to Virtue" in D Stateman (ed.), *Virtue Ethics* (Edinburgh, Edinburgh University Press, 1997) 128 at 138–9.

[39] For a discussion about the utility and disutility of rights discourse, see P Williams, *The Alchemy of Race and Rights* (Cambridge, Mass., Harvard University Press, 1991), 146–165 and a review of same in R West, "Murdering the Spirit: Racism, Rights and Commerce" (1992) 90 *Michigan Law Review* 1771.

[40] *Report of the Committee of Inquiry on Industrial Democracy* (Cmnd 6706, 1977).

[41] *Industrial Democracy* (Cmnd 7231, 1978).

[42] D Millon, "Communitarians, Contractarians and the Crisis in Corporate Law" (1993) 50 *Washington and Lee Law Review* 1373 at 1379.

corporate goals. These goals then become, by definition, more than profit maximization. This confrontation with established capitalist hierarchies is absolutely central to the theoretical integrity of stakeholding. However its proponents have been quick to realise that this sort of intervention poses a large political and economic question – the wholescale reconfiguration of capitalism. Consequently stakeholding has modified its claims somewhat. It presents itself as an oppositionary argument to the views of Law and Economics scholars. The idea, it seems, is to soften the hammer of the shareholder primacy view without creating a model that affords rights that are real in any sense. The rights that could be offered within this oppositionary argument are only the ones that are already present within the prevailing legal system.

The disappointment of stakeholding

The basis of stakeholding in ethics is lost in such circumstances and consequently the reality of what is suggested under the umbrella of stakeholding is a collection of much weaker approaches divorced from any real theoretical underpinning. These include, for example, the informal widening of corporate governance participants through the gradual absorption of business culture from the more social democratic European economies such as Germany.[43] Piecemeal measures such as these cannot found an operating culture. What results tends to look more like social responsibility – vague notions of participation or even weaker ideas of consultation.[44] The disappointment of social responsibility is that it does not create the platform for improved and uniform standards of behaviour, legal or ethical, amongst its proponents in the corporate sector: "the term is a brilliant one; it means something, but not always the same thing, to everybody. To some it conveys the idea of legal responsibility or liability; to others it means socially responsible behaviour in an ethical sense; to still others, the meaning transmitted is that of 'responsible for', in a causal mode; many simply equate it with a charitable contribution."[45]

[43] While one can see the basis for asserting, as Hansmann and Kraakman do (H Hansmann and R Kraakman, "The End of History for Corporate Law" (unpublished manuscript available from the authors)), that this is a time of worldwide corporate governance convergence around the model of shareholder primacy, there is much more work to do on the nuances of individual regimes before such a declaration can have any real force, see G Jackson, "Comparative Corporate Governance: Sociological Perspectives" in J Parkinson et al (eds), *The Political Economy of the Company* (Oxford, Hart Publishing, 2000) 265.

[44] See the debate between Ireland and Campbell in the pages of the *Journal of Law and Society*: P Ireland, "Corporate Governance, Stakeholding and the Company: Towards a Less Degenerate Capitalism" (1996) 23 *Journal of Law and Society* 287 and D Campbell, "Towards a Less Irrelevant Socialism: Stakeholding as a 'Reform' of the Capitalist Economy (1997) 24 *Journal of Law and Society* 65.

[45] D Votaw, "Genius becomes Rare" in D Votaw and S Sethi (eds), *The Corporate Dilemma: Traditional values versus contemporary problems* (New Jersey, Prentice Hall Englewood Cliffs, 1973) 11 at 11.

The effect of the presentation of stakeholding in these terms is that it can be constructed as an exclusionary discourse that focuses on labour market participants only. This construction reveals another fundamental difficulty with stakeholding and that is that as a theory it depends upon not only on the bestowal of rights but also on the prior identification of groups on which to bestow these rights. This is deceptively simple in the context of employees. However as a general position proponents of stakeholding have never offered on its behalf an agreed mechanism for identifying the wouldbe holders of rights in a corporate stakeholding world.[46] It has yet to decide whether stakeholders are identified by society at large or by the corporation. In a system such as stakeholding where the corporation stands as separate from the polity at large this would appear to be a fundamental question. This problem around identification is perhaps not surprising. It is very difficult if not impossible and even inappropriate in a world where meta-narrative has given way to multi-faceted individual identity to present uni-focus categories. It is impossible to speak of community without recognising that geographical containment within a particular area is insufficient to provide an all-encompassing identity for the individuals collected there. If we return to the question of employees there are numerous cross-cutting identities that repose in each individual employee and may cause that employee to have different interests and a different perspectives on desirable rights. For example, work status such as skilled or not and full-time or part-time are joined by social and cultural issues such as race, ethnicity, sexuality, religious affiliation and parent or not to list just some of the possibles in the adoption of identity. A rights based theory has to consider these questions of identity and as a follow-on from that has to provide some sort of methodology for dealing with competing claims. Stakeholding does not offer this level of sophistication. It places the corporation at the centre of its theory and considers relationships from that viewpoint only.[47] Further, even as a discourse that delivers an improved position only to labour market participants, stakeholding finds itself undercut from a position of primary recourse by the proposals emanating from another much more powerful and influential supporter of the labour market participant – the EU. The EU can influence not only national level measures and initiatives but also introduce binding pan-European measures. An enhanced position for employees is of course to be welcomed and they are by no means excluded from the Aristotelian based theory that I posit later in this paper. My difficulty with stakeholding on this point is that stakeholding appears to offer the possibility of tangible benefits to employees only.

[46] The word "legitimate" is frequently used to describe the interest that must be held in order to be a stakeholder in relation to a corporation. However, legitimacy as a definitional construct depends upon the view one takes of the ambit of corporate concern, some discussion on this point is offered by Mitchell et al, "Toward a theory of stakeholder identification and salience: Defining the principle of who and what really counts" (1997) 22 *Academy of Management Review* 853.

[47] J Frooman, "Stakeholder Influence Strategies" (1999) 24 *Academy of Management Review* 191 at 195.

PART 3: THE WORLD OF VIRTUE ETHICS

I want to explore the possibilities offered by Aristotelian ethics as a way of offering a system of behaviour for corporations that is based not upon ideas of duty but upon ideas of values or virtues in Aristotelian terms. Under their broadest definition virtue ethics are a set of ethical principles that concentrate on establishing moral positions from which ethical decisions can be made. These are not moral positions that give rise to a single answer to an ethical dilemma, either as a result of a moral law or as a result of an *a fortiori* application of fixed principles. Rather, virtue ethics encourages contemplation of the options that confront the individual who has developed moral positions. Key to virtue ethics is the development over time of the moral character.[48] There are numerous recent expositions of applied ethics in fields such as education,[49] health care and, pertinently for this chapter, business ethics[50] that claim an intellectual association with Aristotle. Discussion of some of the business ethics literature appears below. Here it is worth making the point that the appearance of applied ethics with an Aristotelian flavour in health care and education is, in philosophical terms, not particularly surprising. Both are well within the remit of Aristotle's general philosophical position.

The application to business issues is of more interest since at first the connection between business and Aristotelian ethics is hard to see. The parts of Aristotelian philosophy that would seem to engage directly with business ethics, rather than issues of economic principle such as value and exchange, make a case for slavery, and condemn profit-making activity, indulged in for its own sake, and usury.[51] Aristotle was not opposed to economic activity as such; shoemakers, carpenters and builders receive mention without condemnation, for example. His concern was with justice in exchange evidenced by an attempt to achieve proportional equality of goods and reciprocal action.[52] Usury was not

[48] J Barton, "Virtue in the Bible" (1999)12 *Christian Ethics* 12.

[49] D Carr and J Steutal (eds), *Virtue Ethics and Moral Education* (London, Routledge, 1999); J Steutel, "The Virtue Approach to Moral Education: Some Conceptual Clarifications" (1997) 31 *Journal of the Philosophy of Education* 395.

[50] Denis Collins asserts a claim to be the first such proponent by virtue of a literature search of the Business Periodicals Index, see D Collins "Aristotle and Business" (1987) 6 *Journal of Business Ethics* 567 at 571.

[51] There are a number of texts devoted to Aristotelian economic thought. Several of these are referenced below. Useful overviews are provided in S Fleetwood, "Aristotle in the 21st Century" (1997) 21 *Cambridge Journal of Economics* 729 and J O'Neill, "Essences and Markets" (1995) 78 *The Monist* 258.

[52] See *Nicomachean Ethics* 1132b21–1134a11. The passages that deal with fair exchange/justice in exchange can be seen not as Aristotle's interest in economics but as Aristotle putting forward an ethical position or question. Judson puts this as "What is the basis of fairness in the exchange of goods" and then suggests the answer "it is the strength of the needs which exchangers have when they satisfy these conditions which in central cases determines the equivalence of return of goods": L Judson, "Aristotle on Fair Exchange" (1997) XV *Oxford Studies in Ancient Philosophy* 148 at 148 and 172.

necessary to stimulate this type of activity. Its goal then was seen as being an anti-social one of exploitation driven by greed.[53] The economy that concerned Aristotle was a stagnant one in which material goods were in fixed supply thus capping total wealth. A collective or common good could only be reached if each individual citizen set out to acquire no more than he actually required for life. Economic activity could not be an end in its own right. More assistance for developing a model for contemporary business ethics comes from the wider Aristotelian perspective on ethical behaviour, the relationship of the individual to the community and the governance of that community.

Aristotelian virtue ethics

Aristotelian philosophy advocates that an individual should live life according to the virtues and Aristotle duly provides a list of the virtues: courage, temperance, generosity, style, pride, ambition, gentleness, truthfulness, wittiness, friendliness, modesty, good nature, righteous anger. There are at least several individual virtues in this list that contemporary society, in so far as it is possible to point to a generalised shared position, would not consider merited the title of virtue, for example, pride. In the same way there are also others that would probably figure as virtues in any age, for example, truthfulness. Absent from Aristotle's list are any of the virtues that we would traditionally associate with the Judeo-Christian world and other religions as well: repentence, remorse, forgiveness to name but a view. Given the stress that Aristotle laid upon battlefield courage it is unlikely that he would have regarded moral courage ending perhaps in humility rather than physical victory as a virtue. However the key point here is not the virtues themselves but the structure for life of which they are part. Of greater significance to my mind at this point is the "agent-centered" telelogical situation of the virtues. Hence, after examining Aristotle's suggestions for a virtuous life I use the work of Alisdair MacIntyre as the methodology for identifying contemporary virtues.

I use "agent-centered" here as the counter-point to "act-centered" ethics. By this I mean that what is important is not a particular individual act but the character of the doer of the act. The virtues are qualities of character[54] that can be learned and practised.[55] They are not ethical principles of themselves nor can actions done in their name possess an ethical character. Virtues can be taught and inculcated, and indeed must be, which is not the case with compliance with pre-ordained principles or "best-off" solutions. This position is essentially

[53] See *Nicomachean Ethics*. Aristotle heaps invective upon those who lend small sums at high rates of interest, they do this he feels for an improper desire for or love of gain.

[54] *NE* 1105b28.

[55] *NE* 1103a33. According to this passage, which appears at the beginning of book 2, virtue is of two types: intellectual and moral. Intellectual virtue is possessed as a result of birth and honed by teaching, moral virtue can be acquired through habit.

anti-Kantian[56] and anti-utilitarian,[57] both of which are philosophies that are traditionally classed as act-centered approaches to ethics. The apparent simplicity of these propositions makes a neat, if basic ideological point, and, as one would expect, ignores a huge range of debate in between.

A common complaint amongst those who are not supporters of virtue ethics is that the basic approach of virtue ethics is not certain enough to enable anyone to identify anybody else as virtuous nor does it assist in answering the question "What is the right thing to do?" in particular hard cases. In other words, this is an attempt to push towards act-centered rather than agent-centered approaches to ethics. In many ways this is an accurate summary of virtue ethics but rather than undermine the concept it instead demonstrates its potential as an approach to dealing with dilemmas. The work of Rosalind Hursthouse[58] is pertinent here. Hursthouse takes as one of her examples the debates around abortion surrounding the position of the fetus and the position of the carrier. In her view, by considering the different motives and thinking behind decision making, virtue ethics can be used to examine particular actions and to form moral rules for guidance. Abortion is a classic hard case in which there are likely to be sharply conflicting views. Virtue ethics requires individuals to inquire into the sort of people they need to have become or the type of characters they must develop in order to be able examine the spectrum of choices available. The moral voice will come not from a system that provides right answers but from one that allows the construction of and the playing out of a series of different propositions.

For corporations a character based approach has the advantageous effect of distancing rights based dialogues but the disadvantage of insisting upon consideration of the various possible outcomes of particular acts, for example.[59] The teleological nature of the Aristotelian position comes from the stress laid upon the importance of the end result/goal of an activity and of the motive that underlies the doing of particular acts. The doing of a virtuous act does not make the doer virtuous unless the doer did the act for its own sake and not resentfully or as part of an exercise to enhance reputation.[60] At this point Aristotelian philosophy enters an on-going debate within business ethics scholarship: whether the intention behind an act of corporate social conscience should matter as long as the outcome of the act was broadly acceptable.

[56] The definition of this position I would give as obeying the moral law which itself is founded on a universal and impartial law of rationality.

[57] I take as my definition for this acts that are done if they are ones that give the best outcome for as many people as possible.

[58] R Hursthouse, "Virtue Theory and Abortion" in R Crisp and M Slote (eds), *Virtue Ethics* (Oxford, Oxford University Press, 1998) 217; and R Hursthouse, "Applying Virtue Ethics" in R Hursthouse, G Lawrence and W Quinn (eds), *Virtues and Reasons* (Oxford, Oxford University Press, 1995) 57.

[59] T White, *Business Ethics* (New York, Macmillan, 1993) 14.

[60] *NE* 1105b5. See also R Audi, "Acting from Virtue" (1995) 104 *Mind* 449 at 455.

Adoption of Aristotelian principles would end this debate. A stance such as this would be very useful for moving corporations away from the "feel good" factor obtained from an act of social responsiveness structured by competition and into a position where there was more effective participation in the political and social project identified earlier. The whole point is that there is no underlying principle about what ought to be done[61] only the question about what individual actors should become. This would allow corporations to assert that profit was merely one objective that was held along with others.

Part of living life through the virtues is contained in making a well-judged choice between two extremes. This is often expressed as the choice between virtue and vice, or realising the mean. Each virtue is a mean in the sense that it occupies the middle ground between two vices. For example, courage is the mean between cowardice and ill-considered rashness. But over and above the mean that each virtue represents, the individual pursuing the virtues is required to follow the mean ground between excess performance and falling short.[62] Over zealous performance in relation to a virtue is no more meritorious than under performance or non-performance. The mean is a relative standard for each individual to determine in relation to each virtue, for example, what might be cowardice for a professional trained soldier might be quite appropriate behaviour for an ordinary citizen. As a relative standard it would permit corporations to weigh community contributions against the need for long term investment in plant, for example. It would permit the resources committed to the wider society to reflect the level of commercial success over any given period. Most importantly, it would allow the corporate entity to set its own standards for contribution to society against the backdrop of the accumulated choices of individuals collected together in the polis.

MacIntyre's virtue ethics

MacIntyre's theory of virtue is, as one would expect, similar to Aristotle's in that it describes first virtue ethics within the life of the individual and then uses virtue ethics as a way of relating the life of the individual to that of the larger community.[63] MacIntyre wastes no time in restoring what he sees as one of the principal casualties of the retreat from Aristotelian thought – the background

[61] The issue of the importance of motive to Aristotle is often used to emphasis the difference with the Kantian principled approach to actions, which asserts that the doer acts out of a sense of duty. However, there is a school of thought that advocates that this is an inaccurate reading of both of them and that they are far closer to each other in putting forward an idea of moral motivation: see R Louden, *Morality and Moral Theory* (New York, Oxford University Press, 1992) 295; and C Korsgaard, "From Duty and for the Sake of the Noble" in S Engstrom and J Whiting (eds), *Aristotle, Kant and the Stoics: Rethinking Happiness and Duty* (Cambridge and New York, Cambridge University Press, 1996) 152.

[62] *NE* 1006b36.

[63] J Schneewind, "Virtue, Narrative, and Community: MacIntrye and Morality" (1982) 79 *Journal of Philosophy* 653 at 655–661.

context of an individual's life. Within the life of the individual the background context of every activity is constituted as a "social practice". A "social practice" is a co-operative form, the purpose of which is the achievement of goods internal to that practice rather than external. Internal goods in relation to any particular practice are goods that can only be achieved by participating in that particular practice.[64] MacIntyre's example is of a chess game; the internal good here is in playing chess well. An external good in the chess example is winning money for becoming a chess champion. The distinction lies in the fact that it is not necessary to be a champion chess player in order to acquire money. Virtue(s) result from ability acquired first through compliance with rules and recognised standards and then enhanced by going beyond that position to achieve internal goods. In the chess example the virtues necessary would be those of justice, courage and honesty. These virtues would be honed through submitting to criticism, learning to accept defeat and keeping to the rules of the game.[65] The term "practice" or "social practice" is also found in the business ethics literature as a term for describing a corporate activity which has a stronger ethical foundation in favour of participation than would normally have occurred in the era of post-fordism.[66]

It is the case that MacIntyre appears not to accept the relationship of employees' skills, within business activity, to the products produced as part of his scheme of internal goods and social practices. Rewards within a market economy for employees as part of the production process are driven not by their skill and endeavor but by the success of the business activity itself in producing goods for which there is a demand.[67] His criticism is aimed at the way in which business activity is organised: he sees it as excluding the features of activity that would allow business to be considered a practice. MacIntyre illustrates this through use of his, perhaps, best known example of the two fishing crews: one is organised as a profit maximizing event for each individual employee, manager and owner and the other (the form he favours) is organised as a venture where individuals value each other and consider the impact of events on the surrounding community. To the first crew economic reward is the only value that they are interested in; to the second their concerns, while not excluding the economic, also centre on honing the skill of fishing and committing themselves to a life within a fishing community, whatever the pitfalls. MacIntyre admits that his two fishing crews are ideal economic types. We might critique the first type as

[64] A MacIntyre, *After Virtue* (London, Duckworth, 2nd ed, 1985), 175.

[65] *Ibid*., at 191. For a sustained critique of the notion of practices and the games analogy that MacIntyre uses, see D Miller "Virtues Practices and Justice" in J Horton and S Mendus (eds), *After MacIntyre* (Cambridge, Polity Press, 1996), 250–258.

[66] Solomon describes the "idea of business as a practice [as] absolutely central to this approach" ie. an analysis based on virtue ethics: see R Solomon, "Historicism, Communitarianism, and Commerce: An Aristotelian Approach to Business Ethics" in P Koslowski (ed) *Contemporary Economic Ethics and Business Ethics* (Berlin, Springer-Verlag, 2000) 117 at 122.

[67] A MacIntyre "Rights, practices and Marxism: reply to six critics" (1985) 7 *Analyse und Kritik* 234 at 245.

crediting employees, even skilled employees, with more economic power than they are ever likely to enjoy.[68] The second crew type does not say enough about the uncertainties of economic life in the era of post post-fordism to form a useful model for moving forwards. However, there is a more basic point to be drawn out of MacIntyre's reasoning and that is that internal organisation of a particular practice is not of itself enough to change a paradigm of behaviour. A practice, if it is to embrace the virtues, must be institutionalised within a wider society.[69] This is a point that I return to in part five.

So the problem with using MacIntyre in this way is that this is only the first building block in his description of the inculcation of virtue into an individual life and from there into the wider community.[70] MacIntyre's first caveat on how the virtues are acquired – that not all practices are morally acceptable and virtues cannot be seen to emerge from the arbitrary activity of individuals[71] – is of major significance to those who classify corporate activity as a practice. Clearly, the internal goods they identify and the virtues that result from them need to be part of a holistic approach. In addition some virtues cannot be tied to a specific practice, for example integrity. To overcome these difficulties MacIntyre turns to look at the narrative of an individual's life. By narrative he means an individual's identity and responsibility for past action. Narrative, through intention, is what explains the actions of an individual. Narrative history is essential to explaining a particular act. Every individual's life has a definite narrative form, a narrative unity that the individual lives out. The life of each individual, however, is not a pre-planned project because if that were the case there would be no room for that individual to exercise choice. The role given to choice by MacIntyre echoes Bauman's position on the fate of human kind. MacIntyre presents the role of choice as "life as an unfinished narrative". Each individual has a quest to seek the good and in seeking it the individual will find out more about both the good and their own character. Individuals are never more than the co-authors of their own narratives in the sense that an individual plays a part in the narrative of others and vice versa. Sometimes this part is a subordinate one but nevertheless the individual is constrained by this.[72]

[68] This approach has many similarities in result, if not sentiment, with the contractarian approach to corporate activity. In this approach, employees are seen as contracting with their employers in a world where they have equal bargaining power. If they do not like their working conditions the assumption is that they will bring the contract to an end and work elsewhere.

[69] A MacIntyre "A Partial Response to My Critics" in Horton and Mendus (eds), *supra* n.64, at 284–8.

[70] As Dobson points out virtue ethics in relation to corporate activity based upon MacIntyre and applied as part of his total scheme places the "firm in a role that is far more active and intrusive than merely creating a contractual structure nexus or a wealth-creating machine": J Dobson, "Theory of the Firm" (1994) 10 *Economics and Philosophy* 73 at 75.

[71] See *supra* n.64, at 186–8. Practices that are not acceptable are theft, perjury, bigamy, betrayal and the taking of innocent life.

[72] *Supra* n.64, at 213.

Ideas for contemporary virtue

To be able to situate virtue ethics within a framework that acknowledges the progressive nature of society in the twenty first century is essential if virtue ethics is to be the bulwark of ethical life in the way that I suggest. While it is useful in structural terms to set out at this juncture the virtues that might suggest themselves in contemporary society and to explain the approach that has been taken to first changing Aristotelian virtues and second to identifying their successors, this necessarily involves a brush with MacIntyre's theory of community prior to its receiving more thorough treatment in part five. MacIntyre's insistence that possession of the virtues must come from the "local and particular"[73] society that an individual is situated within and that the individual can move forwards beyond the position that the particular society offers does much to allow Aristotelian philosophy to speak to the difficulties of life in the third millennium highlighted by Bauman[74] and Giddens.[75] There is no requirement of a universalistic community with a corresponding common good. The common good is now that of a particular society at a particular time. Virtues are relative to each community as that community forms and reforms them.[76] Virtues contain aspects of an individual's character and each individual's motive in doing an act is what holds the key as to whether that act is virtuous. This is straight from MacIntyre's Aristotelian inheritance. However, the cumulative effect of MacIntyre's approach to Aristotelian ethics is to move them significantly towards the postmodern critique; gone are stumbling blocks such as the existence of fixed identity and fixed community in either locus or temporality. It is possible to assert that some behaviours can never be virtues and that some virtues, such as integrity, attach to all social roles, irrespective of community.

From the many discourses employed by New Labour since their return to power in 1997 there is compassion; the idea that others should not be allowed to feel lonely and helpless. There is an idea of the refreshing of the self here, that the emotional (and therefore the non-rational) can be admitted through the project of self-reflexivity, as can also, on a different level, ideas about issues such as quality of life and work/life balance. Trust and the idea of the individual being able to place trust in another, be it another individual, or some larger collective unit is an integral part of the virtues. From Giddens, one of the leading proponents of the "new politics", there are the virtues of respect, toleration and the pursuit of social justice. Respect and toleration encourage an interaction with and indeed a veneration of difference, not just an embrace of it followed by absorption and ultimately eradication. An idea of social justice in many ways underpins all of these virtues but becomes a virtue in itself through

[73] *Ibid*., at 126–7.

[74] For a brief overview of Bauman's work on this point, see Z Bauman, "Alone Again" in G Mulgan (ed.), *Life After Politics* (London, Fontana, 1997) 7.

[75] *Supra* n.2.

[76] MacIntyre, s*upra* n.64, at 256–8.

notions of the promotion of social inclusion and participation. Bauman, with his idea of an individual's choice to be moral or not, and his description of choice "as fate" makes it clear that pursuit of these virtues is not easy, thus the element of individual aspiration that Aristotle focused upon is still present.

PART 4: THE NATURE OF THE ARISTOTELIAN POLITY

Aristotle's Politics (hereinafter P) and Nicomachean Ethics (hereinafter NE), taken together, as it is thought Aristotle intended,[77] offer a model for construction and maintenance of a society beginning with the individual. Hence NE is an account of what the individual citizen has to be and to do in order to live a good and successful life. P concentrates on what is, for Aristotle, the natural outcome of living a good life. This is participation in the polis. The inter-relationship that Aristotle constructs between the individual and the larger community is best explained by looking at the opening passages of P. These build on the position taken in NE that for every individual, eudaimonia is the ultimate goal and highest good and that it is achieved through practice of the virtues. Every association is formed for some good and the polis aims at the highest good. Through participation within the polis individuals can practice the virtues that bring about eudaimonia. Aristotle regards the polis as a natural phenomenon;[78] it exists to promote the happiness of all as identified by individuals through pursuit of the virtues.[79] Thus it is not possible to posit a virtue ethics framework for corporate activity without explaining how the actor that is the corporation fits into the larger community.

Whether participation in the polis in terms of political participation is the only form of participation that Aristotle envisages to satisfy this idea of eudaimonia is a matter of some debate. If the polis is viewed purely as a political entity then obviously participation and so fulfillment of eudaimonia can only be through political participation. There is considerable support for this interpretation.[80] However a far more constructive interpretation, which would allow the individual to reach eudaimonia even in conditions where political participation

[77] S Cashdollar, "Aristotle's Politics of Morals" (1973) 11 *Journal of History of Philosophy* 145.

[78] *P* 1252a1–7.

[79] *P* 1253a18. This is the passage in which Aristotle refers to the *polis* as prior to the individual by using a bodily analogy with the *polis* as body and the citizen as hand or foot. As Taylor points out, there is a danger that this passage could be construed as advocating that the good of the individual is always subject to the superior good of the state. However Aristotle's meaning is quite the opposite; political participation is required to promote the well-being of citizens and the good of the *polis* is an aggregate of the good of individual citizens: see C Taylor, "Politics" in J Barnes (ed.), *Cambridge Companion to Aristotle* (Cambridge, Cambridge University Press, 1995) 233 at 239–40.

[80] See, eg, T Irwin, "The Good of Political Activity" in G Patzig (ed.), *XI Symposium Aristotelicum: Studien zur Politik des Aristoteles* (Gottingen, 1989) 73; and D Keyt, "Three Basic Theorums in Aristotle's *Politics*" in D Keyt and F Miller (eds), *A Companion to Aristotle's Politics* (Oxford and Cambridge, Mass., Blackwell, 1991) 118.

is impossible, is to view the polis as a social as well as a political community.[81] The idea of a political forum and a social phenomenon combined sits well with the idea that NE and P are intended to offer a holistic view of the human condition. Eudaimonia is usually translated as "happiness" or "flourishing"[82] which indicates a condition, for the majority of us, of a purely transitory nature. As Duvall and Dotson point out this is difficult to square with the assertion in NE that eudaimonia is an activity of the soul.[83] Their suggestion is that a better conception of eudaimonia is as an activity whereby individuals "[get] their act together" to be "completely moral and intellectual beings".[84]

The position of the corporation within an aristotelian structure

Where, within the structure that Aristotle gives to society, should the corporation be situated? There are several possibilities from the corporation as a polis or as a smaller community like the village or household, to the corporation as an individual. A vital pre-cursor to labelling the corporation as an individual is the location of the corporation's soul. For Aristotle a condition precedent for all living beings was the possession of a soul. Without a soul a corporation cannot engage in eudaimonia. If the corporation has a soul then the next question might logically be whether other bodies, often unincorporated, such as Charities or Trade Unions have a soul. As my argument in relation to this point develops below it will, I think, become clear that the case for these bodies possessing a soul has to be considered on an individual basis against a general template of inquiry.

The stance of some business ethicists is to ignore the Aristotelian distinction between the polis as a political and social community and the individual and therefore offer no firm positioning of the corporation while still purporting to rely upon Aristotelian philosophy.[85] This approach has a certain superficial

[81] R Mulgan, "Aristotle and the Value of Political Participation" (1990) 18 *Political Theory* 195. Mulgan posits the view that Aristotle means "political" in the sense that "tribal" or "post-industrial" is likely to be used, ie as an all encompassing term which includes every area of life. He dislikes the use of a "public/private" divide (*koinon/idion*) in translation as it attracts a Western liberal idea of privacy that Aristotle did not have. The whole point of Aristotle's analysis was to facilitate and encourage interaction with the community. See also J Ober, *The Athenian Revolution* (Princeton, Princeton University Press, 1996), 166. Ober's view is that the passages from *P* 1274b32 to *P*1283b40 show that Aristotle saw *polis* also as a geographical term that would necessarily include those living within it including non-citizens. The co-habitation of citizens and non-citizens is taken by Ober to be crucial to the nature of the *polis* as a community. On this basis *polis* has to be seen as a concept wider than the merely political.

[82] R Kraut, "Two Conceptions of Happiness" (1979) 88 *Philosophical Review* 167.

[83] *NE* 1098a17.

[84] T Duvall and P Dotson, "Political Participation and *Eudaimonia* in Aristotle's *Politics*" (1998) XIX *History of Political Thought* 21 at 26.

[85] B Shaw, "Sources of Virtue: The Market and the Community" (1997) 7 *Business Ethics Quarterly* 33; R Duska, "Aristotle: A Pre-Modern Post-Modern? Implications for Business Ethics" (1993) 3 *Business Ethics Quarterly* 227; B Shaw and J McCraken, "Virtue Ethics and Contractarianism: Towards a Reconciliation" (1995) 5 *Business Ethics Quarterly* 297; and K Schudt,

attraction in the sense that it overcomes the problem of fitting into Aristotle's structure a form of association that has no parallel in fourth century BC Greece. However, I have several difficulties with using Aristotelian ethics in this way. It involves placing the emphasis, within the application of Aristotelian philosophy to the corporation, on the virtues themselves rather than on the conceptual structure of which the virtues are a part. This means not addressing issues such as the telelogical nature of the pursuit of the virtues and the question of motive. As I point out in my discussion of the virtues below, this is the most significant part of Aristotle's philosophy for corporate behaviour. There is also a tendency to present Aristotle's virtues as "hard and fast" rules and principles. This, of course, is contrary to the Aristotelian position.[86] Some, at least, of the virtues that Aristotle identifies have no more application to modern living and the corporation than the corporation has a place within Aristotle's original thinking. So it is not as though this position deflects criticism that Aristotle did not write with a corporate structure in mind. The most important point to be made about this approach is that it involves no attempt to inquire how even base line positions might be identified, never mind virtues, for application.

Notwithstanding my conclusions immediately above, if we take the application of the virtues to the next stage, that is to the corporation itself, then we have to confront the following problems. The application of the virtues themselves concentrates on creating a new blueprint for the performance of individual corporate executives[87] in relation principally to the internal governance of the corporation. By internal governance, here I mean the treatment of each other, existing and potential employees, in relation to issues that are concerned with the day to day running of the corporation, such as discrimination and equality issues. It may be the case that within this narrow agenda individual business executives have developed effective ethical policies. There are two difficulties with advocating the adoption of the virtues by individual business executives, rather than the corporation as a whole. One is that what is ignored or denied is the ability of the corporation to outlive these particular executives. The corporation has the potential to continue in existence long after the departure of particular individuals to another corporate world or just another world. The second is, in Bauman's terms,[88] the adiaphorization of individual business

"Taming the Corporate Monster: An Aristotelian Approach to Corporate Virtue" (2000) 10 *Business Ethics Quarterly* 711. Schudt also rejects the idea that corporations can have souls (*ibid*., at 712 and 721). His solution is to create corporate virtues as an adjunct to profit-making and ignore all other aspects of Aristotelian philosophy.

[86] I Maitland, "Virtues Markets: The Market as School of the Virtues" (1996) 6 *Business Ethics Quarterly* 1.

[87] B Shaw, "Virtues for a Postmodern World" (1995) *5 Business Ethics Quarterly* 863 at 874.

[88] Bauman's ideas such as moral neutrality and ethical distance began in Z Bauman, *Modernity and the Holocaust* (Cambridge, Polity Press, 1989). There he seeks to explain why the Holocaust occurred and why it was not prevented. He does this in terms of the suppression of human desire to be moral, the existence of ultra-efficient bureaucracies and the imposition of rules by those bureaucracies.

executives; their moral neutrality. This is caused by their distance from the consequences of their actions through the way in which the corporation is organised and the way in which they perceive their role in it. Even physical closeness, as sometimes occurs between executive and employee, is not sufficient to prevent this ethical distance from arising. The face of the employee (the other) becomes clouded by the totality of the organisation and its processes. Once this occurs then individual executives, freed from the moral demands of the other, are able to concentrate on purposive or procedural issues, technical events, as Bauman describes them. Structures of ethical behaviour have to be inculcated into the corporation as a holistic and potentially perpetual[89] structure if they are to have any significant impact.

This last point sets out a case for the corporation to be given a specific place within the Aristotelian structure, but it does not necessarily mean that the place that the corporation should occupy is that of polis. This is inappropriate from both the perspectives of the corporation and wider society. As I alluded to earlier, corporations are currently engaged in presenting themselves as "citizens". To give effect to this desire would mean incorporating them not as the receiver of the good works of other citizens but as individuals within the structure. It may well be that the corporate perspective of what it is to be a citizen or a participating individual is not the same as that envisaged in current social and political discourse. However the corporate desire to be included at this level is an opportunity for corporate education to take place and so one not to be missed.

From a more general viewpoint the corporation that was seen as a polis would not be in a reciprocal relationship with its component parts such as employees, customers and providers of services. In Aristotelian terms, the polis is constructed by what individuals put in and nothing is attached to what the polis puts out. The same points militate against the corporation being classed as a micro community in the way that Aristotle deals with villages and households. Aristotle holds out the idea of all associations being formed for some good purpose.[90] This has a certain resonance with the concession theory of

[89] See P French, "Responsibility and the Moral Role of Corporate Entities" in T Donaldson and RE Freeman (eds), *Business as a Humanity* (New York, Oxford University Press, 1994) 88 at 97. French is positively eulogistic about the role that corporations can play in sustaining "[t]he protection of civilization and the environment for future generations. It is certainly the case that corporations are in a position of infinite lifespan and this point has a rhetorical and symbolic importance about it because it plays into one of the advantages of the corporate form over other forms of business association that law as a discipline emphasises. However the reality of fluctuating markets and business fortunes dictates that corporations may have an existence considerably shorter than a human lifetime. See on this point for a snapshot view of the first business associations to incorporate, L Shannon, "The First Five Thousand Limited Companies and their Duration (1932) 3 *Economic History* 396; and G Robb, *White Collar Crime in Modern England* (Cambridge, Cambridge University Press, 1992), 24–30.

[90] This is the sentiment which forms the opening passage of Book 1of *P*, para 1252a1.

incorporation;[91] corporations owe their existence to a concession of the state in allowing their formation. In the nineteenth century and earlier this was a way of viewing the idea of incorporated associations. It also had considerable factual accuracy; in the UK as incorporation was allowed only by Royal Charter until 1844.[92] Adam Smith saw incorporated structures as being desirable only in circumstances where what was to be carried out by the corporation was a project with the greatest public utility requiring large-scale investment unlikely to be available from private venturers. Smith's examples of such industries were water supply, banking, insurance, and canal construction.[93] Since the availability of incorporated status as a mainly administrative process it is hard to assert that all corporations are formed for some good purpose. The Registrar of Companies would be unlikely to register a company which declared as its purpose the sale of an illegal drug or promotion of bare knuckle boxing, but this aside the legality of a corporate purpose does not necessarily make it good in an Aristotelian sense.

Corporations as individuals

It would appear then that the only place for corporations within the Aristotelian structure is at the level of the individual. It is only this designation that places the corporation in a position where its desire to be a citizen can be realised. It would place corporations in the position to address the expectations of it formed by both social and political discourses and where it can re-establish its legitimacy. To keep faith with the Aristotelian structure the corporation is required to have a soul and the capacity for rational thought. The issue of corporate "personhood" – whether it exists and what it means if it does exist – is one that the disciplines of both philosophy and law address. The 1844 legislation mentioned above conferred the status of "separate legal identity" on corporations that satisfied the administrative formalities for registration that it set out. The emphasis on legal here is mine to draw attention to the fact that what is conferred on corporations by this intervention is a fairly narrow part of individuality. The separate legal individual nature of the corporation is played out in

[91] See M Stokes, "Company Law and Legal Theory" in S Wheeler (ed.), *The Law of the Business Enterprise* (Oxford, Oxford University Press, 1994) 81 at 88 for an explanation of this. For differences in the constitutionality of the concession being made by the State between the US and the UK, see W Goedecke "Corporations and the Philosophy of Law" (1976) 10 *Journal of Value Inquiry* 81 at 84f.

[92] Companies Registration and Regulation Act 1844.

[93] Ekelund and Tollison, "Mercantilist Origins of the Corporation" (1980) *Bell Journal of Economics* 715. The picture painted there is that Smith was afraid of the self-interested behaviour that incorporators would indulge in. A simpler picture, which synchronises Smith's view on educational institutions and religious institutions with that on joint stock corporations, is offered by A Ortmann, "The Nature and Causes of Corporate Negligence, Sham Lectures, and Ecclesiastical Indolence: Adam Smith on Joint-Stock Companies, Teachers, and Preachers" (1999) 31 *History of Political Economy* 297.

arenas such as taxation policy and law where the corporation is taxed on its profits just as corporate executives are taxed on their wages and shareholders on their dividends.

Where the disciplines of law and philosophy come together is in the consideration of the issue of responsibility and the corporation. The debate on this point within the legal academy stems primarily from the legal definitional requirements of some criminal offences. Most criminal offences require in addition to an act which causes harm to another, a mental element – *mens rea*.[94] The criminal law is naturally individualistic in outlook[95] but its obsession with individualism encompasses only that of a human kind. This leads it to declare that in the case of a corporate perpetrator separate legal personality is not sufficient to allow *mens rea* to be fixed upon the corporation. The corporation for the purposes of *mens rea* becomes an aggregation[96] of its human components and there is then a search for a directing mind[97] – a human individual of sufficient seniority[98] to be the personification of the company. This is known as the identification theory. The perpetrator of a particular act or omission is not the object of the search. While individual figures within particular corporations may not be without some influence over collective corporate strategy, the idea of a directing mind militates against a finding of liability except in the smallest of companies.[99] For example, despite the finding of the Department of Transport inquiry into the sinking of the *Herald of Free Enterprise* that "from top to bottom the

[94] The literal meaning of this is "guilty mind". According to JC Smith and B Hogan, *Criminal Law* (London, Butterworths, 8th ed, 1996), 56 "all serious and most minor offences require proof of a fault element … The traditional term for the state of mind which must be proved [is] "*mens rea*" (original emphasis).

[95] C Clarkson, "Kicking Corporate Bodies and Damning Their Souls" (1996) 59 *Modern Law Review* 557 at 560

[96] The idea of the corporation as an aggregation of its parts, with parts conventionally taken to mean directors and shareholders only, forms another strand of the legal analysis of corporate existence along with the concession theory. For discussion of these positions in general terms, see D Millon, "Theories of the Corporation" (1990) *Duke Law Journal* 201: and M Hager, "Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory" (1989) *University of Pittsburgh Law Review* 575. It is not my intention to engage with the questions raised by this literature. My inquiry has a different starting point, namely can a corporation be considered an individual in a holistic sense, whereas the starting point from this perspective is what underscores the corporation's legal personality.

[97] Denning LJ in *HL Bolton (Engineering) Co Ltd* v *TJ Graham and Sons Ltd* [1957] 1 QB 159 at 172: "[a] company may … be likened to a human body. It has a brain and a nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre." This is interesting not only for its use of analogy but also because it clearly envisages those who bear the tools are not responsible for corporate acts.

[98] *Tesco* v *Nattrass* [1971] 2 WLR 1166 is an illustration of this point. The House of Lords decided by reference to a very simple model of company structure that the acts of a branch manager of a store could not be considered as acts of the company: see C Wells, *Corporations and Criminal Responsibility* (Oxford, Oxford University Press, 2nd ed, 2001), 100–1.

[99] See for example *Kite and Others, The Independent,* 9 December 1994, and the comments of J Gobert, "Corporate Criminality: four models of fault" (1994) 14 *Legal Studies* 393.

body corporate was infected with the disease of sloppiness" and that "[t]he failure on the part of the shore management to give proper and clear directions was a contributory cause of the disaster",[100] Turner J in a subsequent prosecution of the company for corporate manslaughter[101] was able to form the view that there was insufficient evidence of a directing mind for the charge to be put to the jury. Recent attempts to improve corporate responsibility have all centered around board level responsibility. The offence of corporate killing proposed by the Law Commission follows the structure of director responsibility by focussing on corporate conduct and whether it had fallen below what could have been expected.[102] This offence, as conceived by the Law Commission, has never found its way to the statute book[103] and it has now been overtaken by a Home Office paper.[104]

In short then, at the point where the recognition of corporate legal personhood should have the most impact on the existence of a corporate soul and the corporation's capacity for rational thought, law currently rejects these possibilities[105] in search of another individual – a senior figure within the corporation who possesses the directing mind. As will become clear, my own argument takes the opposite trajectory from conventional legal analysis on the point of intention and individuality. It is precisely because large corporations are large that I advocate their status as individual and responsible actors.

The most detailed discussion within philosophy of corporate responsibility is

[100] Department of Transport, *The Merchant Shipping Act 1894, mv Herald of Free Enterprise*, Report of Court No 8074 (London, HMSO, 1987), para 14.1.

[101] *P&O European Ferries (Dover) Ltd* (1991) 93 Cr App R 73.

[102] Legislating the Criminal Code: Involuntary Manslaughter, Law Commission Report No 237, 5 March 1996.

[103] Interest in opening up the possibility of convicting corporations of this offence rose following the Paddington Rail Disaster in October 1999, see *The Guardian*, 7 October 1999 for comments in support of this position attributed to Deputy Prime Minister John Prescott and Home Secretary Jack Straw. In *AG's Ref 2/99*, the Court of Appeal confirmed that the identification theory was still the correct way to approach the issue of corporate responsibility for manslaughter in the absence of legislative intervention. In November 2001 the company *Euromin* was acquitted of corporate manslaughter by the jury. Any suggestion that this was an offence that was impossible to prosecute with any realistic prospect of conviction was effectively ended by the Divisional Court's review of the original Crown Prosecution Service decision not to prosecute in this case, which described such a notion as irrational.

[104] *Reforming the Law on Involuntary Manslaughter: The Government's Proposals* (May 2000). The Home Office paper accepts the broad outline of liability suggested by the Law Commission.

[105] The interpretative possibilities that law could adopt and the struggle that it in fact embarks upon are set out in L Moran "Corporate Criminal Capacity: Nostalgia for Representation" (1992) 1 *Socio-Legal Studies* 371. There is a dearth of legally grounded scholarship which comments directly upon law's position on the corporate form. Wells, *supra* n.98 is one such attempt. Moran, in a later piece than that already cited above, offers the most original comment to date on judicial and juristic attitudes towards the corporate form: see L Moran, "Eloquence and Imagery: Corporate Criminal Capacity and Law's Anthropomorphic Imagination" in P Rush, S McVeigh and A Young (eds), *Criminal Legal Doctrine* (Aldershot, Dartmouth, 1997) 156.

provided in the work of Peter French.[106] As a result, the position taken by other commentators coalesces around agreement or not with French's position. The common strand between the parallel debates in law and philosophy is their methodology. Both look at the internal decision-making structure of the company. For legal analysis this inquiry results in the vast majority of cases of individual action not being attributable to the company. For philosophical analysis the question is framed rather differently and there is a wider range of answers. For French the internal decision making structure makes it not only possible to recognise the individuality of corporations as distinct from decision making individuals but also to assert that corporations are moral actors in their own right capable of intentionality. He illustrates his position thus:

> [a]lthough X voted to support the joining of the cartel because he was bribed to do so, X did not join the cartel, Gulf Oil Corporation joined the cartel. Consequently, we may say that X did something for which he should be held morally responsible, yet whether or not Gulf Oil Corporation should be held morally responsible for joining the cartel is a question that turns on issues that may be unrelated to X's having accepted a bribe.[107]

While this example would not command universal approval[108] for the idea of a corporation having sufficient metaphysical standing to be considered an individual, there is one point on which I think French makes an unassailable case. It is one he shares with Robert Solomon: that "business is a social practice".[109] By this both Solomon and French are drawing attention to the cultural embeddedness that corporations, particularly large ones, enjoy within current societal structures. For corporations to have an ethical existence they need to recognize this position and build upon it.

[106] P French, *Collective and Corporate Responsibility* (New York, Columbia University Press, 1984); P French, "The Corporation as a Moral Person" (1979) 16 *American Philosophical Quarterly* 207; P French, "Responsibility and the Moral Role of Corporate Entities" in T Donaldson and RE Freeman (eds), *Business as a Humanity* (New York, Oxford University Press, 1994) 88.

[107] P French, "The Corporation as a Moral Person", *supra* n.106, at 214.

[108] There are a range of criticisms to which the following references provide a fairly comprehensive overview: J Ladd, "Corporate Mythology and Individual Responsibility" (1984) 2 *International Journal of Applied Philosophy*; R Manning, "Corporate Responsibility and Corporate Personhood" (1984) 3 *Journal of Business Ethics* 77; and E Wolgast, *Ethics of an Artificial Person* (Stanford, Stanford University Press, 1992), 79–95.

[109] R Solomon, "Business and the Humanities: An Aristotelian Approach to Business Ethics" in T Donaldson and RE Freeman (eds), *Business as a Humanity* (New York, Oxford University Press, 1994) 64. Solomon is one of the most well known proponents of the appropriateness of Aristotelian philosophy for business ethics. Solomon in the context referred to here considers the corporation to be an individual. However, he also views the corporation itself as a *polis* like entity made up of individuals. This dual view is most clearly expressed in R Solomon, *Ethics and Excellence* (New York, Oxford University Press, 1992), 57.

PART 5: MACINTYRE AND BUSINESS ETHICS

The Aristotelian dependency on a universalistic polis structure for its validity decreases its potential for recognition as a "live" position in the context of the fragmented postmodern society in which we live. To this end, it is important to look at the adaptations and modifications that can be made to the Aristotelian structure, without losing its very essence, in order that it can become more acceptable to a pluralist society. What is required by both Alasdair MacIntyre, an undoubted conservative, at one end of the spectrum, and by proponents of postmodernism at the other end of radicalism, is a new settlement for individuals and the collective. The need for this settlement for both of them arises out of their discontents with modernity and the account of human existence presented by liberalism.[110] MacIntyre's work forms part of the canon of literature from which some Business and Society and Business Ethics scholars draw their inspiration in setting out new models of behaviour for business executives and new methods of business practice for corporations. He views current society as being in moral crisis. Disagreements and disputes within society cannot be resolved[111] as those on each side have different positions with no shared human good that can be drawn upon. The argument of each individual may be logical in the sense that it is based upon a premise and follows that premise, but what is no longer possible for the individual is to evaluate one premise against another and reach a decision. Instead, claims are repeated in the language and thought of emotivism, hence moral debates are irresolvable.

Illustrative of the difficulties that modernity finds itself in according to MacIntyre are the identities of its characters. Character is a central part of MacIntyre's thesis about the consequences of the rejection of Aristotelianism as the governing ethics of the life of the polity. The label "character" does not just denote a social role such as doctor or chef,[112] instead it indicates that particular moral beliefs and doctrines are both represented and practiced by that character. Characters are, in addition, the moral representatives of their culture, the masks worn by moral philosophers. The demands on a character are imposed by the way in which others view the character in comparison to themselves, they look to the character as a moral and cultural ideal. The characters that MacIntyre identifies as representative of the age or "of our own time" are the Rich Aesthete, the Manager and the Therapist.[113] All three operate in a

[110] "At the end of the road modern society has traversed in its pursuit of a Law-like, universally binding code of ethical rules, stands the modern individual bombarded by conflicting moral demands. Options and cravings, with responsibility for actions landing back on her shoulders … Individuals were to be spared the agony of uncertainty in a rationally organised – 'transparent' – society in which Reason and Reason alone rules supreme": Z Bauman *Postmodern Ethics* (Oxford, Blackwell, 1993), 31. See in particular, MacIntyre, *supra* n.69, at 290–4.

[111] *Supra* n.64, at 6–7.

[112] *Ibid*., at 27 and 28.

[113] The emphasis, through choice of the upper case, is MacIntyre's.

framework drawn by emotivism, which means that they treat people as a means rather than an end. People are no longer being rational and thus the possibility of moral debate is removed. Through this assertion MacIntyre reverses the Kantian imperative of treating people as an end and not a means.

MacIntyre's use of the manager as an emblematic figure in *After Virtue* and his later employment, when explaining his own approach to the discovery of virtues, of examples drawn from corporate/business culture has endeared him to some of those working within the field of business ethics,[114] despite the fact that this as a topic in itself is one on which he has written relatively little of a specific nature.[115] The adoption by business ethicists of virtue theory played through the lens provided by MacIntyre is usually presented as a counter point to theories of stakeholding. The objective for this type of business ethics is to find a new way for business activity to operate, often irrespective of the need to fit that operation within a larger theory of society. In other words, there is no engagement with the possibilities created by premising a society on an Aristotelian structure. The result is a manifesto for revised internal operation of a given business entity, either through exhorting individual business to change their way of managing or to advocate conducting business in a way which incorporates particular policies. Both of these suggested methodologies are parochial in the sense that they look almost exclusively towards the treatment of employees within the enterprise, not that this of itself is to be discounted. In relation to individual business executives this is because they can only achieve change within their own immediate working sphere of operation. In relation to calls for a particular business to change the way that it operates in a vacuum, this involves casting the enterprise as a polis.

Communities that form and reform

The idea of the corporate actor invoking its own individual action plans in recognition of its status as a polis is given merit by MacIntyre's own gloss on Aristotle's ideas; that each community forms and reforms its own virtues relative to its own historical context.[116] This, however, I feel is to take MacIntyre's point out of context. The idea that communities can reshape virtues to match their histories is a central one to the project of finding a position between the ideas of

[114] See J Dobson, "MacIntyre's Position on Business: A Response to Wicks" (1997) 7 *Business Ethics Quarterly* 125 and the references contained therein; and the observations contained in J Liedtka, "Constructing an Ethic for Business Practice" (1998) 37 *Business and Society* 254. See also C Horvath, "Excellence v. Effectiveness: MacIntyre's Critique of Business" (1995) 5 *Business Ethics Quarterly* 499 and the references contained therein.

[115] A MacIntyre, "Utilitarianism and Cost-Benefit Analysis" in K Sayre (ed), *Values in the Electric Power Industry* (1977) 217; A MacIntyre, "Power Industry Morality" in *Symposium* (Washington, Edison Electrical Institute, 1979) 94; and A MacIntyre, "Why are the Problems of Business Ethics Insoluble" in B Baumrin and B Freedman (eds), *Moral Responsibility and the Professions* (New York, Haven, 1982) 351.

[116] *Supra* n.64, at 146–56 and 256–8.

Aristotle and Bauman – the differences between a universalistic community and the barriers to forming community look less formidable if they are mediated by the idea of changing values. Within the idea that the corporation of itself is a polis the most conspicuous constituent group is the employees. Leaving aside for the moment that, in the main, this business ethics literature, erroneously in my view, treats employees as a homogeneous group with identical concerns and needs, the position of employees within a corporation is clearly a valid if not a valuable concern. However, employees are far from the only group with an interest. Using virtue ethics, with either the corporation viewed as a polis or with individual business managers and executives viewed as agents of cultural change, is fundamentally flawed for the reasons that I gave above. Namely, that individual business executives are not in a position to ensure that the corporation continues their ethical stance after the duration of their employment nor can they prevent their moral neutrality from clouding the face of the other. The whole point of placing the corporate entity within a virtue ethics structure and using an Aristotelian framework is to ensure that corporations understand the nature of social contributions and that these contributions are reciprocal.[117]

The third phase of MacIntyre's account of virtue ethics echoes in part the Aristotelian structure. At this stage the life of the individual meets the life of the community. The virtues carry forward the social fabric of society because an individual brings into the community an identity inherited from the past. As MacIntyre puts it, "[t]he possession of an historical identity and the possession of a social identity coincide".[118] The message from MacIntyre is that all living traditions are negotiable through debate and that the virtues are those qualities that sustain traditions as they provide practices and individual lives with their historical context.[119] At this point MacIntyre turns away from the idea of a universalistic community by asserting that no individual is bound by the limitations of the particularities of the society they find themselves in. The individual can, and indeed is exhorted to, move forwards.[120] What is required is that a community is sustained through pursuit of the good. The good is defined, it seems, by those parts of an individual's tradition that the individual is prepared to be at one with. Thus MacIntyre is not suggesting that tradition confers any fixed or firm social identity. Like Bauman he sees the eventual location of this as an individual's choice. Like Aristotle (and thus unlike Bauman) he sees identity as an attainable goal. Above the level of the individual MacIntyre suggests that consensus is impossible to achieve and so desirable instead is "the creation of local forms of community within which civility and the intellectual and moral life can be sustained through the new dark ages which are already upon us."[121]

[117] J Morse, "The Missing Link between Virtue Theory and Business Ethics" (1999) 16 *Journal of Applied Philosophy* 47.

[118] *Supra* n.64, at 221.

[119] This is paraphrased from *ibid*., 221–3.

[120] *Ibid*., at 221.

[121] *Ibid*., at 263.

CONCLUSION

My vision of a corporate ethical life then is one where the worst excesses of neoliberalism are tempered by a desire from the corporation to be a contributing member of the wider polity. Contributing here should mean a desire to connect with the goals of wider society in terms of the pursuit the good life, in addition to the more practical meaning of contributing in terms of sharing some of the benefits of corporate wealth accumulation. Corporations using the model of virtues ethics where motive is key should be able to make beneficial strategic intervention in society. Participation is, after all, key to notions of virtue ethics in an Aristotelian sense. The entire character of such interventions will be superior to those made under the guise of marketing ploys or through the playing out of notions of social responsibility. Of course, what this chapter offers is only a starting point. The step beyond is to sketch out what an operation of involvement under this ethical rubric would look like. There are possibilities, I believe, for corporate involvement in society through regional representative forums, audits of localized needs, and codes of commitment.

5

The European Union: Promoting a Framework for Corporate Social Responsibility?

JO HUNT

INTRODUCTION

In July 2001, the Commission of the European Union brought forward a Green Paper "Promoting a European Framework for Corporate Social Responsibility".[1] With the Green Paper, the Commission is seeking to launch a debate with public authorities, international organisations, enterprises, the social partners and NGOs on the possibility of the EU taking a lead role in developing "a model of corporate social responsibility (CSR) based on European values",[2] and applicable to enterprises operating throughout the Union. According to the Commission, CSR may be defined as the voluntary taking on by companies of commitments which go beyond common regulatory and conventional requirements, in an endeavour to "raise the standards of social development, environmental protection and respect of fundamental rights, and embrace an open governance, reconciling interests of various stakeholders in an overall approach of quality and sustainability".[3]

The EU's focus on CSR can be seen as responding to a number of broader issues currently on its agenda. The CSR initiative may be seen as potentially contributing to the realisation of both the Sustainable Development Strategy for Europe, agreed upon at the June 2001 Gothenburg European Council Summit meeting,[4] and the new ten-year strategic goal for the EU agreed at the Lisbon Summit in 2000, and which now acts as a framework for policy development generally. The goal is for the EU to become "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion".[5] Finally, with CSR's emphasis on voluntary self-regulation by enterprises, increased accountability,

[1] Commission of the European Communities (CEC), COM(2001) 366 final.
[2] *Ibid.*, at para. 89.
[3] *Ibid.*, at para. 3.
[4] Gothenburg European Council, 15–16 June 2001, Presidency Conclusions SN 200/1/01 REV 1.
[5] Lisbon European Council, 23–24 March 2000, Presidency Conclusions SN 100/00.

and involvement of relevant stakeholders, there is a clear resonance with the Commission's work programme on reforming governance throughout the Union. The "new governance" agenda is one premised on the idea of a more inclusive, participatory form of democracy, and on more responsive, flexible forms of policy steering, including a "lighter touch" in relation to regulation.[6]

As this chapter argues, however, there are doubts surrounding the true added value which the EU's engagement with CSR may bring, particularly if the voluntary CSR route is presented to the business world as an alternative to EU level regulation. These doubts arise not least from the fact that the "stakeholder" notion of the firm,[7] upon which a strong model of CSR could be based has not found a strong foothold at EU level, despite its existence in the legal orders of certain of the Member States. The EU has to date offered a forum for the "accommodation" of the different models of corporate governance operated by the Member States,[8] enabling shareholder primacy models[9] to co-exist alongside more stakeholder-oriented conceptions of the firm. Supranational interventions such as the European Company Statute provide sufficient flexibility for both models (and their variants) to be represented. This (perhaps necessarily) ambivalent take on the stakeholder/shareholder model debate at EU level does however lead to the possibility that the EU's role in developing a CSR framework may be little more than a partial, pragmatic move which lacks a strong ethical underpinning.

This chapter will commence with an introduction to the concept of CSR, and an exploration of its connections with the stakeholder and shareholder paradigms of the firm. As will then be shown, the thrust of the EU's "new governance" agenda is suggestive of the development of a stakeholder model of the firm as a "European model of the enterprise". The prospects for the development of such a model will then be addressed, before an account of the EU's initiatives to date in the field of CSR is presented. Finally conclusions will be drawn as to the prospects for the development of a European Framework for CSR.

[6] See further CEC, "European Governance : A White Paper" COM(2001) 428.

[7] The "stakeholding" model of the firm is usually portrayed as one which allows for the recognition, and reconciliation of the interests of a range of actors (such as shareholders, workers, creditors and the local community) who have a stake in the operation of the firm, and that often provides mechanisms for the participation of such interests in the governance of the firm: i*nfra* n.28 et seq and accompanying text.

[8] JJ Du Plessis and J Dine, "The Fate of the Draft Fifth Directive on Company Law: Accommodation Instead of Harmonisation" [1997] *Journal of Business Law* 23.

[9] In contrast with stakeholding notions, the shareholder model prioritises the interests of shareholders in the operation of the company, &, in its strongest form, the notion that the company has an organizational existence separate from the relationship between owners and managers is conceptually rejected: i*nfra* n.11 et seq and accompanying text.

CORPORATE SOCIAL RESPONSIBILITY

Whilst Milton Friedman famously opined that "the social responsibility of business is to increase its profits",[10] the dominant Anglo-American view of the firm which dictates that its (or more properly, its directors') primary responsibility is one of profit-maximisation owed to its shareholders[11] is one which is demanding re-evaluation from some quarters.[12] The evolving concept of CSR is one that recognises that companies owe responsibilities to groups other than their shareholders, most obviously to employees, but also to customers, consumers, and communities. Clearly, the law may recognise and provide for a level of protection, and possibly participation, of such constituencies in relation to the company and its operations. Most obviously, one could cite regulation relating to basic worker protection, equality, and health and safety laws in relation to the workforce, rules on product safety requirements for the benefit of consumers, and environmental protection measures in respect of the wider community. As has become conventionally understood, however, CSR is the label applied to socially responsible corporate behaviour that goes over and above compliance with such minimum standards as are laid down in the form of legal regulation.

At heart, the CSR debate involves considerations of the place of the modern corporation within society. It appears in the literature to be synonymous with the concept of "corporate citizenship".[13] Invoking the language of rights and responsibilities, the concept of corporate citizenship is premised around the

[10] M Friedman, *New York Times*, 12 September 1962, at 126.

[11] See, eg, on the "shareholder primacy" model of corporate governance: J Weimer and J Pape, "A Taxonomy of Systems of Corporate Governance" (1999) 7 *Corporate Governance* 152; J Cook and S Deakin, "Stakeholding and Corporate Governance: Theory and Evidence on Economic Performance" ESRC Centre for Business Research, University of Cambridge, 1999 (paper prepared for the UK Department of Trade and Industry Review of Company Law www.dti.gov.uk/cld/review.htm); W Wedderburn "The Legal Development of Corporate Responsibility: For Whom Will Corporate Managers Be Trustees?" in K Hopt and G Teubner (eds), *Corporate Governance and Directors' Liabilities* (Berlin/New York, Walter de Gruyter, 1985).

[12] From within the academic community, see, eg, J Kay, "The Stakeholder Corporation" in G Kelly, D Kelly and A Gamble, *Stakeholder Capitalism* (Basingstoke, Macmillan, 1997) and M Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Washington, DC, Brookings Institution, 1996). The question of the proper scope of company law, that is, the determination of those in whose interests the company is designed to operate was addressed by the Company Law Steering Group as part of the three year programme of consultation conducted for UK Department of Trade and Industry. The Group presented its final report "Modern Company Law for a Competitive Economy" in July 2001 (available at http://www.dti.gov.uk). See further below for discussion of the recommendations.

[13] See, eg, C Marsden and J Andriof, "Towards an Understanding of Corporate Citizenship and How to Influence It" (1998) 2 *Citizenship Studies* 329; S Zadek, N Hojensgard and P Reynard, *Perspectives on the New Economy of Corporate Citizenship* (Copenhagen, The Copenhagen Centre, 2001). The use of the term in this context should be distinguished from its use in relation to the position of *employees as citizens* within the company: see further J Barbelet, *Citizenship: Rights, Struggle and Class Inequality* (Milton Keynes, Open University Press, 1988), 22–7.

idea that in return for the "right" and the benefit gained through the grant of a licence to operate and the status of limited liability, the company in turn owes responsibilities to those it comes into contact with. As was stated in a Report from the UK Institute of Directors in 1973, "a company should behave like a good citizen in business. The law does not (and cannot) contain or prescribe the whole duty of the citizen".[14] Thus, as the law alone does not prescribe all the components of "good citizenship practice" for natural persons, it may similarly be seen not to contain them in relation to legal persons.

Advocating the CSR approach to businesses operating with in the dominant Anglo-American paradigm according to which the company is first and foremost a vehicle for (shareholder) wealth maximisation, Carroll has suggested that businesses' economic responsibilities ("to produce goods and services that consumers need and want and to make an acceptable profit in the process") and legal responsibilities may be seen as the two foundational layers of a four-layered pyramid which "constitute total CSR".[15] In addition to fulfilling these responsibilities, the "moral manager" would also have regard to ethical responsibilities ("activities and practices that are expected or prohibited by societal members even though they are not codified in law", an obligation to do "what is right, just and fair, and to avoid or minimize harm to stakeholders").[16] At the tip of the pyramid are a company's philanthropic, or discretionary responsibilities, which are distinguishable from ethical responsibilities in that the former are "not expected in an ethical or moral sense",[17] and which could embrace, for example, charitable donations. Whilst distinguishing between different layers of responsibilities, Carroll suggests that employing a CSR perspective requires the firm to "focus on the total pyramid as a unified whole, and how the firm might engage in decisions, actions and programs that simultaneously fulfil all its component parts".[18]

Although not employing the same language, Parkinson provides a typology of CSR that for the most part parallels Carroll's model. Parkinson draws a distinction between so-called "relational responsibility" and the "social activism" species of CSR.[19] "Relational" CSR may be defined as actions designed to "promote the welfare of groups such as employees, customers, or neighbours who are affected by the conduct of the company's mainstream business activities".[20] Such "relational" CSR could equate to Carroll's "ethical" responsibilities, whilst the "social activism" species, which refers to action

[14] Institute of Directors, *Guidelines for Directors* (London, IoD, 1973).

[15] AB Carroll, "The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders" (1991) 34 *Business Horizons* 39.

[16] *Ibid*.

[17] *Ibid*.

[18] *Ibid*.

[19] JE Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford, Clarendon Press, 1994), 267.

[20] *Ibid*.

which is "putatively beneficial to society or particular interest groups, but which falls outside the scope of the company's ordinary commercial operations",[21] is more in the nature of a company's philanthropic responsibilities.

Whilst Brudney defines CSR as "incurring uncompensable costs for socially desirable but not legally mandated action",[22] Parkinson notes that both relational/ethical CSR and social activism/philanthropic CSR might involve the voluntary sacrifice of profits by companies: for example, by incurring additional costs in the course of business operation for purposes which benefit certain non-shareholder groups (relational), or through charitable donations (social activism), or may be in the form of profit neutral (or indeed positive) "social involvement" activity. This latter concept refers to corporate behaviour that "reflects an increased sensitivity to the impact of the company on third parties, or a corporate concern with social issues more generally, without any necessary implication that a divergence from the profit goal is involved".[23]

With the growing significance of the "reputation market place",[24] companies are finding that a positive engagement with broader constituencies is becoming an essential aspect of management strategy, as popular pressure mounts on business to demonstrate a value added responsiveness to, and a responsibility for the societal impacts of their operations. However, the case for CSR, whether profit-sacrificing or cost-neutral, is not universally endorsed. As Wilson has observed, "if every … manager were to take into account all the potentially far reaching consequences of their individual actions, the result would be bewilderment and confusion with action paralysed by unending iteration".[25] Not only would effective management decision making be rendered nigh on impossible if businesses were to be forced to balance multiple, complex and competing claims of the those affected by, and thereby having a stake in the company's operations, but concerns with, and costs incurred in respect of the wider societal impacts of company operation could prove suicidal in the market place. After all, the financial securities markets, at least in the Anglo-American tradition, are structured in favour of the achievement of short-term economic results.[26] "Socially responsible" actions by companies, understood as behaviour which detracts from the goal of making as much for shareholders as possible was described by Friedman as "a fundamentally subversive doctrine" capable of "thoroughly undermin[ing] the very foundations of our free society".[27]

[21] *Ibid*.

[22] V Brudney, "The Independent Director – Heavenly City or Potemkin Village?" (1982) 95 *Harvard Law Review* 597 at 605.

[23] Parkinson, *supra* n.19, at 261.

[24] Marsden and Andriof, *supra* n.13.

[25] T Wilson, "Sympathy and Self-Interest" in T Wilson and AS Skinner (eds), *The Market and the State: Essays In Honour of Adam Smith* (Oxford, Clarendon Press, 1976).

[26] Weimer and Pape, *supra* n.11.

[27] *Supra* n.10, at 133. See also in defence of Friedman's views, E Sternberg, *Just Business: Business Ethics in Action* (Oxford, OUP, 2nd ed, 2000), esp ch 2.

These are some of the most common arguments advanced in opposition to[28] the development of a "stakeholder" concept of the firm. In its strongest form, the stakeholder concept suggests a fundamental "redesigning [of the] underlying purpose of the firm. It is no longer to be a vehicle for maximising the welfare of shareholders but one for enhancing the welfare of all stakeholders".[29] Such a conception of the firm is commonly ascribed to the German system of corporate governance, under which the company is regarded as "social institution",[30] in relation to which investor returns are considered "alongside employee and customer welfare in almost equal measure".[31] This replacement of the shareholder primacy model for one in which no single group's interests have an *a priori* claim to priority is perhaps the defining quality of the stakeholder model, which at its most developed may also demand the direct, active participation in the operation of the company's affairs and decision-making structures of the company's stakeholding constituencies.[32] There is, of course, ongoing debate as to how widely the concept of stakeholder is to be defined. In some accounts it is limited to those most closely tied into the operation of the firm, such as employees, customers, suppliers and lenders,[33] whilst others advocate a wider conception, going as far as to embrace "any party which can affect or be affected by the activities of a business",[34] which would extend to include the local (and perhaps) wider community. Reflecting this wider view, Nader et al advocate the constitution of a board of directors on which each director has responsibility for a particular constituency: employee welfare, consumers, environment and community, shareholders, law-enforcement, marketing, finance, planning and research, and management,[35] and to which we would perhaps today add information technology.

Other suggestions include the development of structures and processes for the mandatory consultation of stakeholder groups,[36] which would be seen as

[28] See, for staunch attacks, Sternberg, *ibid;* &, for an alternative set of concerns from a Marxist perspective, P Ireland, "Corporate Governance, Stakeholding and the Company: Towards a Less Degenerate Capitalism?" (1996) 23 *Journal of Law and Society* 287.

[29] S Wheeler, "Works Councils: Towards Stakeholding?" (1997) 24 *Journal of Law and Society* 44 at 47, drawing on eg W Evan and RE Freeman, 'Stakeholder Theory of the Modern Corporation: Kantian Capitalism' in T Beauchamp and N Bowie (eds) *Ethical Theory and Business* (NJ, Prentice Hall, 1993).

[30] J Kay and A Silberston, "Corporate Governance" (1995) *National Institute Economic Review* 84 at 88.

[31] Cook and Deakin, *supra* n.11.

[32] An approach that is already to some extent reflected in the German system of co-determination. See further on this model, particularly from a CSR perspective, S Donnelly, A Gamble, G Jackson and J Parkinson, *The Public Interest and the Company in Britain and Germany: Report to the Anglo-German Foundation for the Study of Industrial Society* (London, Anglo-German Foundation, 2000).

[33] Cook and Deakin, *supra* n.11.

[34] Freeman, *supra* n.29, at 25.

[35] R Nader, M Green and J Seligman, *Taming the Giant Corporation* (New York, Norton, 1976).

[36] See the discussion in Parkinson, *supra* n.19, at 383–6. This, of course, may already be provided

qualitatively the next step on from a duty of disclosure. Whilst board level participation, or consultation rights may afford stakeholder constituencies the opportunity to become directly involved in managerial decision making processes, public disclosure of a company's activities in relation to the workforce and the community at large present an opportunity for influence to be exerted on the company from increasingly sophisticated, information rich consumers and NGOs, influence which may contribute to the development of an "other-regarding" approach to corporate behaviour.

