The Immanent Conservatism of Corporate Adjudication: Thoughts on Kingsford Smith's 'Interpreting the Corporations Law'

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1. Introduction

Churchill once said that anyone who was not a liberal at the age of 20 lacked a heart; anyone who was not a conservative at the age of 40 lacked a brain. The history of statutory interpretation is an analogous story of generation and ideology gaps. It represents a clash between new policy and the venerated common law. Conservatism and literalism can blunt the sharp edge of liberal policy, but whether that is good or bad depends hugely on perspective.

In her powerful article in this *Review*, Dimity Kingsford Smith considers this issue in the context of the interpretation of corporate statutes.[1] She observes, in common with other scholars, that regulation has changed greatly in the twentieth century, becoming more complex and more pervasive.[2] She argues that the processes and aspirations of the modern regulatory state should be brought to bear on the sympathetic interpretation of statutory law. In so doing, Kingsford Smith advocates an approach, based on 'practical reasoning', which applies the purposes of enactments to interpret legislation in a 'public-regarding' way. In this reply to her article, I will often abbreviate this method to PPR interpretation.

PPR interpretation appears to inform contemporary interpretation of a number of areas. Modern constitutional interpretation has a fluid quality, which in the late 1990s balances both policy and pragmatism in varying measures.[3] It also characterises modern tax law interpretation. Here, the presumption that tax law, being punitive, must be read narrowly, is substantially a relic of the past.[4] The

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1 Kingsford Smith DA, 'Interpreting the Corporations Law – Purpose, Practical Reasoning and the Public Interest' (1999) 21 *Syd LR* 161.

2 Calabresi G, *A Common Law for the Age of Statutes* (1982); Sunstein CR, 'Interpreting Statutes in the Regulatory State' (1989) 103 *Harv LR* 405; Rubin E, 'Law and Legislation in the Administrative State' (1989) 89 *Colum LR* 369.

3 See generally Mason A, 'Trends in Constitutional Interpretation' (1995) 18 *UNSWLJ* 237; Craven G, 'The Crisis of Constitutional Literalism in Australia', in Lee HP and Winterton G (eds), *Australian Constitutional Perspectives*; Goldsworthy J, 'Originalism in Constitutional Interpretations' (1997) 25 *Fed LR* 1. Compare *Re Wakim ex parte MacNally* (1999) 31 ACSR 99.

4 Compare *IR Commrs v Duke of Westminster* [1936] AC 1 at 19–21 and *Hepples v FCT* (1992) 173 CLR 492 at 511.

interpretation of s52 of the *Trade Practices Act* 1974 (Cth) has become increasingly flexible and expansive, in the PPR sense, as time goes by.[5] So PPR interpretation is a fair description of several areas of the law.

Kingsford Smith claims that the interpretation of corporate statutes in Australia has not been PPR. Rather, in cases such as *Mesenberg v Cord Industrial Recruiters Pty Ltd*[6] and *Bank of New Zealand v Fiberi Pty Ltd*,[7] courts confronted by these statutes have inappropriately emphasised the general law of companies inherited from common law and equity. The general law 'contains "private law baselines" or values, and is not public regarding, unlike the underlying "purposes and objects" of modern corporate regulation.'[8] It is a pity that it is difficult to test rigorously the absolute and relative conservatism of corporate adjudication. Nonetheless, I am content to assume that judges do lean towards coherence between corporate legislation and the general law. Given that assumption, I want to consider three issues. First, is there a difference between public-regarding interpretation of corporate laws and private values? Second, are there valid reasons why private law values would be accorded influence in corporate law cases? Third, is it possible to develop more explicit and focused interpretive principles that reflect both desirable norms and defensible positive theories of corporate phenomena?

PPR interpretation is a good beginning. Ultimately, though, scholars and regulators must work to develop better positive theories of their subject, which can function as the basis for establishing presumptions about how particular types of legislation can operate. The best developed theories of corporations we have now are economic. They explain much of corporate law's immanent conservatism. At the end of this paper, I attempt to transcend the conservative/public-regarding logjam by seeking to develop explicit and focused interpretive principles in order to improve the quality and predictability of corporate adjudication.

2. *What is Public-Regarding in Corporate Law?*

There is an important ambiguity in Kingsford Smith's article that warrants attention. To understand this let me recast her argument in syllogistic form. First, the general law of corporations expresses private values and is not public regarding. Second, judges prefer to look to general law, rather than to the policy or purposes of the legislation in issue. Third, judges prefer to be guided by private law values, and do not interpret corporate statutes in a public-regarding way. I want to explore the major premise and the conclusion.

5 For example, *Brown v Jam Factory Pty Ltd* (1981) 53 FLR 340 at 348. See generally Marshall BM, 'Liability for Unconscionable and Misleading Conduct in Commercial Dealings: Balancing Commercial Morality and Individual Responsibility' (1995) 7 *Bond LR* 42; Harland D, 'Misleading or Deceptive Conduct: The Breadth and Limitations of the Prohibition' (1991) 4 *JCL* 107.

6 (1996) 39 NSWLR 128 (hereinafter *Mesenberg*).

7 (1994) 12 ACLC 48.

8 Above n1 at 184.

Kingsford Smith's explanation of 'public-regarding' is ambiguous, because she conflates two different meanings. I will describe these as *welfarist* and *analytical* meanings of 'public regarding'. Welfarist public regarding interpretation resolves interpretive dilemmas by favouring wide-ranging interests, rather than limited and exclusive ones. According to economists, statutes either maximise wealth or redistribute it. Interest groups seek legislation to redistribute wealth to themselves. Jonathan Macey advocates a public-regarding approach to statutory interpretation to limit the capacity of interest groups to redistribute wealth.[9] Widening the eligibility for special concessions or restricting the scope of invasions of personal freedom is Macey's strategy for limiting interest group behaviour, which he claims is consistent with many venerable biases in statutory interpretation. This theory is vulnerable to criticism.[10] But, at least in theory, Macey draws a clear line between his public and his private (interest groups).

Analytical public-regarding interpretation resolves problems by reference to the policies and purposes of the enacting legislature. Perhaps this sort of interpretation partakes of a limited civic republicanism – the closer we get to the policy, the more we engage with it and debate its scope, the better our laws will be, compared to Burkean approaches in which policies are reticently shrouded by emphasising continuity in method.[11]

Kingsford Smith seems to me to be public-regarding primarily in the analytical sense. Her praise of the judgment in *Statewide Tobacco Services Ltd v Morley*[12] cites not its consequential properties, but its method and the judge's marshalling of relevant policy. Analytical public-regarding interpretation may be the only tenable form of public-regarding interpretation in corporate law. A welfarist approach can only really apply where there is a third party effect or externality.[13] Thus, a law which confers a benefit on an interest group by restricting price competition and barriers to entry affects consumers, because the protected parties can raise prices and decrease quantity. Consumers are public; the sellers are private. This is not a scenario which is typically true of corporate law, because corporations are primarily the artefacts of voluntary interaction between parties who use contracts to govern their relations. Contracts enable externalities to be internalised.[14] Corporations may impose externalities on, say, tort victims and the

9 Macey JR, 'Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model' (1986) 86 *Colum LR* 223.

10 Mashaw JL, *Greed, Chaos, & Governance: Using Public Choice to Improve Public Law* (1997) at 81–105.

11 There is an element of this in Sunstein's article, which reflects his intellectual interests: see Mercuro N and Medema SG, *Economics and the Law: From Posner to Post-Modernism* (1997) at 79–83, 97–100 (describing the civic republican school in law and economics).

12 (1990) 2 ACSR 405.

13 Kingsford Smith acknowledges this when she comments 'that there is often a public interest in the regulation of undesirable by-products of otherwise beneficial private transactions': above n1 at 202.

14 Compare Bratton WW, 'The "Nexus of Contracts" Corporation: A Critical Appraisal' (1989) 74 *Cornell LR* 407 at 413.

environment, but these have never been addressed in corporate statutes, but remain the concern of tort and environmental law.

If we look at an insolvent trading case such as *Morley*, the beneficiary from imposing a duty on the director is the creditor extending credit to the insolvent corporation. But these parties contract with each other. The only meaningful goal can be better credit contracting, which is a fundamental private law value. If we look at *Mesenberg*, that case involved the right of an individual shareholder to assert rights against another shareholder. Private values, again. There is a more basic issue here. If there are no, or no major, differences between the apparent objective of the general law, and the policy of particular legislation, resort to general law is both unsurprising and appropriate. Where ends have not substantially changed, the traditional means employed has strong claims where the current means is ambiguous.

Some may object that the principal tension between traditional and modern approaches to corporations law is that the former elevates the importance of shareholders at the expense of other stakeholders, such as employees and the community in general.[15] This, however, can only be credited, according to Kingsford Smith, if stakeholder protection is an articulated policy of enacted legislation, which survives the winnowing effect of the dynamic interpretive model she advocates. Yet this condition – which is *positive* in nature, not normative – does not hold. Corporate statutes in Australia have never substantially departed from the principal premise of investor protection.[16] The Corporate Law Economic Reform Program intensifies this.[17] The principal instances of expanded constituencies being recognised in the common law world – the 'other constituency' statutes of some American states[18] – are a useful test of the two conceptions of public-regard we have explored. These were, on most accounts, a rather cynical attempt to protect managers from takeovers.[19] If that is so, a welfarist public-regarding interpretation arguably favours *limiting* them in a way which may be linked to a 'private' value (shareholder welfare).[20] But analytical

15 This claim is characteristic of communitarian scholarship: see many of the essays collected in Mitchell LE (ed), *Progressive Corporate Law* (1995).