Whilst there has been a remarkable rise in the incidence of company reporting on "sustainability" issues, on their social, and more often environmental records,[37] usually in relation to in-house codes of practice, the evaluation of such reports is "fraught with measurement problems, and the two central criticisms are that measures used are not inclusive or standardised enough".[38] There are active steps being taken to respond to these criticisms, however. A number of agencies are working with businesses to develop standardised codes, and implement more formalised reporting and monitoring structures. The UK based NGO SustainAbility[39] has been particularly influential in developing the concept of "Triple Bottom Line" reporting, which refers to reporting of a company's financial, environmental and social performance, with the recognition that financial performance alone should not be regarded as the "bottom line" in assessing a company's "success". In addition, the International Labor Organisation has produced standards, reporting mechanisms and routes to accreditation in relation to workplace conditions known as SA8000,[40] and similar work has been undertaken by the Institute of Social and Ethical Accountability with its IS1000 standard.[41]

Whilst the development of CSR may appear most pressing in relation to firms operating in less developed countries, where there may be an absence of basic legal protections for the workforce, it should not be seen as lacking significance for first world countries. Non-legally mandated initiatives such as the provision of flexible (from an employee perspective) working patterns; of crèche facilities; positively encouraging participation of disabled people in the workforce; the development of worker training schemes; and of partnerships with schools may all be cited as examples of socially responsible corporate behaviour. As the UK

for in law in relation to specific groups in the event of specific occurrences. Eg, in the UK (as a result of EC directives) there is the requirement to consult with workers representatives in the event of redundancies and transfers of undertakings.

[37] The Centre for Social and Environmental Accounting at the University of Glasgow hosts a well-resourced site relating to company reporting and accountability on "sustainability" issues: http://www.gla.ac.uk/departments/accounting/csear/.

[38] Cook and Deakin, *supra* n.11.

[39] http://www.SustainAbility.co.uk.

[40] See further A Marlin, "Social Accountability as Measured by the Treatment of Laborers" in Transcript of the Roundtable "Corporate Social Responsibility: Paradigm or Paradox" (1999) 84 *Cornell Law Review* 1282 at 1339–42, and the sources cited therein.

[41] http://www.accountability.org.uk.

Government's recent initiatives in relation to CSR[42] show, a professed commitment to the promotion of companies' social responsibility need not necessarily be premised upon a strong stakeholder conception of the firm. However, when CSR is pursued within a legal order that gives effect to a shareholder model, it will be refracted through the prism of the goal of shareholder wealth maximisation. Thus, in the UK, where the "stakeholding" or "pluralist" model[43] of the firm has been rejected by the Company Law Review Steering Group in favour of an "enlightened shareholder value" model,[44] CSR is being promoted first and foremost as a strategy which can generate commercial benefits for companies: "Through businesses' engagement in the community they can strengthen their competitive position – by creating stronger links with consumers and employees. By making the most of these less tangible resources, businesses can create an edge over competitors in the market place".[45]

From within a stakeholder perspective of the firm, however, the basis for CSR may be found not in a pragmatic prudence on the part of the company, but in a deontological belief that stakeholder groups are ends in themselves, and not means to an end.[46] According to Freeman, this in turn demands that stakeholder groups must "participate in determining the future direction of the firm in which they have a stake".[47] Arguably, a system that accommodates a stakeholder, rather than shareholder model, of the firm provides a more receptive framework for the pursuit of CSR, particularly in its "relational" form. From a normative perspective, it could therefore be advanced that it would be desirable for the EU to link its promotion of CSR with the endorsement of a stakeholder model of the firm. Certainly, the EU's "new governance" agenda is suggestive of the development of such a model.

[42] A Minister for Corporate Social Responsibility was appointed in March 2000. Key initiatives currently include companies taking a lead role in adult literacy and numeracy programmes for staff and the local community, and the establishment of "local partnerships for renewal", entered into between companies and deprived local communities, involving, eg, the sourcing of staff and supplies from within such communities, and involvement with local projects: see further http://www.societyandbusiness.gov.uk.

[43] Pluralism was seen as "neither desirable nor workable" given the difficulties surrounding the balancing of competing interests that it requires: see the consultation document *Completing the Structure*, point 3.5, available, along with the preceding *The Strategic Framework and Developing the Framework* at http://www.dti.gov.uk. As Dean comments, the Company Law Review Steering Committee's preference for the label "pluralist" rather than "stakeholding" model "marks a subtle shift of emphasis from the inclusivity and rights implied by "stakeholding" to the diversity and conflict emphasised by "pluralism": J Dean, *Directing Public Companies: Company Law and the Stakeholding Society* (London, Cavendish, 2001), 93.

[44] Retaining the maximisation of shareholder wealth as the bottom line, this model purports to allow due regard to the company's business, and wider external relationships. Whilst the rights of others may not be legally enforceable, a mandatory Operating and Financial Review (OFR) is proposed, designed to improve disclosure of a company's social and environmental track record.

[45] Statement from the current Minister with responsibility for CSR, *supra* n.42.

[46] K Gibson, "The Moral Basis of Stakeholder Theory" (2000) 26 *Journal of Business Ethics* 245 at 248.

[47] Evan and Freeman, *supra* n.29, at 76.

THE "NEW GOVERNANCE" AGENDA

For the past five years, the Commission's internal think tank, the Forward Studies Unit (FSU) has, in collaboration with a team of external experts, been involved in an investigative programme into the transformation of governance within contemporary society.[48] This has been undertaken with the objective of providing the Commission with insights into how it can better adapt its role to the changing context, and improve the nature and mode of governance it employs in the development and elaboration of policies, in terms of both their legitimacy and their efficiency. The FSU's work has fed into the Commission's White Paper on European Governance,[49] which puts forward a number of proposals for the reform of governance.

As the reports of the FSU highlight, the legitimacy and efficacy of traditional forms of norm production and application, which rely on a "top-down" definition of ends and means, are being challenged. Alternatives to governance under a conventional parliamentary model of representative liberal democracy are being sought – alternatives that are more responsive, more representative. Academic commentators are increasingly turning to approaches premised on participative democracy and civic republican ideals, incorporating participation rights for all those "stakeholders" affected by decisions, and by decision-making through deliberation and mutual learning (rather than the aggregation of opposing views) as a route to enhanced legitimacy of EU governance.[50] And such participation should be an on-going process, part of a reflexive process which ensures that lessons learnt can be fed back into the loop, enabling policies to keep pace with change. For the FSU, the ideal form of governance is perceived as incorporating a system of norm production and application based on ongoing collective learning between stakeholders, on a transcendence of policy segmentation, and on responsive and reflexive governance. An essential role of public actors would become one of facilitating, co-ordinating, and guaranteeing participation in the processes.[51] In turn, the regulatory tools produced under this system may be less in the nature of substantive "solutions" but

[48] See, eg, N Lebessis and J Peterson, "Evolutions in Governance: What Lessons for the Commission? A First Assessment", Working Papers of the FSU, 1997. The further work of the FSU is collected in O de Schutter, N Lebessis and J Paterson (eds), *Governance in the European Union* (Luxembourg; OOPEC, 2001).

[49] *Supra*. n.6.

[50] See, eg, J Scott, "Law, Legitimacy and Governance: Prospects for 'Partnership'" (1998) 36 *Journal of Common Market Studies* 175; J Cohen and C Sabel, "Directly-Deliberative Polyarchy" (1997) 3 *European Law Review* 313; D Curtin, "Civil Society and the EU: Opening Spaces for Deliberative Democracy" in *Collected Courses of the Academy of European Law*, Vol VI, Book 1 (1996).

[51] See N Lebessis and J Peterson, "Developing New Modes of Governance" in de Schutter et al, *supra* n.48 and O de Schutter, "Proceduralising European Law: Institutional Proposals" in de Schutter et al, *supra* n.48.

instead may themselves be frameworks within which solutions are reached through consultation and stakeholder participation at the level of implementation, and incorporating their own procedural requirements as regards this process.[52]

The Commission's White Paper reflects in large measure many of the proposals made by the FSU. Good governance, it is advanced, should be based upon the principles of openness, participation, accountability, effectiveness and coherence.[53] The White Paper argues that policy making should follow "a less top down approach", should include alternatives to legislative instruments, and should facilitate the involvement of civil society in the formulation and implementation of policies that affect them. The emphasis that is placed on full and effective participation in the processes of governance of a wide range of actors has obvious parallels with the development of a stakeholder notion of the firm in relation to corporate governance. Furthermore, in the light of Pateman's suggestion that a developed form of worker participation within the firm would act as an educative process for participation in other "higher" forms of participation,[54] developments towards a stakeholder concept of the firm could signal not simply the response to demands for new forms of governance by the EU, but a critical building block in their effective realisation.

A "EUROPEAN" STAKEHOLDER MODEL OF THE FIRM?

According to Lannoo, "corporate governance is an interesting example of the dialectic in the European integration process between integration and disintegration, between the need for more centralization in certain areas…and the insistence by Member States on respect for national traditions and cultures".[55] And of the different national corporate traditions and cultures in existence in the European Union,[56] it is those of the UK and Germany that are perhaps the most in conflict, and most staunchly defended by their advocates. As has been already indicated, the UK model is conventionally presented as one premised on the goal of shareholder wealth maximisation. It has also been described as operating an "outsider" system of corporate governance,[57] which is characterised by

[52] For a critique on the "proceduralization" of governance through the use of regulatory tools allowing "flexibility in implementation", see J Scott, "Flexibility, 'Proceduralization' and Environmental Governance in the EU" in G de Burca and J Scott (eds) *Constitutional Change in the EU: From Uniformity to Flexibility?* (Oxford, Hart Publishing, 2000).

[53] *Supra* n.6, at 10.

[54] C Pateman, *Participation and Democratic Theory* (Cambridge, Cambridge University Press, 1970), esp 42–3.

[55] K Lannoo, "A European Perspective on Corporate Governance" (1999) 37 *Journal of Common Market Studies* 269 at 270.

[56] For an overview of the different systems, see, eg, E Bergløf, "Reforming Corporate Governance in Europe" (1997) *Economic Policy* 93; and Lannoo, *supra* n.55.

[57] See further Cook and Deakin, *supra* n.11 & the sources cited therein.

a highly liquid capital market, diffuse shareholdings, and a ready market for share transactions and takeovers. Little role, if any is foreseen for the involvement of stakeholder groups in the strategic management of the firm. Germany's "insider" system meanwhile is characterised by a less volatile relationship between owners and the corporation, with shareholding often highly concentrated in the hands of banks or family groups. Joining the shareholding constituency "inside" the company are stakeholder groups, most significantly workers, who are involved in the governance of the firm through their place in the two-tier board system and through participation by way of works councils.

To the extent that the EU Single Market project demands a degree of harmonization, or approximation of the divergent corporate governance systems operating within its Member States,[58] it would appear that a choice between these contrasting models may need to be made. However, despite the Treaty mandate for the harmonisation of at least some aspects of the Member States' company law systems, such progress as there has been[59] has occurred within relatively uncontroversial areas. This is not to say that the measures adopted have been insignificant in their effects,[60] but they have not directly endorsed one model of the firm over another. Attempts to do just that, with the proposals for the Fifth Company Law Directive on the structure of public limited companies, and for the European Company Statute have unsurprisingly met with strong resistance. Both proposals date back some thirty years,[61] and in their original form proposed a company structure modelled on the German system. The Draft Fifth Directive as first proposed sought to introduce the German two-tier management and supervisory board structure to all public limited companies with over

[58] The rationale for EU intervention in the company law field is that the existence of diverse corporate governance systems across the Member States of the EU may act as a deterrent to cross border investment and company establishment. Positive integrative measures would involve legislative harmonisation that could stimulate free movement in these areas. The legal basis for the introduction of such harmonising measures can be found at Article 44(2)(g) EC Treaty (ex Article 54(3)(g)), which allows for the adoption of directives aimed at "co-ordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies and firms … with a view to making such safeguards equivalent throughout the Community". The Treaty's "catch-all" general legal bases (Articles 95 and 308) could also give rise to positive legislative intervention. In addition, in the absence of harmonising legislation, economic operators could potentially challenge, before the courts, national measures perceived to be obstacles to the exercise of their free movement rights, contained in Articles 43 and 48 EC Treaty. Schmitthoff, writing in 1973 argued that nothing less than the "virtual unification of national company laws" was demanded: C Schmitthoff (ed.), *The Harmonisation of European Company Law* (UKNCCL, London, 1973), 8.

[59] For a useful account of the EU's company law harmonisation programme, see C Villiers, *European Company Law – Towards Democracy?* (Aldershot, Ashgate Dartmouth, 1998), chs 2–4.

[60] As Cheffins notes, EU Directives lie behind much of the UK Companies legislation introduced over the last two decades: B Cheffins, *Company Law: Theory, Structure and Operation* (Oxford, OUP, 1997), 425.

[61] The Commission's proposal for the European Company Statute was originally presented in 1970: [1970] OJ C124/2; and the Draft Fifth Directive was presented in 1972: [1972] OJ C131/44.

five hundred employees, incorporating options for employee participation rights which reflected those operated in Germany and the Netherlands.[62] Continued opposition from the UK led to a number of amendments to the original proposal,[63] to the extent that in its most recent form,[64] the draft, which now applies to companies with over one thousand employees, allows for a either two-tier or unitary board structure, and a host of options relating to employee participation, ranging from co-determination to a consultative works council, to no participation where the employees have indicated their opposition to it.

Similar space for the "accommodation" of the different national traditions is also offered under the recently adopted Statute for a European Company (the Societas Europea (SE))[65]. As originally conceived,[66] the SE was to offer the possibility for truly transnational "European" companies, governed by the same supranational laws regardless of their place of incorporation. Again, the original proposal foresaw a two-tier board structure, with co-determination rights for workers. As finally adopted however, the Regulation allows Member States a choice in the type of board structure, and, whilst providing certain general principles on the SE's operation, leaves much detail to be supplemented by the Member States' own legal orders. As a result, "SE's will differ from one Member State to another. There will not be one European SE, but an SE with French, Spanish or German features",[67] with scope for further diversity within the same Member State. A separate Directive,[68] now provides the options for worker participation in the company's system of governance. As a first principle, where companies are considering setting up a SE, they must negotiate with workers' representatives in advance through a special negotiating body with a view to making arrangements for the systems of worker involvement that are to apply once the SE is established. As a minimum, employees have rights to information and consultation in regards to the company's operations. Participation rights are additional to these, and available models could range from direct participation at board level, down to Member States opting out of the participation rules altogether. It would appear, in principle at least, that the Directive provides the possibility for the circumvention of co-determination rights, though agreement of a two-thirds majority of the employees' representatives on the special negotiating body is required to mandate any reduction in existing participation rights.

Rather than advancing a German co-determination style model of the firm across the EU as it was initially designed to do, the European Company Statute in

[62] See further on the history of the Draft Fifth Directive Du Plessis and Dine, *supra* n.8.

[63] [1983] OJ C240/2.

[64] [1991] OJ C321/1.

[65] Council Regulation 2001/2157/EC of 8 Oct 2001, [2001] OJ L294/1.

[66] [1970] OJ C124/2.

[67] European Parliament, Report on the Draft Council regulation in the Statute for a European Company (SE), 26 June 2001, A5–0243/2001, Rapporteur H-P. Mayer, at 19.

[68] Council Directive 2001/86/EC of 8 Oct 2001, [2001] OJ L294/22.

its current form may well present a threat to the stakeholder based tradition. And challenges are coming in judicial form as well as legislative. As Deakin suggests, the recent European Court of Justice decision *Centros*,[69] which characterizes the *siège réel* doctrine[70] as an obstacle to freedom of establishment, is "unavoidably, a challenge to the stakeholder model of the firm",[71] as the doctrine "forms part of the organizational orientation to the legal conceptualisation of the business enterprise"[72] that is inherent in the stakeholder model, and that is absent in the financial relationships orientation of the shareholder model.

However, in the face of apparent pressures on the sustainability of the stakeholder model of the firm[73] Cioffi points to the continued resilience and stability of the codetermination in Germany.[74] Furthermore, he argues that the network, stakeholder concept of the firm has been advanced across the EU with the introduction of the European Works Council Directive,[75] which "alters the structure of governance in the company" and "devolves power and legal authority within the corporation downward to employees and their representatives. This reallocation of authority effectively circumscribes the power of the management, the board of directors, and shareholders."[76]

[69] Case C–212/97 *Centros Ltd*. v *Erhvervs-og Selkabsstryrelsen* [1999] ECR I-1459.

[70] The doctrine provides that a company's registered office is determined by its place of central management or administration. In *Centros*, *supra* n.69, Danish citizens incorporated a private company in the UK in an attempt to circumvent the minimum capitalisation rules applying to company incorporations in Denmark. They then sought to establish a branch in Denmark from which to trade, though the Danish Registrar of Companies, applying the *siège réel* doctrine refused to register the company as a branch, considering it instead to be it principal business establishment. The application of the *siège réel* doctrine could in principle amount to a restriction on the freedom of establishment, and one that in this case at least was not objectively justifiable.

[71] S Deakin, "Regulatory Competition versus Harmonization in European Company Law" in DC Esty and D Geradin (eds) *Regulatory Competition and Economic Integration: Comparative Perspectives* (Oxford, OUP, 2001), 198.

[72] *Ibid*.

[73] A number of commentators have noted the increasing tendency towards market control of German (and other continental) firms, precipitated by the greater role played by institutional investors. The shift towards "shareholder capitalism" was seen most dramatically with the first cross-border hostile takeover bid in Germany, that of Mannesmann by Vodafone in 2000. Opinions are divided as to the long term prognosis for the stakeholder model under these conditions: Lannoo, *supra* n.55. Cf M Rhodes and B van Apeldoorn, "Capital Unbound? The Transformation of European Corporate Governance" (1998) 5 *Journal of European Public Policy* 406.

[74] JW Cioffi,, "Governing Globalization? The State, Law, and Structural Change in Corporate Governance" (2000) 27 *Journal of Law and Society* 572, 592–7. See also Rhodes and van Apeldoorn, *supra* n.73.

[75] Dir. 94/45/EC, as amended by Dir. 97/74/EC [1997] OJ L10/20. The successful adoption of the Directive owes much to the fact that it was introduced under the Social Policy Protocol and Agreement (the 'Social Chapter'), from which the UK had excluded itself. The Directive was re-adopted to cover the UK in 1997 following the 'opt-in' by the newly installed UK Labour Government. C Barnard, *EC Employment Law* (Oxford, OUP, 2000) provides coverage of the Directive and the background to its adoption.

[76] *Supra* n.74, at 597. However, according to Sally Wheeler, the prospects for active stakeholder participation under the EWC may be more illusory than real. Whilst the Directive "concentrates on

Whilst the European Works Council Directive may be seen as an attempt by the EU to promote a more stakeholder based model of the firm, prospects for the establishment of such a model as the "European" norm would appear slim to say the least, as evidenced by the denuding of the stakeholding-based philosophy which underpinned the proposed European Company Statute in its earlier incarnations. To stand any chance of adoption, EU level legislative interventions in the company law sphere must at the same time respond to, and resonate with, models of the firm which have quite different philosophical and ethical underpinnings, and ingrained histories. The most that could perhaps be expected is for the EU to provide a space for the accommodation of these different traditions.

EU INITIATIVES IN RELATION TO CORPORATE SOCIAL RESPONSIBILITY

Given the disparities that remain within the different approaches to company law and the perception of the place of the firm in society that may be seen to exist amongst the Member States, the Commission has clearly sought to present the case for CSR in a way which resonates with both the stakeholder and the shareholder models of the firm. The Green Paper is replete with the language of stakeholding: responsibility is owed to "all the stakeholders affected by business and which in turn can influence its success",[77] and this includes employees, shareholders, business partners, suppliers, consumers, and local communities.[78] It talks of the firm as being a forum for the reconciliation of the "interests of various stakeholders in an overall approach of quality and sustainability"[79] and of "the growing expectations that European citizens and stakeholders have of the evolving role of companies in the new and changing society":[80] all of which contribute to an image of the company as a social institution. At the same time, however, it seeks to appeal to the shareholder value constituencies, reminding us that "the prime responsibility of a company is generating profits, [though] companies can at the same time contribute to social and environmental objectives",[81] and the "business case" for CSR is given particular prominence in the Green Paper.

providing a macro framework for participation which at first glance sets up a forum which is likely to foster active participation … its inability to engage with any of the issues that occur below that initial macro threshold is likely to see employees framed out as active participators": Wheeler, *supra* n.29, at 59. Villiers sees the EWC as a "protectionist rather than a participatory measure," and one which goes no way to challenging "the existing balance of power in the company", *supra* n.59, at 188–93.

[77] COM(2001) 366 final at 4.

[78] A somewhat more inclusive definition of stakeholding constituencies is presented on the Commission's website – this lists the workforce, their families, the local community and society at large: Commission, "What is corporate Social Responsibility?" http://www.europa.eu.int/comm/employment_social/social-dial/csr/csr_index.htm.

[79] *Supra* n.77, at 3.

[80] *Ibid*., at 4.

[81] *Ibid*.

The Commission is clearly keen to ensure that as many businesses as possible are convinced of the case for CSR, however they choose to interpret it, as the EU would appear to be relying on business responsiveness as a key tool that can contribute to realising broader policy objectives. The Heads of State and Government at the Lisbon European Council made a direct appeal to businesses. Setting the new strategic goal for the Union, "to become the most competitive dynamic knowledge based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion",[82] the Council recognised that achieving the goal "will rely primarily on the private sector".[83] With this in mind, the Council made "a special appeal to companies' corporate sense of social responsibility regarding best practices on lifelong learning, work organisation, equal opportunities, social inclusion and sustainable development".[84] Subsequent European Council meetings have reiterated this call.[85]

And businesses may be prepared to respond to this call for reasons other than altruism, or a belief in the business case for CSR. The message coming from the EU institutions would appear to be that an engagement with CSR will offer companies the choice of "responsible self-regulation" as an alternative to traditional forms of regulation in the social and environmental spheres. According to Commission President Prodi, in his address to the 2000 European Business Summit, "We are … beginning to see a growth in numbers of "responsible" and "socially responsible" companies. The more durable and genuine this process is the fewer rules and regulations will have to be imposed by the State and the European Commission, and this is a trend we should all welcome".[86] In a similar vein, the Commissioner with responsibility for Employment and Social Affairs, Anna Diamantopoulou, stated that "globalisation and advances in communications technology are making it increasingly hard for legislators to address social problems with the necessary flexibility and lightness of touch. I suspect that, in many cases, corporate social responsibility and partnership will come to be seen as the preferred solution".[87]

The price to pay for a lighter regulatory touch is greater transparency and accountability in respect of businesses' dealings with their stakeholding communities. A key component of the EU's activities in the field of CSR to date[88] has

[82] Lisbon European Council, Presidency Conclusions, 23 and 24 March 2000, SN 100/00, at para. 5.

[83] *Ibid*., at para 41.

[84] *Ibid*., at para. 39.

[85] Conclusions of the Feira European Council Meeting, and Presidency Conclusions of the Stockholm European Council Meeting, 23–23 March, 2001.

[86] R Prodi, "Innovation and Responsibility: Business and the Citizen in a Changing World", Speech to the European Business Summit, Brussels, 11 June 2000. SPEECH/00/214.

[87] A Diamantopoulou, "Corporate Responsibility: Codes of Conduct", Speech to the EU Committee of the American Chamber of Commerce, Brussels, 30 October 2000. SPEECH/00/409.

[88] It should be noted that, over the five years or so, there has been a range of activities by both the European Parliament and the European Commission in relation to developing CSR in the context of fair trade with developing countries: see, eg, Commission DGV/D, "Codes of Conduct and Social

involved working directly with businesses to develop common standards for CSR, and its reporting.[89] The issue of social reporting had already been suggested in the Conclusions of the so-called Gyllenhammar Group,[90] in its 1998 "Managing Change" report.[91] Again, the importance of the role of the private sector is highlighted, specifically in relation to contributing to an environment in which industrial change can be positively anticipated and dealt with. Processes of benchmarking of corporate social performance were suggested, along with the proposal that large companies should report on their responses to envisaged structural change, "the company's policies and programme of training of employees to maintain their employability and adaptability to new demands, and also to outline what progress is being made towards equal opportunities",[92] and practices in relation to work organisation and rhythm of work".[93] Such public reporting is seen as "the best means of spreading good social practice in businesses".[94]

Viscount Etienne Davignon, who took a lead role in the work of the Gyllenhammar Group, is also Chair of CSR Europe, which has, with the support of the European Commission, recently drawn up a set of voluntary guidelines for CSR action and reporting.[95] The guidelines, signed on behalf of CSR Europe and the European Commission by Davignon and Diamantopoulou, look set to become the European industry standard for social reporting. As was made apparent at the May 2000 Commission-organised conference on Socially Responsible Investment (SRI), techniques and tools for social reporting lag far behind the those for financial reporting,[96] and indeed behind the third aspect of

Labels: Ethical Consumption and Production" *European Social Dialogue Newsletter*, Special Edition, May 1999, and the initiatives reported therein. The initiatives considered in this section refer specifically to those that are directed to fostering CSR in respect of their EU-based operations.

[89] In addition to its work on reporting CSR, the EU is seeking to promote CSR through awareness-raising programmes and other mechanisms. Funding under the European Social Fund is now available for "new approaches to CSR including awareness raising, extension to include small and medium sized enterprises and exchanges of best practice" (under ESF Regulation EC 1784/1999, Article 6 "Innovative Measures"): see Commission Communication on the Implementation of Innovative Measures under ESF Article 6, COM(2000) 894 final, 12.01.2001.

[90] The High Level Group on the Economic and Social Consequences of Industrial Change, established following the Luxembourg Jobs Summit 1997.

[91] "Managing Change: Final Report", November 1998.

[92] *Ibid*., at 5.

[93] *Ibid*., at 11.

[94] *Ibid*. It should be noted that the Group further suggest (*ibid*., at 13) that such reporting should be "considered as the criterion for the award of all government contracts and grant aid at European, national and regional levels" – which would perhaps prove a more effective stimulus than peer pressure alone.

[95] Guidelines signed at the European Business Convention on Building Corporate Social Responsibility, 9–10 November 2000, www.csreurope.org/Communication/voluntaryguidelines.pdf.

[96] The Commission has recently brought forward proposals (COM(2001) 80 final) for a regulation requiring all listed companies to report on financial performance using the International Accounting Standards. Internal Market Commissioner Bolkestein presented the proposals saying that they "signal the beginning of a new era of transparency and the end of the Tower of Babel in financial reporting in Europe", and will contribute to the integrated market for financial services in the EU.

the triple bottom line approach – environmental reporting.[97] Whilst a common approach to social reporting was seen as a prime concern at the SRI Conference, the conclusions reached[98] suggested that the better course of action at the present time was to devise a voluntary system, as with environmental reporting, rather than one set out in legislation, as with the proposed financial reporting regulation. The Commission has further invited all publicly listed companies with five hundred or more staff to adopt a triple bottom line reporting system as part of its programme of work on sustainable development.[99] Processes of benchmarking and resulting peer pressure that reporting will facilitate are considered to be significant drivers towards greater social responsibility. The EU's role in "promoting consensus on, and supporting best practice approaches to evaluation and verification of CSR practices" is one of the key issues that it hopes the Green Paper will stimulate discussion on amongst all affected stakeholders. The Commission envisages taking the responses to its Green Paper into account in the preparation of a more formal Communication on CSR, to be delivered in 2002.

CONCLUSIONS

The development of CSR, allied with the endorsement of a "European" model of the firm based on a stakeholder model would appear to resonate with the concerns of the EU's "new governance" agenda, with its emphasis on stakeholder participation, mutual learning, flexibility, responsiveness and responsibility. As has been seen, however, legislative activity by the EU has to date had only limited success in giving stakeholders an active voice in the processes of corporate governance. Enhanced reporting requirements, based on the "triple bottom line" approach, which would require greater transparency and accountability by businesses in respect of their interactions with their stakeholding communities may have the incremental effect of creating a Europe-wide shift towards a stakeholding orientation within the firm. Given that the social and environmental reporting facets of triple bottom line reporting are, as yet at least not legally binding on companies, even this "lower order" form of stakeholding may prove to be of limited impact in the face of the increasingly dominant shareholder value model of the firm. Whilst the limitations of legislation in ensuring effective dialogue have been noted, there could clearly be a role for the law to play in enforceable guarantees for participation by affected stakeholders

[97] In May 2001, the Commission introduced a (non-legally binding) Recommendation on the "Recognition, Measurement and Disclosure of Environmental Issues in Annual Accounts and Annual Reports", Recommendation 2001/453/EC.

[98] M. Donnelly, Speech to the closing session of the Conference on Socially Responsible Investment, Lisbon, May 2000.

[99] Commission Communication, "A Sustainable Europe for a Better World: A European Strategy for Sustainable Development" COM(2001)264 final, at 8.[93] *Ibid*., at 11.

in the processes of corporate governance. In the absence of assurances as to the democratic credentials within the firm, the Commission is playing a dangerous game in offering the business world the option of developing CSR as an alternative to being regulated. Without careful monitoring, support, and legal guarantees, CSR may become nothing more than a black hole into which issues of corporate accountability, legitimacy, and social responsibility may fall.

POSTSCRIPT

In July 2002, and following a year long consultation during which over 250 responses were received from business and employer organisations, trades unions, consumer and environmental organisations, the Commission delivered its Communication on CSR.[100] In it, the Commission proposes an 'EU Action Framework for CSR', placing a strategic focus on, inter alia, integrating CSR across EU policies, establishing an EU level 'multi-stakeholder forum' on CSR and facilitating the convergence and transparency of CSR practices and instruments. The strategy will be built upon respect for a number of key principles, including the principle that EU activity is to be compatible with existing international initiatives undertaken by bodies such as OECD and ILO, and that business engagement with the EU's CSR strategy is to be voluntary. In relation to the employment-related aspects of CSR (or 'internal' CSR), the Commission recognises that 'social dialogue is seen as a powerful instrument to address employment-related issues'. Indeed, as has been argued, a well-supported internal social dialogue is fundamental to the realisation of effective, meaningful CSR, especially if CSR is to occupy a space traditionally identified for social rights and regulation. In March 2002, a further EU instrument on worker involvement, the directive on worker information and consultation at national level, was adopted.[101] Given the political distance between Member States on the position of employees as stakeholders, it was inevitable that this Directive contained as much flexibility and ambiguity as the ECS directive. The extent to which the new directive may successfully 'strengthen dialogue and promote mutual trust'[102] within undertakings can only be questioned.

[100] COM(2002) 347 final.
[101] Directive 2002/14/EC, OJ L80/29.
[102] *Ibid*., Preamble, para 7.

6

The Relative Importance of the Statutory Derivative Action in Australia

STEPHEN BOTTOMLEY*

INTRODUCTION

In November 1999, the Australian Commonwealth Parliament introduced a statutory derivative action into the Corporations Law, simultaneously abolishing the right of a company member to bring a derivative action at common law.[1] This amendment was one part of a larger set of amendments which were introduced by the Corporate Law Economic Reform Bill 1999.[2] Described briefly, the statutory derivative action (hereafter referred to as the SDA)[3] allows a person to commence proceedings on behalf of a company against corporate insiders who have caused harm to the company in a situation where the company is unable or unwilling to bring the action itself. The standard case would be one where directors have breached their duties causing loss to the company, with the board declining to cause the company to bring an action to recover that loss. A disgruntled member will be able to use the SDA to pursue the company's interests, with any remedy that is awarded by the court going to the company. With

* Thanks to Peta Spender & Daniel Stewart for comments on parts of this paper.

[1] See Corporations Law Part 2F.1A (ss 236–242). The Corporations Law is nationally applicable legislation which governs all aspects of corporate activity, including incorporation, corporate governance, corporate finance, winding up, as well as securities and futures markets, and takeovers.

[2] Other amendments introduced by the Bill related to corporate fundraising, directors' duties accounting standards, and takeovers. These changes are not discussed in this chapter except as they relate to the derivative action. All of these amendments (including the statutory derivative action) commenced operation in March 2000.

[3] The legislation does not use the term "derivative action", referring instead to "proceedings on behalf of a company" which are brought "in the company's name". However, for the sake of brevity, and because the term "derivative" action is now widely used to describe this type of proceeding, that term is used in this chapter. For an objection to this usage, see B Welling, *Corporate Law in Canada: The Governing Principles* (Toronto, Butterworths, 2nd ed., 1991) at 534 and 544, preferring the term "representative actions". Similarly Professor Wedderburn's leading article describes this form of action as representative: K W Wedderburn, "Shareholders' Rights and the Rule in Foss *v.* Harbottle" [1957] *Cambridge Law Journal* 194 and [1958] *Cambridge Law Journal* 93, at [1957] *Cambridge Law Journal* 205.

this statutory amendment Australia joined countries such as Canada,[4] France,[5] Japan,[6] New Zealand,[7] South Africa,[8] and the United States,[9] all of which make legislative provision for derivative actions. In the United Kingdom the Law Commission has recommended that a statutory derivative action should be introduced into the UK Companies Act 1985.[10]

The enactment of the derivative action in Australia followed a decade of public discussion and law reform recommendations which are described later in this chapter.[11] Nevertheless, during the Parliamentary debates on the Bill, the Senate was told that "the response from one of the leading law firms of this country was that the statutory derivative action as defined in this bill was a joke, it was irrelevant, and it would be something which companies could ignore at will."[12] This contrast between continuing calls for the enactment of a derivative action and its dismissive reception in some quarters raises questions about the importance of this legislative change.

This chapter analyses the significance of the SDA with particular reference to Australia, and argues that the statutory provision of a derivative action is an important component of a modern system of corporate law and governance. It is important because it provides a mechanism for contestation which is an important part of a legitimate system of corporate decision-making, and because it emphasises the role of "voice" instead of "exit". These claims are elaborated later. However, the chapter also recognises that the SDA is only one in a range of mechanisms available to company members for responding to corporate problems (including the option of exiting from the company), and that the

[4] Canada Business Corporations Act 1975, s 239. Seven of the ten Canadian provinces (Alberta, Saskatchewan, Manitoba, New Brunswick, New Foundland, Nova Scotia, and Ontario) have enacted provisions which are modeled on this provision; British Columbia has enacted an SDA which differs from this model: see B Cheffins, "Reforming the Derivative Action: The Canadian Experience and British Prospects" [1997] *Company Financial and Insolvency Law Review* 227 at 234.

[5] The French derivative lawsuit is described by J Fanto, "France" in A Pinto and G Visentini (eds.), *The Legal Basis of Corporate Governance in Publicly Held Corporations – A Comparative Approach* (London, Kluwer, 1998), 1 at 43.

[6] Commercial Code of Japan, Articles 267–268.

[7] Companies Act 1993 (New Zealand) ss 165–168.

[8] Companies Act 1973 (South Africa) ss 266–268.

[9] In the United States provisions for derivative actions are found in individual States' corporations legislation, with variations between States. Rule 23.1 of the Federal Rules of Civil Procedure regulates derivative actions brought in federal courts; it is also a model for some State statutes: L Ribstein, *Business Associations*, (2nd ed., New York, Matthew Bender, 1990), at 578. The US debate has also been influenced by the American Law Institute's *Principles of Corporate Governance* (1994), Part VII of which contains standards and procedures for derivative actions.

[10] Law Commission, *Shareholder Remedies*, Report Law Com No 246, 1997. See also Department of Trade and Industry Company Law Review Steering Group, *Modern Company Law for a Developing Economy: Developing the Framework*, Consultation Document, March 2000, ch 4.

[11] See *infra*, text following n..

[12] Commonwealth of Australia, *Parliamentary Debates*, Senate, 13 October 1999, 9242, Senator Conroy.

role of the SDA should not be overstated. While it is necessary for good corporate governance, the SDA works best by not being used with great frequency. For this reason the claim about the importance of the SDA is qualified: in an effective system of corporate governance, the SDA is *relatively* important.

THE STRUCTURE OF THE SDA IN AUSTRALIA

In this section I outline the main features of the SDA in Australia as a prelude to the analysis which follows. The derivative action provisions in Part Pt 2F.1A of the Corporations Law deal with how a person obtains standing to bring such an action. That is, these sections are not concerned directly with the substantive issues which might be raised in a particular action, although, as will be seen, substantive issues are likely to influence the decision about standing. It is also worth noting that the legislation does not define or delimit the type of matter which can be the subject of a derivative action.[13]

A derivative action is defined in s 236 as an action in which a person either brings proceedings on behalf of and in the name of a company, or intervenes in any proceedings to which the company is a party for the purpose of taking responsibility for those proceedings on behalf of, and in the name of, the company. There are two broad categories of persons who can bring a derivative action: members and company officers. More precisely, to be included in the "member" category a person must be a current or former member, or be entitled to be registered as a member, of the company or of a related body corporate. The reference to related bodies corporate means that the statutory derivative action will be relevant to those corporate groups which are defined by holding/subsidiary company relationships.[14] To be included in the "company officer" category, a person must be a current or former officer of the company.[15]

The prerequisite to commencing a derivative action is obtaining leave from a court (s 236(1)(b)). The court must grant leave if five criteria – set out in s 237(2) – are satisfied. These are as follows:

1. It is probable that the company will not bring the proceedings itself or take responsibility for them. One way of determining this will be to look at how the board of directors has responded to the notice of intention to apply for leave

[13] This is similar to the situation in Canada and New Zealand. By contrast, the UK Law Commission has recommended a statutory derivative action that would be restricted to breaches of directors' duties or directors' negligence, *supra* n., at paras 6.24 – 6.49.

[14] A related body corporate is defined in terms of holding company – subsidiary company relationships (Corporations Law, s 46 then defines the concept of subsidiary company). Corporate groups are not limited to these types of relationship, and can be structured around cross-shareholdings, common directorships and other legal devices.

[15] An officer is defined to include a director, secretary, executive officer or employee of the company (Corporations Law, s 82A). Note that it is not sufficient to be an officer of a related body corporate.

which the applicant may have served on the company (discussed at point five, below). Presumably another factor to take into account in determining the probability of corporate action will be the extent to which any board decision regarding corporate inaction has been influenced by directors whose very actions are the subject of the potential derivative suit.

2. *The applicant is acting in good faith*. The purpose of this requirement is to rule out suits in which the applicant's real goal is pursuit of a personal, rather than a corporate, remedy. Thus the Court will be required to review the motives of the applicant, a review which is likely to involve some judgment about the merits of the action. To the extent that this also catches frivolous or vexatious suits, this overlaps with the "serious question" criterion, discussed at point four below. This inquiry will also be necessary in deciding the next criterion.

3. *It is in the company's best interests for the Court to grant leave*. This criterion lies at the heart of the derivative action because it is the company's interests, rather than those of the applicant or any group of directors or shareholders (no matter how large their voting stock), which are at stake. Welling's description of the equivalent Canadian provision is appropriate here: "what the complainant is really doing is presenting the court with 'a corporation in need of protection'".[16] It is not left to the company alone (through either the board of directors or the general meeting of shareholders) to decide what is in the company's best interests. While the views of these two groups are clearly relevant, the company's interests are a matter for judicial determination. There is one limitation to this. The legislation contains a rebuttable presumption that granting leave will not be in the company's best interests if the derivative action involves a suit between the company and a third party and the directors, acting according to the standards of the business judgment rule,[17] have decided not to bring, defend or continue with the proceedings (s 237(3)). Leaving that presumption aside, it seems that these sections permit an approach in which the company is regarded "as a continuing concern which must encompass the interests of past, present and future shareholders, creditors and (one would hope) employees".[18]

The "best interests" criterion has one further implication. Even if the company has suffered a wrong which could, in theory, be the subject of a derivative suit, it may nevertheless not be in the company's interests for action to be taken. For example, it may be that the benefit to the company of the potential remedy will be significantly outweighed by the financial or reputational costs of the action. It may be that the actions of the directors, whilst constituting a breach of duty, have not had a material effect on the company.

[16] Welling, *supra* n., at 535.

[17] That is, the directors made their decision in good faith for a proper purpose, without any material personal interest in the decision, were informed to the extent they reasonably believed to be appropriate, and rationally believed the decision to be in the best interests of the company (Corporations Law, s 237(3)(c)).

[18] MA Maloney, "Whither the Statutory Derivative Action?" [1986] 64 *Canadian Bar Review* 309 at 328.

4. *There is a serious question to be tried.* This criterion is intended to import the test which is used regularly by Australian courts in determining interim injunction applications.[19] In other words, the Court must determine that the applicant's claim is not frivolous or vexatious, that it has a real prospect of succeeding, and that the balance of convenience favours granting leave.[20] It is on this criterion that the court may be faced with the prospect of engaging in a "mini-trial" on the substantive issues of the case.

5. *Whether the applicant has notified the company of the application.* Although this is the last criterion in the list, as a matter of procedure it precedes the others. Before applying for leave, the applicant should give the company fourteen days written notice of the intention to apply, together with the reasons for the application. Obviously this notice will give the board of directors the opportunity to decide whether the company should commence the action in its own right, thereby avoiding the need for a derivative suit. Alternatively, receipt of the notice might lead to the settlement of the dispute out of court, thereby avoiding the need for any litigation at all. However, giving notice is not crucial to the leave application in all cases; the Court may grant leave in the absence of such notice provided that it is "appropriate" to do so (s 237(2)(e)), and provided that the previous four criteria have been satisfied. Some guidance about when it will be appropriate to forego the notice can be found in the Explanatory Memorandum to the Bill which introduced these provisions: "[t]he applicant does not need to meet the requirement of 14 days notice where it is not practical or expedient, thus allowing for an ex parte hearing where there is a need for urgent litigation."[21] The difficulty with this is that it leaves it to the applicant to predict whether a court will agree that practicality or expediency provide sufficient reasons for dispensing with notice in a given case.

Neither the right to apply for leave to commence a derivative action, nor the right to bring the action once leave has been granted, will be ruled out by the fact that a majority of shareholders in the company has voted to ratify or approve the conduct in question. The Court may take that ratification into account in deciding what order to make in the leave application or in the actual the proceedings, but it must be satisfied that the act of ratification or approval was well-informed and that the members were acting for proper purposes (s 239).[22] This reverses the common law position in which ratification by members had the effect of negating the possibility of derivative suit.[23]

[19] Explanatory Memorandum, para 6.46.

[20] *Nicholas John Holdings Pty Ltd* v *ANZ Banking Group Ltd* [1992] 2 VR 715 at 722–23, per Hedigan J.

[21] Explanatory Memorandum, para 6.50.

[22] Section 242 of the Canada Business Corporations Act contains a similar provision.

[23] In *Residues Treatment and Trading Co Ltd* v *Southern Resources Ltd* (1988) 6 ACLC 1160, King CJ doubted (without deciding the matter) that a majority vote could ratify a share allotment that was made for an improper purpose. At any rate, his Honour held that where there has not yet

The Corporations Law does not contain any detailed prescriptions about who bears the costs of either the leave application or the substantive derivative action. Instead it gives the Court the discretion "at any time [to] make any orders it considers appropriate" about the costs of the applicant, the company, or any other party to the application or proceedings, including an order for indemnification of costs (s 242).

How are we to assess this new law? Is it, as Whincop and Keyes suggest, further evidence that Australia is developing a "new corporate law", based on public law-like standards of fairness and propriety and in which public review and regulation are emphasised alongside private ordering of affairs?[24] Or should it be dismissed as an irrelevance or as "a joke"?[25] To answer these questions I begin by describing the context within which the new SDA was introduced. First I identify some contemporary trends and tensions in corporate law, and then I describe history behind this change.

CONTEMPORARY TRENDS IN AUSTRALIAN CORPORATE PRACTICE, LAW AND REGULATION

It is important to consider the wider context in which the SDA will operate. This section briefly lists four significant contemporary trends which affect corporate operations and corporate regulation in Australia.[26]

Size and diversity of the corporate sector

As at 30 June 1999 there were over 1.1 million companies registered in Australia.[27] Proprietary (or private) companies constituted just over ninety eight per cent of these registrations, with public companies accounting for the remainder. Listed companies do not form as significant a part of the economy in Australia as in other Western countries, with seven per cent of public companies being listed on a stock exchange.[28] While the company legal form dominates the

been any ratification by the general meeting, the mere potential for ratification cannot deprive a member of these personal rights. See *Link Agricultural Pty Ltd* v *Shanahan* (1998) 16 ACLC 1,462 at 1,468 for a similar argument.

[24] M Whincop and M Keyes, "Corporation, Contract, Community: An Analysis of Governance in the Privatisation of Public Enterprise and the Publicisation of Private Corporate Law" (1997) 25 *Federal Law Review* 51 at 92.

[25] Commonwealth of Australia, *Parliamentary Debates*, Senate, 13 October 1999, 9242.

[26] For a similar exercise regarding the UK, see D Sugarman, "Reconceptualising Company Law: Reflections on the Law Commission's Consultation Paper on Shareholder Remedies" (1997) 18 *The Company Lawyer* 226 at 227–236.

[27] These figures are taken from Corporate Law Economic Reform Program, *Simplified Lodgements and Compliance – Streamlining Paperwork under the Corporations Law*, Paper No 7, AGPS, 2000, 77.

[28] G Stapledon, "Share Ownership and Control in Listed Australian Companies" (1999) 2 *Corporate Governance International* 17.

private business sector, it also features prominently in the public sector (in the form of wholly government-owned companies, partially privatised government business enterprises, or as a result of contracting-out of government services).[29] The corporate form is now also used throughout the welfare, community service and non-profit sectors. In short, while the corporate form continues to be used largely as a business vehicle, it has long ceased to be solely that. Despite recent regulatory trends, discussed below, Australian corporate law should not be categorised solely as a species of business regulation.

Patterns of share ownership in public companies

In recent years there has been significant growth in the number of individual adult shareowners in Australia. According to an Australian Stock Exchange (ASX) survey conducted in 1999, Australia has the highest levels of direct and indirect share ownership in the world.[30] This has been driven by factors such as the compulsory superannuation requirement which has operated since 1987, and the privatisation by public share offer of large government owned businesses such as Telstra and the Commonwealth Bank.[31] In 1999 forty one per cent of Australian adults owned shares directly, compared with thirty nine per cent in the United Kingdom, thirty two per cent in the United States, and twenty six per cent in Canada. The same pattern applies to indirect share ownership, where the levels in 1999 were Australia: fifty four per cent; Canada: fifty two per cent; United States: forty eight per cent; and United Kingdom: forty per cent. According to the ASX, shares are now the third most popular form of personal investment in Australia, ranking behind superannuation and cash products (for example, bank deposits). However, although individual share ownership has increased, most shareholders are inactive traders owning limited share portfolios. In 1999 thirty six per cent of shareholders had not engaged in any share trading in the past twelve months (twenty nine per cent had traded only once in that period), and sixty two per cent of shareholders held shares in three or less companies.

Levels of institutional share ownership in Australia are high, but not as significant in Australia as those overseas. According to Stapledon's research, in 1997 domestic institutional investors owned thirty five per cent of the Australian share market. In the UK the comparable figure was fifty six per cent.[32] Stapledon's data also shows that in 1996 ninety seven per cent of companies in

[29] See, eg, N Seddon and S Bottomley, "Commonwealth Companies and the Constitution" (1998) 26 *Federal Law Review* 271.

[30] All figures in this paragraph are taken from Australian Stock Exchange, *2000 Share Ownership Survey*, February 2000.

[31] On superannuation, see Stapledon, *supra* n., at 21. Telstra, the Federal Government owned telecommunications company was partially privatised in 1997 with the public float of 33% of its shares. A further 16% was sold in 1999. The Commonwealth Bank was fully privatised in 1991.

[32] *Supra* n., at 18.

the ASX All Ordinaries Index had at least one substantial shareholder,[33] with an institution being the largest or only substantial shareholder in thirty four per cent of those companies; forty five per cent of those companies had a non-institutional shareholder which controlled twenty per cent or more of the equity. According to Stapledon, these large non-institutional shareholders were mainly founding families, entrepreneurs, overseas companies, and other listed Australian companies.[34]

Assumptions about business regulation

Since the mid-1990s law reformers, legislators and regulators have reaffirmed their faith in the capacity of competitive market forces to provide effective and efficient regulation of business, financial, and corporate activity.[35] The Corporate Law Economic Reform Program (CLERP) is a clear example of this. CLERP was created in 1997 when the Federal Government shifted the main responsibility for corporate law reform from the Attorney-General's Department to the Department of the Treasury, within which it is now the responsibility of the Minister for Financial Services and Regulation. The Government now regards corporate law exclusively as a form of economic regulation the objective of which is "to promote business and market activity leading to important economic outcomes".[36] Within this framework, the large proprietary company and the public company have become the standard model in corporate law discourse. Small proprietary companies are now exempted from many requirements in the corporations legislation, including those relating to the holding of annual general meetings and to the submission of annual financial reports.

Standards v. legal rules

Predating this faith in market forces, but continuing with it, has been a growing judicial and legislative reliance on the use of normative standards rather than detailed rules in corporate regulation. For example, corporations and corporate personnel are subject to broad standards of fairness,[37] good faith,[38] reasonableness,[39] equality of opportunity,[40] accountability, and the absence of prejudice or

[33] A substantial shareholder is one who has a "relevant interest" in at least 5% of the company's voting shares: Corporations Law, s 9.

[34] *Supra* n., at 25, 27–8.

[35] Eg, Independent Committee of Inquiry into Competition Policy in Australia (F Hilmer, Chairperson), *National Competition Policy* (Canberra, AGPS, 1993), and Financial System Inquiry (S Wallis, Chairperson), *Final Report* (Canberra, AGPS, 1997).

[36] Corporate Law Economic Reform Program, *Policy Framework*, 1.

[37] Eg, *Gambotto* v *WCP Ltd* (1995) 13 ACLC 342 (imposing a fairness requirement when a majority seeks to expropriate minority shares by way of amending a company's constitution).

[38] Eg, Corporations Law, s 181 (officers' duty of good faith).

[39] Eg, *Daniels* v *Anderson* (1995) 13 ACLC 614 (directors duty of reasonable care).

[40] Eg Corporations Law, s 602(c) (shareholders in a target company to have, as far as practicable, "a reasonable and equal opportunity" to participate in the benefits of a takeover offer).

discrimination.[41] As a result, Australian corporate law reform is affected by a tension between calls for business certainty and the need for regulatory flexibility.

This list of trends could be longer but it is enough to make the point that the reform of Australian corporate law is confronted by complex and sometimes contradictory factors to which simple regulatory models are unlikely to be an adequate response. Unfortunately the history of the SDA in Australia reveals this inadequacy.

THE SDA IN AUSTRALIA: A BRIEF HISTORY

The SDA replaces the limited and uncertain common law rules regarding derivative actions under the exceptions to the rule in *Foss v Harbottle*.[42] The rule in *Foss v Harbottle* prescribes that (i) the company is the proper plaintiff in any situation in which a wrong is alleged to be done to the company (the proper plaintiff principle), and (ii) the actions which constitute the alleged wrongdoing can be made binding on the company by a majority vote at a general meeting of shareholders (the internal management principle). Over the years limited and vaguely defined exceptions have been grafted onto this rule. The most relevant one here is that an individual member may sue on behalf of the company where the wrongful conduct constitutes a "fraud on the company" and the wrongdoers are in control of the company.[43] It is generally accepted that this exception has been substantively and procedurally difficult, leading the courts to initiate two responses. One has been to recognise a further equally vague exception, allowing a derivative action when it is required "in the interests of justice".[44] The second response has been to expand the scope of the so-called personal rights exception, thereby avoiding the derivative process and giving a remedy directly to the plaintiff member.[45]

There have been several proposals to clarify this situation by introducing a derivative action into the corporations legislation. The idea was put forward by the Companies and Securities Law Review Committee (CSLRC) in 1990 as part of its inquiry into the standards of conduct and performance of company directors and officers.[46] This recommendation was driven partly by a concern about

[41] Eg, Corporations Law, s 232 (members' remedy for oppressive or unfair conduct).

[42] (1843) 2 Hare 461; 67 ER 189. The classic discussion of the rule and its exceptions is found in Wedderburn, *supra* n..

[43] *Edwards* v. *Halliwell* [1950] 2 All ER 1064.

[44] *Biala Pty Ltd* v. *Mallina Holdings Ltd (No 2)* (1993) 11 ACLC 1,082; *Mesenberg* v. *Cord Industrial Recruiters Pty Ltd* (1996) 14 ACLC 519.

[45] *Residues Treatment and Trading Co Ltd* v. *Southern Resources Ltd* (1988) 6 ACLC 1160. An action to protect a personal right is not strictly an exception to the proper plaintiff rule, which is concerned with corporate rights. See P Hanrahan, "Distinguishing Corporate and Personal Claims in Australian Company Litigation" (1997) 15 *Companies and Securities Law Journal* 21.

[46] Companies and Securities Law Review Committee, *Enforcement of the Duties of Directors*

the unsatisfactory nature of the common law. But it was also prompted by the Committee's belief that a new regime of civil proceedings:

> …might serve a useful purpose in the general scheme of regulation of corporate activity in the interests of investors and creditors. Civil proceedings brought by members might provide enforcement in cases which the regulatory authorities are unable to prosecute because of competing demands on limited resources.[47]

The Committee used the derivative action provisions in the Ontario Business Corporations Act 1982 as the model for its recommendations.

These recommendations were considered by the Federal Parliament's House of Representatives Standing Committee on Legal and Constitutional Affairs (the Lavarch Committee) in its 1991 report on *Corporate Practices and the Rights of Shareholders*.[48] The Lavarch Committee also relied on the Ontario Business Corporations Act model, but narrowed the scope of the recommendations that had previously been made by the CLSRC (for example, by denying standing to creditors and other interested parties). In doing this the Committee was persuaded by concerns that an overly extensive SDA would be used by complainants "as part of a forensic strategy", that directors would be "so vulnerable to suit that able people won't take up positions as directors", that "complainants could pursue actions on … tendentious grounds", and that this would "exacerbate the congestion of the court lists".[49]

In 1993 the Companies and Securities Advisory Committee (CASAC)[50] endorsed the general purpose of the CSLRC's recommendations, but added further clarifications and restrictions.[51] Some of the restrictions were taken from the Lavarch Committee's report, while others were new recommendations. In the latter category, for example, CASAC recommended that standing should not be granted to *former* members or officers. In 1995 the Federal Attorney-General's Department released a paper which set out draft provisions for an SDA. This draft was based upon, but not entirely the same as, the 1993 CASAC recommendations. For example, former members and officers of a company were once more included within the list of persons who had standing to bring a derivative action.

and Officers of a Company by Means of a Statutory Derivative Action, Report No. 12, November 1990.

[47] Companies and Securities Law Review Committee, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action*, Discussion Paper No. 11, July 1990, para [2].

[48] Australian Commonwealth Parliament, House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (Canberra, AGPS, 1991). The Committee took its name from its chair, Michael Lavarch MP.

[49] *Ibid*., at 200.

[50] CASAC is the successor to the Companies and Securities Law Review Committee.

[51] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action*, July 1993.

In 1997 the proposal was resuscitated by CLERP,[52] apparently as a trade-off for shareholders in light of the proposed introduction of a statutory business judgment rule to protect directors. It was the CLERP recommendation that formed the basis of the November 1999 amendments. The policy and concerns which underpinned this recommendation are apparent in the following passage:

> Any enhancement of members' rights must be assessed against the need to encourage managerial risk-taking which is an essential element in the pursuit of profit. The conferral of rights on members should not work against their interests by causing management to avoid commercial risk-taking because of the risks of personal liability. The overall goal of conferring rights on investors is to provide an incentive for management to exercise its powers appropriately and discharge its functions for the ultimate advantage of the providers of the corporation's capital.[53]

The CLERP recommendations were thus built on a simple economic model of the corporation in which directors (and managers) are separate from, and act as agents for, shareholders in the pursuit of commercial risk, and in which there is therefore a need for the law to supply incentive-mechanisms so that directors will act in the shareholders' interests.

Significantly, according to the CLERP proposal the SDA was "not intended to be regulatory in nature but to facilitate private parties to enforce existing rights".[54] In other words, during a decade of law reform proposals the underlying rationale for the SDA underwent a subtle shift, from being regarded as a component in a broader public scheme of corporate regulation to being classified as a "self-help" remedy in a system of private enforcement of legal rights.

CONCEPTUAL CONFUSION IN THE AUSTRALIAN SDA

Read together, the final version of the SDA and the preceding reform proposals demonstrate considerable policy confusion about whether the SDA is solely a private enforcement mechanism or whether it also has a role in the public regulation of corporations. This reflects a deeper confusion about the conceptual basis of the modern corporation. This can be demonstrated by contrasting the requirements about standing, the rule about ratification, and the requirement for leave of the court.

Early proposals for an SDA recommended that the Australian Securities and

[52] The CLERP proposals were developed in consultation with the Government-appointed Business Regulation Advisory Group, comprised of representatives from peak bodies representing business, company directors, investment managers, accountants, lawyers, as well as the Australian Stock Exchange and the Sydney Futures Exchange.

[53] Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors*, Paper No. 3, (Canberra, AGPS, 1997) at 31.

[54] *Ibid*., at 35.

Investments Commission (ASIC) should be included amongst those who would have standing to seek leave to bring a derivative action. As the CSLRC argued in the original 1990 proposal, the SDA would "assist in the recognition of the Commission as a protector of the broader public interest in the orderly administration of the affairs of companies".[55] From this perspective companies are not regarded solely as private arrangements between private individuals, but also as key participants in the public economic and social arena. The derivative action would therefore have a dual role, serving an equitable function (eg allowing relief for harm arising from misuse of fiduciary position) *and* a public law function (eg improving the accountability of corporate decision making).[56] However, the final CLERP proposal specifically removed the Commission from the scope of the SDA.[57] As already noted, CLERP argued that the SDA is not intended to be regulatory in nature.[58] The refusal to give standing to the Commission is all the more significant in light of Ramsay's study of corporate litigation, comparing the enforcement of corporate rights by shareholders and by the Commission. Ramsay found evidence that the Commission undertook such litigation to a much higher degree than did shareholders, concluding that "the [Commission] is often in a superior position to shareholders to enforce corporate rights and duties".[59] The message from this aspect of the new SDA appears to be in favour of minimising the opportunities for external regulatory intervention in corporate life.

This contrasts with the ratification aspect of the SDA. As noted earlier, evidence that a majority of members has ratified the conduct in question will not preclude a court from granting leave. The message here is that the principle of majority rule does not always provide a complete justification for corporate actions. In this regard, CLERP seems to accept a more interventionist approach than the 1990 CSLRC proposal which argued that "uncontradicted evidence of a valid resolution of the company in general meeting ... should act as a bar to the granting of an application to take derivative proceedings".[60] Curiously the CLERP proposal had little to say on the ratification question, simply adopting

[55] *Supra* n., at para 63.

[56] See Sugarman, *supra* n., at 281.

[57] The Lavarch Committee's 1991 report also removed the Commission from the recommended list of applicants, but without explaining why: see *supra* n. at 202 (rec. 26) and 194–5. The Commission's standing was reintroduced in the 1993 CASAC proposal: *supra* n..

[58] CLERP relied on s 50 of the Australian Securities and Investments Commission Act 1989 which gives the Commission power to commence proceedings in another person's name. This discretion only arises as a result of an investigation or examination conducted by ASIC, and the power can only be exercised if "it appears to the Commission to be in the public interest". One view is that Australian courts have implied a "Foss *v*. Harbottle consideration" into the public interest prerequisite by inquiring into the company's ability to make a decision about the proceedings: Hanrahan, *supra* n., at 32.

[59] I Ramsay, "Enforcement of Corporate Rights and Duties by Shareholders and the Australian Securities Commission: Evidence and Analysis" (1995) 23 *Australian Business Law Review* 174 at 179.

[60] *Supra* n., at para 116.

the Federal Attorney-General's 1995 proposal which, in turn, can be traced to the 1993 CASAC recommendations. Those latter recommendations were based on the view that "in some circumstances judicial action is preferable to action by the shareholders".[61] An important consequence of this is not only to reinforce the role of judicial decision-making but also to thereby reinforce the importance of general standards and norms, rather than specific rules, in corporate governance. This is further reinforced in the proposed requirement that those voting in favour of the ratification must be acting for proper purposes.

The importance of judicial involvement is also underlined by the fact that it is the courts, rather than the board of directors, that provide the primary screening mechanism for derivative actions. As explained earlier, a derivative action cannot proceed without court leave. And although the legislation promotes the giving of notice to the company, the response of the board to that notice is only one factor to be taken into account by the court. In short, the SDA does not equate the actions of the board with the interests of the company. The corporate interest is a matter for judicial determination in each case. While it may be an overstatement to say that this gives the courts "unprecedented centrality in corporate governance",[62] it is significant in that it emphasises the public dimension of corporate existence. The message is that corporate activity (or inactivity) must be able to be justified publicly.[63]

Taking these points together – the denial of standing to the Commission, the non-determinative effect of ratification, and the screening role of the courts – it can be seen that the SDA seeks to underline the private status of the corporation while at the same time preserve space for broad standards and judicial intervention. The SDA thus occupies an uncertain and poorly defined role somewhere between the private and the public spheres of economic and political life. It is possible that the lack of a clear conceptual or policy base for the SDA was deliberate – the SDA may only have been intended as a symbolic exercise that would not serve any real practical purpose. However in the remainder of this chapter I will assume that the SDA was intended as a serious contribution to corporate governance laws in Australia. What is needed is more thorough explanation of its conceptual and policy basis, and the remainder of this chapter sets out to provide this.

THE IMPORTANCE OF LEGISLATING FOR A DERIVATIVE ACTION

In this section I map out a conceptual justification for a statutory derivative action. The justification draws on three interrelated ideas: the need for corporate decisions to be contestable, the importance of allowing for "corporate-

[61] *Supra* n., at 21.

[62] Whincop and Keyes, *supra* n., at 91.

[63] See further S Bottomley, "The Birds, the Beasts and the Bat: Developing a Constitutionalist Theory of Corporate Regulation" (1999) *Federal Law Review* 243.

regarding" behaviour by members, and the affirmation of "voice" alongside the "exit" as an appropriate response to corporate problems.

Contestability

From a corporate lawyer's point of view there are two decision-making sites in a company – the board of directors and the general meeting of company members. In nearly all Australian companies managerial decision-making power is vested by the company's internal rules in the directors (and through them, is exercised by the company's managerial staff). The decision-making power of the general meeting is much narrower and is constrained by statute. Shareholders are presumed to consent to this distribution of power. More often than not, this consent is implied from the act of voluntarily purchasing shares and thereby accepting the terms of the corporate constitution. Furthermore, corporate decisions, including the decision to grant decision-making power to the directors, are legitimised by the mechanism of majority rule.

These two ideas – consent and majority rule – exercise a powerful, though rarely acknowledged, hold on the minds of corporate lawyers.[64] Corporate lawyers do recognize, however, that these ideas can create and disguise problems such as lack of accountability and oppressive or self-serving behaviour by directors or majority shareholders. These problems can arise because consent need not be, and most often is not, actually given – as just noted, corporate lawyers are content to imply consent from the simple act of purchasing shares. The problem with majority rule is that it can easily slide into majority domination or self-interested rule, which may then undermine the quality of consent that is given on a particular issue.[65] The response to these potential problems is to impose standards and to require procedures which will ensure that the members' consent is informed and that majority power is exercised properly. For example, the Australian Corporations Law contains detailed disclosure and reporting requirements, and the courts have imposed proper purpose requirements on majority shareholders in certain instances.[66] Nevertheless, as important as these standards and processes are they are limited because they presume that consent and majority rule are sufficient legitimating mechanisms for corporate decision-making.

[64] Examples can be found throughout the Corporations Law, eg, general meeting approval mechanisms for reductions of share capital, share buy backs, and financial assistance transactions. See also J Hill, "Changes in the Role of the Shareholder" in R Grantham and C Rickett (eds.), *Corporate Personality in the 20th Century* (Oxford, Hart Publishing, 1998) at 200.

[65] The idea of majority rule is also transformed within corporations from a majority of voters to a majority of votes.

[66] Eg, Corporations Law, s 219 (information requirements for related party transactions), s 256C (information and notice requirements prior to reduction of share capital), s 257B (procedures for share buy-backs), ; *Gambotto* v. *WCP Ltd* (1995) 13 ACLC 342 (proper purpose and fairness requirements when corporate constitution is amended in order to expropriate minority shares).

If these ideas are suspect then we need a way of responding to the risks of arbitrariness and self-interest in a way which does not rely on them. Legislating for a derivative action offers a way of doing this. A statutory derivative action provides a mechanism for what Philip Pettit calls "contestability".[67] Adapting Pettit's idea to the corporate context,[68] contestability refers to the permanent possibility of members of a company effectively contesting managerial decisions which conflict with the company's interests. Contestability, as Pettit argues it, is a necessary constraint on the problems that can be created by over-reliance on majority rule and presumed consent.

The importance of contestability in a corporate context can be illustrated in the following way. Imagine a system of corporate law in which directors were free to make decisions without fear of challenge or liability. Imagine in particular that shareholders had no effective recourse to challenge the improper exercise of managerial power. Such a system would be likely to encourage self-interested decision-making, and that possibility would create mistrust and suspicion in the minds of shareholders. It would not matter whether the decisions being made were in fact proper or improper; the fact that they were beyond challenge would make them all suspect. The reply might be that the quality of the decisions could be judged by the results for the corporation and the shareholders – the market would supply the necessary corrective influence. One problem with this argument is that it means that shareholders could not have any ex ante confidence in directors' decisions – they would always have to wait for ex post results. If, instead, a corporate law system has clear mechanisms for contestability, such as a statutory derivative action, then there is scope for ex ante confidence. A corporate decision will be legitimated in the eyes of the members not because they are presumed to have consented to it, but because it is made against the background possibility of being contested by the members if it is not in the interests of the company. In its statutory form the derivative action provides a public assurance about the possibility of contestation. Note that this does not require that there must be an actual contestation in every case. As Pettit says, what is important is "the possibility of contestation".[69] I will return to this point later.[70]

There is a subtle but important difference between the contestability argument and the more commonly encountered argument that the SDA provides an incentive for directors to act in the best interests of the company.[71] The incentive argument takes a "top-down" view of the corporation. It is concerned with whether the directors feel sufficiently compelled to act in accordance with the members' interests. In contrast, the contestability argument is concerned with

[67] P Pettit, *Republicanism* (Oxford, Clarendon Press, 1997) at 61–63 and 183–185.

[68] Pettit's idea of contestability is developed by reference to decision-making in society at large. It therefore has different components and goes further than the SDA.

[69] Pettit, *supra* n., at 185.

[70] See *infra*, text following n..

[71] The CLERP proposal relied on the "incentive" argument – see *supra*, text accompanying n..

whether the members can feel that they are in some way part of the decision-making process. The contestability argument is therefore concerned with the legitimacy of corporate decision-making power from the members' perspective.

The newly introduced SDA seems to recognise the importance of contestability. This is evident in the fact that a ratification of a corporate decision by a majority vote will not foreclose the possibility of the court granting leave for a derivative suit (s 239).

Corporate-regarding behaviour

The managerial incentive argument has been adopted by many commentators on derivative suit legislation, especially those writing from a law and economics perspective.[72] Within this framework shareholders are regarded as investors who seek to maximise the returns on the capital that they have invested, who are keen to protect that investment, and who will therefore weigh the costs and benefits of legal suits according to a criterion of net personal return. The statutory derivative action does not rate very well against these criteria; it is judged to be a poor mechanism for providing managerial incentives. The argument goes that shareholder/investors will be discouraged by the fact that any benefits of a derivative action will flow to the company while the risks of the suit remain with the plaintiff shareholder. Furthermore, the amount recovered by the company will translate into relatively small benefits on a per share basis. Plaintiff shareholders will also be discouraged by the prospect of other inactive shareholders getting a free ride on the benefits (albeit small and indirect) that do flow through to shareholders.[73]

These would be damaging criticisms if this was an appropriate framework to use in assessing the SDA, but it is not. The derivative action, in either its common law or statutory forms, is not and never has been intended as a personal form of action designed to yield direct benefits to the individual shareholder/investor. By definition, the derivative action presumes that a shareholder is willing to act as a "corporate-interest plaintiff" in pursuit of a goal that will yield benefits for the corporate body as a whole.[74] In short, the SDA is a mechanism for "corporate-regarding" behaviour. It would, of course, be naïve to suppose that SDA applicants will be devoid of self-interested motives, and there

[72] For example, D Fischel and M Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis" (1986) 71 *Cornell Law Review* 261; R Romano, "The Shareholder Suit: Litigation Without Foundation?" (1991) 7 *Journal of Law, Economics and Organisation* 55.

[73] For a discussion of these and other perceived disincentives, see I Ramsay, "Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action" (1992) 15 *University of New South Wales Law Journal* 149.

[74] The benefits of a successful derivative action may also flow to other stakeholders in a company, such as secured and unsecured creditors and employees: Hanrahan, *supra* n., at 30. A derivative action may also directly satisfy a plaintiff's non-financial personal goals, such as a concern to see that rules are followed, or a concern for fairness.

will be degrees of corporate-regarding motivation. Actions such as the misappropriation of company property by directors, the foregoing of a corporate opportunity, or abandoning a corporate claim against a third party – any of which could be the subject of a derivative action – will involve some element of personal grievance and redress on the part of the plaintiff shareholder. The point is, however, that the derivative action is oriented primarily towards collective outcomes. In this sense the existence of free riders is not a problem in a derivative action because the action is deliberately intended to be for the benefit of the corporation.

The statutory derivative action therefore symbolises an aspect or dimension of corporate law and corporate life that has been drowned out by the volume of wealth maximisation/managerial incentive arguments. In 1960 Eugene Rostow summed up the precarious status of this dimension in the following way:

> [O]ne would expect those concerned for the integrity and future of private business institutions to applaud the intrepid souls who ferret out corporate wrongdoing, and risk their own time and money against a contingency of being rewarded, if in the end sin is found to have flourished. Not at all. Such men are not treated as honored members of the system of private enterprise, but as its scavengers and pariahs … At best they are viewed as necessary evils, the Robin Hoods of the business world, for whom a patronizing word may sometimes be said, when they succeed in revealing some particularly horrendous act.[75]

Similarly, consider Kirby P's dissenting judgment in the New South Wales Court of Appeal in *Parker v National Roads and Motorists Association*:

> [The plaintiff's] cause was at no time one for personal gain or for his own financial profit. It appears to have arisen from an anxiety about unequal treatment of company directors. It blossomed into a concern about the lawfulness of the conduct of his fellow directors and the companies in their charge. It came to full fruit in a determination to seek out the shield of the law when his fellow directors (as he saw it) attempted, by oppression, to suppress his complaints and to get rid of him. The judges should not deny that shield of the law. They should support corporate gadflies when their cause is the correction of apparently unlawful and self-interested action by directors, defended by oppressive conduct.[76]

The statutory derivative action symbolises the importance of corporate concerns, rather than purely personal goals. It ties in with that dimension of corporate law that stresses the constitutional ties within a corporation, rather than the nexus of contractual relationships between individual corporators.

[75] E Rostow, "To Whom and for What Ends is Corporate Management Responsible?" in E Mason (ed.), *The Corporation in Modern Society* (Cambridge Mass., Harvard University Press, 1960) 46 at 49.

[76] (1993) 11 ACLC 866 at 877–78. The case involved an action under the statutory remedy for oppressive conduct in which the plaintiff sought orders that he be allowed to conduct proceedings in the name of the respondent companies. See also *Wallersteiner* v. *Moir (No. 2)* [1975] QB 373 at 389 per Denning MR.

Voice rather than exit

The key to the managerial incentive argument is that the incentive for directors and managers to act properly is supplied by the potential for shareholders to exit the company by selling their shares, with consequent adverse signaling effects to the market and other relevant parties. Leaving aside the empirical question as to whether this incentive effect actually works, there is another question: why should corporate law be built upon the presumption that shareholders are looking for reasons to exit the company? Why should we assume that the image of the shareholder as a passive bystander is the only one (or the most appropriate one) on offer?[77] Why not allow for the possibility that sometimes shareholders might seek reasons to stay with a company and, possibly, voice their concerns in an effort to change the company's performance or behaviour? Furthermore, why not allow for the possibility that they might be prepared to use the legal system to do this? To put it another way, why should we construct our corporate law around the assumption that "exit" is the best option, rather than allowing for the possibility of "voice"?

The classic analysis of the "exit" and "voice" responses to poor organisational performance was written by Albert Hirschman.[78] Hirschman defines voice as:

> … any attempt at all to change, rather than to escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge, through appeal to a higher authority with the intention of forcing a change in management, or through various types of actions and protests, including those that are meant to mobilize public opinion.[79]

Hirschman notes that there is a strong alignment between exit and voice on the one hand, and economic and political behaviour on the other. Exit involves shareholders using the market to defend or improve their position:

> [Exit] is the sort of mechanism economics thrives on. It is neat – one either exits or one does not; it is impersonal – any face-to-face confrontation … with its imponderable and unpredictable elements is avoided and success and failure of the organization are communicated by a set of statistics; and it is indirect – any recovery on the part of the declining firm comes by courtesy of the Invisible Hand…[80]

In contrast, "[v]oice is political action par excellence".[81] It involves personal and direct action, and it requires the articulation of reasons or the defence of one's position. A concern for derivative actions serves as a reminder that

[77] See Hill, *supra* n., for a discussion of other images of shareholders which underpin corporate law.

[78] A O Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organisations and States* (Cambridge, Mass., Harvard University Press, 1970).

[79] *Ibid*., at 30.

[80] *Ibid*., at 15–16.

[81] *Ibid*., at 16.

modern corporations are not solely economic actors – they are also political structures.

It is important to keep this argument in perspective. The SDA is just one type of voice response and compared with other voice mechanisms, such as asking questions at a general meeting, it will be used much less frequently.[82] Moreover, voice responses, considered together, are just one type of response to perceptions of corporate problems. Exit responses will continue to dominate in large companies because they are faster, cheaper, and impersonal. This is particularly so in Australia given the high number of individual shareholders who own relatively small share portfolios.[83] The point here, however, is that this does not mean that corporate law should simply ignore or abandon other possible responses.

Conclusion

As noted before, the ideas of contestability, corporate-regarding behaviour, and voice are interrelated. In other words, the SDA should operate as a publicly assured mechanism for contestability in which a member may act in the corporate interest by voicing concerns about corporate behaviour. Consistent with the growing reliance on normative standards in other areas of corporate law,[84] the ideas of contestability, corporate-regarding behaviour, and voice ought to guide the courts in deciding applications for leave to commence an SDA. This is not to say that leave should be granted in every case. To understand this point it is necessary to develop the argument further.

CRITICISMS OF THE SDA

In this section I develop the conceptual justification in the previous section by examining four criticisms that have frequently been made of the SDA – that institutional shareholders are a better means of monitoring corporations; that the SDA increases the risk of wasteful strategic litigation by minority shareholders; that the SDA is not important because it is rarely used and is ineffective; and that sufficient shareholder protection mechanisms already exist in the Corporations Law.

Institutional shareholders as monitors

One criticism of SDAs is that they allow small or minority shareholders to disturb the economic rule that the shareholders with the largest stake in the

[82] Personal and representative actions are further examples of voice response, although they are often a prelude to exiting the corporation – see *infra*, text at n..

[83] *Supra*, text accompanying n..

[84] *Supra*, text accompanying n..

company should be the ones to determine corporate policy. As Fischel and Bradley explain it, "[b]ecause shareholders with the largest stakes will gain the most from good performance and bear most of the costs of bad performance, they have the best incentives to maximize the value of the firm."[85] It is therefore said to be more efficient if the task of monitoring and correcting corporate management is left to large or institutional shareholders.

There are at least three problems with this argument. First, in Australia the evidence of institutional shareholder activism is equivocal. Although there have been some well-publicised instances,[86] it is also true that institutional investors have often "functioned as passive, short-term and self-interested investors".[87] In part this passivity has been a product of legal rules which impede overt intervention in company management by large investors.[88] If large investors are either not willing or unable to act then, in the absence of an SDA, other shareholders will be left without an effective means of voicing corporate concerns. Secondly, when large or institutional investors do take steps "to maximize the value of the firm" their power is often exercised informally through private, direct communications with senior company officers.[89] If corporate monitoring was left to these shareholders then access to information about corporate governance issues would become the preserve of large corporate insiders, rather than a matter of general corporate knowledge. Consequently the ex ante confidence of other shareholders in the operation of the corporate decision-making system would be reduced accordingly. The third problem is that, as noted earlier, levels of large or institutional investment in Australia do not match those overseas.[90] Institutional investors do have a role in corporate governance, but it should not be a central role. Where action by large or institutional investors is possible the SDA should still operate as a necessary component of a larger scheme of formal and informal corporate governance mechanisms.

The institutional investor argument involves two further claims about minority or small shareholders: it is argued that they will either have "very little incentive to consider the effect of the action on other shareholders", preferring to engage in strategic or selfish litigation,[91] or that they will lack the incentive to bring actions at all. The first of these arguments is considered under the next heading, and the second is dealt with at point three, below.

[85] *Supra* n., at 271.

[86] See G Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford, Clarendon, 1996), at 189ff.

[87] Submission from Australian Shareholders' Association to the Parliamentary Joint Committee on Corporations and Securities, Inquiry into the Role and Activities of Institutional Investors in Australia, Canberra, 1994, quoted in Hill, *supra* n., at 203.

[88] See Stapledon, *supra* n., at 271ff discussing the impact of laws on insider trading and takeovers.

[89] *Ibid*., at 189; R Tomasic and S Bottomley *Directing the Top 500 – Corporate Governance and Accountability in Australian Companies* (Sydney, Allen and Unwin, 1993), at 161–2.

[90] *Supra*, text accompanying n. ff.

[91] Fischel and Bradley, *supra* n., at 271.

Strategic behaviour by minority shareholders

The concern here is that the introduction of a statutory derivative procedure will lead to an increase in frivolous, self-serving, or strategic law suits by minority shareholders which will distract company managers from their proper tasks.[92] While this risk cannot be discounted entirely it is easily overstated, at least in Australia.[93] As was noted earlier,[94] the court has full discretion regarding costs orders in relation to the initial leave application and the subsequent derivative action. This includes discretion about the timing of any such order. Thus a shareholder plaintiff faces the uncertainty and risk of having to bear at least some of the legal costs of the derivative litigation. In the United States some incentive towards shareholder suits is provided by cost rules[95] and the use of contingency fee arrangements whereby the plaintiff lawyer's fees are calculated as a percentage of the amount awarded by the court in a successful action.[96] Contingent fee arrangements of this sort are prohibited in all Australian jurisdictions.[97] Additional disincentives for a minority shareholder are presented by non-legal factors such as the opportunity costs of protracted litigation. In the end, the risk of strategic lawsuits can be adequately met by the effective use of judicial screening devices such as the good faith, best interests of the company, and serious question criteria found in the Australian SDA.

Derivative actions are under-used and ineffective

Ironically, assurances that the SDA will not result in a flood of strategic lawsuits raise a potentially more telling criticism.

The SDA is premised on the operation of rules which impose liability on company officers for breach of duty. In theory, liability rules work in two ways. First, they have direct effects when officers are sued for breach of duty. The SDA is one mechanism for the direct application of liability rules. Some critics are sceptical about the direct effect of liability rules because of evidence that shareholder litigation is a relatively rare occurrence. They warn that shareholders

[92] Eg, *ibid*., at 272; Romano, *supra* n., at 55–6.

[93] It is noticeable that most of the concerns about overuse and misuse of the derivative procedure have been raised in the US. One explanation for this is that "the US is more permissive towards derivative litigation" in the framing of its procedural rules: G Miller, "Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England" (1998) *Columbia Business Law Review* 51, at 52.

[94] *Supra*, text following n..

[95] See J Coffee, "The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation" (1985) 48 *Law and Contemporary Problems* 5, at 16.

[96] J Macey and G Miller, "The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations" (1991) 58 *University of Chicago Law Review* 1.

[97] G Dal Pont, *Lawyers' Professional Responsibility in Australia and New Zealand* (Sydney, Law Book Co, 1996), at 310–11. It is permissible for a lawyer to enter a speculative fee arrangement, whereby the lawyer acts on a "no win, no fee" basis.

will not use the derivative procedure because of uncertainties about costs, collective action problems, and problems with obtaining access to corporate information, amongst other difficulties. Evidence from overseas jurisdictions is used to support this critique. One assessment of the Canadian experience has concluded that "the statutory derivative action has, on balance, not made the impact on Canadian corporate law which might have been expected".[98] Even in the United States research has shown that shareholder litigation is "an infrequent experience", and similar results have been predicted for the SDA in Australia and the United Kingdom.[99] Secondly, liability rules are said to have an indirect effect when the prospect of, or potential for, lawsuits deters officers from misconduct. The availability of a derivative action in the statute book is said to reinforce this. Indeed, one commentator has argued that "[d]eterrence is the major reason for and principal effect of derivative suits".[100] But critics are also sceptical about the indirect effect of liability rules, and thus of the SDA. If liability rules have little direct effect because of under-use then, consequently, their deterrent effect is likely to be reduced. Romano's study of shareholder litigation in the United States bears this out. She found "little evidence of specific deterrence" and concluded that "it is virtually impossible to identify a general deterrent effect" from the prospect of litigation.[101]

In theory there are two potential causes of poor deterrent effects. One of these, noted previously, is that shareholder litigation, including the derivative action, is under-used. This is a problem for the SDA inasmuch as its role as a mechanism for contestability is thereby undermined. Contestation of corporate decisions must be a real option for members. If procedural rules are too restrictive or cumbersome and the prospect of enforcing liability rules via a derivative action is too remote, then there will be no assurance of contestation. The SDA will fail, on this view, if it does not make the exercise of corporate decision-making power answerable to the interests of members. Assuming that this proves to be the case in Australia, one response should be to amend the SDA to include the Australian Securities and Investments Commission in the list of persons who can seek leave to bring an action.[102] The Commission has a legislatively mandated role in maintaining, facilitating and improving the performance of corporations, and in promoting the confidence of investors.[103] Giving the Commission the capacity to seek leave on behalf of company members would

[98] Cheffins, *supra* n., at 256.

[99] For the US, see Romano, *supra* n., at 59. For Australia, see Ramsay, *supra* n., at 175. For the UK, see Cheffins, *supra* n., at 260.

[100] D Schwartz, "In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley" (1986) 71 *Cornell Law Review* 322, at 331.

[101] *Supra* n., at 84 and 85.

[102] As was noted earlier, the Commission was deliberately removed from the final version of the SDA which was approved by Parliament: see *supra*, text accompanying n..

[103] These words are derived from the Australian Securities and Investments Commission Act, s 1(2).

provide a partial response to the practical difficulties confronting some shareholders in obtaining access to the courts.[104]

Poor deterrence can also be caused by over-use of the litigation option. Although the evidence does not suggest that this is happening it is nevertheless worth considering because of what it tells us about the SDA. As was noted earlier, the derivative action is one example of the "voice" response to corporate problems. Overuse of the voice option can diminish its effectiveness. If the purpose of using the voice option is to restore or improve company behaviour and performance then, as Hirschman argues, it is important to avoid reaching the point where discontented members become so harassing that their protests hinder rather than help the efforts at recovery.[105]

The point is to find the appropriate balance between under-use and over-use of the SDA. Hirschman observes that in business corporations, shareholders use the "exit" option far more commonly because it is impersonal, cheaper, and faster.[106] Voicing one's concerns, on the other hand, is usually more expensive, requires time and planning, and involves some level of face-to-face interaction. The exercise of voice will be conditioned by the influence and bargaining power which shareholders estimate that they can bring to bear on the company, and by the members' willingness to trade the certainty of exit for the uncertainties of improvement due to voice.[107] As Hirschman observes, in large business corporations the availability of the exit option tends to drive out the voice option; voice is the subsidiary mode of reaction.[108] Provided that voice is a genuine option, I suggest that this balance between exit and voice is appropriate. In fact it is necessitated by the business environment in which most public companies operate, taking into account the necessary division of managerial functions, the need for directors to discharge the managerial oversight function which shareholders have given to them, and the need for managers to get on with the day-to-day job of management. This is not the same as saying that there is no room for the exercise of voice or that the importance of voice options should be played down. Indeed the task is to ensure that "the art of voice" (to use Hirschman's phrase)[109] is not lost or underestimated. As Fischel and Bradley concede, voice, in the form of the derivative action, has a "limited, albeit important" function.[110]

By imposing preconditions which limit the use of the SDA we underline the significance and magnitude of those occasions when such actions are commenced. Hirschman notes that there is a paradox at work here: the ease

[104] It would be a partial response because the Commission is unlikely to act in all cases, having regard to its limited resources and to competing regulatory priorities: see *supra* n., at para. 62.

[105] Hirschman, *supra* n., at 31.

[106] *Ibid*., at 33 and 76.

[107] *Ibid*., at 77.

[108] *Ibid*., at 76.

[109] *Ibid*., at 31.

[110] *Supra* n., at 287

with which the exit option can be used undermines the extent to which the voice option is used, but on the other hand the ready availability of exit can strengthen the effectiveness of the voice option when it is used.[111]

Availability of other shareholder protection mechanisms

Many modern corporate law statutes contain provisions which have the same potential effect as the SDA. The best example is the statutory remedy for oppressive or unfair conduct.[112] The Australian Corporations Law permits a court to make a variety of orders if it is proven that a company's affairs or a members' resolution is either contrary to the interests of the members as a whole, or oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members (s 232). Under s 233 the Court can make any order that it considers appropriate, including an order that the company be wound up, that the company's existing constitution be modified or repealed, or that a member's shares be purchased. This section also allows the court to order a derivative form of action, authorising a member to institute proceedings in the name of the company (s 233(1)(g)).

If, as many commentators contend, the oppression remedy is likely to continue to be the main form of shareholder action,[113] then the question is whether it is necessary to preserve a separate derivative action in the statute. The remedy for oppression or unfairness ("the oppression remedy") clearly satisfies the criterion of contestability, and it offers the opportunity for members to voice their concerns rather than simply exiting the company. It also promotes "corporate-regarding" behaviour insofar as it permits legal action on the grounds that corporate conduct is contrary to the interests of the members as a whole. So does the oppression remedy do the job of the SDA?

In practice it is often difficult to maintain a clear distinction between actions for oppression or unfair conduct and derivative actions. In Australian courts the primary method of distinguishing between derivative and personal actions is to examine the nature of the legal right or duty which is alleged to have been infringed.[114] Thus derivative suits are said to be concerned with breaches of officers' duties such as diversion of corporate opportunities away from the company, the improper use of corporate information, self-dealing, or negligent

[111] Hirschman, *supra* n., at 83.

[112] For example, s 459 UK Companies Act 1985, s 459; Canadian Business Corporations Act 1985, s 241.

[113] J Poole and P Roberts, "Shareholder Remedies – Corporate Wrongs and the Derivative Action" (1999) *Journal of Business Law* 99, at 117; Cheffins, *supra* n., at 260; Sugarman, *supra* n., at 243.

[114] Hanrahan, *supra* n., at 34. An alternative approach, common in the US, is to look at whether the direct effect of the wrongful conduct is on the company or the shareholder: see T Brandi, "The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action" (1993) 98 *Dickinson Law Rev*iew 355, at 359.

management,[115] while personal actions are concerned with issues such as the wrongful expropriation of shares, or the deprivation or manipulation of voting or other rights of members. Even though a member's statutory right to bring an action for oppression is personal and is not derived from the company, the substance of many of these actions has a strong derivative quality.[116] For example, the oppression remedy has been used in cases where corporate controllers have exercised their powers for an improper purpose,[117] awarded themselves excessive remuneration,[118] or have made uncommercial loans to a director's company.[119] In a survey of Australian cases Ramsay found that the most common ground of shareholder litigation was oppression (thirty five per cent of reported judgments).[120] In a separate study of oppression actions, Ramsay reported that twenty six per cent of these cases concerned breach of fiduciary duties, a further twenty per cent concerned misappropriation of corporate assets, and twelve per cent concern excessive remuneration.[121] In other words a significant number of oppression cases concerned the enforcement of corporate rights and duties.

The usual remedy which is sought and granted in oppression actions is an order requiring another shareholder or the company to purchase the plaintiff member's shares.[122] Although it serves the purpose of providing contestability and voice, in practice the oppression remedy "has largely become an exit remedy".[123] In Australia this is because the remedy is used primarily by minority shareholders in proprietary (that is, private) companies, where there is usually no market for the sale of shares.[124] In the jurisprudence of the oppression remedy, the use of voice is oriented towards exit rather than loyalty. In contrast, the use of voice in the SDA is tied to the plaintiff's wish to remain within the company and to improve the way in which it operates. The SDA thus operates as a "dedicated" voice – loyalty response.

The danger arising from the overlap between the oppression remedy and the SDA is that the effectiveness of the SDA in cases where the action is solely or largely derivative will be undermined by the easier availability of the oppression

[115] These are derivative wrongs because the duties are owed to the company or the members as a whole.

[116] CSLRC, *supra* n.4, at para [251]; Hanrahan, *supra* n., at 38

[117] Eg, *Re Bagot Well Pastoral Co Pty Ltd* (1992) 11 ACLC 1.

[118] Eg, *Roberts* v. *Walter Developments Pty Ltd* (1992) 10 ACLC 804.

[119] *Re George Raymond Pty Ltd* (2000) 18 ACLC 85. See further examples in E Boros, *Minority Shareholders' Remedies* (Oxford, Clarendon Press, 1995), at 231–2.

[120] Ramsay, *supra* n., at 175.

[121] I Ramsay, "An Empirical Study of the Use of the Oppression Remedy" (1999) 27 *Australian Business Law Review* 23, at 33.

[122] Ramsay's survey shows that in nearly 49% of cases the plaintiff sought an order for the sale of shares, and this was granted in nearly 31% of cases: *ibid*., at 35–6.

[123] Law Commission, *supra* n., at para 6.11, referring to UK Companies Act 1985, s 459.

[124] Ramsay, *supra* n., at 31 shows that nearly three quarters of plaintiffs are minority shareholders in proprietary companies.

remedy. The oppression remedy contains none of the SDA's procedural requirements. Even though "there is room for doubt whether the Australian statutory 'oppression' remedy covers cases which only involve a wrong to the company"[125] it would be preferable for the legislation to be drafted to ensure that solely derivative wrongs are channeled through the SDA.

CONCLUSION

This chapter is prompted by the inadequate justification that has been offered for the SDA in Australia. In response, the chapter offers an argument about the relative importance of the SDA. The SDA is *important* because it offers a legitimating device for corporate decisions via the mechanism of contestability, and because it offers an avenue for arguments about the corporate interest to be voiced by members. It is *relatively* important, first, because the SDA should not be regarded as the centrepiece of an effective corporate governance and accountability system. Indeed, as Rostow warned three decades ago:

> [t]he stockholders' suit is not a uniformly effective remedy for the misdeeds of directors – indeed, it is not often an effective remedy for such misdeeds at all. Sporadic in its incidence, costly in its procedures, it has been, from time to time, a vehicle for extortion as well as for purification.[126]

The SDA is relatively important, secondly, because while it is an important symbol of the corporate or collective dimension of corporate law, the mere enactment of an SDA will not breath new life into that dimension. Much depends, for example, on the format of the SDA. In this regard the Australian enactment could be improved as has been suggested in this chapter, particularly by the inclusion of the Commission in the rules on standing. Much also depends on how the courts respond to the new provision. If the judicial response is restrictive or too narrow, shareholders will be discouraged from using the SDA procedure. This chapter has argued that greater incentives will be provided if the SDA provisions are applied and interpreted by courts in a way that recognises the importance of allowing contestability, corporate-regarding behaviour, and the exercise of shareholder voice.

[125] R Simmonds "A Summing Up and a Search for Solutions" in M Gillooly (ed.), *The Law Relating to Corporate Groups* (Sydney, Federation Press, 1993) 239.

[126] *Supra* n., at 49.

7

Privatisation and the Challenge of Corporate Governance in Nigeria

ADEDEJI ADEKUNLE

INTRODUCTION

The rules and structure for directing the affairs of and participating in the fortunes of registered companies assumed global prominence in the last decade. A spate of corporate failures having international implications, fraud and increasing globalisation of stock markets, have heightened international concern over corporate governance and control. Also, in the last decade, privatisation of State Operated Enterprises (SOEs) was vigorously pursued by many countries trying to reform or re-orientate their economy. The high point of Nigeria's first attempt at large scale privatisation spanned 1989 to 1993, during which time the state divested (in many cases fully) share holdings in eighty eight out of one hundred and eleven enterprises slated for privatisation.

A renewed effort at privatising SOEs in Nigeria started in December 1999. Certain factors distinguish this fresh exercise from the 1989 privatisation. First, the profile of enterprises affected by the new exercise is dominated significantly by strategic undertakings in major sectors such as telecommunications, petroleum, power, steel, aviation as well as banking.[1] The first privatisation, on the other hand, involved the sale of government holdings in essentially commercial sectors like transportation, hotels, construction and manufacturing. Secondly, this time around, it is to be expected that the shortcomings observed during the first exercise would guide and influence the fresh privatisation process. Lastly, since some of the affected enterprises are in fact statutory corporations or extra-ministerial bodies, there will be a need post-privatisation, to re-model the governance structure in order to conform with the provisions of the Companies Legislation and also other laws and policies applicable to registered companies. This raises the problem post-privatisation of balancing the corporate goal of increasing the value of shareholdings with the public interest in the provision of sevices of strategic importance.

[1] Enterprises in these sectors are presently wholly owned by the state. 60% of state holdings will be privatised; of this, 40% is reserved for core strategic investors: see Public Enterprises (Privatisation and Commercialisation) Act 1999 (Privatisation Act), s 1(1) and First Schedule.

This chapter will examine the adequacy of the legal and institutional framework in Nigeria in relation to these issues. The advent of a globalised village means also that domestic standards affecting investments, corporate law and administration, will increasingly be subject to closer scrutiny by foreign investors who will inevitably push for harmonization in certain minimum standards. One such attempt at harmonization in the area of corporate governance is the recent statement of principles[2] adopted by the Organisation of Economic Cooperation and Development (OECD) in May 1999. In a bid to attract foreign investors Nigeria has effected major institutional and legal reforms in the capital market.[3] With the advent of a new democratic government in May 1999, an increasing stream of foreign investors have made determined moves to acquire shares and stocks in Nigerian enterprises. The new privatisation effort is expected to give fillip to these reforms. The ramifications of these developments on issues like corporate control, ownership, and management responsibilities will to a large extent depend on the state of legal institutions and the legal framework.

THE LEGAL FRAMEWORK IN NIGERIA: AN OVERVIEW

The primary legal framework in Nigeria is provided by the Public Enterprises (Privatisation and Commercialisation) Act 1999 (Privatisation Act). The legislation, which was decreed into existence in the twilight of the military regime that preceded the current civilian government, establishes the National Council on Privatisation (the Council), an inter-ministerial policy making body, and reconstitutes the Bureau for Public Enterprises[4] (the Bureau) which will now be supervised by the Council.[5]

The Council, in addition to supervising the Bureau, is saddled with the responsibility of:

(a) determining objectives, approving policies and setting guidelines for the privatisation of public enterprises;
(b) approving, upon the recommendation of the Bureau, the public enterprises to be privatised and their legal or regulatory framework;
(c) determining the time and mode of privatisation;
(d) approving the prices for shares or assets of the public enterprises offered for sale;

[2] Available at http://www.oecd.org/principles/htm.

[3] An example of legal reform in this regard is the Investment and Securities Act 1999, which introduced a comprehensive legal framework for securities transactions. Major institutional reforms such as the computerisation of the stock exchange and cross-border trading of securities have also been implemented.

[4] Formerly established under Bureau for Public Enterprises Decree No. 78 of 1993 (repealed).

[5] Privatisation Act, s 13(1)(o).

(e) reviewing from time to time the socio-economic effects of the programme of privatisation and commercialisation.

The Bureau is the technical and implementing agency. It is the body that undertakes the preliminary activities such as valuation of assets and shares, the vesting of financial statements, the screening and selection of agents, stockbrokers and in appropriate cases investors. Although section 13 of the Privatisation Act states that the Bureau acts in an advisory capacity to the Council, there is no doubt that the Bureau is also expected to be involved in the minute and technical stages of the privatisation scheme. The legislation also prescribes basic rules and guidelines to be followed in the process of privatization. These basic rules are twofold. First, shares of the affected enterprises are to be sold either by way of public issue or private treaty. The decision to choose either option rests on the Bureau but the Council is required to take account of the need for balance and meaningful participation by Nigerians and foreigners in accordance with the relevant laws of Nigeria.[6] In the 1989 to 1993 phase an overwhelming majority of shares were sold by public offer. Save for a few exceptions, all the enterprises were listed on the Stock Exchange. The requirements of the Exchange, particularly that of full disclosure of material information, no doubt complemented the relevant statutory requirements under Part XVII of the Companies and Allied Matters Act 1990 (CAMA), which at the time governed public offers.[7] Secondly, unlike the former effort where in addition to an underlying policy of widespread allotment a substantial percentage (that is, ten per cent) was reserved for employees of the privatised enterprise,[8] the 1999 Act, while retaining the philosophy of dispersed share holdings, limits the percentage of shares reserved for the staff of such enterprises to one per cent. It provides further that the shares shall be held on trust by the public enterprises for its employees.[9]

Privatisation is essentially the transfer of public ownership or control in respect of an undertaking to the private sector. It typically involves the sale of shareholdings or interests in these enterprises. But it could also mean contracting out some services to private hands. Privatisation has various objectives. The first privatisation programme in Nigeria was meant, among other objectives, to:

(a) reduce public spending on unproductive extra-ministerial bodies and enterprises;[10]
(b) boost the revenue base of the State;

[6] Privatisation Act, s 13(1).

[7] See now Part VIII of the Investments and Securities Act 1999 (fomerly Part XVII of Companies and Allied Matters Act 1990 (CAMA)).

[8] See Privatisation and Commecialisation Act 1990, s 7(5) (repealed by Privatisation Act).

[9] Privatisation Act, s 5(3).

[10] Presenting the 1996 Budget, the then President of the country, Gen IB Babangida, disclosed that although by 1990 total investments by government in the form of equity and loans was N66 billion, annual return was below N500 million.

(c) boost the capital market; and
(d) enhance competition.

In the current phase there is more emphasis on boosting the low level of efficiency of the targeted enterprises. Privatization is however not a panacea to end inefficiency in the provision of goods and services. Apart from reforming other macro economic policies that impact on banking, fiscal and investment sectors, a strong institutional and legal framework is required in order to provide a more conducive environment for the privatised enterprises to operate. The experience in most countries (particularly developing transition economies) has shown that in the absence of strong institutions and legal standards, the objectives of privatisation could be frustrated by the unscrupulous and fraudulent, who can also very easily corner the shares on offer and strip corporate assets to the detriment of minority shareholders and other stakeholders.

Nigeria has fairly developed institutions and rules. Of these institutions, the oldest is undoubtedly the Stock Exchange which has in the past reacted in a timely and decisive fashion with respect to irregularities in the affairs of quoted companies that could have some negative impact on their shares. There is also the Securities and Exchange Commission which has been considerably strengthened by a new Investments and Securities Act 1999. Its main function is to regulate the securities market, and in this role it oversees all stock and securities exchanges in the country. CAMA, and to a lesser extent the Corporate Affairs Commission established under it, prescribe rules for the incorporation and operation of companies. Apart from elaborate provisions on the nature and enforcement of shareholders' rights,[11] CAMA also codifies the common law duties of directors to the company,[12] as well other as principles affecting corporate management and control.[13] It is not possible to elaborate in this chapter on these provisions. They are, however, referred to cursorily to give broad insights into how relatively advanced and settled Nigerian legislation is in this sphere.

CORPORATE GOVERNANCE

The concept of corporate governance undoubtedly pre-dates that of privatisation.[14] However, it is a major fulcrum for the effective transformation of privatised enterprises and it is therefore of growing significance, particularly in

[11] CAMA, ss 114 and 115.

[12] CAMA, ss 279–287.

[13] Eg, on disclosure of substantial shareholdings or beneficial interests therein, see CAMA, ss 94–96.

[14] It has been observed that the concept has been in vogue for 10 years ,but suffers from a lack of precision: see J Farrar and M Hannigan, *Farrar's Company Law* (London, Butterworths. 4th ed, 1998), 301. The accountability of directors to shareholders is emphasized as central to the concept: cf P Davies (ed), *Gower's Principles of Modern Company Law* (London, Sweet and Maxwell, 6th ed, 1997), 66.

developing countries. The size and nature of transactions in the securities of privatised enterprises during the privatisation process, and the consequent change in their ownership and capital structure, present significant challenges for the corporate governance framework in these enterprises. In most cases, new owners will seek to effect changes in the board, management, and corporate policies and objectives.[15] This may, in turn, lead to rationalisation of areas of operation, staff and other corporate polices. Unless a credible, transparent and objective process for effecting these changes is in place, the opportunities presented to the controlling shareholder may be abused, thus diminishing the value of the company. Although the dichotomy between management and ownership is of fundamental significance,[16] the fact that these interests can conflict, in ways detrimental to the joint enterprise of corporate profitability, makes a system of balancing these interests necessary. Apart from the narrow legalistic model found in company legislation, an underlying network of socio-economic factors come into play. Thus, although stakeholders' rights relating to employees and the community are not recognized as such by law, companies are increasingly becoming sensitive to these interests in setting corporate policies.[17]

In a sense, therefore, corporate governance is a set of arrangements internal to the corporation that define the relationship between managers and shareholders. At the centre of the system is the board, whose overriding responsibility is to ensure long term viability of the corporation and synchronise interests of shareholders with those of other stakeholders such as creditors, investors and employees. In its external manifestation, however, corporate governance entails a network of public policies and regulatory institutions that ensure the existence of a level playing field and compliance with rules.[18] The essence of corporate governance is transparency and the protection of the minority rights of shareholders. There are various methods of ensuring that corporations pay attention to these issues. Many developing countries (Nigeria included) have fairly adequate legislative provisions, but lack the institutional strength or political will to create a culture of compliance with a view to transforming the management patterns of corporations.

Institutional or capacity weaknesses can be remedied through long term support strategies to developing countries by organisations and countries that

[15] See A Verr, "Post-Privatisation Appraisal of Control and Management In Privatised Banks: The Need for A Golden Share" in I A Ayua and Owasanoye (eds), *Privatisation of Government Owned Banks and Issues of Ownership and Control (Legal and Economic Perspectives)*, Proceedings of a Roundtable, Nigerian Institute of Advanced Legal Studies, Lagos (1996), 75–76. (Mr Verr was the Chief Executive Officer of BPE, the privatisation agency, during Nigeria's first phase of privatisation.)

[16] See CAMA, s.63, which is essentially a codification of *Marshalls Valve Gear Co Ltd* v. *Manning, Wardle and Co* [1909] 1 Ch 267, which has been approved by Nigerian courts: see, eg, *Taiwo Okeowo* v. *Migliore and Ors* (1979) 11 S C (Supreme Court Reports) 138.

[17] See further Farrar and Hannigan, *supra* n.14, at 303.

[18] See further World Bank, *Corporate Governance: A Framework for Implementation – An Overview* , http://www.worldbank.org, 12–14.

have made appreciable strides in developing principles in the field. It is in this way that the OECD Principles of Corporate Governance and the World Bank initiatives on corporate governance are helpful. In the light of an increasing trend towards harmonization of principles, developing economies need to ensure that domestic standards meet minimum criteria recognized by investors in developed market economies.

THE OECD PRINCIPLES

The OECD Principles of Corporate Governance represent a first attempt to move beyond analysis to the definition of international guidelines on corporate governance. The product of a Task Force set up in 1998, the Principles, which were approved in May 1999, were developed jointly by public and private sectors in the territories of national governments of the OECD and relevant international organisations such the World Bank and International Monetary Fund.

The principles are intended to assist member and non-member governments to evaluate and improve the legal, institutional and regulatory frameworks for corporate governance in their countries. Apart from the guidance function, the OECD while acknowledging the evolutionary nature of the principles and of course the concept itself calls on governments, investors and corporations to adapt corporate governance practices so as to meet new challenges in an increasingly competitive market. Although the importance of external policies and institutions are acknowledged, the OECD Principles are essentially concerned with governance problems that result from the separation of ownership and control. They cover the following broad areas:

(a) The protection of the rights of shareholders. The corporate governance framework should protect shareholders rights, such as the rights to:
- secure methods of ownership registration;[19]
- convey or transfer shares;[20]
- obtain relevant information about the corporation on a timely and regular basis;
- participate and vote in general shareholder meetings;[21]
- elect members of the board;[22] and
- share in the profits of the company.[23]

(b) The corporate governance framework should ensure the equitable treatment of all shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. Of particular relevance

[19] For equivalent domestic provisions see CAMA, ss 88–91.
[20] CAMA, s 115.
[21] CAMA, s 81.
[22] See CAMA, ss 248 and 262.
[23] See CAMA ss 379–381.

to the subject matter of privatisation are the recommendations that insider trading and self-dealing should be prohibited[24] and that directors and other members of management should disclose any material interests in transactions or matters affecting the corporation.[25]

(c) The corporate governance framework should recognize the rights of stakeholders under the law and also encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises. Stakeholders such as employees and creditors contribute to the corporate wealth. Increasingly also the need to maintain goodwill and a responsible profile have made community relations a key feature of corporate governance framework.

(d) The corporate governance framework should ensure timely and accurate disclosure of material information, such as information on the financial situation, performance, ownership and governance structures of the company.

(e) The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and its shareholders.

(f) Board members should act on a fully informed basis, in good faith, with due diligence and in the best interest of the company and the shareholders. Privatisation can bring about changes in management or corporate objectives. It is incumbent on the board to ensure that these changes do not diminish the corporate value. The Board should among other key functions:
- review, develop and supervise corporate strategies and projections;
- review key executive and board remuneration, and ensure a formal and transparent board nomination process; and
- monitor and manage potential conflicts of interest of the management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

The OECD Principles offer useful parameters for evaluating the adequacy of domestic legal rules on corporate governance. They were arrived at through an intense consultative process involving OECD members and observers, the private sector, international organisations, and a distillation of diverse national principles and practices. Reform of the corporate governance system within its basic parameters is therefore expected to generate the confidence of foreign investors in domestic capital markets. In relation to the privatisation of state owned enterprises in Nigeria, the following questions are pertinent. What is the primary rationale for privatisation: to cut down on state expenditure or make the affected enterprises profitable? What modalities will be put in place to ensure a transparent privatisation? For those enterprises that are presently

[24] See further Investment and Securities Act 1999, ss 8(m) and 89.

[25] Eg, in relation to loans to directors (CAMA, s 340) and financial statements (CAMA, s 349).

without shareholders, how will corporate policies take account of the shareholders' interest post-privatisation? These questions are examined in the following sections of this chapter.

CORPORATE OBJECTIVES AND POLICIES

There is much to be said for the theory that the ultimate corporate goal is increased profitability. Although there are divergent opinions as to whether this is so under Nigerian company law, it is clearly the only way to enhance the value of shareholdings.[26] However, the methods and strategies adopted by management to increase profitability can make the difference between sustainable profitability or ruin in the long term.

State controlled enterprises, even those motivated by profit, are invariably influenced by extraneous or political considerations in determining policies. The degree of overt interference by state officials varies – the interests of the state being largely protected by government appointees on the Board. Such appointees, however, rarely perceive that their duties to the company and indeed other shareholders (if any) are of paramount importance. Consequently crucial decisions such as staffing, investment, and clientele become issues with serious political undertones. The state, declares section 16 of the Nigerian 1999 Constitution,[27] shall control the national economy in such manner as to secure the maximum welfare, freedom and happiness on the basis of social justice and equality of status and opportunity. The section goes further, providing that the state shall also direct its policy towards ensuring that the material resources of the community are harnessed and distributed as well as possible to serve the common good. However, these lofty but vague objectives are often irreconcilable with economic realities and efficiency.[28] Ostensibly, in the pursuit of these objectives, government had invested in essentially commercial enterprises. In doing this it was filling a void created by a dearth of requisite private sector expertise and capital. It was thus able to render essential services (consistent with the responsibility of the state) providing also employment, and manpower development. Invariably, by virtue of internal rules governing the company the power to manage the company's affairs falls squarely on the directors,[29] while

[26] Cf *Gower's Principles of Modern Company Law*, *supra* n.14, at 68.

[27] See ch II "Fundamental Objectives and Directive Principles of State Policy", 1999 Constitution.

[28] While it may provide a political rationale for certain economic policies *ex-post facto*, the increasing trend to privatise challenges the concept of rigid controls on the economy for political or egalitarian reasons: see further O Fubara, "State Control and Intervention in Strategic Business and the Promotion of Private Investment" in Ayua and Owasanoye, *supra* n.15, at 25–7.

[29] Perhaps it is more accurate today to recognise that the board does not itself run the company but determines policy guidelines for management: see M Arden, "Corporate Governance – Change for Good in the 21st Century: What Good Corporate Governance Involves and How it is Achieved", Paper presented at the session on "Corporate Governance: Challenges of the Next Century", *12th Commonwealth Law Conference* (Kuala Lumpur, September 1999), 15.

the general meeting retains a supervisory and residual role. This position is replicated in section 63(3) of CAMA which provides that:

> except as otherwise provided in the company's articles, the business of the company shall be managed by the board of directors who may exercise all such powers of the company as are not by this Act or the articles required to be exercised by the members in general meeting.

It further provides in section 63(5) that, notwithstanding subsection (3), the general meeting may:

(a) act in any matter if the board is unable to act
(b) ratify or confirm any action by the board
(c) make recommendations to the board on corporate policies.

One of the major objectives of the current privatisation is to achieve efficiency in the operations of the affected enterprises. Unless a reorientation of management policies is effected, the dismal performance of these enterprises will continue post-privatisation. However, change can be difficult – executive and non-executive directors, as well as their cronies, may have become so entrenched in the system as to be able to frustrate reformatory moves by the new owners of the corporation.[30] Not having been attuned to shareholders' views and interests, the management team may, unless replaced by the new hands, carry on with polices and practices as if nothing had changed. This was a major issue of contention in the aftermath of the first privatisation exercise of 1989–93.

Not long after government shares in certain major banks were sold off to the public in 1993 new owners of the privatised entities initiated moves to appoint their nominees on the board and thus gain effective control of management. Although this was a logical consequence of the new ownership structure, considerable resistance was mounted on the one hand by the existing directors who were nominees of the government and on the other hand by employees who feared an imminent cut-back in employment. Some of the fallouts of this development were catalogued by the Chief Privatiser of the exercise as follows:[31]

(a) Frequent board room squabbles and shareholder crises became the norm in some banks post-privatisation. In the case of one bank, the Central Bank had to dissolve the existing board and constitute an interim board in order to preserve the goodwill and assets of the affected bank.
(b) The new non-executive directors interfered excessively in the day to day management of the privatised banks contrary to operational procedures stipulated by the Central Bank.
(c) The re-organisation and restructuring programmes initiated by the boards of the newly privatized banks were at odds with public policy and some shareholders appeared to have assumed powers and authorities that were not commensurate with their shareholdings.

[30] A strong motivation for this in many cases is the desire to shield cases of corrupt practices from detection and to perpetuate such practices.

[31] See Verr, *supra* n.15, at 75.

These were, of course, issues of serious concern to a developing economy in a sector as vital as banking, however, they could equally be explained away as natural consequences of the privatisation. Corporate governance at the post-privatisation stage is basically concerned with the establishment of a new decision making mechanism. It has been observed that at the initial stages new shareholders in privatised entities may demand that their representatives be more active in the day to day running of the enterprise.[32] In a developing economy, where macro-economic policies are frail and information scant, the level of supervision by the board may be pronounced. It is instructive that in terms of the supervision by the board over managers, the OECD Principles recognise the importance of directors' access to accurate, timely and relevant information in order to ensure that applicable laws are obeyed and an adequate return is achieved for shareholders. However, the concern of regulatory bodies in a strategic sector like banking over the irreconcilable nature of corporate goals with public policy or interest is not misplaced. Given the strategic nature of the enterprises slated for the fresh privatisation, this concern will expectedly be a recurring note. Indeed, section 11(I) of the Privatisation Act, appears to have anticipated this by empowering the Council to review from time to time the socio-economic effects of the programme of privatisation and commercialisation and decide, if necessary, on appropriate remedies. Some of the enterprises earmarked for privatisation, like the National Electric Power Authority (NEPA) and Nigerian Telecommunications (NITEL) have for a long time been sole suppliers of electricity and telecommunications, respectively. Unless contestible markets in these services are guaranteed, it is unlikely that privatisation will make their services more efficient.

While increased profitability is a legitimate corporate objective, monopolistic structures cannot be in the public interest. It is important therefore that the corporate governance framework be strengthened by external policies and institutions that can provide a competitive playing field and check the excesses of insiders, whether managers or shareholders. Such policies can minimize the divergence between social and private returns through greater transparency, monitoring by regulatory bodies and compliance mechanisms.[33] Several options are being pursued in line with the understanding that contestible markets and suitable regulatory policies must be in place before the enterprises are privatised.[34] In the case of NITEL, several private companies have been licensed and a regulatory body established[35] with wide ranging powers to ensure fair competition and viable markets. It is envisaged that shares in NITEL will be sold when these outfits attain a reasonable degree of viability. In the electricity sector,

[32] See K Brom, "Issues of Post-Privatisation Corporate Governance", http://www.oecd.org/sge/ccnm/progams/tomsk/corporate.htm.

[33] See World Bank, *supra* n.18, 7–8.

[34] See "Privatisation should Not Be Done In A Hurry", Report of an Interview with Mr. I Usman, former Finance Minister, *THISDAY*, 11 January, 1999.

[35] See the Nigerian Communications Commission Act 1992.

although privately owned power generating corporations as well as a regulatory body are being contemplated as long term strategies, the government prefers first to re-structure NEPA into three distinct corporations with responsibilities for (1) generation, (2) distribution, and (3) transmission, of electricity, before Government equities are privatised. In the previous privatisation, particularly in relation to the financial sector, the concept of the golden share as a regulatory tool was considered and indeed applied in the insurance sector. This is a monitoring mechanism to enable governments retain a measure of control in strategic enterprises post-privatisation. It would entail consultation with and the consent of the government before major changes in policy or ownership in the privatised enterprises are effected. The golden share carries no right to dividend and normally exists for a stated period. However, the risk that it would become a source of intimidation and unwarranted interference by political agents was enough to sway opinion in favour of the establishment and empowerment of regulatory bodies, as alternative tools to check post-privatisation monopolies. There is nothing so far in the current exercise to suggest that the golden share concept is being contemplated.

SHAREHOLDERS' RIGHTS AND PROTECTION

These are major planks of a system of corporate governance. They assume marked significance in the post-privatisation phase, mainly on account of the re-alignment of shareholdings, control, and corporate policies. Shareholders are entitled to participate in these issues as guaranteed by the articles, as well as by CAMA. Participation is to some extent enhanced by the rights to receive notices of, attend and vote at meetings.[36] The shareholders' ability to do this is further enhanced if they are:

- sufficiently informed about the date, location and agenda of general meetings as well as provided with full and timely information regarding the issues to be decided at the meeting;
- provided with the opportunity to ask questions of the board and to place items on the agenda at general meetings; and
- able to vote in person or in absentia – in the case of the latter, effective participation of shareholders in general meetings can be enhanced by developing secure electronic means of communication and allowing shareholders to communicate with each other without having to comply with the formalities of proxy solicitation.[37]

Despite legal protection, in Nigeria certain factors are serious obstacles to the effective participation of shareholders in governance. Apathy on the part of

[36] The right to attend and vote at general meetings is protected by CAMA, s 114 from deprivative provision in the Articles.

[37] See OECD Principles, *supra* n.2, at 8–9.

shareholders and widespread dispersal of shareholdings in public companies invariably facilitate oppression by controlling shareholders or management. The Lagos Stock Exchange, though undoubtedly the largest and most active in Nigeria, is still characterized by low volumes of transactions, particularly in the secondary market. To the majority of Nigerian investors, shares are valuable savings options – the speculative and other proprietary potentials of shares are hardly explored. The few institutional investors in the market are too timid to assert their influence by insisting on fairness and transparency. In the case of foreign investors, invariably their shareholdings represent a minute fraction of a highly diversified portfolio. Hitherto, therefore, save for few instances, they have not risen above the environment of shareholder apathy. In addition, infrastructural inadequacies coupled with a rigid, expensive and complicated judicial system have clearly worsened the unenviable position of shareholders. Notices of general meetings are routinely received late[38] and rarely advertised ahead of time in the mass media, while the venue of such meetings are made practically inaccessible to the larger proportion of shareholders.[39]

DIVERSIFIED OWNERSHIP: MOBILIZING SHAREHOLDERS

The factors discussed above seem to diminish the prospects of active participation on the part of shareholders in post-privatisation corporate policies. Importantly, a golden rule observed since the initial privatisation has been to ensure widespread and dispersed shareholdings through the allotment process. Highlighting the political undertones of the exercise, a former President of the country solemnly assured citizens that care will be taken to avoid the divested holdings "being concentrated in the hand of a few individuals or areas of the country".[40] Almost fourteen years later, the same philosophy has been retained as fundamental to the fresh privatisation effort. Section 5 of the Privatisation Act provides that the shares of privatised enterprises which are the subject of a public offer shall be allotted as follows:

(a) The shares on offer to Nigerians shall be sold on the basis of equality of (the 36) states of the Federation and of the residents of the Federal Capital Territory Abuja.
(b) Not less than one percent of the shares to be offered for sale to Nigerians shall be reserved for the staff of the public enterprises to be privatised and the shares shall be held in trust by the public enterprises for its employees.

[38] Although CAMA, s 217 stipulates 21 days notice, time runs from the date the notice was sent out. An epileptic postal system is a convenient excuse for delayed receipt.

[39] It has become fashionable for public companies to hold general meetings thousands of miles from where most shareholders reside. The transport costs are a major disincentive to many, while voting by proxy is made impossible by late notices and poor communication.

[40] President IB Babangida, 1996 Budget Speech.

(c) Where there is an over-subscription for the purchase of the shares of privatised public enterprises no individual subscriber shall be entitled to hold more than 0.1% equity shares in the privatised public enteprises.

These are the primary rules of allotment that the Council and Bureau are obliged to follow. The rationale for these rules is presumably constitutional, particularly the injunction in section 16 of the Constitution that the economic system should not be operated in such a manner as to permit the concentration of the means of production and exchange in the hands of a few individuals. Privatisation is not necessarily at odds with this ideal. The difference between state control and state ownership is being increasingly appreciated in developing economies. Also, the notion that the shares earmarked for sale are held by the state on trust for the people must have given support to the adoption of an egalitarian allotment formula. However, while section 5 of the Privatisation Act appears to be consistent with egalitarian values and social justice, it could also weaken the cohesion of minority shareholders and pave the way for the majority shareholder or insider to strip corporate assets. Fully cognisant of this risk, the privatisation agencies have sought firstly by law and secondly as a practical measure to provide impetus and leadership to the diffused corps of shareholders in privatized entities. Of particular importance in this regard is the discretion of the Council to determine the mode of privatising any particular enterprise.[41]

CORE/STRATEGIC INVESTORS

The methods sanctioned by CAMA for securing accountability to shareholders are grounded in the principle of full disclosure of material information to shareholders. According to Gower, these methods can be effective only if shareholders are: first, sufficiently knowledgable fully to understand the information; secondly, have shareholdings large enough to influence decisions; and, thirdly, are willing and able to resort to the courts.[42] Institutional or core strategic investors are in the best position to meet these conditions. In the previous privatisation exercise, core investors were considered important to the restructuring process of privatised enterprises. Even in cases where it was decided to offer a substantial proportion of shares to the public, a smaller but strategic proportion had invariably been reserved for such investors. The Council has recently demonstrated that it will follow this practice. Indeed, in the case of enterprises listed in Part I of the First Schedule, strategic investors are being offered a larger proportion of shareholdings than individuals. Unlike previous exercises, however, the criteria for determining whether any person qualifies as "a strategic investor" is more clearly defined by law. Section 34 of the Privatisation Act provides now that a strategic investor means a reputable core

[41] Privatisation Act, s 2 provides generally for two options: public issue or private placements.

[42] See *Gower's Principles of Company Law*, *supra* n.14, at 66–7.

investor or group of investors having the requisite technical expertise, the managerial experience and the financial capacity effectively to contribute to the management of the enterprises to be privatised. These four qualifications, *viz.* good reputation, technical expertise, managerial experience and financial clout, are the main parameters for determining a strategic investor. The concept is relative. Thus, while an investor may be considered "strategic" in relation to certain enterprises this need not, in the absence of, for example relevant technical expertise, be the case for others.

As strategic investors are expected to be in the forefront of post-privatization management reforms, it is important that limited fetters be placed on their capacities to do this. A potential source of worry in this regard is section 4 of the Privatisation Act, which provides that a privatised enterprise that requires participation by strategic investors may be managed by the strategic investor as from the effective date of the privatisation on such terms and upon conditions as may be agreed. As the government will be retaining controlling shares in the corporation, the temptation to insert unduly restrictive clauses in such agreements should be resisted. In terms of profit motivation, strategic investors are no different from other investors. If returns on investment are hampered by unnecessary restrictions, they will naturally sell off their holdings to willing buyers.

Also within the contemplation of the provision are performance agreements exclusively between the Council and the strategic investor. Although material details of such an agreement must be disclosed along with the public offer,[43] the company is not bound to comply with it.

ACTIVIST SHAREHOLDER BLOCS

Another strategy that has been used, apart from strategic investors, in a bid to enhance shareholders' capacities to participate in corporate governance, is the formation of shareholders' associations.[44] The majority of members of these associations comprise shareholders in privatised enterprises. Their impact has been mostly felt in mobilising minority shareholders and protecting participatory rights in general meetings. These associations also played a pivotal role in the removal of "sit tight" directors in some privatised enterprises, particularly when it became apparent that these insiders had used their privileged positions, and also corporate funds, to acquire controlling shares in the company. The efficacy of these corps of "activist shareholders" of course depend on their ability

[43] See CAMA, s 15, para II, which requires the prospectus inviting subscription to give the dates of the parties to and general nature of every material contract.

[44] One of these associations, Zonal Shareholders Association, formed during the 1986–94 privatisation, was actively promoted by the state and is almost exclusively constituted by allotees of privatised shares. The other, Nigerian Shareholders Solidarity Association, was ostensibly meant to mobilise shareholders against negative corporate policies and other lapses in the privatisation process.

to garner investors' confidence; particularly, the extent to which their procedures for taking decisions are open and transparent.

Although at the initial stages much bickering and unorthodox methods were used in order to exert pressure against unpopular management policies, or upon recalcitrant directors, shareholders' associations are practical mechanisms in the Nigerian context for ensuring the protection of the rights of minority shareholders. Apart from the near comatose state of the judicial remedies, few shareholders have the funds or patience to sustain minority actions in court.[45] The endearing quality of these associations is that they provide a framework for communication between minority shareholders on matters of common interest and they have significantly assisted shareholders in privatised and other corporations in effective participation at meetings and the realisation of basic rights. Given the expected widespread diversification of shareholdings, therefore, it is envisaged that the shareholders' associations will have an enlarged role to play in the privatised enterprises.

MASS PRIVATISATION: OTHER OPTIONS

Despite the shortcomings identified earlier, privatisation will be implemented mainly through the Stock Exchange and shares are expected to be fully paid up before allotment. The exercise has, on account of this, been criticized as calculated to exclude many Nigerians who, because of the high prices of the shares, cannot afford to take them up. There is no doubt however that given the country's population some formula for diverse holdings is important if only to lessen socio-political discontent amongst the polity. However, a mass privatisation program that allocates shares for free or at unreasonably low rates is more prone to abuses. The mass privatisation exercise in Russia – also a country with a large population – attempted to address the poverty issue by auctioning shares to citizens through vouchers and also by reserving large percentages of these shares for workers and other key interest groups.

Although this method assisted in diversifying holdings among the populace it suffered serious structural flaws,[46] which together with the fact that shares were sold at cheap rates, led to massive insider dealing and asset stripping. As shares were transferable, citizens found it more expedient to discount them for cash to less than scrupulous investors, whose main objective was to plunder corporate

[45] By actively using the legal protection in legislation, such as Audit Committees set up under CAMA composed of an equal percentage of shareholder and management, these associations can ensure accuracy in financial statements and transparency in corporate management.

[46] Auctions were not centralised as Russia had no Stock Exchange at the time. They were conducted piecemeal and gave undue advantage in terms of access and advanced knowledge to the managers of the privatised companies: see B Black, R Krakman and A Tarassova, "Russian Privatisation and Corporate Governance: What Went Wrong", http://www.papers.ssrn.com/paper.taf? abstractid=181348.

assets. The World Bank "IPO-Plus" model of mass privatisation for developing economies is reputed to be capable of securing widespread ownership while also guaranteeing an efficient corporate governance system. The main objectives of the IPO-Plus method of privatisation are to achieve:

- equity through widespread public participation in the privatisation process; and
- efficiency through transparent privatisation procedures and development of the capital market and independent financial institutions (investment funds) whose responsibility it is to exert pressure on companies to improve their financial performance.[47]

The IPO-Plus option differs from other mass privatisation strategies by according an integral role to investment funds, who act as intermediaries for individuals in initial public offers and are expected to provide short cuts to the enforcement of corporate discipline. As the divestment process will be centralised through the stock exchange, and at reasonable rates, rent or manipulation is substantially eliminated.

Under the IPO-Plus scheme, investment funds can buy the privatised shares with or without deferred payment conditions while the public participates, by buying shares of the investment funds at uniform low rates. This mechanism, comparable to the unit trust concept, has however limited appeal in an economy where large sections of the public are unresponsive to or unfamiliar with the formalised structure of capital market. Although, as an integral part of the IPO-Plus option, investment funds can more quickly enforce post-privatisation corporate governance, it is still dependent on a fairly efficient and responsive capital market. In the absence of such a market there is a high probability that the shares of these funds may also be cornered by a few wealthy individuals. There is also a need for a coherent and effective regulatory framework for investment funds[48] in order to minimize the dangers of fraud and misrepresentation, which are common to funds in some emerging markets.

CONCLUSION

A close reading of section 5 of the Privatisation Act leaves no one in doubt about the concern of the state for an equitable spread in the shareholdings of privatised enterprises. Despite similar provisions in previous laws, however, past privatization efforts have achieved very little of this. Commonly recorded cases include multiple applications by one individual, usually an insider using surrogates,

[47] See I Goldberg, G Jedrzejczak and M Fuchs, "A New Approach To Privatization: The IPO-PLUS", http://www.worldbank.org/ecspf/final/htiml/papes/ipo-plus.html.

[48] See, in this regard, Investment and Securities Act 1999, Part XI, entitled "Collective Investment Schemes". By virtue of this Part, unit trust schemes must be approved or authorized by the Securities and Exchange Commission.

colluding with issuing houses to retain or wrest control. Insider trading occurs under Nigerian law where a person or group of persons who are in possession of some confidential and price-sensitive information not generally available to the public utilizes such information to buy or sell securities for the benefit of himself, itself or any other person.[49] Insider trading is a phenomena strongly suspected but hardly ever established in Nigeria. Since it was criminalised in 1990 no prosecution has been initiated by the Securities and Exchange Commission against any person or firm. One suspects that the main reason for this is the requirement that penalties be imposed by the ordinary courts after conviction – as the criminal process entailed much delay and uncertainties the Commission no doubt was reluctant to initiate prosecutions.[50]

As a preliminary step towards privatisation some discussions and decisions relating to sequence and methods of pre-privatisation re-structuring will have to be made by the Bureau or Council in consultation with officials of the targeted enterprises. The temptation and opportunities for abuse are therefore present since insiders are sufficiently informed about the timing and pricing of issues before the public offer is announced. As these consultations are inevitable, the capacity of regulators to detect and punish those who violate the existing codes of ethics and law is of paramount significance. This presents to Nigerian regulators and prospective foreign investors an interesting paradox. Unlike markets in transition, such as Russia, existing regulations covering the Nigerian securities market and corporate behaviour are generally quite strong and adequate. Furthermore, save for few instances where heavy trading was deliberately induced (for example, as a result of indigenisation or privatisation), the market has remained inelastic. These few instances have, however, been accompanied by irregularities and unfair manipulations. What is becoming increasingly clear, therefore, is that in the absence of a will and capacity to enforce rules privatization could lead to frustration and disenchantment with the performance and corporate governance systems of privatised enterprises.

The challenge of post privatisation corporate governance in Nigeria is exacerbated by very weak judicial systems, under-developed institutions, scarce human resource capabilities and a weak private sector. All these areas have been the subject of, or are currently undergoing, reforms in order to make them more efficient. It is still too early to give an accurate assessment of these efforts. It was only in 1999 that Nigeria transited to a more liberal political process – an important factor towards a more conducive environment for long term investment. Hopefully, the reform process will itself be catalysed by increased levels of economic activity. Institutional reforms should also be complemented by vigorous measures to reduce rent seeking and corruption that also encourage

[49] Investment and Securities Act 1999, s 264. See further ss 88 and 89, for provisions prohibiting and penalising insider dealing.

[50] This long-standing problem has not been solved by the new Investment and Securities Act 1999. Section 253 provides that where an offence is committed the Attorney-General should initiate prosecution.

transparency. Such reforms should go beyond merely enacting laws. Corporate governance is about establishing a climate of trust and confidence through oversight. It involves a collaboration between government and the private sector to evolve and enforce sustainable compliance mechanisms. How efficiently this is done in the period after privatisation depends not only on how new shareholders perceive their role in the internal governance mechanisms but also on how well regulatory institutions adjust to the global pressures for transparent rules and a culture of compliance in capital investment markets.

8

Importing Law Reform: Vietnamese Company Law as a Case Study

JOHN GILLESPIE[1]

INTRODUCTION

The Communist Party of Vietnam (CPV) in 1986 committed Vietnam to *doi moi* (renovation) economic and political reforms. Fearing political isolation and economic decline, the party and state gradually liberalised private production, attracted foreign investment and joined bilateral and regional trade associations. Law reformers believed that regulations governing company formation and organization were integral elements of modern commercial legal systems, but reforms could not wait decades required to construct a corporate law regime from local commercial practices. Reluctantly, lawmakers turned to Western laws for inspiration.[2]

With French assistance, the National Assembly enacted Vietnam's first modern Law on Companies (LC) in 1990. Research outlined in this chapter indicates that over the intervening years, entrepreneurs, the social group most likely to benefit from the LC, rarely structured their activities around corporate rules. The reputed benefits of incorporation, such as limited liability, raising public capital and corporate governance proved only marginally relevant to the secretive family and patron-client networks ordering Vietnamese commercial life. In the end, imported corporate rules formed a mosaic of legal norms, overlaying, but rarely informing official decision-making, much less commercial habits, customs and traditions.[3]

[1] The author gratefully acknowledges an Australian Research Council grant funding field research in Vietnam during 1999 and 2000.

[2] Interviews with Phan Huu Chi, former adviser to the Minister of Justice, Vice Rector of the Hanoi Law College and member of the Company Law drafting committee, 1992–1994; Nguyen Chi Dung, Deputy Director, Library and Information Services National Assembly, Hanoi, October 1997, July 1998, March 1999.

[3] See J Gillespie, "Law and Development in the Market Place: An East Asian Perspective" in K Jayasuriya (ed.), *Law, Capitalism and Power in Asia*, (London, Routledge, 1999), 118–150. See generally K Pistor and P Wellons, *The Role of Law and Legal Institutions in Asian Economic Development* 1960–1995 (Oxford, Oxford University Press, 1998), 113–152; R Cooter, "The Theory of Market Modernization of Law" (1996) 16 *International Review of Law and Economics* 142, at 146.

This chapter speculates that incompatibilities between donor and host country legal ideologies, power structures and commercial institutions impedes the reception of transplanted company in Vietnam. The investigation is timely, because the Vietnamese National Assembly recently enacted the Enterprise Law 1999 (EL) to redress the perceived failure of the LC to order commercial activities.

TRANSPLANTATION THEORY

Many commentaries concerning the role of law in socialist transforming markets have observed that host country legal cultures and business practices both facilitate and impede the reception of transplanted Western market-law.[4] Montesquieu[5] first captured the uncertain relationship between transplanted law, local environmental and social conditions, when he (and many others)[6] posited that rules of law only coincidentally produce the same behavioral outcomes in different societies.

External pressures for legal harmonization have stimulated and influenced commercial law reform in Vietnam since *doi moi* policies were promulgated in 1986. Initially, law reforms sought to attract and accommodate foreign investment, however, since accession to the Association of South East Asian Nations (ASEAN) in 1995 and a United States Bilateral Trade Agreement in 2001, the orbit of legal harmonization has broadened to encompass trade, taxation, tariffs, transport, customs protocols and banking.

Western proponents of transplanted legal development, such as the World Bank, the United Nations Development Programme (UNDP) and the Asian Development Bank (ADB)[7] contend that as law becomes a more sophisticated regulator of commerce, it also becomes ever more remote from its host culture. Globalizing forces are credited with accelerating and reinforcing this "decoupling" process by creating one international legal dialogue comprised of a collection of regional sub-variations. In its extreme form, some postulate a future where a single transnational jurisdiction emerges, as national legal

[4] See generally P H Rubin, (1994), "Growing a Legal System in the Post- Communist Economies" (1994) 27 *Cornell International Law Journal* 1; TW Waelde and JL Gunderson, "Legislative Reform in Transition Economies: Western Transplants – A Short-Cut to Social Market Economy Status?" (1994) 43 *International Comparative Law Quarterly* 347; C W Grey, "The Legal Framework for Private Sector Activity in the Czech Republic" (1993) 26 *Vanderbilt Journal of Transnational Law* 271.

[5] See Baron de la Brede et de Montesquieu, *De L'Espirt des Lios* (1749, JP Mayer and AP Kerr eds, Paris, Gallimard, 1970) Livre I, ch 3.

[6] See A Seidman and R Siedman, *State and Law in the Development Process* (London, Macmillan, 1994), 46; P Legrand, "The Impossibility of Legal Transplants" (1997) 4 *Maastricht Journal of European Comparative Law* 111, at 119.

[7] For an example of the transplant model of law reform, see UNDP, *Completion of Vietnam's Legal Framework for Economic Development*, (Hanoi, United Nations, March 1999).

systems wither away.[8] It is a small step from this vision of global equivalence and conversion, to the proposition that legal transplants no longer convey ideology and culture from one society to another, but rather, are a series of technical adjustments between legal systems. By the late nineteenth century Western lawyers institutionalized jurisprudential rules that laid claim to an inner logic that did not apply, and was not cognizable, to the general public in host countries. "De-coupled" from their social moorings, legal ideas were treated as technological fragments unconstrained by cultural borders. Continuing this tradition, multilateral donors believed that when correctly assembled, transplanted laws can introduce market mechanisms to developing economies.[9]

Bilateral donors (for instance SIDA)[10] and researchers observing the interaction between imported laws and domestic institutions believe, on the contrary, that effective legal transplantation must comprehend and accommodate differences in the ideological, institutional and cultural composition of donor and host countries.[11] This nuanced approach to law reform rejects as naïve the contention that if laws are improved, legal institutions strengthened and law schools modernized, nothing can hold back legal convergence.

In explaining the uneven international reception of transplanted industrial law, Otto Kahn-Freund postulated that the viability of imported law depends on the compatibility of donor and host country sociopolitical structures.[12] Compatibility, he maintained, was partially determined by the strength of "coupling" between laws and donor country ideology, power structures and

[8] See M Cappelletti et al, "Introduction" in M Cappelletti et al (eds), *Integration Through Law: Europe and the American Experience* (Berlin, Walter de Gruyter, 1986).

[9] Responding to the failure of World Bank and International Monetary Fund structural adjustment programs of the 1980s, Douglass North influentially argued that the fault often lay with the institutions and legal systems required to implement reforms. Institutions, he believed, could be refashioned into the western neo-liberal mould: see generally D North and B Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England" (1989) 49 *Journal of Economic History* 803; D North, *Structure and Change in Economic History* (New York, W. W. Norton, 1981). For a World Bank perspective, see D Webb, "Legal System Reform and Private Sector Development in Developing Countries" in R Pritchard (ed.), *Economic Development, Foreign Investment and the Rule of Law* (London, Kluwer Law International, 1996), 46.

[10] Interview with Christina Johanson, Swedish Embassy, Hanoi, 3 March 2000.

[11] See generally L Webster, "SMEs in Vietnam: On the Road to Prosperity", Mekong Project Development Facility, Private Sector Discussions, No. 10 (Hanoi, 1999); MPI-UNIDO, "Research Report: Improving Macroeconomic Policy and Reforming Administrative Procedures to Promote Development of Small and Medium Enterprises in Vietnam" (Hanoi, 1999); O Bring, C Gunnarsson and A Mellbourn, "Viet Nam: Democracy and Human Rights", (Hanoi, Swedish International Development Agency, 1998); P Bergling, "Theory and Reality in Legal Co-operation – The Case of Vietnam" in P Sevastil (ed.), *Legal Assistance to Developing Countries* (Sweden, Kluwer Law International, 1997), 61–80; Gillespie, *supra* n.2, at 118–150.

[12] See O Kahn-Freund, "On Uses and Misuses of Comparative Law" (1974) 37 *Modern Law Review* 1, at 7–11 & 27; O Kahn-Freund, "Common Law and Civil Law – Imaginary and Real Obstacles to Assimilation" in M Cappelletti (ed.), *New Perspectives for a Common Law Europe* (Oxford, Oxford University Press, 1978), 160.

economic institutions. Since all laws have "de-coupled" to some extent from their social roots, he believed that legal transplantation across cultural boundaries was a theoretically possible. But as laws have not "de-coupled" to the same extent, some were more likely to survive the journey to different cultures than others. Put differently, Kahn-Freund believed that there is much "law" beyond legal rules and the transplantation of statutory and doctrinal rules does not necessarily transfer the "whole law". His "coupling" metaphor infers that some statutory and doctrinal rules comprise more of the "whole law" than others. These rules are unlikely to transplant successfully unless host country sociopolitical structures are compatible with the "whole law" of the donor country.