16 Jenny Hill is the most significant advocate of changing shareholder primacy in Australian law: see Hill J, 'At the Frontiers of Labour Law and Corporate Law: Enterprise Bargaining, Corporations and Employees' (1995) 23 *Fed LR* 204 and 'Public Beginnings, Private Ends – Should Corporate Law Privilege the Interests of Shareholders?' (1998) 9 *Aust J Corp L* 21. Compare Whincop MJ and Keyes ME, 'Corporation, Contract, Community: An Analysis of Governance in the Privatisation of Public Enterprise and the Publicisation of Private Corporate Law' (1997) 25 *Fed LR* 51 at 69–72.

17 The Treasurer, 'New Focus for Corporate Law', Press Release No 15, 4 March 1997; Baxt B, 'Costello's Dual Challenge' 13:8 *Co Director* 25; Tomasic R, Editorial (1997) 7:2 *Aust J Corp L*; Campbell I, 'Corporate Law Economic Reform Program: Returning the Law to its Fundamental Purpose' (1997) 49 *Aust Co Sec* 138.

18 For description and analysis, see Carney WJ, 'Does Defining Constituencies Matter?' (1990) 59 *U Cinn LR* 385.

19 Ibid.

20 For instance, it may permit corporations to opt out of them when they are incorporated.

public-regarding interpretation would presumably *not* give this interpretation, at least if the policy and statutory text were clear.

This example indicates that the application of analytical PPR may produce results that are undesirable, when compared with norms of social choice. I want to take this further by reconsidering the result in *Statewide Tobacco Services Ltd v Morley*,[21] which Kingsford Smith offers as an exemplar of PPR. The case concerned the liability of a passive director of a family company for insolvent trading. The defendant occupied a maternal role in the family and held a directorship to make up numbers on the corporation's board. She was not permitted to rely on her passive role when asserting that she lacked the requisite objective knowledge of insolvency, or that she had not authorised the debts being incurred. Justice Ormiston, after thoroughly reviewing policy, antecedents, and the structure of other relevant provisions, discerned a policy of imposing more severe liability on directors, in order to force them to take a more diligent interest in the corporation.

Is the result as good as the judgment? Consider how the case would be decided if its facts occurred in 1999. An analysis of the current insolvent trading provisions suggests that the law's policy may be even more demanding. But I would suggest, heretically, that it was an unfortunate decision then, and the passage of a decade has not improved it. First, the ubiquity of spouses acting as passive directors of family companies is the consequence of a pointless mandatory rule that required companies, even those with only one beneficial owner, to have at least two directors.[22] Since the *First Corporate Law Simplification Act* 1995, that provision no longer exists, yet the inertial effect of status quo, as well as possible capital gains and stamp duty imposts, make it likely that many existing companies will not switch to the one shareholder/one director model. A judge might sensibly take an approach to these sorts of passive directors that recognised their functional redundancy, and reduced liability accordingly.

Second, the insolvent trading provisions are not clearly cast in the form of default rules that particular directors can opt out of. Because that is so, judges should lean towards interpreting the provisions in a manner which reflects the sort of bargain directors and creditors might strike if transaction costs were zero. Imposing liability on hapless spouses who play no useful role in the business's management, if debts are incurred under conditions of insolvency, is unlikely to form part of such a deal.

Third, the current *Corporations Law* has, since Morley was decided, been amended to include a voluntary administration provision. Directors of apparently insolvent companies may initiate administration,[23] and it is clear policy that the insolvent trading provisions take their intense form in order to make director choose administration when faced with insolvency.[24] The key policy question is to

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21 Above n12.

22 Formerly, *Corporations Law* s221.

23 Section 436A.

24 See, for example, *Corporations Law* s1317JA(2).

what extent the insolvent trading provisions need to be construed to impose liability in order to provide the optimal incentive to initiate administration. The approach taken in *Morley* is appropriate when applied to executive directors and any non-executive directors who give business advice (such as appointed professionals). Personal liability provides strong incentives for these directors to persuade the board to resolve to enter administration. However, it is hard to see how the incentive to enter voluntary administration will be improved by subjecting passive directors to liability when active directors are already subject to that liability.

Fourth, we may gain some guidance by examining empirical regularities in family businesses. Would we be likely to discover any consistent practice in which each and every director takes a diligent interest in the business? I suspect, although I cannot yet prove, the contrary. Requiring a spouse responsible for other functions, whether it be parenting or some unrelated occupation, to take a diligent interest in the corporation's solvency seems to erode the benefits of specialisation of labour, and offers benefits that are difficult, perhaps impossible, to discern. If this is the case, the imposition of standards out of phase with the norms and practice of closely held corporations is likely to be dysfunctional, and likely to impose costs that exceed its dubious benefits.