Ultimately, most measures of legislative effectiveness examine whether new laws are compatible with existing values and are actually followed and enforced.[13] In short, is there social change of the kind contemplated by laws? Like many others engaged in "implementation research", Griffiths opined that the implementation of law is affected by so many variables and competing interests that it is never clear whether behavior that appears to comply with a particular rule is brought about by the rule. Other factors, like moral pressures, religious beliefs, habits or customs, may explain the behavior.[14]

Rather than attempting to unravel the causal effects of law, Kahn-Freund's analytical framework circumvents Griffiths' dilemma by assessing transplanted laws according to the congruence between donor and host country ideologies, institutional cultures and business structures. Kahn-Freund identified three sites of interaction between imported laws and host country sociopolitical structures:

i At a macro-sociopolitical level, legal coupling is strongly influenced by lawmaking mechanisms and the congruence between the ideological content of transplanted laws and host country politico-legal ideologies.
ii The effectiveness of transplanted law is profoundly affected by its compatibility with the legal culture (epistemologies) of host country bureaucratic and judicial institutions.
iii Certain laws require particular configurations of state and non-state interest groups, such as market support organisations (for example banks, lawyers and accountancy firms, markets and family-based commercial structures) to function effectively.

Kahn-Freund concluded that compatibility between donor and host country sociopolitical institutions is a crucial factor determining successful legal transplantation. His explanation for the general failure of transplanted laws to

[13] See generally R Tomasic, "The Sociology of Legislation" in R Tomasic (ed.), *Legislation and Society* (Sydney, Law Book Company, 1980), 23, at 35.

[14] During the early 1970s a group of American scholars devised a series of empirical studies that asked whether law achieves a reasonable resolution of the social problems it purports to address? See WH Clune and RE Lindquist, "What 'Implementation' Isn't: Towards a General Framework for Implementation of Research" [1981] *Wisconsin Law Review* 1044, at 1045–1051.

induce expected behavioral outcomes in host countries is used as an analytical framework to explore the transplantation of company law to Vietnam.

IMPORTING A COMPANY LAW REGIME

Before contrasting the sociopolitical structures underlying Western and Vietnamese company law, it is first necessary to comprehend the sociopolitical structures that have historically shaped commercial organizations in Vietnam.

Pre-colonial period

Borrowing deeply from Chinese legal codes, the pre-colonial Vietnamese imperial codes used top-down criminal sanctions to control social behavior, while leaving most aspects of commercial regulation to village custom.[15] State laws only intervened on the rare occasions where commercial behavior offended Confucian morals designed to preserve social hierarchies. Instead of law, the state used bureaucratic mechanisms to constrain commercial organization outside the orbit of royal patronage and mandarate supervision.[16] State monopolies policed by mandarins ensured that urban artisans plied their crafts in officially sanctioned trading streets (*phuong*).[17] Tight bureaucratic controls inhibited the formation of corporations sole[18] and proto-corporate structures capable of mobilizing trading capital, distributing profit and losses and, more importantly, rivalling state concessions.[19]

In the villages, where most people lived, commerce revolved around personal relational networks backed by the moral authority of village and clan heads:

[15] See Nguyen Ngoc Huy and Ta Van Tai, "The Vietnamese Texts" in MB Hooker (ed.), *The Laws of Southeast Asia*, Vol 1, (Singapore, Butterworths, 1986), 476–480.

[16] Encapsulated by the Confucian adage *Trong nong mat thu ong* (Emphasize agriculture, commerce is peripheral) the state actively impeded commercial organization outside state and village-based structures: see A Reid, *Southeast Asia in the Age of Commerce 1450–1680*, Vol II (Chiang Mai, Silkworm Books, 1993), 62–77. Clan based corporate behaviour, similar in form to structures in China, developed in Vietnam: see J Chen, *From Administrative Authorisation to Private Law* (London and Dordrecht, Martinus Nijhoff, 1995), 72–74; P Lawton, "Berle and Means Corporate Governance and the Chinese Family Firm" (1996) 6 *Australian Journal of Corporate Law* 348, at 351–353.

[17] The legacy of this licensing system can be seen in the names of the 36 commercial streets in the ancient quarter of Hanoi, eg, Paper Street, Fish Street: see Nguyen Duc Nhan, "Do the Urban Regional Management Policies of Socialist Vietnam Reflect the Patterns of the Ancient Mandarin Bureaucracy?" [1984] *International Journal of Urban Regional Research* 74–75; Reid, *supra* n.15, at 136–138.

[18] For a broad discussion of the different development paths followed by Western and Neo-Confucian societies like Vietnam see SE Finer, "Problems of the Liberal Democratic State: An Historic Overview" (1990) 25 *Government and Opposition* 334, at 335–40.

[19] See generally JK Whitmore, "Social Organization and Confucian Thought in Vietnam" (1984) 15 *Journal of Southeast Asia Studies* 296, at 299–303.

Confucianism's "superior men" (*quan tu*).[20] Rather than written rules, a syncretic mix of customary practices, rituals and mystical beliefs determined permissible forms of commercial behavior and organization.[21] The situational validity (*thoa dang*)[22] of village rules and rituals produced commercial practices that were too contextualized and fragmented to form the basis of universal commercial norms.

French colonialism

The transplantation by the French of Western rights-based law to Vietnam during the second half of the nineteenth century, induced a dualistic political economy. French company law remained the preserve of the tiny Francophone elite managing the colonial economy.[23] But even within the colonial economy the monopolistic behavior of the French authorities and the hegemonic practices of Banque de l' Indochine (the Central Bank) ensured that company law had little application beyond a core group of urban industrialists.[24] Abstract transplanted notions of legal personality and limited liability held no meaning for the overwhelming majority of the population engaged in customary commerce.

Soviet revolutionary period

After gaining independence from the French in 1954, the Democratic Republic of Vietnam (DRV) imported from the Soviet Union an entire legal and institutional system designed to implement a socialist command economy.[25] The central ideology of *phap che xa hoi chu nghia* (socialist legality) propounded

[20] See A Woodside, "Exalting the Latecomer State: Intellectuals and the State During the Chinese and Vietnamese Reforms" in A Chan et al (eds), *Transforming Asian Socialism: China and Vietnam Compared* (Sydney, Allen and Unwin, 1999), 21–23.

[21] *Dien* was an important form of rural transaction that arose where A transferred land to B, in return for payment and an expectation of retransfer on repayment of the original payment. During the period of transfer B was entitled to enjoy profits from the land. Since the transaction transferred use and profit, and not an outright alienation, it did not generate debt obligations: see H McAleavy, "Dien in China and Vietnam" [1958] *Journal of Asian Studies* 403, at 405–11.

[22] The term *thao dang* is used to denote the situational validity of morals and rights. The word for rights, *quyen*, is derived from a Han (Chinese) word for balance. It emphasizes the oscillating nature of rights and their susceptibility to power. Rights ultimately belong to the powerful; there is no concept of natural rights in traditional Vietnam: Interviews with Hoang Ngoc Hien, Sociologist, Nguyen Du School of Creative Writing, Hanoi, June 1998, April and September 1999.

[23] See MB Hooker, *A Concise Legal History of South East Asia* (Oxford, Clarendon Press, 1978), 157–61.

[24] See M Murray, *The Development of Capitalism in Colonial Indochina (1870–1940)* (Berkeley, University of California Press, 1980), 138–156, and 189–209.

[25] Ginsbergs thinks it is unlikely that Vietnam's attempts to "restore legality" were directly linked to the "de-Stalinization" commenced by the 20th Party Congress in February 1956. However, the timing of the Soviet reforms aided the Vietnamese program: see G Ginsburgs, "The Genesis of the Peoples' Procuracy in the Democratic Republic of Vietnam" (1979) *5 Review of Socialist Law* 187, at 191.

the three tenets of socialist governance: the people as owners, the party as leader, and the government as manager. In practice this meant large private companies were nationalised and converted into state owned enterprises (SOEs). Small-scale private business were "bought out", a process that transferred managerial control to the state and seven percent of enterprise profits to private "owners".[26] The "new social relationships" (*moi quan le xa hoi moi*) were structured around Marx's syllogistic axiom that capital is accumulated from exploitation, class exploitation is morally wrong, therefore productive assets (the means of production) should belong to the exploited classes (peasant worker alliance) under state management.[27]

The principle of "state economic management" (*quan ly kinh te nha nuoc*) was devised in the Soviet Union to link state planning and economic production under the unified political and economic leadership of the state.[28] Since law was only "an important tool in the socialist state's management of society and economy",[29] the "legal position of the parties in economic law [was] defined by their rights and obligations under the law, the plan, or the economic contract".[30] This meant that state policy embedded in economic plans and administrative contracts drafted by line-ministries enjoyed a regulatory status equivalent to written laws.

As with other Stalinist states, line-ministries in Vietnam issued administrative directives that allocated resources according to legally binding planning targets.[31] Since private commerce was officially discouraged and SOEs were treated as state production arms, lawmakers believed there was no need for company law. Despite triumphantly proclaiming the complete socialization of private industry in 1960, in practice the state never succeeded in entirely eliminating private production.[32] As state production and distribution began to

[26] A 7% share of profits was considered roughly equivalent to a worker's salary and thus not exploitative: see Committee for the Reform of Industry, "Review of the Reform of Private Industry in Hanoi from June 1958 to May 1960" (Hanoi, Central Committee Archive File T 127, 1960), 32.

[27] See Nguyen Khai Vien, *Tradition and Revolution in Vietnam* (Berkeley, University of California Press, 1974), 24; W Duiker, "Ideology and Nation-Building in the Democratic Republic of Vietnam" (1977) 17 *Asian Survey* 413, at 415–7; S Young, "Vietnamese Marxism: Transition in Elite Ideology" (1979) 19 *Asian Survey* 770, at 770–4.

[28] See Nguyen Nien, "Several Legal Problems in the Leadership and Management of Industry Under the Conditions of the Present Improvement of Economic Management in Our Country" [1976] *Luat Hoc* (*Jurisprudence*) 33, at 33–5 (trans. J.P.R.S., 30 September 1976, 34–36).

[29] *Ibid*., at 36.

[30] *Ibid*., at 43.

[31] Only technical decisions affecting local conditions like packaging and delivery were devolved to production managers: see Pham Thanh Vinh, "The Obligatory Nature of Planning Targets" (1966) 12 *Review of Contemporary Law* 82, at 89–97. See also Nguyen Ngoc Tuan et al, "Restructuring of State-Owned Enterprises Towards Industrialization and Modernization in Vietnam" in Ng Tee Yen et al (eds.), *State Owned Enterprise Reform in Vietnam* (Singapore, Institute of South East Asian Studies, 1996), 19, at 19–24.

[32] According to official statistics, by 1960 most large scale private trading entities had converted to state or cooperative production, leaving a mere 12% of retail trade for small scale private traders.

collapse after reunification of the country in 1975,[33] state enterprise managers and rural communes (*xa*) increasingly based production and distribution on spontaneous market transactions that disregarded central planning directives.[34]

Post *doi moi* reforms

Confronted with a rapidly expanding private sector and moribund SOEs, the Communist Party of Vietnam (CPV) in 1988 reluctantly passed a resolution authorizing the formation of private commercial organizations.[35] The *Law on Companies* 1990 (LC) and *Law on Private Enterprises* (*doanh nghiep ta nhan*) 1990 (LPE) went further by legally recognizing private rights to "own the means of production",[36] "and lawfully generate profits from business".[37] These economic liberalizations were formalized in the 1992 Constitution and the 2001 amendments. In recognizing a multisector economy and the right of "individual economic entities and the private capitalist sector … to choose their forms of production and business" and operate in any business sector "not banned by law",[38] the new Constitution unambiguously repealed provisions in the orthodox socialist 1980 Constitution prohibiting private production.[39]

Other sources suggest a far greater role for private commerce. By the inception of *di Omi* over 40% of state production passed through private distribution channels and household production accounted for the fastest growing economic sector: see A Ford, "Law and Socialist Agricultural Development in Vietnam: The Statute for Agricultural Producer Cooperatives" (1994) 10 *Review of Socialist Law* 315, at 318–21; A Fford and S de Vylder, *From Plan to Market* (Boulder, Westview Press, 1996), 56–67 and 129–131; "The Non-State Trade Sector" [1996] *Vietnam Economic Review* 35; Vo Van Kiet, "Report to the National Assembly on the 1987 Socio-Economic Development Plan", Hanoi Domestic Service, 26 December 1986, *FBIS Asia and Pacific Daily Report,* 30 December 1986, K.9; TG McGee et al, "Household Economy Under Impacts of Economic Reforms in Vietnam" [1996] *Vietnam's Socio-Economic Development* 26, at 31–34 and 44–47.

[33] During the five-year plan from 1976–1980, food, coal, electricity, cotton and paper production only reached 69, 52, 72, 39 and 37%, respectively, of planning targets: see Vu Tuan Anh (ed.), *Vietnam's Economic Reform: Results and Problems* (Hanoi, Social Science Publishing House, 1994), 18.

[34] See Nguyen Nien, *supra* n.27, at 40–50; Dao Tri Uc, "Market and Law" [1994] *Vietnam Social Sciences* 18, at 19–21. See generally A Fforde and S Paine, *The Limits of National Liberation: Problems of Economic Management in the Democratic Republic of Vietnam* (London, Croom-Helm, 1987).

[35] Communist Party of Vietnam Resolution No 16 of 1988: Interviews with Phan Huu Chi, *supra* n.1.

[36] Law on Enterprises 1990, art 4.

[37] Law on Companies 1990, art 4.

[38] Constitution 1980, arts 18, 25, 26; Constitution 1992, arts 15, 21.

[39] Constitution 1980, arts 18, 25, 26; Constitution 1992, arts 15, 21.

DRAFTING CORPORATE LAWS

The Law on Companies 1990

Private commerce posed a regulatory dilemma for policy makers accustomed to suppressing spontaneous markets. The state urgently needed market entry and exit controls, uniform business organizational structures and incentives to mobilize domestic capital to counterbalance large foreign investment flows.[40] Lawmakers were reluctant to base companies rules on existing business practices, which were considered sub-optimal legislative models. Distorted by decades of state suppression, business practices were primarily structured to avoid, rather than reflect general normative standards.[41] The tendency of socialist laws to crowd out private interests made them unsuitable sources of market law.[42] Reluctantly the state asked foreign legal advisers for assistance.

Drafted with considerable French legal advice, the LC was passed by the Eighth Session of the Eighth Legislature of the National Assembly on 21 December 1990 and commenced operation on 15 April 1991.[43] Given the historical antipathy towards the French and their colonial legal system,[44] it is unclear why the drafting committee borrowed so heavily from French company law. The explanation provided by Professor Phan Huu Chi (a member of the drafting committee) that French civil law most closely corresponded with the Vietnamese civil law system is implausible, considering the Soviet origin of most Vietnamese laws, institutions and legal thinking. Others suggested that rather than compatibility, French trained drafters were attracted to company law models presented in a familiar language and legal style.[45]

Borrowing from the French *société anonyme*, the LC introduced shareholding

[40] The capital growth rate of foreign investment in the period following the enactment of the Law on Foreign Investment 1987 ranged between 47 and 132%: see Tran Dinh Thien, "Foreign Direct Investment in Vietnam" [1995] *Vietnam's Socio-Economic Development* 24, at 25.

[41] Traders designed business practices to evade government regulation during the orthodox socialist period when market transactions were actively suppressed by the state. Distorted by years of inhabiting a legal twilight, business norms and habits were considered sub-optimal sources of commercial law by Vietnamese legal drafters: Interviews with Dao Tri Uc, Director, Institute of State and Law, Hanoi, 1994–1999, and Phan Huu Chi, *supra* n.1.

[42] See Cooter, *supra* n.2, at 142 and 146.

[43] See V Senghor, "France Lends a Hand for Legal Overhaul" *Vietnam Investment Review*, 10 October 1993, 1; Interviews with Phan Huu Chi, *supra* n.1.

[44] The DRV vigorously suppressed colonial commercial principles and practices. In contrast to the treatment of colonial commercial law, civil and land laws were declared temporally valid by Order No 97 issued by President Ho Chi Minh on 22 May 1950. A Cirulare issued by the Ministry of Justice, 10 July 1959, formally abrogated French law: see Ginsburgs, *supra* n.24, at 192; Hoang The Lien, "On the Legal System of Vietnam" (1994) 1 *Vietnam Law and Legal Forum* 33, at 34; Interview with Le Kim Que, President, Bar Association of Hanoi, Hanoi, 9 July 1998.

[45] These comments are based on numerous interviews with two prominent French trained lawyers who drafted the Law on Companies 1990: Pham Huu Chi, *supra* n.1; Luu Van Dat, Legal Advisor to the Minister of Trade, Hanoi, January 1992 and November 1994.

companies (*Cong ty co phan*) and limited liability companies (*société à Responsabilité Limitée* or in Vietnamese *cong ty trach nhiem luu han*) to Vietnam.[46] With only forty-six articles the LC was a skeletal facsimile of the 509 provisions in the French Law No. 66-537 on Commercial Companies 1966. Despite its brevity, the LC contained most elements of modern company law. For instance, company members shared profits and losses in proportion to their capital contributions and were not personally liable for company debts.[47] Companies were entitled to own property and businesses and enter legally binding transactions.[48] Employing vague terminology, the LC separated the functions of, and powers bestowed upon, members, company officials and employees. Shareholding companies were authorized to issue shares and raise equity capital from the public.[49] The LC also contained basic rules governing company mergers and liquidations.

Discrepancies between Western and Vietnamese company rules were largely attributable to the influence of company law experiments conducted by Chinese lawmakers in Shenzhen and Shanghai during the 1980s.[50] These included strict state controls over market-entry and fixed term business registrations designed to limit the life of companies to periods rarely exceeding twenty years.

The Civil Code 1995

Without referring to the LC, the Civil Code 1995 enunciated four fundamental corporate elements. Companies must:

- be established or recognized by competent state authorities,
- possess an organizational structure,
- separate ownership, control and legal responsibility for assets, and
- possess the capacity to form legal relationships.[51]

In addition to limited liability and shareholding companies established under the LC, the Civil Code also described a broad range of juridical entities including those "established or recognized by authorities" (such as SOEs, army, party and Fatherland Front commercial organizations) as juridical entities (*phap nhan*).[52]

[46] Law No 66–537 on Commercial Companies 1966, ch IV.

[47] Law on Companies 1990, art 2.

[48] *Ibid*., art 12.

[49] *Ibid*., art 20.

[50] National company law was not enacted in China until 1993: see R Tomasic and Jian Fu, "Company Law in China" in R Tomasic (ed.), *Company Law in East Asia* (Aldershot, Dartmouth, 1999), 137–138 and 143–144.

[51] Civil Code 1995, art 94. The Vietnamese definition differs from its counterpart in General Principles of Civil Law (PR China), art 37, because it specifies the need for internal division of ownership and authority.

[52] Law on State Owned Enterprise 1995, arts 16 and 17; Civil Code 1995, arts 110–115.

Company law reform policy

In 1995, five years after its enactment, the Eighth Congress of the Central Committee of the Communist Party of Vietnam (CPV) decided that the LC required major amendments. Le Dang Doanh, the director of the Central Institute of Economic Management (CIEM) (a research organization attached to the Ministry of Planning and Investment) was appointed to lead the drafting committee. Three pivotal areas of reform were identified.[53]

1 Legal equality

Company law should comport with the Constitutional injunction that all economic sectors are equal before the law.[54] It will be recalled that the LC was drafted before the 1992 Constitution recognised a mixed-market economy. The drafting committee concluded that a uniform company law governing foreign, state and privately owned entities was the most effective means of achieving legal equality.[55] Their proposal was rejected by the party on the basis that legal equality would compromise the paramountcy of state owned enterprises (SOEs). Drafters were directed to retain legal divisions based on ownership and maintain separate legal regimes for SOEs, cooperatives, and private corporations.[56] This decision was widely perceived by legal-drafters as anomalous, for the Civil Code collapses legal distinctions between corporations based on ownership.[57] In separating state and private ownership, the party effectively preserved the socialist doctrine that treats all companies as administrative apparatus "owned" by the state.[58] Drafters were successful, however, in abolishing regulatory distinctions based on capitalization levels. Commercial entities with low capital levels were previously registered as "household" entities;[59] larger entities were licensed as unincorporated "private enterprises" (*doanh nghiep tu nhan*);[60] while entities with the highest capital levels were incorporated.

[53] See Le Dang Doanh, "Enterprise Law – A Must for Further Development of Multi-Sectorial Economy" [1999] *Vietnam Law and Legal Forum* 11, at 11–13.

[54] Constitution 1992, arts 15 and 21.

[55] Ministry of Justice, "General Report: Law of Enterprises of Different Forms in Vietnam" (UNDP Program VIE/94/003, 1997), 14–18.

[56] See Dan Duc Dam, "Administrative Reform-Changes to Meet the Requirements of the Market-Orientated Economy" in J Gillespie (ed.) *Commercial Legal Development in Vietnam: Vietnamese and Foreign Commentaries* (Butterworths, Singapore, 1997), 477, at 483–491.

[57] Interview with members of the Enterprise Law drafting committee, September 1999.

[58] See OS Ioffe, *Soviet Civil Law* (Dordrecht, Martinus Nijhoff, 1988), 34–46; S Lucas and Y Malter, "The Development of Corporate Law in the Former Soviet Republics" (1996) 45 *International Comparative Law Quarterly* 365, at 366–8.

[59] Decree No 66 on Individuals and Business Groups with Capital Lower the Legal Capital Set Out in Decree No 221/HDBT, 23 July 1991, 2 March 1992.

[60] Law on Private Enterprises 1990.

2 Legal harmonization

Foreign investors and multilateral organizations, such as ASEAN and the Asia Pacific Economic Cooperation Forum (APEC) urged the harmonization of the LC with company regimes in Vietnam's trading partners. Uncertainties surrounding corporate governance rules (directors' duties and rights of minority shareholders) and winding up provisions were targeted for reform. More fundamentally, foreigners complained that the LC did not apply to foreign investment entities. This had the affect of quarantining foreigners from the domestic market. They also argued that legal distinctions between foreign and domestic companies unnecessarily complicated business transactions and arbitrarily inhibited novel and adaptive ownership structures.[61] Resisting foreign lobbying, drafters refused to extend the company law to foreign owned investment companies.[62]

3 Economic changes

Drafted during the early stages of *doi moi* reforms, the LC contained socialist planning provisions that unduly restricted entrepreneurial activity. Some entrepreneurs complained that the "corporate law shirt" (*an so mi luat cong ty*) had not kept up with the "economic body" (*co the kinh te*).[63] The LC, for example, did not cover partnerships, shareholding in limited liability companies and the conversion of limited liability companies into shareholding companies. In short, the types of business organizations permitted under the LC did not cater to the needs of an increasingly sophisticated business community. Finally, some LC provisions were inconsistent with other laws. The Law on the Promotion of Domestic Investment, for example, permitted overseas Vietnamese to establish commercial enterprises in Vietnam, whereas the LC only conferred this privilege on Vietnamese citizens.[64]

Drafting the Enterprise Law

Although most agreed that the LC had not kept pace with economic development, differences of opinion concerning appropriate reforms emerged between the state and business community. Within the state orbit, CIEM legal drafters

[61] See Nguyen Thanh Binh, (1995), "Its Time to Amend the Law on Companies", *Saigon Giai Phong* (Saigon Liberation) 3 July 1995, 3 and 4; Xuan Bao and Nam Hong, "Problems in Implementation of the Law on Companies" *Dien Dan Doanh Nghiep* (Entrepreneur Forum), 28 September 1995, 11.

[62] See "Orientating to a Common Corporate Law", *Dien Dan Doanh Nghiep* (Entrepreneur Forum), 22 May 1998, 4.

[63] See Phan Van Tan, "Laws Should Predict New Economic Forms", *Kinh Doanh va Phap Luat*, 27 May 1998, 3. See also Dang Duc Dam, *supra* n.55, at 489–91.

[64] See Tran Huu Hiep, "May Y Kin Ve Luat Cong Ty" ("A Number of Opinions on the Company Law"), *Dien dan Doanh Nhiep* (Entrepreneur Forum), 12 January 1996, 10.

concluded that strict regulation of company formation and market entry procedures reflected command economic thinking that was inappropriate in mixed-market conditions. Other state organs, especially city/provincial peoples committees (local government) that faced losing business licensing powers, advocated limited technical changes. Deregulation of market entry procedures became a litmus test of the party-state's commitment to the constitutional guarantees of commercial freedom.[65]

State and domestic business commentaries on the draft EL were similarly polarized. Domestic investors were largely unconcerned with internal management rules, rights of minority shareholders and legal relations with third parties, and concurred with CIEM legal drafters that liberalized market-entry procedures were the most pressing requirements.[66] The strength and consistency of business opinion convinced some drafters that elaborate provisions regulating activities remote from every day commercial practice would counter-productively further isolate entrepreneurs from the law.

Disregarding these concerns, the Enterprise Law adopted by the National Assembly on 12 June 1999 comprehensively regulated corporations and, thus, bears little resemblance to the LC. Across one hundred and thirty-four articles, the EL borrowed from Western (principally Anglo-American) company law in regulating corporate governance, disclosure, members' rights (especially those of minority shareholders), directors, board of management and inspection board rights and duties, dividend payments, conversion among corporate entities, dissolution, merger, and liquidation.

There is compelling evidence that the trade-off between the technical sophistication of the EL and the ease with which it could be read and understood by corporate regulators, courts and entrepreneurs, favored foreign interlocutors. A release condition for the first tranche of the 100 million USD Financial Sector Development and Capital Market Loan advanced by the ADB, required five substantive company law reforms:[67]

- Market entry rules should be abolished allowing companies to enter any lawful area of business.
- Distinctions between domestic, state and foreign enterprises should be abolished enabling foreigners to incorporate as, and own shares in, domestic companies.
- The division of responsibilities between corporate managers and members

[65] Constitution 1992, art 21.

[66] See Dang Duc Dam, *supra* n.55, at 489–90; Ministry of Justice, "General Report: Law of Enterprises of Different Forms in Vietnam" (UNDP Program VIE/94/003, 1997), 20–21.

[67] See the reports written by the chief legal advisers appointed by the ADB: Chapman Tripp Sheffied Young, "Enterprise Law Reform – Some Issues and Some Suggestions" (1995); Interim Report, "Enterprise Reform Legal and Regulatory Issues" (ADB, 1997), 41–5. See also Research Report, "Improving Macroeconomic Policy and Reforming Administrative Procedures to Promote Development of Small and Medium Enterprises in Vietnam", (MPI-UNIDO Project, US/VIE/95/004, 1999), 99–101.

required greater clarity. Specific reforms promoted by foreign consultants included rules governing the functions of, and division of powers between directors and members, protection of minority shareholders, and a clearer statement of directors' duties.[68]

- The payment of dividends, mergers and winding up required more prescriptive regulation.
- Companies should provide accurate and timely information concerning directors, share registries and financial records to a central registrar.

Of the five ADB reforms, only the second condition concerning legal equality between foreign and domestic companies was rejected by the party-state.

Though it is too early to authoritatively ascertain the compatibility of the EL with Vietnamese sociopolitical structures, extensive research concerning the LC conveys some pertinent insights. The following discussion examines the reception of the LC and EL from the perspective of market-entry.

MARKET ENTRY IDEOLOGY

The first arm of Kahn-Freund's analytical framework evaluates congruence between transplanted norms and host country sociopolitical ideologies. This comparison draws heavily on Gramscian understandings of the relationship between ideology and law. In seeking explanations for law's capacity to order social and economic behavior in advanced capitalist states, Antonio Gramsci deduced that law is both ideologically constructed and a bearer of ideology.[69] Building on Gramsci's work, Poulantzas subdivided state or dominant ideologies into "moral, juridical and political, aesthetic, religious, economic, philosophical ideologies".[70] In his estimation, certain ideas or values located in the dominant ideology (which he termed *regions*) consistently influence state institutions and

[68] See R Kraakman, "Comments on the Proposed 'Law of Companies' March 1997 Draft" (UNDP Program, VIE/94/003, 1997), 4–7 and 10–15.

[69] Influenced by Lenin's belief that legal systems are integral to and characteristic of capitalism, many early Marxist writers emphasized the oppressive and coercive nature of law. As a Marxist, Gramsci worked through the Marxist base-superstructure metaphor and consequently located clusters of social interests, the way people make sense of the world, in and around economic relations. Marx's preoccupation with commodity relationships is not, however, a pivotal aspect of Gramsci's theories. They apply equally well to a broad range of social and psychological ordering phenomena, such as gender, race and social interests. Others argue that Gramsci's theories set up a legal system that oscillates between coercion and consent according to struggles between capital, labor and the state. Hunt, in particular, believes that hegemony results in an "undesirable bifurcation in our approach to law" since the relationship between coercion and consent is not adequately established. But this criticism forms part of the general failing of legal theory to account for the complex relationship between law and social change: see A Hunt, "Dichotomy and Contradiction in the Sociology of Law" in P Beirne and R Sharlet (eds.), *Selected Writings on Soviet Law and Marxism* (ME Sharpe, New York, 1982), 87–8.

[70] N Poulantzas, *Political Power and Social Classes*, (trans T O'Hagan, London, Sheed and Ward, 1973), 204–5.

economic behavior more powerfully than others. For example, the conversion of feudal serfs into wage earners and the expansion and consolidation of national markets under capitalism required a shift from the religious ideology of feudalism to the politico-legal ideology of capitalism. The new dominant ideology of universal, normative law weakened communitarian values and constrained the monarch's (or central state's) prerogative or discretionary powers to appropriate property and disrupt the contractual relations required for investment and labor markets.[71] According to Poulantzas, the dominant strand or *region* of Western legal ideology resides in liberal Lockean notions of liberty, equality, sanctity of property rights and atomistic individuals notionally free from, and equal to, one another.[72]

Western market-entry ideology

Company law draws from Lockean liberal ideology and together with property and contract law, it arose out of, and shaped the patterns of commercial activity in capitalist societies.[73] Prototype corporate organizations developed from chartered trading and shipping firms during the 1600s. Trading firms like the Dutch East Indies Company received their rights as independent legal entities from royal charters.[74] Each incorporation required a special statute. Charters granted separate legal identities for companies, directors (managers) and members, but not liability status. As state concessions, charters were only given to companies performing public benefits such as building railways, banking or pursuing foreign trade. States extracted high rents for these monopolistic concessions.

The concessionary treatment of companies persisted, until the doctrine of freedom of contract attempted to bring the privileged and corrupt power relationships—entrenchedduring the eighteenth-century—within greater control.[75] Echoing nineteenth century liberal notions of equality, contract law rejected claims to economic rights based on ideology, superior wealth or inherited rights,

[71] *Ibid*., at 205.

[72] Poulantzas further postulated that in capitalism the juridico-political ideology of the elite "not only justifies the direct economic interests of the dominant class but that above all it presupposes, composes or imposes the image of an 'equality' of 'identical', 'disparate', and 'isolated' individuals, unified in the political universality of the state/nation": Poulantzas, *supra* n.69, at 206. See also O Handlin and M Handlin, *Commonwealth: A Study of the Role of Government in the American Economy: Massachusetts, 1774–1861*: Cambridge, Belknap Press, 1969), 87 and 91–2.

[73] See D North, *Structure and Change in Economic History* (New York, WWNorton, 1981), 174; M Stokes, "Company Law and Legal Theory" in W Twining (ed.), *Legal Theory and Common Law* (Oxford, Basil Blackwell, 1986), 156–60.

[74] See D Sugarman, "Law, Economy and The State in England, 1750–1914: Some Major Issues" in D Sugarman (ed.), *Legality, Ideology and the State* (London, Academic Press, 1983), 218–9; R Tomasic, "Company Law and the Limits of the Rule of Law in China" (1994) 4 *Australian Journal of Corporate Law* 487.

[75] See Sugarman, *supra* n.73, at 240–2.

and instead promised the "efficient" allocation of resources according to market competition.[76] Corporate charters granting monopoly powers were first replaced in England, and later during the mid nineteenth century in Continental Europe, with company certification systems. Liberal ideology extolled entrepreneurs as the engines of capitalism; corporations became vehicles for harnessing capital and risk taking. Company formation, as a corollary, became inexpensive and freely available to anyone fulfilling routine registration procedures.[77]

The historical evolution of corporations evinces a close "coupling" between contractarian approaches to company formation and Lockean liberal ideology. As Thurman Arnold noted, the legal recognition of corporate personality enabled the "laissez faire religion, based on a conception of a society composed of competing individuals".[78]

Vietnamese corporate ideology

As the historical discussion intimated, until the 1990s companies were treated as either colonial or capitalistic artifacts standing outside indigenous experience and ideology. It is thus hardly surprising there are very few references to companies in the Vietnamese literature. Contrasting with the vigorous academic and popular debates about corporate law reform in China,[79] Vietnamese reforms passed virtually unchronicled. Most scholarly legal literature is preoccupied with narrow doctrinal issues like company law terminology, the efficacy of licensing and registration procedures and inconsistencies between corporate and commercial laws.[80] Occasionally, the vernacular press ventures beyond these narrow doctrinal parameters speculating whether corporate regulation stimulates or inhibits private investment.[81] Some articles denounce the fiction of separate legal personality from an orthodox socialist perspective that abhors private wealth accumulation. For example, the fraudulent use of "ghost companies" (*cong ty ma*) to defraud creditors attracts more media attention than the

[76] See H Collins, "Contract and Legal Theory" in Twining (ed.), *supra* n.72, at 136–41.

[77] See E Steindorft, "Legal Consequences of State Regulation" in T Borislav et al (eds.) *State and Economy*, *International Encyclopaedia of Comparative Law*, Vol XVII, (Tubingen, JCB Mohr, 1979), 8.

[78] See T Arnold, *The Folklore of Capitalism*, (Westport Conn., Greenwood Press, 1937 rep 1980), 185 and 189.

[79] For an overview of the vernacular literature, see Fu Tingmei, "Legal Person in China: Essence and Limits" (1993) 41 *American Journal of Comparative Law* 261.

[80] See generally Duong Dang Hue, "Phap Luat ve Viec Cap Giay Phep Thanh Lap Doanh Nghiep Dang Ky Kinh Doanh o Viet Nam: Thuc Trang va Mot Vai Kien Nghi" ("Legal Regulations in Relation to Issuance of Permits to Establish Enterprises and Business Registration in Vietnam: The Present Situation and Some Recommendations") (1994) 4 *Nha Nuoc va Phap Luat* (State and Law) 20; "Enterprises Operating Under the Corporate Law and the Law on Private Enterprise", *Thoi Bao Kinh Te Sai Gon* (Saigon Economic Times), 26 May 1996, 6–7.

[81] See, eg, Huy Duc, "Bi An Minh Phung" ("Minh Phung Mystery"), *Thoi Bao Kinh Te Sai Gon* (Saigon Economic Times), 24 April 1997, 36 and 38; "More Arrested as Size of Fraud Case Hits $700", *Vietnam Economic Review*, Database, 13 October 1997.

problem deserves.[82] More importantly, endless speculation in economic writings about the erosion of family values and community standards by market mechanisms (though no doubt active in the minds of legal drafters) is absent from legal literature.[83]

Vietnamese commentaries rarely engage Western jurisprudential analysis of legal personality.[84] Either oblivious to, or considering Western theories irrelevant, Vietnamese lawyers generally portray legal persons as institutions recognized by law.[85] There is little attempt to blend traditional Vietnamese or socialist precepts with Western corporate forms. The struggle in Western theory to justify the attribution of personal authority to abstract legal bodies is a non-issue in Vietnamese jurisprudence. Without a tradition of natural rights theory and individualism (*ca nhan chu nghia*),[86] it does not enter the legal consciousness that corporate rights require a source of legitimacy outside legislative and bureaucratic power; or that companies should be treated as human individuals, rather than state concessions. Since both natural and legal persons derive their legal capacity through state law, legal personality is considered a creature of state power.

Vietnamese lawmakers differentiate natural from legal persons along functional lines by reference to the independence of the latter from the former. Independence falls far short of western notions of a legal "mind", rather, it is explained as a separation of liability and property ownership. Never far below the surface is the Marxist concern that although company law disperses legal

[82] See, eg, Pham Thanh Khiet, "Thuc Trang Cua Kinh Te Ngoai Quoc Doanh O Quang Nam-Da Nang va Nhung Van De Can Giai Quyet" ("The Present Situation of the Non-State-Owned Economic Sector in Quan Nam-Da Nang and Problems to be Solved") [1995] *Nghien Cuu Kinh Te* (Economic Studies) 26, at 29–30; Phan Ngoc, "Invisible Companies", *Saigon Times*, 5 March 1997, 31.

[83] See, eg, Thanh Duy, "Family Culture and Market Economy in Vietnam" [1998] *Vietnam Social Sciences* 35, at 35–9; Anh Tuan Vu, "Law and Negative Aspects of the Market Economy" [1998] *Journal of Theoretical Studies* 26; Mai Huu Thuc, "Some Thoughts on the Process of Industrialization and Modernization in Our Country", *Tap Chi Cong San*, June 1994, 30–3.

[84] The literature in this area is vast: see SJ Stoljar, *Groups and Entities – An Inquiry Into Corporate Theory* (Canberra, Australian National University Press, 1973); AES Tay, "Introduction: The Juridical Person in Legal Theory, Law and Comparative Law" in AES Tay and Leuong (eds), "Legal Persons and Legal Personality in Common Law, Civil Law and Socialist Law' [1992] *Indian Socio-Legal Journal* 4; P Blumberg, "The Corporate Personality in American Law: A Summary Review" (1990) 38 *American Journal of Comparative Law* 49.

[85] See Nguyen Ngoc Tuan, "Renovating the Enterprise Model in Our Country", *Tap Chi Cong San* (Communist Review), December 1993, 29–33; Nguyen Nhu Phat, "Conceptions on the Legal Status of Entrepreneurs in the Market Economy" [1993] *Nha Nuoc va Phap Luat* (State and Law) 24, 25–7.

[86] For a detailed discussion about notions of individuality in Vietnam, see D Marr, "Concepts of 'Individual' and 'Self' in 20th Century Vietnam" (unpublished paper, 1999); M Sidel, "Vietnam: The Ambiguities of State-Directed Legal Reform" in Poh-Ling Tan (ed.), *Asian Legal Systems: Law, Society and Pluralism in East Asia* (Sydney, Butterworths, 1997), 356 and 360–363. See also Nguyen Duy Quy, "The Question of Building a State of Law in Vietnam" (1994) 1 *Vietnam Law and Legal Forum* 32, at 33.

ownership and control, economic ownership remains in the hands of the capitalist class. Through Soviet literature some Vietnamese legal theorists[87] are familiar with Berle and Means' classic study *The Modern Corporation and Private Property*. They find Marx's warnings about corporate capitalism echoed in the passage: "[t]he corporate system has done more than evolve a norm by which business is carried on. Within it exists a centripetal attraction which draws wealth together into the hands of fewer and fewer men."[88]

Company law as a concessionary privilege

Augmenting the meagre legal literature, legislation and state policy provide some valuable insights into Vietnamese corporate ideology. The LC, for example, is a hybridization of imported contractarian and socialist concessionary market-entry principles. In theory it permitted company founders to invest in any economic area, except seven sectors reserved for SOEs (LC, Article 11). Provided founders satisfied capitalization, education and health requirements, regulatory authorities were required to process applications within strict time limits and provide written explanations for rejections (LC, Articles 14-16). On balance, though, market-entry licensing criteria were considerably broader than those found in most Western jurisdictions. Although licensing is still widely used in the West (and especially in France and Germany), it is restricted to the protection of consumers from unscrupulous and unqualified finance and health service providers. The LC also provided mechanisms for appealing against unfavorable decisions. In sum, the surface meaning of the LC reflected imported Western contractarian market-entry ideology.

By narrowly restricting the permissible range of business activities, business licenses were used by the bureaucracy to "uniformly manage" private investment.[89] The general powers to pursue authorized objectives conferred on companies were quite extensive and included the capacity to raise capital, enter economic contracts, hire labor, use foreign currency and own land use rights, buildings, movables and intellectual property. But companies were not permitted to expand their business capacity by including a "shopping list" of associated or tangential objectives. For example, companies licensed to manufacture *phu* (rice noodles) were permitted to diversify into *mee* (wheat noodles), but not rice or wheat milling. The consequences for breaching business licenses, were, and continue to be, draconian. Ultra vires contracts are void and according to

[87] Interviews with Nguyen Nhu Phat, Director Center for Comparative Law, Institute of State and Law, February 1997, June and July 1998.

[88] AA Berle and GC Means, *The Modern Corporation and Private Property* (New York, Harcourt, 1968), 18.

[89] Vien Nghien Cuu Quan Ly Kinh Te Trung Uong (Central Institute of Economic Management) (CIEM), "Danh Gia Tong Ket: Luat Cong Ty va Kien Nghi Nhung Dinh Huong Sua Doi Chu Yeu" ("Review of the Current Company Law and Key Recommendations for Its Revision") (unpublished paper, Hanoi, January 1998), 100–1. Business licenses determined company "rights and obligations" – their legal capacity: see Civil Code 1995, art 96(1); Law on Companies 1990, art 13(1).

the seriousness of the breach, company officers face[90] administrative[91] or criminal sanctions.[92]

Contrasting with the tight control of companies, unincorporated household businesses registered under Decree No. 66 HDBT 1992 were not constrained by restrictive business licenses. They circumvented the prohibition against forming "economic contracts" for "income producing" property by transacting businesses through "civil contracts".[93] The theoretical division between licensed and unlicensed entities reflected classed-based morality that differentiated economic activity according to its exploitation of the "working class".[94] At one end of the spectrum, companies exploited the surplus value of workers and thus required strict "state management" to minimize social harm.[95] At the other end, small-scale household businesses employing family members were considered non-exploitative and were consequently trusted to pursue business opportunities without the shackles of business licenses.[96]

CIEM released an authoritative report showing that corporate regulators used licensing powers to transform the LC into an "asking-giving" concessionary market entry system. The threat of administrative and criminal penalties for license breaches engendered a psychology of compliance. It concluded that "[a]lthough the issue of state management has not been legally provided yet, in fact, there seems to be a view that state management or operating companies is a responsibility of line government bodies (line department, line ministries)".[97] That is, market-entry licenses were used by the state to "manage" corporate activities during the life of the company.

The available evidence strongly implies that business licensing profoundly disrupted the contractarian ideology embedded in the LC. The following discussion explores whether this means that Vietnamese legal ideology is

[90] Law on Companies 1990, art 44.

[91] Decree No 1–CP, Sanctions Against Violation of Administrative Regulations in the Field of Trade, 3 January 1996, art 4 (3) (Government).

[92] Penal Code 1986, art 168(1); Penal Code 1999, art 159.

[93] There is some confusion over the term "business registration". Most commentators believe that private enterprises are licensed, while small scale household traders registered under art 16 of Decree No 66 on Individuals and Business Groups with Capital Lower than the Legal Capital as Set Out in Decree No 221/HDBT, July 23, 1991 (2 March 1992), can only form economic contracts with legal entities: see Ordinance on Economic Contracts 1989, art 2. Private enterprises are unincorporated entities licensed to carry out specified business objectives: see Law on Private Enterprises 1990, arts 8, 12 and 13.

[94] The division of economic and civil contracts also retained the socialist distinction between income and non-income producing property: see generally A Harmathy, "Comparison in the Sphere of Economic Contracts" in I Szarbo and Z Peter (eds), *The Socialist Approach to Comparative Law* (Leyden, Sijthoff, 1977), 197–201.

[95] The bifurcation of economic and civil contracts also retained the socialist division between income and non-income producing property.

[96] Civil Code 1995, arts 17 and 394; Ordinance on Economic Contracts 1989, arts 1 & 2. See generally Duong Dang Hue, *supra* n.79, at 20.

[97] CIEM, *supra* n.88, at 103.

composed from different ideological *regions*, and by subverting contractarian ideology bureaucrats simply followed another official-line.

Reforming concessionary privileges

For a few years following the enactment of the LC, companies were registered and supervised by state economic arbitrators. Because they failed to evolve beyond their original role administering central planning contracts, their supervisory powers were devolved to provincial/city level, planning departments in peoples committees (local government). Some commentators interpret the consolidation of regulatory powers over companies in the same bureaucratic body (peoples committees), as the first tentative attempt to streamline state regulation of private companies. The next reform more significantly abolished discretionary powers over promoters' health and educational standards.[98] This liberalization aimed to minimize rent-seeking and other deleterious administrative abuses, without fundamentally dismantling concessionary powers.

Far-reaching market-entry liberalizations were eventually introduced when the EL substituted business licenses with a simple certification system. Article 7(2) of the EL gave effect to the constitutional right "to choose forms of production".[99] It permits enterprises "to select an industry, line [of business], area and form of investment and take the initiative to broaden the scope and line of business". Decree No 2 ND-CP 2000, implementing the EL unequivocally brought company formation procedures within the contractarian ideological orbit. It provides that "[t]o establish an enterprise and to carry out business registration in accordance with the law is the right of the people and of organizations, which shall be protected by the state".[100] This provision transmits a liberal market-entry ideology that contradicts concessionary thinking.

The ideological message is weakened, however, by incomplete reforms. Of an estimated two hundred and seventy licenses controlling market access, only eighty-four have been abolished.[101] Licenses also remain in key manufacturing, mining, tourism and various import/export sectors. In addition, private companies remain barred from economic sectors considered harmful to the public interest, such as national defense (Article 6(1)) and areas reserved for SOEs like telecommunications, transport and rice export. Even in areas open to private investment the state preferentially treats enterprises "carrying out business according to the orientation and targets of the strategies and plans of social and economic development" (EL, Article 114 (4)).

[98] Circular No 5, 10 July 1998, Ministry of Justice and Ministry of Planning.

[99] Constitution 1992, art 21.

[100] Decree No 02 2000 ND-CP on Business Registration, 2000, art 2(1).

[101] Decision No 19–2000–QD-TTg on the Revocation of all Types of Licences Inconsistent with the Provisions of the Law on Enterprises, 2000.

"Marrying" economic liberalism and state economic management?

Company law reforms suggest an inexorable progression towards contractarian market-entry ideology. This trajectory appears less certain when the analysis expands to consider the contested meanings of law. Though the focus of the party and state has shifted from class struggle to economic development, the Marxist metaphor of the base (mode of production) determining the superstructure (ideals, culture and law) is still alive in the minds of central policymakers.[102] The purpose of law in socialist ideology is to create a superstructure reflecting the "will of the ruling class" (*y chi cua giai cap thong tri*) and its domination over the means of production. Socialist legality (*phap che xa hoi chu nghia*), and its handmaiden "state economic management" (*quan ly nha nuoc kinh te*), requires state organs to "manage" (*quan ly*) legislative norms.[103] Law is ultimately regarded as a management tool to protect the working class from "exploitative" private ownership.[104]

Sitting comfortably with Poulantzas' postulation that dominant ideologies are comprised of multiple ideological strands or *regions*, socialist legality (*phap che xa hoi chu nghia*) overlays the law-based-state doctrine (*phap quyen nha nuoc*).[105] Introduced by the Seventh Communist Party Congress in 1991, the law-based-state (*phap quyen nha nuoc*) stresses stable, authoritative and compulsory law, equality of economic sectors before the law, and a shift from bureaucratic to normative economic regulation.[106] Contrasting with the

[102] Applying a historical-materialist analysis, society passes through various stages of development during its transition to advanced socialism. According to the Communist Party, Vietnam is currently traversing state-capitalism, where a dominant state sector co-exists with private ownership. In this mixed economy, private ownership is tolerated provided it does not disrupt state economic management and "collective mastery" – state and collective ownership.

[103] "The characteristics of our laws are different from those of bourgeois laws. Our laws are aimed at developing our nation in accordance with the socialist orientation while the laws of the bourgeois state are aimed at protecting capitalism": "Resolution 7, Mid-term Congress Resolution, Part V", *Saigon Giai Phong* (Saigon Liberation), 19 March 1994, 2; Vu Oanh, "Developing Combined Forces in Mass Motivation Work and Renovating the Work Content and Method of the Fatherland Front and Mass Organizations", *Nhan Dan* (The People), 23 December 1993, 3; Do Phuong, "Party-State-Law" (1995) 1 *Vietnam Law and Legal Forum* 3, 3–5; Do Muoi, "Building and Perfecting the State" (1995) 1 *Vietnam Law and Legal Forum* 6. It should be noted that arts 11 & 12 of the Constitution not only demand official obedience to the law, but also require citizens to observe the law and assist the state to observe the law.

[104] For a description of the relationship between Marxist-Leninist economic theory and state regulatory policy, see Doan Trong Truyen, "Market Economy and State Management" [1997] *Vietnam Social Sciences* 10, at 10–12.

[105] The law-based-state is based on the Soviet *pravovoe gosudarstvo*. The term was first used in the Soviet Union 19th Party Conference in 1988 and was added to *perestroika*, *glasnost and demokratizatsiia* as principles of the "new thinking": see HJ Berman, "The Rule of Law and the Law-Based State (Rechtsstaat)" in *Towards the "Rule of Law" in Russia?* (Dortmund, Martinus Nijhoff, 1992), 43, at 50–52.

[106] This new terminology first appeared in a speech made by Do Muoi at the 7th Party Congress in 1991: see *Sua Doi Hien Phap Xay Dung Nha Nuoc Phap Quyen Viet Nam Day Manh Su Nghiep Doi Moi* (Amending the Constitution, Establishing a "law based state" and Promoting Doi Moi Achievements) (Hanoi, The World Publishing House, 1992), 30, 32–3 and 37.

concessionary ideology of "state economic management", the "law-base-state" promised immutable legislative norms investing entrepreneurs with rights to determine where and how to allocate resources.[107] At issue is whether private commercial freedoms penetrate core Marxist-Leninist precepts, or are merely pragmatic surface adaptations leaving underlying values unchanged.

The enormous effort invested by Vietnamese party theorists in selectively plundering Marxist-Leninist and Ho Chi Minh canon to reconcile socialism with market-liberalism, implies that core socialist ideology remains inviolable. Some theorists confidently assert, for example, that "[c]ommodity production is not the opposite of socialism…on the contrary it is essential to building socialism".[108] Others opine that private capital, market price mechanisms and SOE privatization are "a waiting room for socialism". Theoretical debates occasionally challenge the relevance of Marxist-Leninism to contemporary East Asian conditions, but invariably reaffirm the "timelessness" of historical materialism, surplus value and the mission of the working the class.[109] Though differing in detail, these accounts identify "state economic management" as the central organizational principle in the "socialist-orientated multi-sector economy operating under the state-managed market-mechanisms" (*Kinh Te Thi Truong Theo Dinh Huong Xa Hoi Chu Nghia*).[110]

Still, others contend that economic reforms were a misconceived attempt to combine socialist morality with capitalist productivity and that "the marriage of a private sector and a 'socialist orientation' is one of convenience, not true love. Therefore, it is inevitable that the two economic partners must always be suspicious of one another."[111] Market-entry deregulation was only countenanced, according to this view, because concessionary restrictions impeded the capacity of private entrepreneurs to employ Vietnam's proliferating unemployed.[112]

[107] Unlike Western European notions of "rule of law", *rechtsstaat* developed in authoritarian Prussia. As an extreme form of positivism, *rechtsstaat* promotes the implementation of state policy through legislation, and de-emphasizes social customs and precedents that might check political and bureaucratic power: see Berman, *supra* n.104, at 46–47.

[108] Vu Son Thuy, "Interview With Politburo Standing Board Member Nguyen Tan Dung, Head of the CPV Central Committee Economic Department: New Year Discussion on Economic Issues", *Hanoi Tuan Quoc Te*, 16 February 1997, 1, at 2.

[109] See Tran Quang Nhiep, "Symposium on Marixism-Lenism and Our Era", *Tap Chi Cong San*, December 1993, 61, at 62.

[110] See Luu Ha Vi, "Vietnam: Industrialization Viewed from the Interplay between Productive Forces and Relations of Production", *Economic Development Review*, January 1997, 1, at 1–4; Nguyen Phu Trong, "Market Economy and the Leadership of Role of the Party", *Tap Chi Cong San* (Communist Review), January 1994, 29, at 29–33.

[111] Webster, *supra* n.10, at 15.

[112] Party theorists believe that unemployment rates of eight to ten million by 2001 present a massive social problem that can not be resolved by SOEs: Interview with Le Dang Doanh, Director Central Institute of Economic Management, Hanoi, March 2000; and with Vu Duy Thai, Vice Chairman and Secretary The Hanoi Associations of Industry and Commerce (member of the Central Committee of the Fatherland Front), Hanoi, April 1999, February 2000.

Party-state narratives suggest that imported market-liberalization ideology is treated as an optional adjunct to commercial legislative reform. Socialist legality is sufficiently nebulous to co-exist with, co-opt, and neutralize ostensibly incompatible ideological *regions* like market liberalism. Though some change seems likely, the evidence does not clearly indicate whether core socialist principles have been altered by their proximity to Western liberal values. The evidence does, however, strongly suggest that contractarian market-entry principles imported by the LC, and strengthened in the EL, function as a subordinate ideological *region* within the dominant socialist legality.

Kahn-Freund's analytical framework suggests that the reception and implementation of company law is most likely in the areas where imported liberal ideology comports with the dominant Marxist-Leninist ideology. Ideological compatibility is most likely in technical areas, such as company reporting, internal management, rights of minority shareholders, and is least probable in matters concerning the allocation and ownership of resources and market-based competition. As socialist ideology gradually gives way to other ideological *regions* considered more conducive to economic development, corporate principles will presumably gain wider acceptance.

Since market-entry is primarily determined by discretion, ideological compatibility also depends on the "legal culture" of corporate regulators. This observation shifts the discussion from ideology to the precepts, habits and rituals informing corporate regulators.

BUREAUCRATIC CULTURE AND CONCESSIONARY PRIVILEGES

This section explores Kahn Freund's second proposition that host country bureaucratic legal culture critically affects the reception of imported legal ideology. Legal culture is used in this discussion to mean the "specific way in which values, practices, and concepts are integrated into the operation of legal institutions and the interpretation of legal texts".[113] Functioning as a specialized component of institutional culture, legal culture influences institutional perceptions of rationality, efficiency and merit.[114] The following discussion revolves around two presumptions: that legal culture underlies the structure and function of laws, and that these precepts reinforce or undermine transplanted statutory law.[115]

[113] J Bell, "English Law and French Law – Not So Different?" (1995) 48 *Current Legal Problems*, 63 at 70.

[114] *Ibid*. See also JE Rouse, "Perspectives on Organisational Culture: An Emerging Conscience for Public Administrators?" (1990) 50 *Public Administration Review* 480.

[115] Scholars from every field of legal theory, including comparative law, philosophy, sociology, anthropology and the history of law, have studied legal cultures: see, eg, HJ Berman, *Law and Revolution: The Formation of the Western Legal Tradition* (Cambridge Mass, Harvard University Press, 1983). See also Legrand, *supra* n.5, at 56–60; and S Macaulay, "Popular Legal Culture: An Introduction" (1989) 98 *Yale Law Journal* 1545.

Administrative structures affecting corporate regulation

Bureaucratic culture is deeply conditioned by the organizational structures shaping the decision-making environment. Vietnam is constitutionally divided between central (ministries) and local executive bodies (provincial/city people's committees). Central authority is decentralized (*phan bo*) through branch (*nganh*) and true vertical (*doc*) center-local power sharing.[116] For example, the LC devolved business licensing power to functionally specialized, industry departments (branches) attached to people's committees (*uy ban nhan dan*), but delegated registration powers to local level planning departments. In abolishing business licenses, the EL withdrew industry department powers, while leaving company registration with planning departments (Article 12).

The dual lines of accountability in the branch system generate tensions between central ministries enacting and supervising company legislation, and "branch" (*nganh*) people's committee departments implementing rules. Disagreements and uncertainly are partially attributable to provincial localism (*dia phuong chu nghia*). Branch administration amplifies central-local tensions, by undermining the capacity of central authorities to control conferred authority (*uy quyen*). There are two aspects to the problem. First, fragmented and contradictory subordinate legislation coincidentally delegates (*thua uy*) broad discretionary powers to branch officials. Secondly, the branch system generates divided loyalties. Although central bodies supervise and fund local branches, powers delegated to branches are filtered through powerful horizontal patron-client obligations within people's committees. People's committees reward staff loyalty with promotions, salary increases and improved accommodation and conditions.

What little is known about local level bureaucracies implies ambivalence (even hostility) towards central laws and authority. Some informants describe an implausible state management model where local officials meditatively implement central law and policy to order society. Others perceive central law and policy as remote and out of touch with regional issues and believe they owe a "higher" duty to "take the people as the root" (*lay dan lam goc*). By this they mean bureaucrats must ensure that state power produces beneficial or realistic outcomes for the public. Where central laws and policies do not address local understandings of reality (*cuoc song*), some officials believe they are obliged to "soften" law (*luat mem*) to suit local conditions.

There is little evidence that the law-based-state ideology is understood by local officials to mean that laws are immutable. On the contrary, the following case studies imply that the doctrine of "state economic management" has a powerful grip over the bureaucratic consciousness.

[116] Constitution 1992, arts 112, 118 and 124.

Company formation case studies

Incorporation procedures under the LC

Under the LC, company formation required approval from two state authorities. In the initial business-licensing step, founders submitted details of company officials, members, capital contributions, feasibility plans and health and education records to provincial/city people's committees.[117] Corporate regulators controlled market-entry in ways never contemplated by the LC. Discretion over capital adequacy, educational qualifications and even health, were routinely used to discourage or change unacceptable investments.[118] In the second registration step, promoters were required to register with provincial planning departments.[119] Although these bodies were only authorized to verify procedural compliance, in practice they frequently revisited the merits of applications.[120]

Educational qualifications case study

The improper use of market entry criteria is illustrated by the incorporation of Cong Ty T. D. in 1998.[121] Ho Chi Minh City People's Committee officials initially rejected the application to incorporate this financial service company on the grounds that the promoters lacked university qualifications specializing in microeconomics. Since the principal promoter worked for over thirty years as the chief accountant of a large SOE, and other promoters had extensive professional experience, informants speculated that Finance Department officials used educational qualifications as a pretext to reject the application. Consistent with this interpretation, Officials opined that state-banks should only advance loans according to government policy directives (state economic management) and the soundness of business plans and creditworthiness. Financial consultants were perceived as meddlesome intermediaries hindering state financial "management". Eventually officials relented when the promoters provided free training courses for officials to explain differences between macro and microeconomics. Guidance from the Ministry of Finance also changed local opinions.

Legal capital case study

Peoples Committee officials frequently refused to incorporate businesses with

[117] Circular No. 472 1993, arts 5 and 6 (Ministry of Justice).

[118] For a general criticism of pre-incorporation discretion, see CIEM, *supra* n.88, at 36–42.

[119] Law on Companies 1990, art 16; Joint Circular No. 5/1988/TTLT-KHDT-TP Guiding the Establishment and Business Registration Procedures for Private Enterprises and Companies Part II 1998, arts 1 & 2.

[120] Circular No. 5 UB/TT-LB Providing Guidance on the Functions, Tasks and Organization of Planning Committees of Provinces and Cities, 1995 (SPC and Government Organization and Personal Committee).

[121] This information is gleaned from interviews with domestic Vietnamese lawyers involved in the application. A version of this case study is reported in MPI-UNIDO, *supra* n.10, at 79–80.

novel or unusual objectives. Consider an application to incorporate a musical promotion company by a group of famous artists. Rather than educational qualifications, the Hanoi People's Committee refused the application on the grounds that Decree No 222-HDBT 1992 did not specify the legal capital required for music promotion companies. Applying the concessionary approach to market-entry, the officials contended that "since the law does not specifically provide a legal framework for such business activities, it means that people are not allowed to do such business".[122]

Economic priority case study

State edicts mandating priority to certain economic sectors are another powerful force shaping bureaucratic attitudes to company formation. The Regulations Making Detailed Provisions for a Number of Articles in the Company Law 1991, for example, established market-entry mechanisms designed to encourage private investment in manufacturing, agriculture, transport repair and handicrafts.[123] Though economic priorities have changed over time, they are primarily designed to direct private capital away from service industries such as retailing, restaurants and entertainment into industrialization and technical modernization - the twin state developmental objectives.[124]

Some measure of the extent and depth of the procedural barriers to the service sector are evinced by the incorporation of Song Thu Ltd, a company established in Ho Chi Minh City to operate a mini-hotel. Incorporation took eight months. During this time promoters submitted forty documents, requiring eighty three official seals and one hundred and seven signatures from twenty six different official bodies.[125] Complex procedures inflate the cost of incorporation from approximately USD 150 in Korea and Singapore to USD 1,000-10,000 in Vietnam.

Overcoming formidable procedural barriers, statistics indicate that most private companies operate in the service sector.[126] Informants attribute this counterintuitive outcome to systemic bribery of state officials and the domination of industrial sectors by SOEs. Indeed, some believe that complex procedural rules exist primarily to extract rents. This historically rooted regulatory

[122] This passage is quoted from a letter sent by the Hanoi Peoples Committee to the law firm acting for the artists.

[123] Regulations Making Detailed Provisions for a Number of Articles in the Company Law 1991, art 6. The Law on the Promotion of Domestic Business 1994 and Law on the Promotion of Domestic Business 1998 have superseded this provision.

[124] See generally CIEM Report s*upra* n.88, at 33–4.

[125] These comments are based on interviews with Vietnamese Legal practitioners. More typically 8 to 10 documents were required for each of the two stages of incorporation. Accordingly, applicants must attend licensing authorities approximately 40 times: see CIEM, *supra* n.88, at 30–1.

[126] See Hoang Minh Ha, "Non-State Economic Sector in Ho Chi Minh City: Actual State and Problems" [1999] *Vietnam Economic Review* 33, 33–34.

technique is encapsulated by the evocative Vietnamese proverb, "storks grow fat in muddy waters" (*dut nuoc beo co*).

Bureaucratic responses to market–entry reforms

Circular No 5 of July 1998 introduced the first tentative shift towards a contractarian market-entry regime by abolishing education and health standards in company formation procedures. A CIEM investigation conducted six months after its introduction found that most corporate regulators were still applying the repealed procedures.[127] The Circular failed to change company formation procedures, much less bureaucratic perceptions regarding the use of discretionary power proactively to regulate companies. CIEM investigators concluded that an institutional culture that holds officials morally, if not legally, responsible for corporate criminality and business failures perpetuates a state managerial culture.

Deeply engrained managerial attitudes are also evident in official responses to business license deregulation under the EL. When the Ho Chi Minh City People's Committee experimentally issued broad business licenses in 1998 authorizing some companies to engage in "the textile and clothing trade" and "general manufacturing",[128] instead of stimulating commercial autonomy, many companies sought more restrictive and precise license conditions. This counterintuitive response is explained by a representative incident. A company licensed to "trade in consumer goods" was fined by *ban quan ly thi truong* (market control board) for selling televisions. The administrative order classified televisions as luxury, rather than consumer, goods. The company returned to the People's Committee Industry Department requesting a license specifying each permitted trade item. Cases like this have convinced some informants that as licensing gateways close, the locus of "state economic management" simply migrates to economic policing.[129]

Insufficient time has elapsed to accurately assess bureaucratic reactions to the EL, though early responses unsurprisingly indicate that legislation only gradually changes deeply conditioned precepts and practices. Consider, for example, the deregulation of food safety and hygiene licenses in Ho Chi Minh City (HCMC). Before deregulation, HCMC People's Committee food safety inspectors incorporated food hygiene standards into license conditions. In addition to generating negative outcomes, such as regulatory discrepancies and corruption, proactive market-entry controls preserved standards by excluding inexperienced and recidivistic entrepreneurs from the market place. For example, the HCMC

[127] Nguyen Dinh Cung, "New Business Entry Survey", unpublished CIEM Report (1999), 1–3.

[128] These comments are based on interviews with Vietnamese private legal practitioners in Ho Chi Minh City during July 1998.

[129] These findings were reported by Nguyen Dinh Cung in an internal memorandum prepared by CIEM in March 1999 that discussed the effects of prior liberalizations of the business-licensing regime.

People's Committee was unprepared for license deregulation and six months after the EL commenced it had not passed guidelines implementing central food safety and hygiene regulations.[130] Informants report that in the regulatory vacuum officials arrogated discretion to "manage" market entry. Typically this involved applying indirect pressure to modify, delay or withdraw unacceptable company formation applications. Officials, for instance, delayed processing documents, charged excessively for land use rights (*quyen su dung dat*), utility tariffs and imposed highly restrictive environmental, fire and building controls.[131] Similar responses are expected in other areas where deregulation threatens public safety, such as the abrogation of environmental and finance brokerage licenses.

A recent case study from Hanoi suggests that in some circumstances market-entry liberalizations have the capacity to induce bureaucratic change. A retired police captain attempted for several years to incorporate a private detective agency. The Hanoi People's Committee rejected his applications, stating that the Ministry of Police had not issued guidelines regulating this type of company. After several rejections, the applicant invoked Article 6 of the EL, which permits entrepreneurs to form businesses in any sector not specifically prohibited by law. Since the Ministry of Police had not prohibited private detective agencies, this sector was open to private investment. Eventually, the applicant prevailed and the *Cong Ty Dieu Tra Ha Noi* (Hanoi Inspection Company) was incorporated.[132]

More generally, market-liberalization ideology has so far failed to deeply penetrate central level ministries. Undeterred by losing licenses during the current deregulatory cycle, the Ministry of Information and Culture intends to license the performance of folk music to foreigners.[133] Other ministries have continued applying abrogated licenses. Ministry of Transport officials, for example, instructed HCMC City People's Committee officials to apply some licenses three months after they were abolished by Decision No 19 QD-TTg on the Revocation of all Types of Licenses Inconsistent with the Provisions of the Law on Enterprises 2000.

[130] *See* Nguyen Van Cam, "Business Beat", *Vietnam News*, 2 February 2000, 2. The Ministry of Health issued Decision No. 4196 QD-BYT Promulgating Regulations on Food Quality, Hygiene and Safety, December 1999.

[131] These practices have been observed where ever legislation does not devolve explicit authority: see Ngu Phong, "From Factories to Construction Sites", *Nhan Dan* (The People), 26 January 1996, 2.

[132] Interestingly, the Peoples Committee rejected the preferred company name Cong Ty Tham Tu Tu Ha Noi (Hanoi Detective Company) on the grounds that it invoked unacceptable capitalist images.

[133] *Vietnam Investment Review*, 3 March 2000.

Conceptualizing bureaucratic culture

Tracing the origins of bureaucratic culture

Cultural disdain for entrepreneurs predates socialism. The Confucian saying, "[e]mphasize agriculture, commerce is peripheral" (*trong nong mat thuong*), epitomized an imperial policy that inhibited the emergence of large-scale commercial organizations independent of Royal patronage and particularistic linkages.[134] During the late colonial period a tiny group of literati embraced entrepreneurialism, but their objective was Vietnamese nationalism rather than wealth creation.[135] After independence, neo-Confucian anti-mercantilism fused with socialist class theory profoundly shaping the contours of bureaucratic culture.

Economic production in the command economy resided in dual, but interwoven systems. One system operated as a facsimile of soviet central planning.[136] Line-ministries and people's committees regulated production through administrative directives that allocated raw materials according to quantitative planning targets. Products were released through state-managed distribution networks. As Burawoy and Lukacs observed in Eastern Europe, ideology is vital to the functioning of socialism because it legitimizes a system that appropriates assets in everyone's best interest.[137] Like other Stalinist states, the Vietnamese government devoted considerable resources manufacturing ideological compliance.[138] In addition to periodic ideological campaigns, the state used incentives - like housing and consumer goods - to reward displays of ideological loyalty. Officials were encouraged to hide bourgeois backgrounds and dedicated themselves to socialism.

The other economic system produced spontaneous markets that co-existed with, and infiltrated, state distribution networks. Commercial incentives for unauthorized private production and distribution were extremely potent. Officials estimate that by 1986 less than forty per cent of manufactured consumer goods passed through state-trade networks.[139] The resultant economic duality deeply influenced bureaucratic perceptions of Marxist-Leninist ideology.

[134] See Reid, *supra* n.15, at 62–77.

[135] See D Marr, *Vietnamese Tradition on Trial 1920–1945* (Berkeley, University of California Press, 1981), 122–123.

[136] See Nien, *supra* n.27, at 33–43. See also A Fforde and S Paine, *The Limits of National Liberation: Problems of Economic Management in the Democratic Republic of Vietnam* (London, Croom-Helm, 1987).

[137] See M Burawoy and J Lukacs, *The Radiant Past: Ideology and Reality in Hungary's Road to Capitalism* (Chicago, University of Chicago Press, 1992), 82–5.

[138] See Thaveeporn Vasavakul, "Vietnam: The Changing Models of Legitimization" in M Alagappa (ed.), *Political Legitimacy in Southeast Asia: The Quest for Moral Economy* (Stanford, Stanford University Press, 1995) 257–289.

[139] Vo Van Kiet, "Report to the National Assembly on the 1987 Socio-Economic Development Plan", Hanoi Domestic Service, 26 December 1986, *FIBIS* Asia and Pacific Daily Report, 30 December 1986, 9.

The class-based morality tolerated small-scale household producers, but demonized large-scale private producers, imbuing bureaucrats with an antipathy to private traders and respect for the state economic sector.[140] At the same time bureaucrats were encouraged to believe that socialist ideology expressed reality, officials lived in a world where family and friends profited from private markets.[141] The ensuing ideological ambivalence and cynicism was exacerbated by *Doi Moi* reforms that required the guardian of socialism (the state) to defend- even create - markets.[142]

Research indicates that market liberalizations have not fundamentally changed an underlying antipathy to the private sector.[143] A recent survey showed that many bureaucrats accept media depictions of private entrepreneurs as incompetent, and probably fraudulent and corrupt.[144] Media commentators routinely speculate that:

> this sector bears the latent danger of bankruptcy and hides a lot of unhealthy activities, ie giving shelters to foreign offices … Many enterprises, following establishment only declare the prescribed capital equal to the legal capital and afterwards increase their operating capita in the form of a "debenture" to gain tax deductions.[145]

Officials surveyed were convinced that most companies engaged in some form of illegal activity, especially tax evasion, and many were established as *cong ty ma* (ghost companies) for the sole purpose of fraudulently raising capital from state banks.[146]

Finally, bureaucrats were primarily recruited for "morality and talent", rather then technical proficiency.[147] Their training in former Eastern Block countries provided a sound grounding in public law concepts underpinning bureaucratic law, but few of the theoretical and cultural tenets of Western market-liberalism

[140] See Vo Dai, "Renovation of the Ownership Structure in Vietnam in the Shift to a Market Economy", *Economic Problems*, No 17, July-August 1992, 2, at 4–5; Dang Phong, "The Private Sector: In Vietnamese Industry from 1945 to the Present", *Vietnam's Undersized Engine: A Survey of 95 Larger Private Manufacturers*, MPDF Discussion Paper No. 9 (Hanoi, 1999) 73, at 78–80.

[141] See G Porter, *Vietnam: The Politics of Bureaucratic Socialism* (Ithaca, Cornell University Press, 1993), 130–131; and Interviews with officials from the Hanoi and Ho Chi Minh Peoples Committees, April and September 1999.

[142] See A Fforde and S de Vylder, *From Plan to Market* (Boulder, Westview, 1996), 268; Do Nguyen Phuong, "On the Phenomenon of Social Stratification in Our Country at Present", *Tap Chi Cong San* (Communist Review), May 1994, 30–4.

[143] See Dang Phong, *supra* n.139, at 15–16. Also see Bui Tuong Anh et. al., "Doing Business Under the New Enterprise Law", Private Sector Discussion Paper No. 12, (MPDF, Hanoi 2001), at 20–21.

[144] See Dang Phong, supra n.139 at 14–15.

[145] "Enterprises Operating Under the Company Law and the Law on Private Enterprises", *Thoi Bao Kinh Te Vietnam* (Vietnam Economic Times), 15 May 1996, 3.

[146] See Phan Ngoc, "Invisible Companies", *Thoi Bao Kinh Te Vietnam* (Saigon Economic Times), 3 March 1997, 31.

[147] See Tuong Lai, "The Issues of Social Change after Ten Years of Doi Moi in Vietnam" in A Fforde (ed.), *Doi Moi: Ten Years After the 1986 Party Congress*, Political and Social Change Monograph 24 (Canberra, Australian National University, 1997) 181, at 195.

embedded in imported company law principles.[148] Soviet-style education and ideology, placing the state at the centre of society, inculcated state officials with an unqualified confidence in their ability and moral mission to manage society. Known as "manage to manage" (*quan ly de quan ly*), state managerialism is often treated as an objective in its own right, independent from economic, much less legal imperatives.

State managerialism and market-entry deregulation

Open textured legislative drafting devolved broad discretionary powers to corporate regulators, blurring distinctions between central and local rules, ideologies and precepts. To some extent the problem is common to all bureaucracies, as none function as Weberian archetypes meditatively following prescribed laws.[149] A propensity to manage seems to characterize bureaucratic organizations the world over. But in Vietnam there is a dimension to managerialism infrequently encountered in Western countries. Since socialist legality treats law as management tools (*cong cu quan ly*) that are interchangeable with state policy directives, where imported company law comports with policy it must be followed, and where there is ambiguity bureaucrats are required to favor policy. In reality, however, it is rarely clear whether bureaucrats bending company laws are acting contrary to conferred authority (*uy quyen*) or are legitimately using extralegal means to implement state policy. The conundrum lies in determining which policy (central, local, or particularistic) they should follow.

Corporate regulators are socialized by their local cultural and political matrix. Local social pressures are especially acute where central policies, rules and procedures are vague, changeable and place different emphases on local, commercial precepts and practices. Given the bureaucratic antipathy to private enterprises and deeply engrained belief in a moral obligation to "manage to manage," local corporate regulators are likely to view imported contractarian market-entry rules that break down monopolistic privileges invested in SOEs, stimulate the private sector, and worse still reduce rent-seeking opportunities as culturally alien and inappropriate. From a central perspective, local "cultural" attitudes may seem obstructionist, even corrupt.

Central authorities regard local rule bending as an integral component of the state economic management. It suits all levels of government to sanction a degree of unofficial activity, since this invests authorities with broad administrative controls over areas that are technically outside their legal framework. In this

[148] See generally M Sidel, "Legal Reform in Vietnam: The Complex Transition from Socialism and Soviet Models in Legal Scholarship and Training" (1993) 11 *UCLA Pacific Basin Law Journal* 226–228.

[149] See M Weber, "Bureaucracy" in HH Gerth and C Wright Mills (eds), *From Max Weber: Essays in Sociology* (New York, Oxford University Press, 1946) 196–244; C Morris, *The Cost of Good Intentions* (New York, WW Norton, 1980), 22–4.

arrogated legal space, corporate regulators develop the precepts and principles that reconcile imported legal concepts with action on the ground. If central authorities uniformly perceived violations of company formation processes as malfeasance, then in time retraining programs could bring bureaucratic culture in-line with contractarian values. According to Kahn-Freund's analytical framework, the resulting convergence would increase the probability that company formation procedures were internalized and implemented by bureaucrats. At the same time, however, the central state uses bureaucratic discretion to localize imported corporate rules. This "fuzzy legality" allows bureaucrats to filter imported rules through "cultural" values, a process that produces new and novel adaptations of corporate law.

MARKET ENTRY AND VIETNAMESE RELATIONAL CONFIGURATIONS

Relational networks

The third arm of Kahn-Freund's analytical framework concerns the role of organized interest groups in supporting and maintaining imported law.[150] He speculated that both economic and non-economic interest groups, such as unions, employer associations, religious organizations, political parties and family structures, influence and/or contribute to legal development. The degree of coupling between law and society, he posited, is partially determined by the extent to which legal rules owe their existence and support to particular interest groups.

Following Kahn-Freund's work in the 1970s, legal research exploring relational contracting flourished. Macaulay and Macneil[151] convincingly demonstrated that non-state relational connections shape the development and implementation of law. They found, for example, that simple "one-shot" transactions require little ongoing cooperation and generally conform to the contractual ideal of offer and acceptance. Long-term transactions, on the contrary, required sustained organizational cooperation through relational links between contracting parties. Relational networks are even more important to the internal and external organization of complex commercial institutions like companies. Linkages include internal arrangements between managers, shareholders and employees; market transactions with suppliers, distributors and purchasers.

[150] See Kahn-Freund, *supra* n.11, at 12.

[151] See S Macauly, "Non-Contractual Relations in Business: A Preliminary Study" (1963) 28 *American Sociology Review* 55; IR Macneil, "Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law" (1978) 72 *North Western University Law Review* 854, 890–900. In the context of Asian business, see J Kaufman Winn, "Relational Practices and the Marginalization of Law: Informal Financial Practices of Small Businesses in Taiwan" (1994) 28 *Law and Sociology Review* 193, 193–215; F K Upham, "Relational Practices and the Marginalization of Law" (1994) 28 *Law and Sociology Review* 241; JO Haley, "Relational Contracting: Does Community Count?" in H Baum (ed.), *Japan: Economic Success and Legal System* (Berlin, de Gruyter, 1997) 167, at 167–180.

On a macro-level, company law in the West is finely balanced to accommodate state corporatist[152] links between companies, employer associations, trade unions and the state.

Those comparing relational structures in different types of capitalism, argue that company laws are most likely to transfer successfully between countries with similar market entry and business networks. In explaining the divergent forces shaping production in Japanese and American companies, Aoki identified a matrix of market institutions governing information systems, financial arrangements, corporate governance, industrial relations, contracting networks and cross-shareholding.[153] These relational configurations were considered just as responsible for determining the rules of the game as transplanted American company laws and legal institutions. Comparative research examining the application of Japanese production methods in Europe, likewise identified "internal coalitions" of forces holding companies together.[154]

Relational networks are especially important in Vietnam, because unlike their counterparts in the West, Vietnamese private companies have only a partially functioning legal system to fall back on. Both anecdote and empirical research indicates that commercial relationships are formed with little expectation of legal proceedings, they are not formed "within the shadow of the law". For example, a survey of small and medium private companies showed that less then ten per cent of respondents thought that courts would resolve commercial disputes effectively.[155] The following discussion speculates that in Vietnam's undeveloped legal system, transplanted company law conveys few of the legal advantages enjoyed by Western companies operating in mature legal systems.

The economic integration of companies in Vietnam

One means of measuring the local reception of transplanted company law is the integration of companies to the Vietnamese economy. Twelve months after the

[152] Corporatism is usually defined as centralized and monopolistic interest mediation and public policy-making through the collaboration of state and non-state interests, including, but certainly not limited to employer groups and unions: see generally HJ Wiarda, *Corporatism and Comparative Politics* (New York, E Sharpe, 1996), 47–55. State-corporatism is not just a Western phenomenon, it has been identified in countries with widely varying political and economic structures, including China and Vietnam: see, eg, I Norlund, "Democracy and Trade Unions in Vietnam" (1997) 11 *Copenhagen Journal of Asian Studies* 73, 92.

[153] See M Aoki, "The Japanese Firm as a System of Attributes: A Survey and Research Agenda" in M Aoki and R Dore (eds), *The Japanese Firm: The Sources of Competitive Strength* (Oxford, Oxford University Press, 1994) 12–22, 27–8 ; VL Taylor, "Continuing Transactions and Persistent Myths: Contracts in Contemporary Japan" (1993) 19 *Melbourne University Law Review* 352, 270–276; C J Milhaupt, "A Relational Theory of Japanese Corporate Governance: Contract Culture and Rule of Law" (1996) 37 *Harvard International Law Review* 3.

[154] See A Jenkins, "Just-in-Time 'Regimes' and Reductionism" (1994) 28 *Sociology* 21, 22–24; B Wilkinson and S Robinson, *The Japanization of British Industry* (Oxford, Blackwell, 1988).

[155] J McMillan and C Woodruff, "Interfirm Relationships and Informal Credit in Vietnam" (1999) 114 *Quarterly Journal of Economics* 1285, 1286.

commencement of the LC in 1991, 1,170 limited liability and 65 joint stock companies had incorporated.[156] By the time the EL was enacted in 1999 company numbers had plateaued at 26, 000.[157] Although the rate of incorporation sharply increased following the abolition of certain business licenses by the EL in January 2000,[158] six months later application rates had dropped back significantly .

Statistics only poorly reveal the complex interrelationship between company law and the social and economic demand for business organizations. Incorporation levels in China suggest that private companies are comparatively unimportant in Vietnam. Following the enactment of the National Companies Law, the number of registered companies increased in China from 486,700 in 1993 to 1,448,000 in 1994.[159] Allowing for population differences, eight years after the enactment of the LC there were approximately sixty per cent fewer companies in Vietnam than in China, one year after the enactment of the National Company Law. The comparison is even more startling when it is realized that SOEs dominated and thus potently crowded out private sector investment to a much greater extent in China than in Vietnam. Moreover, incorporation rates in China are extremely low by Western standards.[160] In overall terms, private companies in Vietnam accounted for a mere 2.4 per cent of industrial production in 1997.[161] With the exception of a few state-connected Southern joint-stock companies, most companies have been unable to accumulate capital under the company law regime.[162] Despite the reputed legal advantages of incorporation, unincorporated household enterprises are on average more profitable and grow at twice the rate of private companies.[163]

Economic and legal disadvantages are reflected in a general reluctance to incorporate. Researchers estimate that more than ninety five per cent of an estimated one million business entities with sufficient capital to incorporate remain unlicensed.[164] This statistic suggests that imported company law norms have

[156] See R Mallon, "Mapping the Playing Field: Options for Reducing Private Sector Disincentives in Vietnam" (Asian Development Bank, unpublished paper, 1997), 5.

[157] See Webster, *supra* n.10, at 55.

[158] See Luu Quang Dinh, "Dung Do Loi Cho Luat Doanh Nghiep", (Do Not Blame the Enterprise Law) *Lao Dong*, 30 July 2001, at 3; "New Law Promotes Record Business Registrations", *Vietnam News*, 7 March 2000, 1, at 2.

[159] See C A Png, "Some Concerns About Chinese Company Law" (1996) 17 *Company Lawyer* 199.

[160] See KTW Ong and Colin R Baxter, "A Comparative Study of the Fundamental Elements of Chinese and English Company Law" (1999) 48 *International and Comparative Law Quarterly* 88, 97–98.

[161] General Statistical Department, *Statistical Yearbook* (Hanoi, General Statistical Department, 1997) 29, 165.

[162] See Vu Quang Viet, "State and Private Sectors in Vietnamese Economy" [1998] *Vietnam's Socio-Economic Development* 30, 36–40.

[163] See P Ronnas, "The Transformation of the Private Manufacturing Sector in Vietnam in the 1990s" (unpublished paper, May 1998), 25.

[164] See "The Non-State Trade Sector" (1994) 3 *Vietnam Economic Review* 35, 36. More recent

not been widely received and internalized by Vietnamese entrepreneurs. What it does not disclose is whether an unwillingness to form companies is attributable to cultural discord, administrative abuses and corruption, ignorance of the law, or some combination thereof. A comparison of Western and Vietnamese reasons for incorporation elicits more textured explanations.

Limited liability

Western business organisations

Western entrepreneurs can chose from many types of business organisation. Their reasons for selecting corporations over partnerships, trusts or other types of business organisation are (in addition to taxation) broadly explained by the advantages of limited liability and separate legal personality.[165]

The introduction of limited liability in England is usually attributed to a high social demand for risk capital during the industrial revolution.[166] Influenced by the utilitarian notion that companies are vital economic players, the English Parliament enacted the Limited Liability Act 1855 overriding creditors' concerns that limited liability would distort markets.[167] The separation of personal and corporate liability in *Salomon v Salomon & Co Ltd*,[168] which transfered risk from corporate investors to trade-creditors, is credited with making private companies the dominant Western business organization.[169] Some attribute the development of publicly held companies and organized stock exchanges to the limited liability doctrine.[170] By equating risk with transactional value, they argue that stock markets only exist where investors can limit their exposure to loss. Regardless of the socio-economic reasons, the legal capacity to transfer

estimates suggest little alteration in the pattern of compliance: Interviews with Dang Duc Dam, Vice Director, Central Institute of Economic Management, Hanoi, July and October 1996, and November 1997.

[165] See generally FH Easterbrook and Daniel R Fischel, "Limited Liability and the Corporation" (1995) 52 *Chicago Law Review* 89, 90–109. Factors relating to capital raising and floating charges are not relevant to Vietnam, which lacks capital markets and securities over company assets.

[166] The doctrine arose early in civil law countries: see generally P Ireland, "Triumph of the Company Legal Form 1856–1914" in J Adams (ed), *Essays for Clive Schmitthoff* (New York, LEXIS Law Publishing, 1983) 29.

[167] The literature in this area is vast, but see JW Hurst, *The Legitimacy of the Business Corporation in the United States 1780–1970* (Charlottesville, The University Press of Virginia, 1970), 13–56; JH Farrar et al, *Farrar's Company Law* (London, Butterworths, 1988), 20–23.

[168] [1897] AC 22, at 49.

[169] Though the ruling in *Salomon* v *Salomon* [1897] AC 22 has endured profound changes in the western political economy, it has been criticized as a political decision designed to shift risk from entrepreneurs to trade creditors: see Kahn-Freund (1974), *supra* n.11, at 54. Others suggest that if the legal principles had not existed, firms would have invented limited liability through insurance cover to compensate for business failure: see Easterbrook and Fischel, *supra* n.164, at 55.

[170] See H Manne, "Our Two Corporation Systems: Law and Economics" (1967) 53 *Virginia Law Review* 259; Halpern, Trebilcock and Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 *University of Toronto Law Journal* 117.

risk from company founders to creditors is a pivotal factor in making companies the dominant Western economic organisation.

Vietnamese business organisations

The LC and EL both extended limited liability (*trach nhiem huu han*) protection to company investors. But limited liability is only commercially meaningful where there is a perceived threat of litigation from creditors. The doctrine does not protect investors against extra-legal debt collection, which is the primary method of debt collection in Vietnam.[171]

Commercial litigation levels are extremely low. The economic courts, which hear debt and bankruptcy cases against companies, considered five hundred cases in 1995[172] and fewer than four hundred cases in 2001. Less than a third of economic cases involve debts and most of these involved SOEs.[173] More significantly, litigation rates remained static over a period where the number of companies has increased twenty times. Various explanations are advanced for low litigation rates. Litigants are concerned that court proceedings will reveal commercially (and personally) damaging information; standards of proof are too onerous (in other words, courts require formal documentation when none exists); and long procedural delays in listing actions (over twelve months in Ho Chi Minh City) enable debtor companies to dispose of their assets.[174]

Public skepticism about judicial competency and impartiality also discourages debt litigation. High on the list of concerns is a chronic shortage of experienced commercial judges.[175] Litigants also complain that judges base their decisions on internal guidelines that are unavailable to creditors and debtors.[176] More generally, the public believes that courts treat legal rules as convenient, but optional ways of getting things done. Like most bureaucrats, judges generally evince a deep-rooted antipathy towards the private sector and its role in economic development.[177] Whether grounded in fact or myth, the perception of

[171] See J McMillan and C Woodruff, "Dispute Prevention without Courts in Vietnam" (1999) 15 *Journal of Law, Economics, and Organization* 637, 637–658.

[172] Petitions from enterprises in economic courts fell by 28% in 2000. See Pham Xuan Tho, "Economic Courts Failed to Win Enterprise Confidence", [2000] *Vietnam L. Legal Forum* (77), at 20; Ha Hung Cuong, "Resolution of Economic Disputes in Vietnam and the Accession to the 1958 New York Convention" in J Gillespie (ed), *Commercial Legal Development in Vietnam: Vietnamese and Foreign Commentaries* (Singapore, Butterworths, 1996), 163–164; "Settlement of Economic Law Suits and Bankruptcy Declarations" [1996] *Vietnam Law and Legal Forum* 11.

[173] Official court statistics are not publicized, these figures are based on estimates given by Hoang Huu Bat, Chief Judge Hanoi City Court, Hanoi, 28 February 2000.

[174] See Tran Van Su, "The People's Economic Court of Ho Chi Minh City: A Year of Establishment and Operation"[1995] *Tap Chi Toa An Nhan Dan* (People's Court Review), 2–3.

[175] Statistics from the Ministry of Justice suggest an overall shortage of 1,714 judges.

[176] These views are based on interviews with private lawyers from Investconsult and Leadco, Hanoi, and IMAC, Ho Chi Minh City.

[177] This opinion is based on numerous interviews with Supreme Court, Hanoi Economic Court and Ho Chi Minh City Economic Court judges from 1994–2000.

systemic bias and incompetence led more than ninety per cent of private sector respondents in a recent survey to conclude that courts would not satisfactorily resolve commercial disputes.[178]

Even on the rare occasions where debts are enforced, judges manufacture reasons to lift the corporate veil and attach the assets of company officials and their relatives.[179] Company laws that insulate personal assets from corporate losses are neither intuitively appealing nor obvious to judges. This is especially true where creditors are state authorities or employees. The neo-liberal proposition that the social cost of limited liability is counterbalanced by the "utility" of entrepreneurial investment does not inform judicial thinking. The corporate veil consequentially lacks the legal and moral authority to quarantine company investors' assets from creditors. As a corollary, judicial decisions rarely conform to legal norms, though they sometimes appear to embody customary principles of fairness, such as *co long tot voi dan* (good heartedness towards the people). In this "fuzzy" legal environment creditors are understandably reluctant to litigate and find extra-legal routes and means to enforce payments.[180]

Separate legal personality

Western concepts

Following the publication of Berle and Means' influential study of the separation of management and ownership in public corporations, neo-classical scholars have postulated that the modern corporation is the optimal business organization.[181] Confidence in corporations has endured structural changes that allowed the managerial elite running large public companies to displace individualist, entrepreneurial capitalists as the dominant, economic decision-makers.[182] Though some commentators point to discrepancies between

[178] McMillan and Woodruff, *supra* n.170, at 1285 and 1286.

[179] When deciding whether relatives of the managers of companies in liquidation have received preferential payments, Asset Liquidation Teams apply the interpretive principle in art 135(2) of the Civil Code, that where all things are equal, the interests of the weakest economic player (often employee creditors) should prevail: see Decree No. 189 CP Providing Guidance on the Implementation of the Law on Enterprise Bankruptcy 1994, art. 32; and Interviews with Nguyen Ngu Phat, *supra* n.86.

[180] See Le Tho Binh and Vu Thuong, "Fighting Corruption: In Addition to Energy, Courage is Needed", *Tuoi Tre* (Youth), 8 April 1997; Pham Van Thuyet, "Legal Framework and Private Sector Development in Transitional Economies: The Case of Vietnam" (1996) 27 *Law and Policy in International Business* 591, 591–594.

[181] See Berle and Means, *supra* n.87. See also MC Jensen and WH Meckling, "The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 4 *Journal Financial Economics* 305; EF Fama and MC Jensen, "Separation of Ownership and Control" (1983) 26 *Journal Law and Economics* 301.

[182] See generally WJ Samuels, "A Critique of Capitalism, Socialism and Democracy" in RD Coe and C K Wilber (eds), *Capitalism and Democracy: Schumpeter Revisited* (Chicago, University of Notre Dame Press, 1985).

neoclassical corporation theory and economic reality, few doubt that the separation of ownership from professional management is essential for Western corporate organization.[183]

Separate legal personality in Vietnam

Separate legal personality was unknown in pre-colonial Vietnamese society.[184] Case studies of early twentieth century companies show little change from traditional organizational structures. Vietnamese-owned ceramic manufacturers during the 1930s, for instance, exhibited few of the long-term (non-family) integrative relationships found in Western corporate structures. Excepting seasonal sub-contractors, firms were structured entirely along familial lines.[185] To protect technical knowledge and business secrets, village relatives were hired in preference to strangers (non-relatives) and daughters were not permitted to marry outside the village. Hierarchical kinship rules arose out of, and defined, interlocking mutual obligations (family sentiment, secrecy and paternalism) that formed the building blocks of commercial organizations.[186]

Contemporary studies show that relational business structures endured socialist and more recently market forces and continue to bind private business organizations.[187] Proverbs like *gia dinh la tien het* (family first others second) invoke a social ordering where close family connections form the bonds generating dependable and trustworthy management structures.[188] Where external skills are required, family members turn first to friends from the same village or those with long standing personal ties. Recruitment is often based on membership of the

[183] See, eg, M Barzelay and RM Smith, "The One Best System? A Political Analysis of Neoclassical Institutionist Perspectives on the Modern Corporation" in WJ Samuels and AS Miller (eds), *Corporations and Society: Power and Responsibility* (New York, Greenwood Press, 1987) 81, at 81–4.

[184] See Reid, *supra* n.15, at 62–77.

[185] See Hy Van Luong, "Capitalism and Noncapitalist Ideologies in the Structure of Northern Vietnamese Ceramics Enterprises" in T Brook and Hy Van Luong (eds), *Culture and Economy: The Shaping of Capitalism in Eastern Asia* (Ann Arbor, University of Michigan Press, 1997), 191–3 and 198–200; Hy Van Luong and Diep Dinh Hoa, "Culture and Capitalism in the Pottery Enterprises of Bien Hoa, South Vietnam (1878–1975)" (1991) 22 *Journal of Southeast Asian Studies* 16, 23–4 and 26–8.

[186] The family structure in Vietnam embodied elements sycretistically drawn from neo-Confucian, Buddhist, Tao and animistic spirit cults. Though Buddhism and spirit cults ameliorated rigid neo-Confucianism, kinship power structures followed imported Confucian patterns. *Hieu* (filial piety) bound children to their parents through *on* (moral debt); and *de* (the relationship between brothers) required the eldest to "teach, nurture and protect" and the younger brother to "respect, support and obey" their elder sibling(s): see NL Jamieson, *Understanding Vietnam* (Berkeley, University of California Press, 1993), 16–8; Hy Van Luong, "Vietnamese Kinship: Structural Principles and the Socialist Transformation in Northern Vietnam" (1989) 48 *Journal of Asian Studies* 741, 742, 748–9 and 753–4.

[187] See Hoang Kim Giao and Nguyen Dac Thang, "A Profile of Vietnamese Owners of Private Enterprise" [1995] *Vietnam Economic Review* 27, 29–30.

[188] *Ibid*.

same village, university class, or military unit. In each case, attempts are made to find sentimental attachments that replicate *trung thanh* (loyalty), *tinh cam* (sentiment towards others) and *tin* (trust) binding family members.[189]

Resembling Western close corporations, the management structures of Vietnamese family owned and operated companies differ from Berles and Means' bifurcated ownership and management structures. Corporate rules strictly separating family and corporate assets are considered inconveniences. CIEM research confirms that where family members are both majority shareholders and company mangers, there is little incentive to differentiate family and company activities and assets.[190] Family members withdraw invested capital to repay personal loans and pass assets between themselves and the company without regard for company law procedures. Flexible accounting practices designed to avoid taxation further blur distinctions between family and company assets.

Western company law theories explaining anomalies between close corporations and large public owned corporations, predicate that the benefits of separate legal personality increase with the size of the firms and market sophistication. They attempt to explain conditions in developed countries and only tangentially apply to Vietnam. In the first place, there are very few large corporations in Vietnam. From a total of approximately 26,000 companies each employing on average nineteen workers; only four hundred and fifty employ more than one hundred workers.[191] Studies show that approximately two thirds of large companies are family owned and managed. Like small companies, they borrow capital from family and friends; less than ten per cent is derived from long-term bank loans. Public capital is raised directly from cross-shareholding arrangements with SOEs.[192] Most sales are made to customers belonging to business or family networks located in the same city, and frequently the same neighborhood.[193] In aggregate, these factors intimate that even large, professionally managed companies are constructed from relational connections.

Private lawyers indicate that in a small number of cases the fiction of separate legal personality is used as a moral, if not legal, means of quarantining family assets from non-family company managers. This occurs on the rare occasions

[189] These views are based on interviews with private entrepreneur associations in Hanoi and Ho Chi Minh City: Vu Duy Thai, Vice Chairman and Secretary, The Hanoi Associations of Industry and Commerce, Hanoi, 1999 and 2000; Nguyen Trung Tuc, Chairman, Vietnam German Entrepreneurs' Club, Hanoi, 1999 and 2000; Pham Thi Thu Hang, Deputy General Director, VCCI (Small and Medium Enterprise Promotion Center), Hanoi, 1998 and 1999; Nguyen Hoang Luu, General Secretary, *Hiep Hoi Cac Doanh Nghiep Vua Va Nho Ha Noi* (Hanoi Small and Medium Enterprises Council), Hanoi, 1999 and 2000; Cao Thi Kim Dung, Information Service Manager, *Hiep Hoi Cong Thuong Thans Pho Ho Chi Minh* (Union of Associations of Industry and Commerce), Ho Chi Minh City, 1998 and 1999.

[190] See CIEM, *supra* n.88, at 69–70.

[191] See Dang Phong, *supra* n.139, at 47.

[192] *Ibid*., at 50–1.

[193] McMillan and Woodruff, *supra* n.154, at 1295–1296.

where companies conduct business in provinces where family-owners lack personal contacts or where founders commercializing scientific or technical knowledge require non-family business managers. At first glance these cases appear to signify that as market information expands and local technology is commercialized, the need for separate legal personality will increase. Deeper analysis discloses countervailing trends. Improved educational qualifications for company owners (especially in finance and management), for example, have reduced the need for non-family mangers in manufacturing companies and as a corollary the necessity to separate management from capital.[194]

Contradicting Western competition theory, corporate structures generally become less important in Vietnam as the market-economy becomes more highly developed. Consider the clothing industry in Ho Chi Minh City. During the years immediately following the introduction of the LC many family-based clothing manufacturers incorporated. By 1998 the trend had reversed and reliance on company structures, both in terms of new incorporations and formal separation of capital and management had declined.[195] Informants believe that as the textile market grew in size and competitiveness, the capacity of state officials to influence commercial decision-making decreased. This in turn, meant that retired officials and others hired to moderate "state economic management", became less useful and were eventually jettisoned. Released from the need to protect capital from non-family managers, the corporate form became less beneficial.

State economic management and relational structures

Further evidence of qualitative differences between Western and Vietnamese relational configurations comes from Vietnamese perceptions about companies. Rather than the benefits of limited liability and separate legal personality, informants speculate that most companies are formed to accommodate the requirements of "state economic management".[196] In contrast to Western jurisdictions, where company law functions as both public and private law, informants believe that company law in Vietnam is primarily an instrument of public law.

[194] See Ronnas, *supra* n.162, at 14–5.

[195] Interviews with Cao Thi Kim Dung, *supra* n.188.

[196] Unless otherwise indicated, the description of Vietnamese companies is based on interviews conducted with Vietnamese legal practitioners and their corporate clients from June 1994–September 2000. If they exist, statistics concerning compliance with company laws are not publicly available. Though rich sources of information concerning corporate organization and attitudes to markets, interviews with company officials gave only a rough guide to compliance and attitudes to the law. Informants understandably emphasized their compliance with the law. When they were asked questions that assumed legal knowledge, they expressed reluctance to discuss legal issues, indicating that this was the role of their lawyers. Lawyers confirmed the low priority attached to legal compliance and suggested that corporate clients rarely sought preventive advice and only sought assistance when facing prosecution.

The public psychology of companies

Informants belive that psychological and regulatory factors excite many company formations.[197] Chief among these is the mystique of the corporate (*cong ty*) body. Particularly in the years immediately following the introduction of the LC, corporations were equated in the popular imagination with modernity and Western consumerism. Ironically, business licenses designed to subordinate private corporate rights to state economic management, in the public's estimation, conveyed an impression of financial solidity and state endorsement. Even the instrument of state regulation endowed prestige: the fact that a law (*laut*) (LC) issued by the highest legislative body (the National Assembly) governed companies invested them with a higher public status than unincorporated traders regulated by a Prime Ministerial decree.[198] Close state supervision of companies paradoxically enabled private traders to achieve hitherto unobtainable levels of commercial and social legitimacy.

State economic management

For many entrepreneurs, incorporation is a strategy of last resort where trading as an unincorporated commercial entity is no longer permitted.[199] Wherever possible, businesses disguise capital and employment levels to avoid the dubious privileges of increased state supervision and taxes that accompany incorporation. Although there is no law requiring business entities to incorporate, regulators routinely arrogate powers to compel medium sized firms to form companies. Some attribute this policy to vague Marxist convictions that small household businesses employing family members are non-exploitative, whereas larger firms hiring non-family members are exploitative and require close supervision. Officials use rough measures based on numbers of employees and registered capital to determine levels of exploitation.[200] Many officials still consider companies exploitative where owners derive more than the equivalent of a salary from invested capital.[201]

Sustained press vilification tarnished the image of companies,[202] and as a consequence access to state quotas and incentives replaced public prestige as the

[197] Interviews with Nguyen Nhu Phat, *supra* n.86.

[198] Household enterprises with low capital levels were regulated under Decree 66 of 1992.

[199] See Hoang Kim Giao and Nguyen Dac Thang, *supra* n.186, at 27–31 (overseas Chinese working through relatives accounted for 27.9% of all medium to large enterprises in Ho Chi Minh City in 1995).

[200] Decree No 222–HDBT 1992, replaced by Decree No 26 ND-CP 1998, set out capital levels for a wide variety of companies.

[201] These views are widely held by members of Vietnamese "progressive" bureaucracy: see, e g, interview with Pham Thi Thu Hang, Deputy Director, Small and Medium Enterprise Promotion Center, Vietnam Chamber of Commerce and Industry, Hanoi, 23 September 1999.

[202] For an account of media treatment of the private sector see Webster, *supra* n.10, at 14–15 and 17.

primary reason for incorporating. Companies form to access state import/export quotas, highly regulated markets (such as tourism and construction) construction tenders, and finance from state owned banks. State economic management generates an unstable economic environment where private companies generally pursue small-scale, low risk, high return ventures, such as real estate speculation, trading and entertainment services.[203] The resultant short-term opportunistic trading relationships binding private companies are far removed from the individualistic entrepreneurialism underpinning early Western company law, much less the large-scale bureaucratic corporations of contemporary Western capitalism.[204]

Market relational structures affecting Vietnamese company regulation

A comprehensive analysis of the full range of market relational structures, such as state-employer-labor relations and market support institutions underpinning company law in Vietnam, is beyond the scope of this discussion.[205] The analysis of company formation, however, tentatively indicates that two relational orbits - the state and family - predominantly govern the reception of company law. Relational connections supporting companies are almost entirely located in state economic management relationships formed among state officials and family/clan business structures. Licensing gateways control market entry in many important economic sectors, while even in deregulated sectors access to land use rights, non-family labor and finance remain tightly controlled by discretionary processes.[206] The extent and depth of state economic management leaves little public space for the types of relational connections that support Western company law. Nothwithstanding equivocal signs of an emerging commercial civil society in Vietnam, private companies predominately inhabit a binary world comprised of state and familial relations. Without robust non-state relational structures mediating the boundaries between public and private space, imported principles of company law are not credible alternatives to defensive and secretive family/clan structures.

[203] See Vu Quang Viet, "State and Private Sectors in Vietnamese Economy" [1998] *Vietnam's Socio-Economic Development* 30, 32; Hoang Kim Giao and Nguyen Dac Thang, *supra* n.186, at 28–9.

[204] See Ronnas, *supra* n.162, at 20.

[205] Highly restrictive rules ensure that employee and industry associations are co-opted and controlled by party-state mass organizations: see M Sidel, "The Emergence of a Voluntary Sector and Philanthropy in Vietnam: Functions, Legal Regulation and Prospects for the Future" (1997) 8 *Voluntas* 283, 283–302. See also Phan Ngo, "Major Reshuffle at VCCI", *Saigon Times Weekly*, 5 October 1997, 27.

[206] See Webster, *supra* n.10, at 55–9.

CONCLUSION

The application of Kahn-Freund's analytical framework to company formation revealed deep-seated incongruities between Western and Vietnamese sociopolitical structures. It was found that imported contractarian ideology conflicts with the dominant Marxist-Leninist ideology, which reserves a leading role for "state economic management". Ideological inconsistencies, it has been argued, inhibit the reception of company law. For example, research indicated that insufficient judicial protection for limited liability and separate legal personality diminished the credibility of corporate vehicles in Vietnam. This is, however, only a partial explanation because transplanted company law flourishes in other East Asian states with sub-optimal legal systems.[207]

Another explanation is implied by Chalmers Johnson's observation that North East Asia companies relied on "the development of a market system … that reduces the uncertainties or risks faced by entrepreneurs, generating and disseminating information about investment and instilling an expansionist psychology in people."[208] Vietnamese entrepreneurs, on the contrary, receive contradictory ideological messages. Market entry deregulation conveys the ideology of commercial freedom promised by *doi moi* economic reforms. But the daily reality of "state economic management" reinforces the impression that socialist planning remains the primary allocative force. Put differently, company law norms are important in East Asian countries that emphasise the economic and cultural values embedded in the norms, such as shareholder interests, corporate management and creditors' rights. They are less important in countries like Vietnam where the dominant ideology undermines corporate values.

Ideology in Vietnam is in a state of flux. As market allocation displaces socialist planning as the primary form of economic decision-making, the relative importance of *regions* within the dominant ideology will also change. For example, the "law-based-state" privileges private decision-making, whereas "socialist legality" favours state economic management. If "law-based-state" thinking gains support, the dominant ideology will increasingly reinforce liberal market-entry norms.

Discrepancies between Western and bureaucratic legal cultures also inhibit the transplantation of company law. One of the difficulties facing corporate

[207] See Pistor and Wellons, *supra* n.2, at 125–130. One of the distinguishing features of East Asian capitalism is the insulation of policy-makers from society. Capital operates in an illiberal political ideology: see A Chowdhury and I Islam, *The Newly Industrializing Economies of East Asia* (London, Routledge, 1993), 45–56; JE Campos and HL Root, *The Key to the Asian Miracle: Making Shared Growth Credible* (Washington, The Brookings Institution, 1996), 138–173; World Bank, *The East Asian Miracle* (Oxford, Oxford University Press, 1993), 167–181.

[208] C Johnson, "Political Institutions and Economic Performance: The Government-Business Relationship in Japan, South Korea, and Taiwan" in RA Scalapino, S Sato and J Wanandi (eds), *Asian Economic Development – Present and Future* (Berkeley, Institute of East Asian Studies, University of California, 1985) 68.

reform is the cultural bifurcation of elite central policy-makers and provincial corporate regulators. For Western-trained reformers in the CIEM the epistemological language of company law appears both natural and desirable. Participating in international conferences and collaborating with foreign legal advisers, members of CIEM drafting committees are enmeshed in the "flatting out of economic and cultural diversity" among elite lawmakers. In contrast, market-entry liberalizations present a dilemma for elite party theorists, because an emerging capitalist class may eventually challenge party legitimacy.[209]

There are two political reasons why the Party supported the enactment of the EL. Facing spiraling unemployment produced by declining foreign investment, party leaders believe that market-entry liberalisations will mobilize domestic capital for job creation. The other explanation lies in the treatment of laws as "management tools" (*cong cu quan ly*). Isolated from practice on the ground, the party-state elite have unbounded confidence in their mission to bend laws to suit policy implementation. This ultimately means that congruence between imported legislative norms and domestic polices are not of paramount importance, because legislative norms are not regarded as universal immutable precepts.

If liberal market-entry rules are merely symbols of power relationships to elite policy makers; to provincial regulators they strip away discretionary powers. Filtered through an anti-mercantile culture and a moral obligation to "manage to manage" (*quan ly ve quan ly*), local officials understandably perceived market-entry liberalizations as externally imposed and inappropriate. Discretionary powers, moreover, are the only means available to reconcile imported norms with local business practices and percepts. Unless the state invests normative rules with greater ideological authority, officials are unlikely to abandon economic managerialism and rent-seeking as the preferred modus operandi of corporate regulation.

State saturation of public space, is arguably, the most intractable impediment to the reception of company law in Vietnam. State economic management suppresses the emergence of the types of entrepreneurial organizations and markets that support and maintain Western company law. Without supportive non-state institutions, businesses construct defensive family structures and form particularistic, frequently corrupt alliances, with state bureaucrats.[210] Without market support institutions and integrated markets, the vital transformation of company law from public privileges to private rights has not occurred. As public law, company law has little to offer entrepreneurs.

[209] The Control Committee of the Communist Party has commissioned researchers to investigate whether the LC and EL laws have created a capitalist class: Interviews with Vu Duy Thai, Vice Chairman and Secretary, The Hanoi Associations of Industry and Commerce, Hanoi, April 1999 and February 2000.

[210] The rise and fall of the Minh Phung textile empire illustrate the dangers of entrepreneurs using particularistic relationships to reduce risk: see "Minh Phung and Epco had the Risk of Going Bankrupt from their Establishment", *Saigon Giai Phong*, 13 May 1999, 1, 3.

9

Revitalising Japanese Business Strategies by Corporate Restructuring: Live or Let Die ?

JUNKO UEDA

INTRODUCTION

In the face of the new millennium in 1999, the first notable business phenomenon coming to most Japanese minds would probably be the drastic reorganisation of corporations especially financial institutions. At the end of August, presidents of three major banks, namely Nihon Kogyo Bank, Daiichi Kangyo Bank and Fuji Bank jointly announced that they agreed upon their consolidation under the control of one holding company to be set up by those three banks investing equally in each other.[1] This seems to have caused a shock wave in the business world and had a great impact on other financial institutions. This is shown by the fact that two months later two other banks announced future co-operation schemes, which will be a temporary measure before merging.[2] Not only in banking, but also in other financial areas such as the non-life insurance business, the move towards amalgamation has been predicted among the biggest companies in the same business field.[3] A wide range of intensive financial reforms have already taken place under the name of the financial big bang initiated by the government, and those changes seem to be inevitable as one of the resulting managerial strategies. Financial institutions, in fact, still suffer from financial difficulties, and in June 1999 one medium-sized life insurance company went bankrupt. Still more, the competitive pressures upon financial institutions will have been much higher and tougher as some companies that do not have much

[1] See, eg, *Nihon Keizai Shimbun*, 20 August 1999, evening version. These three banks were merged into one mega bank named "Mizuho Bank" as of 1 April 2002. Now Japanese major banks are classified by five mega financial groups: Mizuho, Mitsui-Sumitomo, Tokyo-Mitsubishi, UFJ and Risona.

[2] Eg, *Nihon Keizai Shimbun*, 14 October 1999; *Nihon Keizai Shimbun*, 14 October 1999, evening version; *Nihon Keizai Shimbun*, 15 October 1999.

[3] Mitsui non-life insurance company, Nihon non-life insurance company, and Kowa non-life insurance company announced an agreement for consolidation to strengthen their managerial foundations: see, eg, *Nihon Keizai Shimbun*, 16 October 1999, evening version; *Nihon Keizai Shimbun*, 17 October 1999; *Nihon Keizai Shimbun*, 10 December 1999.

understanding of the financial business have already decided to enter the field.[4] Apart from this trend of financial businesses aiming at survival in this period of deregulation, reconstruction of business by mergers and acquisitions (M & A) has dramatically increased in 1999, the statistics of which, as noted below, indicate a number that is even much higher than that observed during the bubble period.[5] One notable characteristic of this trend is that M & As initiated by foreign companies have occurred frequently in the same year. Even though it is reported that the Japanese economy has shown signs of recovery,[6] Japanese business enterprises are, on the whole, obliged to produce new structural endeavours.[7] There has been a flourishing of reforms in which board members are being replaced by executive officers and also an increase in activities enhancing investor relations by corporations.[8] The Japanese Commercial Code was amended by introducing a new method of share exchange, share transfer, disclosure of corporate affairs between parent-subsidiary relationships, a new method of appraisal of corporate financial assets and so on. The reconstruction of companies has been greatly expedited after the operation of the amended Commercial Code, which might, as touched upon at the beginning, have caused that (1999) highlight of an increasing number of corporate reconstructions.[9] The tax regime that was revised in line with this amendment has also been significant to the business world. Negotiations between the USA and Japan were held in 2000, particularly

[4] The fact that one of the biggest distribution companies decided to enter the financial business has been the big news, and the newspapers have carried articles on the some other companies' similar intentions.

[5] On the increasing number of M and As, see, eg, *Nihon Keizai Shimbun*, 12 December 1999, 24 December 1999, 25 December 1999, evening version.

[6] Eg, *Nihon Keizai Shimbun*, 13 July 1999, evening version; *Nihon Keizai Shimbun*, 9 September 1999; *Nihon Keizai Shimbun*, 4 October 1999, evening version; *Nihon Keizai Shimbun*, 15 October 1999, evening version; *Nihon Keizai Shimbun*, 24 October 1999. Also 100 CEOs, having answered the questionnaire about the Japanese economic situation prepared by a newspaper company suggest that little by little they are feeling that the Japanese economy has recently been heading towards recovery: *Nihon Keizai Shimbun*, 28 September 1999.

[7] Keizai-kikakucho (ed.), *Keizai Hakusho 1999: Keizai-saisei eno Chosen* (Okurasho Insatsukyoku, 1999), 115ff.

[8] It is reported that executive officers were appointed in 179 corporations by June 1999, which corresponds to 7% of the listed companies in Japan: see *Nihon Keizai Shimbun*, 25 June 1999; 28 November 1999. On this point, see eg, S Iwahara, et al (a conference), "Keiei-kankyo no Henka to Kigyo no Torishimari-yaku-kai-kaikaku" (1998) 1505 *Shoji-homu* 6; K Hatada, "Shikko-yakuin no Hoteki-chii to Sekinin" (1998) 1505 *Shoji-homu* 49; M Sawada, "Shikko-yakuin-seido no Jitsumu-manyuaru" (1999) 1524 *Shoji-homu* 4; M Sawada and K Takano, "Shikko-yakuin no Zeimu-jo no Toriatsukai" (1999) 1534 *Shoji-homu* 67; M Nakahigashi, "Torishimariyaku-kai-kaikaku no Yukue" (1999) 537 *Hogaku-seminar* 20; S Matsui, "Shikko-yakuin-seido wo meguru Riron to Jitsumu (1) (2)" (1999) 1539 *Shoji-homu* 75 and 1540 *Shoji-homu* 23; M Kondo et al, "Shikko-yakuin-seido ni kansuru Hoteki-kento (1) (2)" (1999) 1542 *Shoji-homu* 4 and 1543 *Shoji-homu* 17. In relation to the account taken of shareholders' interests, see *Nihon Keizai Shimbun*, 25 June 1999; Nihon Keizai Shimbun, 24 October 1999. See also, eg, H Watanabe, "Inbesta Rireshonzu to Koporeto Gabanansu (1) (2)" (1999) 1518 *Shoji-homu* 19 and 1519 *Shoji-homu* 22.

[9] See, eg, *Nihon Keizai Shimbun*, 24 December 1999.

on matters facilitating direct foreign investment between the two countries, and as a result, the revision of the Japanese Commercial Code and its relevant laws will inevitably be put forward in due course.

In relation to the deregulation of business world, an effective legal framework safeguarding customers of financial institutions has been under review. This includes the issue of compensation to deposit holders. That is, from April 2001 onwards, deposit holders may be paid back from the deposit insurance institution only up to the amount of 10 million yen if the bank in which he or she has his or her bank account goes bankrupt; amongst other things, the postponing of the date for commencement and the services to be affected were a controversial issue throughout 1999 in Japan. Regarding the former, a political compromise was finally reached to allow a one-year moratorium.[10] Turning our attention to the securities market, the new OTC listing system of 'Mothers' (**M**arket **o**f **t**he **h**igh-growth and **e**mer**g**ing **s**tocks) was introduced in the Tokyo Stock Exchange in November 1999 to collect and absorb new venture capital effectively and to compete with the scheduled operation of 'NASDAQ' in the Osaka Stock Exchange which was implanted from the USA in 2000.[11] The above observations all seem to indicate that rapid and acute changes will continue in the Japanese business environment in the new millennium.

The following sections will be devoted to detailing these business issues from legal perspectives. Since it is difficult to cover all the matters above given publishing constraints, the primary focus will be on corporate structural changes. The sources for this chapter were based upon those available up to January 2000.

AN OVERVIEW OF THE 1999 AMENDMENTS TO THE JAPANESE COMMERCIAL CODE

As noted, the Japanese Commercial Code was amended in 1999 to introduce new methods of corporate amalgamation, that is, share exchange and share transfer. This amendment was initiated by the operation of the revised Anti-Monopoly Act (January 1999),[12] which was relaxed by allowing for the setting

[10] See the headlines of Japanese major newspapers, 30 December 1999. Now the government has agreed to allow a further moratorium until 31 March 2005 in order for the banks to concentrate on cleaning up their bad loan problems first. See eg, *Nihon Keizai Shimbun*, 7 October 2002.

[11] The coalition of NASD that operates and takes responsibility for NASDAQ and the Soft Bank Corporation negotiated with the Osaka Stock Exchange and reached agreement on the co-operation of the Osaka Stock Exchange: see, eg, *Nihon Keizai Shimbun*, 12 October 1999, evening version; *Nihon Keizai Shimbun*, 17 October 1999; "A Topic" (1999) 1541 *Shoji-homu* 38–39. For details, see *Nihon Keizai Shimbun*, 22 December 1999, evening version; "Mothers", *Nihon Keizai Shimbun*, 23 December 1999; H Shiraishi, "Shinko-kigyo-muke Shin-shijo 'Mothers' no Sosetsu" (1999) 1545 *Shoji-homu* 16ff. NASDAQ withdrew from the Osaka Stock Exchange in August 2002, and the substance of NASDAQ Japan will continue under the new name "Hercules". See *Nihon Keizai Shimbun*, 30 September 2002.

[12] See the amended Anti-Monopoly Act, s 9, which provides that one may set up a holding

up of pure holding companies that had been strictly prohibited as a result of an institutional legacy of what General Head Quarters desired as the economic democratic policy for Japan. The Commercial Code was scheduled for amendment with an intention to prompt pure holding companies in line with the modified Anti-Monopoly Act,[13] but this took a little bit longer than the business sector had expected.[14] The Law Commission (*Hosei-shingi-kai*) at the Ministry of Justice published a statement on the legal issues of parent-subsidiary companies (*Oyako-gaisha-hosei-to ni kansuru Mondai-ten*) in July 1998 to invite public feedback regarding the law.[15] Having taken some opinions into account, an Amendment Bill was submitted to the Lower House (*Shu-gi-in*) on 10 March 1999 under the regular procedure, but it was not until the middle of July that debate in the Diet actually started. The Sony Corporation, in fact, at first planned to propose as agenda items at its annual general meeting (AGM) in June 1999 that the existing three subsidiaries become wholly-owned subsidiaries with an intention of taking advantage of this new regime. However, because of the serious delay by the Diet, they could not but change their timetable for restructuring plans.[16] With crammed scheduling, the Bill was finally passed by the Diet on 9 August and came into force on 1 October 1999. The amendment includes not only the new procedures for share exchange and share transfer but also relevant matters such as obligatory disclosure of the financial positions and affairs of subsidiary companies to shareholders of parent companies in a bid to protect the interests of those shareholders, and appraisal of corporate financial

company or change an existing company to a holding company unless this will result in an over-concentration of economic power.

[13] The revision of Anti-Monopoly Act of 1998 carried a postscript by the Diet that there has been an emergent need for introduction of new facilitating methods like share exchange in adjustment with the amendment of the same Act. Also, a similar comment has appeared in "A Three-Year Deregulating Programme (*Kisei-kanwa-san-kanen-keikaku*)"(see also, text below on de-merger) and "An Action Plan for Reforms and Creation of an Economic Structure (*Keizai-kozo no Henkaku to Sozo no tame no Kodo-keikaku*)". In 1999, another new piece of legislation entitled "The Act on Special Measures for the Industrial Rehabilitation (*Sangyo-katsuryoku-saisei-tokubetsu-sochi-ho*)" came into force as part of the new legal framework enabling corporate reconstructions. This comprehensive scheme for corporate reorganisation was concluded with the final stage of introducing new procedures for corporate de-merger: see Editorial Note, "Sho-ho-to no Ichi-bu wo Kaisei suru Horitsu-an no Kokkai-teishutsu" (1999) 1520 *Shoji-homu* 4–5; M Oki, "Sangyo-katsuryoku-saisei-tokubetsu-sochi-ho no Gaiyo" (1999) 1541 *Shoji-homu* 4; K Yoshimoto, "Kabushiki-kokan / Kabushiki-iten to Kaisha-bunkatsu no Riron-teki-kento" (1999) 1545 *Shoji-homu* 4; T Ibayashi, *Sho-ho Kaisei no Juten-chikujo-kaisetsu* (Zeimu-keiri-kyokai, 1999), 1ff.

[14] For background, see S Motogi, "Heisei 11–nen Sho-ho-to-kaisei-an no Gaiyo" (1999) 51 *Kigyo-kaikei* 49; K Ehara et al, "Sho-ho-to no Ichibu wo Kaisei-suru Horitsu no Gaiyo" (1999) 1163 *Jurisuto* 87; (1999) 1555 *Kinyu-homu-jijo* 6; K Harada, "Kabushiki-kokan-to ni kakaru Heisei 11–nen Kaisei-shoho no Kaisetsu (1)" (1999) 1536 *Shoji-homu* 4.

[15] K Harada et al, "'Oyako-gaisha-hosei-to ni kansuru Mondai-ten' ni taisuru Kaku-kai-iken no Bunseki" (1998) 1506 *Shoji-homu* 20.

[16] This news has widely been distributed and thus widely known: see, eg, Editorial Note, "News" (1999) 1520 *Shoji-homu* 89; "99 Shoji-homu Hairaito: Kigyo-homu ni totte Kotoshi wa donna Toshi datta no ka" (1999) 1547 *Shoji-homu* 15.

assets on a market price basis for the purpose of giving a true and fair view of the financial positions of companies. This has been eagerly anticipated by the business world because of the difficulties in using the existing procedures, which cause many practical complications.[17]

Share exchange

Share exchange was, as noted above, introduced to facilitate the formation of holding companies modelled mainly on US corporate legislation. The past ten years have seen rapid business expansion in Japanese corporations, which can be seen by statistics showing that the average number of subsidiaries held by the Japanese listed companies is now double what it was ten years ago.[18] The main purpose for establishing subsidiaries is to make its management more efficient by the division and specialisation of corporate business entrusted to such subsidiaries.[19] However, if a company sets up many subsidiaries over a period of time, it will eventually become difficult for the management of a parent company to balance the interests of itself and those of various subsidiaries or, in other words, the strategic management of the parent company and the business management of subsidiaries. Setting up a pure holding company is an alternative for such group companies as long as they can benefit from the separation of these two distinct purposes of management.[20]

The procedures for introducing share exchange could be outlined as thus: Company A and Company B demonstrate agreement by preparing a statement of share exchange that declares they will exchange shares between the two companies, and any such proposal of share exchange must be approved by a special resolution[21] at the AGMs of both companies respectively.[22] The series of

[17] As the precondition for the statutory corporate reconstruction schemes, the pertinent facts to note are the amendment of the Anti-Monopoly Act and introduction of special legislation on reconstruction of the banking business (*Ginko-mochikabu-gaisha no Sosetsu no tame no Ginko-to ni kakaru Gappei-tetsuduki no Tokurei-to ni kansuru Horitsu*), which has enabled the amalgamation of three banks by a method of so-called triangular merger in 1997. However, new legislation concerning the reconstruction of banking business could not meet practical needs in terms of procedural complications. Therefore, since the introduction of new legislation on the reconstruction of banking business, no reconstruction under these procedures has been observed. On this special legislation, see eg, H Hori, "Ginko-mochikabu-gaisha no Sosetsu no tame no Gappei-tetsuduki-tokurei-ho ni yoru Gappei-hoshiki no Kento" (1997) 1477 *Shoji-homu* 27; M Kishida, *Heisei 11–nen Kaisei-shoho-kaisetsu* (Zeimu-Keiri-Kyokai, 1999), 10ff. Also on this point, see the text of this chapter below.

[18] DIR Market Information dated 19 July 1999 provided by Daiwa So-ken, quoted by K Abe, "Kabushiki-kokan, Kigyo-bunkatsu no Jitsumu to Kongo no Tenbo" (1999) 1557 *Kinyu-homu-jijo* 13.

[19] *Ibid*.

[20] *Ibid*., at 14.

[21] A special resolution requires a quorum of shareholders who hold more than half of total issued share capital, and two-thirds of such participating shareholders must agree to the resolution: see Commercial Code (CC), s 343.

[22] See CC, ss 353 and 354.

procedures set out in new provisions should provide a safeguard for shareholders who suffer any disadvantage from the major structural changes in corporations.[23] On condition of approval, Company A can successfully acquire the total issued shares of Company B in the form of exchange of total shares issued by Company A for the Company B shares held by shareholders of Company B. Where share exchange comes into effect, all the shares held by shareholders of Company B are void regardless of whether or not shareholders of Company B have submitted them to Company A for the purpose of exchange.[24] The shares held by dissenting shareholders may be bought back by the comany,[25] and approving shareholders must provide their shares, before Company A can become a pure holding company of Company B in any sense.[26] In addition, shareholders, directors, auditors and liquidators of both concerned companies may act against Company A to nullify the effects of such a share exchange within six months after the exchange takes place.[27] It is much easier for Company A to set up a pure holding company only with the issuance of shares tantamount to net assets of Company B, with no special funds needed to acquire Company B.[28] Furthermore, if Company A already holds its own outstanding shares,[29] it can achieve the same goal with the issuance of less new shares to shareholders of Company B.[30] Providing its own shares instead of issuing new shares is explicitly permitted in new legislation.[31]

Short-form share exchange

Where Company A, a future pure holding company, is scheduled to exchange shares with a small company, short-form procedures are available for the reason that the influence of such an exchange on the part of shareholders in Company A is not serious.[32] The positive requirements for such of share exchanges are that the amount of the new issuance of shares of Company A be less than one-twentieth of the total issued shares of that company, and that special payments in balancing the exchange rate for shareholders of Company B by Company A, if any, are less than one-fiftieth of net present assets of the latter company calculated from the latest balance sheet, approval by shareholders can be omitted.[33] If

[23] See, eg, H Konno (ed.), *Heisei 11–nen Kaisei-shoho Report* (Nihon-horei, 1999), 17ff.

[24] See CC, s 368. On the reasoning behind this provision, see K Harada, "Kabushiki-kokan ni kakaru Heisei 11–nen Kaisei-shoho no Kaisetsu (2)" (1999) 1537 *Shoji-homu* 8–9.

[25] See CC, s 355.

[26] See CC, s 352.

[27] See CC, s 363.

[28] Eg, Ibayashi, *supra* n.13, at 2–3.

[29] Under the Japanese Commercial Code, share repurchase by the principal company is in principle prohibited: see CC, s 210ff. Now shares can be, in principle, repurchased from distributable profits and retained in a company as treasury shares after the amendment to the CC in 2001.

[30] Ibayashi, *supra* n.13, at 3.

[31] See CC, s 356.

[32] Konno, *supra* n.23, at 24.

[33] See CC, s 358.

more than one-sixth of shareholders of Company A object to a short-form share exchange, Company A cannot proceed further.[34] These procedures are in line with those for short-form mergers.[35]

Share transfer

Share transfer is similar to share exchange, but occurs where Company A, which is to be a pure holding company of Company B, is newly created for that purpose. Share exchange, on the one hand, is particularly applicable to existing companies. Share transfer, on the other hand, is appropriate for a company that pursues the establishment of a new holding company independently or jointly with another company.[36] The procedures for share transfer are subject *mutatis mutandis* to those of share exchange.[37]

Legal problems

There may also be some legal problems associated with the introduction of these new methods. In this regard, this chapter refers to the following seven points, namely: (i) the relationship between the Anti-Monopoly Act and the Commercial Code; (ii) the legal nature of share exchange and share transfer; (iii) protection of shareholders in parent companies; (iv) protection of the creditors of both companies, that is, parent and subsidiary companies; (v) tax matters; (vi) extraterritorial application of share exchange and share transfer; and (vii) succession of a derivative suit by (shareholders of) a parent company that was involved in such legal proceedings as those of what is now a subsidiary company. The last matter does not seem to be inherently related to the topic of share exchange and share transfer, however, and will be dealt with only briefly.

(i) *Relationship between the Anti-Monopoly Act and the Commercial Code*

This chapter has so far used the term "pure holding company" rather freely; however, to be more precise, the wording should be taking as that used and found only in the Anti-Monopoly Act. The Anti-Monopoly Act defines a subsidiary company as the company in which more than half of the total issued shares are held by another company (a parent company).[38] Where the amount of payments for acquired shares is more than half of the total assets of an acquiring company, such an acquiring company becomes a pure holding company.[39] Although the Commercial Code gives the same definition to the parent-

[34] See CC, s 358 (8).
[35] See CC, s 413–3.
[36] Editorial Note, *supra* n.13, at 7.
[37] See CC, ss 364ff.
[38] See Anti-Monopoly Act (AA), s 9(3).
[39] *Ibid*.

subsidiary relationship,[40] it has no definition of pure holding company as does the Anti-Monopoly Act. This disparity is brought upon by big differences between the ultimate regulatory purposes of these two pieces of legislation. The Anti-Monopoly Act aims to improve fair and free competition, and because of this, it stipulates the strict prohibition of pure holding companies, which induce an over-concentration of business powers based either on direct or indirect causes.[41] The Commercial Code, on the other hand, places emphasis upon the harmonisation of various individual interests among the stakeholders of companies, in particular, shareholders in an internal sense and creditors in an external sense. Therefore, even if a company falling within the definition of a parent company under the Commercial Code is, at the same time, a pure holding company under the Anti-Monopoly Act, it is of no practical interest for the Commercial Code to identify such a company as a pure holding company.[42]

(ii) *Legal nature of share exchange and share transfer*

As illustrated above, the procedures for share exchange and transfer could be regarded as being similar to those of merger under the Commercial Code. This is because the amendment adopts such procedural matters as the stipulation of the items to be included in a statement of share exchange and transfer, requirement for approval at a shareholders' meeting in a proposed pure holding company, the upper limit of increasing capital assets in the same company, some mandatory requirements for an inspector appointed by the courts and so on, which are likened to those of merger.[43] The results of any agreement between two companies that act for themselves directly affect the shareholders of a proposed subsidiary company.[44] However, in terms of their fundamental factual and legal meaning, they are also interpreted as formation of a pure holding company by payment in kind (shares held by shareholders of a future subsidiary company) for the new issuance of shares. Additionally, even though one should interpret the legal nature of share exchange and transfer as a structural change somewhat like merger, he or she might notice an essential difference in relation to share exchange and transfer. That is, the legal personality of the relevant companies would never be in question; in contrast, in a merger, the whole or part of the former legal personality inevitably disappears.[45] This does not seem to raise many practical problems. It should be noted, however, that there are still different ways to grasp the legal concepts of share exchange and transfer. Any legal problems concerning these procedures should, therefore, be addressed with interpretation on a case by case basis for the time being.[46]

[40] See CC, s 211–2 (1).
[41] See AA, ss 9 (1) and 9 (2).
[42] See Konno, *supra* n.23, at 44–45.
[43] See CC, ss 352ff.
[44] Harada, supra n.14, at 11.
[45] Kishida, *supra* n.17, at 18–19.
[46] See Konno, *supra* n.23, at 45–46.

(iii) *Protection of shareholders in parent companies*

Again, taking the above example of Company A and Company B for illustration, shareholders of Company B may exercise their shareholders' rights as long as the company has no relationship with another company. However, they cannot do so any more in the same manner after the share exchange takes place. This is self-evident because they are no longer shareholders of Company B and could not control Company B via a direct check and monitor. It was this very point that concerned those who were involved from the early stage of the Bill's drafting.[47] Company A, being set up as a pure holding company, has the main objective of controlling Company B by holding all or part of its shares. The profits and risks of Company A stem from the corporate activities of Company B, therefore, shareholders of Company A are seriously concerned with the corporate affairs of Company B; however, they cannot take part in its decision-making process. One possibility is that shareholders of Company A appoint appropriate directors at the shareholders' meeting and leave management, including the monitoring of subsidiaries, to them.[48] The Amended Act takes account of this point by providing useful measures for shareholders of Company A, for example, if any modification in the articles of association of Company A results in a share exchange, such modification must be noted in the statement of share exchange,[49] and also they can claim their rights to access relevant corporate information.[50] However, this is still not sufficient and continued review for improving such measures is needed.[51]

(iv) *Protection of creditors in both parent and subsidiary companies*

In the case of share exchange and transfer procedures there is no need to protect company creditors if there is no reduction in a company's financial assets.[52] Nevertheless, if the share exchange rate is extremely disadvantageous to the subsidiary company and the amount of special payments for the purpose of balancing the exchange rate to the shareholders therein is high, the reduction in financial assets of a subsidiary company does occur. This point relating to the need to protect company creditors is contentious. However, at least some creditors, for example debenture holders, should be protected under the special treatment of existing rights, such as the right to convert bonds into shares that might

[47] See, eg, S Morimoto (opinion), "Junsui-mochikabu-gaisha no Kisei-kanwa wo meguru Sho-mondai" (1995) 1388 *Shoji-homu* 22; Kigyo-hosei Kenkyu-kai, "Junsui-mochikabu-gaisha oyobi Dai-kibo-gaisha no Kabushiki-hoyu-kisei no Minaoshi Teigen" (1995) 132 *Shiryo-ban Shoji-homu* 12.

[48] See E Kuronuma, "Mochikabu-gaisha no Ho-teki Sho-mondai (3)" (1995) 120 *Shihon-shijo* 71; H Tarui, *Kaisha-ketsugo to Kazei-mondai* (Zeimu-keiri-kyokai, 1999), 92–93.

[49] See CC, s 353(2) I.

[50] See CC, ss 244 (4), 263 (2), 263 (4), 274–3, 281–3, 282 (3), 293–8 (1).

[51] See Konno, *supra* n.23, at 47.

[52] See, eg, Ehara et al, *supra* n.14, at 88 (*Jurisuto*) and 7–8 (*Kinyu-homu-jijo*).

well be as a matter of course transformed in the event of share exchange, particularly when the parent company is going private.[53]

(v) *Tax matters*

Tax might be imposed upon capital gains, if any, that belonged to shareholders who were allotted shares by a proposed parent company in exchange for the shares of a proposed subsidiary company.[54] This is because even if share exchange and transfer could be regarded as a fundamental structural change for companies similar to merger, from the tax perspective it is still characterised as share trading.[55] However, the Act on Special Tax Measurements (*Sozei-tokubetsu-sochi-ho*), revised in line with the Commercial Code, does not impose tax on capital gains at the moment of share exchange or transfer, but only when shares received in the process of exchange or transfer are sold.[56] As for the parent company, it raises its share capital by issuing new shares in share exchange and transfer,[57] nevertheless, this is regarded as capital trading, which is not subject to tax upon companies under the corporate tax law.[58] Where the parent company allots its own shares to the subsidiary in the new issuance, tax will be imposed because such treasury shares are regarded as corporate assets.[59]

Not only capital gains tax but also other taxes, such as stamp duty for the registration of companies, would be considered from the tax perspective in the case of share exchange and transfer. The Committee on Investigating the Tax System of the Liberal Democratic Party (*Jimin-to Zei-sei Chosa-kai*) has decided to mitigate such registration tax and has amended the relevant legislation so as to assist corporate reconstruction.[60]

(vi) *Extraterritorial application*

In a practical sense, this is one of the most serious concerns in the context of the current dramatic increase in trans-boundary M & As in Japan. It is reported that the number and the value of M & As involving Japanese corporations had already reached a record of as many as 1,160 and as much as nearly seven billion yen by the end of 1999 (see Figure below). However, this is not a phenomenon special to Japan, the same has been observed throughout the world, particularly

[53] Kishida, *supra* n.17, at 33–34.

[54] Tarui, *supra* n.48, at 99ff and 189ff.

[55] *Ibid*., at 103–4.

[56] See the Act on Special Tax Measurements, s 67–9–2, as well as the Statutory Instruments of the same Act, 39–30–2(3).

[57] See CC, ss 357 and 367.

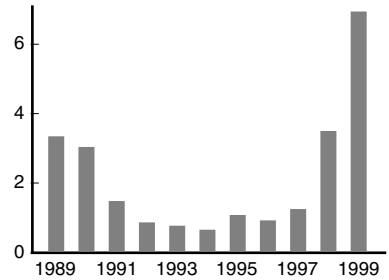
[58] See the Corporation Tax Act (*Hojin-zei-ho*), s 22(2) and (3).

[59] *Ibid*. For details, see Tarui, *supra* n.48, at 104–5. Also, for the legislative proposal from the tax perspective, *ibid*., at 228 ff.

[60] See *Nihon Keizai Shimbun*, 11 December 1999.

in Europe.[61] The issue was of real international concern when a UK company, Cable and Wireless (C & W), was struggling with a rival Japanese company, Nippon Telecommunications and Telephone (NTT) towards acquiring the Japanese company, International Digital Communications (IDC). NTT, a domestic corporation in any sense, would undoubtedly take advantage of the new procedures of share exchange, conversely, it was not clear as to whether or not C & W could do the same.[62]

Figure *Total Values of M & A involving Japanese Corporations (unit : trillion yen)*



Provided by Nikko Securities Co. Ltd. based upon publicly released data quoted in *Nihon Keizai Shimbun*, 25 December 1999, evening version.

The Japanese Commercial Code does not have definitions that differentiate between domestic companies and foreign companies. However, in principle the former are regarded as being established under the procedures of the Japanese Commercial Code and the latter under equivalent foreign legislation.[63] Consequently, it might be expected that foreign companies formed and registered outside Japan would not be able to use the new acquiring methods. However, if their registered office or principal business place is in Japan, they can, pursuant to certain conditions such as reformation under the Japanese Commercial Code,[64] utilise provisions of the Japanese Commercial Code on some occasions,[65] even though such provisions were introduced, it appears, for the purpose of preventing fraudulent formation of foreign companies.[66]

[61] In 1999 the sum for total global M & As reached a record of 3.32 billion US dollars: see *Nihon Keizai Shimbun*, 25 December 1999, evening version.

[62] In the end, C and W successfully acquired IDC at the approximate price of 55 billion yen: see, eg, *Nikkei Sangyo Shimbun*, 23 June 1999; *Nihon Keizai Shimbun*, 25 December 1999, evening version.

[63] M Tatsuta, *Kigyo-ho to Kokusai-shakai* (Yuhikaku, 1997), 9ff; *supra* n.16, at 16.

[64] This point has revealed some different points of view. For example, that reform is not required and the Japanese Commercial Code is applied directly except those provisions concerning setting-up procedures or as long as such corporations are reconstructed in the equivalent forms recognised under the Japanese Commercial Code.

[65] See CC, s 482. See generally on the extraterritorial application of the Japanese Commercial Code, H Kawamura, "Kokusai-kaisha-ho no Kannen ni tsuite" (1997) 3–2 *Kyushu-kokusai-daigaku-hogaku-ronshu* 47–78.

[66] See, eg, Z Okamoto, *Shin-ban Chushaku Kaisha-ho* (Yuhikaku, 1990), 533ff.