A watchdog's pedigree is important, but the fact that it barks at robbers is much more so. Similarly, the consequences of a particular resolution of textual uncertainty may be more important than the extent to which the judgment is inspired by legislative policy. Unfortunately, policy and welfare will not always be mutually supportive. Judges often have to make hard choices that scholars will disagree about. But the real point, I think, is this – good scholarship can clarify the consequences of particular legal rules by developing positive theories of corporate phenomena. These theories can potentially assist judges to understand the consequences of particular interpretations. Particular theories may yield implications of considerable normative weight, and these implications counterbalance the policy derived from applying PPR method. The way is then clear for formulating focused interpretive principles that will assist judges to adjudicate corporate cases. This is the approach that Cass Sunstein advocates in his seminal article on interpretation,[25] and one which Kingsford Smith herself perceives as promising, if principles can be properly specified.[26] I attempt this task in the next part, preceded, first, by analysis and discussion of what exactly the baselines of the general law of companies are.

3. The Once and Future Baselines of Corporate Law

Kingsford Smith asserts that judges often desert policy for coherence with the 'private law baselines' of corporate law. This prompts me to explore what exactly those baselines are. It may be instructive to recall that its origins lie in bastardy – after the Bubble Act, and before general incorporation legislation, corporations

25 Sunstein, above n2.

26 Kingsford Smith, above n1 at 177.

were the progeny of a union, unblessed by parliament, of contract law (which was needed to bind participants in the common enterprise) and such creatures of equity as the partnership and the deed of settlement (which was needed to establish a framework for property rights in equity interests, and to lend the relation a fiduciary aspect). That derivation meant a slow, molecular process of transforming concepts used in other relations for use in very different contexts. For example, there was a gradual shift in promoters' duties, from a governance conception in the 1870s, exemplified by *Erlanger v The New Sombrero Phosphate Co*,[27] to a disclosure conception by the end of the century, exemplified in *Gluckstein v Barnes*.[28] It was only with the decision of Romer J in *Re City Equitable Fire Insurance Co Ltd*[29] that the courts made a decisive break between a trustee's and a director's duties of care. So baselines depend on timing, as most are evolutionary to some degree.

Nonetheless, behind particular legal principles are a range of adjudicatory biases. These are mostly *structural*, in the sense that they establish processes, responsibilities and powers. If these are respected, the law tends to be indifferent as to the actual outcomes – an attitude best described as passivity. These biases are broadly consistent with the sorts of legal principles appropriate to the governance of long-term relational corporate contracts. Their appeal and persistence across time suggests their suitability, rather than any ideological conservatism. After identifying and explaining them, I will demonstrate how they might be reformulated as focused interpretive principles for corporate adjudication.

A. Private Ordering

Economists hold that corporations represent a network of the contracts associated with the functioning, financing and governance of a particular firm. The most important contract to corporate lawyers is between shareholders and managers. Managers have extensive discretion to manage the firm, which is difficult to observe or govern. Substantial moral hazard problems therefore arise. Various economic analyses of long term contracts hold that the parties will make discriminating alignments between attributes of their contract and possible forms of opportunism, and the mechanisms of governance that they select.[30] Because the forms of opportunism vary between contracts, the freedom to contract in relation to matters of governance is strongly desirable. There is ample doctrinal proof that until statute intervened and gradually removed those freedoms, the law took a highly enabling approach to governance, including changes to or amendments of legal principles and duties.[31]

27 (1878) 3 App Cas 1218 ('*Erlanger*').

28 [1900] AC 240 ('*Gluckstein*').

29 [1925] Ch 407.

30 See generally Williamson OE, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (1985).

31 Whincop MJ, 'Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Corporate Law' (1997) 21 *MULR* 187.

The law was also characterised by a strong preference for resolving particular issues by *ongoing* private ordering and dispute resolution. It did this in two ways. First, the courts regarded corporate organs such as the board and the general meeting as the appropriate forum to resolve many concerns or disputes. Rules such as *Foss v Harbottle* compelled complainants to rely on these internal institutions, the decisions of which were only exceptionally reviewed.[32] Second, a party seeking to acquire a right not recognised as belonging to him under either the general law or constituting contracts was compelled to contract for those rights with the person or group entitled to them.[33] For example, fiduciary breaches, such as an appropriation of a business opportunity, could only proceed with the fully informed consent of all shareholders. The risk that individual shareholders would act strategically by holding out from consenting to a change was mitigated by permitting the decision to be taken by a majority of shareholders collectively. Thus, the corporation is not a static contract, but a product of ongoing contracting within the parameters of the original contracts and the law.

The normative implications of a bias favouring private ordering are straightforward. I will formulate them as tentative canons:

1. Resolve interpretive doubts about the contractibility of legal rules or the waiver of rights by favouring their contractibility.
2. Resolve interpretive doubts about governance and changes in entitlements by treating as dispositive the decision of the appropriate corporate organ acting intra vires.

Regarding the first canon, the preference for treating legal rules as defaults accords with orthodox economic analysis.[34] Although third party effects might limit one's enthusiasm in this regard, I have already noted that these arise infrequently. Where a change to a legal rule is proposed at the time the corporation is floated, investors have the opportunity to 'price' its implications in the terms of trade. Because ongoing private ordering is, as I have argued, of the essence of corporations, it would be irrational to preclude changes to the initial contracts on the basis that the change may not be priced. There is, however, reason for caution where the number of shareholders is large, because of the difficulties of collective action in resisting opportunistic proposals. These should be foiled by sufficient disclosure, a matter I turn to later.

One sees elements of the first canon in Young J's casuistically contortionist judgment in the insider trading case, *Exicom Ltd v Futuris Corporation Ltd*.[35] In

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32 *Burland v Earle* [1902] AC 83 at 93–4; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 NSWLR 68 at 74.

33 Whincop MJ, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' (1999) 19 *Oxf J Legal Stud* 19.

34 See generally Coase RH, 'The Problem of Social Cost' (1960) 3 *J L & Econ* 1; Easterbrook FH and Fischel DR, *The Economic Structure of Corporate Law* (1991). The scope of this canon is potentially vast. It could apply to directors' liability for negligence, the scope of application of the related parties' provisions, and the range of defendants liable for defective statements in a prospectus.

35 (1995) 18 ACSR 404.

that case, Young J refused to hold that a subscriber for a private placement of shares could be liable for insider trading in circumstances where the board had supplied the subscriber with private information. To so hold – a result which is plainly right – Young J forced himself into a corner by having to hold that 'securities' do not include unissued shares – an interpretation which is almost untenable.[36] Although there are other ways to vindicate the decision, the result resonates with the first canon – the board could make a *bona fide* decision on behalf of its shareholders to contract around the prohibition in the insider trading provisions by permitting the acquirer to subscribe for the shares.

The second canon defends the substance of the internal management principle of *Foss v Harbottle*. Litigants complaining of deficient governance should be obliged to follow 'due process' within the corporation. Although aspects of the particular decision are puzzling, Young J's judgment in *Mesenberg* prevents these entities being emasculated by expanded rights to litigate. Empirical evidence suggests that corporate litigation rarely has beneficial effects on the value of the corporation,[37] so limitations may serve shareholder welfare while fortifying ongoing bargaining within firms.

B. Passivity

A pervasive feature of relational contracts is that parties accumulate substantial information about each other, and the nature and value of each other's performance under the contract. That information is typically difficult to verify to third parties such as courts.[38] For instance, in a closely held corporation, the shareholders may have a good idea of how much the managerial services of the current chief executive are worth, but they may find this very difficult to demonstrate to other people.[39] Alan Schwartz has shown that under these circumstances courts should, and usually will, adopt a passive approach to adjudication.[40] Lacking vital information, they will refrain from asserting an active managerial or supervisory jurisdiction over these contracts. Schwartz argues that a hallmark of this form of adjudication is that legal rules will tend to binary in quality – they will either accord complete discretion, or no discretion, or will generally prohibit or generally permit.[41] Balancing approaches and standard-like adjudication will be eschewed.

Because corporations, especially closely held corporations, fit the relational description very well, we should not be surprised that corporate adjudication has long been passive in quality. In discussing private ordering, we have already seen

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36 For analysis, see Whincop MJ, 'Towards a Property Rights and Market Microstructural Theory of Insider Trading Regulation: The Case of Primary Securities Markets Transactions' (1996) 7 *JBFLP* 212.

37 Romano R, 'The Shareholder Suit: Litigation Without Foundation?' (1991) 7 *J L Econ & Org* 55.

38 Schwartz A, 'Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies' (1992) 21 *J Legal Stud* 271.

39 Rock E & Wachter M, 'Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in the Close Corporation' (1999) 24 *J Corp L* 913.

40 Above n38.

41 Ibid.

one instance of passivity – the unwillingness of courts to interfere with or pre-empt the operation of the organs of internal management of the corporation, except for two special cases where intervention has strong efficiency justifications. There are, first, overreaching and self-dealing, and second, violations of the 'pro rata' entitlement between shareholders (traditionally called 'fraud on the minority').[42] These have been prohibited absolutely, rather than permitted according to standards of 'fairness', but subject to the entitlement of the two sides to cut a deal – which accords with the private ordering bias.[43]

Second, the law traditionally adopted deliberately biased principles applying to managerial discretion, by using standards of care that are difficult for any shareholder to successfully plead against an honest director. The contrast between duties of care and fiduciary duties are typical of passivity in the law – the law either entrusts all discretion, or no discretion. I will demonstrate below that even today, this principle has some influence on the law applying to director negligence.