(vii) *Derivative suit rights for ex-shareholders of a subsidiary*

When the proposal for amendment to the Commercial Code in order to facilitate pure holding companies came out as a public issue, some newspapers criticised it for benefiting proposed subsidiary companies which want to legitimise the shutting-down of derivative actions by shareholders.[67] In other words, they posed difficult questions as to whether or not shareholders who once invested in the subsidiary company may bring a derivative suit against the subsidiary company after share exchange or, where they already did so while they were shareholders of the same company, whether or not they may continue such actions even after share exchange – since, as has been noted, they would no longer shareholders of the subsidiary but of the parent company. However, effective statutory measures for this have not yet been incorporated into legislation. The review initiated by the Ministry of Justice has just started considering this point.

NEW CORPORATE ACCOUNTING STANDARDS

The modification of appraisal standards for corporate assets was set out by the report on adjusting co-ordination of the provisions of the Commercial Code and corporate accounting practice (*Sho-ho to Kigyo-kaikei no Chosei ni kansuru Kenkyu-kai Hokoku-sho*) submitted in June 1998. This report strongly recommended that the appraisal of corporate assets on a market price basis should be introduced into the Commercial Code from the following viewpoints: firstly, to give a true and fair view of corporate assets in financial statements in response to the varying risk and return of the financial instruments possessed by companies; and, secondly, to protect company creditors from the threat of appraisal loss caused by differences between a cost evaluation and a market price.[68] A draft on the accounting standards relating to financial instruments (*Kinyu-shohin ni kakaru Kaikei-kijun no Settei ni kansuru Iken-sho*)[69] was also prepared on the same day, and this draft gave a basis for the statement on the legal issues of parent-subsidiary companies (*Oyako-gaisha-hosei-to ni kansuru Mondai-ten*), as referred to above. The latter covered and called the matters of validity of appraisal on a market price basis and measurement for net appraisal profits into question. Public opinion approved appraisal on a market price basis and most considered that net appraisal profits should be deducted from net assets.[70]

[67] *Supra* n.16.

[68] For this report, see (1998) 1496 *Shoji-homu* 29–32; (1998) 50 *Kigyo-kaikei* 11(appendix).

[69] For this draft, see (1998) 1499 *Shoji-homu* 46–47; (1998) 50 *Kigyo-kaikei* 36–50 (appendix).

[70] Harada et al, *supra* n.15, at 20. For background, see M Yanaga, "Shisan-hyoka-kitei no Kaisei to Tochi-sai-hyoka-ho no Kaisei" (1999) 1163 *Jurisuto* 105 ("Yanaga 1"); M Yanaga, "Shisan no Jika-hyoka no Donyu ni tuite" (1999) 51 *Kigyo-kaikei* 69 ("Yanaga 2").

The amendment considered public opinion submitted in response to the statement on parent-subsidiary companies, and changed the statutory basis for appraisal of corporate assets, which had been based upon cost valuation standards since 1962 (subject to a 1974 amendment).[71] First of all, it should be noted that almost any kind of corporate asset that has a market price can be evaluated on a market price basis. The amendment may be summarised as follows. Firstly, corporate assets listed in provisions can be estimated by market price.[72] Secondly, the differentiation of negotiable instrument assets between those for which a price is given on exchange and those for which a price is not given on exchange is changed to a differentiation based on whether or not they have a market price, irrespective of which market it might be.[73] Thirdly, as a general rule, monetary credits that carry a market price should be regarded as tantamount to the real value of such credits; however, if such monetary credits were purchased by a price higher than the real value of the credits, it is possible to use the higher value.[74] This is in line with the introduction of appraisal by market price.[75] Fourthly, net appraisal profits caused by market price evaluation should be deducted from distributable profits.[76]

The introduction of appropriate appraisal standards for corporate assets is currently a major problem in the international sphere as well. The International Accounting Standard Committee (IASC), set up as a private body corporate by the professional bodies of nine advanced countries, had a semi-official nature after the International Organisation of Securities Commission (IOSCO) was appointed as one of its advisory groups.[77] It has been involved in preparing the *de facto* international accounting standards.[78] The revision of Japanese corporate accounting standards was apparently initiated with the purpose of going along with this move towards international standards. Both the Commercial Code and the domestic accounting standards were mandated to change in accordance with the international standards. However, introducing and recognising the new evaluation standards might be, as one commentator has

[71] On the backdrop of the adoption of appraisal on a cost basis, see M Mori, "Kodo-keizai-seicho to Keisan-kitei no Kindaika: Showa 37–nen no Kaisei, Showa 38–nen Keisan-shorui-kisoku-seitei" in M Hamada (ed.), *Nihon-kaisha-rippo no Rekishi-teki-tenkai* (1999), 304ff; J Ueda, "Nihon-teki Kikan-kosei eno Ketsudan: Showa 49–nen no Kaisei, Shoho-tokurei-ho no Seitei" in *ibid*., at 410–411.

[72] See CC, ss 285–4 (3), 285–5 (2), 285–6 (2).

[73] See CC, ss 285–2 (1), 285–2 (2), 285–4 (3) (debentures with market price), 285–4 (2) (debentures without market price), 285–2 (1), 285–2 (2), 285–4 (3) (shares with market price), 285–5 (2), 285–5 (3), 285–6 (2), 285–6 (3) (shares without market price).

[74] See CC, s 285–4 (1).

[75] Kishida, *supra* n.17, at 111–112.

[76] See CC, ss 290 (1) vi, 293–5 (3) v.

[77] IOSCO made an agreement with IASC to recommend that a corporation with an intention of listing on a stock exchange should prepare its financial statements based on IAS, which aimed at improving cross-border trading: see Y Hirose, "Kigyo-kaikei no Kokusai-teki-chowa to Kokunai-teki-chowa" (1998) 1500 *Shoji-homu* 62.

[78] Kishida, *supra* n.17, at 107–108.

suggested, like undergoing Copernican change within the framework of existing domestic accounting standards,[79] and further detailed discussions on individual accounting matters are still required.[80]

PROPOSED NEW PROCEDURES FOR DE-MERGER

All the reforms indicated above were introduced as part of extending and utilising corporate restructuring methods. There is still one important procedure of de-merger left to be taken. This institutional need was referred to in the Three-Year Deregulating Programme (*Kisei-kanwa Suishin San-kanen Keikaku*) decided by the Cabinet in March 1999, which was followed and forwarded by the Private Advisory Board of the Prime Minister, the Conference Reviewing Industrial Competition (*Sangyo-kyoso-ryoku Kaigi*).[81]

From a comparative perspective, the procedures for de-merger were adopted in corporate legislation as early as the 1960s in Europe,[82] while Japan has never had such provisions in the Commercial Code before. Therefore, in practice when a company had plans to separate its business by creating another independent company, they could only pursue the best available measure within the existing statutory framework. This would have allowed, at best, the transfer of part of their business to another company by an individual contract, not enabling comprehensive succession of their business and as a result, the two companies would still be combined through a parent-subsidiary relationship.[83] This is definitely not the kind of de-merger that the business world has desired.[84] The lack of a clear legal base for de-merger has been a matter of life or death to Japanese corporations in their struggle to survive, particularly in this changeable and deregulating business environment, and in response to this mood the Law Commission at the Ministry of Justice initiated and has

[79] For further discussion on this point, see Hirose, *supra* n.77, at 63ff.

[80] Individual problems that still need consideration are: (1) interpretation of depletion to fixed assets, which should be depreciated; (2) review of the evaluation standards for shares of subsidiary companies; and (3) appropriation of the payments for new shares issued in exchange for warrants or convertible rights for capital reserve: see Yanaga 1, *supra* n.70, at 109ff; Yanaga 2, *supra* n.70, at 73ff.

[81] See Editorial Note, "Sukuranburu" (1999) 1533 *Shoji-homu* 62; s*upra* n.16, at 19.

[82] France adopted this type of legislation, the earliest among other European, and possibly all other, countries in 1966. The EC produced the 6th Directive on de-merger in 1982, which was implemented by the UK in 1987, and by Germany in 1994.

[83] See M Hayakawa, "Shoho kara mita Kaisha-bunkatsu-rippo no Arikata"(1999) 1165 *Jurisuto* 10.

[84] A serious concern of the business world in relation to de-merger can be traced back to the 1960s when capital trading was liberalised in times of high economic growth and Japanese corporations were terrified at the predicted competition with foreign corporations in a deregulating business environment: see, eg, Kei-dan-ren, "Kaisha no bunkatsu ni kansuru Ho-seibi ni tsuite Yobo" (1968) 463 *Shoji-homu* 55; Kei-dan-ren-rizai-bu (ed.), *Kaisha no Bunkatsu/Gappei ni kansuru Hosei*, Keizai-shiryo No.253 (1969).

concentrated on drafting new legislation, which was published an interim draft bill in July 1999[85] and came into operation in 2000.[86]

An outline of the amendment will be considered next by reference to the following four matters: (1) proposed procedures; (2) de-merger to be covered within the scope of the Commercial Code; (3) relationship between de-merger, share exchange and merger; and (4) protection of shareholders and creditors. I will summarise proposed procedures first, and then examine individual legal issues.

Proposed procedures

As noted in the foregoing subsection, a general survey suggests that the amendment adopts procedures similar to those of share exchange and merger. Firstly, it notes the concept of de-merger. That is, a company may set up a new company with a view to transferring part of its rights and obligations, and also, that a company may transfer part of its rights and obligations to an existing company. In both cases, the company that will be separated, as noted, should exist after the procedures are completed.[87] The amendment puts these two types of de-merger into individual procedures. However, the following discussion will deal with them comprehensively as the procedures look much alike. Secondly, the amendment obliges a company with plans of de-merger to prepare a statement of de-merger that must be submitted to a shareholders' meeting. The proposed de-merger cannot be carried out unless shareholders approve the statement by a special resolution.[88] This requirement is modelled on that of share exchange and merger discussed earlier. Where a company has an intention not to allot shares of a new company to shareholders but only to transfer their net assets which amount to less than one-tenth of the former company calculated from the latest balance sheet, approval by shareholders may not be required.[89] The statement must be kept and open for the inspection by shareholders and creditors at a registered office.[90] Finally, shares of dissenting shareholders must be repurchased by a company at a fair price.[91] There is also a proposal for judicial proceedings that give *locus standi* to shareholders, directors, auditors, liquidators and so on of the relevant companies to nullify any effects of the de-merger.[92]

[85] See *Nihon Keizai Shimbun*, 7 July 1999, 8 July 1999. For background, see K Harada et al, "Shoho-to no Ichi-bu wo Kaisei-suru Horitsu-An-Yoko-Chukan-Shian no Kaisetsu" (1999) 1533 *Shoji-homu* 4; (1999) 1553 *Kinyu-homu-jijo* 6.

[86] *Nihon Keizai Shimbun*, 7 July 1999; 8 July 1999.

[87] See I-1, No.1 of the Amendment.

[88] See I-2, No.1 of the Amendment.

[89] See I-10, No.1 of the Amendment.

[90] See I-3 and I-15, No.1 of the Amendment.

[91] See I-4, No.1 of the Amendment

[92] See I-16, No.1 of the Amendment.

De-merger covered

It seems necessary to clarify the policy towards de-merger under the Commercial Code as there is still broad vagueness in laying down the forms of de-merger for practical usage. The amendment covers a mixture of the forms of de-merger, for example, those without the separation of assets and those involving the separation of assets *and* shareholders (a new company allots shares to the shareholders of a existing company, and as a result, such shareholders will also be separated from the former company), and clearly states that companies limited by shares may set up a new company for the purpose of separating and transferring part of their business to that company. It, however, excludes such procedures whereby the former companies dissolve at the time of de-merger without going through any winding-up procedures. The reason for the omission might be, according to the lawmakers, that such procedures are unusual from a comparative perspective, and also the business world is negative to their use.[93] It should be noted, however, that there is some remaining controversy on this point.

Relationship between de-merger, share exchange and merger

The amendment imposes an obligation on a company that is going to take advantage of the procedures of de-merger to make a statement of de-merger. The format of the statement is similar to that required for share exchange. Since de-merger is likened to share exchange and merger, it is taken as nearly the same or the exact reverse phenomenon of share exchange and merger. In the process of lawmaking, therefore, it should be considered which could be the best of three alternatives as a legal policy - that is, being in line with that of share exchange and merger, or distinct from that of share exchange and merger, or a mixed approach.[94] The procedures might be different depending upon which option is taken, in particular regarding protection of shareholders and creditors. Furthermore, if the last option is favoured, those procedures essential for de-merger should be limited to common rules amongst de-merger, share exchange and merger. Thus de-merger would be referred to as a typical de-merger in which, as already indicated, a company going to de-merge must dissolve under the procedure without liquidation. However, as already noted, the amendment does not adopt a type of de-merger that amounts to a dissolution of the former company. Considering the significance of these alternatives, the amendment, as a whole, relies upon the procedures of share exchange and merger.[95]

Protection of shareholders and creditors

Most of the procedures, as discussed above, are introduced in order to protect

[93] See, eg, Harada et al, *supra* n.15, at 16. For supportive discussion, see Hayakawa, *supra* n.83, at 11.

[94] For details on these three different approaches, see Hayakawa, *supra* n.83, at 11ff.

[95] *Ibid*.

shareholders and company creditors. Firstly, shareholders of both companies can take part in the process of decision-making for de-merger via a resolution at a shareholders' meeting. This also has the function of providing relevant information for shareholders. A special resolution is required for approval but whether or not such a strict condition is needed for both companies is unclear. Secondly, shareholders who disagree with the proposed arrangements of de-merger can make a claim against the company to sell their shares at a fair price. Thirdly, shareholders can file a complaint against the company to nullify any effects of de-merger. Fourthly, shareholders and company creditors can access information concerning any de-merger. Finally, a company planning to de-merge must ensure an opportunity for its creditors to express their opinions. The amendment provides that the company shall publicise the planned de-merger in the official gazette in order to invite objections from creditors, and must also notify each creditor whose address is known in order to invite his or her dissenting opinion within a specified period of time after the resolution.

LEGAL PROBLEMS WITH THE AMALGAMATION OF FINANCIAL INSTITUTIONS

Finally, this chapter will touch upon inherent legal problems with the reorganisation of financial institutions. As already noted at the beginning, the momentous move towards rebuilding financial institutions, which crossed over the *keiretsu*, or Japanese six major corporate groups, could have never been imagined until recently in Japan.[96] The backdrop of accelerating occurrences of crossing over might be attributable to recent relaxation of *keiretsu* relationships.[97] As general legal problems with the corporate amalgamations have hitherto been looked at, those rather unique to financial institutions, especially banks (which are of major concern), are separately dealt with here.

First and foremost, the banking business is noteworthy because it must be made subject to strict regulation due to its serious impact on the economy and public interest. In this respect, the banking business must be supervised and monitored by the Financial Reconstruction Commission (*Kinyu-saisei-iin-kai*) (hereinafter Commission), which was set up in December 1998 for the purpose of rectifying the flawed financial business sector and producing a sound economy (the Financial Services Agency took over the Commission as of

[96] As newspaper articles focusing upon the crossing over of the 6 major corporate groups, see eg, *Nihon Keizai Shimbun*, 22 September 1999; *Nihon Keizai Shimbun*, 14 October 1999, evening version; *Nihon Keizai Shimbun*, 15 October 1999; "Geki-ryu Mega-banku" *Nihon Keizai Shimbun*, 15 October 1999, 16 October 1999; *Nihon Keizai Shimbun*, 16 October 1999, evening version; *Nihon Keizai Shimbun*, 17 October 1999; "Aitsugu Kinyu-dai-togo", *Nihon Keizai Shimbun*, 18 October 1999; "Kuzureru Kigyo-shudan 1–4", *Nihon Keizai Shimbun*, between 21& 24 November 1999; "Todori Tachi no Ketsudan", *Nihon Keizai Shimbun*, 15 December 1999.

[97] The corporations and banks are said to have sold their shares particularly in situation of poor yield in relation to plans for re-arrangement: "Kinyu Dai-saihen 4", *Nihon Keizai Shimbun*, 23 October 1999; *Nihon Keizai Shimbun*, 28 December 1999.

6 January 2001 concurrently with the abolition of the Commission).[98]

Secondly, new legislation entitled the Special Act adjusting the Existing Financial Legislation to the Release of Holding Companies (*Mochikabu-gaisha no Setsuritsu-to no Kinshi no Kaijo ni tomonau Kinyu-kankei-horitsu no Seibi-to ni kansuru Horitsu*) was passed in the Diet in December 1998, which largely modifies existing financial services legislation, that is the Banking Act (*Ginko-ho*), the Securities Exchange Act (*Shoken-torihiki-ho*), the Insurance Business Act (*Hoken-gyo-ho*) and so on. The Banking Act as amended by the new legislation defines a holding company of a bank consistently with Article 9 (3) of the Anti-Monopoly Act (it must be a pure holding company) holding more than half of the shares of subsidiary bank, and must be approved by the Commission.[99] For its part, when a bank notices that more than half of its total issued shares have been acquired by another company, the bank must notify the matter to the Commission.[100] However, in this case that company need not be regulated under the Banking Act unless it falls within the definition of a pure holding company under the Anti-Monopoly Act. It should be pointed out that the fact that only a pure holding company controlling a bank is covered by the regulations cannot be justified in terms of equity.[101]

Thirdly, a holding company of a bank may carry out only a limited range of business affairs such as the business management of subsidiaries and related affairs.[102] Such a holding company cannot own subsidiaries other than financial companies.[103] In addition, the conditions set out in the Act for filing with and concession from the Commission vary amongst types of financial business.[104]

Fourthly, the percentage of shares that a holding company of a bank as well as its subsidiaries may hold in companies other than its subsidiaries is limited to 15 per cent.[105] It might be possible for such a holding company to own 10 per cent of the shares of another non-financial company (and its subsidiary bank to hold 5 per cent, which is in principle the upper limit of shares permitted for financial institutions to have in another company under the Anti-Monopoly Act)[106]; however, it seems incompatible with not only the significance of separation of financial affairs and non-financial ones in order to establish sound financial business but also with the exclusion of over-concentration of economic power conferred on financial institutions.[107]

[98] On the background of the Commission, and its establishment and activities, see Kinyu-kantoku-cho (ed.), *Kinyu-kantoku-cho no 1–nen* (Okura-sho-insatsu-kyoku, 1999), 5ff; *Nihon Keizai Shimbun*, 15 December 1999.

[99] See the Banking Act (BA), s 2(10) and 2(11).

[100] See BA, ss 53 (1)-7.

[101] On this point, see H Fujise, "Ginko-mochikabu-gaisha-gurupu no Kochiku ni kansuru Hoteki-sho-mondai (1)" (1999) 1560 *Kinyu-homu-jijo* 9.

[102] See BA, s 52–5 (1).

[103] See BA, s 52–7 (1).

[104] See BA, ss 52–7 (3) and 53 (3).

[105] See BA, s 52–8 (1).

[106] See AA, s 11.

[107] See Fujise, *supra* n.101, at 10.

Finally, directors who are involved in the actual management of a holding company of a bank cannot, in principle, get in touch with the management of other companies.[108] The aim of this provision is to ensure that directors concentrate on banking management and to prohibit easy lending between a subsidiary bank and the other companies associated with such directors. In practice, executive officers have been rapidly overwhelming board members. One thus might ask whether or not 'the directors' include in the provision executive officers as well. This should not be regarded as a minor problem.

CONCLUSION

This chapter has thus far given an overview of the recent legal problems accompanied by the ever-changing economic situation and corporate statutes in Japan. A significant amount of individual legal problems still need discussion and resolution. Each point of the debate has been summarised, but the one point I would like to emphasise is that the recent amendments or proposals for revision of corporate legislation have been motivated by practical need. This seems to raise an essential question as to whether or not enhancing economic efficiency by satisfying and fulfilling such demand would ultimately have a positive impact within the evolving corporate legal framework towards which Japan should direct itself. The practical need, if urgently required, should be taken seriously into account within the legal framework, and it should be noted that a certain amendment would come after. The Ministry of Justice has intensively reviewed and hastily acted towards drafting new legislation, which is rather unusual in Japan, but some concerns, as has so far been pointed out in this chapter, have to be raised in future discussions. Given the situation in which these procedures of law-making have occurred, if they are inconsistent with other related procedures are they still better than nothing?

The Platform for Revision of the Tax System released by the Liberal Democratic Party (*Jimin-to Zei-sei-kaisei-taiko*) in December 1999 deals with corporate tax matters with special reference to de-mergers, but it notes that the consolidated tax regime would be introduced after a new tax regime for de-merger is introduced in the fiscal year 2001.[109] This means, in effect, that the introduction of consolidated tax will be extended at least until the fiscal year 2002, which has caused serious concerns in the business world. Norio Ohga, former CEO of the Sony Corporation, which as noted above has been keen on setting up pure holding companies under the new procedures, said in response that if the introduction of the consolidated tax regime is considerably prolonged then the real business impacts of establishing pure holding companies will be largely reduced, which also waters down all deregulating effects.[110] Further, he worries that this may be a

[108] See BA, s 52–4 (1).
[109] *Nihon Keizai Shimbun*, 17 December 1999.
[110] *Ibid*.

plausible reason for international business enterprises, which look for the optimal business operational sites, to withdraw from Japan.[111] As long as the recent situation surrounding lawmakers, the business world, academia, the general public and so on is closely monitored, the dynamics of the interaction between practical needs and construction of a legal framework are not balanced in any sense. As noted, practical needs have caused haste on the part of the drafters leading to some inconsistency in the new provisions of the Commercial Code with other relevant provisions. This has triggered practical frustration arising from the lack of apparent horizontal connection between the systems.

After all, only new legislation that has been properly reviewed and systematically prepared for allows the business world to reconstruct and revitalise in, and to adjust to, unstable economic situations in a bid to survive the new millennium.[112]

POSTSCRIPT

Our corporate statutes were drastically changed between 2001 and 2002. The proposed amendment relating to de-merger was successfully adopted in almost the same state as what it was in May 2000. After the adoption of new schemes for corporate reorganisation, which was rather in pressing need for the business world, was completed, the Law Commission within the Ministry of Justice initiated the full review of the Commercial Code in September 2001 along the following four main pillars: *i.e.*, 1) effective framework for corporate governance; 2) ensuring voluntary use of advanced information technology (IT) within the corporate statutory framework; 3) expediting the procedures for corporate capitalisation; and 4) ensuring global corporate activities within the corporate statutory framework. The Commission pointed out a number of issues from the many multifaceted perspectives. Some pressing points in its proposal were advanced in order to be adopted in November 2001. They are, for example, the regulation of share capitalisation, reformation of class of shares, re-conceptualisation of pre-emptive rights and acknowledgement of electronic documents in the area of corporate statutes in view of the current IT advancement. Some of the rest of the reviewing points became an amended act to the Commercial Code in May 2002, which largely related to corporate decision-making organs, capitalisation and accounts.

During the reviewing process initiated by the Commission, there were other amendments made which were strongly driven by legislature, independent from the administration. One was to release treasury shares as in the US regime, and the other was to strengthen status and powers of statutory auditors whilst relaxing reponsibilities of board members and statutory auditors who confirmed compensatory liabilities for their misconduct, for example, through derivative suits. The former was adopted in June 2001, and the latter in December of the same year.

Finally, the extremely important reform such as the consolidated tax regime pointed out above, was eventually incorporated in the Corporation Tax Act in June 2002.

[111] *Ibid.*

[112] As an example of the literature that gives a useful forecast, see Y Maeda et al, (free discussion), "Kon-go no Kaisha-ho-kaisei ni kansuru kihon-teki-na Shi-ten"(2000) 1548 *Shoji-homu* 8; K Harada et al (special issue), "2000 Shoji-homu Tenbo" (2000) 1548 *Shoji-homu* 34ff.

10

CLERP and its Impact on Australian Futures Regulation

RASIAH GENGATHAREN

INTRODUCTION

The Corporate Law Economic Reform Program (CLERP), launched in March 1997, is an initiative to improve the regulatory environment for business and forms part of the Federal Government's drive to promote economic growth and employment in Australia. It involves a major review of a number of key areas of regulation that impact on business and investment activity. In line with the Federal Government's intention to undertake regulatory reform through a consultative process, seven discussion papers were issued to the public for comment.[1] The sixth paper, *Financial Markets and Investment Products* (CLERP 6)[2], which was released in December 1997, contained an extensive range of proposals that sought to implement the broad recommendations of the Financial System Inquiry (FSI).[3] The FSI concluded that the deficiencies in financial regulation were largely the result of the rapid changes taking place in the financial services industry:

> The [Australian] financial system has entered an era of accelerated change that is likely to continue into the next century. Change in the financial system implies the need to adapt regulations imposed on financial institutions and markets. Regulation must adapt both to facilitate greater competition and efficiency in the financial sector and to secure the integrity and stability of its operations.[4]

In March 1999, the Federal Treasury released a consultation paper, *Financial Products, Service Providers, and Markets – An Integrated Framework*[5], which

[1] The discussion papers covered the following areas: accounting standards, fundraising, directors' duties and corporate governance, takeovers, electronic commerce, financial markets and investment products, and simplified lodgements and compliance.

[2] Treasury, *Financial Markets and Investment Products* (Canberra, AGPS, December 1997) ("CLERP 6").

[3] The FSI was established in June 1996 by the Federal Treasurer and was charged with providing a comprehensive stock-take of the Australian financial system.

[4] See Treasury, *Financial System Inquiry Final Report* (Canberra, AGPS, March 1997), 1.

[5] Treasury, *Financial Products, Service Providers and Markets – An Integrated Framework* (Canberra, AGPS, 1999) ("Implementing CLERP 6 Consultation Paper").

further developed the proposals for reform of financial market regulation presented in CLERP 6. Following a period of public consultation, an exposure draft Financial Services Reform Bill was released to the public for comment in February 2000. The exposure draft was subsequently amended to accommodate the comments received from various stakeholders, the Parliamentary Joint Committee on Corporations and Securities and the Business Regulation Advisory Group. The Federal Government had originally intended that the Financial Services Reform Bill would amend the Corporations Law[6] and come into effect on 1 January 2001.[7] However, the High Court decisions in *Re Wakim; Ex parte McNally*[8] and *R* v. *Hughes*[9] raised doubts about the constitutional validity of the Corporations Law scheme and it was decided that the implementation of the Financial Services Reform Bill should be deferred until a solution was found.[10] In early 2001 the constitutional crisis was resolved when the States and Northern Territory referred to the Commonwealth their powers to make laws about corporations. On 15 July 2001, following the referral of state powers, the Federal Government passed the Corporations Act 2001 and the Australian Securities and Investment Commission Act 2001. Both pieces of legislation operate as Commonwealth laws and apply Australia-wide.

The Financial Services Reform Bill 2001 (the Bill) was introduced into parliament on 5 April 2001. The central theme of the Bill is the introduction of harmonised regulation for all functionally similar financial products. Under the existing approach, financial products are subject to different regulatory schemes. For example, Chapter 7 of the Corporations Act regulates the trading of securities, while Chapter 8 regulates the trading of futures contracts.[11] The new regulatory regime will significantly alter the current regulatory framework

[6] The Corporations Law was the predecessor of the Corporations Act 2001. Until it was replaced on 15 July 2001, it had been the main source of statutory law for companies in Australia. Although it operated as if it was a single law governing the whole of Australia, it was in fact a set of separate State and Territory laws that adopted common provisions found in the Corporations Act 1989 (Cth). The principal reason behind the co-operative arrangement was that s 51(xx) of the Australian Constitution empowered the Commonwealth to make laws only with respect to "foreign corporations, and trading and financial corporations formed within the limits of the Commonwealth". The courts have always adopted a narrow construction of the Commonwealth's power contained in s 51(xx). In *New South Wales* v. *Commonwealth* (1990) 169 CLR 482, the High Court construed s 51(xx) to mean that the Commonwealth only had powers to make laws with respect to companies that have already been formed. This means that the power to make laws with respect to incorporation lie not with the Commonwealth but with the States and the Northern Territory.

[7] See Treasury, *Financial Services Reform Bill: Commentary on the Draft Provisions* (Canberra, AGPS, February 2000) ("FSRB Commentary"), 2.

[8] (1999) 163 ALR 270.

[9] (2000) 171 ALR 155.

[10] For a useful discussion of the previous Corporations Law scheme and the constitutional crisis, see P Lipton and A Herzberg, *Understanding Company Law* (Sydney, Lawbook Co, 2001), 7–14.

[11] Apart from ch 7, there are also other provisions in the *Corporations Act* that regulate the trading of securities. For example, ch 6 regulates the acquisition of shares in a takeover while ch 6D regulates the issue and sale of shares to the public.

for futures. In view of the international nature of futures trading and the increasing linkages between financial exchanges worldwide, any changes to Australian futures regulation would be of interest to members of the international financial community. Yet, there has been relatively little published literature on the proposed regulatory changes. This chapter has been written with the object of addressing this need. I propose to divide this chapter into a number of parts. The first part will explain the nature of futures contracts and trace the development of the Australian futures market. In the second part, I will outline the existing regulatory scheme for futures contracts. The third part will examine some of the existing regulatory problems and issues. The fourth part will set out the key changes proposed by the Federal Government. In the fifth and final part, I propose to comment on the new framework and its implications.

PART I: DEVELOPMENT OF THE AUSTRALIAN FUTURES MARKET

Nature of futures contracts

Before tracing the development of the Australian futures market, it would be useful briefly to explain the nature of a futures contract. A futures contract is an exchange-traded derivative. For those unfamiliar with financial jargon, a derivative is any agreement whose value changes in relation to the price of some underlying asset or instrument. Derivatives do not themselves grant or transfer the underlying interest from which they are derived.[12] Although derivatives are principally used for the management of risks, ironically they are also capable of creating risks. The highly leveraged nature of derivatives makes them more risky than other conventional financial instruments. Leverage magnifies gains and losses, making derivatives unsuitable for many investors. Some types of derivatives are traded on organised exchanges, while others are traded over-the-counter (OTC). The four most common categories of derivatives are futures contracts, swaps, forward contracts and options. There are a number of other financial instruments in Australia that are also "derivatives" in the sense that their values are derived from the values of other variables. For example, interests in managed investment schemes[13] are, from an economic viewpoint, functionally similar to derivatives even though they are legally classified as "securities".[14] Despite the fact that there are many different types of derivatives, only futures contracts are subject to regulation. Other types of derivatives, especially those traded over-the counter, are rarely subject to any form of direct regulatory control. This inequality in regulatory treatment has prompted calls for a more level playing field.

[12] See HAJ Ford *et al*, *Ford's Principles of Corporations Law* (Sydney, Butterworths, 1999), para 22.071.

[13] Managed funds and property trusts are examples of managed investment schemes.

[14] See Corporations Act, s 92(1) for the definition of "securities".

A futures contract is a form of forward contract as it is also an agreement to buy or sell an underlying asset at an agreed price at a specified future date.[15] Yet in many ways futures contracts are different from forward contracts.[16] First, most of the terms of a futures contract are standardised. For example, all 90-Day Bank Accepted Bill Futures contracts are based on 90-Day Bank Accepted Bills of Exchange with a face value of $500,000 and have specified delivery months and settlement days. Forward contracts, on the other hand, are customised agreements, the terms of which are open to negotiation. Second, futures contracts are traded on organised exchanges such as the Sydney Futures Exchange. Since the contractual obligations under futures contracts are entered directly with the exchange's clearing-house, the credit risk is minimal. Forward contracts are traded OTCand they tend to be more risky from a credit viewpoint. Third, futures contracts are relatively smaller in value and therefore more accessible to retail investors. Forward agreements, on the other hand, are typically larger transactions and are used mainly by corporate and institutional investors.

Origins of futures trading

The Australian futures industry owes its origins to the establishment of the Sydney Greasy Wool Futures Exchange in 1960.[17] There was at that time a need to provide a hedging facility for the Australian wool industry. Trading in Greasy Wool (Deliverable) Futures started on 11 May of the same year.[18] In the first fifteen years of its existence, the Australian futures exchange traded only in wool futures contracts. With the decline in usage of wool, the exchange saw the need to offer futures contracts based on other commodities. In 1972, the Sydney Greasy Wool Futures Exchange changed its name to the Sydney Futures Exchange (SFE) to reflect its new role. On 16 July 1975, the SFE launched its Trade Steers (Deliverable) Futures.[19] This was followed by the launch of a gold futures contract on 19 April 1978.[20] On 17 October 1979, the SFE introduced the 90-Day Bank Accepted Bill contract, making it the first exchange outside the United States to introduce a financial futures contract.[21]

Like many other exchanges, the SFE expanded very rapidly during the 1980s. A couple of factors contributed to its development and success during that

[15] See Global Derivatives Study Group, *Derivatives: Practices and Principles* (Washington DC, Group of Thirty, July 1993), 30–1: A forward contract has been defined as an agreement that "obligates one counterparty to buy, and the other to sell, a specific underlying at a specific price, amount, and date in the future". "Underlyings" include agricultural or physical commodities like wheat and gold, as well as currencies, interest rates, and financial indices.

[16] *Ibid*., at 32–3.

[17] See Sydney Futures Exchange, "Chronological History of the SFE", http://www.sfe.com.au, accessed 1 November 1999.

[18] *Ibid*.

[19] *Ibid*.

[20] *Ibid*.

[21] *Ibid*.

period. The first was the collapse of the Bretton Woods Agreement and the second was the deregulation of the Australian financial system. Both factors created a huge demand for financial futures contracts not only in Australia but also worldwide. Against this favourable backdrop, the SFE introduced a whole range of futures and options contracts. By the end of the 1980s, the SFE had transformed itself from a single product exchange catering for the domestic wool market to a multi-product exchange serving the global financial and commodity markets. Today, the SFE offers, via trading links with the New York Mercantile Exchange and the New Zealand Futures and Options Exchange, around-the-clock electronic access to more than seventy different futures contracts. The SFE is the largest financial futures exchange in the Asia Pacific region with annual turnover approaching thirty million contracts.[22]

At the time of writing, the SFE is also the only active futures exchange in Australia. The other licensed Australian futures exchange is the ASX Futures Exchange Pty Ltd (ASXF), but it has been inactive since its clearinghouse, International Commodities Clearing House, ceased operating in Australia in 1991. The ASXF is a wholly owned subsidiary of the Australian Stock Exchange Limited and was incorporated in 1986 under the name of Australian Financial Futures Market Pty Ltd.[23] It recently made an application to reactivate its futures market in accordance with the rule amendment procedures under s 1136 of the Corporations Act.[24] Some mention should also be made here of the failed Australian Derivatives Exchange Limited (ADX). The ADX was established in July 1998 by a group of derivatives market participants with the aim of offering an alternative market to the SFE. Between July 1998 and December 2000, the ADX raised nearly twenty million dollars from investors. Since the exchange opened in December 2000, it had only managed a few hundred trades a day.[25] At those low turnovers, it was not surprising that the ADX was placed in voluntary administration in March 2001. Its futures licence was subsequently revoked and the company placed under liquidation in July 2001. The quick demise of the ADX raises the question whether there is room for a second Australian futures exchange, given the highly competitive nature of the futures trading business.

Structure of the exchange

In the last few years, the SFE has undergone major changes; not only in the way it operates but also in the way it is structured. In line with overseas developments, the SFE abandoned its "open outcry" system and switched to fully elec-

[22] See Sydney Futures Exchange, "A Brief History of SFE", http://www.sfe.com.au, accessed 21 August 2001.

[23] It changed its name to ASX Futures Exchange Pty Limited in 1994.

[24] See ASIC, *ASXF Futures Exchange and OCH Futures Clearing House – Consultation Summary* (12 March 2001).

[25] See "Was ADX An Insolvent Trader? Former Chairman Says No" (2000) *Butterworths Company Law Bulletin* 182.

tronic trading on 12 November 1999. On 11 September 2000, the SFE changed from a company limited by guarantee and operated as a mutual company for the benefit of its members, to a company limited by shares and owned by its shareholders. Very shortly after its successful demutualisation the SFE announced its merger with Australclear Limited, the central securities depository for commercial paper and non-government registered securities in Australia. On 29 May 2001, the SFE changed its name to SFE Corporations Limited as part of its new branding strategy. The SFE acts as the holding company for SFE Clearing Corporation Pty Ltd, Austrclear Limited and the New Zealand Futures and Options Exchange Limited.[26] The SFE Clearing Corporation Pty Ltd. (SFECC) undertakes the clearing of futures contracts for the SFE. Futures contracts executed on the SFE are submitted to the SFECC for registration. On registration, the original contract is extinguished and its place two new contracts are formed. By acting as counterparty to both new contracts the SFECC assumes responsibility for their performance.

Trading rights on the SFE are no longer based on membership, but participation rights. There are now five main categories of market participants on the SFE and they are: Full Participants, Proprietary Full Participants, Associate Participants, Local Participants and Clearing Participants.[27] Full Participants have direct access to the SFE markets via SYCOM IV, the SFE's screen dealing system. They may deal in futures contracts for clients and hold clients' funds, provided they hold a futures broker's licence. Only firms and corporations are eligible to be Full Participants. Proprietary Full Participants also have direct access to the SFE markets, but they cannot deal for clients or hold their funds. Full Participants and Proprietary Full Participants are eligible to become Clearing Participants provided they satisfy the SFE Clearing Business Rules. Associate Participants are those market participants who do not wish to become Full Participants, yet wish to deal for clients, become Clearing Participants or introduce business to other participants. There are various subcategories of Associate Participants, but none of them have direct access to SYCOM IV. Individuals, corporations and firms may apply for admission as Associate Participants. Local Participants have direct access to the SFE markets via SYCOM IV to trade on their own account. They are not permitted to deal for clients on the SFE, but may do so on offshore exchanges if they are licensed futures brokers. Clearing Participants can register and clear contracts executed on the SFE and the New Zealand Futures and Options Exchange. As clearing is considered to be dealing they are required to hold a futures broker's licence when they clear on behalf of clients.

[26] The New Zealand Futures and Options Exchange has been a fully owned subsidiary of the SFE since December 1992.

[27] See Sydney Futures Exchange, *Participation Guide* (20 July 2001) for details about participation types.

PART II: THE EXISTING REGULATORY ARRANGEMENTS

Legislative background

In its early years, the Australian futures industry operated on a self-regulatory basis. It was only in 1979 that the Futures Markets Act (NSW) was passed. The Act provided that the Minister might approve a body corporate if its business rules satisfied certain criteria.[28] In addition, the Minister was empowered to disallow any business rules promulgated by the body corporate.[29] The Act confirmed that futures contracts were not gaming or wagering contracts.[30] The Act was a short one and very limited in scope. It suffered from a number of shortcomings but the main drawback was that it did not give the SFE the power to control either non-members trading in futures contracts or members trading in futures contracts OTC.[31] This was because the SFE business rules only applied to SFE members and had no application to those involved in OTC trading.

By the early 1980s, a number of factors had emerged which created a favourable climate for the introduction of legislation on a national scale. These factors included the growing realisation that the futures industry was an integral part of the Australian financial industry, widespread concern about the lack of consumer protection, and the emergence of the SFE as an international futures exchange.[32] The SFE was firmly in favour of the introduction of national legislation. In its submission on the second exposure draft of the Futures Industry Bill 1985, the SFE declared that:

> The Exchange strongly supports the implementation of the Bill at an early date and would not wish enactment of the Bill to be delayed. The Exchange believes that it is important that the industry is, and is seen to be, appropriately regulated and the Exchange is ready to perform its role in the co-regulatory process.[33]

In mid-1986, the Commonwealth Government passed the Futures Industry Act and by June of the following year, the Act and its supporting State and Territory Codes were operational throughout Australia. The Futures Industry Code (as the Act and its supporting Codes were collectively called) was the first comprehensive legislation to regulate the Australian futures industry. One of the principal driving forces behind the introduction of national legislation was the belief that state legislation would result in regulatory arbitrage.[34] Another major driving force was the need to curb the unsatisfactory behaviour and practices of some

[28] Futures Markets Act (NSW), s 3.
[29] *Ibid*., s 4.
[30] *Ibid*., s 7.
[31] See JS Currie, *Australian Futures Regulation* (Melbourne, Longman, 1994), 30–1.
[32] *Ibid*.
[33] See Attorney-General, *Explanatory Memorandum to the Futures Industry Bill 1986* (1986), 16.
[34] See Currie, *supra* n.31, at 30.

futures brokers.[35] The Futures Industry Code remained in operation until it was replaced in June 1991 by Chapter 8 of the Corporations Act. Chapter 8 substantially re-enacted the provisions of the Code and did not introduce any significant changes to the legislation.

Existing futures regulatory scheme

Introduction

Australian futures legislation follows the general format of the Securities Industry Act (SIA) 1980 (the predecessor of Chapter 7) but with the necessary modifications to reflect the distinctness of the futures industry.[36] Some aspects of the legislation are modelled on the Ontario Commodity Futures Act 1978, while a number of provisions were based on those found in the US Commodity Exchange Act.[37] It was decided at the drafting stage that it would be impractical to incorporate the futures legislation into the SIA. To do so would make the SIA a complex and cumbersome piece of legislation and would fail to take into account the different roles of securities and futures markets. Securities markets are concerned with the transfer of title in property, while futures markets facilitate the management of risk.[38] Although the Corporations Act is the main legislation that regulates the futures industry, members of the SFE are also required to comply with the Business Rules of the exchange. However, this chapter will focus on Chapter 8 and the relevant provisions of the Corporations Act. It would be outside the scope of this chapter to examine the Business Rules of the exchange.

Co-regulatory structure

The regulation of the futures industry is shared between the Australian Securities and Investment Commission (ASIC) and the SFE, with the ASIC responsible for administering the provisions of the Corporations Act relevant to the futures industry, and the SFE responsible for administering the Business Rules of the exchange. The respective roles of the ASIC and SFE within this co-regulatory structure have been described by Currie in the following terms:

> [T]he day-to-day running of the futures market, and the detailed surveillance of market trends, is left to the futures exchanges, and essentially to the SFE itself, operating in conjunction with its clearing house, [SFECC]. The [ASIC] on the other hand, in addition to its information-gathering functions and powers, has what might best be termed reserve powers of examination, investigation and prosecution. Above all it is

[35] *Ibid.*

[36] See Attorney-General, *Explanatory Paper on Exposure Draft of Futures Industry Bill 1985* (1985), 10.

[37] *Ibid.*

[38] See Attorney-General, *Explanatory Memorandum to the Futures Industry Bill 1986* (1986), 18.

> the central licensing authority for all institutions … as well as participants in the markets.[39]

Where the market participants are deposit-taking institutions, life and general insurance companies and superannuation funds, they are also regulated by the Australian Prudential Regulation Authority (APRA). It is important to note that that ASIC and APRA have related but distinct roles. While ASIC is responsible for consumer protection and market integrity regulation, APRA is responsible for prudential regulation. This regulatory structure appears to be based on the "Twin Peaks" model articulated by Taylor and Goodhart.[40]

Futures contract

Australia, like a number of other common law jurisdictions,[41] has adopted an essentially product-based regulatory framework for the futures industry. This is not surprising as the Australian framework is patterned after the US model, which has for a long period adopted separate legal frameworks for futures contracts and securities. Currently, under Australian law only those financial instruments that fall inside the legal definition of "futures contracts" are regulated under Chapter 8 of the Corporations Act. The statutory definition of "futures contract" is found in s 72(1), as expanded by s 9, and includes:

- an "eligible commodity agreement", which is a deliverable contract since the subject matter is capable of physical delivery;
- an "adjustment agreement", which is a cash settled contract since physical delivery of the subject is neither permitted nor possible;
- a "futures option", which is an option over an eligible commodity agreement or adjustment agreement; and
- an "eligible exchange-traded option", which is an exchange-traded option over a specified commodity or index.

The futures contract definition encompasses not just futures contracts, but also options over futures contracts. It plays an important role as it determines the regulatory ambit of Chapter 8. Not surprisingly, the futures contract definition has been described as the "cornerstone" of the legislation.[42] One of the

[39] See Currie, *supra* n.31, 63.

[40] See C Goodhart *et al*, *Financial Regulation: Why How and Where Now?* (London, Routledge, 1998), 157. Under the "Twin Peaks" model there is one regulatory agency for systemic stability and another for consumer protection.

[41] New Zealand, Singapore, Malaysia and Hong Kong SAR have also adopted essentially product-based regulatory frameworks. For a comparative analysis of the regulatory schemes in these jurisdictions, see R Gengatharen, *Derivatives Law and Regulation* (London, Kluwer Law International, 2001), ch 4.

[42] See MG Hains, "Futures Contracts: Do They Include Forwards and Swaps?" in G Walker and B Fisse (eds), *Securities Regulation in Australia and New Zealand* (Auckland, Oxford University Press, 1994) 846, at 847.

difficulties with the definition is that it is made up of a number of other definitions. For example, if a contract is either an eligible commodity agreement or an adjustment agreement, then it is a futures contract. But determining the precise scope of an eligible commodity agreement or adjustment agreement has not been easy. This has given rise to some uncertainty over the width of the futures contract definition.

Eligible commodity agreement

For an agreement to be an "eligible commodity agreement", it must be first be a "commodity agreement".[43] A "commodity agreement" is a "standardised agreement" and involves a "commodity". Section 9 defines "standardised agreements" as agreements of "the same kind". There is no clear judicial guidance on what constitutes a standardised agreement. In *Shoreline Currencies (Aust) Pty Ltd* v. *CAC (NSW) & Anor*[44] the court held that agreements were standardised as long as they dealt with foreign currency purchases "in the same way", regardless of whether they were with the same party.[45] In *CAC (NSW)* v. *Lombard Nash*[46] the court interpreted the words "of the same kind" to mean that the agreements were substantially the same and referred to the same type of transactions.[47] Both interpretations suggest that a wide range of agreements could potentially fall within the meaning of "standardised agreements". The use of the concept of standardisation as a device to differentiate futures contracts from other derivatives contracts has been criticised on the grounds that the widespread use of standardised market documentation has increased the likelihood of OTC derivatives contracts being construed as standardised agreements. Some commentators have suggested that fungibility should replace standardisation as a device for differentiating futures contracts from other derivatives.[48]

An eligible commodity agreement as its name suggests must involve a commodity. "Commodity" is defined in s 9 as either "anything that is capable of delivery pursuant to an agreement for its delivery" or "an instrument creating or evidencing a thing in action". In *Shoreline Currencies* the plaintiff claimed that foreign currencies were not commodities as money was not capable of delivery. But the court rejected this argument and held that foreign currencies were commodities so long as their prices and delivery dates were specified in the underlying agreement.[49] In *Sydney Futures Exchange Ltd* v. *Australian Stock*

[43] See s 9 of the Corporations Act, for the definitions of "eligible commodity agreement" and "commodity agreement".

[44] (1986) 4 ACLC 686.

[45] *Ibid*., at 693.

[46] (1986) 11 ACLR 566.

[47] *Ibid*., at 569.

[48] See, eg, MG Hains, "FRAs, Swaps, Futures, Options and the Concept of Standardisation" (1990) 4 *Journal of International Banking and Financial Law* 158.

[49] (1986) 4 ACLC 686, at 694.

Exchange Ltd[50] the court held that a share was not a "commodity" as it was not a thing capable of delivery pursuant to an agreement for delivery since title was only acquired by registration.[51] This decision appears to be at odds with the policy underlying the Futures Industry Code, which clearly contemplated regulating futures contracts based on shares.

Adjustment agreement

An adjustment agreement has been described as "a cash form of futures contract" since it does not call for delivery of the underlying commodity or instrument.[52] One of the criteria for an adjustment agreement is that a "particular person will either be under a Chapter 8 obligation to pay, or will have a Chapter 8 right to receive, an amount of money". Hodgson J in *Carragreen Currency Corporation Pty Ltd* v. *Corporate Affairs Commission (NSW)*[53] interpreted the provision to mean that the person must in one set of circumstances be under an obligation to pay money, and in another set of circumstances have a right to receive money.[54] Where the person only had the right to receive money without ever having any obligation to pay any more money, then the contract was not an adjustment agreement. In *CAC (NSW)* v. *Lombard Nash (No 2)*[55] the purchaser of the leveraged foreign exchange contracts was not bound to pay any sum of money beyond the initial investment. Cohen J adopted the reasoning of Hodgson J and ruled that the contracts were not adjustment agreements since the purchaser was not under any obligation to pay any money on closing-out.[56]

Banking exclusion

Industry concern over the width of the futures contract definition led to the inclusion of the "banking exclusion" provision. Under s 72(1)(d), currency swaps, interest rate swaps, forward exchange rate contracts and forward interest rate contracts, to which an Australian bank or merchant bank is a party to, are not futures contracts. This provision was included as a result of the submissions made to the Attorney General by the Australian Bankers' Association and the Australian Merchant Bankers' Association.[57] The intention behind the banking exclusion was expressly to exclude from regulation a number of transactions, which are typically transacted in the wholesale markets. Although four

[50] (1995) 16 ACSR 148.
[51] *Ibid*., at 181, per Gummow J.
[52] See Currie, *supra* n.31, at 39.
[53] (1986) 11 ACLR 298.
[54] *Ibid*., at 311.
[55] (1987) 11 ACLR 866.
[56] *Ibid*., at 875.
[57] See Currie, *supra* n.31, at 43.

categories of contracts are expressly excluded from the futures contract definition, none of them have been defined in the legislation. The Explanatory Memorandum is of little assistance because instead of elaborating on the agreements excluded, it merely makes reference to the description of swaps and forward exchange contracts in a commercial text.

Futures exchange

Under the existing framework, no person may establish or conduct an unauthorised futures market. An unauthorised futures market is neither a futures market of a futures exchange nor an exempt futures market.[58] Any person who operates an unauthorised futures market would be committing an offence.[59] There is provision for the Minister[60] to declare a market an exempt futures market, subject to certain conditions.[61] For the Minister to approve a futures exchange, the Minister must be satisfied that the following criteria have been satisfied:

- the exchange is a body corporate;
- it has satisfactory business rules and compensation arrangements;
- the Minister has approved its clearing arrangements; and
- the interests of the public will be served by granting the application.[62]

The futures exchange must, in addition to satisfying the above criteria, establish a fidelity fund to provide compensation to persons who suffer loss because of defalcation or fraudulent misuse of funds.[63] "Defalcation" includes the failure to account for funds entrusted to a firm as trustee, even if the failure was due to negligence instead of dishonesty.[64] The person responsible for the loss must be an exchange member or an employee, director or partner of the member.[65] Additionally, the loss must have been suffered in respect of funds placed at the hands of person in connection with dealings in futures contracts.[66] If a client suffers loss as a result of the insolvency of the broker, the client cannot claim from the fidelity fund.

Futures market

A "futures market" has been defined as a "market, exchange, or other place at which, or a facility by which, futures contracts are regularly acquired or

[58] Corporations Act, s 9.

[59] Corporations Act, s 1123.

[60] For the definition of "Minister", see s 80A of the Corporations Act. The term refers to the Federal Treasurer and any Minister acting for, or on behalf of the Federal Treasurer.

[61] Corporations Act, s 1127(1).

[62] *Ibid*., s 1126.

[63] *Ibid*., ss 1228(1) and 1239(1).

[64] See *Daly* v. *Sydney Stock Exchange Ltd* (1986) 160 CLR 371, at 381, per Gibbs J.

[65] Corporations Act, s 1239(1).

[66] *Ibid*.

disposed of".[67] From the above definition, Chapter 8 should not apply to OTC markets since OTC derivatives are not futures contracts.[68] But the uncertainty over the scope of the futures contract definition, coupled with the broad interpretation of the futures market definition adopted by the courts has led to a number of banks applying for exempt market status. In the *Carragreen Currency* case, the plaintiff provided the infrastructure in the form of personnel, means of communication and access to foreign currency information to its clients to enable them to trade in futures contracts. Hodgson J held that the infrastructure amounted to the provision of a "facility" and was therefore a futures market.[69] The need for certainty among market participants prompted ASIC to adopt a "safe harbour" approach to professional OTC derivatives markets. In mid-1993, ASIC issued Policy Statement 70, which outlined guidelines that the Minister would adopt when granting approvals for exempt futures market status. Policy Statement 70 provides for the approval of exempt market status applications provided certain conditions are fulfilled. The test is a predominantly participant-based test which excludes from regulation transactions involving specified categories of facility providers and users.

Futures broker

Australia has adopted a universal licensing regime and all intermediaries who fall within the definitions of "futures brokers" or "futures advisers" must be licensed, unless exempted.[70] Futures brokers and advisers must satisfy specified criteria ranging from financial solvency to educational qualifications and experience for the grant of a licence.[71] Futures brokers, but not futures advisers, must be members of a futures organisation.[72] Currently, this means the SFE, as there is no separate futures association in Australia.[73] Only a person who deals in futures contracts on another person's behalf or holds themselves out as carrying on a futures broking business need to be licensed. The phrase "deal on another person's behalf" would cover acting on the express and implied instructions of another person. "Dealing" is given an extended meaning and covers not only the acquisition and disposal of futures contracts, but also offering and inducing to acquire and dispose of futures contracts.[74] Since it is not unusual for

[67] Corporations Act, s 9.

[68] The majority of OTC derivatives are currency options, forward rate agreements, interest rate swaps and interest rate options.

[69] (1986) 11 ACLR 298, at 312.

[70] Corporations Act, ss 9, 1142 and 1143.

[71] *bid*., ss 1144A and 1145.

[72] *Ibid*., s 1148

[73] To satisfy the requirement laid down in Corporations Act, s 1148, all SFE participants are required to hold a participation share. Participation shares are redeemable preference shares issued by the SFE to participants. These shares enable the participants to trade on the SFE but do not confer any right to vote or share in the profits and assets of the company.

[74] Corporation Act, s 25(1).

futures transactions to involve several intermediaries, the concept of dealing would embrace the activities of these intermediaries.[75] Clearing participants who clear for clients are required to be licensed as futures brokers because clearing is considered to be a form of "dealing". Futures brokers who trade on their own account are exempt from the licensing requirement. Trading on a person's own account extends to trading on behalf of an associate of the person or a body corporate in which the person has a controlling interest.

Futures adviser

A person is prohibited from carrying on a futures advice business, or from holding out as a futures adviser, unless that person is licensed or is an exempt futures adviser.[76] Futures brokers who are also involved in the giving of advice on futures contracts do not require a futures adviser's licence. The Corporations Act specifically exempts certain categories of persons from licensing and they include proprietors and publishers of newspapers or periodicals that are "generally available to the public, otherwise than only on subscription".[77] In *Australian Securities Commission* v. *Dempster*[78] the respondent, who was neither a licensee nor an exempt futures adviser, provided information about commodity prices to about two hundred farmers for an annual charge. Those who subscribed to his service received, among other things, copies of a newsletter produced by him. In the newsletter, Dempster monitored commodity prices, made predictions about their future movements, and gave opinions about the desirability of acquiring put options on futures contracts. The court held that the newsletter was disseminated as part of a business and involved the proffering of advice about futures contracts.[79] Although the newsletter was made available from time to time to a substantial number of farmers who were not subscribers to his service, the evidence did not suggest that it was so widely distributed as to be a publication "generally available to the public".[80]

Futures representative

Representatives of futures brokers and advisers need not be licensed but must hold proper authority from a licensed broker or adviser.[81] A proper authority is a copy of the broker's or adviser's licence on which are endorsed statements by the licensee that the holder is the licensee's representative. Futures representatives are natural persons who are either employed by, or act for or by arrangement with, a

[75] *Ibid*., ss 26–28.
[76] *Ibid*., s 1143.
[77] *Ibid*., s 71(5).
[78] (1992) 10 ACLC 1050.
[79] *Ibid*., at 1056.
[80] *Ibid*.
[81] Corporations Act, ss 1172 and 1173.

broker or adviser. Not all employees are regarded as representatives, only those who assist in the execution of futures business or those who tender advice about futures trading. Representatives must be registered with the SFE and satisfy certain skills requirements. Brokers and advisers are responsible for their representatives and cannot contract out their liability, even if the representatives act outside the scope of their authority.[82] They may be required, for example, to pay damages to clients who have suffered losses as a result of the actions of their representatives. Licensees are required to keep a register of holders of proper authorities and the register must contain information such as the holders' names and addresses.[83]

Revocation of licence

ASIC has powers to revoke or suspend a licence on a wide range of grounds. In some cases, ASIC may revoke a licence without a hearing, such as when the licensee is convicted of a serious fraud or becomes insolvent.[84] But in most cases, revocation can only take place after a hearing.[85] Currently, there is no provision preventing the licensee from acting for clients, pending the outcome of the hearing. A person who enters into an agreement with a non-licensee is entitled to rescind the agreement, subject to the fulfilment of certain criteria.[86] The non-licensee cannot recover any fees or brokerage from the client in respect of the agreement, nor enforce the agreement against the client.[87] Where ASIC revokes or suspends the licence of a natural person, it can also make a banning order against that person.[88] The banning order may be temporary or permanent in nature. It is made under specified circumstances such as when the licensee has engaged in egregious conduct. The effect of a banning order is that person is ineligible for the grant of a broker or adviser's licence.[89] Instead of making a banning order, ASIC may apply for a disqualification order after a licence has been revoked.[90] A disqualification order, unlike a banning order, is applicable to both natural persons and corporations.

Sources of obligations

Futures intermediaries are subject to various obligations. These obligations currently arise from three main sources: statute, general law and the business rules of the exchange. Only those statutory obligations arising from Chapter 8

[82] *Ibid*., ss 1183–1188.
[83] *Ibid*., ss 1176(1) -1176(3).
[84] *Ibid*., s 1190.
[85] *Ibid*., s 1191.
[86] *Ibid*., s 1164.
[87] *Ibid*., ss 1167–1168.
[88] *Ibid*., s 1192A.
[89] *Ibid*., s 1194.
[90] *Ibid*., s 1201.

will be discussed here, as they are specific to futures intermediaries, unlike those arising from general law, which are of more general application. An example of a general law obligation is the duty of a broker to sell in good faith when closing-out a client's transaction.[91] Another example is the broker's duty to explain the existence and effect of margin calls when dealing with a client unfamiliar with futures trading.[92] Before the introduction of futures legislation, the general law played an important role in governing the relationship between broker and client. General law plays a less important role today. It acts mainly as a "gap-filler" as the Corporations Act does not cover the field.[93] The business rules of the exchange, while important, are outside the scope of this chapter. The failure on the part of an intermediary to observe the business rules of the exchange can result in termination of participation. Since membership of a futures organisation is a prerequisite for a licence, termination of participation can lead to revocation of the participant's licence.

Risks disclosure and suitability

While securities law seeks to protect consumers through the disclosure of accurate and timely information, futures law relies largely on risks disclosure. Before a futures broker accepts a person as a client, the broker must give that person a document explaining the nature of futures contracts, the essential terms of the futures contracts entered into on behalf of that person, the nature of the obligations assumed by that person, the risks associated with futures trading, and the terms of the broker-client agreement.[94] A futures adviser, on the other hand, is not subject to the risk disclosure requirement. Risk disclosure documents must be given by brokers to all their clients, as no distinction is currently made between retail and wholesale clients. Securities advisers are subject to a suitability obligation when providing advice on derivatives that are classified as "securities".[95] A good example of such derivatives are share option contracts. This obligation has been interpreted to mean the duty to make reasonable inquiries about the client and to research adequately the products recommended.[96] Futures brokers are, however, not subject to a similar obligation as it was felt that such a requirement was unsuitable for derivatives, given the nature of the products and the types of end-users.

[91] See *Option Investments (Aust) Pty Ltd* v. *Martin* [1981] VR 138, at 143.

[92] See *Rest-Ezi Furniture Pty Ltd* v. *Ace Shohin (Aust) Pty Ltd* (1987) 5 ACLC 10, at 14.

[93] See *Halsbury's Laws of Australia*, Vol 8 (Sydney, Butterworths, Loose-leaf), para 120–19340.

[94] Corporations Act, s 1210.

[95] *Ibid*., s 851.

[96] See *ASC Policy Statement 122– Investment Advisory Services: The Conduct of Business Rules (s 849 and s 851)* (3 March 1997).

Segregation of funds

A futures broker must segregate clients' funds from the broker's own funds.[97] The underlying objective of this provision is not just to prevent the broker from misusing clients' funds, but also to protect the funds from the insolvency of the broker. There are specific guidelines on where the funds should be deposited, when they should be deposited, and how they should be dealt with. For example, clients' funds must be deposited in a clients' segregated account maintained in Australia or where the funds are received, on or before the next day after receipt of the funds.[98] Property (such as letters of credit and bank guarantees provided for margining purposes) deposited with a broker in connection with futures trading is to be dealt with in a similar manner. The broker is not under any legal obligation to maintain separate accounts for each client. Clients' funds are commingled in one account and the funds of one client may be used to meet the margin calls of another. This would suggest that if one client defaults, other clients could suffer losses if the broker involved is not in a position to meet margin calls of the defaulting client using its own funds.

Contracts, records and advertising

A broker is required to issue clients with contract notes to keep them informed of transactions entered on their behalf.[99] The contract note must specify the matters referred to in s 1206(3). However, exempt brokers are not subject to this obligation.[100] A broker must also maintain separate records of all dealings in futures contracts by the broker on the broker's own account.[101] There are accounting and auditing requirements set out in Part 8.5 which the broker must comply with. For example, a broker must keep proper financial records and appoint an auditor one month after becoming a licence holder.[102] Where it is in the public interest, ASIC may by a written order prohibit a person from broadcasting or publishing statements about futures contracts, dealings in futures contracts or futures advice businesses, unless ASIC has first approved the form and content of the statements.[103] However, such an order may only be made after the person has been given an opportunity to appear at a hearing before ASIC.[104]

[97] Corporations Act, s 1209.
[98] *Ibid*.
[99] Corporations Act, s 1206.
[100] *Ibid*., s 1205A.
[101] *Ibid*., s 1208(1).
[102] *Ibid*., ss 1214 and 1215.
[103] *Ibid*., s 1205.
[104] *Ibid*.

Abusive market behaviour

A broker would be committing an offence if the broker engages in abusive market behaviour like "front-running", "bucketing" or "churning". "Front-running" is the practice of brokers giving priority to their orders over their clients' orders. Section 1266 regulates how clients' instructions should be dealt with. For example, brokers are required to transmit their clients' instructions at or near the market price and in the sequence they are received. "Bucketing" refers to the failure to execute a futures trade on an authorised exchange when required to do so. Section 1258 prohibits "bucketing" by providing that a broker shall not deal in futures contracts on behalf of another unless the dealing is effected: (1) on the SFE; (2) on a recognised futures exchange; (3) on an exempt futures market; or (4) is permitted under the SFE's business rules. "Churning" is the excessive trading of an account for the purpose of generating commissions, without regard to the needs or objectives of the client. Churning is not specifically dealt with in Chapter 8, but it could constitute fraud under s 1264.

Market manipulation

Chapter 8 also contains a number of offences, which interfere with the operation of the market. Any person, including a non-intermediary, is capable of committing these offences.[105] The Corporations Act prohibits a person from being involved in any transaction that is intended to have, or is likely to have, the effect of creating or maintaining an artificial price for futures contracts.[106] Price manipulation usually takes the form of a "corner" or a "squeeze". A "corner" involves controlling the supply of a commodity with the purpose of raising or depressing the price of the futures contract based on that commodity.[107] Although a squeeze is similar to a corner, there is one important difference; in the case of a squeeze the scarcity of the commodity is due to natural causes such as drought and not the actions of the person holding the bought position.[108]

False trading and market rigging are some of the other forms of market manipulation prohibited under the Corporations Act. It is an offence for a person to create, cause to be created, or do anything, which is calculated to create a false or misleading appearance of (1) active trading in futures contracts, or (2) with respect to the market or price for dealings in futures contracts.[109] In *Australian Securities Commission* v. *Nomura International PLC*[110] the meaning

[105] The term "person" instead of "futures broker" or "futures adviser" is used in ss 1259, 1260, 1261, 1262, 1263 and 1264. In *Shoreline Currencies (Aust) Pty Ltd* v. *CAC (NSW) and Anor* (1986) 4 ACLC 686, at 697–698, the court held that the term "person" has a general application.

[106] Corporations Act, s 1259.

[107] See D A Chaikin, "Futures Frauds in the Asia Pacific Region" in C Lye and R Lazar (eds), *The Regulation of Financial and Capital Markets* (Singapore, SNP Corporation, 1991), 264–265.

[108] See *Cargill, Inc* v. *Hardin*, 452 F 2d 1154, at 1162.

[109] Corporations Act, s 1260(1).

[110] (1998) 29 ACSR 473, at 573.

of the phrase "calculated to create" was considered. The court agreed with the argument that it meant "intended or designed" to create, not "adapted or suited" to create. Other market manipulation offences include: (a) using a fictitious transaction or device to maintain, inflate, depress or cause fluctuations in the prices of futures contracts;[111] and (b) making a statement or disseminating information that is false or misleading in material particular that is likely to induce futures dealing or have an effect on futures prices.[112]

Insider trading

The insider trading provisions found in Part 8.7 of the Corporations Act are based on those found in Chapter 7. But despite the Chapter 7 insider trading provisions undergoing substantial changes in 1991, the Chapter 8 provisions have remained unchanged. This means that the insider trading provisions for futures trading are not consistent with those for securities trading. The basic prohibition is that a person is precluded from dealing in a futures contract concerning a body corporate in which he or she possesses inside information.[113] There must be a connection between the insider and the corporation whose futures contracts are traded. The requirement that the person be connected with a body corporate curtails the categories of persons who could be found liable for insider trading. Following the amendments carried out in 1991, this requirement has been removed from the Chapter 7 provisions.[114] Another weakness of the Chapter 8 provisions is that they apply only to insider trading in equity futures and do not extend to insider trading in futures contracts that are based on physical commodities such as gold and silver. [115] This is because of the requirement that the futures contract dealt with should relate to the securities of a body corporate.[116]

Penalties and extraterritoriality

The penalties imposed in relation to futures offences are set out in Schedule 3 of the Corporations Act. Contravention of the offence provisions would result in fines, or imprisonment terms, or both. Section 1265 sets out the circumstances in which a person who contravenes any of the offence provisions is liable to make restitution for the loss or damage suffered. For example, if a person in possession of certain information is precluded by s 1253 from dealing in a futures contract, nevertheless deals in that futures contract in contravention of s

[111] Corporations Act, s 1260(2).

[112] *Ibid*., s 1261.

[113] *Ibid*., s 1253.

[114] *Ibid*., Div 2A.

[115] See S Ansell, "The Regulation of Insider Trading in Derivatives" (1995) 13 *Company and Securities Law Journal* 476, 480.

[116] Corporations Act, s 1251.

1256, that person may be liable for compensation for losses or damages sustained by another person. None of the offences set out in Part 8.7 have any extra-territorial reach since s110D, which deals with the extra-territorial reach of the legislation, does not make any reference to Chapter 8. This is an obvious shortcoming considering that it is possible to manipulate the Australian futures market from anywhere in the world. On the other hand, it should be recognised that even if Chapter 8 applied extra-territorially there is the practical difficulty of trying to enforce the law in another jurisdiction.

PART III: EXISTING REGULATORY WEAKNESSES

Since the introduction of the Futures Industry Code in 1986, there has been little change to the laws regulating futures trading in Australia. While the existing regulatory scheme for futures trading has worked well, it has failed to keep pace with market developments. As Australia's financial markets become increasingly integrated with international markets, it is important that Australia's regulatory framework facilitate competition, promote innovation and reduce compliance costs. Before analysing how the new regulatory legislation will alter the existing regulatory framework, it would be useful to examine some of the weaknesses of the existing scheme in greater detail.

Legal uncertainty

Despite the crucial role played by the futures contract definition, there is still some uncertainty about its precise legal meaning. Generally, whether a particular activity is regulated or not by Chapter 8, depends on whether a futures contract is involved. For example, any person who deals in futures contracts on behalf of another must be licensed as a futures broker. Similarly, a person cannot establish or conduct a futures market unless it is an approved futures exchange or an exempt futures market. The uncertainty surrounding the precise meaning of "futures contract" arises from two different sources. Firstly, there is uncertainty about the type of financial instruments that fall within the definition. The use of the concept of standardisation to distinguish futures contracts from other instruments has made the definition unnecessarily wide. Secondly, there is uncertainty about the type of instruments that are excluded from the futures contract definition. The failure to define the instruments excluded from regulation has spawned doubts about the precise scope of the banking exclusion provision.

This uncertainty creates a number of problems for market participants and regulators alike. First, OTC market participants are always under the threat of prosecution as they are never sure whether they are conducting unauthorised futures markets. This has in the past led to a number of banks applying for exempt market status. Second, it restricts competition between the exchanges

and can result in turf wars when one exchange tries to introduce a product that is functionally similar to that offered by another exchange. For example, when the Australian Stock Exchange (ASX) proposed trading in Low Exercise Price Options (LEPOs), the SFE launched a legal battle to restrain the ASX from doing so on the ground that LEPOs were futures contracts and should only be traded on a futures exchange.[117] Although, the Full Federal Court ruled that LEPOs were securities and not futures contracts, many felt that the matter had not been satisfactorily resolved.[118] Third, it could result in market participants being subject to overlapping regulation. For example, if a securities exchange wishes to trade in futures contracts, it must seek authorisation as a futures exchange. Subjecting an exchange to overlapping regulation would raise the costs of compliance. Fourth, OTC market participants face the risk that their transactions may be invalidated under state gaming and wagering laws. The Corporations Act does not protect derivatives that are not futures contracts, from the application of these laws.[119]

Different regulatory treatment

The existing regime treats functionally similar products differently. Whether derivatives are regulated under Chapter 7 or Chapter 8, depends on whether they are "securities" or "futures contracts". Although the provisions in Chapters 7 and 8 are broadly similar, they are different in a number of important ways. For example, a securities adviser who offers advice on share options is subject to a suitability obligation, but not a futures adviser who offers advice on futures options. Both categories of options are functionally similar, but regulated differently. Different regulatory treatment of functionally similar products encourages regulatory arbitrage. Products may be deliberately structured so that they are more lightly regulated. It has been suggested that it is possible to structure a futures contract, which would otherwise fall within the definition of "eligible commodity agreement", so that it would escape regulation by making cash-settlement compulsory.[120] Different regulatory treatment does not only lead to regulatory arbitrage, but could also distort competition.