Third, where the law recognised a breach of duty, a cause of action tended to prefer orders reinstating the antebellum status quo. The principal examples are the preference for rescission in cases of interested transactions between a director and the corporation,[44] and between the promoter and the corporation.[45] The parties are restored to their pre-contract position. Awards of equitable compensation are very rare, and the use of orders which permit the corporation to keep the asset *and* seek compensatory orders are only granted where constructive trust is available (which may correspond to the most serious cases).[46] These traditional approaches require courts to have less information than other orders.[47] It is easier to take a transaction apart than it is to attempt to value an asset, particularly assets with unique or 'transaction-specific' properties where market proxies do not exist.[48] Moreover the remedy may be efficient because it minimises the amount of litigation necessary, since rescission will only ever be sought where the cause of action is made out, *and* the value of the transaction turns out to be negative. The corporation does not have a wasteful incentive to seek compensation from transactions from which it gains.[49]

Thus, the general law has been absolutely unprescriptive, substantially enabling, exceptionally prohibitive, and largely anti-litigious. Economic analysis holds that passivity of this sort suits renegotiation because it establishes clear threat values (payoffs if parties cannot reach agreement).[50] The incentive to

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42 Above n39. As to fraud on the minority, see *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656; *Peters' American Delicacy Company Ltd v. Heath* (1939) 61 CLR 457. There is a complex issue here, as fraud on the minority is literally expansive enough to function as a discretionary standard. On the other hand, the principle seems historically restricted to two types of cases – violations of the pro rata norm and majority attempts to abrogate minority rights.

43 In fiduciary contexts, see, for example, *Parker v McKenna* (1874) 10 Ch App 96 at 124; *Miller v Miller* (1995) 16 ACSR 73 at 87.

44 *Peninsular and Oriental Steam Navigation Co Ltd v Johnson* (1938) 60 CLR 189.

45 *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215, 239–40.

46 Compare *Gluckstein v Barnes* [1900] AC 240.

47 Schwartz A, 'The Case for Specific Performance' (1979) 89 *Yale LJ* 271.

48 Above n38; see generally Williamson OE, *The Economic Institutions of Capitalism* (1985).

renegotiate reinforces the private ordering bias, by favouring *ongoing* contractual solutions to the relational problems that the parties experience.[51] The clear allocation of property rights used in the general law also makes it likely that if litigation does begin, settlement will occur because of the lower degree of substantive uncertainty in outcome.[52]

Closely related to these 'rational choice' arguments is the possibility that passivity and conservatism counteract cognitive biases in adjudication. To take an example, the current s232(4) enacts a duty of care which officers must comply with. How should it be interpreted? The adjudication of negligence is never easy because of the heterogeneity of underlying case types, the need to respect business judgments, differentiation in managerial processes across corporations, and so on. There is a high risk that judges may hold directors were negligent when in fact they were not (a type II error).[53] The only negligence cases that will be adjudicated are those in which sufficiently substantial loss has been sustained to warrant the commencement of litigation.[54] This may give rise to two types of effects – a hindsight bias and a salience bias. Hindsight biases involve the *ex post* overestimation of the *ex ante* likelihood of an event occurring, as a result of the knowledge of the fact that the event did occur.[55] Salience biases distort the estimation of *ex ante* likelihood because of the estimator's ability or inability to recall instances of the event to mind.[56] Because the sample of litigated negligence cases is likely to be excessively weighted to calamity situations, judges may overestimate the likelihood of such events transpiring. This will in turn lead to overestimation of the requirements of due care. A standard biased against findings of negligence – as the general law was, with its references to gross and subjective negligence – is a rough, but possibly effective control on these biases.[57] Its

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49 That is not to say that courts should adopt an approach to rescission which is quite as vulnerable to displacement as the old law tended to be. Often the right could be lost where *restitutio in integrum* was not possible, or other delays were occasioned: for example, *Lindsay Petroleum Co v Hurd* (1874) LR 5 PC 221. In the late twentieth century, courts have increasingly taken robust approaches to these cases: *Vadasz v Pioneer Concrete (SA) Pty Ltd* (1995) 184 CLR 102. The risk of delay or change in the condition of the subject matter should often be on the party who would assert the defence.

50 See Baird DG, Gertner RH & Picker RC, *Game Theory and the Law* (1994) at 112–118.

51 Whincop MJ, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' (1999) 19 *Oxf J Legal Stud* 19.

52 Cooter RD & Rubinfeld D, 'Economic Analysis of Legal Disputes and Their Resolution' (1989) 27 *J Econ Lit* 1067.

53 A type I error would be to hold that a negligent director acted with reasonable care: see generally Davis K, 'Judicial Review of Fiduciary Decision-making – Some Theoretical Perspectives' (1985) 80 *Nw ULR* 1 at 25–29.

54 Above n52 at 1082–1084.

55 See for example, Bukszar E and Connolly T, 'Hindsight Bias and Strategic Choice: Some Problems in Learning from Experience' (1988) 31 *Acad Mgmt J* 628.

56 Tversky A & Kahneman D, 'Judgment Under Uncertainty: Heuristics and Biases' in Kahneman D, Slovic P & Tversky A (eds), *Judgment Under Uncertainty* (1982) 3 at 11.

57 To similar effect, see Whincop MJ, 'A Theoretical and Policy Critique of the Modern Reformulation of Directors' Duties of Care' (1996) 6 *Aust J Corp L* 72.

effectiveness is perhaps reflected in the Corporate Law Economic Reform Bill's proposal to introduce a business judgment rule.[58]

The following canons of interpretation are therefore suggested:

3. Favour statutory interpretations that limit the extent to which legal rules encourage active judicial review or intervention in the management of corporations.
4. Where two constructions of statutory provisions (not concerned with fraud or overreaching) are possible, prefer the one that does not create personal liability for directors.
5. Favour statutory interpretations that prohibit particular forms of behaviour outright (such as overreaching), rather than by reference to standards or discretionary tests, at least where the prohibition is subject to private ordering.
6. Where a statutory provision contemplates a remedy, prefer the construction which would restore the status quo ante.

For example, my analysis suggests that the apparent linguistic similarities between the language of a statutory provision like s232(4) and the old law, provides a pragmatic justification for conservatism at the margins. Yet, a PPR analysis might have claimed – at least prior to CLERP – that the policy of this area of law was raising the standard of governance in corporations, as in other bureaucracies in our regulatory state.[59] That might have lead to an approach that intensified, rather than counteracted, the cognitive bias of courts.

Are there cases where courts could reasonably impose liability for negligence under s232(4) without substantially departing from the passivity norm? Courts should normally avoid imposition of liability in cases where, for instance, the corporation did not have a particular form of committee, or because it did not have a majority of non-executive directors. Such findings could only be tenable if there is strong evidence that a substantial majority of similarly situated corporations act differently. On the other hand, liability might be imposed by reference to failures to act according to *adopted* procedures or customary procedural norms within the corporations. The passivity canon actually provides a useful way of explaining two of the most important Australian directors' negligence cases. In *Daniels v Anderson*,[60] a finding of negligence was supportable because of the failure of the chief executive to do what the non-executive directors had specifically charged him to do. By contrast, in *Permanent Building Society (in liq) v Wheeler*,[61] one of the directors was not liable for negligence. In his excellent judgment, Ipp J claimed

58 *Corporate Law Economic Reform Bill* 1998 s180(2).

59 See for example, Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989); Companies & Securities Law Reform Commission, *Company Directors and Officers: Indemnification, Relief and Insurance* (1990); Companies & Securities Law Reform Commission, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (1990); House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (1991).

60 (1995) 16 ACSR 607.

61 (1994) 14 ACSR 109.

that it could not be shown that the acquisition of further information by the defendant, which due care required, would have produced a different result. Justice Ipp thus applies something like a passivity canon, by refusing to second guess the effect of managerial processes.

These canons, especially the third and fourth, would obviously support my analysis of liability in a case like *Morley*. They would also support a constrained reading of the ambiguous and open-ended s1324(10). That provision appears to permit damages to be ordered whenever a court has power, under s1324(1), to order the grant of an injunction. In substance, this is when any person is or would be aggrieved by an actual or potential contravention of the Law. Although explicit civil penalty provisions obviously sanction personal liability,[62] s1324(10) would be read under this second presumption in a narrow and restricted way.

C. *Disclosure*

Information disclosure has a central role in modern regulatory strategies, in corporate law and elsewhere. We perhaps think back to legislation like the US Securities Acts as the place where disclosure 'began', but the *Securities Act* 1933 was itself modelled on the *English Companies Acts* of 1900 and 1929,[63] which rationalised the substantial inroads made by the development of promoters' duties in equity.[64] Early statements of directors' fiduciary obligations likewise emphasised that its contractibility was bought at the price of disclosure, either by requiring high specificity in exclusionary articles, or by requiring full disclosure in ratification.[65] The need for disclosure is of course intensified by the growth of securities markets; it is an article of faith that some level of mandatory disclosure is required for efficient capital markets.[66] Information disclosure strategies are partially hindered by the fact that the information is unverifiable. Nonetheless, in many relational contracts, information may still be *observable*, meaning that the recipient can ascertain whether the information is true, even if unable to verify it to a third party. If information is observable in this sense, directors forced to disclose will often disclose truthfully, because of the risk of informal 'punishment' for falsehood under implicit contracts.[67] The following canon is therefore suggested:

7. Where two constructions are possible, favour the one requiring material information to be disclosed to shareholders, or other parties with the benefit of the duty.

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62 *Corporations Law* s1317HD.

63 63 & 64 Vict ch 48; 19 & 20 Geo 5 ch 23.

64 Mahoney PG, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62 *U Chi LR* 1047 at 1077–1088.

65 Whincop MJ, 'Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Corporate Law' (1997) 21 *MULR* 187.

66 Ramsay IM & Blair M, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker G, Fisse B & Ramsay IM, *Securities Regulation in Australia and New Zealand* (2nd ed, 1998).