Regulatory avoidance

Another frequent criticism levelled against the existing regime is that it facilitates regulatory avoidance. Under Australian law, only derivatives that fall within the definitions of "futures contract" and "securities" are regulated. This

[117] See *Sydney Futures Exchange Ltd* v. *Australian Stock Exchange Ltd* (1995) 16 ACSR 148.

[118] See, eg, J Lawrence, "The Regulation of Derivatives and the LEPOs Litigation" (1996) 14 *Company and Securities Law Journal* 90.

[119] Corporations Act, s 1141.

[120] See JO'Sullivan, "Derivatives – A Survey of the Law and Practice" (1994) 5 *Journal of Banking and Finance Law and Practice* 89, 94.

would mean that financial instruments that fall outside both definitions would not be regulated either under Chapter 7 or Chapter 8. This creates the risk that participants wishing to avoid regulation may exploit this loophole by structuring their products in such a manner so as to disqualify them from being either a futures contract or a security. For example, it has been suggested that a compulsorily cash-settled OTC option is neither a futures contract nor a security.[121] Yet it may be in the public interest to regulate such a product, since it could be offered to retail investors who may require to be protected.

As traditional product boundaries fall, the regulation of hybrid products becomes a more serious issue. Section 92 of the Corporations Act states that the expression "securities" does not include a "futures contract". In other words, Chapter 7 does not apply to any instrument that is deemed a futures contract. However, there is no guidance as to which particular regulatory regime will apply to a hybrid instrument, such as a share ratio contract. A share ratio contract has characteristics found in both securities and futures contracts. Section 92 offers little help to market participants. This problem has been resolved, albeit for the time being, through the introduction of cross-regulation by the Corporations Law (Securities and Futures) Amendment Act 1995 (Cth). The amending legislation inserted ss 72A and 92A, which enable regulations to be made to modify the application of the Corporations Act to particular futures contracts or securities, or to exempt them from particular provisions.

Limited regulatory reach

Currently, Chapter 8 does not apply to derivatives that are traded OTC since they do not satisfy the definition of "futures contract". While many regard this as a weakness, there are some who do not share this view. Whether the lack of regulatory reach is a weakness or strength is open to debate, but it appears there is a shift in favour of regulation. There are several reasons for wanting to extend regulation to the OTC market. One reason is that the Corporations Act has created four categories of OTC products, with each category subject to different regulatory treatment.[122] Another reason is that the lack of uniformity in regulation favours OTC markets over exchange-traded markets.[123] A third reason is the increasing retail participation in OTC markets.[124] On the other hand, it has been argued that regulating OTC markets similar to the way exchanges are regulated may drive business offshore. It has also been argued that OTC markets have worked well so far without any direct regulation. There is therefore no justification for changing this satisfactory state of affairs.

[121] See S Dow and ND'Angelo, "Derivatives Regulation: A New Regulatory Environment?" in Mallesons Stephen Jaques (eds), *Australian Finance Law* (Sydney, Law Book Co, 1999), 847–848.

[122] See Companies and Securities Advisory Committee, *Regulation of On-exchange and OTC Derivatives Markets: Final Report* (June 1997), para 2.11.

[123] See CLERP 6, *supra* n.2, 56.

[124] *Ibid*.

PART IV: PROPOSED REGULATORY CHANGES

When introducing the Financial Services Reform Bill 2001 (Bill) into the House of Representatives, the Minister for Financial Services and Regulation said that the proposed legislation would achieve, *inter alia*, the following objectives:

- aensure that Australia's regulatory framework kept pace with market developments;
- aremove regulatory barriers to technological innovations and assist the Australian financial services industry meet challenges posed by e-commerce;
- areduce the compliance costs associated with carrying on a financial services business;
- abenefit financial institutions intending to provide the full range of financial services; and
- aimprove the capacity of consumers to understand and compare different financial products.[125]

The proposed legislation will introduce uniform regulation of functionally similar products. Harmonisation will be achieved through the adoption of a single licensing, conduct and disclosure regime for financial service providers. There will also be a single statutory regime for financial product disclosure that allows for flexible treatment of different products where it is appropriate. The multiple routes to authorisation of exchanges and clearing and settlement systems will be replaced by a single authorisation scheme for financial markets and for clearing and settlement facilities.

The new framework will cover a wide range of financial products including securities, derivatives, general and life insurance, superannuation, deposit accounts, non-cash payments and some foreign exchange transactions. Credit will be expressly excluded from regulation under the Bill, as it will continue to be regulated under the Consumer Credit Code. Greater obligations will be imposed on licensees dealing with retail clients and the provisions relating to market misconduct and insider trading will be streamlined. The existing Chapters 7 and 8 of the Corporations Act will be replaced by a new Chapter 7. There will also be consequential amendments to the Corporations Act and other relevant legislation. It is not the purpose of this chapter to outline all the changes, but rather to focus on some of the more important ones. It should be borne in mind that these changes affect not just futures contracts, but also other financial products.

[125] See "Financial Services Reform Bill 2001 – Extracts from Second Reading Speech by Hon Joe Hockey, Minister for Financial Services and Regulation, House of Representatives 5 April 2001" (2001) *Butterworths Company Law Bulletin* 146.

Key definitions

The Bill will introduce a number of new definitions to replace the existing definitions in the Corporations Act. It would be useful to look at each of these definitions before discussing the main changes brought about by the Bill. The definition of "financial product" establishes the scope of the new Chapter 7. It comprises three parts: a general definition, a list of inclusions, and a list of exclusions. The general definition focuses on the main functions provided by financial products. It encompasses any facility through which (or through the acquisition of which), a person does one or more of the following:

(a) makes a financial investment;
(b) manages a financial risk;
(c) makes non-cash payments.[126]

A list of specific inclusions provides examples of products that will fall within the general definition. Securities and derivatives fall inside the list of specific inclusions. The general definition is then narrowed by a list of specific exclusions. In addition there is a regulation-making power to add or remove any product from both lists. The financial product definition is sufficiently flexible to accommodate new products as they emerge.

The futures contract definition will no longer be required and a definition for derivatives will be included in the Corporations Act. "Derivative" is defined in the Bill as any arrangement, under which:

- a party to the arrangement must, or may be required to, provide at some future time consideration of a particular kind to someone; and
- that future time is not less than the time prescribed by regulations; and
- the amount or value of that consideration is ultimately determined, derived or varied by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable).[127]

Specifically excluded from the derivative definition are several classes of agreements, such as arrangements that relate to physical property (except Australian or foreign currency) that cannot be cash settled, regulated credit transactions, and contracts for the provision of futures services. By removing any reference to "commodity" in the derivatives definition, the proposed legislation overcomes some of the weaknesses found in the definition of "futures contract".

"Security" has been redefined in the Bill to mean:

(a) a share in a body;
(b) a debenture of a body ;
(c) a legal or equitable right or interest in a … security covered by (a) or (b); or
(d) an option to acquire by way of issue in a security covered by (a), (b) or (c).[128]

[126] Financial Services Reform Bill 2001, cl 763A.
[127] *Ibid*., cl 761D.
[128] *Ibid*., cl 761A.

The definition of "security" does not include options over issued securities. By narrowing down the definition of "security", non-fundraising products such as warrants will not be subject to the separate disclosure regime for securities.

The Bill also introduces for the first time a definition for "retail client".[129] A product or service is provided to a person as a retail client except in three instances:

- the price of the product or service equals or exceeds the prescribed amount;
- the product or service is provided for use in connection with a business employing at least twenty people (one hundred in the case of manufacturing business); or
- the person acquiring the product or service provides a certificate stating that the person has net assets of at least $2.5 million or a gross income of at least $250,000 a year in each of the preceding two years.[130]

If the product or service is not provided to or acquired by a retail client, then it is deemed to be provided to or acquired by a wholesale client.

The Bill will introduce a financial market definition to replace the existing stock market and futures market definitions. A "financial market" is defined as a facility through which, or a place at which:

- offers to acquire or dispose of financial products are regularly made or accepted; or
- offers or invitations are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in the making or acceptance of offers to acquire or dispose of financial products.[131]

Excluded from the definition of "financial market" are transactions that do not involve multiple buyers and sellers, treasury operations between related bodies corporate and auctions of forfeited shares.

The Bill introduces a definition of "clearing and settlement facility" to replace the existing clearing house and clearing house facilities definitions. A "clearing and settlement facility" is defined as a facility that provides a regular mechanism for parties to financial product transactions to meet obligations to each other that arise from entering into the transactions and are of a kind prescribed by regulations.[132] The clearing and settlement facility definition contains a number of exceptions. For example, an ADI (Australian Deposit-taking Institution within the meaning of the Banking Act 1959) acting in the ordinary course of its banking business is not deemed to be operating a clearing and settlement facility.

[129] A different rule applies to general insurance, superannuation and retirement savings account products.

[130] Financial Services Reform Bill 2001, cl 761G.

[131] *Ibid*., cl 767A.

[132] *Ibid*., cl 768A.

Uniform licensing scheme

Three new licences will be introduced when the Bill becomes law: Australian market licence, Australian clearing and settlement (CS) facility licence, and Australian financial services licence. A person must only operate, or hold out that the person operates a financial market, if that person has an Australian market licence or the market is an exempt market.[133] Since payments made by the delivery of Australian or foreign currency do not fall within the definition of financial product, transactional foreign exchange dealings will not constitute a financial market and therefore will not require to be licensed. There will be no restrictions on the types of financial products that can be traded in a particular market. Under existing regulatory arrangements, separate authorisation is required, for trading in securities and futures contracts.

It is envisaged that some markets may not operate their own clearing and settlement facilities. In which case that function may have to be undertaken by an independent operator. A separate licence for the operation of a clearing and settlement facility is therefore necessary to accommodate this new development. The Bill provides that a person must only operate or hold out that the person operates a clearing and settlement facility if that person has an Australian CS facility licence or the facility is exempt.[134] The Bill introduces a shareholder limitation of fifteen per cent for financial markets and CS facilities.[135] The Minister may approve an application for a higher shareholding if it is in the national interest. This new shareholding limit will facilitate partnerships with overseas exchanges and CS facilities.

A single licensing regime would also apply to all financial intermediaries. Any person who carries on a financial services business in Australia must hold an Australian financial services licence.[136] Financial services is defined broadly and includes the provision of financial product advice, dealing in a financial product, making a market for a financial product, operating a registered scheme or providing a custodial or depository service. However, a person who deals in a product on his or her own behalf is taken not to be dealing. Regardless of whether the service is provided to a wholesale or retail client, a licence will be required. Licences may cover all financial services in relation to all products or a subset of products. A licensee may authorise another person to provide financial services on the licensee's behalf. The categories of persons who may act as authorised representatives have been extended to include corporations and partnerships. Currently only natural persons may act as authorised representatives.

[133] *Ibid*., cl 791A.
[134] *Ibid*., cl 820A.
[135] *Ibid*., cl 851A.
[136] *Ibid*., cl 911A.

Compensation, disclosure and clients' money

A licensed financial market through which participants provide services for retail clients must have in place approved compensation arrangements.[137] Markets licensed under special provisions relating to overseas markets are not subject to the same compensation regime. The proposed compensation regime protects retail clients against losses in defined circumstances. The client must have given the money or property to the market participant in connection with effecting a transaction or proposed transaction covered by the rules of the market. Only losses arising from defalcation or fraudulent misuse of money or property by the participant are covered. The compensation regime provides that a claim will be allowed even if the person against whom the defalcation or fraudulent misuse is alleged has not been convicted or prosecuted, and the evidence on which the claim is allowed would not be sufficient to establish guilt of that person in a criminal trial.

Financial service licensees and authorised representatives must provide their retail clients with a Financial Service Guide.[138] The purpose of giving such a guide is to provide clients with the key information about the services provided. Before providing personal advice to a retail client, a providing entity must have a reasonable basis for the advice. There is a reasonable basis for the advice if: (a) consideration has been given to the client's objectives, financial situation and needs; and (b) an investigation of the subject matter has been carried out as is reasonable in all the circumstances.[139] The providing entity is obliged to inform the client if the advice is based on incomplete or inaccurate information. In addition the providing entity must disclose any commission, pecuniary interest or relationship with the issuer of the financial products. Financial services licensees are required to establish and maintain a separate account in which to hold clients' money.[140] There are rules in place governing the use of clients' money and property. Where licensees hold funds or property on behalf of clients, they must provide their clients with periodic statements.

Market misconduct

The Bill contains a number of market misconduct provisions.[141] Some of the prohibited forms of conduct relating to financial products and services include market manipulation, false trading and market rigging, price manipulation and dissemination of information about illegal transactions. There is a also a general prohibition on engaging in conduct in relation to a financial product or service that is misleading or deceptive, or is likely to mislead or deceive.

[137] *Ibid*., cl 881A.
[138] *Ibid*., cl 941A and cl 941B.
[139] *Ibid*., cl 945A.
[140] *Ibid*., cl 981.
[141] *Ibid*., cl 1041.

Contravention of this provision attracts only a civil liability. The insider trading provisions that are currently applicable to securities will be extended to all financial products. An insider is now defined as a person who possesses information that is not generally available, but if generally available a reasonable person would expect to have a material effect on the price of the particular product. The market misconduct and insider trading provisions have been made civil penalty provisions to facilitate prosecution of breach of the provisions.

PART V: SUMMARY AND COMMENTS

The Bill will introduce a single regulatory regime for all financial products. No longer will there be a different regime for securities and futures contracts. By introducing a derivatives definition, the Bill will seek to regulate all types of derivatives, including those traded OTC. The derivatives definition makes no reference to commodities, thus making it easier for the new regime to accommodate products such as weather derivatives and credit derivatives. The security definition has been narrowed to exclude exchange-traded options, so that they will not be subject to the disclosure requirements laid down in Chapter 6D of the Corporations Act. All the abovementioned changes will address the legal certainty issues that have arisen as a result of adopting narrow product definitions.

Members of the financial community should welcome the proposed changes, as the Bill will greatly facilitate competition. Financial exchanges will be able to expand their range of products easily. With the raising of the shareholding limitation and the possibility of negotiating an even higher limit, Australian exchanges will be in a better position to form strategic alliances with other overseas exchanges. The Bill will also encourage independent clearing and settlement facilities to service the Australian financial markets. Other changes to be introduced include a single licensing regime for financial intermediaries. Intermediaries will be free to provide a range of services for more than one product type. The existing distinction between brokers and advisers will be abolished.

By harmonising the disclosure regime for financial products, compliance costs will fall in the long term. The introduction of a distinction between wholesale and retail clients allows for more flexible regulation. The Bill also gives more discretion to regulators to include or exclude certain products from the application of the proposed legislation. The Bill will also introduce a general prohibition on misleading and deceptive conduct, extend the securities insider trading provisions to all financial products, and make the market misconduct provisions civil penalty provisions. These proposed changes will hopefully make it easier to prosecute those intermediaries who abuse the trust of their clients and, thus, preserve the integrity of the market. The Bill may undergo further amendments before it becomes law, but it is unlikely that the amendments will be significant.

Overall the Bill appears to be an improvement over the existing framework. There are a few areas of concern such as whether there will be adequate supervisory resources. Another worry is whether a single licensing scheme will lead to lower standards and less protection for investors. Allowing a financial services provider to deal in a range of complex products may not be in the best interest of the client as the provider may lack the necessary skills and experience. A third concern is whether disclosure alone is sufficient to protect clients. Many clients still do not bother to read the written materials given to them and giving them more information would not improve things. This raises the issue whether there should be some form of control over the types of products that can be offered to retail clients.

It is interesting that when futures legislation was first introduced in Australia it was felt that combining the futures legislation with the securities legislation would be impractical and also not take into account the different roles played by each market. The proposed legislation, not only combines futures and securities regulation, but also covers a number of other financial products. This raises the question, which is probably in the minds of many, whether the proposed legislation is workable. It is not possible to provide an answer at this stage. Only time will tell whether a harmonised approach will work better than the existing approach.

11

Multinational Enterprises, the World Trade Organisation and the Protection of the Environment

FIONA MACMILLAN

THE NATURE OF THE MULTINATIONAL ENTERPRISE

The multinational enterprise is a pervasive fact of life in the twenty first century. It is easier to describe than to define. This is demonstrated by the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises,[1] which eschew a precise definition in favour of a more general description of a multinational enterprise:

> These usually comprise companies or other entities established in more than one country and so linked that they may co-ordinate their operations in various ways. While one or more of these entities may be able to exercise a significant influence over the activities of others, their degree of autonomy within the enterprise may vary widely from one multinational enterprise to another. Ownership may be private, state or mixed.[2]

As this description suggests, the dominant legal form and vehicle of the multinational enterprise is the multinational corporation, which is typically a corporate group organised around holding corporation and subsidiary relationships.[3] Thus, in reality, the multinational corporation is a network of separate corporations each enjoying separate legal personality under corporate law doctrine. Dating from the second half of the twentieth century there has been an enormous growth in the number, size and influence of these multinational corporate groups,[4] which is not unrelated to the progressive liberalisation of international trade and investment since the end of the Second World War.

There has been some debate over whether or not these multinational corpora-

[1] OECD Guidelines for Multinational Enterprises, Revision 27 June 2000 ("OECD Guidelines").

[2] OECD Guidelines, *ibid*., Art I.3.

[3] See, eg, PI Blumberg, "The Corporate Entity in an Era of Multinational Corporations" (1990) 15 *Delaware Journal of Corporate Law* 283.

[4] See EW Orts, "The Future of Enterprise Organization" (1998) 96 *Michigan Law Review* 1947, 1962–1963 ("Orts 1998").

tions should be regarded as global entities.[5] For the purpose of this debate, a distinction is generally made between the concepts of globalisation and internationalisation: "globalisation denotes a process of *denationalisation*, whereas internationalisation refers to the co-operative activities of *national* actors".[6] In the context of this distinction (and irrespective of reality), systems of legal regulation continue to recognise multinational enterprises as international rather than global. That is, each corporation in the group comprising the multinational enterprise is incorporated in a state and is, thus, technically a national entity of that state. This obviously also applies to the ultimate holding corporation of each corporate group.[7] Relevant national law frequently recognises the group structure through the obligation on members of corporate groups to disclose the existence of parent and subsidiary corporations.[8] Thus, legally speaking, the multinational corporate group looks like it is characterised by "co-operative activities of national enterprises"[9] dominated by one particular national enterprise. Of course, legal technicalities may disguise a quite different operational, organizational and business strategy.[10]

Whether any particular multinational corporate enterprise, or even multinational corporate enterprises in general, are properly described as global enterprises or not, it seems to be incontrovertibly true that the markets in which these corporations operate are frequently global. For example, the concurrence of a number of factors has resulted in a global, rather than an international market for capital. In a nutshell, the major forces here have been economic liberalization, deregulation and advances in rapid communication technology.[11] The

[5] See, eg, M Ball, "Cosmocorps: The Importance of Being Stateless" (1967) 2 *Columbia Journal of World Business* 25; T Levitt, "The Globalisation of Markets" (1983) 61(3) *Harvard Business Review* 92; D Fleenor, "The Coming and Going of the Global Corporation" (1993) 28 *Columbia Journal of World Business* 6; PN Doremus et al, *The Myth of the Global Corporation* (Princeton, Princeton University Press, 1998); F Macmillan, "Legitimating Global Corporate Power" ("Macmillan 2000") in F Macmillan (ed), *International Corporate Law Annual: Volume 1* (Oxford, Hart Publishing, 2000) 155.

[6] G Walker, S Mellor, M Fox and S Francis, "The Concept of Globalisation" (1996) 14 *Company and Securities Law Journal* 59, 59.

[7] Unsurprisingly, it seems that approximately half of the ultimate holding corporations of multinational corporate groups are incorporated in the US, UK, Germany or Japan: see Orts 1998, *supra* n.4, 1963, citing UN Department of Economic and Social Development, *World Investment Report, 1992: Transnational Corporations as Engines of Growth* (UN Doc ST/CTC/130, 1992), 13, Box I.1, n 1.

[8] See also OECD's Guidelines for Multinational Enterprises, n 1 *supra*, Part III; and F Macmillan, "Corporate Disclosure On-Line: An Appropriate Response to Globalisation?" (1998) 21 *University of New South Wales Law Journal* 514, 522–524.

[9] See *supra* n.6 and acc text.

[10] See further Fleenor, *supra* n.5, at 8; and Macmillan 2000, *supra* n.5, at 157–9.

[11] See DK Ghosh and E Ortiz, "The Changing Environment of International Financial Markets: Introduction" in DK Ghosh and E Ortiz (eds), *The Changing Environment of International Financial Markets* (New York, St Martin Press, 1994) 1, 4–5. On the significance of information technology to the development of global financial markets, see also WB Wriston, *The Twilight of Sovereignty* (New York, Schribner, 1992), 61–62. Walker et al, *supra* n.6, suggests that "the rise of

processes of economic liberalization and deregulation have, of course, been accelerated under the auspices of the World Trade Organisation (WTO). The WTO General Agreement on Trade in Services (GATS), especially its Fifth Protocol on financial services, have been and seem likely to continue to be of particular significance in this context.[12] The WTO General Agreement on Trade and Tariffs (GATT) and, more recently, the WTO multilateral agreements in general,[13] have also had an important role in the progressive globalisation of the markets for goods and services in which multinational corporate enterprises operate.[14] As a result of progressive international market liberalisation under the WTO, goods and services are increasingly able to move across national borders with little hindrance from national laws and with little risk that the valuable intellectual property rights that underpin them will be eroded.

The emergence of global business strategies is a response to the globalisation of markets[15] and, therefore, is closely connected to this process of international market liberalisation. In simple terms, such global strategies underpin the rise and perpetuation of the multinational corporate entity. The structure of these entities and the power that they wield make the relationship between the multinational corporate sector and the governments of nation states problematic.[16] This is not least because the legal segmentation of the corporate group through the doctrine of separate corporate personality, allied with its multi-jurisdictional character, make it difficult for any one nation state effectively to regulate these entities.

global business strategies", privatisation and "the rise of the institutional investor" have also been influential in creating a global market for capital.

[12] See Macmillan 2000, n 5 *supra*.

[13] See the Agreement Establishing the World Trade Organization, 15 April 1994, Annexes 1–3. Annex 1A contains the multilateral agreements and understandings on trade in goods. Annex 1B contains the General Agreement on Trade in Services (GATS). Annex 1C contains the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs Agreement). Annex 2 contains the Understanding on Rules and Procedures Governing the Settlement of Disputes. Annex 3 contains the Trade Policy Review Mechanism. All members of the WTO are bound by the agreements and other instruments in Annexes 1–3: Agreement Establishing the World Trade Organization, Art II.2.

[14] For two pictures of the globalised market, contrast Levitt, *supra* n.5 and N Klein, *No Logo* (London, Flamingo, 2001).

[15] Information technology has played an important role in the effective implementation of these strategies: see, eg, JF Lyotard, *The Postmodern Condition: A Report on Knowledge* (trans G Bannington and B Massumi, Manchester, Manchester University Press, 1984), 3; and P Bradley, M Housman and P Nolan, "Global Competition and Technology" in P Bradley, M Housman and P Nolan (eds), *Globalization, Technology and Competition: The Fusion of Computers and Telecommunications in the 1990s* (Boston, Harvard Business School Press, 1993) 4.

[16] See Lyotard, *supra* n.15, at 5: "the problem of the relationship between economic and State powers threatens to arise with a new urgency." See also, Macmillan 2000, n 5 *supra*.

THE WTO AND MULTINATIONAL ENTERPRISES

The multilateral agreements concluded under the auspices of the Agreement Establishing the WTO[17] are, of course, all about the progressive liberalization of international markets and the consequent facilitation of international trade. Given that multinational corporate entities are a response to such liberalization as well as being the engine of international trade, then it might be said that the WTO is all about multinational corporations.[18] It is worth noting, however, that for the WTO the current ascendancy of the multinational corporate sector is instrumental rather than fundamental. While the effective operation of multinational enterprises may be predicated upon the liberalization of markets and the facilitation of free trade, from the WTO point of view, the inverse is also true. That is, the multinational enterprise is a primary instrument of free international trade, which is arguably the fundamental concept on which the WTO is based.

The promotion of free international trade derives from the doctrine of comparative advantage.[19] The doctrine was developed in the work of nineteenth century classical English economists:

> The classical law of comparative advantage sought to demonstrate that productive resources in all countries could be more efficiently employed if each country, through the exchange of goods and raw materials, specialized in producing the few goods and raw materials that it could produce most efficiently.[20]

As a result of the operation of the classical doctrine of comparative advantage, resources would be allocated in the most optimal fashion with consequent welfare benefits. One modern problem with the doctrine of comparative advantage, whether it is regarded as prescriptive or merely descriptive,[21] is that it is predicated upon the movement of commodities across borders rather than the movement of the means of the production of those commodities. The twentieth century, however, witnessed a considerable increase in the movement of the means of production across borders. This generally occurs by means of foreign

[17] See *supra* n.13.

[18] See also, Macmillan 2000, *supra* n.5.

[19] See, eg, J Jackson, "World Trade Rules and Environmental Policies: Congruence or Conflict ?" (1992) 49 *Washington and Lee Law Review* 1227, 1231.

[20] HJ Leonard, *Pollution and the Struggle for the World Product: Multinational Corporations, Environment and International Comparative Advantage* (Cambridge, Cambridge University Press, 1988), 8, citing D Ricardo, *Principles of Political Economy and Taxation* (1817), reissued as P Sraffa (ed.), *The Works and Correspondence of David Ricardo,* Vol 1 (Cambridge, Cambridge University Press, 1951).

[21] According to Leonard, *supra* n.20, at 1:

> A … neutral way of thinking about the concept of comparative advantage is that it describes the array of social, economic and political forces that account for the general export and import patterns prevailing between nations.

direct investment by multinational corporate enterprises, which establish subsidiary undertakings in the foreign market for this purpose. Since foreign direct investment involves the movement of the means of production across borders, rather than merely the movement of commodities, it may be regarded as raising questions about the current applicability of the doctrine of comparative advantage.[22] To the extent that the promotion of free trade is regarded as being justified by the doctrine of comparative advantage, the conclusion that foreign direct investment may undermine the classical concept of comparative advantage seems problematic for the WTO. This is especially so given that there appears to be some relationship between the WTO multilateral agreements and the growth of foreign direct investment. Of particular note in this respect are the major new agreements arising from the Uruguay Round, the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs Agreement) and GATS. There is obviously a chicken and egg aspect to the relationship between foreign direct investment and these two agreements. Essentially, both agreements might be seen as responding to the demands of enterprises involved in foreign direct investment, while at the same time being likely to stimulate further such investment.

Leonard has identified three theoretical concepts that explain the increase in foreign direct investment.[23] These are the international product cycle, the monopoly motivation, and the issue of industrial location. These three concepts are cumulative rather than independent. Under the concept of the international product cycle, products emanating from one country that are marketed internationally become subject to imitation by enterprises in other countries. There are two main ways for the originating enterprise to defend its international market. One is by licensing the relevant technology and marketing rights and the other is by establishing a manufacturing base in those countries where the product is subject to imitation. This type of defensive strategy may partly explain the cross border movement of production facilities by an enterprise. However, despite defensive strategies, product imitation by competitors is likely to be successful over time.[24] This, plus the cost of setting up foreign production facilities, suggests that there must be other drivers for such a decision. This is where the monopoly motivation, that is the desire to exploit market imperfections, manifests itself:

> In this view, a multinational corporation must maintain significant monopolist advantages over local firms in order to produce and sell in foreign markets with unfamiliar or even hostile economic, political, cultural, linguistic, legal, and social circumstances. The advantage must be perceived as less fleeting than the mere possession of one technique or formula because … successful adaptive imitation is more or less inevitable. Moreover, the potential profit in setting up abroad not only must

[22] Leonard, *supra* n.20, at 8–10 and 28–9.
[23] See Leonard, *ibid*., ch 1.
[24] Leonard, *ibid*., at 11–2 and 13.

> compensate for the increased risks and logistical complications, but must be higher than the profit potential for investing at home or the profit potential for local entrepreneurs in the foreign market.[25]

There are a number of possible monopolist advantages that may be relevant in encouraging multinational corporations to engage in foreign direct investment. These include advantages that may derive from international economies of scale as a result of both horizontal and vertical integration.[26] However, it seems that the major determinant of whether or not any industry will be dominated by multinational corporate entities through foreign direct investment relates to the sophistication of the necessary technology:

> The more advanced the technology, the more research-dependent the industry and the more in need of sophisticated managerial and technical skills, the more likely it is that foreign direct investors with these advantages will be able to outmaneuver domestic firms in other countries.[27]

This may explain why there is an increasing trend in industries that rely on simple non-proprietary technology to farm out production to unrelated undertakings in other countries that are able to produce the commodities in question cheaply, rather than engaging in foreign direct investment.[28] In these sorts of situations the global strategy of the relevant multinational corporations is a marketing strategy, rather than a production strategy.

The final factor that is of considerable importance in the decision about whether or not to establish a foreign subsidiary for the purpose of establishing foreign production facilities is the question of optimal industrial location. This is a factor that plays a part in any foreign direct investment decision, but it may also be particularly important in explaining the type of strategy whereby multinational corporations set up global production networks in which different components of a product are produced in different countries.[29] There is general agreement on the factors that affect the decision about optimal industrial location:

> These factors include raw materials, energy sources, markets, labor supply and costs, transportation availability and costs, capital availability, the potential for economies of scale, services and infrastructure (electricity, water supply, waste disposal, and so forth), governmental actions (taxes, incentives, regulations), and site costs.[30]

[25] *Ibid*., at 15.

[26] See Leonard, *ibid*., citing CP Kindleberger, *American Business Abroad* (New Haven, Yale University Press, 1969), 14.

[27] Leonard, *supra* n.20, at 17. See also, SP Magee, "Information and the Multinational Corporation: An Appropriability Theory of Foreign Direct Investment" in JN Bhagwati (ed), *The New International Economic Order: The North South Debate* (Cambridge, Mass., MIT Press, 1977); and S Hymer, "The Multinational Corporation and the Law of Uneven Development" in JN Bhagwati (ed), *Economics* and *World Order* (New York, Macmillan, 1972).

[28] This is a particular feature of the clothing industry and has lead to the growth and perpetuation of the pernicious sweatshop phenomenon: see Klein, *supra* n.14, ch 9.

[29] See Leonard, *supra* n.20, at 17–20.

[30] *Ibid*., at 21.

There is disagreement amongst theorists about the relevant weight to be attached to each of these factors.[31] As Leonard shows, however, the significance of the various factors tends to differ from industry to industry.[32] Overall, technologically advanced industries tend to be more dependent upon services and other incentives provided by government than they are upon natural features such as transportation and the availability of raw materials. Nevertheless, technologically advanced industries are usually capital intensive, which means that once they have established production facilities in a particular location they are unlikely to move in a hurry.

The fact that the monopoly advantages of high technology industries may make business enterprises operating in such industries more likely to establish foreign production facilities has an interesting interface with the strong system of intellectual property rights provided for in the TRIPs Agreement. A feature of high technology industries is that much of the relevant technology is subject to intellectual property rights. WTO orthodoxy has it that strong systems of intellectual property rights encourage the transfer of technology.[33] Whether transfer of technology occurs through some type of licensing arrangement or through foreign direct investment,[34] the existence of intellectual property rights in the recipient country would appear to play some part. This is particularly true in relation to high technology industries, in which technology owners are unlikely to risk their monopoly advantages by transferring that technology to countries where their intellectual property rights will not be protected.[35] As is noted above, however, such industries are more likely than other industries to establish foreign subsidiaries for the purpose of utilising their proprietary technology. From the point of view of a recipient country, the problem with this type of technology transfer is that it provides limited opportunities for the development of domestic capacity. It may be that, in terms of capacity building, the recipient country will eventually benefit from the training of a local workforce[36]

[31] See further Leonard, *ibid*., at 21–6, who considers, *inter alia*, the theories propounded in: A Weber, *Theory of Location of Industries* (trans CJ Friedrich, Chicago and London, University of Chicago Press, 1929); EM Hoover, *The Location of Economic Activity* (New York and London, McGraw-Hill, 1948); A Lösch, *The Economics of Location* (New Haven, Yale University Press, 1940); and A Pred, *Behaviour and Location*, Part 1, (Lund, Royal University of Lund, 1968), Part 2 (Lund, Royal University of Lund, 1969).

[32] Leonard, *supra* n.20, 26–8.

[33] See, eg, WTO Committee on Trade and Environment, *Factors Affecting Transfer of Environmentally-Sound Technology* (WT/CTE/W/22, 1996) ("WTO 1996"); and WTO Council for Trade in Services, *Environmental Services* (S/C/W/46, 6 July 1998), para 43.

[34] On the methods of transferring technology, see M Blakeney, *The Transfer of Technology to Developing Countries* (London, Sweet and Maxwell, 1989) ("Blakeney 1989"), ch 2.

[35] This is consistent with empirical evidence suggesting that intellectual property regimes may, in particular, affect the type of technology transferred by encouraging the transfer of more "knowledge intensive technologies": see WTO 1996, *supra* n.33, para 31.

[36] Although, it seems that the availability of a suitable workforce influences the decision about whether or not to engage in foreign direct investment (see Leonard, *supra* n.20, at 21 & 26–8) so the idea of a previously untrained workforce acquiring moveable skills may be largely illusory.

and the leaking out of the technology, but the benefits of the technology are largely enjoyed by the multinational enterprise rather than the recipient country.[37]

The relationship between the liberalisation of trade in services under GATS and foreign direct investment by multinational business entities is relatively straightforward. According to Article 1.2 of GATS, "trade in services" means the supply of a service:

(a) from the territory of one Member into the territory of any other Member;
(b) in the territory of one Member to the service consumer of any other Member;
(c) by a service supplier of one Member, through commercial presence in the territory of any other Member;
(d) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.

Article 1.3(b) defines "services" widely to include "any service in any sector except services supplied in the exercise of governmental authority". To the extent that the activities engaged in by multinational corporations involve the supply of services, then foreign direct investment is likely to be facilitated by trade in services falling within paragraph (c) of Article 1.2. It should be noted, however, that GATS adopts a "bottom up" approach, which means that WTO member states are bound by GATS obligations only to the extent that they have agreed to undertake those obligations. As a consequence full liberalisation of the market for the supply of services is still some way off. Nevertheless, there is considerable pressure for further liberalisation under GATS.

MULTINATIONAL ENTERPRISES AND THE ENVIRONMENT

The legal model of the multinational corporate enterprise

There are numerous concerns about the impact that the activities of multinational business enterprises may have on the environment. These include general concerns arising as a result of the legal nature of the multinational corporate enterprise. One of these is that the shareholder primacy model of the corporation,[38] which requires it to put the interests of its shareholders in the generation

[37] See also OECD Joint Working Party on Trade and the Environment, *Future Liberalisation of Trade in Environmental Goods and Services: Ensuring Environmental Protection as Well as Economic Benefits* (COM/TD/ENV(98)37/FINAL, 1999), 19, which notes that this produces "technological 'enclaves'".

[38] For justifications of the shareholder primacy model, see, eg, FH Easterbrook and DR Fischel, "Voting in Corporate Law" (1983) 26 *Journal of Law and Economics* 395; JR Macey and GP Miller, "Corporate Stakeholders: A Contractual Perspective" (1993) 43 *University of Toronto Law Journal* 401; and ME DeBow and DR Lee, "Shareholders, Non-shareholders and Corporate Law: Communitarianism and Resource Allocation" (1993) 18 *Delaware Journal of Corporate Law* 393.

of corporate profits above other considerations, may tend to induce corporate behaviour that is environmentally harmful and to create an environmental "race to the bottom".[39] Another concern arising from the legal structure of the multinational corporate enterprise is that this structure, which is legally fragmented along jurisdictional lines, makes it difficult for the ultimate parent corporation of a multinational corporate group to be made liable for environmental degradation caused by its subsidiaries in other jurisdictions.[40] This problem is compounded by the fact that most legal models of corporate accountability require the corporation to account only, or primarily, to its shareholders for its behaviour.[41] Where a subsidiary that has caused environmental degradation is wholly owned by another corporation in the multinational group, this form of accountability is unlikely to mean much. On the other hand, multinational corporate groups are far from being immune to the consequences of adverse public opinion. Non governmental organisations (NGOs), in particular, have been successful in mobilising and using public opinion to reign in corporations that are perceived to be social or environmental offenders.[42]

Industrial flight

A particular application of the environmental "race to the bottom" is the concept of industrial flight. Industrial flight is typically said to occur where business entities choose to locate or relocate their operations in another jurisdiction in order to reduce the cost of complying with government regulation, in particular, regu-

The shareholder primacy model has been subject to considerable attack: see, eg, D Millon, "Communitarians, Contractarians, and the Crisis in Corporate Law" (1993) 50 *Washington and Lee Law Review* 1373; L Johnson, "New Approaches to Corporate Law" (1993) 50 *Washington and Lee Law Review* 1713; F Macmillan Patfield, "Challenges for Company Law" in F Macmillan Patfield (ed), *Perspectives on Company Law: 1* (London, Kluwer, 1995). Statutory modifications in a number of jurisdictions have made some inroads into the shareholder primacy doctrine by allowing corporate management to take into account other non-shareholder interests: see, eg, British Companies Act 1985, s 309(1); on US corporate constituency statutes, see EW Orts, "A North American Legal Perspective on Stakeholder Management Theory" in F Macmillan Patfield (ed), *Perspectives on Company Law: 2* (London, Kluwer, 1997).

[39] On the environmental "race to the bottom", see, eg, P Rauber, "All Hail the Multinationals!" (1998) 83(4) *Sierra* 16.

[40] The Union Carbide Bhopal disaster of 3 December 1984 appears to be an example of this phenomenon. On this disaster and its consequences, see T Ashford and P Myers, "Policy Issues for Consideration in Transferring Technology to Developing Countries" (1985) 12 *Ecology Law Journal* 4; and M Sornarajah, *The International Law on Foreign Investment* (Cambridge, Cambridge University Press, 1994), 49. There have, however, been some recent developments of interest that may assist aggrieved parties to overcome these jurisidictional problems: see, eg, *Lubbe* v. *Cape plc* [2000] 4 All ER 268 (HL). See also, ch 11, *infra*.

[41] This is another manifestation of shareholder primacy in the legal model of the corporation: see *supra* n.38.

[42] See, eg, H Fabig and R Boele, "The Changing Nature of NGO Activity in a Globalising World: Pushing the Corporate Responsibility Agenda" (1999) 30(3) *International Development Studies Bulletin* 58.

lation with respect to environmental and labour standards.[43] Thus, where it occurs, industrial flight is a consequence of a decision taken by a multinational corporate enterprise about optimal industrial location. In the context of industrial flight for the purpose of avoiding the costs of environmental compliance, the industrial flight theory relies upon the existence of so-called "pollution havens".[44] In this hypothesis, pollution havens are developing countries that perceive the development gains arising from foreign direct investment as being greater than the losses suffered as a consequence of environmental degradation.[45] The WTO's 1999 study on trade and the environment[46] rejects the suggestion that polluting industries tend to migrate from developed to developing countries. It takes the view that environmental regulations are not a primary driver with respect to international investment decisions. The study identifies two trends that it argues tend to undermine the industrial flight hypothesis. One is the assertion that multinational business entities are moving towards a policy of standardised technologies for all their production facilities. The other is that, given international pressure for improved environmental standards,[47] it is most cost-effective for businesses to install state-of-the-art clean technology at the time of initial investment. On the other hand, Leonard's comprehensive and convincing study[48] of the twin phenomena of industrial flight and pollution havens, suggests a less rosy picture. Leonard found that, while there is no evidence for a generalised phenomenon of industrial flight from US environmental regulation, industrial flight can be identified in certain pollution intensive sectors.[49]

The typical situation of industrial flight, which has been described above, involves a form of foreign direct investment. That is, the establishment of a foreign manufacturing facility run by a foreign subsidiary. However, there is another type of multinational behaviour that might also be conceptualised as a species of industrial flight. This occurs when multinational corporations

[43] See, eg, I Castleman, "The Export of Hazardous Factories to Developing Countries" (1979) 9 *International Journal of Health Services* 569; M Porter, *The Competitive Advantage of Nations* (New York, Macmillan, 1990); S Baughen, "Mutinationals and the Export of Hazard" (1995) 58 *Modern Law Review* 54; Leonard, *supra* n.20; and UNCTAD, *Environment: UNCTAD Series on International Investment Agreements* (UNCTAD/ITE/IIT/23, 2001), 36.

[44] See Leonard, *supra* n.20, 1–3; and see also, UNCTAD, *supra* n.43, Box 7.

[45] There is a considerable body of literature on the relationship between foreign direct investment and development. Commentators are divided on the question of whether or not the relationship is a positive one: see, eg, GL Reuber *et.al*., *Private Foreign Investment in Development* (Oxford, Clarendon Press, 1973); C R Kennedy, "Relations between Transnational Corporations and Governments of Host Countries: A Look to the Future" (1992) 1 *Transnational Corporations* 67; J H Dunning, *Multinational Enterprises and the Global Economy* (Wokingham/ Massachusetts, Addison-Wesley, 1993); Sornarajah, *supra* n.40.

[46] H Nordstrom and S Vaughan, *Trade and the Environment* (Geneva, WTO, 14 October 1999).

[47] See also, WTO Committee on Trade and Environment, *Environmental Benefits of Removing Trade Restrictions and Distortions* (13 March 1998, WT/CTE/W/67/Add.1), para 10.

[48] Leonard, *supra* n.20.

[49] See Leonard, *ibid*., ch 4, which identifies the mineral processing and chemical industries as being susceptible to industrial flight.

outsource the manufacture of their product (which may be goods, services or both) to an enterprise in another country and use the global intellectual property rights in their brand name to control the marketing of the product. In this situation the legal relationship between the multinational brand owner and the foreign manufacturing enterprise is based on contract, rather than upon a parent-subsidiary corporate relationship. This sort of arrangement is a particular feature of the apparel industry and is often responsible for the generation of sweatshops in countries that have low standards of labour protection.[50] While there has been considerable focus on abuses of human rights that occur in sweatshops, sight should not be lost of the possible environmental hazards of such manufacturing operations. Outside the sweatshop situation, there are well-known examples of multinational marketing enterprises that have been accused of being responsible for environmental damage in various places around the world as a consequence of the production of their goods and services.[51]

The best solution to the environmental problems caused by industrial flight is, of course, to eliminate the pollution havens. Since this is difficult (if not impossible) to achieve, attention has turned to methods for calling the attention of multinational corporate enterprises to their responsibility for preventing environmental damage. A number of international initiatives that are motivated by this aim are examined in this chapter. However, as will be seen, these initiatives are not generally backed by legal sanctions. The mobilisation of public, customer and investor opinion is, therefore, a significant force in drawing the attention of multinational corporate groups to their environmental responsibilities.

Transfer of environmentally sound technologies

There is some debate over the definition of an environmentally sound technology. Generally, however, the expression is taken to refer to "'clean' technologies which have little impact on the environment in terms of pollution or which are high in energy efficiency compared to other technologies currently in use".[52] Such technologies are generally regarded as falling into two groups. One such group are "end-of-pipe" technologies, which ameliorate polluting outputs. The other group are "cleaner technologies", which reduce the amount of pollutants generated and involve more efficient use of natural resources.[53] The argument

[50] See, eg, Klein, *supra* n 14, esp ch 9.

[51] A well-known object of such allegations is the McDonald's fast food multinational enterprise. The making of these allegations lead to the *McLibel* case, *McDonald* v. *Steele and Morris*, High Court of Justice, 19 June 1997. For a history of this dispute, see J Vidal, *McLibel: Burger Culture on Trial* (London, Pan, 1997).

[52] UNCTAD, *Strengthening Capacities in Developing Countries to Develop their Environmental Services Sector* (TD/B/COM.1/EM.7/2, 1998), Box 1.

[53] See, eg, WTO Council for Trade in Services, *Environmental Services* (S/C/W/46, 6 July 1998), para 19; and OECD Joint Working Party on Trade and the Environment, *Future Liberalisation of Trade in Environmental Goods and Services: Ensuring Environmental Protection as Well as Economic Benefits* (COM/TD/ENV(98)37/FINAL, 1999), 9–10.

that the diffusion of such technologies tends to improve the protection of the environment is reasonably uncontroversial.[54] Where such technologies are subject to intellectual property rights, it is generally up to the owner of those rights to decide whether or not to transfer the relevant technology and on what terms.[55] As noted above, a particular feature of multinational business enterprises is that, where they transfer sophisticated proprietary technology, they often do so by foreign direct investment. That is, they transfer the relevant technology to their own subsidiaries. This is likely to inhibit technology diffusion and domestic capacity building.[56] Where the technology in question is a cleaner or more environmentally sound technology than that otherwise available, the inhibition of technological diffusion and domestic capacity building will have adverse environmental effects.

Since the adverse environmental effects of the refusal to transfer environmentally sound technologies, or the refusal to transfer them on advantageous terms, are less direct and dramatic than those caused by industrial flight, this matter has attracted considerably less public attention. Nevertheless, the importance of securing the transfer of environmentally sound technologies, especially to developing countries, has been recognised in a range of international initiatives. Some of these initiatives are considered in this chapter. In the main, the impact of these initiatives on multinational corporate enterprises are hortatory. The absence of serious public concern about the transfer of environmentally sound technologies may mean that many of these exhortations fall on deaf corporate ears.

UNITED NATIONS INITIATIVES

Draft United Nations Code of Conduct on Transnational Corporations

The draft United Nations Code of Conduct on Transnational Corporations is an example of an instrument directly addressed to multinational corporate enterprises. The fact that the Code has never been formally adopted may undermine its attempts at moral suasion. Its provisions, however, are of interest since they seem to have had some influence on other international initiatives. In some respects, the draft Code is one of the more rigorous of the proposed international instruments addressed to multinational corporate enterprises. Its rigour

[54] Although this may not necessarily be the case where the diffusion of such technologies involves the displacement of superior, or more appropriate, indigenous technologies. See further, F Macmillan, *The WTO and the Environment* (London, Sweet and Maxwell, 2001) ("Macmillan 2001"), ch 7.

[55] The conclusion of the Draft International Code of Conduct on the Transfer or Technology may have alleviated some technology transfer abuses: see Blakeney 1989, *supra* n.34, ch 6. However, differences of opinion between developed and developing countries have prevented the adoption of the Code: see Blakeney 1989, *ibid*., at 131–3.

[56] See Macmillan 2001, *supra* n.54, ch 7.

has, of course, given rise to unresolved disputes. As is evident from the provisions extracted below, some of these disputes have resulted in alternative wordings in the text of the Code.

The draft Code seeks to impose the following obligations on multinational corporate enterprises with respect to environmental protection:

> Transnational corporations shall/should carry out their activities in accordance with national laws, regulations, administrative practices and policies relating to the preservation of the environment of the countries in which they operate and with due regard to relevant international standards. Transnational corporations shall/should, in performing their activities, take steps to protect the environment and where damaged to [restore it to the extent appropriate and feasible][rehabilitate it] and should make efforts to develop and apply adequate technologies for this purpose.
>
> Transnational corporations shall/should, in respect of the products, processes and services they have introduced in any country, supply to the competent authorities of that country on request or on a regular basis, as specified by these authorities, all relevant information concerning:
>
> > Characteristics of these products, processes and other activities including experimental uses and related aspects which may harm the environment and the measures and costs necessary to avoid or at least to mitigate their harmful effects;
> > Prohibitions, restrictions, warnings and other public regulatory measures imposed in other countries on grounds of protection of the environment on these products, processes and services.
>
> Transnational corporations shall/should be responsive to requests from Governments of the countries in which they operate and be prepared where appropriate to cooperate with international organizations in their efforts to develop and promote national and international standards for the protection of the environment.[57]

The United Nations Conference on Environment and Development (UNCED)

Agenda 21

Agenda 21, which was agreed by UNCED in 1992 as part of its Rio Cluster of agreements, wields considerable international moral force. However, as its name suggests, it is in the nature of a programme for environmental protection in the twenty first century, rather than containing specific treaty obligations. It contains three chapters that are of particular importance in the present context. These are: chapter 20, which is concerned with hazardous waste management; chapter 30, which is concerned with the role of business and industry in environmental protection; and chapter 34, which is concerned with technology transfer.

Chapter 20 encourages transnational corporations to "adopt and implement, wherever they operate, policies and standards of operation with reference to

[57] Draft United Nations Code of Conduct on Transnational Corporations, Activities of Transnational Corporations, paras 41–43, extracted in UNCTAD, *supra* n.43, Box 2.

hazardous waste generation and disposal that are equivalent to or no less stringent than those in their country or origin".[58]

Chapter 30 exhorts "business and industry, including transnational corporations" to take a responsible attitude towards the protection of the environment. In pursuit of this objective it lays down two "programme areas". The first of these programme areas relates to the promotion of cleaner production. As part of this programme, business entities are encouraged to engage in a range of activities, which includes the following:

- "aim to increase the efficiency of resource utilization, including increasing the reuse and recycling of residues, and to reduce the quantity of waste discharge per unit of economic output";[59]
- "work towards the development and implementation of concepts and methodologies for the internalization of environmental costs into accounting and pricing mechanisms";[60]
- "report annually on their environmental records, as well as on their use of energy and natural resources";[61]
- "adopt and report on the implementation of codes of conduct promoting the best environmental practice, such as the Business Charter on Sustainable Development of the International Chamber of Commerce/(ICC) and the chemical industry's responsible care initiative".[62]

The second programme area in chapter 30 of Agenda 21 is concerned with "[p]romoting responsible entrepreneurship". As part of this programme, business entities are encouraged to engage in the following activities:

- "establish world-wide corporate policies on sustainable development, arrange for environmentally sound technologies to be available to affiliates owned substantially by their parent company in developing countries without extra external charges, encourage overseas affiliates to modify procedures in order to reflect local ecological conditions";[63]
- "increase research and development of environmentally sound technologies and environmental management systems;[64]
- "ensure responsible and ethical management of products and processes from the point of view of health, safety and environmental aspects".[65]

In contrast to chapter 30, the provisions of chapter 34 on the facilitation of

[58] Agenda 21, para 20.29.
[59] Agenda 21, para 30.6.
[60] Agenda 21, para 30.9.
[61] Agenda 21, para 30.10(a).
[62] Agenda 21, para 30.10(b). The specific mention of the chemical industry is interesting in light of the fact that Leonard, *supra* n.20, ch 4, identifies this industry as being particularly susceptible to industrial flight: see *supra* n.49.
[63] Agenda 21, para 30.22.
[64] Agenda 21, para 30.25.
[65] Agenda 21, para 30.26.

transfer of technology are largely addressed to governments and international organizations rather than to business entities. However, the particular role of multinational enterprises with respect to the transfer of technology is acknowledged in relation to the promotion of collaborative arrangements:

> Long term collaborative arrangements should be promoted between enterprises of developed and developing countries for the development of environmentally sound technologies. Multinational companies, as repositories of scarce technical skills needed for the protection and enhancement of the environment, have a special role and interest in promoting cooperation in and related to technology transfer, as they are important channels for such transfer, and for building a trained human resource pool and infrastructure.[66]

Joint ventures and foreign direct investment are envisaged as avenues for the transfer of environmentally sound technologies and environmental management practices.[67]

Framework Convention on Climate Change

The particular significance of the UNCED Framework Convention on Climate Change[68] in the present context is that it obliges all countries that are parties to it to "promote, facilitate and finance" access to and transfer of environmentally sound technologies relevant to the Convention's objectives with respect to climate change.[69] Additionally, the Kyoto Protocol to the Framework Convention establishes the Clean Development Mechanism, which is intended to encourage the development and transfer to developing countries of cleaner and more energy efficient technology.[70] The obligations under the Framework Convention are, of course, addressed to national governments, which are obliged to facilitate, but not to compel, the transfer of environmentally sound proprietary technologies by undertakings within their jurisdiction to undertakings in other countries.

The Convention on Biological Diversity

Article 16(1) of the Convention on Biological Diversity (CBD)[71] also obliges its parties to provide or facilitate access to and transfer of "technologies that are relevant to the conservation and sustainable use of biological diversity or make use of genetic resources and do not cause significant damage to the

[66] Agenda 21, para 34.27.

[67] Agenda 21, para 34.28.

[68] (1992) 31 ILM 849.

[69] See esp Arts 4(5) and 11(1) of the Framework Convention on Climate Change, *supra* n.68.

[70] The Kyoto Protocol, (1998) 37 ILM 22, has not yet been ratified due to its renunciation by the US in the wake of the election of George W Bush as its President. However, the EU, Japan and Russia have continued negotiations with a view to ratification.

[71] (1992) 31 ILM 818.

environment". This transfer of technology is to be made on "fair and most favourable terms, including on concessional and preferential terms where mutually agreed". Despite the fact that Article 16(2) of the CBD requires the recognition and protection of intellectual property rights, there seem to be considerable problems in reconciling the intellectual property regime under the WTO TRIPs Agreement with the CBD regime.[72]

One consequence of the apparent lack of reconciliation between these two regimes is that multinational biotechnology corporations, relying on the protection offered by their intellectual property rights, continue to transfer genetic technologies that undermine domestic capacity, rather than enhancing it. The most obvious example of this is so-called terminator technology, which involves the production and sale of crop seed that is genetically modified so that the resulting crops do not produce further seed. This necessitates further seed purchases every year. When this seed is also genetically modified to resist highly effective genetically selective weed killers, which are generally supplied by the same biotechnology corporation, then a serious culture of dependency may develop. Such a culture is, of course, inimical to domestic capacity building.

OECD GUIDELINES FOR MULTINATIONAL ENTERPRISES

The OECD Guidelines for Multinational Enterprises have a pedigree that stretches back to its 1976 Declaration on International Investment and Multinational Enterprises. The most recent version of the Guidelines forms Annex 1 to its 2000 Declaration on International Investment and Multinational Enterprises. The Guidelines contain a code that is directed at multinational enterprises, rather than governments. The obligations in the Guidelines are voluntary, but the Implementation Procedures in the 2000 Guidelines have been strengthened. These Implementation Procedures, which are contained in Part 2 of the 2000 Guidelines, are addressed to national governments. They oblige national governments of countries adhering to the Guidelines to establish National Contact Points with a view to promoting the Guidelines[73] and cooperating with National Contact Points in other countries "on any matter covered by the Guidelines relevant to their activities".[74] More specifically, the National Contact Points are required "to further the effectiveness of the Guidelines" in four ways:[75]

[72] See M Blakeney, "Access to Genetic Resources: The View from the South" [1997] 3 *Bio-Science Law Review* 97; C Macmanis, "The Interface between International Intellectual Property and Environmental Protection: Biodiversity and Biotechnology" (1998) 76 *Washington University Law Quarterly* 255; and Macmillan 2001, *supra* n.54, ch 5.

[73] OECD Guidelines, *supra* n.1, Part 2: Implementation Procedures of the OECD Guidelines for Multinational Enterprises, Decision of the OECD Council, June 2000, para I.1.

[74] Implementation Procedures of the OECD Guidelines for Multinational Enterprises, *ibid.*, para I.2.

[75] Implementation Procedures of the OECD Guidelines for Multinational Enterprises, *ibid.*, Procedural Guidance, para I.

first, by putting into place institutional arrangements which are designed to court the "active support of social partners", including the business community, employees organisations and NGOs; secondly, by supplying information about the Guidelines and raising awareness of them with all relevant stakeholders; thirdly, by providing a forum for discussion about and assistance with specific instances of implementation; and, fourthly, by making annual reports on the nature and results of its activities to the OECD Committee on International Investment and Multinational Enterprises. Generally, the Committee on International Investment and Multinational Enterprises is charged with overseeing the activities of the National Contact Points, and with issuing clarifications and making recommendations with respect to the Guidelines.[76] The adhering countries are largely comprised of the OECD member countries,[77] which include the countries in which most parent corporations of multinational corporate groups are based. As is obvious, however, the Implementation Procedures place no obligations on the adhering countries to implement the Guidelines in domestic law. The lack of formal implementation obligations in international codes does not always prevent them having an influence on the conduct of the relevant business actors.[78] However, the history of the influence of the OECD Guidelines for Multinational Enterprises does not give particular cause for confidence in this respect.

The substantive content of the 2000 Guidelines have been influenced by Agenda 21 and by the International Standards Organisation (ISO) 14001 Standard on Environmental Management Systems, which is discussed below.[79] The General Policies of the Guidelines commence with an obligation on multinational enterprises to "[c]ontribute to economic, social and environmental progress with a view to achieving sustainable development".[80] Slightly more specifically, the General Policies also urge corporations to "[r]efrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives".[81] This would seem to address the situation in which multinational corporate enterprises attempt to obtain or are offered pollution havens.[82] The Commentaries on the Guidelines note that this provision should not be seen as "infringing on an enterprise's right to seek changes in the statu-

[76] Implementation Procedures of the OECD Guidelines for Multinational Enterprises, *ibid*., Procedural Guidance, para II.

[77] Argentina, Brazil, Chile and the Slovak Republic, none of which are OECD countries, have also subscribed.

[78] See generally, J Braithwaite and PF Drahos, *Global Business Regulation* (Cambridge, Cambridge University Press, 2000).

[79] See OECD Guidelines for Multinational Enterprises: Commentaries, 27 June 2000, ("OECD Commentaries"), para 30.

[80] OECD Guidelines, *supra* n.1, Art II.1.

[81] OECD Guidelines, *ibid*., Art II.5.

[82] On this process, see Leonard, *supra* n.20, ch 2.

tory or regulatory framework".[83] The Commentaries also contain the following rather puzzling statement with respect to this provision:

> Importantly, however, there are instances where specific exemptions from laws or other policies can be consistent with these laws for legitimate public policy reasons. The environment and competition policy chapters are examples.[84]

Just what might be meant by this reference to the environment chapter, which is discussed below, is unclear.

The provisions of the Guidelines on Disclosure encourage multinational enterprises "to apply high quality standards [of collection and disclosure, presumably] for non-financial information including environmental and social reporting where they exist".[85] Enterprises are also encouraged to communicate "information on the social, ethical and environmental policies of the enterprise".[86] The language of encouragement that is used in these provisions may be contrasted with the more mandatory language, which is used in most of the provisions relating to disclosure. Mandatory(ish) language is, however, employed in Part V of the Guidelines, which is the Environment chapter:

> Enterprises should, within the framework of laws, regulations and administrative practices in the countries in which they operate, and in consideration of relevant international agreements, principles, objectives and standards, take due account of the need to protect the environment, public health and safety, and generally to conduct their activities in a manner contributing to the wider goal of sustainable development.

The particular obligations directed towards enterprises under Part V of the Guidelines include:

- to implement "a system of environmental management appropriate to the enterprise";[87]
- to consult with and provide information to all affected parties with respect to the environmental, health and safety impacts of corporate activities, "[t]aking into account concerns about cost, business confidentiality, and the protection of intellectual property rights";[88]
- to assess and address "forseeable environmental, health, and safety-related impacts associated with the processes, goods and services of the enterprise over their full life cycle";[89]
- to apply a precautionary approach by not using "the lack of full scientific

[83] OECD Commentaries, *supra* n.79, para 6.
[84] OECD Commentaries, *ibid*., para 6.
[85] OECD Guidelines, *supra* n.1, Art III.2.
[86] OECD Guidelines, *ibid*., Art III.5(a).
[87] OECD Guidelines, *ibid*., Art V.1.
[88] OECD Guidelines, *ibid*., Art V.2.
[89] OECD Guidelines, *ibid*., Art V.3.

certainty as a reason for postponing cost-effective measures to prevent or minimise" environmental damage;[90]
- to make plans for preventing, mitigating, controlling and reporting serious environmental accidents;
- to improve their environmental performance across the board, including using cleaner technologies;
- to train employees with respect to prevention of environmental accidents and "more general environmental management".[91]

Possibly, the most interesting of these obligations is the apparent endorsement of the precautionary principle, which may be contrasted with the WTO's apparent resistance to the application of this principle.[92] Of course, not too much should be read into this. As the Commentaries on the Guidelines note:

> The *Guidelines* are not intended to reinterpret any existing instruments or to create new commitments or precedents on the part of governments – they are intended only to recommend how the precautionary approach should be implemented at the level of enterprises.[93]

The Environment chapter of the Guidelines is relatively silent on the question of the transfer of environmentally sound technologies. It deals with the obligations to develop and to use such technologies, but not specifically with the obligation to transfer them. Of course, since the Guidelines are addressed to multinational business entities, they must be predicated on the basis that a certain amount of technology transfer by means of foreign direct investment will occur. In relation to this sort of technology, the Commentaries envisage "the potential for a 'demonstration effect' on other enterprises".[94] However, the type of technology transfer that is more likely to lead to domestic capacity building is dealt with in Part VIII on Science and Technology. According to this Part, multinational enterprises should:

> Adopt, where practicable in the course of their business activities, practices that permit the transfer and rapid diffusion of technologies and know-how, with due regard to the protection of intellectual property rights.
>
> …
>
> When granting licenses for the use of intellectual property rights or when otherwise transferring technology, do so on reasonable terms and conditions and in a manner that contributes to the long term development prospects of the host country.[95]

The respect for intellectual property rights that is evident in both Parts V and

[90] OECD Guidelines, *ibid*., Art V.4. See also, OECD Commentaries, *supra* n.79, para 37, which notes the influence on this provision of Principle 15 of UNCED's Rio Declaration on Environment and Development.

[91] OECD Guidelines, *supra* n.1, Art V.7.

[92] See further, eg, Macmillan 2001, *supra* n.54, ch 6.

[93] OECD Commentaries, *supra* n.79, para 39.

[94] OECD Commentaries, *ibid*., para 41.

[95] OECD Guidelines, *supra* n.1, Art VIII.2 and 4.

VIII of the Guidelines is hardly surprising given that the Guidelines are an OECD instrument. It was, after all, OECD countries that drove the conclusion of the WTO TRIPs Agreement.[96]

NGO INITIATIVES

As was noted above, a range of NGOs have been active in challenging and exposing environmentally threatening activities of multinational corporate enterprises. Fabig and Boele identify the two main types of NGO campaigning strategies as confronting and engaging.[97] Confronting NGOs are in ideological opposition to the corporate interests that they have in their sights: "They have an intuitive distrust of business and to a large extent see themselves as 'outsiders' to the current neo-liberal economic and political system, which they reject."[98] NGOs that engage with business, on the other hand, use the prevailing economic and political system to achieve their aims. They are particularly adept at mobilising public and consumer opinion in order to encourage or coerce big business into more environmentally and socially responsible practices.[99] NGOs that engage with big business use tactics ranging from oppositional to cooperative to achieve their aims. Fabig and Boele refer to "their double strategy of criticising business and constructing creative, solutions-oriented alliances with the business world".[100] They have used this range of tactics to drive the corporate social responsibility movement, with the result that, rhetorically at least, parts of the multinational corporate sector seem to have embraced the concept of their social responsibility.[101]

Consistent with the NGO strategy of engagement, a draft NGO Charter on Transnational Corporations has emerged. Like the draft United Nations Code on Conduct on Transnational Corporations and the OECD Guidelines for Multinational Enterprises, the NGO Charter is addressed directly to multinational corporate enterprises. While being less comprehensive than these other instruments in terms of the substantive obligations it seeks to impose on multinational enterprises with respect to the environment, it goes a little further than them with respect to remediation and compensation for environmental degradation. Its relevant provisions are as follows:

> The TNC shall take full account of its effect and impact on the environment and natural resources and fully conform to national/local laws and regulations regarding protection of the environment and the ecosystem, and the conservation of natural

[96] See further M Blakeney, *Trade Related Aspects of Intellectual Property Rights: A Concise Guide to the TRIPs Agreement* (London, Sweet and Maxwell, 1996), ch 1.

[97] *Supra* n.42, at 62.

[98] Fabig and Boele, *ibid*.

[99] See, eg, Klein, *supra* n.14, ch 16.

[100] *Supra* n.42, at 63.

[101] See further, Fabig and Boele, *ibid*.

resources in the country/region where it operates while conforming to the relevant international standards. When doing so the TNC shall observe the following:

(1) Implement an environmental assessment and follow up with a review.
(2) Establish an environmental/conservation policy and guideline and develop a pro-environmental management system.
(3) Freely disclose information on the company's environmental policy.

When there is any environmental destruction or other negative impact due primarily to the operations of the TNC, it shall take the appropriate measures including compensation for the damage caused by the environmental damage and restore the environment to its original state.[102]

OTHER INDIRECT INITIATIVES ON TRANSBOUNDARY ENVIRONMENTAL HARM

World Bank's Multilateral Investment Guarantee Agency

The World Bank's Multilateral Investment Guarantee Agency (MIGA) will only guarantee projects that are environmentally sound and sustainable. Accordingly, it requires an environmental assessment of proposed projects and places particular emphasis on "preventative measures over mitigatory or compensatory measures, whenever feasible".[103] While the MIGA procedures may have an indirect impact on transboundary environmental harm, it seems unlikely that they will have much impact on the behaviour of multinational corporations because it is unlikely that such enterprises will seek a guarantee for their foreign direct investment from MIGA. Enterprises seeking guarantees from MIGA for outward foreign direct investment are generally developing country enterprises, as developing countries do not usually provide insurance for such investment.[104] Developed countries, in which most parent corporations of multinational corporate enterprises are based, usually do.[105]

Convention on Environmental Impact Assessment in a Transboundary Context

Developed countries providing guarantees or other assistance to their multinational enterprises engaging in foreign direct investment may be affected by the obligations in the Convention on Environmental Impact Assessment in a

[102] Draft NGO Charter on Transnational Corporations (Prepared by The People's Action Network to Monitor Japanese TNCs), Arts 13 and 14: see UNCTAD, *supra* n.43, Box 3.

[103] Multilateral Investment Guarantee Agency, Environmental Assessment Policy (1999), para 2.

[104] Consequently, the tying of financial assistance to environmental standards may be characterised as a form of neo-colonialism: see, eg, M Rodgers, "Looking a Gift Horse in the Mouth: The World Bank and Environmental Accountability" (1990) 3 *Georgetown International Environmental Law Review* 457.

[105] See UNCTAD, *supra* n.43, at 60.

Transboundary Context.[106] Under Article 2(1) of this Convention the parties are obliged to "take all appropriate and effective measures to prevent, reduce and control significant adverse transboundary environmental impact from proposed activities". According to Article 1(v), proposed activities include activities or major changes to activities "subject to a decision of a competent authority in accordance with an applicable national procedure". It seems likely that this definition would include activities arising in the context of foreign direct investment.[107] Thus, these obligations may operate indirectly to circumscribe some environmentally unacceptable behaviour of multinational enterprises.

OTHER INDIRECT INITIATIVES ON TECHNOLOGY TRANSFER

Multilateral Environmental Agreements

In addition to UNCED's Agenda 21, the Framework Convention on Climate Change and the CBD, there are a number of multilateral environmental agreements (MEAs) that call for their member governments to facilitate and encourage the transfer of environmentally sound technologies. These MEAs are, therefore, indirect in the sense that they are not aimed at the owners of the relevant proprietary technologies. Examples of such MEA provisions include Article 4 of the 1985 Vienna Convention for the Protection of the Ozone Layer,[108] Article 10(2)(d) of the 1989 Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal,[109] and Article 10A of the 1987 Montreal Protocol on Substances that Deplete the Ozone Layer, as amended.[110] The obligations on the parties to these MEAs are generally expressed to be subject to national laws. It almost seems to go without saying that multinational corporate interests would urge an interpretation of such obligations that rendered them subject to national laws governing intellectual property rights.

Of these MEAs, the one that is perhaps of particular interest is the Montreal Protocol on Substances that Deplete the Ozone Layer, as amended by the London and Copenhagen Amendments. Under Article 10A each party is obliged to take steps to ensure that the "best available, environmentally safe substitutes and related technologies are expeditiously transferred to" developing country parties on fair and most favourable terms. This is a stronger obligation than

[106] A number of European countries, Canada and the US are signatories to this Convention: see UNCTAD, *supra* n.43, at 17.

[107] See UNCTAD, *ibid*., at 17–8.

[108] (1987) 26 ILM 1529.

[109] (1992) 1673 *United Nations Treaty Series* 57.