67 See Johnston JS, 'The Statute of Frauds and Business Norms: A Testable Game Theoretic Model' (1996) 144 *U Pa LR* 1859.

An example of a recent case which adopts this approach is of course *Gambotto v WCP Ltd.*[68] Both judgments in the High Court indicated that full disclosure of all material information relevant to the valuation of securities was required as a precondition for compulsory acquisition. Modern statutes often prescribe information consequences so this canon is unlikely to be controversial.[69]

D. *Equality*

There must be some limit on the bias of courts not to review the operation of internal management. Otherwise, majorities will use their voting power to expropriate minority shareholdings. Contracts, of course, provide the principal means of preventing this from occurring, but naturally contracting is incomplete and costly. The development of effective institutions, such as norms and legal rules that supplement contracts, are important. What limitations should exist?

It follows from my earlier analysis that the use of reasonable expectations as a principle of limitation is inappropriate. Such expectations are rarely verifiable and permitting them to be pleaded is likely to increase the amount of strategic behaviour in corporations. A preferable approach is an 'equality' or 'pro rata' norm, which requires equal gains sharing, subject to whatever contractual arrangements the parties have executed. This prevents majorities from controlling distributional arrangements to impoverish minorities. It also reinforces incentives to maximise the value of the corporation, since gains will only normally be harvested by increments to the value of the equity or by pro rata dividends. I maintain that the fraud on the minority principle expresses the equality norm.

An equality norm does not endorse a principle that requires a majority shareholder to share equally the gains from a sale of control, or to enable the minority shareholder to have the same opportunity to exit a closely held corporation. A sale in control does but change the identity of the majority shareholder; that new majority shareholder remains subject to the same prohibition against distributing gains solely to himself. Equal opportunity principles increase the cost of changes in control or decrease the liquidity of investments – neither principle is desirable.[70] The canon takes the following form:

8. Favour statutory constructions that require, subject to contract, equality in the distribution of gains between shareholders.

The equality norm occasionally requires limited interference with internal management, lest it be trivialised. For example, a majority faction cannot vote themselves salaries far exceeding a reasonable market rate of return, as that would enable them to violate the equality norm. To do that, a court must take evidence as to market rates of return for chief executives in corporations of similar size and related industries. Errors will inevitably be made, but shareholders' agreements and compensation committees provide a means of limiting allocative inefficiencies of possible errors.

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68 (1995) 182 CLR 432.

69 See for example, the related parties provisions and the buy-back provisions.

70 Above n39.

E. Evaluation

In this section, I have clarified some of the historic biases of corporate adjudication, and demonstrated their broad suitability given the institutional limitations necessarily placed on courts. Yet in formulating them as canons, it might seem that I am doing something that seems contrary to PPR interpretation – not only am I imposing a conservative limitation on policy, I am elevating it to canonical status. This is an incomplete picture. I have already argued that it is difficult to give meaning to public regarding interpretation in corporate law because of the absence of third party effects. Therefore, what I am doing is giving content to the central contracting norms of corporate law, in a manner that suits the administration of justice by a court of limited competence with access to attenuated information. The canons also sift what is important from what simply happens to be old. Not everything that is old is admirable. The canons clarify what parliaments should express if they have different ideas about corporate norms, or the means for serving accepted ends. PPR interpretation allows us to try to understand the situations where that is what parliament wants to do, and to interpret old and new norms in a coherent way. This is preferable to obstinate conservatism or unstructured purposive interpretation.

4. Conclusion

Let me traverse the arguments in this paper once more. First, I have argued that public-regarding analyses in corporate law often run aground, because interest group activity is often relatively limited and because genuine externalities are not pervasive. Public-regarding approaches are often stripped of 'publicness', except in adherence to policy.

Second, I have shown why judges appear to have a conservative bias – not because of explicit Burkean conviction but because of the limits on adjudication in corporate law. The appeal of passivity and the persistence of functional norms in corporate doctrine reinforce the need for continuity with past practices of judging.

Third, I have tried to wed the immanent conservatism of corporate law with an approach which accepts that statutes do not have pre-interpretive meanings. The best way to do this is by explicit canons, which draw on our best positive accounts of the regulated phenomena. I outlined a number of canons, addressing disclosure, liability, rescissionary remedies, passivity, equality, and private ordering. Wedded to PPR interpretive method, we have, I hope, the best of both worlds – a method which is designed to elucidate policy in a sympathetic manner, balanced with an approach to the application of that policy which is likely to result in more effective regulation. Like any good system of presumptions, it offers two very substantial advantages – clarity of adjudication and explication of underlying biases. We should not be so conservative to demand that the origins and motivations of our praxis need suppression. On the contrary, recognising the instrumental worth of the old, while adopting a forward-looking approach to the alternatives is the essence of responsible pragmatism.