[110] (1987) 26 ILM 1529, as amended by Adjustments and Amendments to the Montreal Protocol on Substances that Deplete the Ozone Layer (London Amendment), (1991) 30 ILM 537, and by Montreal Protocol on Substances that Deplete the Ozone Layer: Adjustments and Amendments (Copenhagen Amendment), (1993) 32 ILM 874.

those contained in the other MEAs mentioned. It is also open to being interpreted as constituting an obligation on developed country parties to ensure that the transfer of technologies that are not environmentally safe is prohibited.[111] Such an obligation may be in conflict with the strong system of intellectual property rights mandated by the WTO TRIPs Agreement, which gives intellectual property right holders the exclusive right to exploit their intellectual property. A possible partial resolution of this conflict may lie in the ability of WTO members to exclude certain inventions from patentability under the enigmatic provision in Article 27.2 of the TRIPs Agreement:

> Members may exclude from patentability inventions, the prevention within their territory of the commercial exploitation of which is necessary to protect ordre public or morality, including to protect human, animal or plant life or health or to avoid serious prejudice to the environment, provided that such exclusion is not made merely because the exploitation is prohibited by domestic law.

The application of this provision as a means of resolving a conflict between the TRIPs Agreement obligations and the obligations under the amended Montreal Protocol, would depend upon exclusion from patentability being necessary within the territory of the developed country member for one of the stipulated reasons. What may not be necessary for these reasons in a developed country, where environmental problems are often less severe, may be necessary in a developing country. However, Article 27.2 would not appear to permit developed countries to exclude such technologies from patentability on this basis. Another problem with Article 27.2 is that the scope of the expression "serious prejudice to the environment" is unclear. Presumably, however, it means more than just environmental harm. A final problem with Article 27.2 as a basis for resolving this possible MEA/WTO conflict is that it clearly has no bearing on a situation where the relevant technology is protected by trade secrets law pursuant to Article 39 of the TRIPs Agreement.[112]

WTO initiatives

Two WTO multilateral agreement provisions relate to the transfer of technology. One is Article 66.2 of the TRIPs Agreement and the other is Article IV.1(a) of GATS. Article 66.2 of the TRIPs Agreement requires developed country members to "provide incentives to enterprises and institutions in their territories for the purpose of promoting and encouraging technology transfer to least-developed country Members in order to enable them to create a sound and viable technological base". Article IV.1(a) of GATS provides as follows:

[111] UNCTAD, *supra* n.43, at 45, citing P Sands, *Principles of International Environmental Law*, Volume 1 (Manchester and New York, Manchester University Press, 1995).

[112] Empirical studies have suggested that in many sectors trade secrets protection is more important to technology transferors than patent protection: WTO 1996, *supra* n.33, para 33.

> The increasing participation of developing country Members in world trade shall be facilitated through negotiated specific commitments, by different Members … relating to:
> (a) the strength of their domestic services capacity and its efficiency and competitiveness, *inter alia* through access to technology on a commercial basis;

In terms of facilitating the transfer of environmentally sound technology by multinational corporate enterprises to other enterprises in developing countries, neither provision amounts to much to write home about. Article 66.2 of the TRIPs Agreement applies only to technology transfers to least-developed countries, although it does require developed country members to undertake specific activities with respect to facilitating this. Further, the mention of enabling the creation of "a sound and viable technological base" suggests a focus on technology transfer that permits domestic capacity building. For reasons already explored, this may not be a characteristic of technology transfer that is undertaken solely by foreign direct investment. Article IV.1(a) of GATS appears to be a mandate to negotiate. Given its reference to "domestic services capacity", it may be that it is envisaging technology transfer other than by foreign direct investment. However, the reference to access "on a commercial basis" tends to dilute this argument.

ENVIRONMENTAL MANAGEMENT SYSTEMS: ISO 14001 AND THE WTO AGREEMENT ON TECHNICAL BARRIERS TO TRADE

ISO 14001

As was noted above, the ISO 14001 Standard on Environmental Management Systems was one of the influences on the 2000 Revision of the OECD Guidelines for Multinational Enterprises. As a result, Article V.1 of the OECD Guidelines requires multinational business enterprises to:

> Establish and maintain a system of environmental management appropriate to the enterprise, including:
> (a) Collection and evaluation of adequate and timely information regarding the environmental, health, and safety impacts of their activities.
> (b) Establishment of measurable objectives and, where appropriate, targets for improved environmental performance, including periodically reviewing the continuing relevance of these objectives; and
> (c) Regular monitoring and verification of progress toward environmental, health, and safety objectives or targets.

The emphasis in the OECD Guidelines on environmental management systems is also consistent with chapter 30 of Agenda 21.

The ISO 14001 Standard on Environmental Management Systems was approved by the ISO as a voluntary standard in 1996. It is part of the ISO 14000 series of environmental management standards, but is the only compliance

standard in the series. The other environmental standards are in the process of development and presently take the form of guidelines.[113] Compliance with the international standard may confer a number of internal benefits on business entities. These include economies with respect to waste disposal and consumption of raw materials, as well as the identification and clarification of environmental responsibilities within the business entity.[114] From an external point of view, the particular benefit for enterprises of complying with ISO 14001 is that it opens up the possibility of certification of the enterprise's environmental management system by an independent certification body or by self certification.[115] Not only is this likely to appeal to investors, either because certification demonstrates improved efficiency or because it allays ethical concerns about investment in environmentally unsound enterprises, it will also have a positive effect on the general environmental reputation of the relevant enterprise. This will make an enterprise less vulnerable to adverse public and consumer opinion with respect to its environmental credentials. Of course, the public benefit in business entities seeking ISO 14001 certification is that the procedures they are required to implement in order to obtain this certification are likely to ensure that they introduce an environmental management programme. On the other hand, no minimum levels of environmental performance are set by ISO 14001.

The steps that need to be taken for firms seeking ISO 14001 certification are as follows:

- an initial review by management to identify environmental issues of concern (e g excessive use of polluting inputs; the potential for a serious environmental accident);
- establishment of priorities for action, taking into account local environmental regulations and potential costs;
- establishment of an environmental policy statement, signed by the CEO, which includes commitments to compliance with environmental regulations, pollution prevention and continuous improvement;

[113] ISO 14000 standards still being developed include standards on environmental auditing, performance evaluation, eco-labelling and life cycle analysis: see P Murray, "The International Environmental Management Standard, ISO 14000: A Non-Tariff Barrier or a Step to an Emerging Global Environmental Policy?" (1997) 18 *University of Pennsylvania Journal of International Economic Law* 577, 578; and M Finger and L Tamiotti, "New Global Regulatory Mechanisms and the Environment: The Emerging Linkage between the WTO and the ISO" (1999) 30 *International Development Studies Bulletin* 8, 12.

[114] See UNCTAD, *supra* n.43, Box 11; GH Holliday, "How to Prevent Criminal Prosecution of Senior Management" in FN Edwards (ed), *Environmental Auditing: The Challenge of the 1990s* (Calgary, University of Calgary Press, 1992), 186; J Ueda, "Environmental Challenges for Japanese Corporations in the Twenty-first Century: Legal Aspects of Corporate Environmental Risk Management" in F Macmillan (ed.), *International Corporate Law Annual: 1* (Oxford, Hart Publishing, 2000), 136.

[115] On ISO 14000 certification, see, eg, Murray, *supra* n.113, at 596–600; and E Pinckard, "ISO 14000" (1997) 8 *Colorado Journal of International Environmental Law and Policy* 423, at 435.

- development of performance targets based on the policy statement (e g reduction of emissions by a set amount over a defined period);
- implementation of the environmental management systems,[116] with defined procedures and responsibilities;
- implementation of reviews, performance measurement and management audits.[117]

Despite its name, the ISO is a private body, not an international organisation, and ISO 14001 certification is essentially a private form of international regulation.[118] Its origins lie in the perceived failure of national and public international environmental regulation to deal effectively with national and transboundary environmental degradation, much of which has been a consequence of industrialisation and increased international trade. ISO 14001 has, thus, emerged at the interface of international deregulation and the pressure for, what Finger and Tamiotti describe as, "re-regulation" with respect to the environment.[119] It appears to enjoy considerable support from a number of the relevant actors.[120] Multinational corporate enterprises like voluntary international standards of this sort because they reduce market fragmentation arising from national regulation.[121] There is also considerable support for ISO 14001 within the multinational corporate sector specifically because it is perceived as allowing such enterprises to show that they are good international corporate citizens. NGOs are able use ISO 14001 certification as a weapon against corporate enterprises that fail to live up to the standards to which they have bound themselves. States favour ISO 14001 certification because "voluntary standards which are enforced by indirect pressure (market-based incentives and disincentives) reduce the domestic costs of public legislation and enforcement, by shifting enforcement costs to the producers of pollution, rather than to the taxpayer".[122] Certification bodies like international certification standards generally because they make profits through the certification process. Finally, as we shall see, the WTO seems to like ISO 14001 even though it may create a non-tariff barrier to trade.

[116] ISO 1400 Definitions, http://www.iso14000.com/Implementation/definitions.htm, accessed 28/6/01, defines an environmental management system as: "The part of the overall management system that includes organizational structure, planning activities, responsibilities, practices, procedures, processes, and resources for developing, implementing, achieving, reviewing and maintaining the environmental policy."

[117] UNCTAD, *supra* n.43, Box 11. See further, Murray, *supra* n.113, at 590–3.

[118] On the ISO and the history of ISO 14000, see Murray, *ibid*., at 581–600.

[119] Finger and Tamiotti, *supra* n.113, at 9.

[120] See generally, Finger and Tamiotti, *ibid*., at 11.

[121] See also RB Stewart, "Environmental Regulation and International Competitiveness" (1993) 102 *Yale Law Journal* 2039, 2044.

[122] Finger and Tamiotti, *supra* n.113, citing Pinckard, *supra* n.115, at 439.

ISO 14001 as a trade barrier

The introduction to ISO 14001 states that it "should not be used to create non-tariff trade barriers or to increase or change an organization's legal obligations".[123] According to Murray:

> The rationale was that an international standard would solve the problems created by the inconsistency of a myriad of national and regional environmental regulations. Because the standards are procedural and not substantive, they do not set product and process regulation. As a result, there is no problem of creating regulations that are non-attainable for developing countries and unprotective for industrial countries.[124]

Despite these apparently good intentions there is considerable concern amongst developing countries that widespread adoption could become a de facto non-tariff barrier to trade.[125] This concern, which should be viewed through the spectacles of more general developing country concerns about "eco-imperialism",[126] is focussed on the possibility that ISO 14001 certification may become a requirement for enterprises as a result of supply chain pressures or public procurement policies. This is a problem for developing country enterprises for three reasons: first, because the participation of developing countries in the formulation and implementation of ISO 14001 was minimal;[127] secondly, because their certification bodies lack international accreditation; and, thirdly, because of the cost of obtaining certification.[128] The concerns about accreditation and certification cannot reasonably be regarded as allayed by the self-certification process that is available under ISO 14001. This is because where the voluntary standards in ISO 14001 assume such importance that they become non-tariff barriers to trade it is most unlikely that the parties applying the pressure for certification will accept self-certification as being adequate.[129] If the trade effects of ISO 14001 are as developing country enterprises fear, then a result of their widespread adoption may be an increase in the competitive advantage for multinational corporate enterprises.[130]

[123] See Murray, *supra* n.113, at 579 and 608.

[124] Murray, *ibid*., at 579.

[125] UNCTAD, *Report of the Expert Meeting on Possible Trade and Investment Impacts of Environmental Management Standards, Particularly the ISO 14000 Series, on Developing Countries and Opportunities in this Context* (TD/B/COM.1/10, 1997). See also WTO Committee on Technical Barriers to Trade, *Technical Barriers to the Market Access of Developing Countries* (WT/CTE/W/101 & G/TBT/W/103, 1999), paras 27–34.

[126] See, eg, Rodgers, *supra* n.104; S Charnovitz, "Free Trade, Fair Trade, Green Trade: Defogging the Debate" (1994) 27 *Cornell International Law Journal* 459, 492; and S Vaughan, "Trade and Environment: Some North-South Considerations" (1994) 27 *Cornell International Law Journal* 591, 593.

[127] See further, Murray, *supra* n.113, at 595–6.

[128] In 1997 the reported cost of implementing ISO 14000 ranged from US$8000 to US$100,000: Murray, *ibid*., at 596.

[129] On the limits of self-certification, see Murray, *ibid*., at 597–600.

[130] See Finger and Tamiotti, *supra* n.113, at 13.

Relationship with the WTO Agreement on Technical Barriers to Trade

Non-tariff barriers to trade are not WTO friendly. In relation to trade in goods, they are restricted by GATT, while GATS aims towards the elimination of such barriers in relation to trade in services. Since the ISO 14001 Standard on Environmental Management Systems is voluntary and imposes procedural (rather than substantive) obligations, it seems unlikely that it falls foul of GATT obligations[131] or would fall foul of fully liberalised obligations under GATS. In any case, the application of ISO 14001 by national accreditation or certification bodies appears to fall within the scope of the WTO Agreement on Technical Barriers to Trade (TBT Agreement) and, accordingly, the question of its validity ought to be determined under this Agreement.[132]

The TBT Agreement applies to three types of measures: technical regulations, standards and conformity assessment procedures. A "technical regulation" is defined as:

> Document which lays down product characteristics or their related processes and production methods, including the applicable administrative provisions, with which compliance is mandatory. It may also include or deal exclusively with terminology, symbols, packaging, marking or labelling requirements as they apply to a product, process or production method.[133]

A "standard" is defined as:

> Document approved by a recognised body, that provides, for common and repeated use, rules, guidelines or characteristics for products or related processes and production methods, with which compliance is not mandatory. It may also include or deal exclusively with terminology, symbols, packaging, marking or labelling requirements as they apply to a product, process or production method.[134]

A "conformity assessment procedure" is defined as:

> Any procedure used, directly or indirectly, to determine the relevant requirements in technical regulations or standards are fulfilled.

The significant distinction between a technical regulation and a standard is that the former is mandatory, whilst the latter is voluntary. It does not appear that any national body has adopted ISO 14001 on a mandatory basis. However, if ISO 14001 was adopted as a technical regulation then Article 2 would apply. Article 2.1 requires national treatment[135] and most favoured nation (MFN)

[131] For a discussion of the likely treatment of voluntary standards with respect to labelling under GATT, see Macmillan 2001, *supra* n.54, ch 4. It seems likely that similar treatment would be meted out under GATT to other types of voluntary standards, including ISO 14001. See also Murray, *supra* n.113, at 607–9.

[132] This is a consequence of Agreement Establishing the World Trade Organization, General Interpretative Note to Annex 1A.

[133] TBT Agreement, Art 1.2 and Annex 1, para 1.

[134] TBT Agreement, Art 1.2 and Annex 1, para 2.

[135] National treatment requires WTO member states to treat the products of other member states as favourably as they treat domestic products.

treatment[136] with respect to products subject to technical regulations. Article 2.2 provides that technical regulations must not be "prepared, adopted or applied with a view to or with the effect of creating unnecessary obstacles with respect to international trade". It goes on to provide that "technical regulations shall not be more trade-restrictive than necessary to fulfil a legitimate objective" and includes within its list of legitimate objectives the "protection of human health or safety, animal or plant life or health, or the environment". Under Article 2.4 members wishing to introduce particular technical regulations are obliged to base them on existing international standards unless this would be "an ineffective or inappropriate means for the fulfilment of the legitimate objectives pursued". Besides being required by Article 2.4, adoption of ISO 14001 as a technical regulation, and thus as a compulsory measure would, it seems, have the benefit of the rebuttable presumption under Article 2.5 that it does not create an unnecessary obstacle to trade. In any case, there may be an argument that the adoption of ISO 14001 is necessary to fulfil the legitimate objective of protecting the environment.

There seems to be no problem under the TBT Agreement for members, or national or regional standardizing bodies of members, wishing to adopt ISO 14001 as the basis of a standard. Under Article 4.1 members are required to ensure that central government standardizing bodies comply with the Code of Good Practice for the Preparation, Adoption and Application of Standards laid down in Annex 3 of the Agreement and to take reasonable steps to ensure that local government and non-governmental standardizing bodies also comply with the Code. As would be expected, the Code requires standardizing bodies to afford national treatment and MFN treatment to products from other WTO members.[137] It also requires standardizing bodies to ensure that standards do not create unnecessary obstacles to international trade.[138] Importantly, in the present context, the Code obliges members to ensure that standards comply with existing international standards unless such standards "would be ineffective or inappropriate".[139] The possibility of the WTO concluding that an ISO standard would be ineffective or inappropriate seems minimal in light of the close links between the WTO and the ISO.[140] The Code makes the ISO/IEC Information Centre in Geneva the international information clearing house for notifications from standardizing bodies within the territory of WTO members regarding their acceptance or withdrawal from the Code[141] and for notifications concerning their six monthly published work programmes.[142] The ISO also has

[136] MFN treatment requires WTO member states not to discriminate between products on the basis of the member state from which they emanate.

[137] TBT Agreement, Annex 3, para D.

[138] TBT Agreement, Annex 3, para E.

[139] TBT Agreement, Annex 3, para F.

[140] See also, Finger and Tamiotti, *supra* n.113, at 12–3.

[141] TBT Agreement, Annex 3, para C.

[142] TBT Agreement, Annex 3, para J. See also WTO Decision on Proposed Understanding on WTO-ISO Standards Information System, Agreement Establishing the World Trade Organization,

observer status on the WTO Committee on Technical Barriers to Trade.[143]

Since the adoption of ISO 14001 by a WTO member, either as technical regulation or a standard, would be likely to involve its third party certification,[144] this will also bring into play the provisions of the TBT Agreement on conformity assessment procedures. Conformity assessment by central government bodies is dealt with by Articles 5 and 6. Articles 7 and 8 deal with conformity assessment procedures by local government bodies and non-governmental bodies, respectively. Under Article 5.1 conformity assessment procedures are to be prepared, adopted and applied so as to afford national treatment and MFN treatment to products emanating from other WTO members, and so as not to create unnecessary obstacles to international trade. Article 5.2 contains a range of obligations on national government bodies, including obligations to act expeditiously, publish information about its conformity assessment procedures, keep information requirements to a minimum, observe confidentiality, ensure that fees are equitable, and site facilities in a convenient position. The remainder of Article 5 is mostly concerned with the elaboration of these procedural obligations. Article 6 establishes the principle of equivalence under which members are obliged to accept the results of conformity assessment procedures carried out by other members "even when those procedures differ from their own, provided that they are satisfied that those procedures offer an assurance of conformity with applicable technical regulations or standards equivalent to their own procedures". Under Articles 7 and 8 WTO members are obliged to take reasonable measures available to them to ensure that local government bodies and non-governmental bodies engaging in conformity assessment procedures comply with the obligations in Articles 5 and 6. As with the TBT Agreement provisions on technical regulations and standards, the provisions on conformity assessment procedures are marked by a concern to ensure compliance with applicable international and regional systems.[145] This is subject to the proviso that such systems are not inappropriate "for, *inter alia*, such reasons as: national security requirements; the prevention of deceptive practices; protection of human health or safety, animal or plant life or health, or the environment; fundamental climatic or other geographical factors; fundamental technological or other infrastructural problems".[146]

Many commentators are upbeat about the positive environmental effects of the WTO's likely embrace of the ISO 14001 Standard on Environmental Management Systems. Finger and Tamiotti suggest that it may be the answer to the tensions caused by international economic deregulation and the apparent

Annex 4 (Plurilateral Trade Agreements) and WTO Decision on Review of the ISO/IEC Information Centre Publication, Agreement Establishing the World Trade Organization, Annex 4 (Plurilateral Trade Agreements).

[143] See Finger and Tamiotti, *supra* n.113, at 12.

[144] As to which, see Murray, *supra* n.113, at 596–7.

[145] TBT Agreement, Arts 5.4, 5.5 and 9.

[146] TBT Agreement, Art 5.4.

need for "re-regulation" with respect to the environment.[147] They are sanguine about the move from public environmental regulation to private regulation, seeing this as a consequence of the re-balancing of power amongst major actors as a result of economic deregulation and the globalisation of economic activity.[148] It does seem to be the case that one advantage of this private form of regulation is likely to be that it will be more enthusiastically embraced by multinational corporate interests than forms of public regulation. A number of commentators subscribe to the view that this may create a "race to the top", especially as the ISO 14000 series of standards calls for continual environmental improvement.[149] Murray takes the view that the particular importance of the private ISO 14001 initiative is that it will initiate a move towards a public solution because it is "a means of taking the first steps towards harmonization while governments negotiate meaningful standards".[150]

Notwithstanding all this optimism, however, problems remain. The ISO is a procedural standard, not a substantive standard setting minimum levels of environmentally acceptable behaviour. Despite the fact that is it unlikely to be adopted by WTO members as a mandatory requirement, its adoption as a voluntary standard is still capable of raising de facto trade barriers for developing country enterprises[151] and small to medium sized enterprises generally. If this is so then its effect may be to enhance the monopoly positions held by multinational corporate enterprises without obliging them to comply with a substantive environmental standard. Even though developing country enterprises sometimes experience difficulty in complying with existing environmental regulatory standards, it is not clear that the further entrenchment of the market position of multinational business enterprises would greatly improve their environmental standards and the consequent protection of the environment. There may also be good reasons for being wary of a private solution to a very public problem. Private solutions tend to favour those actors with most clout.[152] Public solutions are much more liable to arrive at an accommodation of the interests of all actors and the public interest. The idea that a private solution might lead to a public solution is a nice one. However, it is hard to see how or why it would happen. On the contrary, the capture of international environmental regulation by private interests seems more likely to be self-perpetuating.

[147] Finger and Tamiotti, *supra* n.113, at 9 and 13–4.

[148] *Ibid*., at 14.

[149] See, eg, Stewart, *supra* n.121, at 2080–1; Murray, *supra* n.113, at 612–4; Pinckard, *supra* n.115, at 440; Finger and Tamiotti, *supra* n.113, at 13–4.

[150] Murray, *supra* n.113, at 615.

[151] Although there has been increased recent interest in ISO 14001 certification in some more industrialised of the developing countries: see S Beloe, "The Greening of Business?" (1999) 30 *International Development Studies Bulletin* 43, 44–45.

[152] And there is a strong argument that as between multinational business interests and national governments, the former enjoys more clout: see further, Macmillan 2000, *supra* n.5.

HAVE MULTINATIONAL BUSINESS ENTERPRISES BEEN GREENED?

As this chapter has shown, multinational business enterprises have been on the receiving end of a plethora of encouragement, exhortations, incentives, and sometimes even threats, to engage in environmentally responsible and acceptable behaviour. Has the sector been consequently greened? Any attempt to address this question is obviously doomed to generalisation and subject to the confusing effects of rhetorical "greenwashing" by some multinational business enterprises.[153] In attempting to assess the real extent of the greening of business, Beloe looks at corporate operational and strategic issues.[154] In relation to operational issues, he suggests that the popularity of ISO 14001 and the general interest in environmental reporting give some cause for optimism. Of course, the popularity of ISO 14001 may not necessarily equate with improved environmental performance. On the other hand, the interest in environmental reporting, especially where this is associated with the publication of verified data demonstrating performance improvements may display a more genuine engagement with environmental issues.

The evidence of greening in relation to strategic issues is similarly mixed. As Beloe notes there have been heartening cases of environmental leadership by representatives of multinational corporate groups – just not enough of them:

> A prime example of this is John Browne the group chief executive at BP Amoco. The leadership he provided in publicly accepting the existence of climate change has been cited by none other than Greenpeace as helping to build consensus behind the Climate Protocol agreed in Kyoto in 1997. There are others, of course, whose rhetoric has helped change attitudes within the business community … However, as important as these corporate leaders have been, they are most notable by their relative absence within the business sectors as a whole.[155]

Further, the fact that many multinational corporate enterprises lobby against improved environmental standards cannot be regarded as raising their environmental credentials.[156]

A particular area identified in this chapter in which multinational business enterprises have shown themselves to be reluctant green citizens is in relation to the transfer of environmentally sound technologies to developing countries under the sort of conditions that will facilitate environmentally sound capacity building in those countries. Considerable amounts of technology transfer by way of foreign direct investment do, of course, occur. However, this often contributes little to domestic capacity building. The reluctance to transfer environmentally

[153] See, eg, Beloe, *supra* n.151, at 43; and Fabig and Boele, *supra* n.42, at 63.

[154] Beloe, *supra* n.151, at 44–7.

[155] *Ibid*., at 46.

[156] A particular example of this relates to the US decision not to ratify the Kyoto Protocol, *supra* n.70, to the Framework Convention on Climate Change, *supra* n.68: see, eg, "How the high priests of capitalism run roughshod over fears for the planet", *The Guardian*, 17 April 2001.

sound technology on other terms is hardly surprising given the value of the intellectual property rights frequently embedded in such technologies. This, perhaps, is as good an example as any of the fundamental tensions that exist between the aspirations of the multinational corporate sector and the goal of enhanced environmental protection. Multinational corporate enterprises will comply with domestic environmental regulations.[157] They will often formulate environmental policies and monitor and improve their environmental management. What they will not do is voluntarily give away their competitive and monopoly advantages. Given the system in which they operate it would be surprising if they did. In these circumstances, it may be folly to place undue reliance on the multinational corporate sector as a source of leadership or significant influence in relation to international environmental protection.

[157] Available evidence suggests that corporate compliance with environmental regulations has greatly improved since the 1970s: see Beloe, *supra* n.151, at 48.

PART TWO

12

Suing Multinational Corporate Groups for Torts in the Wake of the Lubbe *Case– A Comment*

ALEX TAWANDA MAGAISA

INTRODUCTION

The current wave of globalization has increased the conduct of business on a transnational basis.[1] Competition in the marketplace is stiff and firms are continually seeking to exploit new opportunities in different parts of the world. Firms are adopting various strategies in attempts to maximize efficiency and reduce exposure to liability. Indeed, managing liability is now an important part of business strategy. The growth of multinational corporate groups[2] is one such response that has attracted much attention from scholars to activists and therefore calls for further analysis. Various constituencies such as consumers, creditors, employees, the environmental lobby and the public feel the influence of the activities of these large global firms. It is in the interests of all affected constituencies that social and economic costs arising are kept to a minimum while productivity is enhanced.

The growth of multinational corporate groups has brought with it the

[1] "Globalisation" is one of those terms that find themselves thrown about and used by almost everyone as it suits them. It is an everyday word and to give it scholarly meaning would seem to me to rob it of its ordinary character. It is also highly contested, with some viewing it as a concept and others as a process. An attempt to expound on its meaning would probably require its own book. I refuse to confine myself to anyone's definition and as such I will use it in the sense that I think best describes the subject. For purposes of this work, its meaning and application revolves around the idea of the continual fall of economic barriers between countries leading to the close interaction between persons and organisations etc. It is part of a process that has been going on for a long time, only perhaps the process is more accelerated and all encompassing than it was before. For some further insight into this term, see M Smeets, "Globalisation of International Trade and Investment" in F Buelens (ed.), *Globalisation and the Nation-State* (Cheltenham, Edward Elgar, 1999), 7–33.

[2] The term "corporate group" is used in this chapter to reflect the *de facto* grouping of different companies under a common umbrella linked by cross-shareholdings or other links. Typically, there is a parent company and subsidiaries in which the parent holds all or a substantial proportion of the shares. Similar terms like "group of companies" apply equally. A corporate group is not a single body corporate.

problem of ascribing liability for torts committed by individual units of the corporate group operating in different legal and economic jurisdictions. Legal suits involving claimants and defendants in different jurisdictions illustrate this problem. The determination of transnational litigation has not been easy and these suits have illustrated the complex interplay between principles of substantive corporate law and procedural rules of international civil litigation. This chapter comments on the recent case of *Lubbe v Cape plc*,[3] (the *Lubbe* case) involving proceedings by South African victims against an English-based corporate group.

CASE SUMMARY

The matter involved Cape Industries PLC and its asbestos operations *again*.[4] Cape Industries, a multinational company based in England, through its subsidiary units, was involved in the mining and milling of blue and brown asbestos in various locations in South Africa between 1939 and 1979. More than 3000 plaintiffs are suing Cape Industries for wrongful deaths and injuries resulting from exposure to the hazards of asbestos. The claimants are either direct victims of the hazard having worked or lived in the vicinity of the mining and milling operations or dependants of deceased victims. Cape Asbestos Company, through which Cape Industries operated in South Africa, no longer exists and has no assets or insurance to satisfy the South African victims even if they were to sue it and win judgment.

The victims brought the claims against Cape Industries before the High Court in England. The company objected to the suit on the grounds of *forum non conveniens*, arguing that the natural forum for the pursuit of the action was South Africa. The major issue in these proceedings was whether the actions should proceed in the English forum or in South Africa. There were thousands other potential claimants who were waiting for the outcome of these proceedings. In the substantive claim the victims allege harm arising from Cape Industries' negligence leading to exposure to the dangerous substance. The majority claim to be suffering from asbestosis while others have mesothelioma, a slow-developing cancer that affects the lungs and is primarily caused by asbestos when inhaled.[5] They claim that when they breathe, it feels like there is "crackling paper" in their chests, and it is painful.[6] It is alleged that when Cape Industries left South Africa in 1979, it did not rehabilitate the mines, mills and dumps, which continue to pose a hazard to local communities to this day. The

[3] *Shalk Willem Burger Lubbe et al* v. *Cape plc* (2000) 2 Ll Rep 383.

[4] "*Again*" because the same company was party to litigation culminating in a landmark decision that will be discussed in this chapter, *Adams* v. *Cape Industries plc* [1990] Ch 433.

[5] See also the judgment in the *Lubbe* case, *supra* n.3.

[6] W Pantland, "The dust is gone, but the effects linger", http://www.mg.co.za, archives accessed 29/10/99.

roads leading to the abandoned mines are littered with asbestos that is blown into the homes of many people. There are allegations that Cape Industries took advantage of Apartheid laws in South Africa and exploited children who worked in the mines and mills under harsh conditions, without protection. These children are some of the claimants.[7]

Scholars will recall that there have been various suits arising from asbestos related diseases and indeed this includes the landmark corporate law case of *Adams v Cape Industries plc*[8] (the *Adams* case). Perhaps it was partly in the knowledge that an attempt to sue Cape Industries in America and enforce the judgment in England was futile that the victims decided to approach the English courts directly for the trial of the matter. Perhaps they sought to avoid the fate that befell their American counterparts in the *Adams case*. However, they were met with the defence of *forum non conveniens*.

DOCTRINE OF *FORUM NON CONVENIENS*

Forum non conveniens (FNC) is the major defence usually advanced by the parent company, at least in the common law world. This doctrine is that there is a natural and more appropriate forum for the determination of the dispute than the one in which the case has been brought. Originally developed in Scotland[9] and later adopted in other common law jurisdictions, the doctrine was meant to prevent forum shopping by allowing the defendant to argue that there is a more natural forum elsewhere.[10] Forum shopping can generally be defined as the practice whereby the plaintiffs go about picking the forum most advantageous to them regardless of the negative impact on the defendant. Normally the plaintiff gets advantages it would otherwise not have in the natural forum.[11] The effect of a successful defence based on FNC in a suitable case is that the plaintiff is forced to sue in the most appropriate forum in the interests of justice. This doctrine was finally accepted in English law in the landmark case of *Spiliada Maritime Corporation v Cansulex Ltd*[12] (the *Spiliada* case). According to the ruling in that case, when such a defence is presented the applicable test takes two stages:

(1) The defendant must show that there is another natural forum, which is clearly more appropriate for the hearing of the case. Usually this is the

[7] R Meeran, "The battle to beat the big guy", http://www.mg.co.za, archives accessed 19/10/99.

[8] *Supra* n.4.

[9] The *locus classicus* is *Sim* v. *Robinow* (1892) 19 R. 665, in which Lord Kinnear delivered a much quoted judgment.

[10] FK Juenger, "Forum Shopping, Domestic and International" (1989) 63 *Tulane Law Review* 553.

[11] Lord Pearson in *Boys* v. *Chaplin* (1971) AC 356 at 401.

[12] [1987] 1 AC 460. See especially the landmark judgment by Lord Goff of Chieveley in which he chronicles the development of the doctrine and its acceptance into English law and most of the common law world.

forum in which the damage occurred, and in which the evidence, victims and witnesses are based.

(2) Once the defendant satisfies the first stage, the onus then falls on the plaintiff, to prove that regardless of the fact that the natural forum lies elsewhere, nonetheless justice requires that the matter be heard in the prevailing court.[13]The plaintiff has to show that substantial justice will not be done in the appropriate forum.

The court retains discretion whether or not to stay the action depending on the evidence presented by both parties. We shall call this the *Spiliada test*.

In *Lubbe* the judge in the first instance ruled that the matter was distinctly more related to South Africa. In light of that finding he decided to stay the proceedings in the English forum. He relied on the first stage of the *Spiliada test* and found that South Africa was the natural forum. The proceedings took some complicated twists procedurally but the major issue before the House of Lords was whether or not the main action for damages should be stayed on grounds of FNC. Should the action by the victims against the English parent company be pursued in England or in South Africa? As we now know from the landmark judgment handed down on 20 July 2000 by the House of Lords, the action was allowed to proceed in England. In effect the defence of FNC did not succeed. The House of Lords found that on the first stage of the *Spiliada test*, England was not the natural forum. In this case it was South Africa, where the mining and milling of asbestos was done and almost all the victims are located. However, on the second stage, it found that the circumstances of the case indicated that justice required the matter to be heard in England. In the leading judgment, Bingham LJ referred to the lack of funding for the litigation in South Africa, the complications likely to arise from the legal and factual issues in the matter and the absence of developed mechanisms for handling group actions in South Africa. The learned Judge indicated that these factors were relevant to the exercise of the court's discretion at the second stage of the *Spiliada test*. As in the similar case of *Connelly v RTZ Corporation*[14] (the *Connelly* case), there

[13] See the *Spiliada* case, *supra* n.12, at 474–477; and also *Connelly* v. *RTZ Corporation Plc* [1997] 3 WLR 373 at 384 (HL).

[14] *Ibid*. The plaintiff in this case had worked in Namibia at a Uranium mine operated by a subsidiary of a multinational company, Rio Tinto Zinc Corporation (RTZ), which was based in England. He suffered from cancer of the throat and sued RTZ for damages arising from negligence in that it failed to ensure provision of protective clothing when he worked in the mines. RTZ applied to the English High Court for a stay of the proceedings on the grounds of FNC, arguing that Namibia was the natural and most appropriate forum for the hearing. The High Court granted the stay but on appeal the House of Lords decided that the matter should be tried in the English courts. The House of Lords refused to allow the application of the doctrine of FNC on the ground that substantial justice could not be done in Namibia, the natural forum, but in England where the resources required – professional legal representation due to availability of legal aid and scientific expertise – were available. It accepted that due to the lack of legal aid and professional expertise in Namibia, the matter could not be heard at all yet the victim had a legitimate claim. Granting the stay would have effectively killed his action and the company would have escaped liability.

was a possibility that due to lack of funding the victims could not get professional representation, a result that would mean the actions might not be pursued at all in South Africa.

The *Connelly* case was important for showing that courts are prepared to apply the second tier of the FNC test, that is, exercising the discretion to refuse a stay, if justice so requires. At least it provided hope to victims of corporate torts in corporate group situations. As the Court pointed out, after this procedural victory, the next issues relate to the question of whether the parent company owes a duty of care in respect of the activities of its subsidiaries and whether, factually, that duty was breached. This is the issue of liability in tort that is the core of the substantive claim and is pending before the courts.

Despite the formidable hurdle at the procedural level, the decisions in *Connelly* and *Lubbe* open up possibilities for tort victims in similar circumstances to proceed in the courts of England and those who expressed fears that such a judgment could open floodgates to litigation against English-based multinationals may quite understandably be disappointed. There is a fair case for this argument. There are genuine fears that multinational companies based in England might in the long-run consider pulling out and relocating elsewhere, such as the US, where they are not too exposed to such actions because of the application of FNC.[15] The "foreign-victim-friendly" image adhering to the House of Lords in the wake of these recent decisions in the *Connelly* and *Lubbe* cases might be seen as attracting more actions like these. It will not be surprising if there are moves to legislate against foreign victims suing English-based multinationals as a way of boosting international business confidence.

Some will however see the House of Lords' approach as a positive step in making international business accountable regardless of the location of operations. This would counter the negative results of the application of traditional corporate law principles like separate corporate personality and limited liability in corporate groups without necessarily abolishing them. These principles of substantive corporate law ensure that an incorporated company is a separate legal person that is independent from its members, whose liability in relation to the company's debts is limited to the extent of their investment in the company's shares. It is these features of the company that form the foundation upon which a corporate group is constructed. They enable the group to be formally organised in such a way that liability can be split and limited although in reality the group operates as a single economic unit. The gap between commercial marketplace

[15] *Union Carbide Corporation Gas Plant Disaster at Bhopal* 634 F.Supp 842 (1986)(the *Bhopal* case), in which victims of the infamous Bhopal tragedy in India were suing Union Carbide International based in the US, illustrates the successful application of this defence in the US. When the victims sought damages against the US parent in the US court, Judge Keenan held that on the basis of FNC and of policy grounds requiring deference to the Indian courts the matter could be more appropriately tried in India. He held that India was the natural forum and the Indian courts had the capacity to deal with the matter regardless of any perceived complexities: see J Eaglesham, "Lords rule *Cape* cases can be heard in the UK", *Financial Times*, 21 July 2000.

reality and the legal regulatory system has troubled courts, whose dilemma is whether to face up to the economic realities or bow to the sanctity of separate legal entity and limited liability.

Therefore, although the issue in *Lubbe* was primarily a procedural matter the underlying theme had much to do with corporate responsibility. How far that fundamental and topical aspect affected the decision-making process and outcome of the case at the procedural level is not clear but is clearly relevant. Certainly after *Connelly*, and now the landmark *Lubbe* judgment, one can safely say that the House of Lords has been positively victim-friendly. Others, as has already been noted, will fear an avalanche of similar cases against multinationals based in or with a connection to England. The words of Lord Hoffman in the *Connelly* case echo the feelings of those who fear this possibility.

The *Lubbe* decision has major implications for Zimbabwe since it also produces asbestos. Companies such as Africa Resources Ltd, a subsidiary of SMM Holdings Group plc, operate asbestos mines and mills in Zimbabwe in the small towns of Zvishavane and Mashaba. The operations were once owned by an English-based multinational, Turner & Newall plc, until in the mid-1990s when it disposed of them. It is not clear whether the negative image attached to the asbestos mining and milling business was important for the decision to dispose of these operations but that may be relevant. The two towns depend on these operations as the majority of the people work in the mines and mills or related service industries. It is quite possible that over the years the people have been exposed to the potential dangers and they may have contracted various associated illnesses. Anyway, the companies are reportedly on a campaign to demonstrate that white asbestos is safe.[16] It has been indicated that claims against Turner & Newall plc are already being brought. The lawyers representing the victims in the *Lubbe* case have indicated that it is now possible to take on the Zimbabwean cases.[17] There appears to be no reason why Zimbabwean victims should fare less than their counterparts elsewhere in similar circumstances.

As Lord Hope of Craighead pointed out in the *Lubbe* case, matters of public interest and policy have no place in the decision on FNC. In this the House of Lords took a significant and positively different approach from the US courts, which have made similar decisions based on broad grounds of public policy.[18] The reason is that courts are not sufficiently equipped to carry out the necessary inquiries and assessments regarding the international implications of that approach. This appears to be a correct analysis and courts should leave the public policy considerations to the legislature or administrative bodies that have the mandate and capacity to decide whether or not such actions should be allowed to take place within a jurisdiction in general.

[16] "Proposed asbestos ban worries Zimbabwe", *Zimbabwe Daily News*, 21 July 2000, http://www.dailynews.co.zw.

[17] See Eaglesham, *supra* n.15.

[18] See the *Bhopal* case, *supra* n.15.

The decision in *Lubbe* is a culmination of the approach begun by the House of Lords in the *Connelly* case. A contrary decision could have shut the door to foreign tort victims against English-based multinational corporate groups operating in other countries through subsidiaries. The decision leaves the door ajar to potential tort victims. The approach seems to reduce the possible negative impact of the *Adams* case, which appeared to make successful claims in victims' jurisdictions futile when it came to enforcement in England. Indeed, others may cry foul that taxpayers in England are being made to bear the burden of foreign victims' claims through legal aid funding. However legitimate this complaint may be, its opponents will always argue that the profits enjoyed by English-based multinational corporate groups in the areas where they operate always find their way to England and ultimately benefit the economy and the people. In that light perhaps legal aid is just a small way to say thank you to victims of the operations of big corporations that play a significant role in the economy of the country.

CONCLUSION

It is fair to conclude that despite these developments the position of tort victims trying to sue the foreign parent is not an enviable one. It is already settled that it is hard to attach liability of subsidiaries to parent companies due to the concepts of corporate personality and limited liability in corporate groups. It is clear that beyond that issue lies the difficulty of choosing the appropriate forum to pursue the action. If victims choose their local jurisdiction, they run the risk of failing to enforce the judgment. If they pursue the parent corporation where it is based, the latter may succeed in blocking the action there on the grounds of FNC. Of course, the *Lubbe* case goes a long way in giving hope to tort victims living elsewhere, yet it is not automatic to have a right to sue in a foreign jurisdiction and problems in future cannot be discounted at this early stage. The outcome of cases will still very much depend on the facts and circumstances of each particular case.

On the other hand, the decisions also threaten the position of multinational corporate groups since they are now more exposed to liability for operations of subsidiaries. This might negatively impact on business in developing countries, threatening economic stability in the process. It may be time for developing countries to look seriously into the issue and find ways of holding multinational corporate groups accountable for their deeds without benefiting from legal technicalities while at the same time avoiding a hostile image that would deprive them of investment. Of course, the balancing act is a delicate process. However, abolishing the doctrine of FNC may not be the answer, as it does not affect other countries' application of the same doctrine, which is the problem. In addition, for all its defects, FNC can serve an important purpose in the common-law jurisdictions where suitable and its abolition, without considering the effect on

the whole system, might prove to be unproductive. Other ways to counter the effect of FNC could be worked out to make companies more accountable. For example, by obliging all "foreign owned" companies to operate through branches if engaged in specified risky activities. This would avoid the problem of separate corporate personality and establishing the presence of a multinational corporate group in the domestic jurisdiction.

Hopefully, the current approach of the House of Lords will produce a positive effect and persuade multinational corporate groups to operate carefully and ensure safety and protection wherever they are based through subsidiaries or affiliates. This is indeed a matter of corporate responsibility. The complaints against multinational companies are increasing and for a long time now there has not been any international regulatory framework. It is hoped that courts in other countries will take a similar approach and play their part where seemingly the administrative and regulatory authorities seem to have had cold feet for too long. By now the feet of these organisations are probably numb.

Developing countries face the dilemma of trying to attract investment on one hand and to protect their citizens and environment on the other. Quite often, they end up ignoring the latter interests in their bid to lure investment regardless of its hazards. The courts in the developed countries can play a big role by holding parent companies in their jurisdictions responsible for the torts of their subsidiaries in these developing countries. They could do this by enforcing judgments from the courts there or by allowing foreign victims access to their courts. In the latter regard, the House of Lords approach is commendable.

13

Developments in French Company Law

YVES CHAPUT

INTRODUCTION

French law, which had been relatively stable for some decades, has entered into a mutation period. Part of these changes have been illustrated by the evolution of case law. Most of them convey the influence of international exchanges and the movements of securities investments. They contribute generally to an improvement of the shareholders' protection. Some other changes, which are more restrictive, represent a purely national mutation concerning the traditional principles of company law. They are a result of legislative reform, which favours opening up to the market economy and its corollary, freedom of contract. To the extent that there is a contradiction between these changes, it is more apparent than real. However, in ordre to better understand the depth of these changes, it is necessary first to give a general overview of French company law, before examining the perspectives opened up by the most significant recent changes.

GENERAL OVERVIEW OF FRENCH COMPANY LAW

The dominant jurisprudence in France and the *Cour de cassation* (French Supreme Court) recognises the existence of a general case law for all business entities. These general rules permit the organisation of a basic type of company, of which the other company forms are only special applications. However, the rules applying to listed companies clearly derogate form the width of the general case law.

The general case law is asserted despite, first, the diversity of legal sources, secondly, the multiplicity of company forms, and thirdly, the academic analysis of business entities. Each of these matters are now considered.

Legal sources

The basis of French company law is not be found in the Civil Code, but in a statute of 24 July 1966 concerning trading companies. The rules laid down in

this statute influenced the 1978 reform of the Civil Code concerning the provisions dealing with the general law of companies and the rules applicable to civil companies. Nevertheless, besides these general provisions, many statutes have been enacted that apply to special categories of companies. Indeed, what is generally known as the *code des sociétés* (company law code) refers to a compilation of the rules applicable to companies as they have been collected by publishers.[1]

French company law has been largely influenced by the Treaty of Rome, establishing the European Union, and by subsequent European regulation. This is despite the fact that Europe does not have a uniform law of companies. Rather, the European authorities, by means of directives, have lead the legislators of Member States, France included, to harmonise "the guarantees which are expected from the companies in each Member-state to protect shareholders' and third parties' interests". This harmonisation is especially remarkable in relation to companies limited by shares in the field of shareholders' information, directors' powers, the auditing of accounts and company reorganisations. Paradoxically, notwithstanding the European principles of free movement of persons and capital, the transfer of companies' registered offices from one Member State to another have not been liberalised. Moreover, many distortions of competition still exist in the fiscal and social field, and even in relation to the structure of companies.

Different company forms in French law

The legal definition of the "*société*" laid down in the Civil Code, Article 1832, is anachronistic.[2] It is not technically satisfactory because it does not prevent overlaps between the different types of business entities, which are not all registered as companies but may be registered as a society (*association*) or a joint venture (*groupement d'interet économique*). In fact, for incorporated entities, the form by which they are described prevails over the legal criteria, which have a reduced impact except for purely contractual entities.

Under European law, companies may be formed for purposes other than to ake money. In French law, however, this is supposed to be the distinction between a *société* and other entities.[3] Under the generic term *société* French law includes a large variety of business entities that are governed by separate rules. There are more than a million registered companies and partnerships in France.[4] The

[1] See, eg, the so-called *codes Dalloz* or *codes Litec*, respectively published by the Dalloz editions and the Libraires Techniques.

[2] Under this provision, a company (*société*) is instituted by 2 or more persons who agree by contract to assign to a common enterprise some assets or their skill with a view to the sharing of profits or to benefiting from economic gains that may result.

[3] Civil Code, Art 1832.

[4] M Cozian, A Viandier and F Deboissy, *Litec* (1999), 3. It should be noted that under French law most partnerships are *sociétés*.

Sociétés à responsabilité limitée (*Sarl*) constitute more than sixty six per cent of this total and the *Sociétés anonyms* (*SA*) constitute around fifteen per cent. These two forms are the most typical for companies with limited liability, but only the second are authorised to issue shares. The *Société en nom collectif* (*SNC*), which is equivalent to the general partnership but is incorporated, constitutes about two and a half per cent of registered business entities. In addition to these basic forms, a great variety of companies with a special status are available, but they represent a very small percentage of the total. It follows that the two main categories of companies under French law are the *sociétés de capitaux*, in which the liability of the members is limited, and the *sociétés de personnes*, the members of which are jointly and severally liable for the companies' debts. Another distinction must be made between companies limited by shares (*sociétés par actions*), the *SA* being the most used form, and other companies in which the members' interests are not transferable. But another typology is also used, which distinguishes between the private company and the public company (*société faisant publiquement appel à l'épargne*), which because of the influence of the securities laws and of the supervision of the *Commission des Opérations de Bourse* (COB), diverges more and more from the general law of companies.

In contrast with listed companies, the shares of which are widely held by the public, some companies may according to French law be created with only one member, such as the *Sarl*, or since 1999 the *Société par action simplifiée* (*SAS*).[5]

Academic analysis

Historically, French law has ignored the trust, so that the concept of the company has been exclusively built around contract and legal personality. As to its governance, since the company is a group of persons the leading idea has been a reference to an abstract political democracy. The power in the company is deemed to come from the members/citizens, through the general meeting, which is hierarchically above the other powers, especially the directors. Nowadays, the evolution of economic sociology and of social psychology have lead to an attenuated conception of this abstract and simplified view. The company appears more as a technical means to organise and enterprise or the management of assets.[6] Yet the participation of employees in the direction of the business is still marginal and the *Cour de cassation* maintains the fiction of the separation of the subsidiaries assets within a group of companies.

Meanwhile, taking into account the transfer of powers from the members to the directors, French law has traditionally been very eager to ensure the independent control of company accounts by an exterior, independent, responsible and professional authority, the auditor (*commissaire aux comptes*). The appointment of an auditor is obligatory for the *SAs* because of the importance

[5] The *SAS* is further discussed below.

[6] See J Paillusseau, *Le droit is aussi une science d'organisation* ((RTCDom, 1989), 1.

of the company's returns for other parties. Moreover, public companies are under the supervision of the *COB*, which has important regulatory powers.

One should note that, under the influence of Anglo-American law, some provisions for better protection of investors have been introduced in French law by the *Cour de cassation*, such as the duty of loyalty for directors, a duty that was not originally a recognised concept in French law.[7] The duty of loyalty obliges directors to behave transparently towards shareholders and not to take advantage of their inside position, even where the company is not listed.[8] They are also required, in the interests of the enterprise, to protect it against leaks to competitors. Finally, in order to punish corruption, a trend for the rebirth of criminal sanctions in company law has been noticeable from time to time, through the offence of "*abus de biens sociaux*", which literally concerns directors or company employees using the company assets for their own benefit. Presently, it seems that the only efficient means of control in such fields as the class action is embryonic in French law.

REFORMS OF IMPORTANCE

An important reform was made in 1999 with the vulgarisation of the *SAS*. At the same time proposals have been made to introduce principles of corporate governance in France, and on the European side, the intent to institute a European company has been re-affirmed.

The SAS vulgarisation

The common form of the *SA* is a complex and rigid structure, subject to many mandatory legal provisions with little place for contractual adaptations. Lawyers have found a way to evade these strict rules by the means of shareholders' agreements, but the validity of these agreements is uncertain as the courts have in the past set some of them aside, especially when they contained voting agreements. Since 1994 the legislator has given a larger freedom in drawing up of the company's articles through the creation of the *SAS*. Still, this new prvate company was exclusively reserved for cooperation between important businesses.

The 1999 reform (July 12th 1999 Act) realised a true revolution when it allowed any person, natural or legal, to form an *SAS*, even a one man company. The only limitation is an interdiction on the issuing of shares to the public. The members of the company are free to adopt whatever internal organisation they wish. Some binding provisions still exist, but they are marginal. On the other hand, remarkable conceptual innovations can be found in the provision that the

[7] B Daille-Duclos, *Le devoir de loyauté du dirigeant* (JCP Ed E, 1998), Vol I, 1486.

[8] In relation to the prohibition on insider trading for listed companies, see §10–1 of the September 28, 1967 *Ordonnance*.

shares may be made non-transferable for a maximum period of ten years, a measure intended to ensure stability of control, and in the possibility of introducing into the Articles a clause for the exclusion of a shareholder. Moreover, what is not forbidden is allowed, provided it is laid down in the Articles. This reform has been met by some scepticism on the part of the practising profession. Some think that, in the absence of any case-law, members (and their counsel) will find this legal void so dangerous that they will come back to more classical and secure forms of companies. Others estimate that because of its flexibility, the SAS will shortly replace all other forms of companies. Anyway, the new form of company should help to meet the legitimate expectations of many, even though it need s an acclimatisation period.[9]

Corporate governance

Because French law could not stay apart from the preoccupations of foreign investors, the concept of corporate governance has begun to penetrate company law through the *COB* recommendations. Moreover, imitating the English *Code of Best Practice* issued by the Cadbury Committee,[10] proposals have been made in France to subject the board of directors in listed companies to more controls and transparency for the benefit of shareholders.[11] In order to strengthen auditors' investigations, it is desirable that independent directors should be designated by minority shareholders, or that a nominating and remuneration committee should be appointed. It should be said that in French law an information vacancy, tantamount to secrecy, exists in relation to directors' remuneration.[12] Some have seen this as a sort of French cultural exception!

The European private company

Upon the initiative of the Paris Chamber of Commerce, the idea of a true European company has been reactivated. The aim is to create a company, the rules of which would be laid down in a European Regulation, without any reference to national laws. The thirty year old proposal for a European public company is still in abeyance. Therefore, it has been thought that the institution of a European private company, which should facilitate the mobility of small and medium-sized businesses in Europe and complete the technical means of cooperation, had a more reasonable chance of success.

After the creation in 1989 of the *European Groupement d'interet*

[9] J Paillusseau, *La nouvelle société par actions simplifiée, le big bang du droit des sociétés* (Dalloz, 1999).

[10] *The Financial Aspects of Corporate Governance* (London, The Financial Reporting Council, the London Stock Exchange and the Accounting Profession, 1992).

[11] A June, *Le gouvernement des sociétés anonoymes* (RIDComp, 1994), 59s.

[12] The law only obliges the company to disclose to its shareholders the global amount of the directors' remuneration, without any other information.

Economique (*GEIE*), a joint venture structure, the European private company would appear as a new illustration of economic integration within the European Union. With the present perspective of an open financial market, based on international networks, a uniformisation of company law appears unavoidable.

CONCLUSION

To conclude, one should remark that, although French company law has not yet been wholly reformed, two main recent trends are perceptible: one towards the increasing of contractual freedom; and another one towards a better definition of directors' duties for the benefit of the shareholders and the enterprise, and for the protection of investors. The opening of European markets and the globalisation of the exchanges of the world will be an important factors for the acculturation of national laws and their harmonisation.

14

Recent Developments in the Nigerian Capital Market

DESMOND I GUOBADIA

INTRODUCTION

Within the last three years, a number of developments have occurred in the Nigerian capital market. With the repeal of the Securities and Exchange Commission Decree 1988 and the repeal of major sections of the Companies and Allied Matters Act 1990 (CAMA) dealing with unit trusts, the enlargement of the powers and functions of the Securities and Exchange Commission over the capital market, the creation of a new market infrastructure and wide ranging system of regulation of investments and securities business in Nigeria, the Investment and Securities Act 1999 (ISA) has certainly changed the regulatory framework of the Nigerian capital market. Some of the changes are potentially far reaching, depending on what use is made of the enabling statute and the structures it has established. This chapter highlights developments introduced by ISA and fundamental issues in the area of unit trusts. It also focuses on the creation of the Investors Protection Fund and the Investment and Securities Tribunal. As will be seen, in some respects, particularly in relation to unit trusts, the ISA has largely adopted the position under the now repealed portions of the CAMA.

UNIT TRUSTS

ISA defines a unit trust scheme as follows: "any arrangement made for the purpose, or having the effect of providing facilities for the participation of the public as beneficiaries under a trust in profits or income arising from the acquisition, holding, management or disposal of securities or any other property whatsoever".[1]

Creation of a unit trust

A unit trust is constituted by a trust deed made between managers who are responsible for the selection within limits prescribed by the trust deed (and

[1] ISA, s124.

statute) of the portfolio of securities comprised in the trust fund and trustees who are responsible mainly for the safe custody of those securities and the collection and distribution of income from them. The "trust deed" is the agreement drawn up between the trustees and the manager for regulating the operation of unit trust schemes.[2]

Authorisation

No person shall establish or operate a unit trust scheme or carry on the business of dealing in units of a unit trust scheme unless such a scheme is authorised by and registered with the Securities and Exchange Commission (SEC).[3] The power to authorise a unit trust scheme is discretionary. The commission may authorise and register a scheme if it is satisfied as to the following:

i The competence of the manager and trust in matters related to the operation of unit trusts; and
ii the probity of the manager and trustee such as to render them suitable to act as manager and trustee.[4]

The Manager shall be a corporate body incorporated with a minimum paid up capital of N20,000,000.[5] The Trustee shall be a body corporate such as an insurance company licensed under the relevant statute and having a minimum paid up share capital of N40,000,000.[6] Both provisions are obviously aimed at excluding from the operations persons of limited resources. These requirements are now obviously inadequate. The actual practice would be that companies that would act as trustee, for example, the banks, would have an equity base far in excess of the minimum required. The manager and the trustee must be persons who are independent of each other.[7] The two companies must not be related in the sense of being under common ownership or control or being associated companies. This is important because the independence of the trustee would permit its being given the primary supervisory role, reducing the need for SEC or any other central regulatory body to carry out day-to-day supervision.

The trust deed must comply with the provisions of the ISA and the rules and regulations for the time being in force. The trust deed cannot, for example, give the manager wider investment powers than are contained in the ISA.[8] The name of the scheme must not in the opinion of the Commission be undesirable.[9] The name of a scheme can play a significant part in its marketing thus the import of

[2] ISA, s 124.
[3] ISA s 125.
[4] ISA, s 125(3).
[5] ISA, s 125(3)(b).
[6] ISA, s 125(3)(c).
[7] ISA, s 125(3)(d).
[8] ISA, s 136.
[9] ISA, s 125(3)(f).

this requirement would be to ensure that the chosen name does not confuse investors either in respect of the managers of the scheme or its investment objective. The SEC is obliged to notify the manager and trustee within thirty days stating reasons in the event of a refusal to authorise the scheme.[10]

Registration of units

It is unlawful for any person to deal in units of a trust scheme unless such units have been duly registered with the Commission.[11] A unit may be registered by the issuer filing an application with SEC in accordance with the provisions of this decree.[12] Any application for registration of a unit shall become effective on the sixtieth day after filing or such earlier date as the Commission may determine depending on the adequacy of information contained in the application. Such a registration shall be in respect of the units specified as proposed to be offered. Any other units must be duly registered.[13]

Regulation

The SEC has sweeping powers to make regulations governing the constitution and management of authorised unit trust schemes.[14]

Operations

Every manager of an authorised unit trust scheme shall invest only in:

(a) Securities specified under the Government and other Securities (Local Trustees Powers) Act and the Trustee Investment Act as amended from time to time; and
(b) such other and investments as the Commission may from time to time approve.[15]

The Trustee Investments Act, CAP.449 Laws of the Federation 1990(LFN) permits trustees to invest in debentures and fully paid up shares of certain companies incorporated in Nigeria.[16] Private limited liability companies are excluded from the list of permitted investments. Such investments are limited to companies the shares in which are quoted on the stock exchange able to satisfy certain requirements.[17] Thus, the avenues for investment open to the manager

[10] ISA, s 125(4).
[11] ISA, s 126(1).
[12] ISA, s 126(2).
[13] ISA, s 126(3).
[14] ISA, s 138.
[15] ISA, s 136.
[16] Trustee Investment Act CAP 449 (1990), s 2(1).
[17] Trustee Investment Act CAP 449 (1990), s 2(1)(d).

are limited. The legal position is quite clear. Unlike the case of a normal trust in which investments may be made outside of those specified in the Trustee Investment Act if the trust instrument expressly makes provision for such, the manager of a unit trust obviously has limited room for maneuver.

Redemption and cancellation of units

At the request of a unit holder, the manager of the scheme shall within the time specified by the Commission, buy from the holder the units offered at the price for the time being at which the manager buys units of the scheme.[18] In the event of a revocation of authorisation the manager is obliged to purchase all the units under the revoked scheme at the prevailing purchase price for units of the scheme.[19]

Distribution of income

The statute appears to be silent on this. It may be that this is a matter that has been left for the trust deed. This may be the case as the investor is expected to know the character of the unit trust before he makes his investment. The SEC may however choose to make regulations governing this subject.

Prohibited transactions

A company that is manager under a unit trust scheme or is a subsidiary or holding company of the manager or a director or a person engaged in the management of such a company is prohibited from carrying out transactions for itself or himself, or making a profit for itself or himself from transactions in any assets held under the scheme.[20] This provision is designed to avoid any conflicts of interest that may arise in the course of the manager's duties. The manager cannot trade with the scheme or make a profit for itself from transactions in any assets held under the scheme. A manager cannot borrow money on behalf of the scheme, for the purpose of acquiring securities or other property for the scheme.[21] Does this mean that the manager may borrow money in order to redeem units? The manager cannot lend money that is subject to the trusts of the scheme to a person to enable him purchase units of the scheme.[22] The assets of the scheme cannot be charged, mortgaged or encumbered by the manager.[23] The manager cannot engage in any transactions that are not in the interest of unit holders and of the scheme.[24] The penalty for violating these provisions is

[18] ISA, s 131(1).
[19] ISA, s 131(2).
[20] ISA, s 132(1).
[21] ISA, s 132(2)(a).
[22] ISA, s 132(2)(b).
[23] ISA, s 132(2)(c).
[24] ISA, s 132(1)(d).

conviction, a fine equal to the amount of profits from any of the prohibited transactions or N20,000 whichever is higher.[25]

Duties of the manager

It is the duty of the manager to manage the property of the scheme in accordance with the provisions of the trust deed, the ISA and regulations made pursuant to it.[26] Not all the duties of the manager and trustee are spelt out in the Act. Recourse must thus be had to the general law of trusts and the responsibilities of fiduciaries. Detailed duties and functions would have to come by way of rules and regulations made pursuant to the ISA.

The manager is obliged to ensure that proper books of account are kept and annual accounts are prepared, reflecting a fair and true view of the affairs of the scheme. The manager must with the consent of the trustee appoint an auditor to audit the accounts, which must be sent to SEC and also published in national newspapers.[27] The manager shall with the consent of the trustee call an annual general meeting of unit holders to consider the accounts and other matters affecting the scheme.[28] The manager shall also furnish the SEC periodically with any information required relating to the scheme.[29]

Duties of the trustee

The trustee under a unit trust scheme is the person in whom the property for the time being subject to any trust created in pursuance of the scheme is or may be vested in accordance with the terms of the trust.[30] The trustee as the legal owner for the time being of property subject to the trust has a general supervisory role over the manager. It is the duty of the trustee to ensure compliance by the manager with the instrument creating the trust. The trustee would also be expected to exercise voting rights attached to the scheme's equity investments. This function would have to be undertaken with the co-operation of the manager. The trustee may have to act on the instructions of the manager in buying, selling and voting stock as the manager is empowered by the Act to manage the scheme.[31]

The trustee would be liable for breach of trust where, having regard to the provisions of the trust deed conferring on him any powers, authorities or discretions, he fails to exercise the degree of care and diligence required from him as trustee. Furthermore, any provision in the trust deed, which would have the

[25] ISA, s 132(3).
[26] ISA, s 124.
[27] ISA, s 134.
[28] ISA, s 134(2).
[29] ISA, s 141.
[30] ISA, s 124.
[31] ISA, s 124.

effect of exempting the trustee from or indemnifying it against liability for breach of trust, will be void.[32]

Remuneration of the manager and trustee

The statute is silent on the remuneration of the manager and trustee. They have to be paid for their services. The trust deed would contain provisions dealing with the subject. It may be of assistance for the SEC to make regulations in respect of expenses and payments chargeable to the scheme.

Meetings

The manager is obliged to call an annual general meeting to consider the accounts and other matters affecting the unit trust. An extraordinary general meeting of the unit holders may be convened by the manager with the consent of the trustee, at the request of the trustee, at the instance of twenty five per cent of the unit holders, or by a court at the request of a member where the court is satisfied that it is just and equitable to do so.[33]

Price

The price of units of a unit trust scheme shall be calculated in accordance with a formula to be provided by the Commission.[34]

The prospectus

The prospectus and other documents prepared by the manager offering units of a unit trust scheme to the public have to be approved first by the trustee and then the SEC before publication.[35] Furthermore, a manager may incur civil liabilities in respect of a misleading prospectus, which either contains an untrue statement of a material fact or fails to state a material fact and units are sold or offered for sale by such medium.[36]

Inspection and investigation

The SEC is empowered to inspect documents relating to any unit trust schemes[37] and it may investigate and report on the administration of any scheme if it appears that it is in the interest of the investors or of the general

[32] ISA, s 133.
[33] ISA, s 134(4).
[34] ISA, s 135.
[35] ISA, s 129(1).
[36] ISA, s 130.
[37] ISA, s 137(1).

public so to do.[38] The failure of an officer or agent of the manager or trustee whose affairs are being investigated to answer questions or to furnish the Commission with any document that it is his duty to produce in respect of the unit trust is a criminal offence[39] punishable on conviction by a fine not less than N20,000.

Sanctions

Any authorisation granted by the SEC to a unit trust scheme may be revoked in the event of a contravention of the part of the ISA relating to unit trusts or a rule or regulation made by the SEC. The Commission shall before such a revocation notify the manager and trustee and they may make written representation to the Commission in respect of the proposed revocation. It is only after the consideration by the Commission of the representation mode that it may reach a decision.

THE INVESTORS PROTECTION FUND

In an earlier essay on this subject,[40] I stressed the importance of regulation in order to ensure that variants of the unit trust did not escape supervision. That position still holds. We have witnessed the degradation of the money market. The capital market is not immune. Accordingly, the need to protect investors and their investments remains paramount. This accounts, in part at least, for the creation by the ISA of the Investors Protection Fund (IPF) and the Investment and Securities Tribunal.

Pursuant to the Act, each Securities Exchange or Capital Trade Point must set up an Investors Protection Fund.[41] This fund is principally to be applied to pay off individuals who have incurred a pecuniary loss due to defalcations of a member company or its directors or employees. Indeed the Act establishes the right of individuals to institute legal proceedings against a Securities Exchange and claim compensation. The Securities Exchange or Capital Trade Point is responsible for settling all valid claims by aggrieved persons out of the funds. Claims are to be made in writing within six months after the claimant becomes aware of the defalcation. A claimant may be required by the SEC to furnish documents, securities, and other evidence for the purposes of establishing a claim.

The IPF is deemed to be the property of the Securities Exchange or Capital Trade Point but should be kept separate from other assets and funds. This fund

[38] ISA, s 137(2).

[39] ISA, s 137(3).

[40] DI Guobadia, "The Creation, Operation and Regulation of Unit Trusts", *Essays on Company Law* (Lagos, Lagos University Press, 1992), 307.

[41] ISA, Part XII.

is made up of monies payable by companies registered with the Securities Exchange, interests and profits derived from successfully investing the IPF, and other monies paid into the Fund by member companies, other securities exchanges and insurers of the fund. Claims may only be paid out of the IPF. Where the fund contains insufficient funds to pay claimants, SEC may apportion payments between claimants as fairly as possible.

Where the fund falls below the minimum amount fixed by the Securities Exchange or Capital Trade Point, the management committee is liable to refund any deficiency in the fund below the minimum limit set for the Securities Exchange by converting other funds of the Exchange into the IPF or by compulsorily requiring that member companies make up the deficiency. If the monies in the fund are not sufficient to satisfy claims, the governing board may require all member companies to contribute a certain amount to make up the shortfall.

The Fund is administered by a governing board, which has absolute discretion to spend the Fund in any manner it deems judicious (that is, on legal expenses, payment of insurance premiums and incurred liabilities). It may also appoint a management committee to administer the fund and delegate any or all of its statutory powers to that committee provided that any decision taken by that committee is ratified by the board.

Proper books of account are to be kept in respect of the fund and audited. However rather than preparing the usual profit and loss accounts and balance sheet, an income and expenditure account is drawn up.

The Act appears to confer overlapping oversight powers in respect of the IPF on both the Investments and Securities Tribunal and the Commission. The SEC is empowered to approve the setting and varying of the minimum balance of the fund,[42] and shall publish notices calling for claims.[43] The tribunal is responsible for "making rules of practice and procedure generally for proceedings"[44] relating to the IPF.

THE INVESTMENT AND SECURITIES TRIBUNAL

The ISA[45] also sets up a tribunal, the Investment and Securities Tribunal made up of nine suitably qualified Capital Market Assessors, well-informed about the workings and nuances of capital markets. The Tribunal is to be presided over by a Chairman who must be a legal practitioner of at least fifteen years standing with related knowledge of capital markets. Five members of the Tribunal constitute a quorum; and no legal proceedings may be instituted for the sole purpose of challenging the validity of the appointment of a Tribunal member. A Secretary for the Tribunal shall be appointed by the Minister of Finance. He is

[42] ISA, ss 154 and 159.
[43] ISA, s 161.
[44] ISA, s 164(3) ISA.
[45] ISA, Part XIV.

responsible for the daily administration of the Tribunal secretariat, keeping records of proceedings, and overall supervision of other Tribunal staff. Furthermore, acts or decisions of the Tribunal may not be queried on grounds of a defect in the composition or formation of the Tribunal.

The Tribunal has jurisdiction over all disputes that may arise in respect of:

- the ISA or SEC rules and regulations including the interpretation of such laws, rules, or regulations;
- disputes between SEC and a Securities Exchange or a Capital Trade Point;
- disputes between capital market operators;
- disputes between capital market operators and their clients; and
- disputes between quoted companies and Securities Exchange regulators.

Allegations of crime are, however, referred to the State or Federal Attorney-General by the SEC. The Tribunal may also hear actions or appeals instituted against decisions of the SEC by aggrieved persons.

The Tribunal is granted general quasi-judicial powers (that is, the power to subpoena witnesses, order the production and inspection of documents, dismiss an application, review its decisions, set aside any order or dismissal or any *ex parte* order granted by it) in order to facilitate it in its functions. Appeals before the Tribunal are subject to statutes of limitation. Once an award or judgment of the Tribunal has been registered with the Chief Register of the Federal High Court, it shall have the same enforceability as a judgment of the Federal High Court.

The courts are excluded from adjudicating on any civil matter that touches on the administrative, supervisory or judicial powers granted to the Tribunal under the Act. An appeal against a decision of the Tribunal may only be on points of law. Either an aggrieved person or the SEC may appeal to the Court of Appeal in respect of a decision of the Tribunal via the filing of a notice of appeal in accordance with the Court of Appeal rules.

The introduction of the Tribunal may facilitate the orderly development of the capital market. The response of the major players to the new developments will be the determining factor.